Corporate Governance for Financial Inclusion

Insights for Boards of Microfinance Institutions: Managing Current Issues, Crisis and Change

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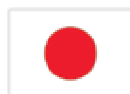
and Development



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Acronyms

ADC	Alternative Delivery Channels
ALCO	Asset-Liability Committee
AML	Anti-Money Laundering
BTCA	Better Than Cash Alliance
CEO	Chief Executive Officer
CFPA	China Foundation for Poverty Action
CGAP	Consultative Group to Assist the Poor
CFI	Center for Financial Inclusion
CSFI	Center for the Study of Financial Innovation
DFS	Digital Financial Services
ECA	Europe and Central Asia
FMO	Dutch Development Bank
FX	Foreign Exchange
GPFI	Global Partnership for Financial Inclusion
G20	Governments and Central Bank Governors from 20 Major Economies
G20 HLPs	G20 High Level Principles for Digital Financial Inclusion
GSMA	Groupe Spéciale Mobile Association
HLP	High Level Principles
IPO	Initial Public Offering
IT	Information Technology
KPI	Key Performance Indicators
KYC	Know Your Customer
IFC	International Finance Corporation
MCF	MasterCard Foundation
MFI	Microfinance Institution
MFX	MFX Currency Risk Solutions
MIS	Management Information System
MNO	Mobile Network Operator
NBFC	Non-banking Financial Company
NBFI	Non-Bank Financial Institution
NGO	Non-governmental Organization
NPLs	Non-Performing Loans
NRA	New Risk Approval
OCP	Open Currency Position
OeEB	Development Bank of Austria
P2P	Peer-to-Peer
PAR	Portfolio at Risk
PAR30	Portfolio at Risk Over 30 Days
PAR9O	Portfolio at Risk Over 90 Days
POS	Point-of-Sale
RFF	Responsible Finance Forum
SME	Small and Medium Enterprises
SPTF	Social Performance Task Force
TCX	The Currency Exchange Fund in Microfinance

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Foreword

"The last 20 years have seen a dynamic maturation of the microfinance sector: from its early stages in small-scale microenterprise lending, through its commercial expansion to offer savings and a broad array of financial services to low-income customers, to its entry into new markets, microfinance ensured that households have access to a range of high quality and affordable financial products and services" (IFC 2015).

Providing Universal Financial Access and Inclusion is at the core of IFC's Financial Institutions Group mission. We are working with over 800 partners globally so that individuals in all market segments have access to a full menu of financial products and services. As one of the leading global investors in microfinance, IFC has committed over US $6 billion to approximately 300 institutions. For more than two decades, we have assisted the industry in becoming commercially viable and sustainable—by working with our partners to strengthen governance, risk management and responsible finance practices.

Our partners have also moved into the digital finance space to reduce costs and diversify their product offerings since 2007. As of June 2017, IFC had invested nearly US $500 million into 40 companies and has 50 active projects offering advisory services in companies adapting to or expanding digital services. IFC's goal in this space is to increase the reach and breadth of financial services to the world's two billion adults who remain unbanked and underserved.

Notwithstanding the opportunities for scaling financial inclusion, unforeseen risks in digital finance have also emerged. Such risks include those introduced by new forms of competition from alternative credit scoring models or big data analytics. In certain countries, these risks are blurring the lines among traditional financial service providers, while in other less developed markets, fundamental credit, operational, liquidity and macroeconomic risks persist. In this context, the report, *Corporate Governance for Financial Inclusion -- Insights for Boards of Microfinance Institutions: Managing Current Issues, Crisis and Change*, was developed to gain a deeper understanding of a myriad of risks, challenges and opportunities facing the financial inclusion industry.

Today, the role of Board Directors in banks and microfinance institutions remain essential, if not more so. To effectively guide their institutions, many will need to deepen their core

Box 1 |

G20 High Level Principles for Digital Financial Inclusion

Principle 1: Promote a Digital Approach to Financial Inclusion.

Principle 2: Balance Innovation and Risk to Achieve Digital Financial Inclusion.

Principle 3: Provide an Enabling and Proportionate Legal and Regulatory Framework for Digital Financial Inclusion.

Principle 4: Expand the Digital Financial Services Infrastructure Ecosystem.

Principle 5: Establish Responsible Digital Financial Practices to Protect Consumers.

Principle 6: Strengthen Digital Financial Literacy and Awareness.

Principle 7: Facilitate Customer Identification for Digital Financial Services.

Principle 8: Track Digital Financial Inclusion Progress.

traditional tools[1] and introduce new ones to achieve sustainable growth. This report culls from selected case studies through interviews and first-hand experiences of IFC board directors who have exercised their role both as individuals and as a collective group. Their stories and personal reflections are woven throughout this report. They provide an illustration of practical steps to be taken, global principles to be adapted locally — or simply to "refresh" one's current approaches to and basic knowledge of some of the essential aspects of corporate governance, risk management and responsible finance.

Going forward, IFC's role as a leading private sector player will remain more critical than before, together with the World Bank, in creating markets and opportunities towards full financial inclusion. This includes private-public sector engagements with global leaders, such as the G20 Global Partnership for Financial Inclusion (GPFI) to help foster digital innovation, promote consumer protection and broader financial market stability.[2] Accordingly, IFC will continue to work with its global partners to operationalize the G20 High Level Principles for Digital Financial Inclusion (Box 1).[3] IFC remains committed to working with its partners in the interest of providing convenient, affordable, and responsible financial services for the unbanked and underserved.

We hope this report will be a "living" resource to spark debate, gain valuable insights and action pragmatic solutions for the broader industry. We hope that it will be helpful in fine-tuning a more strategic outlook for boards serving in institutions that are navigating through a rapidly-changing world —but one that is also filled with new and exciting opportunities on the road to universal financial inclusion.

Martin Holtmann
Manager, Digital Finance and Microfinance

Momina Aijazuddin
Head, Global Microfinance

1. Relevant tools, for example include: IFC's Corporate Governance Framework; IFC's Risk Assessment Framework for banks and microfinance institutions; and IFC's Responsible Finance Assessment Frameworks.

2. Third GPFI/FSI Conference on Standard-Setting Bodies and Innovative Financial Inclusion, Basel, October 26-27, 2016.

See: http://www.gpfi.org/news/global-bodies-advance-dialogue-supervision-digital-finance-third-gpfifsi-conference. See also Economist Intelligence Unit, Global Microscope 2016, The Enabling Environment for Financial Inclusion.

3. G20 High-Level Principles for Digital Financial Inclusion at: https://www.gpfi.org/sites/default/files/G20%20High%20Level%20Principles%20for%20Digital%20Financial%20Inclusion.pdf

"Drawing from actual experiences and case studies, this report helps board members with a mandate to seize opportunities to advance financial inclusion"

Microfinance institutions (MFIs) are exposed to many different types of risks. As MFIs grow and become more complex, their level of risk also increases. Boards have the ultimate responsibility for the level of risk taken by their respective institutions. Regulators, investors, lenders and other stakeholders have increasingly emphasized strengthening corporate governance and risk management of financial services providers. As such, the goal is to guard against risk and to increase the value proposition for customers. Boards with strong corporate governance practices play a vital role in mitigating risks, managing institutional crises, transforming institutions through the adoption of new business models, promoting responsible finance — and ultimately bringing greater value to all stakeholders.[4]

This report stems from interviews of IFC board directors from the IFC's portfolio of partner investees and advisory clients. These interviews occurred against the backdrop of today's evolving global, regional and local contexts, increasing competition, and the rapid pace of innovation in technology, particularly for DFS. In this context, these interviews highlight the need for stronger corporate governance, with particular attention to key areas of board responsibility, namely: risk and crisis management; change management (for example, institutional and digital transformation); and promoting responsible finance. These key areas form the primary focus of this report.

The report gathers and offers many useful observations and practical lessons about corporate governance and financial inclusion from those working on the front lines. It is not meant to be prescriptive in nature. Rather, the purpose of the report is to present viewpoints and draw some preliminary conclusions and lessons about the current state of the industry and practice. In doing so, it draws on evidence of over 20 years of work in the field, as well as the valuable experiences of the interviewees.

This report calls attention to evolving issues to help support board directors faced with the task of navigating through a myriad of opportunities, as well as counterpart risks — present, persistent, and potential risks, as well as unforeseen risks. Key among the risks highlighted in this report are: (1) reputational and operational risks due to fraud, weak agent network management, ineffective customer service and/or poor product uptake; (2) credit risks due to weak approval processes or collection procedures; (3) liquidity risks due to local currency devaluation, combined with related funding constraints; and (4) market risks due to weak or lack of regulations for digital finance and fintech services, or because of fragmented consumer protection and financial education frameworks, among others.

Chapter 1 reviews the board's role in risk governance, identifies key governance issues for MFI Boards, discusses the evolving nature of MFI Boards, and highlights themes from successful boards and reported impacts. Chapter 2 focuses on the board's role in crisis situations, offers insights for improving corporate governance and crisis risk management practices, and provides specific examples from MFIs. Chapter 3 looks at the board's role in change management and, more specifically, strategic transformations; non-

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4. Microfinance Banana Skins – 2012. The Centre for the Study of Financial Innovation (CSFI) surveys microfinance risk, and addresses corporate governance and related topics, such as risk management, which are among the top risks to MFIs. See also CFI 2011, 2012; and IFC 2010.

governmental organization (NGO) transformations to commercial deposit-taking institutions; and digital transformations. Chapter 4 addresses Responsible Finance, and the board's role in calling more attention to new consumer risks related to the provision of DFS. Suggested reading is provided at the end of each Chapter. The Annexes contain practical tools to support the strengthening of corporate governance, risk management and responsible finance practices. Drawing from actual experience and case studies, this report helps board members with a mandate to seize opportunities to advance financial inclusion to the benefit of their current and future customers.

CHAPTER 1

Risk Governance in Microfinance Institutions

"There is no real endpoint to good corporate governance: as market conditions change, as new financial instruments are created, and as technology enables ever-evolving ways of doing business, there will be an ongoing need to adapt, to keep pace." (IFC 2011)

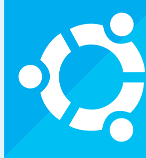
1. Role of the Board

Globally, MFIs are facing numerous challenges and opportunities brought about by changing market conditions, increasing competition, and the advent of new technologies. In many cases, these are altering the way MFIs do business and interact with their customers in fundamental ways. The role of the board in ensuring that the institution adapts and keeps pace cannot be overstated.

The Supervisory Board, or Board of Directors, is a key decision-making body in an institution's hierarchy.[5] In all its activities, the board provides management oversight. At the same time, it does not interfere in day-to-day operations. Each board director has a fiduciary responsibility, a duty of care, an obligation to protect the assets, and to provide institutional continuity, thereby ensuring the institution's long-term sustainability.

Good corporate governance and the role of boards are relatively well defined and documented (CSFI/CFI 2016, CSFI/PwC 2015, Higgs Review 2003; IFC 2003; IFC 2014). Box 2 provides a standard definition of corporate governance, as well as a list of key responsibilities of MFI boards. Based on the interviews with IFC board directors, however, there continues to be a real need for boards to revisit these concepts and remind themselves that such reflection should be an ongoing part of the governance process. This is especially true considering today's evolving and sometimes volatile microfinance landscape. To bring effective change to their institutions, boards may wish to examine and determine their own willingness and ability to change. Section 3 of this chapter concerns the evolving nature of boards and the

5. An assembly of shareholders or members may be held to give fundamental direction regarding material aspects of the institution. However, this happens only annually and for extraordinary reasons. In practice, the board is in charge of the vast majority of all kinds of financial institutions.



Box 2 | What is Corporate Governance?

Corporate governance involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders.

Corporate governance also provides the structure by which the objectives of the company are set, as well as the means of attaining those objectives and monitoring performance.

What is the Board's Role in Microfinance Institutions?

- Constructively contribute to and challenge management's strategy and monitor goals.
- Oversee planning and management performance.
- Ensure adequate human and financial resources to achieve the MFI's mission.
- Appoint the Chief Executive Officer (CEO) and ensure an appropriate succession plan.
- Ensure an appropriate risk management culture and framework.
- Ensure that the institution changes to meet emerging conditions.
- Define and champion the social mission and purpose of the MFI.
- Represent the MFI publicly.

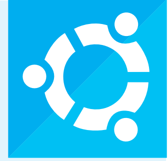
Source: CMEF (2012); IFC (2014).

need for them to continually adapt and change. It also addresses themes from board success stories, as well as reported impacts.

Given the many risks and opportunities currently facing MFIs, it is important to highlight the following roles and responsibilities of boards:

- **Strategic Guidance:** boards constructively contribute to and challenge management's strategy and monitor results. One of the major risks facing MFIs is the risk that they will not be able to develop business models or innovative partnerships which will enable them to remain relevant and compete in a changing marketplace. Too often MFIs are reactive rather than proactive when confronted with a changing environment. It is the role of the Board to ensure that MFI business strategies remain relevant, and that the mission and goals of the institution are achieved.
- **Risk Management:** boards ensure that appropriate controls and risk management systems are effective, and that financial and operational information is comprehensive, timely, and accurate. This is another major risk facing MFIs, namely, the risk that the institution will fail to identify and manage business risks. In this context, the board needs to play a vital role in developing comprehensive risk management systems that identify and manage all business risks.
- **Change Management:** boards ensure that the institution changes to meet emerging conditions. Yet another key risk facing MFIs is the risk that it will fail to keep up with the pace and scale of change, as well as any attendant business impacts. Boards need to ensure that MFI management is effective in bringing about change in their institutions. They also need to ensure that their institutions can react quickly to both changing market environments and unexpected shocks whether internal (management, financial, operational, and so on) or external (macroeconomic, political, environmental, technological, and so on).
- **Human Resources:** boards ensure adequate human capital to achieve the mission, including appointing and replacing the Chief Executive Officer (CEO) as need be, and providing for an appropriate succession plan for the CEO and key senior management members. Boards may find themselves in disagreement or unwilling to make the necessary changes to personnel who may have had the necessary skills in the past, but who lack the skills and leadership necessary to lead the institution in the future. It is ultimately the board's responsibility to ensure that the institution has the right skills, capacity and resources to effect cultural change, establish risk controls, and deepen customer relationships to achieve resilient growth.
- **Responsible Finance:** boards adopt policies that ensure management implements procedures and practices that deliver transparent, inclusive, and customer-centric products and services. This includes protecting customers from risks, such as over-indebtedness or lack of financial awareness, as well as maintaining customer trust. Therefore, an institution's resiliency can be assured as it grows. Such responsible finance policies, procedures and practices are embedded in the risk management framework of the institution.

Section 2 addresses some of the key risks facing MFIs today, as well as the role of boards in addressing these risks. Some potential difficulties for boards are raised in Box 3. Further guidance and tools for boards can be found in the annexes. The suggested reading at the end of each chapter also provides further resources on corporate governance and the role and functioning of boards.



Box 3 | Impediments to Effective Boards

The following are indicators that the board may not be able to properly fulfill its role:

- The majority of board members are related or close friends with the executive management of the MFI or the group, that is, they are not independent. This can be a sign of (intentional) weakening of the board, leading to ineffective control of management.
- The board does not receive reports well in advance, or reports lack important information about the business and risk situation of the MFI. The reason for this may be that the board has not defined its reporting needs sufficiently, or that the MFI management is unable or unwilling to fulfill standard reporting requirements.
- The frequency of board meetings. Infrequent meetings may indicate issues related to the board's tasks and responsibilities. A meeting frequency below once a quarter makes it hard to execute the board's responsibilities. Board meetings occurring more often than once a month are a signal of board capture. Higher meeting frequencies would only be appropriate during times of crisis.
- In the interim, that is between quarterly in-person meetings, management may in consultation with the Board Chair call telephonic meetings to discuss important issues as they arise. Usually telephonic meetings are best if focused on a specific issue, rather than a wide range of issues.
- There are no board committees. The resulting lack of subdivision of board work among members reduces the effectiveness of the board.
- The agenda of board meetings changes with every meeting. A standing agenda is best in ensuring that all topics of importance to the board are considered — at least to confirm the situation is as it should be.
- Board meetings are unusually short or lack substantial discussion. This is a sign of a low level of engagement on the part of board members.
- The board discusses business details during its meetings. Business execution is the responsibility of management, and the board is responsible for strategic direction. This indication of "micro-management" by the board may have to do with a lack of trust in management capacities, or it may simply be a lack of clarity about the distinctive responsibilities/roles of board and management.
- There is no evaluation of the board's work.
- The board executes no direct contact with external auditors, internal audit or risk management staff. It relies only on information provided by management. This is a sign of lack of engagement or inappropriate reliance on management — without exercising the requisite independent controls.
- Board members are partially engaged. They do not attend meetings in their entirety; they do not read reports; and/or they do not challenge management during board meetings. Board meetings will be ineffective because members are not interested, or lack the capacity to fulfill their role. Underperforming board members ought to be challenged by the Chairperson and, if necessary, replaced.
- The Board Chairperson is the same person as the CEO, or one of them is strongly dominated by the other. This is a clear sign of lack of independence at the board level, which may severely compromise the quality of the board's work.

