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Governance Practices Among Microfinance Institutions in India

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Acknowledgement

MicroSave would like to thank SIDBI and DFID for providing us with the opportunity to conduct this study, given the importance of the topic.

We thank all MFIs who participated in the study and shared information with us. This study would not have been possible, without the support of the 24 MFIs covered during the primary research phase, which, apart from providing necessary information, also granted access to their management team and board members. Our detailed discussions with these highly experienced individuals provided critical insights into the governance practices adopted by the institutions. The team is also grateful to the industry experts who agreed to participate in the study and who provided their valuable perspectives.

We would also like to express our gratitude to Mr Brij Mohan and Ms Girija Srinivasan, who both provided valuable advisory support throughout the project. Special thanks to Ms Ragini Chaudhary for her invaluable guidance in designing the study framework and support throughout the project. Mr Prakash Kumar, GM, SIDBI provided support and shared his insights from the corporate sector and best practices being adopted across the world. Mr Surendra Shrivastava, DGM, SIDBI contributed with his immense knowledge of the microfinance sector.

This study has benefitted from previous studies, research reports, discussion papers, credit-rating reports and COCA assessments done by various organisations.

About the PSIG Programme

SIDBI is implementing the Department for International Development's assisted 'Poorest States Inclusive Growth' (PSIG) programme in four states: Bihar, Madhya Pradesh, Odisha and Uttar Pradesh. The programme is expected to benefit the poor and vulnerable people – especially women – in the targeted states, by enhancing access to various financial services such as credit, savings, insurance, pensions, remittance etc. to 12 million poor people, thereby helping enhancement of income and employment opportunities for them.

Note to the Reader

The report is divided into four sections, covering the background of the study, the key findings, the recommendations and annexure. The annexure lists the details of MFIs that participated in the study as well as details of other interviewees.

The names of the MFIs are anonymous to maintain confidentiality.

The key findings are categorised into four broad heads – a) board composition and structure, b) board administration and procedure, c) board's commitment to roles and responsibilities, and d) governance and responsible finance (RF). These categories are the basis for analysis of governance practices.

The overall performance of MFIs along the four categories is provided at the beginning of each sub-section of the key findings section. The discussions in the categories follow the summary of performance. At the end of some of the sub-heads, best-case scenario is presented. This is an amalgamation of some of the current best practices from within the sector as well as other global best practices. These are only the best cases and no participating MFI has adopted all of the practices mentioned.

Acronyms

ALCO	Asset Liability Committee
BPL	Below Poverty Line
CCR	Customer Care Representative
CEO	Chief Executive Officer
CFO	Chief Finance Officer
CGAP	The Consultative Group to Assist the Poor
CGT	Compulsory Group Training
CMEF	Council of Microfinance Equity Funds
COCA	Code of Conduct Assessment
COO	Chief Operating Officer
CSR	Corporate Social Responsibility
DFID	Department for International Development
KPIs	Key Performance Indicators
MCA	Ministry of Corporate Affairs
MD	Managing Director
MFIN	Microfinance Institutions Network
MFI	Microfinance Institution
MIX	Microfinance Information Exchange
NBFC	Non-Banking Finance Company
OECD	The Organisation for Economic Co-operation and Development
OER	Operational Efficiency Ratio
PSIG	Poorest States Inclusive Growth
RBI	Reserve Bank of India
RF	Responsible Finance S
ROA	Return on Assets
ROE	Return on Equity
ROI	Return on Investment
SEBI	Securities and Exchange Board of India
SIDBI	Small Industries Development Bank of India
SMT	Senior Management Team
SPM	Social Performance Management
SPTF	Social Performance Task Force
SRG	Small Reference Group
TAT	Turn Around Time
TOR	Terms of Reference
USSPM	Universal Standards of Social Performance Management

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Executive Summary

Governance has assumed increasing importance in the Indian microfinance sector over the last few years. With the growth in portfolio and outreach of MFIs, intense competition and stricter regulations, the governance practices of MFIs needed to adapt quickly. Strong governance not only contributes to robust growth of the institution but also avoids the possibility of mission drift. There is a need for prudent corporate governance structure to prevent MFIs from committing the same mistakes they made earlier, which led to a crisis-like situation in the Indian microfinance industry in 2010.

In the light of this context, SIDBI's PSIG programme wanted to assess the "as-is" status of key corporate governance models followed by Indian MFIs, boards' roles and responsibilities, executive management and oversight, level of involvement in policy development, corporate oversight and strategic planning process and so on. Through the study, PSIG aims to highlight issues and gaps faced by Indian MFIs with specific reference to corporate governance and at the same time document best practices, if any.

The study has the following three objectives:

- To scan the corporate governance models adopted by MFIs in India;
- To evaluate involvement of board;
- To analyse the current scenario, identify gaps and recommend actions.

About 60 MFIs were initially selected, based on criteria such as outreach, portfolio size, legal form, focus on PSIG states and geographical spread. However, only 42 of the 60 MFIs agreed to participate in the study. As part of the primary research, 24 out of the 42 MFIs were included. During the primary research phase, the team held discussions with the CEO and the senior management of the MFIs. The team also interviewed 21 board members and industry experts to understand their perspectives on corporate governance.

Key Findings
The findings of the study are broadly classified into four categories. These categories coincide with the analysis framework designed for the assessment of governance practices.

I. Board Composition and Structure
MFIs have performed well in expanding the size of their boards for effective corporate governance. However, some MFIs still have very small boards with just one independent director. NBFC-MFIs have an average board size of seven members. While, not-for-profit MFIs, especially cooperative societies, have more than ten members on their board. Independent directors constitute a majority in only 24% of MFIs. In most NBFC-MFIs, mandatory sub-committees have been constituted. However, in some MFIs, especially those where the proportion of independent directors is low, one independent director heads more than one sub-committee. The sub-committee structure in these MFIs is

ineffective and the independence of decision-making in such boards can be questionable.

The representation of women on MFI boards is good and largely in compliance with the provisions of the Companies Act. While 78% of MFIs have at least one women director, only 10% have women directors in the majority. Not-for-profit MFIs such as cooperatives societies have majority women members. Most NBFC-MFIs have board members with relevant qualifications and experience but people with legal, human resources or risk management experience are not adequately represented on the boards of MFIs. However, the boards of not-for-profit MFIs lack these specialised skills, especially, human resource and technology are not represented at all.

Independence of the board is a concern within the sector. A large proportion of MFIs still have their CEOs as chairperson of the board. In about 52% of MFIs, the management team occupies more than one seat on the board.

II. *Board Administration and Procedures*

MFIs have formalised the procedure for selection and appointment of board members, mostly through the Nominations and Remunerations sub-committee. However, the appointment of independent directors is still not institutionalised. Generally, independent directors are identified from among the existing contacts of senior management and sitting board members.

The majority of MFIs, particularly tier-2 and tier 3 MFIs, do not have much say in the appointment of nominee directors. Thus there are instances when such MFIs do not get nominee directors with the required skillsets that the MFI expects from its board.

The level and quality of participation of board members in board and sub-committee meetings has reportedly been increased; greater diversity of expertise among the board members is one of the reasons for this increased participation. The boards of MFIs are found to be discussing a wide spectrum of issues, including social performance as well as client and staff satisfaction. The MFIs also reported that, even with a diverse composition of board, they are mostly able to reach consensus when arriving at key decisions.

The quality of board-meeting minutes requires improvement in many MFIs. The board members, especially the investor nominees, have ensured that the minutes are drafted properly. The level of formalisation of sub-committee meetings desires improvement, as there are only a few MFIs where the chairperson of sub-committees makes a presentation to the board. In most cases, the sub-committees merely inform the board of their decisions or circulate minutes of sub-committee meetings along with the agenda of the board meeting.

III. *Commitment to Roles and Responsibilities*

The involvement of board members in defining the mission, strategy and business plan varies across MFIs and depends largely on the individual(s). In some MFIs, strategies are proposed by the management and approved by the board, while in others the boards play an active role in defining the strategic direction of the MFI.

The boards of the majority of the MFIs ensure that they comply with the regulatory requirements of responsible finance but hardly go beyond that.

The board pursues performance evaluation of the CEO in a majority (90%) of the MFIs, but documented parameters for CEO performance evaluation exist in only a few. Performance evaluation of MFI boards is almost non-existent at present but with the enactment of the new Companies Act, companies have started exploring various possibilities for evaluating a board's performance.

The majority of MFIs suggested that their board members are available for continuous support even in-between board meetings. This helps the management approach them for guidance as and when required. Increasingly, the focus of boards is to ensure that MFIs comply with all the legal and statutory requirements as well as reviewing compliance reports regularly to monitor MFIs in this regard.

Capacity building of board members is not on the radar of most MFIs as the management feels that board members are sector experts and hardly require capacity development.

IV. Governance and Responsible Finance

The majority of MFIs reported that they have a board-approved Fair Practices Code; policies to avoid conflict of interest; policies on transparency and responsible pricing; policies on grievance redressal mechanisms; and policies on loan appraisal and disbursement. The focus of MFIs on staff grievance redressal mechanism is, however, far less when compared to that of client grievance. Only a few MFI boards actively pursue implementation and monitoring of responsible finance initiatives. MFIs are yet to appreciate the value of monitoring social performance data fully. Social performance is largely equated to corporate social responsibility by a majority of boards. MFIs generally do not include social parameters for performance evaluation of CEO/senior management teams.

Generally the majority of the MFIs do not appreciate the need to orient board members on the social missions and goals of the MFI. The general perception is that the board members belong to the sector and therefore do not need orientation.

A few MFIs have adopted certain measures to prevent mission drift. These include protection of promoters' rights, diversified shareholding and a suitable clause in the shareholders' agreement to codify the MFI's mission and social commitments; these would prevent new investors from steering the MFI away from its mission.

Recommendations

The recommendations are based on discussions with different stakeholders for the study, *MicroSave's* experience of working with financial institutions worldwide, OECD Corporate Governance Principles and the CMEF guidelines for corporate governance in MFIs.

The recommendations are classified according to the stakeholders who can be made responsible to implement them.

A. Microfinance Institutions

a. Ensure transparency and disclosure of information

The management should ensure that they share with the board monthly, or at least quarterly, reports on operational and financial performance. This would not only keep them engaged and informed but also provide them with an avenue to offer timely feedback to the management.

b. Institutionalise governance

In order to establish clarity of roles and responsibilities between the board and management, the MFI should document a clear terms of reference for board members. This will help build accountability and responsibility structures within the institution.

c. Establish clear board structures

In the long run the MFI should aim to have a diversified shareholding structure with no investor holding more than a specific percentage. The terms of reference and Key Performance Indicators (KPIs) for the sub-committees as well as the board members should be defined and provided upfront. The MFI should ensure independence of directors, who should be independent in the true sense of the word and not just be friends or colleagues of the promoter/management.

d. Establish robust board procedures

The Nominations and Remunerations Committee headed by an independent director should be made responsible for the selection and appointment of directors. The MFI should adequately compensate the board members for the time they spend at board and committee meetings, and also organise capacity building programmes for board members on both strategic and operational matters.

B. Board of Directors

The board should, as far as possible, ensure that the chairperson of the board is an independent director, and definitely not the CEO/MD. The board of directors should exhibit forthrightness and independence of mind, should be willing to share their ideas and should have an open mind to allow diversity of opinion.

Board members should aim to increase their engagement with the MFI and not restrict their interaction to just one or two members of management. They should find time to review the operational and financial reports shared by the management and provide feedback, or raise their issues and concerns with the management.

C. Investors and Lenders

While investing in an institution, investors and lenders can assess the corporate governance practices of the MFIs. The number of MFIs where a nominee can represent should be capped to ensure that they devote adequate time to the MFI where they represent their institution.

D. Industry Associations

The industry association can draft a generic corporate governance guideline for all MFIs, especially the NBFC-MFIs. It is recommended to maintain a database of individuals who are willing to serve on the board of MFIs to support those MFIs looking to appoint independent directors to their board.

About the Study

Background of the Study

Governance continues to remain a key risk for the microfinance sector

The Microfinance Banana Skins Report 2014 lists corporate governance as one of the top-five risks faced by the microfinance sector globally. In fact, governance has consistently been a major risk in the sector since 2008. The Microfinance Banana Skins Report 2012 that listed corporate governance at second rank also highlighted governance-related issues such as: professionalism of the boards, role of independent directors, measurement of governance performance, executive control, executive compensation, quality of leadership, role of investors, conflict of interests among stakeholders, rapid growth of the organisations, rapid changes in the external environment and inadequate internal checks.

Investors, regulators, industry experts, funding agencies and rating agencies interviewed for the report consider 'governance' to be one of the top-ten risks. The general opinion of the stakeholders is that with the increasing complexity and competitiveness of the microfinance market, the governance structure across the microfinance sector is not yet robust enough to confront competition or adopt and manage change. In fact, the stakeholders also believe that the limited governance and financial skills of the board of directors is one of the reasons for the failure of institutions to combat over-indebtedness, adapt to environmental changes, manage risk and understand its impact on the institutions.

In India, the risk perception due to governance has reduced compared to that in 2012. In the 2014 report, governance ranks 13 in the list of risks faced by institutions in India and other parts of South Asia compared to ranking third in the 2012 report. The report notes that there is generally less concern in the region (South Asia) about institutional risks, the quality of governance, management and staffing, although more can be done to improve it.

Good governance is critical to sustain development of the sector

Good corporate governance means translating intent and values into practice and actions. World over, the microfinance crises that happened in Bolivia, Colombia, Mexico, Cambodia, Philippines and Morocco were more or less caused by absence of good corporate governance practices. As defined by Adrian Cadbury in the Cadbury Committee Report on Corporate Governance in 2004, "Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework should encourage efficient use of resources and be accountable for the stewardship of those resources."

Particularly in the Indian microfinance context, governance has assumed increasing importance for several reasons.

- As microfinance institutions grow in their outreach, the size of their assets, as reflected in their portfolio, also grow to a considerable size. Ensuring effective management of this growth requires added inputs and involvement from the board of directors.
- An unfocused board raises the possibility of mission drift and reputation risks. Attention on social objectives helps ensure achievement of mission and responsiveness to clients and stakeholders.
- Over the last few years, an increasing number of MFIs have become regulated, thereby assuming the responsibilities and challenges of a regulated entity.
- MFIs are operating in increasingly competitive markets, and maintaining or increasing the market share has become an important component of their strategic objectives.

In the Indian microfinance industry (barring tier-1 MFIs) the ownership structure of MFIs is largely characterised by single charismatic promoters[1]. During the growth phase of MFIs, a large share of CEO/promoter involvement was in making financial arrangements for the company and handling issues such as resource mobilisation. There was greater focus (sometimes compromising other areas including governance) on financial sustainability to increase the company's valuation by achieving profitability of operations. Although these efforts led to considerable growth of the sector in terms of size, scale and outreach, it posed several challenges and threats to the industry such as neglect of client-friendly practices, non-independence of board vis-à-vis senior management, non-reporting of crucial and strategic matters to the board and so on. The crisis that followed underlined the need for prudent corporate governance structure, which can prevent the MFIs from committing the same mistakes again.

The MFIs are currently going through a 'corrective phase' where they are rebuilding lost reputations caused by their perceived non-transparency, profiteering orientation and weak credentials. Most MFIs realise that they cannot overlook regulatory/voluntary requirements and must be compliant to and prudent with their corporate governance practices.

In the light of the above context, SIDBI's PSIG programme wants to assess the 'as-is' status of the key corporate governance models being followed by Indian MFIs, the role and responsibilities of the board, the board's executive management and oversight, the board's level of involvement in policy development, corporate oversight and strategic planning process and so on. Through the study, the programme aims to highlight the issues and gaps faced by Indian MFIs with respect to the guidelines of Companies Act and the Reserve Bank of India (RBI), unified Code of Conduct, Social Performance Task Force (SPTF) and best practices in corporate governance. The identified gaps and issues are followed by recommendations for the different stakeholders in their efforts towards strengthening corporate governance.

[1] Refer to Annexure 1 for the description of tiers used for categorisation of MFIs

Objectives of the Study

The study has the following three objectives:

- To scan the corporate governance models adopted by MFIs in India;
- To evaluate involvement of the boards;
- To analyse the current scenario, identify gaps and recommend actions to address broad concerns.

Objective 1

Scanning of corporate governance models adopted by MFIs in India

- Board composition-size, gender, expertise, qualification, experience and independence;
- Board procedures – appointment, induction, remuneration and tenure;
- Roles and responsibilities, executive and corporate oversight functions;
- Existence and effectiveness of board sub-committees vis-à-vis legal requirements appropriate for the structure;
- Board's communication, feedback and decision-making mechanisms.

Objective 2

Evaluate involvement of board

- Board's activity including meeting agenda, attendance, meeting minutes and reports;
- Involvement of board members in defining organisational strategy, risk management, audit (including internal and external) client protection and responsible finance practices;
- Contribution of board members in the growth of the organisation, e.g. fund raising, representation etc.

Objective 3

Analyse current scenario, identify gaps and recommend actions

- Analysis and documentation of 'as-is' corporate governance practices undertaken by Indian MFIs;
- Identification of best practices as well as broad concern areas in current corporate governance practices being followed by Indian MFIs;
- Recommendations to address the areas of concern.

Approach and Methodology

We adopted an integrated four-phased approach to achieve the objectives of this study:

I. Desk Research and Tool Design	II. Collection of Survey Data and Design of Analysis Framework	III. On-site Visits to MFIs	IV. Data Analysis and Report Writing
Secondary research and literature review to understand governance issues	Administer survey with MFIs	On-site visits to MFIs	Data consolidation and analysis
Selection of MFIs for data collection and on-site visit	Design analysis framework	Individual interviews with CEOs/senior management teams of MFIs and board members	Report writing
Design of survey tool	Review key documents and reports related to governance practices in MFIs	Individual interviews with industry experts	
Design of interview guides			

Phase I: Desk Research and Tool Design

The first phase of the study focused on desk research to understand the prevailing governance issues in the microfinance sector, globally and in particular in India. The research team also reviewed relevant a) regulations issued by the RBI, b) the Companies Act, 2013, c) guidelines and circulars issued by industry associations such as Sa-Dhan and MFIN to understand the regulatory environment around corporate governance. The research team also reviewed relevant reports such as Microfinance State of the Sector reports, Credit-rating reports, Microfinance India Social Performance Reports, Code of Conduct Assessment reports, *MicroSave's* Institutional Assessment reports and Social Performance Assessment reports to understand the issues, concerns and current practices around governance in MFIs in India.

Sample Selection. Based on the desk research, 60 MFIs were identified for the secondary research, using a mix of criteria such as outreach, portfolio size, legal entity, focus on PSIG states and geographical spread. A final consent from SIDBI/PSIG was taken to pursue the study with the selected MFIs (refer to Annexure 1 for the distribution of sampled MFIs across different parameters).

Tool Design. Information and responses from the MFIs were gathered using an online survey to understand the governance models and practices adopted by them. The survey questionnaire was broadly divided into three sections: profile of board members, composition of board structure, and roles and responsibilities of the board members.

We also designed interview guides to facilitate discussions with senior management teams in MFIs, their board members and other industry experts. The survey tool and interview guides were shared with the SIDBI/PSIG team for approval and sign-off.

Phase II: Collection of Survey Data and Design of Analysis Framework

During this phase, the research team shared the survey with the selected sample of 60 MFIs. A total of 42 MFIs provided their responses while the rest chose not to participate in the study (refer to Annexure 2 for the list of MFIs that participated in the study).

While the data collection was going on, the research team designed a framework to analyse the governance models and practices of MFIs. The insights gained from the desk research coupled with *MicroSave's* experience with other similar research and previous engagements provided key inputs to the design of the framework.