Source: CMEF 2012; Higgs Review 2003; IFC 2003; IFC 2014.

2. Key MFI Governance Issues

Among the greatest risks facing MFIs working in the financial inclusion space today is the lack of institutional capacity to develop and implement a viable strategic plan. Such a plan can serve as a guide for institutions undergoing rapid change, unpredictable or endemic crises, product diversification and market expansion, or business transformation.

Although some MFIs have successfully implemented strategies in earlier years (see Case 1), a 2016 survey (CSFI/CFI 2016, 7-9; CSFI/PwC 2015, 5-8) of the industry identified Strategy as the number one risk facing MFIs, followed by Risk Management and Change Management.

As shown in Box 4, according to the survey, the top ten risks for advancing financial inclusion are predominantly internal, and therefore within the control of the MFI. In addition, for regulated banks the risks are predominantly external, stemming from: global crises, regulation, cybersecurity, technology risk, and political interference. Accordingly, in addition to Strategy, Risk Management and Change Management risks, the following key risks and related governance issues are the focus of this report:

External Risks

Political/ Regulatory Risk - Interest Rate Ceilings

Caps on interest rates are increasingly put into place by regulators, often under the premise that poor people should not have to pay more for their loans. However, if ceilings are set too low, financial service providers may find it difficult to recover costs. As such, they are likely to grow more slowly, and/or reduce service delivery in rural areas and other costly markets. In addition, they become less transparent about total loan costs, or even exit the market entirely. Institutions with the lowest overhead are best suited to survive this interest rate cap. In this context, boards ought to strategize to improve operational efficiency in their institutions to safeguard against this regulatory risk. This issue is explored further in Chapter 2.

Macroeconomic Risks – Commodity Prices Leading to Foreign Exchange Risk

Many microfinance institutions are borrowing from international debt funds in dollars or euros at relatively high costs. They bear the attendant foreign exchange risk in event of a devaluation of their local (national) currency. For example, Nigeria's economy went into a recession in 2016 following a decline in oil receipts. The oil-based, import-dependent economy has since faced a severe scarcity of foreign exchange, and microfinance institutions have had to adapt accordingly. Case 2 examines how the board of a MFI in Nigeria worked to strategize and mitigate against this risk.

Box 4 |

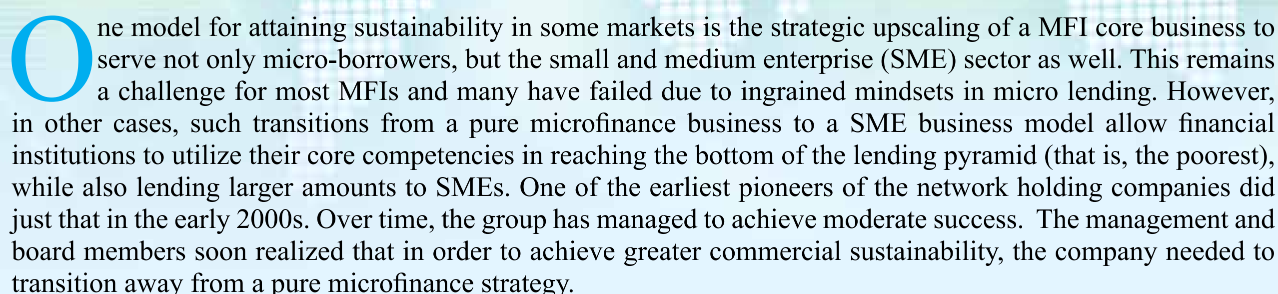
Top Ten Risks for Microfinance Institutions

- Strategy
- Risk Management
- Change Management
- Technology
- Repayment Capacity
- Macroeconomic Risk
- Product Risk
- Credit Risk
- Governance
- Management

Top Ten Risks for Banking Institutions

- Macroeconomic Risks
- Criminality
- Regulation
- Technology Risk
- Political Interference
- Risk Management
- Credit Risk
- Conduct Practices
- Risk Pricing
- Business Model

Source: CSFI (2016).



CASE 1

An Early Pioneer Makes a Strategic Shift

One model for attaining sustainability in some markets is the strategic upscaling of a MFI core business to serve not only micro-borrowers, but the small and medium enterprise (SME) sector as well. This remains a challenge for most MFIs and many have failed due to ingrained mindsets in micro lending. However, in other cases, such transitions from a pure microfinance business to a SME business model allow financial institutions to utilize their core competencies in reaching the bottom of the lending pyramid (that is, the poorest), while also lending larger amounts to SMEs. One of the earliest pioneers of the network holding companies did just that in the early 2000s. Over time, the group has managed to achieve moderate success. The management and board members soon realized that in order to achieve greater commercial sustainability, the company needed to transition away from a pure microfinance strategy.

Guided by the board, the company began to transition its business strategy in 2008, scaling up its operations to serve SMEs in Africa, Europe and Central Asia (ECA), and Latin America and the Caribbean. This shift ultimately revolutionized the business, eventually focusing on markets with stronger SME demand and shifting its average loan size from under US$2,000 to well over US$50,000. Since strategically repositioning the company within the SME market, it has consistently achieved robust returns — including during the recent macroeconomic downturn in the markets and regions in which they operate. The lessons that previous board members learned from this time of transition have continued to inform the actions of new board members. They have guided the company successfully, despite increasing external risks and uncertainties, particularly in the ECA region. Some of the lessons learned include the following:

Understand What Makes the Company Tick

The key to guiding a company through a transition is a holistic understanding of how the group operates on the ground. Therefore, board members need to make it a priority to visit local banks and interact with local board members to understand how the business is run on a day-to-day basis. It is also helpful for them to experience the risks that each subsidiary faces, and meet the people that the company both employs and serves. If holding company board members were only to attend board meetings, they would be too removed from the daily decisions that keep the company running. As such, they would be unable to effectively evaluate the company's direction and set its policy. Without such knowledge, it is impossible for board members to fulfill their role in evaluating the strategic decisions of the company.

Guide the Company to Emphasize its Strategic Advantages

In times of transition, it is essential for board members to use their understanding of the group's core business to develop the areas in which it possesses strategic advantages. Working closely with management, board members can strategically analyze and evaluate where the company currently stands, as well as where it should be in the future. For example, when profits declined in certain regions (partially due to sharp increases in alternative funding sources), it became clear that the focus should be on core strengths in the European and Latin American markets. Although such decisions are never lightly taken, recognizing the strategic value of shedding the areas where the company is not particularly strong is key to freeing up resources to build the areas of comparative advantage or excellence. By exiting market segments and regions that do not offer a critical mass of consumers, the company was able to transform the group from one that had a sprawling network of inefficient branches to one that had a strategic focus and slimmed-down operations. It will often fall to the board to recognize the areas of relative strengths and weaknesses. In this regard, the board needs to have the foresight to rethink its core business strategies that will guide the company toward a more successful future.

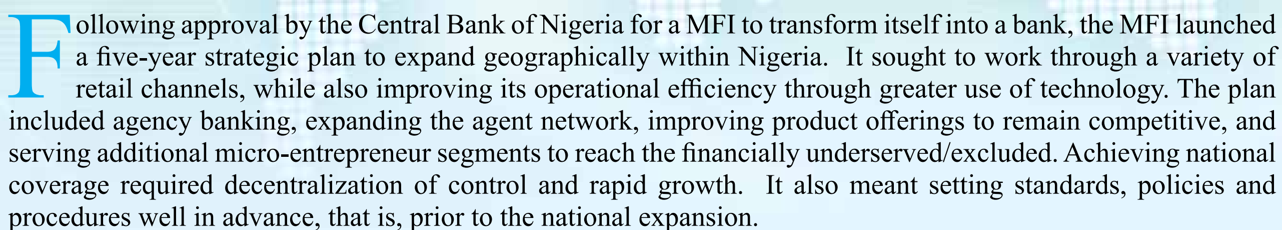
Address Risks by Developing the Company's Staff

The board has repeatedly come to recognize that the people the company employs are its greatest asset. However, one of the most significant ongoing risks that the holding company faced has been staff development. Particularly in times of transition, it is essential that staff possess the proper skill sets to grow those areas of the business that offer strategic advantages. In response to this risk, the structural advantages of the network holding model were utilized to disseminate knowledge to subsidiaries by instituting an in-house training program for young SME bankers to prepare them for the field. Even so, when operating across various regions and markets, it is inevitable that over time certain branches may excel relative to other branches. Therefore, another important role for the board was to establish an active "foreign exchange program" between subsidiary banks. For example, some of the managers from the strongest banks operating in Europe are now being placed on local boards in their Latin American counterparts. In this manner, they can directly share knowledge and best practices with their fellow managers.

Source: IFC Board Interviews.

CASE 2

Strategy for Growth and Mitigating Risks in Nigeria



Following approval by the Central Bank of Nigeria for a MFI to transform itself into a bank, the MFI launched a five-year strategic plan to expand geographically within Nigeria. It sought to work through a variety of retail channels, while also improving its operational efficiency through greater use of technology. The plan included agency banking, expanding the agent network, improving product offerings to remain competitive, and serving additional micro-entrepreneur segments to reach the financially underserved/excluded. Achieving national coverage required decentralization of control and rapid growth. It also meant setting standards, policies and procedures well in advance, that is, prior to the national expansion.

Over a period of 18 months, the Board's Audit and Compliance Committee collaborated closely with Human Resources to develop new policies and procedures to manage this change and shift in the institution's culture. The process involved: (1) updating the bank's process mapping; (2) reviewing the level of risk related to individual processes; (3) instituting refresher training; (4) developing a sanction matrix; (5) explaining the importance of a zero-infraction policy to branch managers as the owners/protectors of branch quality; and (6) monitoring the institution's infraction by business line and branch, including their development over time. Moreover, with the Board's proactive guidance, management prepared several stress tests and developed a worst case operating scenario to help the institution navigate its growth in the face of macroeconomic risks in the country. This included an assessment of a potential cap on interest rates, as well as the effects of a worsening economic environment from the devaluation of the Naira and attendant decline in commodity prices.

Source: IFC Board Interviews.

Internal Risks

Product-Diversification (and Single Product) Risk

Some microfinance institutions are adding new product lines and moving away from the traditional group-lending working capital loans with short maturities. Many are adding agricultural loans that may carry different maturities, terms, and risks. In addition, others are offering insurance, money transfers, remittances, and mobile banking. Still many of the MFIs that have had success in offering group-lending or agricultural loans have not expanded their business models past their core strengths to offer a fuller menu of financial products. MFI boards need to be able to evaluate the strategic fit, investment requirements, potential returns, and risks of such products. Several of the case studies in this manual will address this topic.

Technology Risks

MFIs face various challenges when it comes to technology. They run the risk of not taking advantage of technological innovations that can improve their business, or they may incur losses due to the mismanagement of technology. MFIs often lack the resources or internal know-how to take advantage of new technology. As a result, they may lose market share to others that can better leverage new technologies. However, MFIs may adopt technology without understanding the benefit to its business or customers, thereby spending a lot of resources with little to show for it. Chapter 3 addresses some of the key risks and challenges in developing a digital strategy.

Client Risks

MFIs face very specific governance issues, such as balancing the social impact to entrepreneurs and consumers with their own financial objectives. Over-lending, high interest rates, and crises have increased the demand for client protection and transparency in the sector. The SMART campaign is one of the best examples of an effort to improve client protection while also raising awareness of social impacts. The boards of MFIs are feeling pressure to more closely oversee the performance of their organization with respect to client protection, pricing transparency, and social impact, as well as more conventional concerns of operating and financial performance.

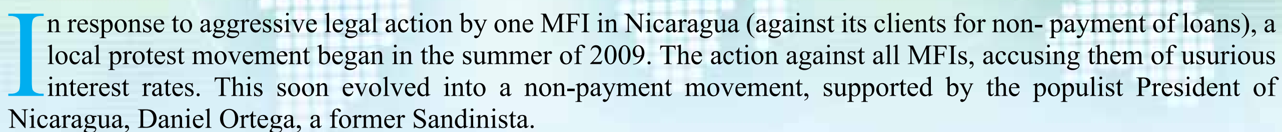
Political and Operational Risk

To provide a wider variety of financial products and defray borrowing costs, many MFIs are transforming into regulated entities and mobilizing deposits. Both institutions and banking supervisors need to understand how best to regulate and safeguard these institutions and their customers through sound governance practices. Financial crises such as non-payment movements in Nicaragua (Case 3) and India (Case 4) suggest that both boards and regulators need to effectively enact policies that prevent overcrowding and over-lending. These crises have damaged the sector's reputation and left some institutions crippled or bankrupted.

Although this list of key risks is not exhaustive, it emphasizes some of the unique governance issues faced by MFIs. Again, most relate to the capacity of the institution to adapt and change. This is further reinforced by the interviews and case studies that were compiled to inform this report.

CASE 3

The Non-Payment Movement in Nicaragua



In response to aggressive legal action by one MFI in Nicaragua (against its clients for non- payment of loans), a local protest movement began in the summer of 2009. The action against all MFIs, accusing them of usurious interest rates. This soon evolved into a non-payment movement, supported by the populist President of Nicaragua, Daniel Ortega, a former Sandinista.

Initial reaction by BANEX was to assure its investors and creditors that the non-payment movement would slow, and that BANEX had ample liquidity and capital to withstand the crisis. By May 2009, BANEX's Board had grown increasingly concerned. Performance had begun to deteriorate, and the board asked management to consider a US$3 million recapitalization plan. Management resisted, expressing confidence that beef prices had bottomed out and that cattle loans — perhaps the riskiest segment of the portfolio — would be safe.

In September 2009, the shareholders met in Managua. Performance had continued to deteriorate. A lack of agreement between international investors about the size of the investment needed met with resistance by local investors who lacked the resources to participate in the rights movement. In addition, a legal agreement with a lender that required majority local ownership made the recapitalization process difficult and less timely than necessary. In addition, creditors, who had to be part of the solution, had not yet been approached.

Many loans were maturing in the first quarter of 2010, and it was clear that BANEX would face difficulty replacing those loans with new loans — or having the creditors roll over their loans. Not only did BANEX need more equity, but perhaps more importantly, there needed to be a debt restructuring as well, with creditors converting a percentage of their loans to subordinated loans which would serve as tier-two capital and equity. A restructuring plan was agreed to, in principle, with the creditors agreeing to restructure 13.6 percent of their senior debts to sub-debt and equity. The equity investors agreed to inject some US$8 million of new funds into equity, a package of some US$20 million.

Unfortunately, the debt restructuring was too little too late. The restructuring called for an 18-month agreement, rather than an intermediate-term agreement of 5-6 years, as recommended by the Advisor. The major creditors, who controlled the creditors committee, were hoping that the market would turn around and that they would be able to get paid because some of their loans were among the first due in the original maturity schedule. Creditors also indicated that the nature of their debt funds, Special Purpose Vehicles, made it very difficult for them to reach agreement on a restructuring. As part of the recapitalization agreement, the managing director was replaced, and the board composition was changed. Nevertheless, losses continued in 2010, and the central bank eventually intervened to protect the depositors. Its portfolio was then allocated to Nicaraguan banks.

Sources: Cole and others (2011); Di Benedetta, Lieberman and Ard (2015).

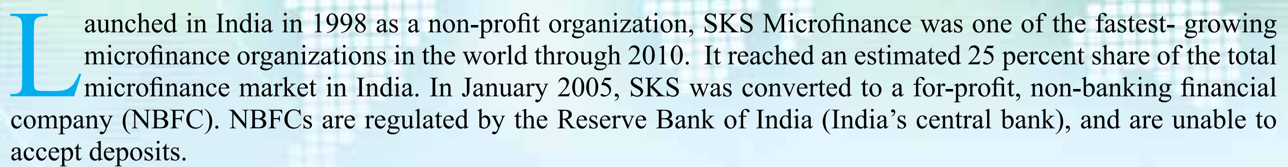
3. Evolution of MFI Corporate Governance

One of the most profound evolutions in the microfinance industry over the past two decades has been its commercialization. Specifically, this involves the shift from institutional structures where virtually all MFIs were NGOs to the point where, at present, the majority of assets are held by "commercialized MFIs" known as non-bank financial institutions (NBFIs) or microfinance banks. What is commercialization? Commercial MFIs meet the following criteria (Di Benedetta, Lieberman and Ard 2015):

- They are structured as shareholder-owned institutions, joint stock, or limited-liability companies;
- They increasingly expand their services to include products, such as insurance money transfers, housing-improvement loans, education loans, and small business loans, as well as a variety of savings products;
- They operate as regulated, non-bank financial institutions or commercial banks, with the latter able to mobilize deposits;

CASE 4

At the Epicenter of India's Andhra Pradesh Crisis



Launched in India in 1998 as a non-profit organization, SKS Microfinance was one of the fastest- growing microfinance organizations in the world through 2010. It reached an estimated 25 percent share of the total microfinance market in India. In January 2005, SKS was converted to a for-profit, non-banking financial company (NBFC). NBFCs are regulated by the Reserve Bank of India (India's central bank), and are unable to accept deposits.