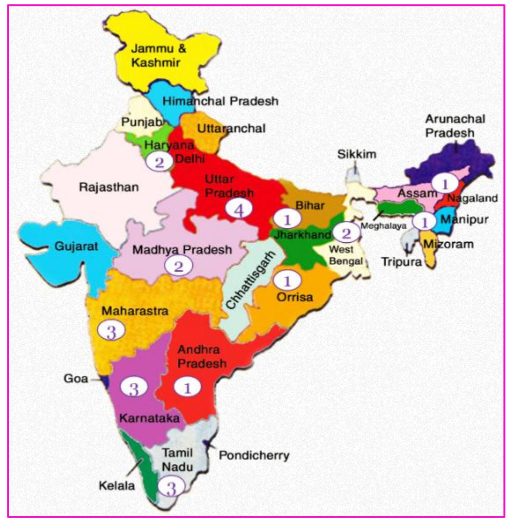

Figure 1: Geographic Spread of Sampled MFIs

The Analysis Framework. The analysis framework for the study is built on four key pillars that determine the quality and robustness of corporate governance systems plus the ability of the board to drive responsible finance practices. These pillars include:

1. Composition and structure of the board;
2. Administration and procedures for board functions;
3. Commitment of members to their roles and responsibilities;
4. Role of the board to ensure adoption and implementation of responsible finance practices.

Each of the above pillars was fragmented into a number of criteria, which formed the basis of assessment of MFI position on each of the four pillars. The research team adopted a three-point scale to grade the MFIs on each criteria categorised under the four pillars of analysis. The scales were 'low', 'acceptable' and 'high', reflecting the level of adoption of corporate governance practices. 'Low' refers to governance practices that are below the existing regulatory requirement or industry norm; 'medium' refers to compliance with existing regulations and norms, while 'high' refers to adoption of world-class governance practices that are beyond existing regulatory requirements (refer to Annexure 5 for more details on Analysis Tool).

The team considered only the MFIs that were sampled for on-site visits for the grading exercise.

Phase III: On-site Visit to MFIs

During the third phase of the study, the sample was further narrowed down to 24 MFIs to undertake a deeper probe into their corporate governance practices. The research team visited the 24 MFIs to hold discussions with their senior management teams (including CEO, MD, CFO, COO, Company Secretary or any other member responsible for managing board functions, heads of social performance management

(SPM) or RF function (where it existed) and their board members, if available (refer to Annexure 3 for the list of MFIs visited for on-site assessment).

During the on-site visits, the research team also reviewed key documents (wherever the team were given access) such as board meeting agenda, minutes of board and sub-committee meetings, reports presented to the board, business plan, risk management reports, internal audit reports, SPM reports and any other document relevant to understanding the governance practices in MFIs.

In addition to visiting MFIs, the research team also conducted telephone and in-person interviews with board members and other industry experts (refer to Annexure 4 for the list of people interviewed).

Phase IV: Data Analysis and Report Writing

During this phase, the research team consolidated the survey data collected from 41 MFIs (one MFI did not provide data but was part of the on-site assessment) and the qualitative information collected through interviews. Based on the above information, the research team graded the 24 MFIs covered during the primary research. Thus, the survey data, qualitative information and grading results provide key inputs for the current report.

Limitations of the Study

The study has the following limitations:

- It is primarily based on voluntary reporting by the participating institutions. The research team has done its analysis based solely on information provided by the MFIs or what is available in public. We could not cross-verify the information, except to some extent validating it through discussions with board members wherever available. Thus there might be scope for bias.

- The grading exercise is based on the information shared by the management teams of the MFIs during the on-site visits. There can be instances where the MFI did not share all the information, and so there might be an impact on the grades of some MFIs.

Literature Review

Role of governance in the microfinance crisis in India

A review of the literature published post the microfinance crisis in India in 2010 suggests that one of the major reasons for the crisis was poor governance practices of MFIs.

In his working paper entitled 'Towards Corporate Governance of Microfinance Institutions in India' (published in 2011), Prasun Kumar Das points out that "the governance of the majority of the MFIs in India is driven by the vision of the promoters and the management committee or the board has very little say on the future direction of the organisation. They generally do not have written documents on various issues and policies being followed by them. The organisational structure and roles are also not much defined and followed. This enables the promoter/CEO to change the policy and direction according to the need of the organisation, which has always a negative impact on the field-level workers and managers. The major drawbacks of the MFIs in India are not differentiating the ownership and governance and they are in fact run and managed by few people and not by the system of governance[2]."

The above opinion points out that if indeed poor governance were one of the reasons for the crisis, then it would be interesting to see what lessons the MFIs have learnt in the four years post the crisis.

A CGAP study conducted in 2012, which draws on in-depth interviews with more than 100 industry insiders globally, concludes that the microfinance industry is lagging behind in applying accepted good governance practices and that equity investors need to step up and do more[3]. The study noted that the equity investors are not doing enough to strengthen governance. There is a need to ensure active engagement of the board in and beyond the boardroom, ensuring adequate qualifications, time commitment and continuity of investors' nominees; addressing director passivity and reticence to question management proposals; and aligning shareholder interests.

The study also observes that the microfinance sector is relatively young and that many institutions are still led by charismatic founders who may be reluctant to accept the need to give up some control in the interest of achieving more balanced governance. Some of the other weaknesses pointed out in the study include lack of clarity on the respective roles of management, the board and shareholders; lack of available policies on conflict of interest and disclosure of information to the board; limited board committees and their use; weak risk management; and human resources management.

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[2] Towards Corporate Governance of MFIs in India, Prasun Kumar Das, KIIT School of Rural Management (2010)
[3] CGAP Focus Note: Voting the Double Bottom Line – Active Governance by MFI Equity Investors, CGAP (2012)

In order to enhance understanding of MFI board structure, policies and activities, Microfinance Information Exchange (MIX) tested a new set of 10 governance indicators in 2011 among a sample of 162 MFIs across 57 countries[4]. The indicators included: number of board members in the MFI; separation of the roles of CEO and chairperson of the board; number of independent directors; board qualifications; frequency of board meetings; attendance at board meetings; presence of board committees; voting rights in sub-committees; appointment of risk manager and internal auditor and their reporting protocol; whether the board changes policies on key matters such as institutional transformation, senior executive compensation, succession plan, source of capital and so on.

The majority of MFIs who participated in the survey were from Latin America and included both NGOs and NBFCs. From India, 21 MFIs participated in the survey.

The key findings of the survey included:

- the median of board size among respondent MFIs was seven;
- the size of the board increased with the size of the MFI;
- more than 80% of MFIs separated the role of CEO and chairperson;
- independent members made up 67% of the median board;
- the majority of MFIs had board members with multiple qualifications, with finance/microfinance and business experience being the most common;
- the majority of boards met with reasonably high frequency during the year;
- half of the MFIs reported having three or more board committees, while 18 reported none;
- the most common committees were 'executive', 'risk' and 'audit';
- the vast majority of MFIs had funders whose representatives did not sit on the board;
- 58% of MFIs reported having a risk manager or a team dedicated to risk management, while 77% reported having an internal auditor or team dedicated to internal auditing. Both functions tend to report to the CEO contrary to accepted best practice;
- MFI boards were found to be taking high levels of review/decisions in key policy areas (especially regarding internal controls, client protection, compliance, and funding sources) and 63% reported having changed five or more areas over the past year.

The above studies present a mixed picture of the adoption of best governance practices among MFIs globally.

Governance and Responsible Finance

The role of the board is critical to drive MFIs to adopt responsible finance practices. The State of the Sector Social Performance Management (SPM) Report of 2013 suggests that the boards of MFIs in India have started

[4] Measuring Governance in Microfinance: Initial Findings from a Pilot Project, Microfinance Information Exchange

taking up this task more seriously than ever before[5] and that the board's attention to responsible finance and social performance agenda has increased. Board committees for SPM/responsible financing have been set up by some MFIs, while others have inducted new board members with SPM/responsible finance expertise. There has also been an increase in the number of independent directors on the board of MFIs. Board committees for audit, social performance and remuneration have also been set up and, according to the report, MFI boards are paying attention to the regulatory compliance.

However, the report notes that despite this progress, MFI boards require improved capacities to attend to social performance issues and also expresses concern on governance standards across institutions. There has not been a systematic review of the constitution of boards or the capacity and competence levels of those manning the boards. The rigour with which boards review customer-protection issues is not being examined, nor is whether the interests of different stakeholders are being satisfactorily dealt with.

MicroSave's research report entitled 'Responsible Finance Practices of MFIs in India' also highlights some good practices adopted by MFIs. The report notes that customer-level issues (clients' complaints and resolution) are more seriously discussed than before. The number of independent directors on the board has also increased.

Both *MicroSave's* report and the Microfinance India Social Performance Report of 2013 are cautious in their assessment of the role of board members to drive responsible finance[6]. According to the *MicroSave* report, the board of directors across the organisations focus mostly on compliance with the code of conduct (as it is similar to the fair practice code of the RBI). While most of the social investors are present on the board of the MFIs and are pushing for implementation of responsible finance practices, this is still not data driven.

The analysis of the literature available suggests that, although governance practices in MFIs may not be as poor as they were at the time of the crisis, they are still nowhere near perfect. There are still a number of issues that the MFIs need to address.

The current research will provide more information about the progress of MFIs in adopting good governance practices.

[5] The Microfinance India Social Performance Report, 2013, Girija Srinivasan
[6] Responsible Finance Practices of MFIs in India, *MicroSave* (2014)

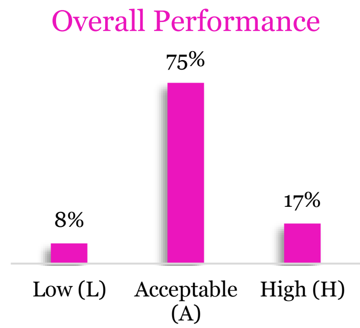
Key Findings

1. Board Composition and Structure
2. Board Administration and Procedure
3. Commitment to Roles and Responsibilities
4. Governance and Responsible Finance

I. Board Composition and Structure

Overall Performance of MFIs

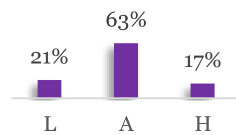
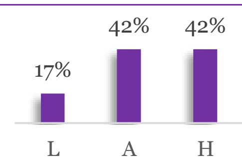
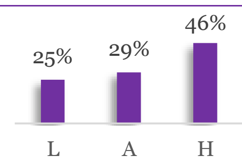
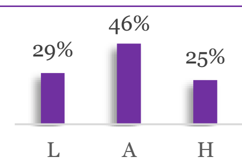
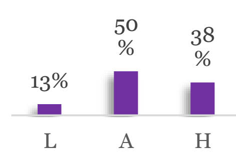
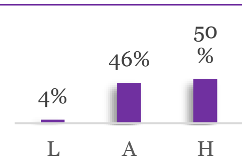
The board composition refers to the parameters that describe the structure of the governance models adopted by MFIs. Some of the key criteria under this head include number of members on the board, the diversity of skills and expertise of the board members, gender diversity, mix of directorships and so on.



As can be seen from the chart (right), three-quarters of the MFIs fall in the acceptable range, while 17% fall in the above-average range.

Given below is the description of each of the criteria and the current status of MFIs for each criterion.

The table is followed by discussion on key findings under each heading.

Criteria	Description	Status (% age of MFIs)[7]
Size of board	Appropriateness of the size of the board for effective consultation and decision-making	
Qualifications, skills and abilities of board members	Sufficiency of qualifications, skills and abilities of the board to lead the MFI	
Relation between chairperson of the board and CEO	Separation of role of chairperson of the board and CEO	
Gender diversity	Proportion of women directors on the board	
Proportion of independent members in the board	Proportion of independent directors, generally, at least one third of the size of the board	
Vacant seats on the board (remained vacant for at least a quarter)	Vacancy on the board and the management's ability to fill up vacant positions	

[7] L = Low, A = Acceptable, H = High. The same scheme is followed in other sections. Also, the percentages in the chart may not add up to 100 due to rounding error

Criteria	Description	Status (% age of MFIs)[7]
Board structure reflecting shareholding pattern (major investors>10% holding)	Ability of the MFI to ensure that the major investors are represented on the board	L 21%, A 33%, H 46%
Investor alignment with mission and vision of the MFI	MFI ensures alignment of the investors' goals and long-term strategy with the social goals and mission of the organisation	L 8%, A 79%, H 13%
Constitution of sub-committees	Presence of sub-committees as per the applicable regulations	L 21%, A 58%, H 21%
Proficiency and skill set of sub-committees members	Sufficiency of experience and skills of sub-committee members to assume their functions and their capability to contribute to their sub-committees	L 8%, A 83%, H 8%

In a Nutshell

STRENGTHS

- Size of board
- Constitution of sub-committees
- Representation of women members

AREAS FOR IMPROVEMENT

- Proportion of independent directors
- Skills and qualifications of board members
- Separation of role of Chairperson and CEO

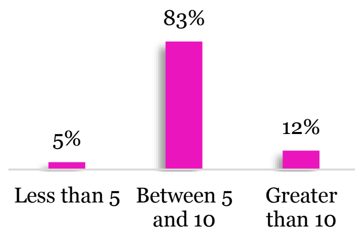
1.1 Size of the Board

Size of the board for the majority of MFIs seems adequate for its effective functioning

The majority of MFIs (83%) have a board size of five-10 members. The average board size of seven members (similar to the finding of the MIX survey) seem neither too small to accommodate all stakeholders nor too large to hinder decision-making and oversight.

Out of the five MFIs that have more than 10 members, three are tier-1 NBFC-MFIs that serve over 1.3 million clients each, while two are co-operative societies. Two of these three NBFC-MFIs have received good governance ratings from an external rating agency. Although a direct correlation between the size of the board and the effectiveness of the governance practices cannot be established, a closer look at the board size of companies from mainstream sectors (such as banking and financial services, information technology, telecom and automobiles) with the highest governance ratings shows that these companies also have more than 10 members on their boards; however they are much larger than those in the microfinance sector. It is difficult to prescribe the number of directors that should be present on the board of an MFI. As per the Code of Best Practice of Corporate Governance issued by OECD, the boards of directors should be as small as possible and may vary in

Board Size



Companies from mainstream sectors that have received the highest CRISIL Governance Rating, such as Bharti Airtel, HDFC Bank, HDFC, Infosys, Mahindra and Mahindra, all have more than 10 members on their boards.

Board Size – Need for a Fine Balance

Board size too small in one of the largest and growing NBFC-MFIs

In one of the NBFC-MFIs, with a portfolio size of more than INR 3.5 billion, there are only five members on the board. Out of these five members, two are from the management team, two are independent directors and one is a nominee director. The small size of the board, with only two independent directors, makes it difficult to constitute enough sub-committees with people from relevant backgrounds. There have been instances when a board meeting was held with the required quorum being complied with the presence of only two directors from the management team. The independence of decisions made in such meetings could be questionable.

Board size too large and yet the board does not have diversified skill sets

In one of the growing NBFC-MFIs, the board consists of eight members. This MFI has a portfolio outstanding of just above INR 500 million. A couple of investors have appointed two nominee directors each on the board and as a result, board size is relatively large when compared to the size and scale of operations. This also limits the ability of the MFI to increase the number of independent directors and women directors who would have brought diversified skill sets to the board.

The presence of two nominee directors appointed by two investors has also led to a concentration of decision-making in the hands of investors. This also leaves less scope for independent directors to contribute to the functioning of the board. Besides, as the board does not have diversified skill sets, the subcommittee structure is also not effective.

"A board size of five-six members means that the company is not serious ... minimum size helps you to grow ... how do you grow becomes a problem (if you have five-six members)."

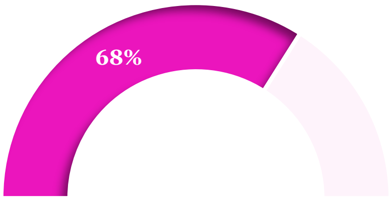
An Industry Expert

size between five and nine members according to the needs of the company. Section 149(1) of Companies Act, 2013 caps the number of directors to 15 but does not prescribe the board size based on either the class of company or its legal status. As OECD observes, a larger board may induce members to free ride on their monitoring responsibility, allowing the CEO greater independence.

It is also important to appreciate that the size of the board is a function of the size of the organisation as well as the maturity of its operations. The size of the board, therefore, needs to be aligned to the operational and geographic growth of the organisation; the products and services it offers; composition of debt and equity; and its legal form, i.e., whether it is a semi-formal service provider or a more sophisticated formal, regulated financial-service provider.

The boards that remain stagnant in size for a long period are often not equipped to respond to the dynamic environment in which the MFIs operate. At the same time, a very large board with many changes in the member composition may lead to instability and lack of focus.

MFIs with Odd Numbers of Members



Case of a Model MFI

1	The MFI has a board size between five-15 members. The MFI prefers that the number of members on the board is an odd number to allow decision-making by majority.
2	The size of the board is appropriate enough to adequately represent major shareholders.
3	The size of the board is large enough to allow people with diverse backgrounds and expertise and yet is small enough so that all members can participate actively in the decision-making.
4	The board is large enough to allow gender diversity, mix of directorships i.e. promoters, investor nominee, independent, executive and non-executive directors.
5	The board is large enough to create sub-committees (as per relevant regulation – RBI and Companies Act, 2013) with diverse skills and relevant experience.
6	The size of the board is such that it ensures that the sub-committees are not represented and/or headed by only a few or limited members.

1.2 Qualifications, Skills and Abilities of Board Members

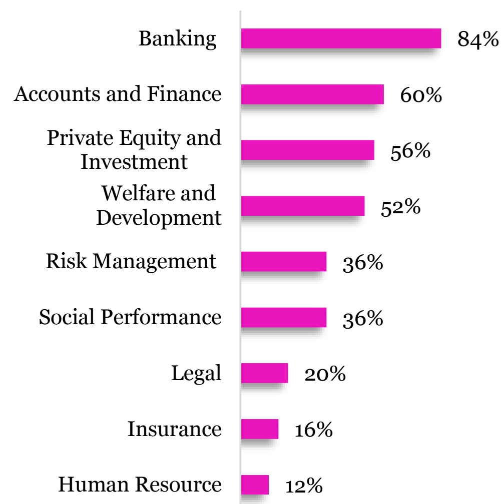
Most NBFC-MFIs have board members with relevant qualifications and experience

In all the MFIs there is at least one board member who has significant microfinance experience. In 64% of the MFIs, the promoter(s), either acting as CEO/MD or just as a director, have significant microfinance experience. The percentage does not include prior experience in banking[8]. The finding is similar to the MIX survey that highlighted that the majority of MFIs had board members with finance/microfinance and business experience being the most common.

However, the case for not-for profit MFIs is very different. Only one out of the six not-for-profit MFIs that provided data of the profile of their board members has persons who have skills such as risk management, private equity and investment, accounts and finance, and legal. Most of the not-for-profit MFIs have board members with experience of social work and development and 50% have members who have knowledge of banking. At the same time none of the not-for-profit MFIs have skills such as technology or human resource management represented on the board.

As MFIs have grown and transformed themselves into regulated financial institutions, promoters have made efforts to strengthen their board by bringing in board members specialising in different domains. There are cases where promoters who did not have prior experience of microfinance have inducted other members with required background and expertise.

Experience Profile of MFI Boards



MFIs still need experts from related fields to strengthen their boards

Most of the tier-1 NBFC-MFIs with pan-Indian operations have board members from related sectors such as banking, audit, financial analysis and planning as well as social development in general. Additionally, for areas such as risk management and social performance management, most of the tier-2 MFIs have ensured that at least one board member has relevant experience. One of the main reasons behind such diversity at the board level in tier-1 and tier-2 MFIs is the RBI's directives and guidelines around corporate governance for NBFC-MFIs. Besides, the Companies Act (2013) also gives guidance to these NBFC-MFIs about the composition of their board and sub-committees[9].

[8] The data refers to only 25 MFIs that provided details about the profile of their board members

[9] See Annexure 6 for a description of the relevant provisions of Companies Act and their applicability on the different types of companies. Section 149 provides guidance on board composition, Section 177 on Audit Committee, Section 135 on Corporate Social Responsibility Committee, Section 178 on Nomination and Remuneration Committee, and Section 178(5) on Stakeholders Relationship Committee

Tier-3 MFIs and a few tier-2 MFIs would benefit more on aspects like social performance management and risk management if any board members have prior experience in these fields. These individuals can act as subject champions to ensure that MFIs implement best practices in these new emerging areas.

Another area that requires strengthening of board expertise is technology, as currently only 20% of MFIs have a member with technology expertise. Although this percentage is small, it may increase as more and more MFIs see technology as a strategic driver for future growth. They will need strategic direction on the use of technology as they try to implement core banking solutions and mobile/hand-held technology to expand their outreach, strengthen their operations and achieve efficiency. Technology upgrades may also be required to meet the requirement of external stakeholders, for example, if an MFI decides to partner with a bank for a business correspondent arrangement, its technology must match the requirements of the bank.

Another trend in the sector is to induct retired bureaucrats who have served at important/senior levels in the government. In most cases where such directors existed, MFIs cited 'rich experience', 'insights into government functioning' and 'better lobbying capacity' as some of the key reasons to bring them on board.

Despite a significant improvement in the diversity of board members over the last few years, skills such as legal expertise and entrepreneurship are still not readily available on many boards. MFIs do feel the need to bring in legal experts as well as successful entrepreneurs, who generally have a good understanding of risks and a better understanding of business nuances.

Recommended Board Member Skills[10]

Leadership Skills	Technical Skills
Commitment to the MFI's mission	Banking/economic expertise
Integrity/trustworthiness	Microfinance industry expertise
Demonstrated leadership success	Accounting
Communication skills	Legal skills
Common sense/sound judgment	Public relations
Willingness to make time commitment	Marketing
Objectivity/independent thinking	Human resources
Ability to work with other board members	Entrepreneurship business success
Consensus building skills	Sociology/community development
Willingness to participate	Information technology
Awareness of personal contribution	Fundraising

Selection of Chairperson

Identify a prospective candidate who:

- *Is experienced, persuasive, and able to lead and steer the board in resolving deadlock situations;*
- *Is able to balance between the social and commercial agenda of board members;*
- *Ensures consensus-based decisions;*
- *Motivates/encourages all to participate/take part in deliberations;*
- *And knows how best to draw upon/channelize the expertise of each board member.*

[10] Guidelines for the Effective Governance of Microfinance Institutions, The Microfinance Network, 1999

Case of a Model MFI

1	The MFI focuses on including members who are willing to devote adequate time, have skills sets that complement the existing board and have the potential to contribute actively and meaningfully.
2	The MFI selects and appoints individuals who, when required, can take on leadership roles in directing and promoting the MFI.

Independent directors with required skill sets are difficult to find

The Tier-1 MFIs have a higher proportion of independent directors on their boards with diversified skill sets. Given the size, scale and influence of these MFIs, they have been able to induct some experienced and renowned professionals on to their boards. On the other hand, tier-3 MFIs in particular experience difficulty in sourcing independent directors with required skill sets. For example, an audit sub-committee has to be chaired by an independent director who must have the ability to read and understand financial reports. MFIs generally prefer professionally qualified chartered accountants for this task but it is always a challenge for tier-3 MFIs to find qualified individuals who are willing to sit on the their boards.

1.3 Relation between Board Members, Chairperson of the Board and CEO

Promoters cum MDs/CEOs act as chairperson of the board

In about 48% of the MFIs, the promoter-cum-managing director/CEO acts as the chair of the board. The finding is contrary to that reported by MIX survey where more than 80% of MFIs separated the role of CEO and chairperson. This is also a deviation from good governance practices and shows that the sector has a long way to go before the fundamentals are in place in terms of board structure.

On the other hand, in about 41% of the MFIs an independent director acts as the chair of the board. It is also likely, although we do not have sufficient evidence to support this, that even in those MFIs where an independent director is the chairperson, the MDs/CEOs can come forward and play the role of chairperson when the independent director is absent from meetings.

MFIs that do not have a fixed chairperson often share the position among all the board members on a rotational basis

In at least two MFIs covered during the primary research, there is no fixed chairperson and the role is taken by each board member in rotation.

The advantage of this practice is that it offers a chance to everyone on the board to chair meetings but this system results in lack of ownership of company affairs by any single individual. Many decisions on company matters such as compliances, structure of board agenda etc. must be taken in consultation with the chairperson, who has to be an authorised signatory. If there is no permanent chairperson, it is difficult to fix the accountability, roles and responsibilities in such a scenario.

1.4 Relation between Management and the Board

In a good proportion of MFIs, the management team occupies more than one position on the board

In about 52% of MFIs, the management team occupies more than one seat on the board and generally the chief of operations/COO is part of the board in such cases. The concept of having an arm's length from the management affairs is defeated if the COO sits on the board. In the case of small boards, this issue seems to be more pronounced and more likely to be misused if the quorum is simply achieved by the presence of two–three members including the CEO and COO.

MFIs with Family Members of the CEO/Promoter on the Board

Management Capture...Perhaps

In at least two MFIs, the family member of the promoter/cum managing director is also part of the board and the management team. The board size in these cases is also small, leading to a high proportion of management representation on the board.

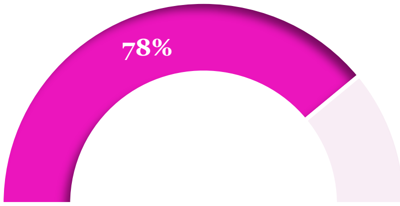
As many as 22% of MFIs have family members of the promoters on the board. In 16% of the MFIs, the family member also occupies a key management position along with the board seat, an indication that microfinance in India is still a family-owned and managed business. MFIs appear to be becoming more aware of such conflicts and are gradually responding to improve the governance standards.

1.5 Gender Diversity

Proportion of women board members is quite low

In 78% of MFIs, there is at least one woman director. Only 10% MFIs have a majority of women members. All of these MFIs are either societies or cooperative.

MFIs with Women Directors

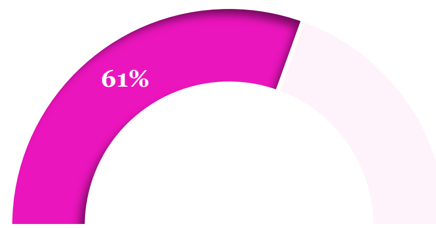


Few MFIs expressed their desire to have a woman board member purely to comply with the provision of Companies Act, 2013 (Section 149 (1) Proviso 2). Thus, in some cases, it is mere compliance rather than MFI really feeling the need and importance to have a women member on its board.

1.6 Proportion of Independent Directors

Only a quarter of MFIs have majority of independent directors
The proportion of independent directors on their boards is a concern in a few MFIs. Only 24% of the MFIs have a majority of independent directors and in 39% of the MFIs, the number of independent directors is less than one-third of the total members. As many as 75% of these are NBFC-MFIs.

MFIs with One-third Independent Directors



Independent Directors bring Immense Value to the Board

One of the MFIs in eastern India appreciated the advisory services and assistance offered by international experts sitting on their board. They said that because of the support provided by the independent director, who was also an expert in a given area, the MFI did not consult any investment-banking agencies and could still successfully close the issuance of non-convertible debentures.

MFIs, particularly the tier-3 institutions, experience difficulty in sourcing independent directors who are well versed with the sector and possess the required expertise to guide the institution. A few MFIs also feel that with the increased liability of independent directors as per the provisions of the Companies Act, 2013 (Section 149)[11], there is a general reluctance among people to sit on MFI boards.

"Independent directors have a larger role to play. While investor directors only protect their interests, the independent directors have to ensure equitable justice to all stakeholders (employees, clients, vendors, etc.). Independent directors therefore have to play a much larger role"

An Independent Director

Case of a Model MFI

1	At least one third of the members on the board of MFI are independent directors.

1.7 Vacant Seats on the Board

None of the MFIs have had vacant board seats for more than a year
We did not find any MFI where there was at least one board seat vacant for more than 12 months. The vacancies that did exist in some MFIs were due to the resignation of board members at the end of the last financial year, and these said they are looking to fill the vacancies before the close of the current fiscal year.

1.8 Board Structure Reflecting Shareholding Patterns

The proportion of independent directors in the overall composition of the boards of mainstream-sector companies such as Infosys and TATA Steel is more than 50%.

Major shareholders have taken a seat on the boards of MFIs
All major investors (those who hold more than 10% equity stake) have generally taken seats on the boards of their investee MFIs. The terms and conditions and the broad roles and responsibilities of the directors

[11] The provisions are applicable to public listed companies. See Annexure 6 for details of applicability of provisions of the Companies Act 2013 on the different types of companies

nominated by such investors are generally agreed upon and drafted in the Shareholders' Agreement. The finding is different from that of the MIX survey, according to which, vast majority of MFIs had funders whose representatives did not sit on the board of the MFIs.

There are other investors with significant shareholding in MFIs that have not taken board positions. This is mainly because the internal policies of such investors require that their mandate is to support MFIs in helping them build their systems through technical assistance rather than taking a seat on the board.

The board members of not-for-profit MFIs are generally acquaintances of the promoters who have an inclination towards social work and development. However, the board of at least one not-for-profit MFI has members from diverse backgrounds and professional experience with no prior familiarity with the promoters.

Lack of Compatibility with the Management may lead to Investors Taking an Exit Route

In one of the MFIs from east India, a social investor decided to take an exit route just after six-eight months of equity infusion. This investor was not pleased with the way the promoters conducted the business.

1.9 Investor Alignment with Mission and Vision

Alignment with Mission and Vision forms one of the most important criteria before investment-related decisions

Major investors in India make sure that their Mission and Vision are aligned with that of the MFI before investing in the institution. Some of the social investors also try to build the capacities of their investee MFI by allocating resources for technical assistance and capacity building.

Pro-active Management can Ensure Mission Alignment

An MFI from south India acknowledged that it benefits from having a strong chairperson who is respected and heard, and who has struck a successful balance between the motives of social and commercial investors.

Another MFI in south India has set high standards in corporate governance principles and is able to negotiate with all new investors so that they are aligned with the organisational Mission and Vision rather than the other way round.

In only a few rare cases, investors have taken an exit route where there was a mismatch between expectations of both the parties.

In a large number of MFIs, the early investors were core microfinance/impact investment firms (generally a hybrid of social and commercial equity investors). With the growth in the microfinance sector, some of the bigger MFIs have seen investment by mainstream sector investors/private equity firms. MFIs, in particular the tier-1 MFIs, acknowledge that although the commercial investors come in with a profit motive, management has been able to balance both the social and commercial agenda of the investors.

1.10 Constitution of Sub-Committees and Board Members' Proficiency and Skill Sets

Mandatory sub-committees are in place

Most NBFC-MFIs have all the mandatory sub-committees in place as prescribed by the Reserve Bank of India guidelines and the provisions of Companies Act (2013).

Independent Directors as Head of Sub-Committees

In one of the tier-1 MFIs in south India, all its sub-committees are headed by independent directors, including their audit and risk, business, Remuneration and Nomination, resourcing and CSR committees. Moreover, none of the independent directors has chairpersonship of more than one sub-committee, which enables them to devote sufficient time to the affairs of their respective sub-committees.

A few MFIs have gone further and constituted more sub-committees than is presently required by regulation. For example, ALCOs are mandated by RBI for NBFCs with an asset size of more than INR 1 billion, but some MFIs have already established this sub-committee even though they do not qualify in terms of asset size. Risk management, CSR, finance and stakeholders' relationship committees are a few examples where MFIs have gone an extra mile to constitute sub-committees.

Non-NBFC-MFIs rarely have effective sub-committee structure

Apart from NBFC-MFIs, other legal forms of MFIs rarely have effective sub-committee structures. Out of 11 non-NBFC-MFIs, two do not have any sub-committees.

Composition and structure of sub-committees suffer due to the smaller number of independent directors

Where the number of independent directors is less, the composition and structure of sub-committees is not effective. The Companies Act (2013), provides that public and listed companies shall have certain sub-committees such as the Audit Committee[12] and Nominations and Remunerations Committee[13] to be constituted by majority independent directors. In cases where an MFI has only one independent director – as is the case in 15% of MFIs – such sub-committee structures are impossible to constitute even though these are not strictly applicable to private limited companies. Having an inadequate number of independent

Board Sub-Commitees

Some of the companies that have received high CRISIL governance rating such as HDFC, HDFC Bank, Dabur, Infosys and Bharati Televentures Ltd have only independent directors as the members of their audit committees. Infosys has only non-executive members as part of its audit, remuneration and compensation committees. In the case of ITC, its compensation committee comprises five non-executive directors, of which four are independent directors.

[12] Section 177(2) provides that the Audit Committee shall consist of a minimum of three directors with independent directors forming a majority.

[13] Section 178(1) provides that the Nominations and Remunerations Committee shall consist of three or more non-executive directors out of which not less one-half shall be independent directors. See Annexure 6 for the applicability of these sections on the different types of companies.

directors on the board very often leads to a situation where the existing independent directors are required to perform a huge set of responsibilities thereby resulting in weak supervision and oversight.

Except for few tier-1 NBFC-MFIs, MFIs find it very hard to match skill sets of committee members with the expertise required for effective functioning of that sub-committee. Tier-2 and tier-3 MFIs in particular face the issue of lack of availability of independent directors with required expertise. Currently, the audit sub-committee is chaired by an independent director in only 72% of MFIs.

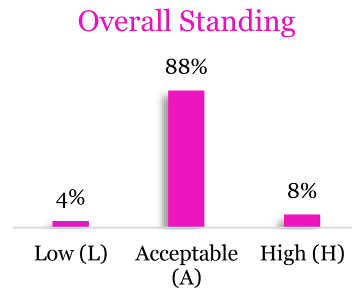
Case of a Model MFI

1	The MFI ensures that all sub-committees on its board are headed by independent directors.
2	The MFI also takes care that each independent director has chairpersonship of only one sub-committee.

II. Board Administration and Procedure

Overall Performance of MFIs

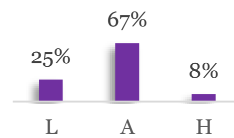
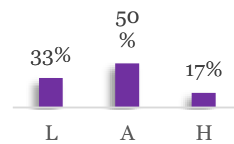
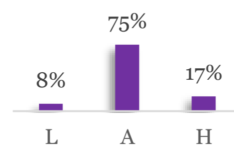
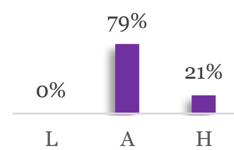
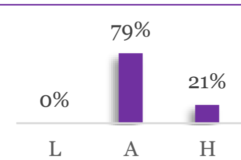
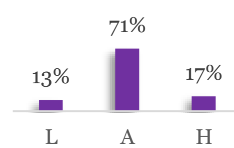
The board administration and procedure refers to the parameters that describe the key board processes and functions of MFIs. Some of the key criteria under this head include process for selection and appointment of board members, processes followed for board and sub-committee meetings and so on.



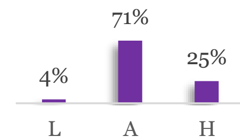
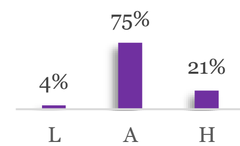
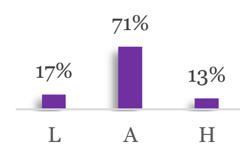
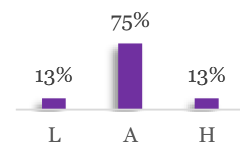
As evident from the chart alongside, an overwhelming majority of MFIs fall into the acceptable range, while only 4% fall in the below-average category.

Given below is the description of each of the criteria and the current status of MFIs for each criterion.

The table is followed by discussion on key findings under each heading.

Criteria	Description	Status (%age of MFIs)[14]
Selection and appointment of board members	Existence of defined process of selection and appointment of board members that is followed most of the time	
Code of Conduct for board members	Existence of Code of Conduct for board members	
Frequency and duration of board meetings	Frequency of regular meetings as well as special meetings (when required) as per the applicable regulation	
Attendance levels in board meetings	Level of attendance of members present at the meetings, either physically or virtually	
Participation in board meetings	Active participation of majority of board members in the discussions during board meetings	
Subject matter in board meetings	Representation of operational, financial and as social goals on the board-meeting agenda.	

[14] The percentages in the chart may not add up to 100 due to rounding error

Criteria	Description	Status (%age of MFIs)[14]
Bottlenecks during board meetings	Openness of members to debate and compromise, and to eventually find a common ground/consensus on important decisions	
Preparation and sharing of board meeting agendas (timeliness and quality)	Preparation of board-meeting agenda well before the meeting and sharing it with all the members to allow them enough time to be prepared for the meeting	
Preparation and sharing of board meeting minutes (timeliness and quality)	Level of detail in preparation of minutes and their timely circulation among members	
Conduct of sub-committee meetings	Regularity of sub-committee meetings, preparation of agenda in advance, proper documentation of minutes and presentation of reports by the sub-committees to the board	

In a Nutshell

STRENGTHS

- Participation of board members

AREAS FOR IMPROVEMENT

- Selection and appointment of directors
- Quality of board meeting minutes
- Formalisation of sub-committee meetings

2.1 Selection and Appointment of Board Members

MFIs are formalising the procedure for selection and appointment of board members

Around 61% of the MFIs report having a formal, documented procedure for the selection and appointment of board members. The Articles of Association of MFIs usually talk about the broad qualities of a board member but do not describe the procedure for appointment of directors in much detail. Besides, there is no separate process for appointment of the chairperson. In few MFIs (41%), the chairperson is usually an independent director, while in most other MFIs they come from the promoter group. Some MFIs rotate their chairperson among the independent directors every year or two years to ensure the role is performed by more than one person. On the other hand, there are a few MFIs where the chairperson has not changed since the inception of the organisation.

Independent Director as Chairperson

The board of a tier-1 MFI in north India passed a resolution to appoint only independent directors as the chairperson of the board. The tenure for the chairperson in such cases would be a maximum of two years, after which another independent director would be appointed to the position.

With the introduction of the Companies Act (2013) about 54% of the MFIs have set up nominations and remuneration committees, which have been assigned the task of nominating and appointing qualified individuals to the board. The terms of reference (TOR) for such committees are still work in progress in most MFIs. Where TOR does exist, it clearly lays down the procedure for the appointment of directors as well as their roles and responsibilities. MFIs are also looking forward to the database of independent directors proposed in the act.

MFIs do not have much say in the appointment of nominee directors by investors

In the case of the appointment of nominee directors by the investors/lenders, the names are proposed to the management by the investors/financial institutions, which then forward them to the board for discussion and ratification. Once the MFI board approves an individual, the nominee directors are inducted on to the board. However, in case of MFIs where a Nomination and Remuneration Committee is constituted, names are considered by the committee first and then presented to the board.

MFIs usually do not have much say in the selection and appointment of nominee directors. While the majority of MFIs acknowledged that nominee directors bring diverse expertise and skill sets, a few also felt that sometimes the individual skills of such directors might not match with what is needed at board level. It is to be noted here that the investors/financial institutions that appoint nominee directors to the

- *61% of the MFIs said that they have a documented procedure for selection and appointment of board members;*
- *54% of the MFIs have either set up or have an existing Nominations and Remunerations Committee;*
- *22% of the MFIs said they have a separate process for appointment of chairperson from that of board members;*
- *41% of the MFIs have an independent director as the chairperson of the board.*

boards of MFIs generally make sure that the nominated individual understands their roles and responsibilities and agrees to the terms and conditions by signing a Memorandum of Understanding.