SKS delivered microfinance through a village banking program, using the joint-liability model developed by the Grameen Bank. SKS also offered its members interest-free loans for emergencies, as well as life insurance. Its NGO affiliate, SKS Foundation, managed the Ultra Poor Program, one of the first programs in the country focused on bringing extremely poor populations into the realm of mainstream microfinance.

SKS's philosophy was focused on aggressive growth and scale. It achieved this through a combination of activities, including entering a state or market where another MFI already existed to ensure that there was demand, and then expanding in that market using technology to automate and lower costs. The strategy was to go deep within the districts to increase the efficiency and productivity of the branches and reduce operating costs.

As a start-up, SKS identified three main constraints to growth: capital, capacity, and costs. Therefore, SKS developed a plan to scale microfinance based on three inter-linked principles that would overcome those barriers. These were: (i) applying a for-profit methodology so that a MFI would not have to depend on limited donor funding; (ii) using best practices from the business world to speed growth; and (iii) deploying technology to overcome high delivery costs.

In August 2010, SKS went public through an Initial Public Offering (IPO), raising some US$350 million and valuing SKS at US$1.5 billion (Rajan 2010). The founder and its investors were sharply criticized in the Indian press for making large profits on the backs of India's poor. The State Administration of Andhra Pradesh, in a running dispute with the large and aggressive MFIs in the state (5 of India's 10 largest MFIs had headquarters in Andhra Pradesh), chose this moment to intervene in the sector and effectively bring payments to a standstill.[6] The Reserve Bank of India, the regulator for the sector, sought to diffuse the crisis through a commission that recommended comprehensive regulation of the sector. These regulations languished in the Indian Parliament, and the sector was left in limbo with many of the largest MFIs in India, including SKS, in difficulty.

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6. On October 15, 2010 the State of Andhra Pradesh promulgated an ordinance seeking to regulate the microfinance sector. (See also Intellecap 2010).

Source: Di Benedetta, Lieberman and Ard (2015).

- They raise funds in commercial markets through various means;
- They seek to operate sustainably, that is, covering all of their costs— including financing costs; in time, they operate profitably and provide an adequate return on assets and equity; and
- They strive to serve the double bottom line, that is, to serve the poor while also operating in a responsible and sustainable manner.

Although there are numerous examples of NGO MFIs that have yet to make the transition to commercial MFIs, the industry trend is increasingly for commercial MFIs to begin adopting new technologies — most recently and importantly digital finance. In seeking to remain relevant and viable in their markets, many MFIs feel growing pressure to transform themselves digitally. Some are looking to form strategic partnerships more deliberately and with greater immediacy than before, especially given the pace of technological change and competition challenging the sector (Di Benedetta, Lieberman and

Ard 2015, 6). Further discussion of these strategic transformations can be found in Chapter 3.

As MFIs have scaled up and transformed, their governance structures have also evolved. Boards have had to become more sophisticated, with more skills to assist management and to maintain oversight. As boards have evolved, they have started to increase the scope of their governance structure. Generally, there are three stages of governance in microfinance, as shown in Figure 1.

Stage 1: The Founding Board

At inception, a founding board is normally selected by the social entrepreneur in charge of establishing the MFI. Such a board is likely to be small, reflecting a deep commitment to the founder's vision. It is likely to be local (from the community or region in which the MFI initially operates), and homogenous in terms of a similar background with the founder. In addition, it likely to operate informally. The MFI is likely to be an NGO and operate in a single city or region with a few branches.

Stage 2: The Governing Board

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

- Board members are overwhelmed by the demands placed on them by rapid expansion; and
- Financial pressure requires the board to commit to substantial fundraising which absorbs a great deal of time.

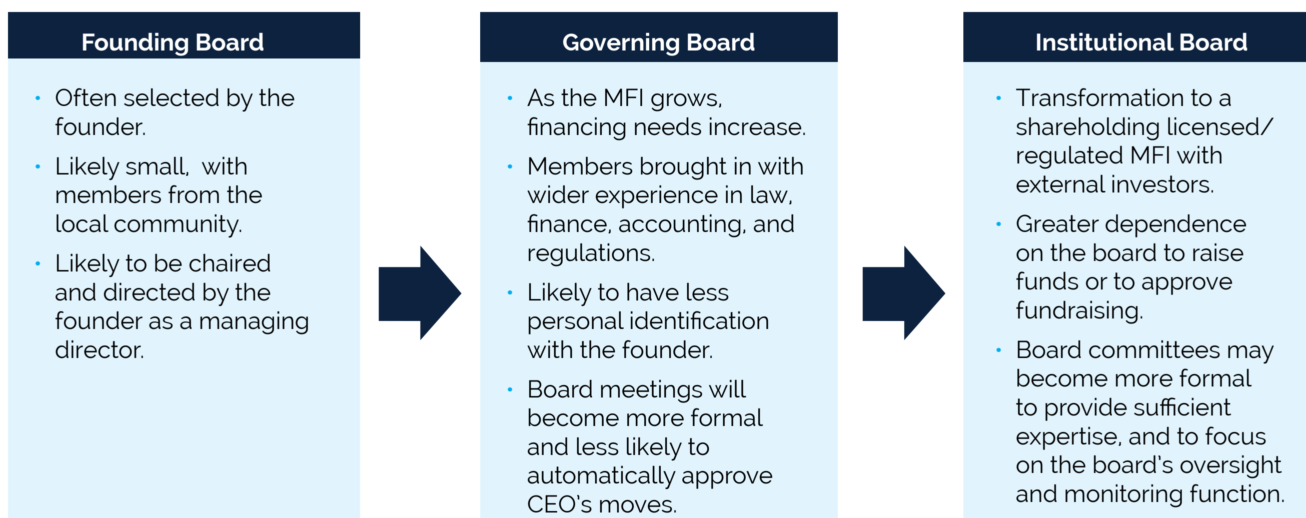
New board members are recruited who may have wider experience, diverse skills, and less personal identification with the founder and his/her mission. Given the changing business and risk profile, the founding board is likely to become more formal — and to assume a more responsible role in the direction and oversight of the institution.

Stage 3: The Institutional Board

Further evolution is prompted by transformation to a shareholding MFI with external investors, and a decision to become a licensed/ regulated, formal institution. There is now greater dependence on the board to raise funds and/or to approve fundraising. Board size may expand, and board committees may become more formal to provide the necessary expertise and to focus on the board's oversight and monitoring function. With changes at the board level, there is a corresponding need to change management governance structures, including expanded risk management structures such as an independent risk management function headed by a senior manager, or a Chief Risk Officer.

It is advisable that MFIs seeking to expand and attract new capital investments periodically conduct a review of their governance practices. Investors are looking to finance institutions with strong corporate governance structures, as this is a leading indicator of financial sustainability and longevity. Such reviews tend to focus

Figure 1: Three Stages of Corporate Governance in Microfinance



Source: IFC 2003; 2010; 2014; Di Benedetta, Lieberman and Ard.

on: (i) key board functions, (ii) board processes, (iii) board effectiveness (cohesiveness) and decision-making, and (iv) governance roles and responsibilities. Although boards can commission a review by an external party, it is advisable that boards undertake an annual self-assessment. A sample Board self-assessment is included in Annex 2.

4. Themes and Impacts from Success Stories

Boards that have successfully transitioned from the founding stage, as well as those that have dedicated time and resources to strengthening risk governance note many common themes and positive results. Among the key themes of such evolving governance structures are the following:

- **Expanded Board size.** MFIs typically increased the number of Board members adding new skillsets as well as independent directors to their ranks.
- **New committees.** All MFIs expanded their committee structures and formalized their terms of reference, appointment process, and procedures.
- **Strengthened management oversight.** Boards clarified the role and responsibility of the CEO and jointly set annual performance objectives for the CEO.
- **Improved decision-making.** Boards that formalized their processes and established annual workplans reported being more efficient and effective in taking strategic decisions.
- **Board renewal.** Many MFIs formalized their annual Board evaluations and ensured board composition is continually refreshed taking into consideration the strategic needs of the company.

The reported impacts of improved board governance are equally encouraging. Among these are the following:

- **Access to Finance.** Investors in microfinance consistently note corporate governance as one of the key risks facing MFIs. Companies that focused on improving corporate governance also noted increased confidence by funders and investors.
- **Proactive responses.** Strong information systems and monitoring means more proactive rather than reactive decision-making.
- **Effective change.** The ability to effectively manage change ensures the MFI can keep pace and adapt to evolving market conditions.
- **Improved crisis response.** Improved governance helped strengthen the response to crises of many MFIs profiled in this report.
- **Greater efficiency.** Stronger risk management systems led to better risk mitigation and the identification of opportunities to eliminate operational inefficiencies.

Returning to the quote at the beginning of this chapter, there is no "real endpoint to good corporate governance." However, it is heartening that a focus on corporate governance can bring about desired changes to a board, with real, positive impacts for the institution and its stakeholders.

Suggested Reading:

Basel Committee on Banking Supervision. "Guidelines: Corporate Governance Principles for Banks." Basel: BIS. July 2015.

Council of Microfinance Equity Funds (CMEF). 2012. "The Practice of Corporate Governance in Microfinance Institutions, Consensus Statement of the Council of Microfinance Equity Funds."

Di Benedetta, Pasquale, Ira Lieberman, and Laura Ard. 2015. "Corporate Governance in Microfinance Institutions." World Bank, Washington, DC.

Global Corporate Governance Forum, and Jonathan Charkham CBE. 2003. "Guidance for the Directors of Banks." Washington, DC.

IFC Nominee Director Training. 2014. "The Role and Functioning of the Board." World Bank, Washington, DC.

The Board's Role in Managing Crisis Situations

"Sound corporate governance and risk management practices may be the best guards against potential crises spiraling out of institutional control."

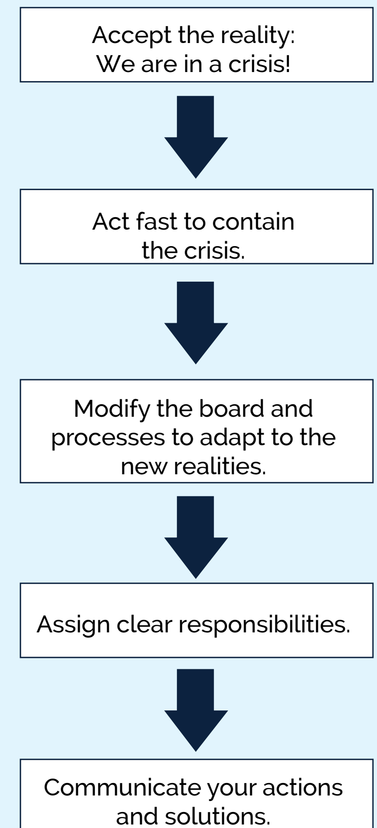
Over the past decade, countless MFIs across the globe have experienced some form of crisis. In many cases, this has resulted in substantial financial losses and, in extreme cases, the MFIs did not survive. The collective industry experience suggests that virtually all MFIs will encounter a crisis at one time or another. It is ultimately the responsibility of the board to ensure the MFI is protected from all sorts of crises before rather than after they hit. As such, it is necessary to ensure that sound corporate governance and risk management practices prevail.

There are several relatively common issues that can lead to a crisis for a MFI. Regarding internal factors, crises can be caused by: poor management; a spike in the non-performing portfolio (which may actually arise from external causes); massive fraud; or material liquidity and funding problems.

Regarding external events, crises may be caused by: political interference (for example, by the introduction of interest rate ceilings or support for a non-payment movement); natural or man-made disasters; macroeconomic instability, especially high inflation or currency devaluation; or financial market turmoil (such as a global financial crisis).

Board members will need to engage critically with management regarding any type of crisis — and especially when management identifies external causes as the primary reason for institutional problems. Figure 2 highlights key steps for boards facing a crisis. If the board loses confidence in management itself, the board ought to assume control of the institution. It will often form an executive committee and appoint a board or management member as interim CEO to help guide the MFI through the crisis and report regularly back to the full board.

Figure 2: Key Steps for Boards Facing a Crisis



Source: IFC, OeEB, 2010.

In all cases, the board becomes the center of attention when there is a crisis. Board rooms can turn porous in a crisis, and long-standing disagreements or divided board factions can severely hinder a crisis response effort. In general terms, boards need to be proactive about crisis management. Boards that are solely reactive to crisis situations, for example, leaving it to management to resolve the issues, are not properly exercising their governance function. Case 5 illustrates the notion that sound corporate governance and risk management practices may be the best guards against potential crises spiraling out of institutional control.

CASE 5

Lessons from a Network Holding Company

An early supporter of the development of the microfinance holding model, IFC has been investing in network holding companies since the early 2000s. Despite the early successes of the network holding model, recent macroeconomic deterioration in emerging markets has highlighted the fact that as these networks have matured, so too have the risks that they face. For example, the Africa and Eastern Europe and Central Asia regions were hit with falling commodity prices and economic spillovers. As a result, they suffered from steep currency devaluations, regulatory interventions, and volatile local markets. One of the largest microfinance markets in the ECA region, Azerbaijan, saw two currency devaluations in 2015, along with the institution of interest rate caps by the central bank.

Although these developments impacted the operations of all financial institutions in the region, network holding companies were faced with the challenges of developing a comprehensive risk management framework that both codifies pre-crisis risk identification and defines the roles for management and the board in times of crisis. From the experience of network holding companies in the region, lessons were learned from boards that had to do "double duty, firefighting work". Building a risk management system during crises has forced boards to make quick decisions to keep portfolio companies afloat. These lessons and those listed below are just as essential for any individual MFI.

Do Your Homework: Establish a Comprehensive Risk Management Framework before a Crisis Hits

Instituting a comprehensive risk management framework ahead of crisis is the key to success for growing MFIs and networks. As network holding companies have grown and matured, they have increasingly become more like traditional global banks, with increasingly complex operations across a range of regions and countries. This expansion requires boards to do their homework in advance, that is, to create a comprehensive risk management framework that is robust, yet flexible enough to adapt to local contexts. By evaluating the relevant risks across the group — from treasury and liquidity risks to unique market risks — the holding company can better prioritize these risks according to likelihood, immediacy, and impact. By running sensitivity analyses on the most significant risks for each country, both the holding company and individual MFIs can more effectively manage and mitigate these risks before a crisis occurs.

This case study shows there are no failsafe ways to prevent all crises. However, to reduce the institution's exposure to crisis situations, it is advisable that boards work to embed the following practices into their corporate governance and risk management systems over time:

- Set a clear strategy that is communicated to all levels of the MFI;
- Work with senior management to establish and periodically review the MFI's risk appetite for all key risk areas (credit, liquidity, market, operational, and so on), considering the competitive and regulatory landscape and the MFI's mission and goals, existing risk exposure and institutional capacity;
- Oversee the implementation and execution of risk-management systems and periodically review them to ensure they remain appropriate given changes to the MFI's size, complexity, geographical footprint, business strategy, markets and regulatory requirements;
- Ensure effective accountability for risk management by establishing appropriate risk structures, including a risk management function headed by a senior manager (for instance, a Chief Risk Officer in larger MFIs);
- Have a CEO succession plan in place in case of sudden departure;

In the Eastern European context, recent work has focused on stress testing, thereby allowing MFI boards and management to dynamically respond in an increasingly volatile environment. Instituting a comprehensive risk management mechanism across the group allowed the relevant stakeholders to evaluate risks, and be better prepared to address them when they arose.

Define the Scope of the Risk: Is it a Quick Fix or a Structural Issue?

In times of crisis, the management and boards of network holding companies are faced with a balancing act: to keep the institution operating in the short term, while simultaneously fixing longer term structural issues that enabled the crisis to develop. As many MFIs in Eastern Europe have learned, striking this balance is not unlike keeping a ship afloat during a storm, while simultaneously building the ship to withstand future storms. To strike the correct balance, the board first evaluates the immediacy and impact of the crisis in relation to the group's core strategy. If the issues present an immediate and clear danger to the operational capacity of the MFI, the board proactively supports management in managing risks and minimizing their impact. At the same time, the board also needs to evaluate strategic options in the context of a volatile operational environment and an uncertain future. Taking a longer-term perspective, the board needs to evaluate the costs, benefits, and potential opportunities that the group faces.

Clarify the Roles of Management and the Board

Crisis situations require management, local board members, and holding company board members to efficiently navigate overlapping responsibilities and competing priorities. In times of crisis, it may also be important to set up new board committees to support management. Due to the potential for overlapping efforts, it is critical for relationships and roles to be well-defined between differing levels of governance. The role of the holding company itself ought to be clarified, giving it the responsibility of developing an overarching risk management framework.