Inviting Prospective Nominee Directors as Observers

The managing director of an MFI in northern India suggested that their board discusses the appointment of all nominee directors. The nominee directors are first invited as observers to board meetings and are also expected to give a presentation to the board about their contribution to proceedings. If the board is convinced about the contribution that the prospective candidates can bring, they are then appointed as directors.

A few industry experts noted that there should be a restriction on the number of MFI boards on which a particular nominee director can have a seat. Since there are common investors across a large number of MFIs, there are cases where the same nominee director sits on the boards of several MFIs, which causes a huge burden on them and may hinder them from discharging their duties appropriately. As per Section 165 of the Companies Act (2013), "No person, after the commencement of this Act, shall hold office as a director, including any alternate directorship, in more than twenty companies at the same time, provided that the maximum number of public companies in which a person can be appointed as a director shall not exceed ten". As per the voluntary guidelines issued by the Ministry of Corporate Affairs, the maximum number of public companies in which an individual may serve as an independent director should be restricted to seven. Thus, with the act already in place, the practice of having seats on multiple boards would be checked.

As it came out during interviews with the nominee directors, there is some doubt among them about the clause related to increased liability of nominee members in the newly enacted Companies Act. One of the nominee directors stated that if there is an increased liability of nominee directors as individuals, there would be very few people willing to take up that job. The Companies Act (2013) states that if the nominee director is an officer in default (various types of default are mentioned in section 2 (60) of the Companies Act) then he shall be liable for his acts either in an official or personal capacity, depending on the type of default.

Generally, independent directors are selected from the existing contacts of the MFI's management and current board members

Scouting for independent directors is largely done from amongst the contacts/networks of the sitting board members as well as the promoters/management. There are also instances where independent experts from foreign countries voluntarily joined the board as independent directors because they could connect with the Mission and Vision of MFIs.

Very few MFIs have a formal system for the orientation of new members

"Although the board has improved in both quantitative and qualitative terms, the 'texture' of the board can determine the effectiveness of the board. The texture is a function of two factors:
1) Type of board members; and
2) Their level of commitment.

The higher the commitment, the stronger the governance"

– A Sector Expert

A suitable prospective board member is one who:

- *Has the necessary skills that complement the existing board;*
- *Is willing to accept responsibility and take active participation in board meetings;*
- *Has adequate time to devote to board matters;*
- *Is preferably based in India so that they can attend meetings in person;*
- *Is committed to board responsibilities.*

In some MFIs, prospective board members are invited to meetings before their formal appointment to allow them to understand the functions of the board. On the other hand, there are MFIs who, on appointment of the board members, administer a formal orientation programme for new inductees. Another MFI in northeast India provides a formal orientation programme to all its directors.

Formal Orientation for New Members

One of the MFIs in south India has a three-day orientation/induction process for each board member, including the nominee directors. During the orientation programme, new board members are briefed about the functions of each department and are taken out for field visits.

Another MFI from western India has a two-day orientation process for board members, covering subjects such as the background information of company, type of reporting to board, TOR of sub-committees and latest sector developments. The second day is reserved for visits to the branches.

Case of a Model MFI

1	The MFI has a formal and documented process for the appointment of board members.
2	The process is transparent and takes into account the interest of the sitting board members.
3	The process involves scanning of the sector to identify the best-suited individuals for the MFI, focusing on the skills, qualifications and experience of the individual.
4	The MFI holds initial discussions with the prospective board members to understand their interest and level of commitment.
5	The MFI invites the prospective board member to a few board meetings to acclimatise with the organisation and its functions.
6	Upon approval and ratification by the board, the MFI appoints the director and provides a detailed terms of reference.

2.2 Code of Conduct for Board Members

While the majority of MFIs report having a formal Code of Conduct for board members, the same is not available in public domain

Around 75% of MFIs reported that they have a code of conduct and/or corporate governance guidelines for their board members. However, in most cases we could not find these either during our visit or on their website but in a handful of MFIs, the corporate governance guidelines are hosted on their websites. There is a general belief among MFIs that the investors and other members sitting on the board have a fair exposure to the microfinance industry and understand the nuances of the business, their responsibility and their commitment to meeting social objectives, hence there is no explicit need for a formal code of conduct.

On the other hand, some tier-1 MFIs not only have a Code of Conduct for the board but they also have a governance policy or governance Code of Conduct, which is broader in scope and coverage.

The members of the senior management team of all the MFIs agreed that there should be a document which lays down the terms of reference for board members in a comprehensive fashion, highlights the manner in which a board member should perform his duties and responsibilities, lists out their liabilities and clarifies what to do to ensure that their conduct is in consonance with the mission, vision and values of the MFI. The Code of Conduct should also, among other details, include a procedure and broad parameters to evaluate the performance of board members.

Case of a Model MFI

1	The MFI has a formal and documented Code of Conduct for the board members.
2	The Code of Conduct is shared with all the board members and the MFI ensures that they are properly oriented.
3	The Code of Conduct covers the manner in which board members should perform their roles and responsibilities, and lists their liabilities as board members.
4	The provisions of the Code of Conduct form the basis for the evaluation of the performance of board members.

2.3 Remuneration of Board Members

Most MFIs pay only a sitting fee to directors

The practice of remunerating the directors varies across the MFIs. About 22% of them said that they do not pay any fees to board members. On the other hand, 73% of the MFIs stated that they pay a fixed fee to their directors. In most of these cases, the remuneration is in the form of a sitting fee for attending board meetings and sub-committee meetings. At least two MFIs in the survey said that in addition to the sitting fee, they also pay a profit-linked compensation to independent directors. A few of the MFIs also said that they do not pay any fee to the nominee directors as their fee is taken care of by the lender/investors themselves.

Almost all the MFIs stated that they reimburse travel expenses to the board member for attending board meetings.

The industry experts were of the opinion that the MFIs should have a system to pay adequate remuneration to independent directors. At least two of the industry experts we interviewed for the study suggested that in order to bring about more accountability and participation of independent directors, an appropriate professional fee/compensation should be paid to them.

2.4 Frequency of Board Meetings

MFIs generally have quarterly board meetings

All the MFIs sampled in the study have at least one board meeting every quarter. Some used to have less than four meetings in a year but have changed their calendars to include four meetings as per the provisions of the Companies Act (2013). This even includes those MFIs that do not come under the purview of the Companies Act. 5% of the MFIs, primarily societies and co-operatives, hold more than four meetings in a year.

In addition to the quarterly meetings, there are a few MFIs that sometimes organise special board meetings. These are organised when important/urgent subject matters need addressing before the next scheduled meeting. Subject matter such as new investments, issuance of non-convertible debentures and finalisation of business plans are usually the agenda items for special meetings. In one of the MFIs in eastern India, a special two-day meeting was organised specifically to finalise a five-year strategic plan for the MFI.

- *95% of the MFIs have quarterly board meetings;*
- *5% of the MFIs have more frequent board meetings;*
- *46% of the MFIs held at least one special meeting in the last two years;*
- *12% of the MFIs said that they also organise retreat meetings for their board members.*

A Very High Frequency of Board Meetings is Not Desired

In one of the MFIs in eastern India, members of the governing body meet almost every month. Although the agenda for such meetings is procedural, there is often little scope to hold quality discussions when the meetings are so frequent.

Some MFIs also organise retreat meetings for board members. This enables them to engage with management/staff in an informal setting.

Most MFIs ensure that the duration of board meetings is restricted to one day

The duration of board meetings is usually one day. Typically for the MFIs, it is difficult to request the time of board members for more than a day, hence they try to squeeze both sub-committee and board meeting into the same day. In some MFIs, sub-committee meetings are usually held a day before the board meeting, thereby stretching the overall time for the board meeting across two days.

MFIs generally prepare the schedule of board meetings well in advance

In almost all MFIs, the schedule for the next board meeting is usually prepared during the current meeting. In one of the MFIs in south India, an annual board-meeting calendar for the following year is prepared in consultation with all board members during the last meeting of the previous financial year. This helps the MFIs and their board members to block the dates in their calendars and therefore be available when required.

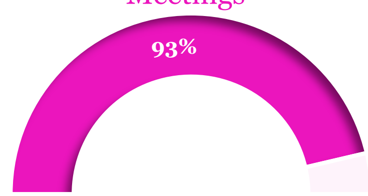
Some MFIs allow board members, particularly those based overseas, to attend meetings via electronic means such as virtual conferences. However, these MFIs mandate such board members to attend at least a few meetings in person each year.

Case of a Model MFI

1	The MFI prepares the schedule for board meetings well in advance after consulting with all the board members.
2	The MFI conducts quarterly board meetings, and if needed, special meetings as and when required.
3	The MFI allows adequate time to board and sub-committee meetings to ensure that all agenda items are covered.
4	The MFI conducts at least one retreat meeting every year for board members to allow them meet management in informal setting.

2.5 Attendance Levels at Board Meetings

MFIs with more than 75% Attendance in Board Meetings



MFIs report above average attendance in board meetings held in the last one year

MFIs have taken significant steps to ensure high attendance at board meetings. This includes, as discussed earlier, finalising their dates in advance, allowing some members to attend via electronic means and conducting some of the meetings in metro cities to avoid long travel to remote locations.

These steps have definitely ensured higher attendance percentages and the attendance of board members in most of the MFIs was satisfactory, with 93% of the MFIs reporting that the attendance percentage in the last year was greater than 75%. As many as 20% of the MFIs said that they had a 100% attendance rate at all the board meetings held over the last year.

The quorum for board meetings of all the MFIs, except two, is also in line with good practices, i.e. at least one-third of the total members or 33%.

2.6 Participation in Board Meetings

The participation of board members in board and sub-committee meetings has increased

MFIs have acknowledged that the average quality of the participation of board members in discussions has gone up over the years. According to the MFIs, the level and extent of participation varies from person to person, but overall there is a higher degree of involvement now than there was in the past.

Limited Exposure to Microfinance Restricts Participation

In one of the MFIs in north India, none of the board members other than the CEO has microfinance experience. While there is little doubt that the board members brought knowledge and experience from their respective areas of expertise, they still have to depend on the CEO to understand the nuances of the microfinance business. This may affect the quality of discussions and also lead to the over-dependence of the MFI board on the management, thereby affecting the quality of supervision and oversight.

Diversity in skills, expertise and experience is one of the reasons for the increased participation of board members. The members usually bring their subject expertise to the table while discussing key issues in board meetings, thereby expanding the spectrum of discussions.

Size of board is another factor that can affect participation in board meetings. As OECD observes, a larger board may induce some members to free ride on their monitoring responsibility, allowing the CEO greater independence.

Two MFIs indicated that having a strong chairperson has helped them ensure higher participation by all board members. According to these MFIs, the chairperson is able to assess the interest and competence of each board member and channel their inputs in the right direction, ensuring that they contribute to all board discussions. However, board members also said that having a larger board provides greater diversity, thus enriching the discussions during board meetings.

There is no evidence to suggest that only a few members participate in discussions but the presence of a senior expert on the board can skew the opinion of board members in favour of their suggestions. They tend to depend on the judgement of such senior experts rather than the collective understanding of the board but we do not suggest here that such dependence is harmful to the board.

The extent of participation of board members in defining the strategic direction of the MFI varies

The discussion with MFIs provided two divergent views about the level of participation of board members in the strategic planning for MFIs. One segment of MFIs believes that it is usually the management that proposes a strategic plan to the board, which then discusses, approves or amends it. Other MFIs believe that the board and management together play an

- *34% of the MFIs said that one or more of their board members participated in board meetings (one or more) via electronic means in the last year;*
- *76% of the MFIs have prescribed the minimum number of board meetings a member should attend in-person every year;*
- *In 84% of the MFIs where special meetings were conducted in the last two years, the attendance was more than 75%.*

The following factors may affect the participation of members in board meetings:

- *Board members have limited domain knowledge of the microfinance sector;*
- *Presence of promoters/ CEOs on the board who are very dominant;*
- *Difference in interests of promoters and major investors, leading to conflict and rancour.*

active role in setting the broad strategic direction within which the management team is expected to operate. There are examples where boards have asked management to introduce key initiatives and/or follow a strategic direction. For example, some of the investor nominees push aggressively for the adoption of SPM practices, which would include adoption of key tools and practices by the management and seek compliance on the same.

We will discuss this issue in detail in subsequent sections.

2.7 Subject Matters in Board Meetings

MFI boards discuss a wide spectrum of issues

The boards across MFIs discuss a wide range of issues, including not only the regular agenda items – such as operational and financial performance, capital mobilisation and allocation – but also any other issues that arise from time to time.

There is an increased focus on compliance, which is a regular agenda item across all board meetings. Apart from reviewing internal audit, risk and compliance reports, the boards also discuss external assessment reports such as credit rating and Code of Conduct assessment reports and seek action from the management. According to the MFIs, the board provides broad strategic direction and raises the flag to management if they perceive any particular pitfall in adopting a specific strategy. Cases of fraud are also monitored by the board members.

Increasingly, boards are monitoring complaints received from clients. While almost all MFIs have a grievance redressal system, the level of reporting of issues/complaints to the board and the action taken varies across institutions. Some go to the extent of reporting the details of cases that are not resolved for a long time, while others categorise the complaints received and present a summary to the board.

Human-resource related matters such as staff grievances also receive attention from board members and are regularly reflected on meeting agendas. Technology adoption is another issue that the board discusses actively.

Succession planning is one area where the boards have still not taken concrete action; except for a few tier-1 MFIs, succession plans in other MFIs are not actively pursued.

Discussion on compliance with Code of Conduct and client grievances occur as an agenda item in every board meeting. The MFIs reported that the boards usually spent ten minutes to up to an hour discussing these issues[15].

"There are three slices of topics that are discussed on the board.

1) Topics/issues that help maintain and continue the institution's values;

2) Financial and operational performance, i.e. budget vs. actuals, target met and reasons for variance;

3) What the board can do to help the institution meet its objectives;

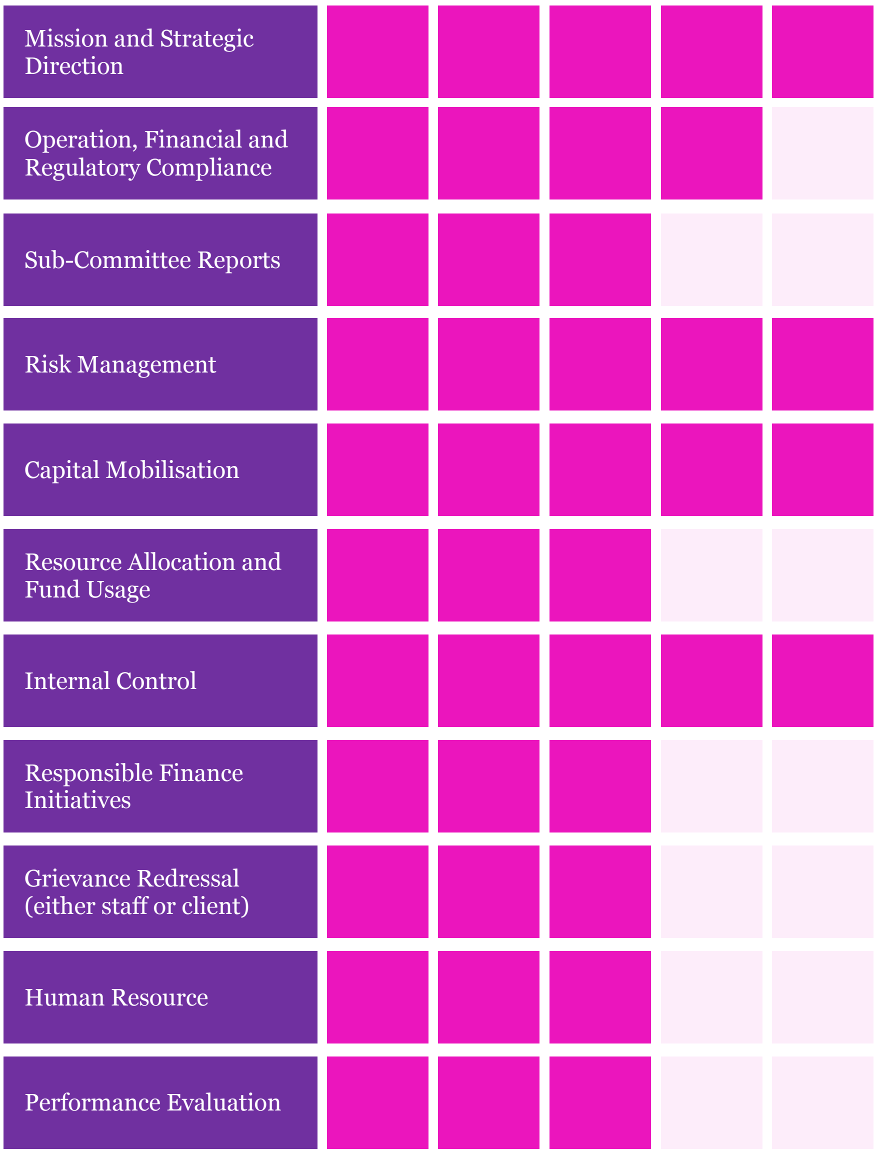
The first two are more of monitoring, governance and risk-management types of function while the last is being engaged. How well the board is engaged with the management/company determines the success and growth of the company."

– A Board Member

[15] This finding was made in response to the question on the time spent by the board members on different issues in the last two board meetings held.

Sub-committees ensure that critical issues receive adequate attention from the board

The creation of sub-committees has also ensured that critical issues are discussed in detail by the individuals who possess appropriate expertise. Risk sub-committee is also constituted in some of the boards, where risks associated with the MFI's operations are discussed.



Issues Discussed during Board Meetings

2.8 Bottlenecks During Board Meetings

MFI boards mostly reach consensus when arriving at key decisions

The boards usually have a range of investors with different investment horizons and different duration and tenure of investment. There may also be a difference in understanding of the Vision and Mission of the

MFI among the different members on the board so it can sometimes be a challenge to bring everyone to a consensus. While certain sets of investors may have aggressive expansion targets, others will be more circumspect.

The independent directors, as discussed earlier, thus have an important role to play in bringing different parties to the same page where they can agree to a common goal. They have to ensure that they protect the interest of all stakeholders, including employees, clients, vendors and so on, while playing a pivotal role in bringing people to a common ground, managing expectation and achieving consensus. However, this is always not possible.

In addition to the role of the independent directors in handling bottlenecks, often the diversity in the expertise of board members helps in widening the perspective of the board and therefore avoiding the myopic views of investors.

However, in this study we do not have enough evidence to assure ourselves on whether or not consensus is achieved at all times. The managing director of one of MFI suggested that generally decisions are made through consensus but in cases where differences still persist, the issues are deferred for the next board meeting, thereby giving enough time to reach consensus.

2.9 Preparation and Sharing of Board Meeting Agendas

The agenda is generally prepared in advance and circulated among board members before the board meetings

The company secretary is usually responsible for the preparation and sharing of board-meeting agendas, which are generally prepared in consultation with the CEO and chairperson of the board. The agenda, along with any supporting reports, are then circulated among board members by e-mail. However, a few board members mentioned that agendas are not shared on time; it is the responsibility of the MFIs to ensure that adequate time is given to all board members to comment on the agenda before the meeting.

- *In 71% of the MFIs, the company secretary is responsible for preparing and circulating the minutes of the board meeting.*

According to the MFIs, usually there are no requests from the board members to add an item to the agenda once it has been circulated.

A few agenda items remain the same for all the board meetings. These include operations and financial status reports, ratification of loan agreements with lenders and internal audit findings. Some MFIs also devote a portion of their time to discuss other functional areas such as human resources, grievance redressal and any other opportunities that might have come up in the sector.

It is important to highlight here that management of the MFIs should be transparent in disclosing information to the board members. A few board members we spoke to hinted that MFIs would present trivial and less important information in voluminous proportions, as part of board agenda, while limiting the presentation of core or critical information either to the last minute or by providing little information on the subject. These board members lamented that presentation of timely and quality information is not followed in practice in some MFIs.

2.10 Preparation and Sharing of Board Meeting Minutes

The board members, especially the investor nominees, ensure that the minutes are drafted properly

The company secretary is usually responsible for the preparation and sharing of board-meeting minutes. The draft copy of the minutes is generally circulated to the board members within seven days of the completion of board meeting. The board members, very often the major investors, provide their inputs on the minutes, especially around inclusion of key discussion points.

Most of the MFIs have started using a minute book to capture the minutes, which also carries the initials of the chairperson. Some MFIs, particularly those registered as societies or co-operatives, still document their minutes in a register/note book but however they are recorded, minutes of previous meeting are ratified and approved by the board every board meeting.

2.11 Conduct of Sub-Committee Meetings

The level of formalisation of sub-committee meetings desires improvement

The sub-committee meetings are generally held at the same time as the formal board meetings, either on the same day or, in rare cases, a day before. Some sub-committees, such as the finance committee, might meet more often to discuss and ratify terms of loans or lending agreement with banks and other lending institutions.

The other sub-committees such as the human resources, asset and liability, management, shareholders and grievance committees, meet as and when they are required.

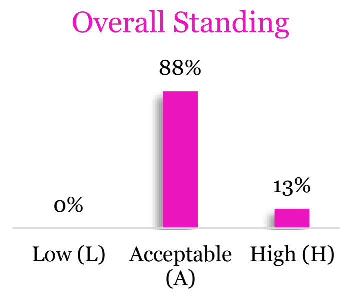
The agenda for sub-committees is generally not as properly documented as compared to the formal board meetings and the minutes taking in sub-committee meetings also need significant improvement.

Sub-committees do not usually present any reports to the board but they present the minutes and summary of their discussions instead. During board meetings, it is often the chairperson of the sub-committee who presents the facts and figures to the board and summarises the discussion that took place in sub-committee meetings.

III. Board Commitment to Roles and Responsibilities

Overall Performance of MFIs

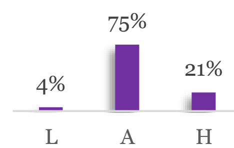
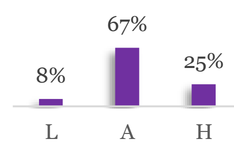
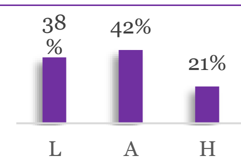
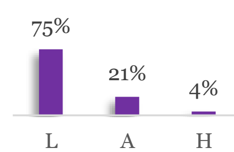
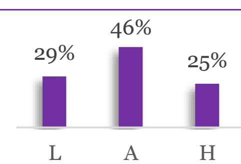
Commitment to roles and responsibilities includes the parameters that describe the level of involvement of board members in strengthening the institution. Some of the key criteria under this heading include contribution of board members in defining strategy, involvement of board to conduct performance evaluation of CEO, and the willingness of the members to contribute to the development of the institution.



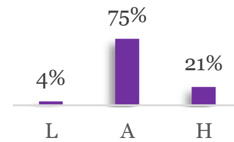
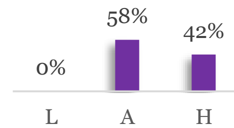
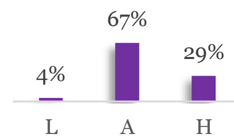
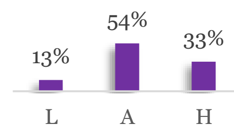
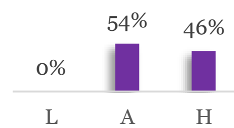
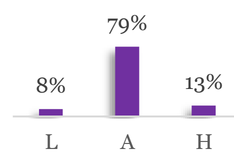
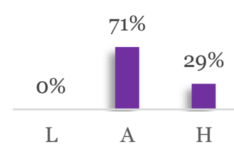
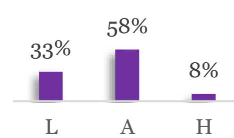
As evident from the chart alongside, an overwhelming majority of MFIs fall in to the acceptable range, while none of the MFIs fall in the below-average category. It clearly suggests that MFIs in India believe that majority of their board members are committed to the cause of the institution and are willing to take the institution forward.

Given below is the description of each of the criteria and the current status of MFIs for each criterion.

The table is followed by discussion on key findings under each heading.

Criteria	Description	Status (%age of MFIs)[16]
Contribution in defining mission, strategy and planning for the MFI	Involvement of board members in defining and upholding the mission of the institution, in developing strategic directions and organisational planning	
Focus on social and financial performance	Focus of board members to ensure a balance between the social purpose of the institution and other financial aspects	
Performance evaluation of CEO/SMT	Regular evaluation of the performance of CEO and other senior management team members by the board	
Performance evaluation of the board	Existence of a mechanism for the performance evaluation of the board (either individually or severally)	
Contribution in fund raising/capital mobilisation	Ability of the board to ensure that the institution raises enough resources to achieve its mission and gives guidance to the management on how it could raise more funds	

[16] The percentages in the chart may not add up to 100 due to rounding error

Criteria	Description	Status (%age of MFIs)[16]
Monitoring the utilisation/allocation of resources	Regular review of financial performance by board members and assessment of the institution's ability to allocate resources based on strategic priorities	
Risk management	The ability of the board to understand and recognise the importance of risk management and ensure that the MFI manages risks effectively	
Responsiveness towards changing environment	Responsiveness of the board members to changing environment and the ability to handle distress efficiently	
Reporting of internal auditor to the board	Existence of a system where the internal audit department of the MFI reports to the board regularly with an administrative reporting to the CEO, and that the board can discuss or give feedback on the same	
Availability of board members other than at board meetings	Availability of access to board members by the management team if there is a need for an in-between meeting discussion or guidance	
Monitoring client and staff satisfaction	Activeness of board members to monitor client and staff satisfaction	
Monitoring of MFI compliances to legal and statutory requirements	Activeness of board members to monitor MFI compliance to legal and regulatory obligations	
Participation in sub-committees	Participation of members in sub-committees based on their skills and expertise	

In a Nutshell

STRENGTHS	AREAS FOR IMPROVEMENT
Accessible board members	Performance evaluation of CEO
Compliance to statutory requirements	Performance evaluation of board
	Capacity building of board members

3.1 Contribution in Defining Mission, Strategy and Planning for the MFI

The involvement of board members in defining mission, strategy and planning varies across MFIs and depends to a large extent on the individual(s)

The management of all the MFIs reported that they share their annual business plan with the board for discussion.

As discussed in the previous section, we encountered two views on the role and involvement of the board in defining the mission and strategic direction of the MFI. On one hand, a section of MFIs believes that the board may not provide a very clear direction but does help to define a periphery for the management to confine their ideas and strategies. They raise flags if they perceive risks and guide the management team to avoid pitfalls. In such cases, the board/business committee usually discusses the possible impact that could happen if the business plan, as proposed, by the management was approved. The impact is assessed mostly around compliance and statutory issues. In such situations, the business committee generally flags the same with the board and the management for consideration.

A Strong Board can Help Steer the Organisation during Crisis

The management of a tier-1 MFI in south India acknowledged the confidence shown by their board in the times of crisis and the guidance provided by them. The board advised the MFI:

1. Not to default in respect of its liabilities;
2. Not to open new branches;
3. To fine tune processes;
4. To slow down the operations;
5. To centralise and consolidate operations;
6. Not to retrench staff.

Similarly, the management of another tier-1 MFI acknowledged the contribution of the board in providing direction and guidance to help them overcome the problems caused due to Andhra Pradesh crisis. The board ensured that the management kept its focus on improving efficiency, ensuring consolidation of operations and effective stakeholder management, thereby helping them to recover from the losses.

On the other hand, there are MFIs that acknowledge that their board members play a more direct and central role in defining strategic direction. In these cases, the board generally collaborates with management during the strategy-development process and actively provides inputs throughout the course of strategy formulation.

MFIs Increasingly Involve Board Members in Strategic Planning

An MFI from eastern India conducted a two-day strategy development session involving all its board members. Similarly, an MFI from central India plans to organise a retreat meeting with board members to discuss the its strategy, especially in the light of RBI's guidelines allowing NBFC-MFIs to act as the business correspondent of banks as well as the regulations on small banks.

The management of some of the MFIs acknowledged that their boards have guided their institutions on a range of issues such as institutional transformation, technology adoption, mergers and acquisitions, human resource, customer service, and to a limited extent, product and services.

3.2 Focus on Social and Financial Performance

MFIs ensure basic compliance to social performance management requirement but hardly go beyond that

MFI boards comprise different kinds of investors and it is extremely important that the focus of the major investors is not only on financial performance but also on social performance. Industry experts believe that MFI board members need to be oriented and trained on social performance management to make sure that they go beyond the compliance mode to internalise and institutionalise SPM policies and practices. In most MFIs, we found that SPM, in a broader sense, is still being followed to please external stakeholders and comply with the prescriptions of regulatory bodies.

In order to drive focus on both social and financial performance, it is also imperative that social performance is integrated into MFI management systems such as the internal audit and control, performance management systems and so on.

The boards of many tier-2 and tier-1 MFIs are sensitised on the need for efficient operations and appreciate its importance for the financial success of the institution.

Board Actively Monitors Operational Efficiency along with other Operational and Financial Parameters

In a tier-1 MFI from south India, Operational Efficiency Ratio (OER) finds a distinct focus in all board meetings. OER, along with margins, is one of the parameters that the board monitors in every board meeting.

However, in spite of being aware of the importance of the need to be socially responsible, a lot of board members still equate social performance management with Corporate Social Responsibility (CSR) activities. For example, customer service, other than being an important driver to measure financial performance, is also an extremely important indicator to assess an MFI's ability to service clients responsibly.

Whether the board of the majority of MFIs see such operational indicators through a social-performance lens is still a question that needs to be answered.

> ***Customer Service – A Key Driver to Measure Financial Performance***
>
> In a tier-1 MFI, focus on customer service is given prime importance. The board monitors the customer retention, type of customer complaints and the turnaround time for the resolution of customer complaints. This focus on service quality has enabled them to convert dropouts to active members. As per an exit survey done by the MFI, staff members were able to bring about 40% of dropouts back into the system. The retention rate also went up from 65% to 80%.

More details on the approach and perspective of board members towards SPM are detailed in subsequent sections.

3.3 Performance Evaluation of CEO/SMT

The board pursues performance evaluation of the CEO in majority of MFIs

Board members review the performance of the CEO in 90% of MFIs. However, three MFIs, including two NBFC-MFIs, reported that their board rarely or never pursues performance evaluation of the management team. In majority of the MFIs, performance evaluation of CEO/SMT is based on the performance of the company, and primarily on the operational and financial parameters. Social performance of the MFI is still not an indicator used for performance evaluation in most MFIs.

"Defining performance parameters for CEO and their reference levels should be meticulously done. The parameters would vary from MFI to MFI as the context and operating conditions are generally different for every MFI."

– An Investor Nominee

Other than the CEO, boards of some MFIs also conduct performance evaluation of other members of the senior management team.

> ***Performance Evaluation of Senior Management Team***
>
> In a tier-1 MFI in south India, the members of the Nominations and Remuneration Committee hold one-to-one discussions with each functional head (in the absence of the managing director) at the time of performance evaluation. As well as reviewing performance, the exercise helps committee members to better understand the roles and responsibilities of the functional heads, the challenges they face and field-level perspectives. The interactive sessions also provide an avenue for staff members to expresses their concerns and share their experiences.

In a large tier-1 MFI, the board/Remuneration Committee evaluates the performance of the CEO/MD as well as that of the CFO. In yet another tier-1 MFI, the board evaluates the performance of all functional heads.

3.4 Performance Evaluation of the Board

The boards of almost all the MFIs have never undergone a performance evaluation of their own

There is no system to evaluate the performance of the board, either individually or severally, in the majority of MFIs. The chairperson of only one tier-1 MFI said that they currently have a system of peer assessment of all board members against predefined parameters.

Two other MFIs have undertaken a governance-rating exercise from external governance-rating agencies. One of these received the highest governance rating among MFIs and there are only six other companies in India in all the sectors that had a better governance score than this MFI.

Performance Evaluation of Board – Mixed Experience

A tier-1 MFI in south India introduced a system of board evaluation about three years ago. However, it found the results to have limited practical value in terms of receiving feedback about the members and has since decided to do away with the system. Instead, the chairperson has provided a forum to each board member to reach out to him in confidence and share their views, concerns and feedback.

The board of this MFI is aware that external rating agencies gives a higher governance rating score to boards that evaluate their own performance, but has still decided to stay away from this practice, even if it means getting a lesser score.

There is a consensus among management teams as well as board members on the need for having a system for the evaluation of board performance. The provisions of the Companies Act (2013) also state that one of the responsibilities of the Nominations and Remuneration Committee is to evaluate the performance of all members of the board of directors. Hence, as MFIs fine-tune the terms of reference of the Nominations and Remuneration Committee, we can expect them to adopt some mechanisms for evaluating all the members of their board.

3.5 Contribution in Capital Mobilisation

The management teams of MFIs expect support from board members to help them raise capital

The management team of at least the tier-2 and tier-3 MFIs expect support from their board members to help them raise capital. This means tapping into their network and affiliations, and seeking their support to become advocates of the institutions to help raise capital. The management team of some of these MFIs did lament their inability to raise capital and wanted to have someone on the board that could help them with this function.

"Our board members helped us to raise equity capital from new investors, especially after the Andhra Pradesh crisis."

– Managing director of a tier-1 MFI

Some other MFIs expect the board to provide them with broader guidance on the ways to attract capital. Thus board guidance on building systems and aligning the business to attract a class of investors is highly appreciated by the management.

Critical Support from a Nominee Director

The nominee director of a leading social investor helped one of the tier-2 MFIs in central India to secure a guarantee of INR 90 million against which the MFI could develop its managed portfolio with one of the private-sector banks in the country.

Extracts of Interview with the Founder and Chairperson of a tier-2 MFI from Western India

[MicroSave]: Is there any specific skill set you would like to see on your board?

[Chairperson]: I think we have a fairly balanced board. However, I think the skill set that I would like to see on the MFI's board is to have someone who has adequate experience in raising funding, including both debt and equity, not actually to help me raise funding (that we can do) but to give us perspective on what the funding institutions look for, how to deal with them, and what are the things that we are not doing right that will later become a problem for funding. Anyone who has run a large financial institution has that perspective. I would like to have someone with such a skill set, not to tell me the possible institutional sources of funds, but to provide me the perspective I just mentioned.

I do not think a board can substitute for the day-to-day fund-raising of an institution. I think that is the skill that a lot of management teams lack and they try to put it to the board. No board can do any day-to-day stuff, really. A board can, at best, provide a strategic perspective.

3.6 Monitoring Resource Utilisation

The board regularly monitors the utilisation and allocation of resources

The review of financial performance is always an agenda item in board meetings at all MFIs. Generally, board members review financial performance against the targets laid out in the strategic plan. However, we are not in a position to comment on the level of discussions that happen on this issue. Financial performance and allocation of resources is one area that is central to most investors and management teams, and hence deliberations around this issue could be assumed to be detailed. One of the independent directors of a large MFI reiterated this while sharing his perspective on the role of independent directors. He mentioned that focus on monitoring the financial performance of the MFI is never an issue at board level because this is central to the institution's existence. And more, this is always a priority for investor directors/nominee directors; an independent director of a tier-1 MFI noted that the presence of commercial investors has brought a lot of rigour in monitoring and oversight of financial management.

Similarly, in board meetings of most MFIs (especially the NBFC-MFIs) discussion on borrowing status takes place. This mainly includes loans received from banks and other financial institutions, their usage and repayment status. Board members also regularly review the liquidity status and idle cash position of the institution as a whole.

In the tier-1 and tier-2 MFIs, finance/resourcing committees have been constituted and entrusted with the responsibility to approve borrowings and review their usage. The equity mobilisation in such MFIs is directly handled by the management team/CEO, who later presents the same to the board.

Although prescribing limits related to cash utilisation is an operational matter, such policy-level decisions are often communicated to the board by the management team, and the board will then provide their feedback on these issues.

Board Advised MFI to Look for Alternate Routes to Raise Debt

The board of a tier-1 MFI constantly reviewed the cost of funds and was concerned about the rates charged by banks for term loans. Board members suggested reducing dependence on banks and increasing exposure to the money markets instead.

The MFI, following the advice of the board, has initiated a debt-instrument rating and has set a target of raising INR 1 billion through the bond market. It expects that over time, the money-market route of raising funds will play an important role in its funding structure.

In some MFIs, we found that board members also prescribe limits and instruments that allow them to invest surplus money for a short term to manage their assets and liabilities position on an on-going basis.

3.7 Risk Management

MFIs are increasingly realising the benefits of having a fully fledged risk-management department

All large scale MFIs have already established a risk-management department[17], largely because of RBI norms. These MFIs have either established a separate committee for risk management at board level or the audit committee is entrusted with the task of risk management. The presence of members with risk-management expertise strengthens such sub-committees. In other cases, MFIs and their board members have begun to recognise the importance of risk management and understand the requirement of having a dedicated function for this task.

- *68% of the MFIs reported that they have either a stand-alone risk management committee or a combined risk and audit committee in place at board level.*

[17] For the purposes of analysis of MFIs on the risk-management function, we mean the capacity and resources of the MFI to adopt an integrated approach towards risk management. This includes the ability of the MFI to understand and focus on all types of risks, and not just restrict to credit and operational risk

For large NBFC-MFIs, risk-based reporting is being regularly given to the board

Tier-1 MFIs have proactively adopted tools for risk management to strengthen their systems further and have separate manuals and tools for risk management. Risk grading is assessed for all branches and is reported to the board every quarter in these MFIs. Apart from this, risk reports such as the MFI's performance on key indicators, credit risk reports, asset and liability management reports, portfolio concentration and exposure reports are reported to the board on a quarterly basis, which result in the effective oversight of the MFI's performance.

In tier-2 and tier-3 MFIs, where there is no risk-management function or it is at a nascent stage, reporting to the board largely focuses on performance of the MFI on key indicators.

Case of a Model MFI	
1	MFI has a separate risk management sub-committee.
2	MFI has established risk management policies and procedures, manual, tool and reports.
3	MFI has at least one risk-management expert at board level.

3.8 Responsiveness towards Changing External Environment

NBFC-MFIs evaluate the external environment carefully

After the crisis, boards of MFIs, particularly the NBFC-MFIs, have shown more responsiveness towards understanding and evaluating the external environment. There is an increasing realisation and awareness of the need to comply with regulatory prescriptions. For example, many MFIs are actively taking steps to comply with the requirements of Companies Act (2013). A few MFI boards have started discussions about new opportunities such as small and payment banks and recent changes in the regulation where NBFCs can also act as business correspondents. These topics feature regularly on the agenda of the board meetings, as and when needed.

3.9 Reporting of Internal Auditor

NBFC-MFIs seem to have better internal audit reporting systems compared to other MFIs

Most NBFC-MFIs have a prudential system in place where the head of internal audit reports directly to the board through the audit sub-committee. Some of the tier-I MFIs have now started outsourcing this function by hiring an outside internal audit firm. In such cases, the outside agency reports directly to the board.

There are still a few MFIs where the internal auditor reports to the CEO, which is a stark deviation from recognised good corporate governance principles. Reporting structures in other legal forms need significant improvements to ensure these MFIs move towards adopting the industry's best and prudent practices.

Quality of audit reports presented to the committee/board varies in terms of comprehensiveness, level of details, type of actions taken and reporting on action taken in previous audit reports.