In most cases the local management will possess a more intimate level of knowledge regarding the underlying risks and issues than the holding company. Therefore, the responsibility of day-to-day risk mitigation and crisis response falls to management. The holding company board will ensure that these individual risk management practices fit within a larger framework, and that they are not overlooking other big picture issues, such as foreign exchange exposures. It is also imperative that the hierarchy of responsibilities is codified, clarifying at what point issues are elevated or transferred to different levels of governance. For example, whereas a treasury issue may originate with local management, when a crisis becomes systemic, responsibilities may be elevated to the holding company level.

Source: IFC Board Interviews.

- Oversee the establishment of fraud prevention programs, including formal systems for the detection of fraud;
- Approve disaster recovery and business continuity plans, and test them regularly;
- Utilize stress tests and scenario analyses to better understand potential risk exposures under a variety of adverse circumstances;
- Establish strong ethical finance and social responsibility practices;
- Ensure the appropriateness and effectiveness of the MFI's policies and procedures for whistleblowing;
- Embed early warning systems to constantly monitor relevant risks, and to alert management and the board whenever the risk turns into a real crisis;
- Issue risk reports and communications in a timely, accurate, and understandable manner, covering both internal and external risks; and
- Establish open and transparent relationships with stakeholders, including regulators when policies are ambiguous or when messages in the market are unclear.

It is vitally important that boards understand the risks their institutions face, and their level of exposure to those risks through both quantitative and qualitative measures. It is equally important that boards understand the crises they might face to effectively prevent and manage them. Therefore, the remainder of this Chapter is dedicated to specific examples of risks that became crises, and provides some first-hand lessons learned. See also the suggested reading at the end of this Chapter.

1. Regulatory Risk – Interest Rate Caps

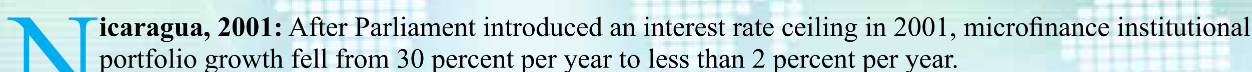
Interest rate caps for microfinance have been imposed in many countries throughout the world. Many legislators and the general public have found it difficult to accept that small loans to poor people generally cost more to intermediate than normal commercial bank loans. Although meant to protect consumers, interest rate ceilings almost always hurt the poor. When politicians and regulators get involved in promoting the notion of interest rate ceilings, this can lead to a real crisis for MFIs — and for the sector as a whole. See examples from selected countries in Case 6.

Interest rate ceilings can hurt low-income populations by limiting their access to finance and reducing price transparency. They can also affect the ability of MFIs to support their operational and financial costs. If ceilings are set too low, financial service providers may find it difficult to recover costs. As a result, they are likely to grow more slowly, reduce service delivery in rural areas and other costlier markets, and become less transparent about the total cost of loans. In some cases, they may even exit the market entirely.

Where interest rate caps have not been implemented, board members should familiarize themselves with "interest rate discussions" in their markets. It is important

CASE 6

Interest Rate Caps – Some Country Examples



Nicaragua, 2001: After Parliament introduced an interest rate ceiling in 2001, microfinance institutional portfolio growth fell from 30 percent per year to less than 2 percent per year.

Bolivia, 2004: Considered the worldwide role model of microfinance, Bolivia had already seen market competition reduce interest rates from over 100 percent a decade ago to 18 percent currently. However, this year, the government introduced an 11 percent interest rate cap on 60 percent of loan portfolios of all regulated financial institutions. Most industry insiders are fearful that such rates will eliminate many small MFIs — or force them to sell, or go up-market to SMEs. They also stated that those MFIs that provide not only loans, but also healthcare and education services to the poor, will be significantly affected.

India, 2011: India launched a cap on microfinance interest rates of 26 percent for loans of up to 50,000 rupees (US$1,124), and stagnation and reduced borrowing followed. In April 2014, the Reserve Bank of India introduced a more flexible rate: cost of funds (at market rates) plus 10 percent for existing MFIs; and cost of funds plus 12 percent for new MFIs. These manipulations of interest rate caps, together with other microfinance government regulations and the political fallout of the Andhra Pradesh crisis, left more than 400 million people in poverty. They were also left without the option of obtaining a micro-loan, and microfinance capital subsequently shrank by 40 percent.

Cambodia, 2017: The National Bank of Cambodia introduced an interest rate cap of 18 percent, but it has not limited fees. Representatives of the microfinance sector in Cambodia and the Government are in dialogue to discuss the cap and fees in the hopes of reaching a satisfactory agreement, especially given the potential negative impacts on the poor.[7]

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7. Asian Review, March 24, 2017, https://asia.nikkei.com/Politics-Economy/Economy/Interest-rate-cap-rattles-Cambodia-s-microfinance-industry?page=1

Sources: Asian Review (2017); IFC (2017); World Bank (2014).

that a concerted effort is made by MFIs collectively (ideally through an industry association) to ensure that appropriate preventive measures are in place before the problems arise that lead to implementation of such interest ceilings. Board members can encourage their CEO to engage with other financial service providers so that concentrated efforts are easier to launch when discussing this issue with various governmental institutions, such as the central bank, the banking supervisor and the ministry of finance.

At the individual institutional level, board members can emphasize the need for transparency of pricing and client centricity, as this can help avoid crisis situations. Implementation of a responsible finance strategy (across the sector) has proven to be effective in this respect. The IFC, the World Bank and the Consultative Group to Assist the Poor (CGAP) — together with other commercially-oriented donors, partners and foundations —are working to improve financial inclusion. Together, they have played a strong advocacy role by sharing best practices and helping to prevent market distortions.

If a situation arises in which regulatory authorities are threatening to implement interest rate ceilings, board members under the guidance or auspices of the Chair can:

- Actively engage in a dialogue with other affected MFIs, banks engaged in microfinance, and regulators. In general, the message to the regulator would be that the industry does not need more regulation. Rather, it needs smarter regulation to ensure that interest rates are fair, transparent and provide reasonable protection to customers, while also allowing for viable business operations and market development.
- Ensure that the MFI and its stakeholders have a communication strategy for the media. A strong retort could be part of a larger damage control exercise. It is also important for the MFI to be in clear communication with its investors and creditors.
- The board can also engage with management in stress testing to understand what the short and long-term institutional effects will be for the lowering of the interest rate.

Irrespective of the regulatory risks associated with interest rates, boards ought to remain cognizant of the key drivers of their own product pricing, especially for loans. Historically, competition and gains in productivity and efficiency have been the key drivers in lowering interest rates, particularly in more mature microfinance markets. Therefore, it is advisable that boards not wait until interest rate ceilings are imposed to consider lowering interest rates. Indeed, remaining competitive may be equally important to long-term survival.

2. Portfolio Risk – Spiraling Non-Performing Loans (NPLs)

A significant increase in the non-performing portfolio has overcome even the best of institutions. This is a potentially dangerous situation that can spiral out of control. Alternatively, it can be contained depending on how (and how fast) the board and management react.[8] Although each situation is unique and requires a tailored approach, the suggested actions presented here outline general principles only. They can be fine-tuned according to the special circumstances of the NPL crisis, as well as the MFI's overall situation.

The starting point for successfully addressing problems of portfolio at risk (PAR) is to conduct a thorough assessment of the origin of the crisis (for example, economic issues, political or social problems, problems within the MFI's own processes, and so on). Following this, a portfolio review can be conducted to understand the actual impact of the problem on the institution. Aside from the regular PAR30 and PAR90 reviews, tailored portfolio quality reports (by product, loan size, branch, loan officer, credit approver, use of loan, and so on) can be undertaken. All can be shared and discussed with the board. In addition, compliance monitoring for internal procedures may be intensified to identify a possible increase in infractions, which can signal a deterioration of underwriting quality or fraud. The detailed portfolio review will allow for a good understanding of which types of loans are affected and to what extent.

As a next step, processes and tools for intensified management can be developed, or the existing ones can be refined to deal with each affected loan as appropriate (Annex 3). In this regard, four alternatives can be considered:

1. Restructure and intensify management (workouts)

- Grace periods, rate adjustments, partial write-offs, additional loans, and so on.

8. Ill-prepared strategic shifts from microenterprise to SME lending are often observed as the source of NPL increases. See also IFC, 2015, page 15.

2. Collections

- Review and strengthen the collection process (defining individual recovery strategy according to client and collateral) following best practice and local standards. Establish a workout and collection group in the MFI, if one does not already exist.
- Define a communications strategy vis-a-vis the regulator, creditors and investors.
- Define legal actions and responsibilities necessary for collection.
- Clarify roles and responsibilities.

3. Take adequate provisions (reserves) for bad debts.

4. Consider full or partial write-offs.

5. Stop or reduce lending in affected regions or for specific products experiencing concentrated losses.

Once it is clear what measures are to be taken, when and how, priorities for intensified management can then be set, often in the form of a workout group. Defined measures can also be applied to all problematic loans. Before acting, it is important to ensure that the required staff capacities and organizational set-up are in place. This includes clarity about authorities and responsibilities for "problem loan managers", "collectors" and required legal capacities, nomination and training of adequate staff (internal or external) and reporting lines. In addition, external counsel, workout specialists and external auditors may need to be retained by the MFI to discover the extent and depth of the problem. External counsel may even assist with collection, depending on the extent of the problem, for instance in the case of Banex in Nicaragua (Case 7).

In parallel to the measures taken for managing problem loans, the tools and processes for the normal lending processes should also be adjusted to avoid new problem loans from entering into the MFI's portfolio. The changes to the existing lending process and the (temporary) shift of activities from "normal lending" to "problem loan management / recovery" may imply a material change to the institution and its staff, especially loan officers. It is especially important to manage expectations about the long-term horizon of the activities taken, as well as the relationship between "normal loan managers", "problem loan officers" / "recovery officers" and/or workout groups.

As in any other crisis situation, the value of active communication — especially to funders who may see a breach in their contract covenants — cannot be underestimated. Also, regulatory authorities, large deposit clients and staff need to be actively informed to avoid speculation about the MFI's ability to successfully deal with the problem.

3. Liquidity Risk - Crisis of Cash

The central issue about liquidity is to find the right balance between avoiding unused but costly liquidity and keeping a liquidity cushion (including alternative funding sources) large enough to ensure the MFI's liquidity — especially in times of unexpected funding shortages, as shown in Case 8.

To this end, the board can ensure that a professional liquidity risk management system is established, including the following main elements:

CASE 7

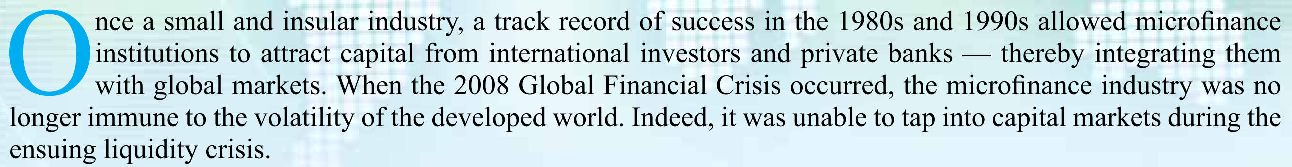
Reassess the Depth of Problem Loans

When Banex experienced problems with rising NPLs due to the non-payment movement in Nicaragua, the board asked the company to reassess the extent of the problem. Whereas management estimated that NPLs had risen to 15 percent, the assessment report ultimately reported to the board that estimated that NPLs would soon rise to 30 percent of the portfolio. Thus, the board was alerted to the true extent of the crisis faced by the institution.

Source: Cole and others (2011); Di Benedetta, Lieberman and Ard (2015).

CASE 8

Staying Afloat in Times of Crisis



Once a small and insular industry, a track record of success in the 1980s and 1990s allowed microfinance institutions to attract capital from international investors and private banks — thereby integrating them with global markets. When the 2008 Global Financial Crisis occurred, the microfinance industry was no longer immune to the volatility of the developed world. Indeed, it was unable to tap into capital markets during the ensuing liquidity crisis.

The Microfinance Enhancement Facility (MEF) was part of the crisis response. It was created as a microfinance investment vehicle in February 2009 by the International Finance Corporation (IFC) and the German Development Bank KfW. Partners included the European Investment Bank, the Dutch Development Bank (FMO), the Austrian Development Agency (ADA), the United States' OPIC Fund for International Development, Germany's Federal Ministry for Economic Cooperation and Development, and Sweden's International Development Cooperation Agency. It was co-managed by BlueOrchard Finance SA, Cyrano Management SA, and responsAbility Investments, AG.

The aim was to calm jitters in the market by processing short- and medium-term financing to MFIs within 2-4 weeks, as opposed to the months-long process required by more formal development institutions. The MEF's mandate to stabilize the sector by mitigating liquidity risk that came about as a result of crises in the microfinance industry. While MEF's investments were mostly in US dollars, it has made an initiative to offer more local-currency loans to hedge against increased foreign exchange risks.

MEF board members rotate every six years, which allows for fresh perspectives. This is important given the fact that fund managers and investment committees do not rotate. Much of the power of microfinance investment vehicles lies with the investment committee. Thus, it is advisable that board members establish clear investment strategies and guidelines, and be cautious when choosing new members. Board lessons learned include the need for: (1) a complementary board composition with deep expertise; (2) regular board member training, especially pertaining to risk management issues in the context of seismic, macroeconomic risks; (3) clear investment policies that deal with conflicts of interest; and (4) continued engagement between the board and the investment committee.

Source: IFC Board Interviews; IFC (2015), pages 1-6.

- Definition of liquidity risk strategies and policies, including the necessary infrastructure investments (for staff, tools, processes);
- A regularly updated and well-structured liquidity oversight table, providing management and the board with a comprehensive overview of the MFI's liquidity situation;
- Liquidity ratios organized in a time series to monitor liquidity trends;
- A regular update of market indicators to describe the liquidity situation in relevant financial markets;
- Maintenance of an adequate liquidity reserve to cover unexpected liquidity needs according to relevant MFI scenarios;
- Review of all elements to inform the board and management about the MFI's state of liquidity under relevant stress scenarios;
- All information will be made available to management on a weekly basis, and discussed in the MFI's Asset and Liability Committee (ALCO). Information will be made available to the board on a quarterly basis for discussion in the Risk Committee; and
- Agreement of funding contracts and credit lines with a variety of possible funders (domestic and international) as alternative sources of funding to the MFI as needed.

From the board perspective, a regular report is required to be submitted to the ALCO, which is then conveyed by the Chair at board meetings. In the event of a liquidity crisis, reporting to the ALCO will need to be more frequent. Indeed, the ALCO itself will need to meet more frequently. The liquidity report should provide details demonstrating that the liquidity situation is being well managed. In this context, the report would provide

evidence that requirements are being met. In case of pre-defined warning and alert limits being reached, it is essential that the board be informed as soon as possible so that it can discuss and agree on possible measures to be taken.

4. Operational Risks

There are many ways to halt a MFI operation, if necessary. For example, political or social unrest or natural disasters may necessitate a cessation of operations. Rather than hoping that such situations will never occur, the board can ensure that the institution is well prepared to deal with such situations. To this end, a business continuity plan can be developed, including related contingency measures. There are also many risks involved when MFIs transform to provide DFS. It is advisable that boards be aware of operational risks given the ongoing shifts in their local context.

Business Continuity Management Plan

At the board level, it is important to conduct an annual verification of the quality and functionality of the MFI's contingency measures. The managers responsible can confirm that contingency measures are in place, and that all important business processes are considered. In addition, management is responsible for conducting an assessment to ensure the survival of the MFI in the event of crisis. This includes the maintenance of corresponding back-up requirements for business records, computer files and data. It also entails the installation of required back-up and protection measures. Finally, testing should be done to confirm the functionality of the contingency processes and resources. In the event that unforeseen situations arise for which there are no contingency plans, the Board may need to step in for high-level coordination and communication activities, as required. It may also replace management staff as necessary.

Mitigating Fraud

Most instances of fraud are petty, often involving amounts below a month's salary. However, even such small events can have negative effects when they occur in massive numbers. Indeed, they can erode the moral soundness of the MFI, as well as its reputation with clients and financing partners.

Some cases can be more serious, especially when staff start colluding. In such instances, even high-quality controls may not be sufficient. The typical case would be a system of ghost loans established by a group of staff in a specific branch or region. If senior management and/or directors are involved, the situation can be become more serious — especially when high amounts are involved with the respective approval limits. Senior management fraud may be perpetrated through a number of schemes, including loans granted to related parties under improper conditions. Other instances of fraud may involve misappropriating the MFI's assets, overpayment for services provided by companies owned by related parties (that is, service or procurement fraud), and/or senior management manipulation of financial statements to hide the poor financial health of the MFI.