In most of the MFIs, this sub-committee is chaired by an independent director. Apart from being a prudent practice, it is also a compliance requirement for NBFC-MFIs. MFIs also prefer to have an independent director holding a professional chartered accountant degree to chair the audit sub-committee.

Case of a Model MFI

1	Internal audit head reports to the board through the audit sub-committee.
2	MFI has a comprehensive internal audit reporting system with well laid-out policies, procedures and tools.

3.10 Availability of Board Members other than at Board Meetings

The majority of MFIs suggested that their board members are available for continuous support

MFIs acknowledged that the board members are available for support and guidance even in-between board meetings; they also make use of electronic channels such as emails, video conferencing and mobile communication to remain in touch with board members.

Board members provide on-going support in a number of ways:

- *Strategic direction and advisory support:* Board members discuss strategic options with the management team and share their views and suggestions. They regularly provide feedback on meeting agenda and meeting minutes.
- *Lobbying and advocacy:* This largely relates to efforts made by the board members to create visibility of the MFI's work in government circles, investors, regulators and so on.
- *Technical insights and capacity building:* Board members offer technical insights to the management team and build their capacities. Technical insights focus on topics such as technology, human resource policies and procedures, market analysis, non-financial services and so on.

Management teams should also ensure that they send regular updates to board members on the progress of the MFI. In two institutions in southern India, CEOs send a detailed report to the board of directors every month, which covers all aspects of business, operations, human resource and other matters related to the management of the institution. This initiative helps to keep board members engaged and informed on a regular basis instead of only sharing the information at the time of board meetings. The directors have appreciated this and felt that such a monthly report not only helps them to keep abreast of the progress but also provides them with a basis on which to provide their own feedback regularly.

Support Provided by Board Members

The CEO of one of the tier-1 MFIs mentioned that some of their directors provided useful support post the Andhra Pradesh crisis by meeting government officials and regulators, not to dispel myths about the institution but by listening to criticisms from these stakeholders and acting as a sounding board for the management to introspect and make any necessary changes.

Another tier-1 MFI acknowledged that the retired senior bureaucrats on their board have helped them gain access to government departments and policy makers with the view to lobbying

One of the MFIs agreed that the technical support provided by a social investor in the areas of HR management, technology and initiatives surrounding financial literacy has helped them to implement best practices.

3.11 Monitoring Client and Staff Satisfaction

Board members review reports related to client and staff satisfaction

MFIs have made significant efforts to improve the quality of reporting to the board around client and staff satisfaction. Through these reports, the boards of the MFIs regularly monitor the nature and severity of grievance, follow-up on action taken and the turnaround time (TAT) for action taken by management to resolve grievances.

Additionally, in 17% of MFIs there are special governance sub-committees constituted at the board level to look at, among other issues, client and staff satisfaction. In a very few cases, MFIs reported that their board members also visit the field and try to gauge client and staff satisfaction through first-hand experience with these key stakeholders.

3.12 Monitoring of MFI Compliance to Legal and Statutory Requirements

Boards have zero tolerance towards non-compliance with legal and statutory requirements

This is one area where board members have been quite active, particularly after the enforcement of RBI directives on NBFC-MFIs. With the new Companies Act (2013) coming in force, boards have shown greater responsiveness towards ensuring compliance. They seek compliance reports, require management to adopt the highest levels of compliance and regularly take feedback from the dedicated compliance team headed by the company secretary to ensure compliance with all legal and statutory requirements.

As an example, after the introduction of Companies Act (2013), most of the MFIs boards requested their company secretaries to submit a report to them on the compliance requirements of the new act as well as their status against the same. Discussions on the Companies Act have been a prominent topic among MFI boards in last three or four board meetings.

"MFIs should update us about legal and compliance issues through simple and clearly written reports/checklists."

– An Investor Nominee Director

Board members often have to rely on the company secretaries for legal advice. Interestingly, there was a general feedback by the board members that company secretaries are still studying the various guidelines of the Companies Act (2013) on NBFC-MFIs and trying to understand the purpose and implications of the provisions. Some MFIs have even engaged independent legal consultants to help them get a deeper understanding of the relevant, applicable provisions of the new act.

3.13 Participation in Sub-committees

Sub-committees are active in a majority of NBFC-MFIs

The sub-committees seem to be working actively in NBFC-MFIs, since they are now mandatory due to various regulations. MFIs also find it convenient to discuss matters first with a smaller group of experts, take their advice and later present to the entire board.

Engaging Sub-committee Chairs

In an MFI in south India, the chairperson of each sub-committee is required to present their committee recommendations to the board. This lends support to the MD during board meetings and also ensures higher involvement and ownership by committee chairpersons.

The sub-committee chairs in the MFI also hold monthly interaction with appropriate teams in management to ensure that they are involved and well informed.

3.14 Capacity Building of Board Members

Capacity building of board members is not on the radar of most MFIs

The management team of most MFIs felt that there is hardly any need to build the capacities of the board members, considering their background, experience and expertise, so therefore they do not undertake any capacity-building activities for their board members. However, they acknowledged that the board members require updating on the latest developments in the sector and the management accepts that the responsibility to conduct such exercises rests with them.

While the majority opinion was as above, there are a handful of MFIs who pursue capacity building of their board members seriously. These MFIs follow a practice of regularly inviting guest speakers to deliver talks to the board members on a range of technical and strategic matters.

Sensitisation of Board Members to Latest Developments

One of the MFIs in southern India, despite having a high-profile board comprising experienced bureaucrats, investors, bankers, insurance specialists, microfinance sector experts and chartered accountants, has a well-structured system of inviting external experts to deliver talks or sensitise board members on emerging issues.

At every board meeting, the MFI organises a session on either technical or strategic issues. Some of the examples of recently discussed issues in such sessions are as below:

1. Technical matters:
    a. Governance rating;
    b. Securitisation and its implications;
    c. Presentation on Companies Act (2013).
2. Strategic matters:
    a. Institution building;
    b. Inclusive finance and its prospects;
    c. Governance and growth.

Not only the management but also the board members of the MFI acknowledged the value that these speakers brought in enhancing and enlightening the board.

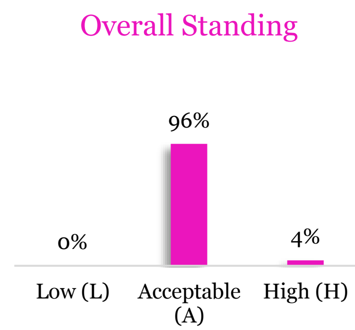
Similarly, another MFI from south India invited guest speakers to orient the board members on the provision of the Companies Act (2013) and the recent RBI regulations on small and payment banks as well as regulations allowing NBFCs to act as business correspondents of banks.

The management teams of the MFIs felt that these were critical issues and could have ramifications on their strategy. Thus, it was imperative that management, as well as the board, is kept abreast with new developments.

IV. Governance and Responsible Finance

Overall Performance of MFIs

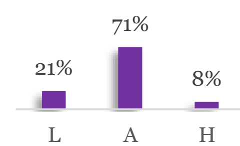
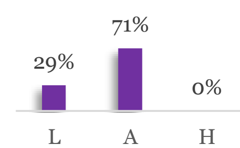
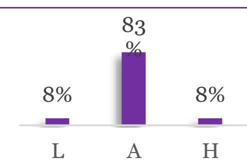
Governance and responsible finance refers to parameters that describe the ability of MFI boards to drive adoption of responsible finance and social performance management practices in the institution. Some of the key criteria under this head include: compliance to the code of conduct; transparency and responsible pricing policy; grievance redressal; orientation of the board towards social goals, if adopted by the institution; client protection initiatives and so on. While the focus is on responsible finance, due recognition is given to MFIs that have institutionalised social management practices in their organisations.



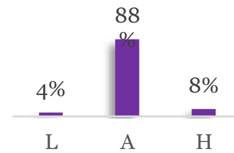
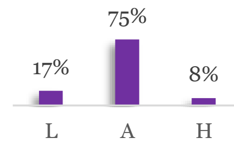
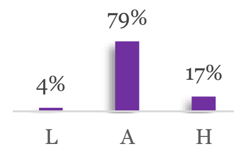
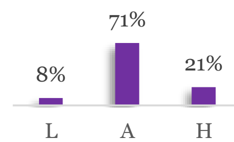
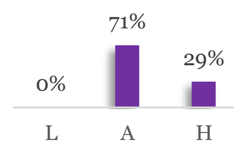
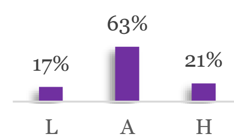
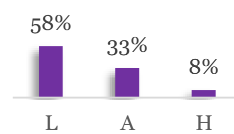
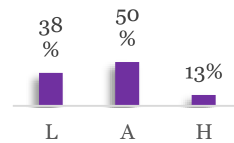
As evident from the chart alongside, an overwhelming majority of MFIs fall into the acceptable range, while none of them fall in the below-average category. It also suggests that MFIs in general have adopted responsible finance practices primarily to comply with the guidelines and directives of the regulator as well as self-regulatory organisations. Only a very small proportion (4%) of MFIs has gone the extra mile to both comply with the regulatory provisions and also adopt practices that set world-class standards. A few board members and industry experts believed that the management of most MFIs is more worried about compliance to Code of Conduct rather than ensuring that their staff members are sensitised and adopt these practices whole-heartedly.

Given below is the description of each of the criteria and the current status of MFIs for each criterion.

The table is followed by discussion on key findings under each heading.

Criteria	Description	Status (%age of MFIs)[18]
Compliance to Code of Conduct and Fair Practices Code	Activeness of the board to discuss the compliance of Code of Conduct and Fair Practice Code during board meetings	
Policy on conflict of interest	Existence, implementation and monitoring compliance of board-approved policies to avoid conflict of interest among the board (such as by being lender and owner at the same time)	
Transparency and responsible pricing policy	Existence, implementation and monitoring compliance of board-approved policies for transparency and responsible pricing	

[18] The percentages in the chart may not add up to 100 due to rounding error

Criteria	Description	Status (%age of MFIs)[18]
Grievance redressal policy	Existence, implementation and monitoring compliance of board-approved policies for grievance redressal	
Loan application and processing, disbursement, recovery practices and interest rates policy	Existence, implementation and monitoring compliance of board-approved policies for loan application and processing, disbursement, recovery practices and interest rates	
Monitoring of client protection initiatives	Regularity of discussions and monitoring of the progress of client protection initiatives/practices adopted by the institution	
Orientation of board members on social mission and goals of the MFI	Existence and implementation of a system to orient board members on the social mission and goals of the institution	
Preventing mission drift	Activeness of the board to prevent institutional mission drift during changes in ownership structure and/or legal form	
Review of social performance data	Review of social performance data including, mission compliance, human resource policy, social performance related risks (e.g., reputational risk, client exit), client protection practices, growth and policy of profit allocation by the board	
Performance evaluation of CEO/SMT on social parameters	Existence and implementation of a performance evaluation system management where social management criteria are also included in the performance evaluation of the CEO/director	
Commitment to rate of return targets and social development initiatives	Forthrightness of the board to fix rate of return target ranges taking into account the balance between financial and social goals	

In a Nutshell

STRENGTHS

- Compliance to industry norms

AREAS FOR IMPROVEMENT

- Staff grievance redressal
- Understanding of social missions and goals

4.1 Compliance to Code of Conduct and Fair Practices Code

MFI boards have approved and adopted Fair Practices Code

The boards of almost all MFIs have passed resolutions to adopt and implement Fair Practices Code. These codes, in most cases, are an amalgamation of MFIN and Sa-Dhan's code of conduct, fair-practices guidelines from the Reserve Bank of India, Smart Campaign's client protection principles and the MFIs' own Code of Conduct.

To ensure implementation, MFIs reported that they have included Code of Conduct as part of induction and regular/refresher training to their staff. A few MFIs also reported that they have printed Code of Conduct on loan passbooks and also indicated that clients are being made aware about Code of Conduct during compulsory group training (CGT).

The majority of MFIs said that board members push for compliance with Code of Conduct. In such cases, the compliance report is generally presented at least once in a year. However, some MFIs have integrated Code of Conduct compliance to key management systems such as internal audit and risk management. The compliance report, in these cases, is submitted to the board through the audit committee once every quarter. Elsewhere, there are other MFIs who submit reports on compliance to Code of Conduct every quarter to the board as part of their comprehensive compliance report.

MFI boards review Code of Conduct Assessment reports

As many as 60 MFIs have undergone Code of Conduct Assessment (COCA) from external agencies to assess the status of compliance with the industry Code of Conduct and the Fair Practices Code of RBI. In fact, a few MFIs even underwent a second round of COCA to check progress. Although a large number of MFIs participated in these assessments, we sense that this exercise was intended primarily to comply with SIDBI's requirements. Most of the MFIs said that they shared COCA reports with their board members. Board members of some of the MFIs also recommended corrective actions based on the findings in COCA. In case of an MFI in north India, board members recommended to the

Case of a Model MFI

1	MFI has board-approved Code of Conduct policies and the management presents the report on its compliance to the board.
2	MFI board discusses the extent of compliance to Code of Conduct and Fair Practice Code during board meetings and takes corrective actions in case of deviations in compliance.
3	MFI board reviews the Code of Conduct periodically so that it is aligned with the growth and changing environment.

- *95 % of the MFIs said that they present the report on compliance to Code of Conduct and Fair Practices Code to the board;*
- *Approximately 51% of the MFIs said that they allocate 10-15% of total board-meeting time for discussion on compliance to Code of Conduct and Fair Practices Code;*
- *85% of the MFIs said that their board members visit the branches and verify that the organisation's Code of Conduct is appropriately displayed in the branch premises and on loan cards, and is in vernacular language.*

management to administer an alternative financial-education programme for their clients to increase their financial literacy. The COCA report of this MFI had indicated low financial awareness among its clients. There are a least four MFIs that said they review their Code of Conduct annually so that it is aligned with the growth and changing environment.

4.2 Policy on Conflict of Interest

MFIs have board-approved policies to avoid connected lending

Almost all MFIs have board-approved policies to avoid conflict of interest such as connected lending (the board members being lender and owner at the same time). About 87% of the MFIs have said that their board always monitors the compliance with such policies on conflict of interest.

4.3 Policy on Responsible Pricing, Transparency and Disclosure

MFIs have board-approved policies on transparency and responsible pricing

Almost all MFIs (95%) have board-approved policies for determining interest rates and processing charges. Most MFIs said that they have taken significant steps to improve transparency in communication of interest rates, loan terms and other terms and conditions of the loan to clients. They said that loan cards issued to clients have interest rates, processing fees and other terms and conditions printed in vernacular. Clients are also made aware about interest rates and loan terms during compulsory group trainings.

"Transparency and accountability is the cornerstone of good governance."

– A Board Member

Most of the MFIs check the awareness level of clients on interest rate and loan terms and conditions as part of internal audit.

The majority of MFIs charge 26% annual interest rate, whereas the management and board of at least six MFIs in the study have reported reducing their interest rate to below 26%. One of the MFIs reported having reduced their processing fees to 0.5% of loan amount and thereby brought down the effective interest rate to 21.17%.

Review of COCA reports of MFIs also suggest a similar observation but points out that there are MFIs who charge more than 26% interest per annum. There are cases where MFIs charge 26% on group loan products but charge a different rate on other loan products such as individual loans. In some cases, it appears that an MFI's interest rate is less than 26% because of the loan term; however, the effective interest rate goes beyond 26%. For example, some MFIs display their interest rate as 12.5% (flat) per loan term with a loan term of 45 weeks. The effective interest rate in such cases works out to approximately 27% per annum (if the remaining loan is assumed to be for a year), although the impression given is that interest rate is around 25%.

MFIs continue to communicate declining interest rates along with flat rates and make the clients aware of the need to remember both interest rates. Clients, particularly illiterate clients, understand flat interest rates better than declining rates, as they have been used to this method for so long – a reason MFIs give to defend their decision to continue communicating flat interest rates.

4.4 Grievance Redressal Policy

MFIs have board-approved policies on grievance redressal mechanisms

All but one MFIs reported to have board-approved policies related to grievance redressal mechanisms for clients. These policies cover aspects such as setting up of customer grievance systems, the protocol for grievance redressal and compliance with grievance redressal policy. In a few cases, MFIs have included customer grievance redressal in their audit checklist. Auditors conduct random checks with customers to find out whether they are aware of the grievance redressal mechanism and whether they have any unresolved grievances.

Most of the MFIs said that they print the toll-free customer care number on loan cards and also put up a complaints box in each of their branches. Clients are also made aware about the mechanism during group meetings. A tier-1 MFI in south India has even nominated an ombudsman to resolve client complaints.

90% of the MFIs said that they discussed staff and/or client grievance redressal in board meetings held in last 12 months.

Some of the MFIs report client grievance data every quarter to the board. However, the majority just report the quantitative numbers instead of giving the details of the nature and severity of the complaints received, action taken on complaints, complaints pending resolution and the reasons for the same. There is a need to categorise complaints according to geographical area, which will provide key insights to board members in order to provide guidance to management if changes are required in MFI products and services. At least five MFIs in the study provide detailed report to the board around customer grievances. Additionally, they also present any action taken on the suggestions made by board members in the following board meeting. Two of the MFIs have also set up grievance redressal sub-committees at board level.

Grievance Redressal Mechanism in MFIs

A tier-1 MFI has adopted a three-level client grievance redressal mechanism:

- **Level 1:** Customer Care Representative (CCR) – 80% of its branches have a dedicated CCR; resolution within three working days;
- **Level 2:** Toll-free helpline; resolution within three working days;
- **Level 3:** Grievance Redressal Officer; resolution within five working days.

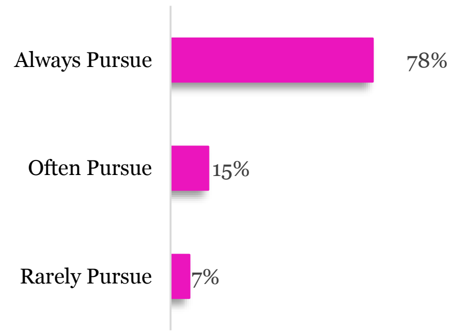
Yet another MFI has one of the most well-established call centres in the microfinance sector in India. The call centre also acts as the service quality department and is capable of handling calls in seven languages: Hindi, Kannada, Marathi, Telugu, Malayalam, Bengali and Oriya. 10,000 calls are recorded on an average per month. A ticket number is generated and there is a well-defined process to handle grievances or queries. The turnaround time for the resolution of complaints is two days. The MFI has recently introduced a system of tracking abandoned calls and establishing contact with such callers. There is also a different number for the ombudsman for complaint resolution.

Focus of MFIs on staff grievance redressal mechanism is far less compared to client grievance

Grievance redressal policy for clients has got due attention from the majority of MFIs, for various reasons. On the other hand, the focus of MFIs on staff grievance redressal is almost negligible. Only a few tier-1 and tier-2 MFIs have board-approved policies on grievance redressal mechanism for staff and these present quarterly reports to the board about staff grievance issues and the action taken by management to resolve them.

Even the COCA reports do not assess staff grievance redressal mechanisms in MFIs. The COCA assessment report produced by *MicroSave* observed that satisfied staff would have a direct bearing on the quality of client service, client retention, reduction in operating cost ratio and better margins. It is, therefore, imperative for MFIs to have a policy to address staff grievance.

Board Monitors Adherence to Client Targeting Policies



4.5 Policy on Loan Application, Appraisal and Disbursement

MFIs have board-approved policies on loan application and disbursement

Boards of all but two MFIs have approved policies for loan application and processing, disbursement, recovery practices and interest rates. This is largely in compliance with the RBI directives to NBFCs and NBFC-MFIs. Boards of a few select MFIs review the policies annually, based on changes in the external environment, growth or profitability of the institution.

4.6 Client Protection Initiatives

Only a few MFI boards actively pursue implementation and monitoring of responsible finance initiatives

About 73% of MFIs have board-approved policies to ensure client protection. These include policies related to loans applications and processing, disbursement of loans, loan recovery practices and interest rates on loans to clients. However, there is very little thrust on understanding the impact of MFI services on the lives of the clients. As shared by some board members, discussion on client protection initiatives is more from a compliance perspective than a genuine action.

Around 94% of MFIs said that their boards track outreach to low-income clients and assess the impact of microfinance services on their lives.

Board members occasionally visit branches/clients of the MFI immediately before or after the board meetings. In the case of one of the leading MFIs in south India, board members participate in CSR activities such as health campaigns undertaken by the MFI.

"Management needs to organise field trips for board members."

– A Board Member

Around 17% of all MFIs have social performance management sub-committees, which are primarily responsible for driving client protection initiatives in the institution and pursuing the SPM agenda at board level.

Regular Review of Client Protection Policies

An MFI in south India has a business committee at board level that regularly reviews policies to ensure that it is aligned with growth, changes in external environment and so on. Board members of this MFI also meet the functional heads before board meetings to understand the policies in place and the challenges faced so they can review the policies accordingly. The organisation was compliant with almost all the recommendations of the Malegam Committee at the time of the release of its report in 2011.

4.7 Orientation of Board on the MFI's Social Mission and Goals

MFIs generally do not appreciate the need to orient board members on their social mission and goals

Most MFIs do not have a formal mechanism or system to orient new board members on their social mission and goals. This is primarily because they believe that board members are microfinance experts and therefore do not require any formal orientation. Some of the MFIs, however, invite prospective board members to their board meetings to acquaint them with the functioning of the board and observe how board discussions focus on both financial and social issues.

4.8 Preventing Mission Drift

Socially oriented MFIs have put measures in place to prevent mission drift

Due to a mix of social and commercial investors on the boards of MFI, often it becomes difficult to balance the expectations from the two sets of investors. To ensure balance between social and commercial objectives, an MFI from south India has ensured that its parent non-profit entity maintains a minimum holding in its NBFC-MFI. However, the MFI also acknowledges that, going forward, with the increase in equity capital, it would be difficult to maintain the cut-off limit required to represent its parent entity on the board. The founder and chairperson of one of the MFIs said that the presence of an anchor investor with the same trajectory as that of the institution helps prevent mission drift to a large extent.

Protection of minority shareholders' right/promoters' right is one of the ways to keep the organisation on the path of its mission. In this regard, an MFI from south India has taken steps to maintain a diversified shareholding structure, wherein no investor holds more than 15% of paid-up capital.

Separating Governance from Ownership

A tier-1 MFI in south India has some highly unusual governance and social commitments enshrined in its article of association. It has a majority of independent directors on its board. Through measures such as restricting the shareholding by a single investor, and restricting the board seats to investors with shareholding above a cut-off limit, the MFI has ensured that the original social fabric of the institution is not altered. This self-perpetuating governance and mission commitment has not limited the ability of the MFI to tap commercial investors; rather it has helped the company to maintain a stable footing.

Some other MFIs have put in place certain clauses in the shareholders' agreement that seek to protect their mission and social commitments and also prevent new investors from steering the MFI away from its mission.

The other ways to prevent mission drift are by execution of long-term contracts with existing management or putting in place self-perpetuating governance structures that prevent takeover by any one shareholder[19].

In case of an MFI in east India, one of the investors has inserted a clause in the shareholder agreement that prevents the promoters of the MFI from being removed from the management. This was done to protect the rights of the promoters, who were in minority.

At least one MFI covered during the primary research has capped the annual bonus and remuneration of their managing director/CEO to prevent undue focus on financial and operational performance.

[19] Daniel Rozas et al, The Art of the Responsible Exit in Microfinance Equity Sales, 2014

4.9 Review of Social Performance Data

MFIs are yet to appreciate fully the value of monitoring social performance data

The boards of MFIs comprise different kinds of investors and it is extremely critical that the focus of the majority investors is not only on financial performance but also on social performance. In some of the tier-1 and tier-2 MFIs, social performance is, in some way, integrated into management systems such as the internal audit and control, performance management system, client targeting and training.

Some of the tier-1 MFIs have set up helplines to attend to customer calls and grievances. They have set up systems to receive calls with prescribed turnaround times that are monitored by a designated staff. These MFIs generally have a dedicated department to manage this function.

Some MFIs present an annual report to the board on the impact of their services on clients, results of client exit surveys and client and staff satisfaction surveys. However, as some board members candidly pointed out, the quality of discussion on SPM/responsible finance issues is far from optimal. The thrust of the board to adopt SPM is still focused around compliance and there does not seem to be an impetus on the part of board members to adopt global best practices and champion the cause of SPM.

Industry experts believe that MFI board members need to be oriented and trained on social performance management to ensure that MFIs really drive the implementation of SPM policies and practices rather than doing it to please external stakeholders and comply with regulatory provisions.

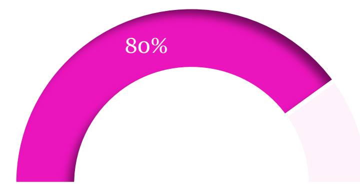
4.10 Performance Evaluation of CEO/SMT on Social Parameters

MFIs generally do not include social parameters for performance evaluation of CEO/SMT

Most MFIs do not have a formal documented framework to evaluate the performance of the CEO and other senior management team members on social performance indicators. However, board members do evaluate the performance of the CEO annually, mostly on the basis of the operational and financial performance of the MFI.

An MFI in north India has incorporated both social and financial parameters in the performance evaluation framework for its CEO. Some of the social parameters considered for the performance evaluation include proportion of poor clients to total clients, proportion of clients that moved out of poverty in a given period, client-satisfaction metrics, client-protection metrics and client-retention rate. The remuneration and annual bonus of the CEO is based on the scores received from using this evaluation framework.

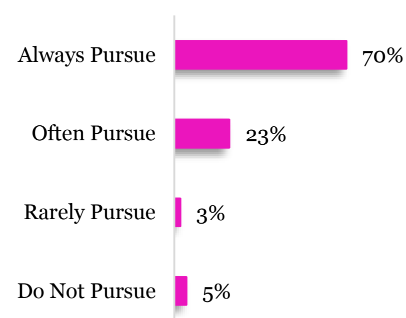
Discussion on RF Initiatives in Board Meeting



Sample Evaluation Parameters for CEO/MD:

A. Growth of outreach to BPL households and financial services to them;
B. Institutional efficiency and financial sustainability;
C. Social impact, client protection and satisfaction;
D. Leadership.

Board Oversees Performance Evaluation of the CEO

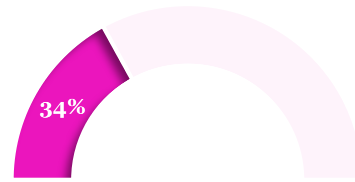


4.11 Commitment to Rate of Return Targets and Social Initiatives

Some MFIs have established mechanisms to ensure commitment to return targets and social initiatives

Boards generally focus on fixing financial goals or targets at the time of approval of business plans. However, some social investors do desist from aggressive expansion or ROI targets; rather they stress the importance of giving adequate focus to client-welfare activities. About 34% of the MFIs have a corporate social responsibility sub-committee, which is responsible for driving all the credit-plus activities like financial literacy, skill development and health education programmes.

CSR Sub-Committee



Asking Clients about Utilisation of Surplus

An MFI in north India conducted a survey with its existing clients to understand their preference on the usage of surplus profit of the company.

Clients were asked to give their response to following question: "Would you like the surplus to be used to provide for health education and/or scholarships for children to stay in school?" or "Would you like the interest rate on the loans to be reduced?"

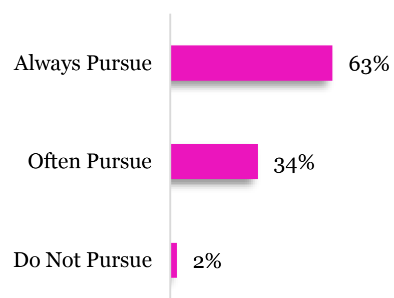
An overwhelming majority of clients chose the option for children to stay in school.

Cap on Return on Equity

A tier-1 MFI in south India has capped its ROE at 25%. If ROE exceeds this figure, loans are re-priced to keep the ROE within the cap. The MFI also donates 5% of its profits to pay for children's education and employs one corporate social responsibility staff member for every 10 branches, whose job is to conduct skill and medical development camps.

Two MFIs said that they have capped their Return on Equity (ROE)/Return on Assets (ROA) targets. At least three also said that they donate a percentage of their profits to development initiatives like scholarship for clients' children, health camps etc., and pass on the benefits to clients by reducing interest rates and other charges.

Balance Financial Returns with Social Targets



Use of Satisfaction Surveys to Design Non-credit Programmes

An MFI in north India conducts annual client satisfaction and impact surveys and shares the report with the board. Based on the report, the board recommends a few non-credit programmes like health education and financial literacy for the clients.

The Way Forward

1. Microfinance Institutions
2. Board of Directors
3. Investors and Lenders
4. Industry Associations

Principles of Good Governance

'"Corporate governance, to me, is about maximising shareholder value legally, ethically and on a sustainable basis, while ensuring fairness to every stakeholder – the company's customers, employees, investors, vendor-partners, the government of the land and the community." Dr N R Narayan Murthy while addressing the students of the George Washington University in 2006.

There is no denying the fact that the governance structures and practices adopted by microfinance institutions in India have evolved from what they were before or immediately after the Andhra Pradesh microfinance crisis. However, to say that the sector has taken significant strides to improving governance would be an overstatement. The present study highlights the gaps that still exist in corporate governance practices and it is worthwhile to reiterate some of the principles of good governance before we discuss the way forward.

Principles of Corporate Governance

Good governance is the process by which a board of directors, working through management, guides an institution in fulfilling its corporate mission and protecting its assets while guided by the highest standard of ethical behaviour of duty of loyalty, care and obedience[20]. It involves adherence to the fundamental corporate governance principles of fairness, accountability, transparency and responsibility[21].

In order to translate these principles into practice, the MFIs and indeed all other stakeholders such as the government and regulating agencies, investors, lenders and industry associations, will have to deliberate and adopt a unified vision for corporate governance in the microfinance sector.

Recommendations

In the following paragraphs, the recommendations and next steps are discussed. Some of these recommendations emerged during the discussions with different stakeholders for the study, while others are based on *MicroSave's* experience of working with financial institutions worldwide, as well as based on the CMEF guidelines for corporate governance in MFIs[22].

The recommendations are classified according to the stakeholders who can be made responsible to implement them.

A. Microfinance Institutions

The managing director of a tier-1 MFI aptly describes the role of management/promoters of MFIs as *"Governance is the responsibility of management. It is the management who can ensure that governance is*

[20] Webley S. and A. Werner , Corporate codes of ethics: necessary but not sufficient, 2008
[21] West A, Corporate governance convergence and moral relativism, 2009
[22] The Practice of Corporate Governance in Microfinance Institutions, Council of Microfinance Equity Fund, Consensus Statement, 2005

world-class, and not the board members. They discuss only what is presented to them. Hence, transparency and full disclosure of information and institutionalising governance in all functions of the company is the key to good governance."

This in essence describes the paradigm shift that MFIs need to undergo with respect to corporate governance, which has to evolve beyond compliance to instilling the same across each MFI in both letter and spirit.

The following are some of the recommendations for the management and promoters of MFIs.

1. Institutionalise Governance

i. *Establish responsibility and accountability structures.*
In order to establish clarity of roles and responsibilities between the board and management, the MFI should document a clear terms of reference for its board members. It should delineate the roles and responsibilities of the board members vis-à-vis the management, which will help build accountability and responsibility structures within the institution, including subsidiaries (if any), related group entities, regional state/offices, branches and so on[23].

ii. *Adopt Code of Conduct for board members.*
The first step to achieving this is by drafting and adopting a Code of Conduct for board members, preferably in line with the requirements under the SEBI Act. This includes Code of Business Ethics, Code of Conflict of Interest (for employees, management and independent directors) and Code of Conduct for Prevention of Insider Trading. However, the code will not be applicable to non-listed MFIs; however, in preparedness of going public, it will be a good practice to start with the Code of Conduct in a limited manner.

2. Ensure Transparency and Disclosure of Information

i. *Keep board members informed by sharing periodic status reports.*
The management should ensure that they share with the board monthly or at least quarterly reports on operational and financial performance. The regular sharing of reports with the board would not only keep them engaged and informed but also provide them with an avenue to offer timely feedback to the management, who should ensure that all reports are shared well in advance, are accurate and presented in a format that facilitates quick reading by board members.

[23] Arunachalam R. S., How to make the boards of large NBFC-MFIs implement corporate governance norms in practice? Part 1, published in Moneylife accessed on Oct 4, 2014

ii. *Ensure greater engagement of the board with the MFI.*
The management should aim to provide access to board members to review operations and meet members of the management team from time to time. Management should ensure that board members with specific skill sets interact with the team managing that function within the MFI. Board members should also be given the opportunity to visit branches, interact with staff and clients and participate in field-level activities.

iii. *Disclose remuneration of directors and top management in Board's report.*
As per Section 197(12) of the Companies Act (2013), "Every listed company shall disclose in the board's report, the ratio of each director to the median employee's remuneration and such other details as may be prescribed". This is one of the best practices that MFIs can adopt. Most of the mainstream corporate companies that have got high CRISIL ratings for corporate governance, such ITC and Tata Steel, disclose in their annual reports the commissions and sitting fee paid to board members for both board meetings and committee meetings. These companies have also disclosed the entitlement of executive directors in the annual report.

3. Establish Clear Board Structures

i. *Aim to achieve optimal board size and diversity of gender and skills.*
CMEF guidelines suggest seven to nine members as a common and ideal board size. Fewer than seven is not generally advisable, as the quorum becomes very small, especially if management is on the board. The MFI should aim to ensure gender diversity as well as diversity of skills including financial, legal, risk management and social impact.

ii. *Diversify shareholding structure.*
The MFI should aim in the long run to have a diversified shareholding structure, with no investor holding more than a specific percentage of paid-up capital.

iii. *Prescribe norms for board seats.*
The MFI should have a prescribed cut-off limit in terms of shareholding that would restrict the investors from occupying a board seat. The MFI should also have a norm (such as voting rights and participation in sub-committees) for investors who want to occupy more than one board seat.

iv. *Formalise structure of sub-committees.*
The terms of reference and KPIs for both the board members and the sub-committees should be defined and provided to them at the time of induction/composition of the sub-committee. Sub-committees should be headed by independent directors possessing relevant skills.

v. *Ensure independence of directors.*
The independent directors should be independent in the true sense and should not just be friends or colleagues of the CEO/management. The Nomination and Remunerations Committee should ensure that independent directors being recommended for appointment on the boards are in no way related or connected with the CEO or senior management. Having independent directors who have some prior acquaintance or relationship with the top management is seen to influence decision-making at the board level.

4. Establish Robust Board Procedures

i. *Formalise appointment procedure of directors.*
The responsibility for selection and appointment of directors should be entrusted to the Nominations and Remunerations Committee, headed by an independent director. The MFIs should scout for prospective board members matching their requirement with the appropriate skill sets and make efforts to ensure that every director has the ability to understand basic financial statements and related documents/papers. The Nominations and Remunerations Committee should ensure adherence to 'fit and proper' criteria for directors of NBFCs as issued by the Reserve Bank of India[24] as well as those issued by the Securities and Exchange Board of India[25]. According to RBI guidelines, independent/non-executive directors nominated to the board of NBFCs should be between 35-70 years of age.

ii. *Design and deliver orientation/induction programmes for newly appointed board members.*
The MFI should have a formal, laid-down system for induction/orientation of board members post their appointment. The orientation should include interaction of the inductee with the board, management team and heads of departments as well as visiting the branches to familiarise them with MFI operations.

[24] Revised Regulatory Framework for NBFCs, November 2014
[25] Securities and Exchange Board of India (Criteria for Fit and Proper Person) Regulations, 2004

iii. *Ensure that the board members are remunerated commensurate to the time they devote for board functions.*

The Consultative Paper of Review of Corporate Governance published by the SEBI observes, "There is need to bring in risk-return parity to the post of independent directors to attract quality people into the board. Since most of the responsibilities for governance are placed on the independent directors, to attract competent persons to the board (to improve their participation in the board and committee meetings), it is reasonable to provide for adequate monetary compensation. On one hand, the quantum of compensation should not affect their independence and at the same time, it should attract competent persons to occupy the position on the board"[26].

CMEF guidelines also suggest that the MFI should adequately compensate board members for the time they spend at board and committee meetings. With the enactments of the Companies Act (2013), board members are required to take on greater responsibilities and be accountable for the acts of the company. This requires them to devote more time to monitoring the affairs and guiding the company from time to time. A compensation level that is commensurate with the roles and responsibilities of the board members would incentivise them in this regard. The remuneration should be commensurate with what the senior-level professionals would earn for spending similar amounts of time.

"Good corporate governance and performance are not mutually exclusive; a performance-linked variable remuneration system can make a significant difference."

– Adi Godrej, Chairperson, CII, National Council on Corporate Governance and Regulatory Framework

iv. *Categorise agenda items to ensure the best utilisation of board members' time.*

While sharing the agenda for board meetings, management should ensure that the agenda items are categorised as items for information only, items that are for the board to discuss and reach decisions, and items that just need the approval of the board. This will help to get the best out of the board's limited time and prioritise the discussions in keeping within that time. The management should ensure that the agenda is shared well in advance to allow enough time for board members to read the documents and prepare for the meeting.

v. *Ensure board-meeting minutes are prepared in detail.*

The MFI should ensure that the minutes of meetings are prepared in detail, including the recording of dissenting opinions.

vi. *Facilitate capacity building of board members.*

The MFI should also organise, as far as possible, capacity building/sensitisation programmes/workshops for its board

[26] Consultative Paper on Review of Corporate Governance Norms in India, Securities and Exchange Board of India

members on both strategic and operational matters. This will ensure greater input from the board on key issues. OECD recommends that efforts by private-sector institutes, organisations and associations to train directors should be encouraged. Such training should focus on both discharge of fiduciary duties and value-enhancing board activities. International technical-assistance organizations should facilitate these efforts as appropriate.

Regular talks on emerging issues such as financial sector developments, microfinance innovations, legal and regulatory issues as well as good governance may be organised for the board members. One of the best practices is to make disclosure about the trainings imparted to independent directors.

vii. *Develop and implement a system to conduct periodic evaluation of the board*.

As also prescribed by the Companies Act (2013), the MFI should develop a system to conduct assessment of board members at regular intervals. Such an assessment should preferably be done by an external agency. However, if the MFI has clearly documented KPIs for board members, then self-evaluation against such KPIs can also be conducted and peer review of the board members can also be considered. The focus during evaluation should be to identify gaps and areas of weakness and make plans to address such weaknesses. Some other board evaluation tools that can be adopted for individual assessment of directors, as well as the overall board, include Incofin[27] board evaluation tool and Promifin[28] assessment tool.

B. Board of Directors

The board of directors also has a collective responsibility to ensure sound corporate governance.

The following are some of the recommended practices that boards can adopt to foster good governance.

1. Separate the Functions of the Chairperson of the Board from that of the CEO

The board should, as far as possible, ensure that its chairperson is an independent director and definitely not the CEO/MD. This will help set up necessary checks and balances to avoid dominance of the management's position during board discussions[29].

[27] Incofin IM Social Performance Report
[28] Evaluation and Development of Good Governance in Microfinance Institutions, Massimo Vita and Juan Vega Gonzales, 2011
[29] Arunachalam R. S., Corporate Governance: What boards of large NBFC-MFIs can do on the ground? Part 2, published in Moneylife accessed on Oct 4, 2014

2. **Prepare and Update Succession Plan of CEO and other Senior Management Team Members**
   The board of directors should always have an updated succession plan for the CEO and all other key persons in the company.