As a board member, it is important to understand that fraud can happen at any time. Nonetheless, it is essential to still feel comfortable with the institution's framework to prevent and detect fraud as quickly as possible. Even the best system to protect the MFI from fraud risk will not be 100 percent safe, and fraud can occur on a large scale. To minimize the risk of material loss due to fraud, the board can ensure that the following preventive elements are in place:

- Appropriate insurance coverage is maintained;
- Clear rules are established to escalate material fraud events to the board;
- A fraud investigation team is nominated to quickly analyze suspicions about potential professional fraud;
- Retain external auditors to perform a fraud audit;
- Legal framework conditions for dealing with fraud are clearly understood and implemented (for example, in working contracts);
- Board and management authority are clearly defined in terms of setting the objective of the investigation and resulting actions (whereby material fraud should lead to termination with no exceptions);
- Communication of the case is managed actively to prevent speculation, and to underline the MFI's no-tolerance approach; and
- Applying lessons learned to improve the fraud prevention and detection system.

Agent Management Risks

Agent risks may be the most difficult and important for the MFI to manage. Adding an agent network can be costly, but it can also make or break the success of DFS. Risks are endemic to the agency business. The board can ensure that the CEO appoints a senior manager reporting directly to her/him to manage DFS. Also, there should be a manger of the agent network within that business unit/ division.

As noted, agent risks include the following: (i) too few or too many agents—too few means a lack of adequate coverage for clients; and too many agents mean there is an inability to achieve a critical mass of business. Getting the balance right is difficult for the MFI, and often requires a super-agent or agency network agreement; (ii) insufficient liquidity—agents maintain an inadequate float and cannot service the clients of the MFI adequately. This can mean loss of business and/or clients; (iii) theft of agent float; (iv) inadequate agent training, including tellers who make mistakes in data entry of transactions; (v) poor agent selection; (vi) poor agent management; and (vii) inadequate branding and marketing materials at the agent and on-line levels, including MFI's website and social media presentation of the MFI's network services.

Data Privacy and Security

The provision of DFS requires detailed client information that is normally obtained by MFI account officers working closely within a village or community—so called high-touch services—or knowing your client (KYC). DFS involves a high degree of automation and operational efficiency. Oftentimes, client information gathering is highly intrusive of client privacy —without the client necessarily knowing that this information and data is being swept from his/her phone. In addition, providers of DFS may be lightly or even unregulated. MFIs as DFS providers ought to seek to achieve a high level of data security for their clients. They can also make potential clients aware of the information they are providing or need to provide for a DFS application to work effectively. Transparency and client literacy with respect to DFS are essential aspects of MFI services.

Technology Risks

Technology risk is the inability to transact business due to system down time or other technical failure. It can potentially lead to reputational risk and/or loss of clients. Technology risk is closely aligned with operational risks. DFS transactions pass through several communications systems and devices, and require complex software. Much of this is out of the direct control of the MFI. In this regard, it is important that the board ensure that the partnership agreement governing DFS covers responsibility for addressing emergencies, such as disruption of services, technical upgrading (as the technology develops), as well as responsibilities for compensating clients for loss of service.

5. Market Crisis

As MFIs are financial institutions, the financial markets define the key parameters of their business environment. The market rates (interest rates, currency exchange rates and inflation rates) may confine an MFI's profitability by determining the cost of funding and the revenues generated from its lending activities (Box 5). As the same rates affect the MFI's clients and their businesses, they may also have a material influence on the MFI's credit risk. If rates remain the same as when the business plan was set up, there will not be any issues. However, once these rates change — and they often change simultaneously or consecutively — then the MFI's ability to conduct business may be seriously impacted. Examples are high devaluations of local currencies in countries, such as Azerbaijan or Zambia, which left MFIs and their clients in dire straits when they had borrowed in foreign currencies.

A market risk management system can be implemented to ensure the risk of unexpected changes in rates is well understood, and constantly monitored and minimized to an amount appropriate to the MFI's business strategy. Related tools and processes will help ensure the board and senior management fully understand the relevance of these risks as a precondition to managing them strategically (and, if the MFI has sufficiently trained and experienced staff, also tactically).

For market risk, funding may only be available in foreign currency, meaning that the MFI may also have foreign exchange (FX) risk. The duration and link to interest rates differs for the loans disbursed and the main sources of financing. As such, the MFI will also have an interest rate risk. In this context, no financial instruments or physical transactions may be available to close related gaps to neutralize these risks. In such cases, the MFI should identify possibilities to adjust its balance sheet structure over the medium and long term. In the meanwhile, the MFI can seek ways for alternative or proxy hedging. If, for example, hedging between the local currency and a currency used for financing is not available, a hedge may also be done using another currency which is closely correlated with the local currency. The negative impact of inflation may be reduced by "natural hedges", as with real estate investments replacing office rents. Whatever the activity is that best fits the MFI's requirements, the cost of dealing with these risks should be evaluated and made visible. It should also be included in the overall operating costs.

Box 5 | Main Elements of Market Risk Management

Foreign Currency Risk

- Ensure open currency positions are avoided and hedged, as appropriate;
- For unavoidable Open Currency Positions (OCPs), ensure that these are evaluated using Vector Autoregressive models and stress testing;
- Hedging with financial instruments (Currency Forwards, Futures, Options, Swaps) or alternative transactions (back-to-back loans or letters of credit) should be used where possible to close OCPs. Specialized institutions, such as MFX Currency Risk Solutions or The Currency Exchange Fund (TCX) may be helpful in finding the most appropriate hedging techniques;
- The attractiveness of FX financing should be judged by FX risk and associated hedging costs; and
- FX loans to clients require a credit risk assessment of the clients' ability to manage FX risk.

Interest Rate Risk

- Avoid duration gaps in the maturity buckets typically applied to the balance sheet (a corresponding overview must be regularly compiled);
- For unavoidable gaps, ensure relevant scenarios are stress tested to understand the level of interest rate risk to the MFI;
- Swaps should be used as available to reduce material gaps and related risks;
- New liabilities and major asset initiatives should be checked for their impact on interest rate risk before launch; and
- Variable rate loans to clients require special efforts to ensure an understanding of associated risks.

Inflation Risk

- In high inflation environments, interest rates may have to be adjusted quickly. Lending rates should be able to cover for unexpected increases;
- High inflation implies high FX and interest rate risks; and
- Client assessments should include a review of their capacity to deal with inflation.

All Market Risks

- Constant monitoring of market rates and a good understanding of the functioning of local financial markets are important;
- A comprehensive report should be generated regularly to provide an update of the situation for all relevant market risks;
- The effects on liquidity and credit risks should be analyzed regularly. Stress test scenarios are useful in understanding correlations between the different types of risk; and
- Sometimes the development of market rates is quite clear to those who understand well the dynamics of financial markets and economies. In such cases, it may be appropriate to take advantage of foreseeable changes in rates, allowing for tactically unhedged positions to generate additional income or to avoid unnecessary hedging cost. However, such positions should be taken with great caution. Strict limits should be applied to ensure the viability of the MFI in the event that markets do not behave as expected.

Source: IFC.

Apart from the direct effects of market risks to the MFI, the indirect effect of credit risk is another very important element to manage. Therefore, the client assessment process should cover the clients' exposure to market risks and their capacity to deal with them. This is especially important when the MFI disburses loans in a foreign currency or at variable rates, as unexpected changes in market rates may increase the cost of the loan to the client beyond his or her repayment capacity. It is not sufficient to just add a few lines in the product disclaimer to deal with this risk. Instead, responsible financing requires that the MFI ensure a full understanding on the part of its clients regarding these risks. In this way, the MFI protects them against undue risk taking. The same is true for the risk of inflation, which clients may be subject to according to their respective business activities. If the MFI's clients are affected by a financial market crisis involving the accumulation of a large portion of non-performing loans, the board can ensure that corresponding measures be taken.

For inflation risk, the MFI can also take their staff into consideration by allowing for attendant salary adjustments. As inflation hits hardest those who spend the most relative to their income, it would be wise to compensate lower ranking staff at a higher rate than the MFI's middle and senior management. Offering a blanket inflation raise to the whole staff is too expensive in uncertain times, and will set the wrong precedent in case inflation continues to increase. In general, it is important for the MFI to maintain good communications with its staff, and explain that the long-term sustainability of the MFI may be endangered if it bears the full burden of inflation. Of course, any dividend payments should not be expected by shareholders during a high inflationary episode — or, at a minimum, they should be very modest.

Suggested Reading:

CGAP. 2013. The Worrying Trend of Interest Rate Caps in Africa.

IFC. 2015. IFC Smart Lessons, Small Beginnings for New Opportunities: Lessons Learned from 20 Years of Microfinance Projects in IFC. Washington, DC: IFC.

______. 2010. Navigating Through Crises - A Handbook for Boards. Washington, DC: IFC.

Marulanda, Beatriz and others. 2010. "Failures in Microfinance: Lessons Learned from Failed Experiences in Latin America." Calmeadow.

Rozas, Daniel. 2011. "Weathering the Storm: Hazards, Beacons, and Life Rafts." Center for Financial Inclusion at Accion."

The Board's Role In Strategic Transformations

"Among the greatest risks facing MFIs working in the financial inclusion space today is the lack of institutional capacity to develop and implement a viable strategic plan."

The evolution of microfinance has led to a global acceptance of the importance of financial inclusion, and is influenced by three main factors: technological innovation, increased capital inflows and improved regulations. Within this improved macro environment, it is essential for MFIs to take advantage of new opportunities and manage change. For instance, the institutional capacity of individual MFIs to absorb capital prudently needs to be enhanced. MFIs can also effectively diversify and deepen their product and service offerings to their clients. Finally, MFIs need to leverage technology more strategically to remain competitive.

There are many different types of institutions that deliver microfinance services, for example, NGOs, cooperatives, non-bank financial institutions, regulated microfinance banks, and others. Soon these institutions will be forced to make some major institutional and operational changes. Such changes will facilitate their efforts to increase outreach, lower operational costs, expand sources of income through new products, diversify funding sources, and/or conform to (changes in) regulatory requirements. Some MFIs have begun to initiate such transitions as market leaders, and some for survival. However, both will need to brace themselves for a difficult transition path.

There are many types of transitions. For illustration purposes, this Chapter groups them into two categories: (1) business expansion, that is, for savings or insurance products, or geographical expansion on a national or international level; and (2) technological transition, that is, for the introduction of DFS, mobile banking or ADCs. In this context, fintech partnerships are now often involving proprietary software models using big data for credit scoring.

Whatever the transformation, the MFI will need to make a number of changes, such as: adding to and/or modifying existing operational procedures; creating new roles; challenging existing institutional culture; revising the business and financial projections; undertaking market and feasibility studies; providing training; requesting approval for additional capital expenditures; developing a clear communications strategy; and possibly making use of external consultants. Such activities require intensive board involvement, preferably through a committee structure which can be formed for the occasion. This committee will then be charged with steering and controlling the transition project in question.

The following sections highlight the role of the board in complex transitions. Section 1 deals with transforming MFIs into licensed, commercial deposit-taking institutions, and Section 2 addresses the necessary transformations to provide DFS. Case 9 at the end of the Chapter provides examples of NGO transformations in Bolivia, Cambodia and Kenya.

1. Commercial Deposit-Taking Institution

There are ample incentives for MFIs to transform and attract deposits. The most commonly cited are meeting client demand for such services, thereby boosting overall client satisfaction, and diversifying institutional sources of funds with cheaper and more stable sources of local currency. If implemented well, these prove to be true. However, many institutions underestimate the challenges involved in attracting

and managing customer deposits. For instance, deposit taking requires a license and with that often comes changes to governance structures, policies, procedures and systems for monitoring and reporting. Deposit taking also requires significant physical changes to branch structures to accommodate depositors, and provide branch security such as counting rooms and safes. Perhaps most significant, the transformation requires a shift in institutional culture given the new risks the MFI will face, as well as the new types of customers the MFI will inevitably serve (Calmeadow and the Centre for Financial Inclusion 2008).

Prior to considering the benefits of mobilizing deposits, the overall issue of transformation – usually from a NGO to a deposit-taking institution, such as a NBFI or microfinance bank – should be considered. This transformation is critical to the commercial transformation of the NGO, and it usually involves attracting investors seeking a "social return" on investment, at a minimum. The MFI will need to apply for a license as a NBFI or bank. The process involves confirming who its investors will be, and that it will have a "fit and proper" Board of Directors subject to the banking supervisor's review and approval.

The process also implies either replacing the NGO board or diversifying the board by providing for investor representation, increased board skills and independent directors. This is the point at which the transformation often meets the first line of resistance. Founding board members may well resist revolving off the board, or any required board changes that dilute their power. Often, the founding Managing Director (CEO) of the MFI (as an NGO) is also the board chair. As such, investors or their board representatives need to consider whether the NGO's CEO has the skills to guide the transformed microfinance NBFI or microfinance bank, or whether a succession process will need to be launched to hire a more experienced banker as CEO. This is often another point of resistance to transformation. Finally, investors need to think about the appropriate incentives to offer NGO senior management and board members to reach agreement in transforming the institution.

Once the issues at the top level of the organization have been resolved, the board of directors carefully considers the obstacles the MFI needs to overcome at the operational level. Some institutions struggle for years to implement appropriate information systems to facilitate accepting deposits, and to include them in their management information system (MIS). In addition, some MFIs struggle with the increased regulatory and shareholder reporting requirements in terms of volume and required technical expertise. There are also strategic issues that need to be considered. For instance, some institutions target large deposits, which are less expensive to mobilize — but can also be less stable than small local deposits. Other MFIs mobilize primarily small deposits, which might make it more difficult to realize a positive return. The institution must also understand the market in which it operates. Indeed, many MFIs underestimate the competition from the formal sector (Ledgerwood 2013).

MFIs need strong asset management to maintain the security of deposits. MFIs seeking to mobilize deposits need to create and ensure the management capacity and governance to administer a high volume of less predictable liabilities. Generally, this necessitates a grand overhaul of the MFI's control environment (CGAP 2005). In this context, the board can lead such product transformations. The following points provide some guidance about the issues for board consideration (Dean 2011).

- **Assessing institutional human resource needs.** Supporting the transformation will require the organization to build additional capacity in marketing, client services, IT, and operations— including reporting, treasury management, and internal controls.

It may also call for more sophisticated human capital management practices. As such, each part of the organization will bring new and varying skills, people, processes, and tools to aid in the institution's transformation.

- **Assessing operational upgrade requirements.** It is critical to identify those practices or policies that will need to be added or redesigned to make the addition of savings services possible. Building institutional capacity cuts across all areas of the organization. In this context, it is essential that the MFI evaluate and (most likely) upgrade its IT infrastructure; add or refine liquidity management practices; and refine internal controls and process flows to support additional services. To this end, a detailed project plan needs to be created. Such a plan will include the execution of a new risk approval process to identify and manage the new risks, including operational risks, system risks, liquidity risks, interest rate risks and, if foreign exchange savings are offered, FX risks.
- **Developing an implementation timeline.** the Board and senior management are responsible for outlining SMART[9] objectives, defining key performance indicators (KPIs), assigning responsibilities, and targeting completion dates within a detailed project management plan.
- **Financial and operational projections.** New financial and operational projections are required. It is advisable not to be aggressive in the early phase of savings implementation. Also, it is very important that the board guarantee the availability of required capital for capital expenditures and investments in technical and human resources, including the hiring of outside consultants.
- **Managing regulatory compliance requirements.** Expanding the range of services to including deposit taking requires that a MFI apply for a banking or Other Deposit Taking Institution license. For many MFIs, this is the first time they establish contact with regulatory authorities, and compliance risk becomes an important topic. Compliance risk is defined as: the risk of legal or regulatory sanctions, financial or other loss, or loss of reputation resulting from a failure to comply with rules and regulations. It is often underestimated at the management level, especially when a MFI has only been lightly regulated in its early years. A transformation will change this completely by introducing new requirements, such as: regulatory reporting; minimum standards for governance; anti-money laundering (AML) and Counter-Terrorist Financing; demands beyond the "Know Your Customer" (KYC) standards; customer complaint management; risk management; and verification of the qualifications of key staff, such as managers, risk managers, auditors, and compliance officers.

Given the materiality of compliance risk, the establishment of a specialized function should be considered to cover regulation management, AML processes and regulatory reporting. As the establishment of an independent compliance function is underway, it might also be charged with the tasks of complaint management, whistleblowing, regular internal reviews, and controls. It can also be charged with reporting on the MFI's compliance situation, including regulatory relationship management (or related support to senior management).

It is essential for board members to be very critical about the transformation process of deposit taking for two reasons: (1) in many jurisdictions, board members (and senior managers) are personally liable for "their" MFI's compliance with all regulations;[10] a failure to comply may result in extremely high and embarrassing fines — and even the limitation of business or total loss of the required operating licenses; and (2) regulations or their interpretation and enforcement are subject to change at any time. Therefore, even if seemingly irrelevant rules are not enforced today, they may well be a top-priority requirement tomorrow. A MFI with an active compliance management function will be well prepared to deal with such compliance risks.