3. **Develop Policy on Conflict of Interest**
   As stated in the CMEF guidelines, MFIs should ensure that the board members, their family members and relatives, and businesses in which they have a stake do not borrow from the institutions they oversee. The board members should disclose all known conflicts and should withdraw from decision making on matters in which they are conflicted.

4. **Chairperson Should Aim to Achieve Decision Making Through Consensus**
   The person of the board should aim at consensus building for arriving at decisions, which can then be ratified by board members voting.

5. **Increase Engagement with the MFI**
   The board members should aim to increase their engagement with the MFI and not restrict their interaction to just one or two members of the management at the time of board meeting only. They should visit branches to meet staff and clients, preferably without the assistance of the senior management team.

6. **Provide Feedback on the Reports Shared by the Management from Time to Time**
   The board members should find time to review the operational and financial reports shared by the management and provide feedback, raising any issues and concerns. This will ensure sound oversight and will also help management to understand the concerns of the board in between the board meetings.

7. **Remain Accessible to the Management**
   MFIs very often like to interact with board members through electronic media to inform them about developments or seek opinion on issues. Thus it is imperative that the board members remain accessible to management as and when they need guidance. This need is more pronounced in the small- and medium-sized MFIs that require guidance and technical inputs on a variety of subjects.

8. **Stress the Importance of Compliance**
   The board of directors should seek the latest compliance status of the MFI on all legal, financial and statutory matters. The report should be presented in a simplified format for the understanding of the board members. It is a good practice to have the concerned team members/department heads make presentations to the board on such matters and respond to their queries.

9. Ensure Adoption of Services of Credit Bureaux

The board should ensure that the MFI obtains membership of credit bureau and provide client data to the bureaux at the prescribed frequency. The MFI should mandatorily include credit bureaux check as part of its loan-appraisal process. The board should seek status reports on the client data shared by the MFI as well as summary reports on the credit reference checks made with the credit bureaux including number of loan applications checked, number of records hit, number of overlaps, number of records not found, and number of loan applications approved. These reports would not only provide insights on the extent of indebtedness in the operational areas of MFIs but would also help them to expand to less concentrated areas.

C. Investor and Lenders

While investing in an MFI, investors and lenders should conduct due diligence on the corporate governance practices of the institution. As governance remains a key risk for microfinance, it is prudent for investors and lenders to ask that MFIs adopt good governance practices.

The following are the recommended practices for investors and lenders to adopt:

1. **Demand for Code of Conduct and Corporate Governance Guidelines for Investment**

   The investors and lenders should seek from the MFI the Code of Conduct and corporate governance guidelines as part of the due diligence process.

2. **Place a Cap on the Maximum Number of Directorships for their Nominees**

   The investors and lenders who nominate individuals to the board of MFIs should ensure that no individual sits on the boards of more than three MFIs. This will ensure that the nominee gets enough time to devote to the affairs of their MFI and is able to provide the requisite quality of guidance and insights to the investee institutions.

3. **Build Capacity of Nominees and Evaluate their Performance**

   The investor and lenders should take steps to build capacity of the nominee directors they nominate. The investors should also evaluate the performance of their nominees by taking independent feedback from CEO and/or other board members.

D. Industry Associations

The industry associations and self-regulatory organisations have an important role in promoting adoption of good governance practices.

The following are some of the recommendations for industry association and self-regulatory organisations:

1. **Draft Industry-wide Corporate Governance Guidelines**
   The industry association can draft a generic corporate governance guideline for adoption by all MFIs, especially NBFC-MFIs. This should mandatorily be in line with the Companies Act (2013) and preferably aligned to the requirements of the SEBI Act as well. Internationally accepted good governance practices can be included.

2. **Maintain a Database of Independent Directors**
   To support MFIs looking to appoint independent directors on their boards, industry associations should maintain a database of individuals who are willing to serve as board members. The database should contain details of the skill sets, qualification, expertise and experience of the prospective candidates, details of the boards they currently serve on and their contact details.

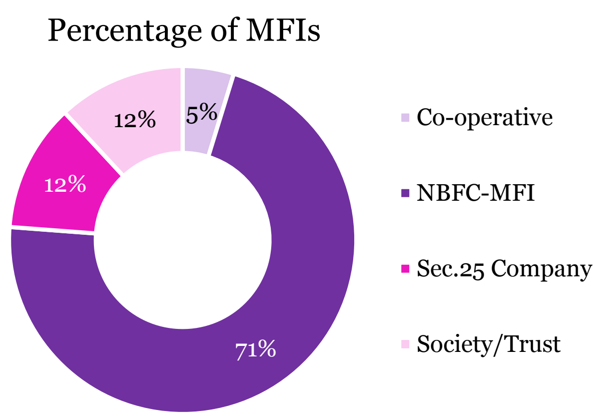
3. **Conduct Sensitisation Programme for Directors**
   The industry associations can plan and conduct programmes to sensitise directors on issues such as statutory compliance, rights and duties of directors in the light of the Companies Act, 2013, and or other local and global developments/best practices that can help the directors perform their roles more effectively.

Annexure

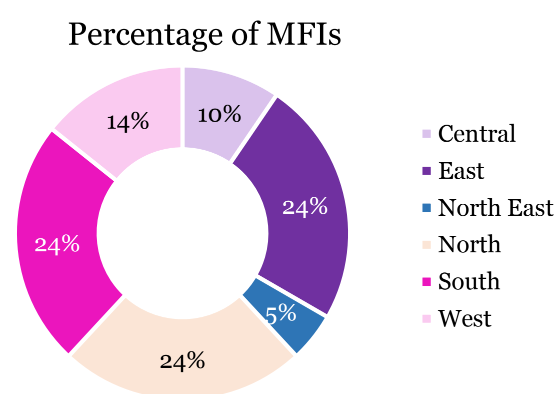
1. Distribution of Sample for the Study
2. List of MFIs Participated in the Study
3. List of MFIs Visited for Primary Research
4. List of Board Members and Industry Experts Interviewed
5. About Analysis Tool
6. Relevant Sections of Companies Act (2013)
7. Corporate Governance Guidelines, RBI

1. Distribution of Sample for the Study

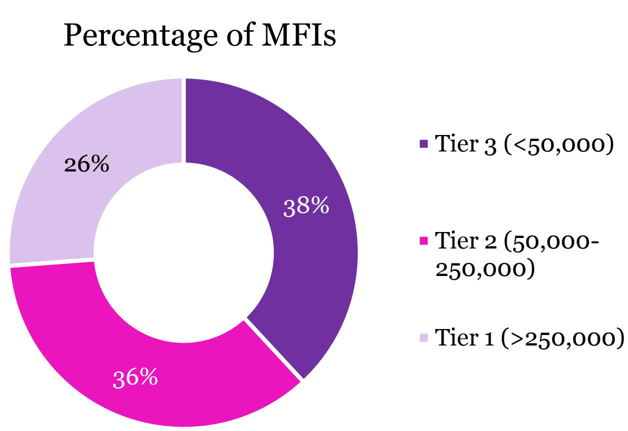
Distribution by Legal Entity



Distribution by Location of Headquarters



Distribution by Outreach



*The numbers in the bracket refer to number of clients: i.e. tier-3 MFIs are those that have less than 50,000 clients and so on.

2. List of MFIs Participated in the Study

1. Adhikar Microfinance Pvt. Ltd.
2. Annapurna Microfinance Pvt. Ltd.
3. Annapurna Mahila Credit Cooperative Society
4. Arohan Financial Service Pvt. Ltd
5. ASA India
6. Asirvad Microfinance Pvt. Ltd.
7. Bhartiya Micro Credit
8. BWDA Finance Ltd.
9. Cashpor Micro Credit
10. Chanura Microfin Manipur
11. Disha India Micro Credit
12. Equitas Micro Finance Pvt. Ltd.
13. Fusion Microfinance Pvt. Ltd.
14. Grameen Financial Services Pvt. Ltd.
15. G U Financial Services Pvt. Ltd.
16. Gram Vidiyal Microfinance Ltd.
17. Humana People to People India
18. Jagaran Microfin Pvt. Ltd.
19. Janalakshmi Financial Services Pvt. Ltd.
20. Mahashakti Foundation
21. Mahila Chetna Manch
22. Margdarshak Financial Services Ltd.
23. Pahal Financial Services Pvt. Ltd.
24. Prayas Organisation for Sustainable Development
25. RGVN NE Microfinance Ltd.
26. Sahara Utsarg Welfare Society
27. Sahayog Microfinance Ltd.
28. Saija Finance Pvt. Ltd.
29. Sambandh Finserve Pvt. Ltd.
30. Samhita Community Development Services
31. Satin Creditcare Network Ltd.
32. Shakti Mahila Sangh
33. SKS Microfinance Ltd.
34. Sonata Finance Pvt. Ltd.
35. Suryodaya Microfinance Pvt. Ltd.
36. Svasti Microfinance Pvt. Ltd.
37. SV Credit Line Pvt. Ltd
38. Swadhaar FinServe Pvt. Ltd.
39. Ujjivan Financial Services Pvt. Ltd.
40. Utkarsh Microfinance Pvt. Ltd.
41. Uttarayan Financial Services Pvt. Ltd.
42. Virutcham Microfinance Ltd.

3. List of MFIs Visited for Primary Research

1. Annapurna Microfinance Pvt. Ltd.
2. Annapurna Mahila Credit Cooperative Society
3. Arohan Financial Service Pvt. Ltd
4. ASA India
5. BWDA Finance Ltd.
6. Cashpor Micro Credit
7. Chanura Microfin Manipur
8. Equitas Micro Finance Pvt. Ltd.
9. Fusion Microfinance Pvt. Ltd.
10. Grameen Financial Services Pvt. Ltd.
11. Gram Vidiyal Microfinance Ltd.
12. Janalakshmi Financial Services Pvt. Ltd.
13. Margdarshak Financial Services Ltd.
14. RGVN NE Microfinance Ltd.
15. Sahayog Microfinance Ltd.
16. Saija Finance Pvt. Ltd.
17. Samhita Community Development Services
18. SKS Microfinance Ltd.
19. Sonata Finance Pvt. Ltd.
20. Svasti Microfinance Pvt. Ltd.
21. SVCL
22. Swadhaar FinServe Pvt. Ltd.
23. Ujjivan Financial Services Pvt. Ltd.
24. Utkarsh Microfinance Pvt. Ltd.

4. List of Board Members and Industry Experts Interviewed

1.	Mr Aditya Bhandari	Regional Director	Incofin Investment Management
2.	Mr Alok Misra	Chief Executive Officer	Micro-Credit Ratings International Ltd.
3.	Mr Alok Prasad	Chief Executive Officer	Microfinance Institutions Network
4.	Ms Amita Narain	Independent Director	Grameen Financial Services Pvt. Ltd.
5.	Mr Bhaskar Sen	Independent Director	Arohan Financial Services Pvt. Ltd.
6.	Mr Brij Mohan	Industry Expert	
7.	Mr Carlos E. Castello	Independent Director	Saija Finance Pvt. Ltd.
8.	Ms Chandni Gupta Ohri	Chief Executive Officer	Grameen Foundation India
9.	Mr Manoj Nambiyar	Managing Director	Arohan Financial Service Pvt. Ltd.
10.	Mr N Srinivasan	Industry Expert and Independent Director	Equitas Micro Finance Pvt. Ltd.
11.	Mr P H Ravikumar	Chairperson	SKS Microfinance Ltd.
12.	Mr P K Biswas	Independent Director	Samhita Community Development Services
13.	Mr Rakesh Arora	Independent Director	SV Credit Line Pvt. Ltd.
14.	Ms Sakshi Varma	Operations Officer	International Finance Corporation
15.	Mr Saneesh Singh	Executive Director	Dia Vikas Capital Pvt. Ltd.
16.	Mr Sunil Patel	Independent Director	Ujjivan Financial Services Pvt. Ltd.
17.	Mr Uday Chitale	Independent Director	Janalakshmi Financial Services Pvt. Ltd.
18.	Mr Venkatesh Natarajan	Managing Partner	Lok Capital
19.	Ms Vijaylatha Reddy	Independent Director	Janalakshmi Financial Services Pvt. Ltd.
20.	Mr Vishwanath Prasad	Managing Director	Caspian Impact Investment Adviser Pvt. Ltd.
21.	Mr Y S P Thorat	Independent Director	Sahayog Microfinance Ltd.

5. About Analysis Tool

The analysis framework is built on four key pillars that determine the quality and robustness of corporate governance systems and the ability of the board to drive responsible finance practices in the institutions. These pillars include:

1. Composition and structure of the board;
2. Administration and procedures for board functions;
3. Commitment of members to their roles and responsibilities;
4. Role of the board to ensure adoption and implementation of responsible finance practices.

Each of the above pillars is fragmented into a number of criteria, which form the basis of assessment of MFI standing on each of the four pillars.

The assessment is done using a three-point scale. The scales are 'low', 'acceptable', and 'high' reflecting the level of adoption of the best corporate governance practices. 'Low' refers to governance practices that are below the existing regulatory requirement or industry norm, medium refers to compliance with existing regulations and norms, while high refers to adoption of world-class governance practices that are beyond existing regulatory requirements.

The extract of the Analysis Tool is given below:

S. No.	Criteria	Sub-criteria	Description (Performance Levels)		
			Low	Acceptable	High
1.1	**Board composition and structure**	***Size of the board***	Size of the board does not permit efficient decision-making by the board (the board is either too small or too big)	Size of the board is appropriate for effective consultation and decision-making by the board	Size of the board is appropriate for efficient decision-making and is reviewed at least once a year to ensure that it is aligned with the growth of the organisation
2.1	**Board administration and procedures**	***Selection and appointment***	There is either no transparency or consensus-based process of selection and appointment of board members or the process is ad-hoc	Defined process of selection and appointment of board members followed most of the time	Selection and appointment process of board members is well defined and documented and is followed all the time
3.1	**Commitment to roles and responsibilities**	***Contribution in defining mission, strategy and planning for the MFI***	The board members either do not take much stake/or are highly involved in defining and upholding the mission of the institution, in developing strategic directions and	The board members are actively involved in defining and upholding the mission of the institution, in developing strategic directions and organisational planning. The institution's	Board members are actively involved in defining the mission, strategy and planning of the MFI, and commit to make modifications if and when necessary

S. No.	Criteria	Sub-criteria	Description (Performance Levels)		
			Low	Acceptable	High
			organisational planning	mission, strategy and planning are jointly defined by the board and management.	
4.1	**Governance and responsible finance**	***Compliance to Code of Conduct and Fair Practice Code***	Board rarely discusses the extent of compliance to Code of Conduct and Fair Practice Code during board meetings	Board discusses the extent of compliance to Code of Conduct and Fair Practice Code during board meetings	Board discusses and tracks the extent of compliance to Code of Conduct and Fair Practice Code during board meetings and takes corrective action in case of deviations in compliance

6. Relevant Sections of Companies Act, 2013[30]

Key Requirements	Applicability			Relevant Section(s)
	Public	Private	Listed	
Board of Directors				
Constitute the board of directors	✓	✓	✓	149(1)
At least 1/3rd of the directors on the board to be independent	✓[31]	-	✓	149(4)
Minimum one director who stayed in India for more than 182 days in the previous calendar year	✓	✓	✓	149(3)
One director may be appointed by the small shareholders[32]	-	-	✓	151
At least one director to be a female director	✓	✓	✓	149(1) Rule 11.1
Committees to be constituted by the board				
Board of directors to constitute an audit committee (consisting of minimum three directors with the majority being independent directors)	✓[31]	-	✓	177(1) Rule 12.4
Terms of reference for the audit committee to be specified by board in writing	✓[33]	-	✓	177(4)
Majority members of audit committee (including the chairperson) to be able to read and understand financial statements	✓[33]	-	✓	177(2)
Vigil mechanism to be established and to be operated by the audit committee, where it exists	✓[33]	✓	✓	177(10) Rule 12.5
Board of directors to constitute a Nomination and Remuneration Committee consisting of minimum three non-executive directors of whom more than 50% should be independent	✓[31]	-	✓	178(1) Rule 12.4
Board of directors to constitute a stakeholders relationship committee consisting of a non-executive director as a chairperson and other members as the board may decide	✓[34]	✓	✓	178(5)

[30] The table below is reproduced from "Companies Act 2013: Keeping Pace with Board Governance Evolution", Ernst and Young, 2014
[31] Paid up share capital > INR 100 crores or outstanding loans or borrowings or debentures or deposits > INR 200 crores
[32] Small shareholder = shareholder holding shares of nominal value of not more than INR 20,000
[33] If accepting deposits from public or have borrowed from banks and public financial institutions in excess of INR 50 crores
[34] More than one thousand shareholders, debenture holders, deposit-holders and any other security holders at any time during a financial year

Key Requirements	Applicability			Relevant Section(s)
	Public	Private	Listed	
Requirements for Independent Directors				
Roles, responsibilities and duties	✓[34]	-	✓	Schedule IV
Selection of independent directors	✓[34]	-	✓	Section 150
Qualification of independent directors	✓[34]	-	✓	Rules under Chapter XI
Enhancing Board Effectiveness				
Performance evaluation of the board	✓[34]	✓	✓	Schedule IV
Performance evaluation of the board members – evaluation of non-independent and independent members	✓	✓	✓	Section 178 and Schedule IV
Training of independent directors	✓[34]	✓	✓	Schedule IV
Guidelines on remuneration of board members	✓	✓	✓	Section 178 and 197
Disclosure by the Board				
Disclosures to be made as part of board report (extract of annual return, policy on appointment and remuneration of directors, comments on qualifications, contracts with related parties, formal evaluation of board performance etc.)	✓	✓	✓	134(3) Schedule V Part II Section IV

7. Corporate Governance Guidelines, Reserve Bank of India

Master Circular – Corporate Governance

Circular Number: RBI/2014-15/36 DNBS (PD) CC No. 390/03.10.001/2014-15

Guidelines are for consideration of the board of directors of all deposit-taking NBFCs with deposit size of INR 200 million and above and all non-deposit-taking NBFCs with asset size of INR 1 billion and above (NBFCs-ND-SI).

1. Constitution of Audit Committee
An NBFC having assets of INR 500 million and above as per its last audited balance sheet is required to constitute an audit committee, consisting of not less than three members of its board of directors.

2. Constitution of Nomination Committee
It would be desirable that NBFCs-D* with deposit size of INR 200 million crores and above and NBFCs-ND-SI** may form a nomination committee to ensure 'fit and proper' status of proposed/existing directors.

3. Constitution of Risk-management Committee
To manage the integrated risk, a risk-management committee may be formed, in addition to the ALCO in case of the above category of NBFCs.

4. Disclosure and Transparency
The following information should be put up by the NBFC to the board of directors at regular intervals as may be prescribed by the board in this regard:

- Progress made in putting in place a progressive risk-management system, and risk-management policy and strategy followed.
- Conformity with corporate governance standards vis-à-vis; in composition of various committees, their role and functions, periodicity of the meetings and compliance with coverage and review functions, etc.

5. Connected Lending
Applicability of the paragraph 2(vi) of the circular dated May 8, 2007 containing instructions on connected lending was kept in abeyance until a review as advised vide DNBS.PD/CC.104/03.10.042/2007-08 dated July 11, 2007.

6. NBFCs shall frame their internal guidelines on corporate governance, enhancing the scope of the guidelines without sacrificing the spirit underlying the above guidelines and it shall be published on the company's website, if any, for the information of various stakeholders.

* NBFC-D: Deposit taking NBFCs
**NBFC-ND-SI: Systemically Important Non-Deposit Taking NBFCs

Notes

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