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9. **S** = Specific: an objective should be precise and should focus on a single result. A specific objective answers the questions, "who, what, where, and how?"
M = Measurable: an objective should include specific criteria or measures that indicate whether the objective has been met. A good measure answers the question, "How will we know if we have accomplished the objective?"
A = Achievable: an objective should be attainable and within the center's or program's reach.
R = Realistic: an objective should be realizable given the time, resources, and activities proposed and available.
T = Time-bound: an objective should include the date it will be started and the date the center expects to complete it

10. Most directors will have a Directors and Officers Liability (D&O) insurance policy executed to cover them against the risk of allegations of misconduct or negligence. However, such protection is very limited, and directors need a clear explanation about the kinds of protections included in such policies.

CASE 9

Transformations in Bolivia, Cambodia and Kenya

In microfinance, "transformation" most commonly refers to the transfer by an "ownerless" NGO-MFI of all or part of its business to a for-profit, shareholding entity. Through the transformation of Prodem, a Bolivian microfinance institution, BancoSol became the world's first private commercial bank in 1992 devoted exclusively to microfinance.

The microfinance industry witnessed the birth of a new trend: the transformation of NGO-MFIs into regulated financial institutions. Such a transformation has since become a strategic objective for many NGO-MFIs globally. Until recently, corporate governance was of secondary interest in the transformation process, but economic downturns and risk exposure have led many in the industry to consider it a primary differentiating factor between those institutions that survive crises and those that do not. IFC has been engaged with many such transformations globally, including ACLEDA Bank in Cambodia and K Rep in Kenya. The resulting challenges and lessons for boards are also highlighted (IFC 2014, 2015).

ACLEDA'S Transformation to a Bank[11]

ACLEDA originated from the tragedy that befell Cambodia when the Khmer Rouge assumed power in 1975. The International Labor Organization (ILO) and Care International recruited the company's management from refugee camps on the Thai-Cambodian border. The program's initial aim was to develop Local Economic Development Agencies. ACLEDA was the association of these independent regional agencies. In 1996, because of a liquidity crisis, ACLEDA had to decide between providing business development services and financial services to its constituency. The General Assembly of the Association ultimately decided to merge ACLEDA's agencies into a single unified institution.

Challenges

- **Expansion:** ACLEDA began the transformation process to a bank in the mid-1990s, and finalized the legal transformation into a bank in 2000. Since then, both the loan portfolio and savings have grown at an extraordinary pace: savings have grown at a cumulative growth rate of 137 percent, and loans at a cumulative growth rate of over 50 percent a year. The Bank has also expanded its base to almost all provinces of Cambodia.
- **Transformation:** Based on the institution's growth and progress, it is widely considered a very successful case. The transformation was driven largely by growth, and by the need to secure funding. As a NGO, the MFI would have quickly outpaced its ability to secure donations and even subordinated debt. Therefore, savings deposits offered an attractive source of leverage that also provided an important service to clients. The governance of the organization included a "General Assembly" that was comprised exclusively of employees. Thus, a strong sense of employee ownership was instilled. When managers and directors began considering the transformation, they took time to explain the process and motives to all employees. Part of this explanation included the creation of an investment company owned by the employees, which would hold shares in the bank—thereby making the employees the real owners.
- **New Investors:** The MFI then "handpicked" the future external investors to ensure that the mission was not an issue. ACLEDA Bank purchased the NGO's portfolio, and the NGO received both shares (a 45 percent stake in the bank) and a subordinated loan for the value of the portfolio. The institution invested heavily in the training of the current management team, and ultimately kept most of the key managers.

Lessons

- Strong values and a shared vision at ACLEDA, which emerged from the shared experience of the tragedy that befell the country.
- Successful transformation with an inclusive process by management, involving all employees in the process.
- Employee incentives and intensive management training.
- Strong representation of the NGO and the staff association on the board; ownership by the NGO in the bank; and employee ownership, thereby aligning all interests.

11. The original case was prepared by Lieberman and others (2015). See also Di Benedetta, Lieberman and Ard (2015).

K-Rep's Transformation from a Rural Enterprise

K-Rep was founded in 1984 in Kenya by a U.S. NGO. It was subsequently funded by the United States Agency for International Development, which provided funding to existing NGOs involved in microfinance and small business development. In 1990, K-Rep established its own MFI and introduced peer-group lending to micro- entrepreneurs. By 1994, K-Rep had decided to transform itself into a microfinance bank and focus on its own operations. This was the first NGO-to-bank conversion in Africa. It took K-Rep several years to transform, partly because of the unfamiliarity of Kenya's Central Bank with microfinance and how best to supervise such an entity.[12]

New Ownership Structure

After careful consideration of its options, in 1999 K-Rep's board decided to establish a holding company to manage its various activities, which included the bank—K-Rep Group (the holding company), K-Rep Bank Ltd. (the NGO), K-Rep Development Agency, and a consulting company, K-Rep Consulting Services. Initially, K-Rep Holdings sought to own 51 percent of the bank, but the Central Bank limited ownership concentration to 25 percent. K-Rep attracted several like-minded investors that would allow the bank to retain its mission.[13]

In 2015 Centum Investment Company acquired a majority stake in K-Rep Bank, and on April 4, 2016 the bank was re-branded as Sidian Bank. On August 1, 2017, the Bank's Board named Chenge Thumbi as its new CEO, replacing Titus Karanja. Succession has been a governance issue for the Bank since its founder and long-term CEO, Kimanthi Mutua, retired.

Challenges

- **Management/Employee Incentives:** With the support of CGAP, K-Rep established a form of Employee Stock Ownership Plan as a cooperative called the KWA. This allowed existing and future directors, managers, and employees to purchase shares in the bank, with a view that it would eventually undertake an IPO on the Nairobi Stock Exchange. CGAP funding allowed the KWA to retain liquidity so that shares could be sold and purchased by employees, including future employees. The KWA retained a 10 percent interest in the bank, but was not allocated a board seat.
- **Management Capability:** Senior management of the NGO remained with the bank following transformation, including the long-serving CEO, Kimanthi Mutua, who was well-known and highly respected in the microfinance sector. In time, employees with specialized knowledge were recruited from the banking sector.
- **Growth and Performance:** K-Rep Bank grew steadily and strongly as a bank: between 2000 and 2007, clients grew from 15,000 to 153,961; savers from 2,724 to 16,701; the gross loan portfolio from US$4.6 million to US$110 million; and the return on equity from 13.4 percent to 22.3 percent. In 2007, the bank began to experience delinquency problems with its portfolio at risk, increasing from 3.6 percent to 12.6 percent. K-Rep's problems increased partly because of the bank's diversification into small business loans, as well as a failed effort at CEO succession. Mutua sought to step down as CEO after many years of running the NGO and the bank. Investors provided the bank with more liquidity in the form of a rights offering. In time, a new managing director was brought in when Mutua retired after some 25 years of service. He remained as chair of the holding company, and the bank was restored to health.
- **Digital Banking:** The bank has also made a successful transformation to provide digital financing services to its clients. Services include: new loans, deposits, account opening, and funds transfer. It is in the process of recruiting some 3,000 agents to complement its branch operations.

Lessons

- Planning and implementing a transformation to attract key investors, including shareholder support through a rights offering to increase tier 1 capital.
- A need to work closely with the Central Bank to obtain regulatory approval for transformation.
- Creating a formal employee stock ownership plan which allowed long-term employees to benefit from their service and newer employees to acquire shares (ownership interest) over time.
- Planning management succession well in advance to ensure a smooth and anticipated handover process
- Board's role in managing losses is key in an internal crisis resulting from losses due to NPLs on SME loans.
- Adopting to technological change and competition by developing digital products through agent networks

Source: Di Benedetta, Lieberman and Ard (2015).

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12. Subsequent transformations in Kenya have benefitted from the K-Rep case. See the Frankfurt School of Finance and Management (2012) for a detailed discussion of the transformation of two other MFIs in Kenya.

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

2. Digital Transformation[14]

Globally, MFIs are increasingly embracing technology to enable the provision of DFS. MFIs are motivated by a variety of factors, including reaching unbanked people, often living in remote rural areas; offering new products; or just to stay ahead of the competition. New tools and technologies are challenging the basic drivers of MFIs which have been in place for decades. The same services can now be offered with greater speed, accountability, and efficiency — and at a lower price, which can translate into savings for the end user. The adoption of DFS has been largely enabled by an ever-increasing mobile phone and cellular network coverage.

The business strategies MFIs pursue with regard to DFS vary, but generally fall into the following categories:

- **Leveraged payment and e-money systems:** Many MFIs partner or use existing payment systems from a fintech or mobile network operator (MNO) to make loan disbursements, repayments or to conduct other cash transfer services. For example, Equity Bank in Kenya has established its own e-money system that allows most its banking transactions to pass through agents. Equitel, Equity Bank Group Limited's mobile banking service, allows customers to access both banking and telecommunications services from voice, data and short message service texts. Banking services include: sending, receiving and withdrawing money through phones; receiving remittances directly to accounts; and accessing accounts on mobile phones; and loans, insurance, and cross border money transfer services.
- **Managed agent network:** FINCA Democratic Republic of Congo (DRC), founded in 2003, is a microfinance institution. It launched an agent banking service in 2011 to expand its footprint beyond its 18 branches. Its 548 agents form the largest agent banking network in the DRC, where only four percent of the population of 75 million has an account with a formal financial institution. FINCA now holds a quarter of a million customer accounts that can be used for savings and loans. More than half of FINCA's business is transacted through agents using biometric point-of-sale (POS) terminals. Transaction details are communicated from the agent POS device by mobile data network to a switch, which then links to the FINCA servers through a secure internet connection (MasterCard Foundation and FINCA International 2016).
- **Fintech solutions:** Many MFIs are now working with fintech companies to digitize different aspects of their business operations. The stated goals include: (i) scaling and innovating products; (ii) using data analytics to enhance customer engagement; (iii) reducing and mitigating risks; (iv) improving product efficiency; and (v) making products more accessible. Such solutions range from introducing tablets to facilitating loan applications and approval processes, to using advanced data analytics to support credit-scoring or product marketing to clients. This space is evolving quickly. There are many new fintech startups with limited track records, which can make partnership decision-making a challenge for MFIs.

Finding strategic partnerships across traditional and innovative technology players is key to successfully transforming institutions to better serve the underbanked. As traditional, higher-touch interactions with customers are "disrupted" by financial technology using low-touch, big data credit decision-scoring or through agent networks, there is an increasing need to sharpen customer focus. This entails a stronger commitment by the board in helping to strategize and navigate a myriad of opportunities and risks to advance responsible financial inclusion in both traditional and digital finance.

Digital transformation involves many of the challenges described with respect to institutional transformation. It is perhaps even more challenging as some of these technologies disrupt and create new markets and value networks. The examples of Equity Bank, among others, illustrate the opportunities that DFS can bring to an MFI when new technologies are implemented well. With the pace of technological change and competition challenging the sector, many MFIs are now looking to transform themselves or form strategic partnerships These actions are being done more deliberately and with greater immediacy than before (Di Benedetta, Lieberman and Ard 2015; 6).

As noted, among the greatest risks facing MFIs working in the financial inclusion space today is the lack of institutional capacity to develop and implement a viable strategic plan to guide the institution through rapid changes, unpredictable or endemic crises, product diversification, and market expansion or business transformation. A recent report by the MasterCard Foundation and IFC's Partnership for Financial Inclusion (MCF-IFC 2016) defined approaches to addressing critical risks for DFS. These are new and unforeseen

risks that appear when implementing DFS, which boards will need to adequately address accordingly. The main risks and challenges for board members to discuss in a potential digital transformation are highlighted in Box 6. See the MCF-IFC Handbook (2016) in the list of suggested readings for further details of each risk category.

Key risks for Board attention are discussed briefly below, and are in line with general aspects of the board's role, as outlined in previous chapters.

Board Ownership

Implementation challenges begin at the top of the organization, and many boards and executive managers do not possess the requisite technological know-how. As such, many are grappling with digital innovations. Even without such knowledge, though, board awareness is important in realizing that such projects are not placed in the realm of the IT department and viewed simply as tech issues—ignoring the fact that introducing ADCs is not just a plug-and-play project. Indeed, digital innovation also represents a great collaboration test for the IT and operations and retail departments, but it should be driven by the latter.

Strategic Risk Guidance

Particularly for DFS, this is the primary area for the Board to be involved and, if necessary, bring in outside expertise. A DFS strategy that is not well thought through will result in losses, missed opportunities and possibly a tarnished reputation. A DFS strategy should be part of the MFI's business strategy and projections. Often the DFS strategy will be leading the overall MFI strategy. Indeed, DFS will define where the MFI can expand, at what cost, with which products, and with what organizational structure. As this is not business as usual, it is important for the board to create a steering committee, including members of the board, executive management, IT, and the risk and operations departments. At this point, the board can decide to make use of external advisors, if in-house knowledge is insufficient.

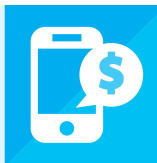
When a MFI starts to define its DFS strategy, it is important that the board take into consideration both internal and external factors (MasterCard Foundation and FINCA International 2015). Internal factors include: vision and mission; products and services; capacity; the IT environment; and the business case or revenue model. External factors include: client needs; competition; the information and communications technology landscape; strategic partnerships; and regulations. These factors will provide the board and steering committee with a holistic understanding of the opportunities and complexities of moving into digital banking services. The board can also ensure that the strategy is up-to-date. Changes in the technological and/or regulatory spheres have the potential to render certain business practices outdated/obsolete, as do changes in the competitive landscape in the financial sector or that of the MNO. Annual strategy sessions are important for capturing a broad and detailed operational scope.

Partnership Risk Management

A successful DFS strategy will require MFI partnerships with third party providers, namely: vendors, mobile-wallet providers, MNOs, and premium rate service providers (PRSPs), among others. A successful partnership entails finding partners that are aligned operationally, technically, and commercially, as illustrated in Case 10 (MCF-IFC 2015). Partnerships in DFS are still relatively new and are continuously evolving. Emerging lessons indicate that there are four factors critical to successful DFS partnerships (IFC 2013; MCF-IFC 2015):

- **Partner role:** Deficiencies in partnerships as a result of either one or more of the partners not playing a role that is key to their success — or one or more of the partners playing a role for which they are ill-equipped or unmotivated to play;
- **Value-add:** DFS partnerships must enable partners to generate value for their respective companies;
- **Alignment:** Partnership roles must be aligned with motivations, and competitive and comparative advantages;
- **Playing-Field:** Partnership agreements rely on a level playing field and an effective regulatory environment.

14. For a complete understanding of the new risks involved with implementing DFS, the authors recommend that directors read the MCF-IFC Handbook of Digital Financial Services and Risk Management (2016). Partnerships and related risks are further described in the MCF-Handbook on Alternative Delivery Channels and Technology (2015). More recent IFC analysis (Saal 2017) distinguishes a technology vendor from a partner, which shares the risks and rewards of the product and will often have its own brand and infrastructure and be clearly visible to the client in the product configuration and delivery.



Box 6 | Top Risks in Implementing a Digital Finance Program

- **Strategic Risk:** This is defined as the losses which arise from an unsuccessful investment in DFS. Given the complexity of the investment—partnerships with a mobile operator and an agency network, investment in technology, marketing the program to existing and new potential clients, and the rapidity of change in the sector — MFIs will need to look carefully at the cost benefits of such a strategy.
- **Regulatory Risk:** This refers to the risks associated with regulation of digital services by banking supervisors, agent networks, anti-money laundering and financing terrorism constraints, and so on. The MFI's Board will need to understand the costs of compliance —or the costs of failure in not complying.
- **Operational Risks:** This refers to the risks of managing the product diversification inherent in DFS, in effect managing the new business line. These risks are for the most part internal—marketing and sales, IT and technical operations, finance, client servicing, and so on. However, they also include operational risks related to managing partnership arrangements with a mobile operator and an agents network.
- **Technology Risk:** This refers to the inability to transact business due to systems down time or other technical failure. It can potentially lead to reputational risk and a loss of clients. Technology risk is closely aligned with operational risks. Transactions within DFS pass through several communications systems and devices, and require complex software. Much of this is out of the direct control of the MFI. Therefore, the board needs to ensure that the partnership agreement governing DFS covers responsibility for addressing emergencies, such as disruption of services, technical upgrading as the technology develops, as well as who is responsible for compensating clients for loss of service.
- **Financial Risk:** It is hoped that the DFS will substantially increase business for the MFI. However, instead of the high-touch, close proximity to clients associated with traditional microfinance, DFS is low touch, meaning that clients will make deposits, take loans, make transfers "out of the sight" of loan offices and outside of bank branches. This potentially puts the MFI at more risk than just the traditional financial risks. Such new risks include: (i) liquidity risk as more clients seek loans; (ii) credit risks as loan officers are not able to vet village or community clients known to them; (iii) interest rate risks, as interest rates on borrowed funds increase, while the MFI is unable to adjust the loan rates advertised for loans provided digitally on a timely basis; (iv) concentration risks, which can include over-exposure to a particular digital product, region or select set of clients actively using DFS; and (v) FX risks, that is, a mismatch between the currency the MFI borrows in and the loans provided, which are usually in the local currency.
- **Political risk:** This generally refers to disruption of DFS due to political turbulence or violence, or simply the decision by a government to intervene in such services. A recent example involves political protesters in the DRC, and the decision by the government to cut internet services, resulting in a loss of services in northern Nigeria where a terrorist group operates. Political risk is out of the control of the MFI, and can arise suddenly without warning. It can also be costly.
- **Fraud Risk:** This is of significant concern to MFIs that have launched DFS. Fraud includes agent fraud, client fraud and employee fraud—largely through the creation of "fictitious accounts" which have cost MFIs millions of dollars.
- **Agent Management Risk:** This is endemic to DFS providers. There are multiple potential risks, such as: (i) too few or too many agents—too few means a lack of adequate coverage for clients, and too many agents means that the MFI is unable to achieve a critical mass of business. Getting the balance right is difficult for the MFI, and often requires a super-agent or agency network agreement; (ii) insufficient liquidity—agents maintain an inadequate float and cannot service the clients of the MFI; (iii) theft of agent float; (iv) inadequate agent training, including tellers who make mistakes in data entry of transactions; (v) poor agent selection and/ or poor agent management; and (vi) inadequate branding and marketing materials.

Box 6 (continued) | Top Risks in Implementing a Digital Finance Program

- **Reputational Risk:** These arise from other risks, such as strategic, technological, operational and agent risks. Reputational risk is the inability to provide high-quality DFS. This can lead to customer dissent, financial losses, partnership legal claims, and so on. One way to mitigate reputational risk is for the MFI to have a management team appointed to operate this business as a stand-alone profit center or product line, with the business manager reporting to the managing director (CEO).
- **Partnership Risk:** Implementing a DFS program requires partnership arrangements at a minimum with a MNO, usually with an agent network, and also a bank — if the MFI is not a deposit-taking institution. Partnership arrangements can be complex, and require carefully negotiated legal agreements in advance of operations, as well as close coordination between the partners. They also require agreement in advance on problem resolution, and arrangements which allow each of the partners to gain added value from the partnership.

Source: MCF-IFC (2016).

CASE 10

Agent Network Partnerships with MFIs

MicroCred Group, established in 2005, is an investment company that builds and manages an international network of financial institutions in emerging markets. These financial institutions share the common mission of providing quality financial services that are accessible and adapted to the needs of the unbanked and/or under-served people — particularly micro, small, and medium entrepreneurs in the five African countries of Côte d'Ivoire, Mali, Madagascar, Nigeria, and Senegal, as well as through two affiliates in China's Sichuan and Nanchong provinces.

In 2013, MicroCred launched a major transformation program supported by a multi-channel distribution network to reach mass market customers beyond the limits of branches and into rural areas. The multiplicity of distribution channels — accompanied by product development, market intelligence, process automation, and marketing efforts — is critical in supporting the delivery of innovative products. MicroCred identified the following quality targets: simplicity/intuitiveness; availability; robustness; and coherence among channels. These are to be applied as core themes throughout the channel strategy. To address these challenges, MicroCred used a human-centered design approach to systems design and development. It aims to make interactive systems more user-friendly by focusing on the customer's use of the system and applying such knowledge and techniques based on human factors, ergonomics, and usability. MicroCred empowered a cross-functional team to design the service based on extensive field research and observation. It also monitors the quality of service provided to customers, frequently releasing small adaptations based on constant feedback loops.

FINCA Democratic Republic of Congo (DRC), an MFI introduced its agent network in 2011 by employing small business owners to offer FINCA DRC banking services. By 2017, the agent network grew quickly to 76 percent of total transactions. However, growth was concentrated in the capital of Kinshasa as well as one of the country's commercial hubs, Katanga. FINCA DRC sought to expand the network into rural areas and built a predictive model to identify criteria that define a successful agent. The results were incorporated into agent recruitment surveys, helping FINCA DRC to select good agents in expansion areas. Moreover, the availability of a successful agent network that customers can use to conveniently repay loans supports the reduction of its portfolio at risk. Data availability and data quality were the main challenges in developing the agent performance model. Digitized data are required for sources, usually only collected on paper, such as agent application and monitoring forms. Missing data must be minimized, both to make datasets more robust and to enable the merging of datasets by matching meta-data fields. This requires standardizing data collected by different people, who may be using different collection methods. Lack of consistent data can lead to significant sample reduction, undermining the model's prediction accuracy and performance.

Successful agents in the DRC are identified by the following statistically significant criteria: geographic location; sector of an agent's main business; gender of the agent; and whether they reinvest profits. For instance, women-owned agents are found to contribute 16 percent more profit with their agent businesses than their male counterparts. Furthermore, the value of their business inventory is 42 percent higher. They were also found to reinvest more into their business inventory, rather than keeping it in a bank account that yields little interest. This resulted in about a 5 percent higher total average transaction value per month. These results were implemented to improve and streamline the agent selection process. This ultimately helped to expand the network into rural areas by incorporating such factors into agent surveys and in the roll-out strategy. The model identified location as a key criterion, revealing another research opportunity.

Sources: MCF and IFC (2016), 3; (2017), 65-66.

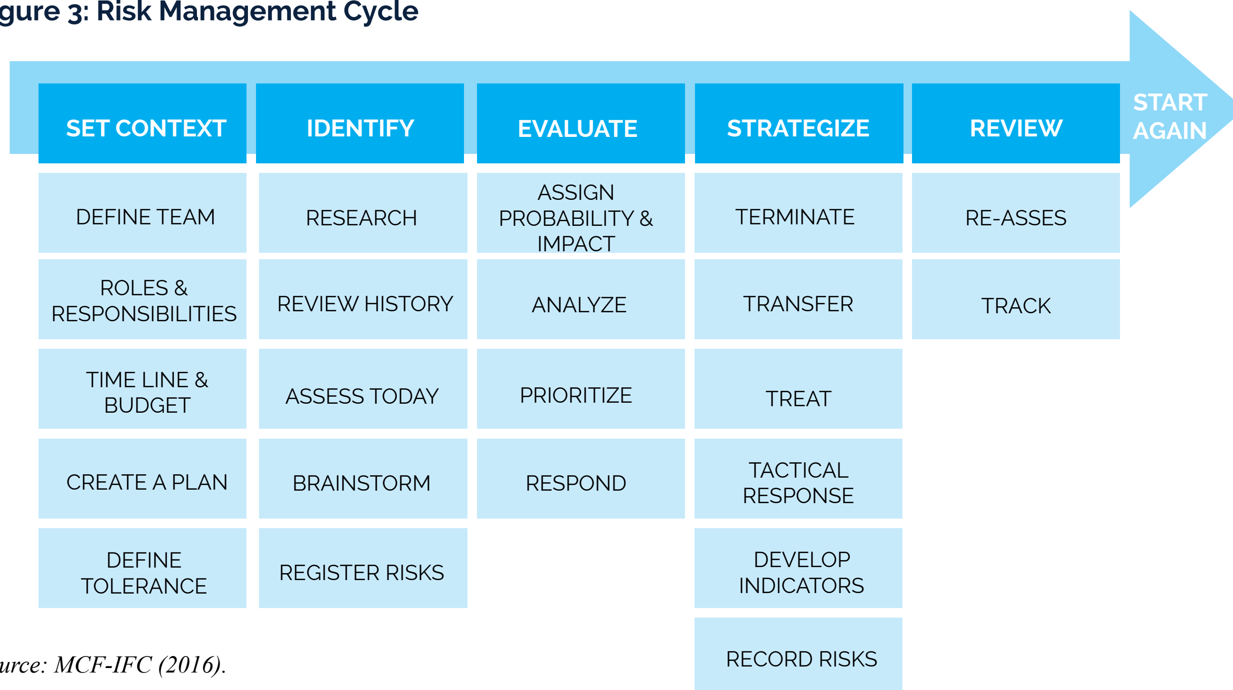
The board should be cognizant that technological advances or regulatory changes can make certain partnerships obsolete. Another possibility is that a MNO and MFI can experience increasing challenges related to who actually owns the client. The general framework for an exit strategy should be available as part of the MFI's business continuity plan and its overall outsourcing management (Parker 2011). Boards can also require that management establish several mitigation strategies revolving around strong customer service, as well as marketing and branding initiatives. On the legal front, MFIs should address the customer ownership issue (when possible) in their partnership agreements, with clauses pertaining to exclusivity and non-compete issues (MCF-IFC 2015).

Directors play a crucial role in partnership negotiations. When partnering with MNOs, MFIs can find themselves in uneven negotiations given their size and power. As such, boards can ensure that their MFI does not accede to all the demands of the MNO (MCF-IFC 2015). Service level agreements should be well reviewed by internal and external counsel to ensure that there is clear ownership level at every stage of the process. Further, the consequences for both parties in case of non-delivery of the agreed service level standards should be specified.

Proactive Risk Management

Although an MFI may have a well-functioning risk management framework, the introduction of DFS will require a new and continuous assessment of risk management. It is important for a board to instill a broader risk focus, including tackling risks that will not be immediately apparent, such as strategic and partnership risks (MCF-IFC 2016). DFS will not only introduce new risks (for example, agent fraud or weak data privacy), but it will also require existing risks to be re-evaluated (such as staff operational capacity and data security of the existing MIS).[15] These are the sort of risks that MFI management can identify, map and incorporate into its daily operations. Figure 3 highlights a step-by-step example of the risk management cycle for institutions, including microfinance and DFS. More specific, detailed actions required across each step are provided in the Handbook (MCF-IFC 2016), as referenced in the suggested readings of this section.

Figure 3: Risk Management Cycle



Source: MCF-IFC (2016).

15. The MFI's risk department, usually with the support of the Board's Risk Committee, should adopt this holistic approach and conduct a New Risk Approval (NRA). This NRA will identify, assess and manage all new risks associated with the new processes and systems developed for the desired DFS strategy.

Suggested Reading:

Council of Microfinance Equity Funds (CMEF). 2011. Aligning Stakeholder Interests in NGO Transformations - Emerging Good Practices.

Ledgerwood J. and Victoria White. 2006. "Transforming Microfinance Institutions." World Bank, Washington, DC.

Lieberman, Ira, Elizabeth Rhyne, Brian Busch, and Stephanie Dolan. 2008. Aligning Interests: Addressing Management and Stakeholder Incentives During Microfinance Institution Transformation. San Jose Costa Rica and Washington D.C.: Calmeadow and the Center for Financial Inclusion.

Mastercard Foundation and IFCs (MCF-IFC). 2016. Digital Financial Services and Risk Management Handbook.

______. 2015. Alternative Delivery Channels and Technology Handbook.

______. 2013. Partnerships in Mobile Financial Services: Factors for Success.

Pugliese, Maria Giovanna. 2010. "Same Game, Different League: What Microfinance Institutions Can Learn from the Large Banks." In Pete Sparreboom (Ed.), Geneva Papers on Inclusiveness No 11. World Microfinance Forum: Geneva, Switzerland.

The Board's Role In Responsible Finance

Responsible finance involves implementing practices, policies and procedures to deliver transparent, inclusive, and customer-centered products and services. Managing risks for customers is managing risks for competitive resiliency and sustainable, prudent growth. [16]

1. Responsible Digital Inclusion: Why it Matters

This Chapter focuses on the Board's role in monitoring potential risks to consumers, defined broadly as individual customers and micro and small business entrepreneurs as users of DFS. While the earlier chapters highlighted governance and risks directly impacting institutions, of equal importance are the risks impacting customers or consumers – particularly lower income segments. This task can be more challenging, and will vary according to a combination of local market conditions, such as over-competition, fragmented consumer protection regulations, and/or weak DFS infrastructure.

Financial crises in the last decade have also weakened public perceptions in certain markets, thereby opening the door for alternative DFS models (IFC 2017). At the same time, this can create unforeseen customer risks. For instance, technology innovation has created "big data" footprints and data trails that capture the personal lives of customers who are using mobile phones, online payment systems, and social media. Although these models are lowering costs and enabling quick and convenient access to finance, they are also raising consumer data protection questions, specifically about data ownership, data use, privacy, and security (GPFI 2017; RFF 2017). They also raise issues about the need for customer recourse, and more effective disclosures for authorized consent.

The use of alternative data analytics and credit scoring methods have recently involved risks related to "data discrimination," that is, when parts of the population are inadequately represented, or when conclusions are based on sensitive personal data—especially when non-predictive data is used against the customer. Customers can be blacklisted, such as in Kenya, where over 600,000 such customers have been blacklisted for failure to repay loans of as little as US$1, without any explanation or recourse.[17]

These developments provide a challenge for MFI Boards that are exploring DFS partnerships or rolling out DFS products and services. At the same time, industry evidence and a focus on customer-centric products and services serves as an opportunity for MFI Boards to strategically enhance their competitiveness, as they embark on a partnership or growth strategy through digital innovation. Box 7 highlights microfinance lessons that are just as relevant for DFS and fintech providers that are today expanding their growth into lower income segments in developing markets.[18]

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16. Responsible Finance Forum VII. 2016. Xi'an, China.

17. The East African, "Kenya's Central Bank to review credit rating system over 'unfair blacklisting'", October 4, 2017.

18. See Jessica Schicks and Richard Rosenberg, "Too Much Microcredit? A Survey of the Evidence on Over-Indebtedness (September 2011), CGAP No. 19. The publication provides a detailed discussion about over-lending and over-indebtedness by MFIs and their clients.

2. Responsible Finance and Risk Management

The advent of DFS, particularly those targeting the two billion poor and underserved, have fostered the need for a more comprehensive risk management framework — one that strengthens board and management awareness of customer risks. Responsible finance practices that mitigate such risks present an added challenge and opportunity for MFI Boards implementing DFS transformations or using ADCs.

Achieving the appropriate balance between scaling DFS and customer protection remains an ongoing challenge. Globally, a number of initiatives over the last decade have surfaced. Earlier examples, such as in China (Cases 11), highlight successful efforts to implement responsible finance. New approaches are evolving to

CASE 11

Approaches to Risk Management and Responsible Finance

NGO Transformation

The China Foundation for Poverty Action (CFPA) managed its transformation from a nongovernmental organization to a commercial institution by maintaining its mission, including strong growth in rural areas representing 80 percent of the country's poorest counties. The CFPA's business strategy integrated responsible finance throughout its operations. It formalized client-centered practices in its policies and procedures across the institution through a comprehensive risk management framework. The business plan established a risk management department to provide regular portfolio reporting and monitoring to senior management on a monthly basis. The CFPA also endorsed the Smart Campaign Client Protection Principles, and embedded these principles into the organization through staff training workshops and incentives. It standardized operational procedures to include handling customer complaints and conducting an annual customer-satisfaction survey. The CFPA continues to report to the credit registry in China to mitigate any over-indebtedness risk. It has also established a credit scoring system. Key monitoring indicators include client retention and new client ratios, which encourage branches to not only focus on business volume, but also on the quantity and quality of their clients to maintain prudent growth. In 2015, the CFPA started to introduce digital innovation — including products ranging from a Peer-to-Peer (P2P) platform designed to provide intermediate debit and credit to micro business start-ups and investors in rural areas —to a rural-oriented insurance P2P platform.

E-Commerce Platform

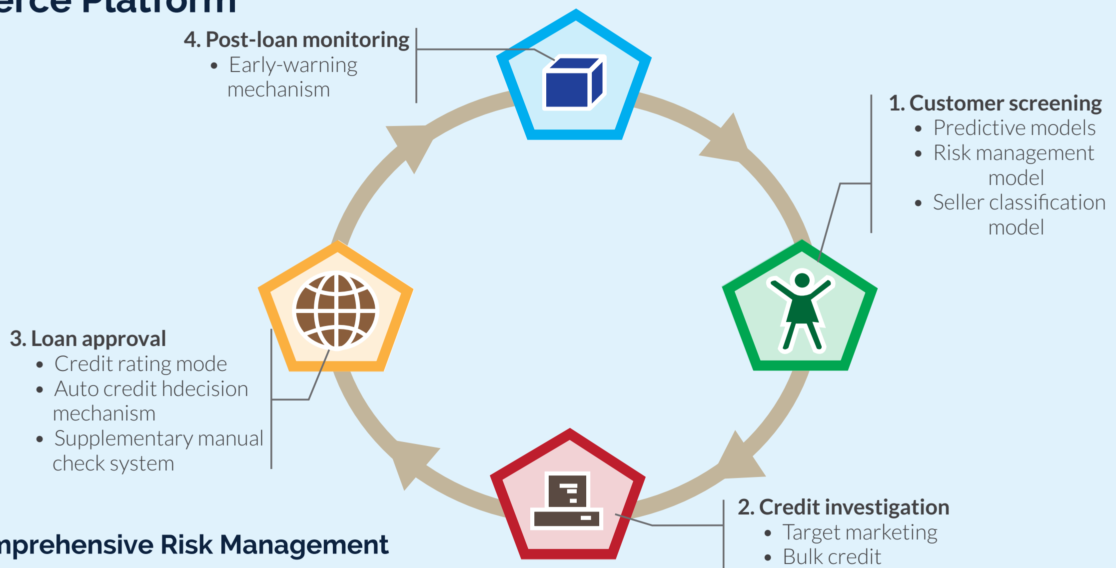


Figure 4: Comprehensive Risk Management

Sources: IFC 2015 and RFF VII 2016.

CASE 11 (continued)

E-Commerce Platform (continued)

Ant Financial Services, the world's largest and fastest growing ecommerce platform, managed to create and scale a diverse set of financial products and services — from online payments to cloud computing and data services. Its successful growth is attributable to its reliance on big data technology, thereby reducing financing costs to micro, small and medium enterprises, increasing accessibility to credit, and enhancing the efficiency of financial resources. Ant Financial takes a complementary view of risk for both its businesses and its customers. As shown in Figure 4, its comprehensive framework covers alternative credit scoring (sesame credit) to help mitigate credit risks for customers. It also factors in multiple dimensions that may come into play, including technology and cyber risk, fraud, and consumer data privacy. Finally, the company provides wealth management as an added customer service to improve financial education for its customers in the critical stages of decision-making throughout the entire lifecycle.

Sources: IFC (2015) and RFF VII (2016).

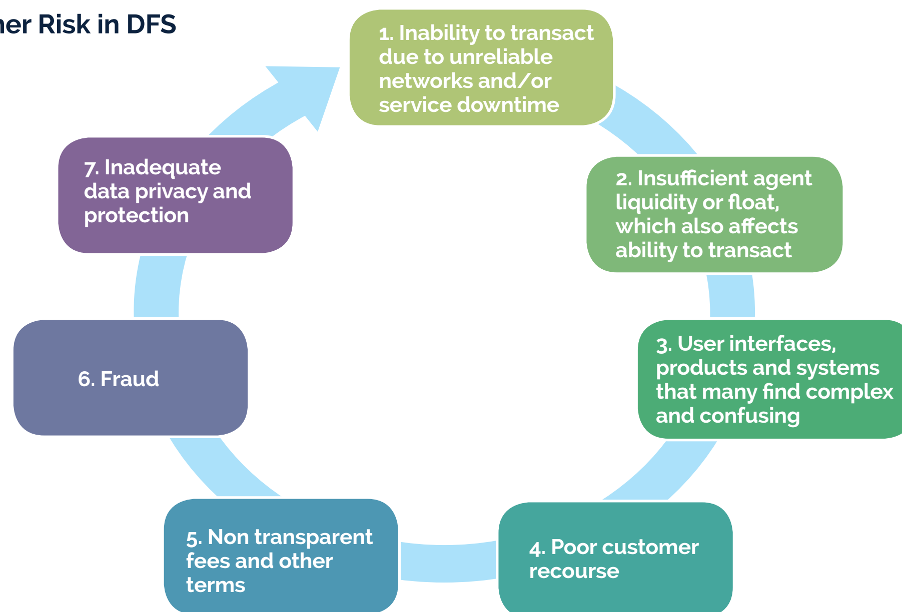
manage risks for customers and providers, and hence potentially for the sustainability of the broader financial inclusion industry (RFF VII 2016).

3. Customer Risks in Digital Financial Services

Given the complex challenges and potential opportunities of DFS, since 2015, the Responsible Finance Forum has continued to focus attention on the importance of responsible digital finance, as shown in figure 5 (RFF 2015). In 2017, the RFF held an event in Berlin focused on consumer protection and data privacy issues, including potential approaches to improving customer consent. Figure 5 provides an overview of risks that financial inclusion customers continue to face with the use of digitally-delivered financial services and products (CGAP 2015; 2017).

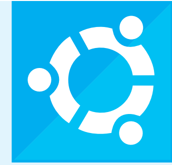
Action steps described in earlier chapters are aligned with board roles with respect to institutional governance and risk management frameworks. Accordingly, depending on its business plan and local market context, the board may consider how it can further help to mitigate potential DFS risks to its customers. Fostering trust with DFS customers is a market differentiator for sustainable growth and competitiveness.

Figure 5: Customer Risk in DFS



Sources: CGAP 2015 and RFFV 2015.

Box 7 | Responsible Microfinance Lessons of Experience



Race for market growth and high profits: An oversupply of funding and pressure from shareholders led to a race for unsustainable growth and high profits. This resulted in high growth rates and less focus on customer service, weak credit approval and underwriting criteria, as well as inappropriate products to fit customer needs.

Increased reputation risks, political scrutiny: In certain countries, the sector and companies have become important players with respect to financial intermediation. This has given them high exposure to scrutiny from politicians and regulators, and potential loss of reputation through social and public media.

Over-indebtedness and loss of customer trust: Consumer protection issues have weakened customer trust. This stems from a combination of low levels of financial capability; a lack of transparency in pricing and disclosure of terms and conditions; repayment issues; ineffective recourse; and coercive collection practices. Yet customer trust and expanding product use are an essential premise for the stability of any financial institution. This is particularly the case when a business shift to provide DFS is an imminent or necessary next step to remain competitive.

Client Protection Principles: In response to crises facing the microfinance sector, the Smart Campaign at the Center for Financial Inclusion at Accion began an industry movement. They did so in partnership with leading stakeholders to pilot indicators and support the development of Certification Standards for MFIs. For instance, IFC responsible finance and risk management advisory work in in Bosnia and Herzegovina and India helped to define practices and standards for protecting clients.

Smart Campaign Certification: Following pilot testing and industry consultations, the Smart Campaign formally launched its Client Protection Certification in January 2013. Since then, over 100 microfinance institutions have been certified, with an outreach of over 40 million clients globally.[19] Certification represents public recognition that the microfinance institution is implementing Client Protection Principles, namely: (1) appropriate product design and delivery; (2) prevention of over-indebtedness; (3) transparency; (4) responsible pricing; (5) fair and respectful treatment of clients; (6) privacy of client data; and (7) mechanisms for complaint resolution.

19. Smart Campaign: http://www.smartcampaign.org/certification/certified-organizations

Sources: CFI/Smart Campaign, 2013; IFC 2017.

Annex III provides a Customer Assessment tool that boards may use as relevant to their market and business context. The assessment tool is structured along the following five areas. These areas are in line with how institutions may operationalize responsible finance practices across governance and risk management systems, policies and procedures. Boards may consider the following questions:

- **Governance and management strategy:** Does the MFI-DFS strategy address consumer risks and include responsible finance practices? Do the code of conduct, policies, procedures and systems incorporate consumer protection practices and principles?
- **Pricing, transparency and disclosure:** Are DFS products priced to mitigate credit risks, such as customer over-indebtedness? How are prices and fees communicated to customers, for example in contracts or key fact statements? Are multiple communication channels used to disclose pricing, terms and conditions, and obligations and responsibilities? The Smart Campaign provides a list of Certified Organizations for MFIs who have implemented these practices. However, DFS standards are still evolving, given the various DFS business models globally.[20]

20. See: Smart Campaign Certified Organizations: http://www.smartcampaign.org/certification/certified-organizations. See also the following for an overview of global business models: "Digital Financial Services: Challenges and Opportunities for Emerging Market Banks." IFC Emerging Compass Note 42. Matthew Saal, Susan Starnes and Thomas Rehermann, August 2017.

- **Customer service:** Do the board and management produce and analyze reports about customer feedback and complaints? Are customer service reports used to improve products and services, or are they used to mitigate potential reputation risks? How are complaints escalated and addressed or resolved, particularly in cases of system authentication, authorization and accounting or related transaction errors? Case 12 highlights two examples in Kenya of effective customer services that have used data-driven analytics.
- **Data privacy and security:** Does the company implement data privacy and security standards? If so, how and which standards? How are customers informed about the way in which their personal data is collected, used, shared, retained, and secured? How is customer consent implemented to promote improved disclosures? Box 8 summarizes the current context of privacy laws, followed by key aspects in data governance planning.

CASE 12

Data Analytics for Improved Customer Services in Kenya

Safaricom M-Pesa

M-Pesa in Kenya was the pioneer of DFS at scale, with 20.7 million customers, a thirty-day active base of 16.6 million, and reported revenues of $4.5 billion in 2016. When Safaricom launched the service in 2007, there were no templates or best practices; everything was designed from scratch. Continuous operational improvement was essential as the service scaled.

Uptake for the service was unexpectedly high from the start, with over 2 million customers in its first year, beating forecasts by 500 percent. This growing demand forced rapid scaling, and required operations to proactively anticipate scaling problems in both the technology and business processes because any bad customer experience could quickly erode customer trust.

The analysis accomplished two things. First, bottlenecks were successfully identified, passing key insights back into operations. Second, other operational issues were uncovered, mainly the extent to which customers erroneously sent money and forgot their personal identification numbers (PINs). As such, the “Managing against the Unanswered Calls” KPI delivered broader operational benefits.

M-Kopa

Established in Kenya in 2011, M-Kopa began as a provider of solar-powered home energy systems, principally for lighting. It was also used for charging small items such as mobile phones and radios. The business combines machine-to-machine technology, using embedded subscriber identification module (SIM) cards with a DFS micro-payment solution — meaning that the technology can be monitored and made available only when advance payment is received. Customers buy M-Kopa systems using ‘credits’ through the M-Pesa mobile money service. They then pay for the systems using M-Pesa until the balance is paid off and the product is owned.

In recent years, the business has expanded into other areas, including the provision of home appliances and loans using customer-owned solar units as refinancing collateral. These products are offered to customers who have built an ‘ability-to-pay’ credit score metric, as assessed by their initial system purchase and subsequent repayment.

M-Kopa is now also available in Ghana, Tanzania and Uganda. M-Kopa uses data proactively across the business to improve operational efficiency. Its databases amass information about customer demographics, customer dependence on the device and repayment behavior. Each solar unit automatically transmits usage data and system diagnostic information to M-Kopa, informing them of when the lights are on, for example. All of this can be analyzed to improve the quality of service, operational efficiency — and to develop a better understanding of customer behavior.

Source: MCF-IFC (2017) excerpt 70-71; 74-75.

Box 8 | Data Governance

Data Privacy and Customer Protection

Currently, there are no uniform or global standards to govern data privacy issues. Privacy laws, where they exist, vary significantly — and even more so between developed and developing markets. In developed markets, such as in the European Union, the right to privacy and data protection is highly regulated and enforced. However, in China and the US, no comprehensive national data protection laws exist. In some developing countries, such as Ghana, South Africa and Uganda, there are customer-centric regulations. Specifically, privacy regulations provide for the following:

- Empowering the customer to make personal decisions about how their information can be used, particularly for automated decisions, such as in alternative credit scoring models.
- Providing clear recourse mechanisms and compensation for data complaints.
- Giving customers "the right to be forgotten."

Developing a Data Governance Plan

Data governance involves issues about how and when data are used, and who has access to it. Planning involves interface with broader corporate governance policies, legal requirements and communications policies. The purpose of the plan is to permit data access to the project team and delivery stakeholders, while balancing the need for data privacy and security.

The data governance plan is usually affected by the project's scale, that is, bigger projects may have much more risk than smaller ones. A main challenge is that the data science approach benefits from access to as much data as is available to bridge datasets and explore patterns. Meanwhile, more data and access also pose greater risks.

Project data governance should also specify the Extraction-Transformation-Loading Plan. This encompasses transportation, or planning for the physical or digital movement. As such, it must consider transit through policy or regulatory environments, such as from a company in Africa to an outsourced analytics provider in Europe. The plan should also consider the following aspects:

- **Encryption:** Sensitive or identifying information should be encrypted, obfuscated, and/or anonymized, as well as maintained through the full data pipeline.
- **Permissions:** Access to datasets should be defined on a granular basis by team roles, or by access points (that is, from within corporate firewalls, versus from external networks).
- **Security:** Datasets placed into the project's 'sandbox' environment should have their own security apparatus or firewall, as well as the ability to authenticate privileged access.
- **Logging:** Access and use should be logged and auditable. It should also be enabled for analysis and reporting.
- **Regulation:** The plan should ensure regulatory requirements are met, and non-disclosure agreements or legal contracts should be in place to cover all project stakeholders. Customer rights and privacy issues must also be considered.

Source: MCF- IFC (2017).

- **Risk and internal audit:** Are consumer protection risks monitored or audited and reported regularly to the Board? What are the trends and performance of key risk indicators? For example, this could include the number and type of customer complaints received and time to resolve complaints; product usage feedback; agent or network performance; fraud incidence; and customer transactions error incidence. What areas can be improved to guide operations, policies and procedures to enhance consumer protection and mitigate potential reputational risks? Selected KPIs are provided in the Table below, and may be used as relevant by the institution.[21]

4. Evolving Standards and Investing in Responsible Digital Inclusion

Digital financial inclusion standards are still evolving and continue to build on existing principles from the microfinance sector, as well as from the broader financial inclusion industry. The G20 GPFI plays a critical role. During China's Presidency in 2016, it developed the G20 High Level Principles for Digital Financial Inclusion (G20 HLPs), which builds on over a decade of experience among international standard-setting bodies. The HLPs recognize the need to support innovation, while also managing risk in the development of digital financial products and services.[22]

Table: Customer Services: Sample Key Performance Indicators

Customer Data	Data Description	Examples
Call Center Records	Issues log; type of issues; and time to resolution (may include semi-structured data in reports).	Customer insights; operational and performance management; and system improvements.
Customer Care Feedback Data	Number of calls; call type statistics; and issue resolution statistics.	Identify technical performance and product design issues; training and communications needs; and third-party issues (for example, agent, biller).
Agent and Merchant Feedback Data	Number of agent or merchant calls; call type statistics; and issue resolution statistics.	Identify technical performance and product design issues; agent training and communications needs; and client issues.
Communication Channel Interactions	Volume of website hits; call center volumes; social media inquiries; and live chat requests.	Customer insights; operational and performance management; and system improvements.
Qualitative Communication Data	Type of inquiries; customer satisfaction; and social media reviews.	Customer insights.
Private Branch Automatic Exchange	Number of call center calls; length of calls; queue wait times; and dropped calls.	Operational and performance management.

Source: MCF-IFC (2017).

21. Useful and additional KPI data, sources and definitions can be found in the IFC-MCF Handbooks: (1) Digital Financial Services and Risk Management, Part IV: Insights and Tools, pages 93-108; and (2) Data Analytics and Digital Financial Services, Chapter 2.2: Resources, pages 136-140.

22. G20 High Level Principles for Digital Financial Inclusion, 2016, which includes principles from the Better Than Cash Alliance, OECD, Smart Campaign, Social Performance Task Force, UNPRI/PIIF, among others.

Recently, a group of leading investors and funders in DFS began the development of Investor Guidelines for investing in digital financial inclusion (RFF VII 2017). The Investor Guidelines aim to foster customer trust essential for DFS providers and the broader digital ecosystem by managing both risks and opportunities associated with digital finance. The investor group is working to integrate customer risks, as part of a comprehensive due diligence and assessment framework for investing in digital inclusion. Potential investor actions and recommendations were also identified, building on evolving industry evidence and existing standards, such as from the G20 HLPs, among others.[23] Practical experiences are being shared among investors and their peers, given the dynamic growth of innovation and the different DFS business models in both developed and developing markets.[24] Such a global collaboration among a broad range of like-minded investors will play a critical role in keeping closer pace with developments in DFS and fintech products and services. The proposed Investor Guidelines ultimately aim to keep investors at the forefront of DFS innovations to sharpen industry best practices, and further catalyze private and public sector investments to advance responsible digital inclusion.

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Smart Campaign Client Protection Principles.

World Bank. 2017. Good Practices for Financial Consumer Protection, 2017 Edition.

23. Industry initiatives include BTCA, Responsible Digital Payments Guidelines, CGAP, GSMA Mobile Money Guidelines, GPFI, OECD, Smart Campaign at the Center for Financial Inclusion/ACCION, SPTF, UNPRI Principles for Investors in Inclusive Finance, among others.

24. The investor guidelines were initiated by Goodwell and IFC and presented at the RFF VII in 2017. A global mapping of different business models across developed and developing markets are analyzed in IFC's Emerging Compass Note 42, Digital Financial Services: Challenges and Opportunities for Emerging Market Banks Matthew Saal, Susan Starnes and Thomas Rehermann, August 2017.

CONCLUSION

"One final note is that the work of the board is always ongoing, and ever evolving."

This report has highlighted important issues related to the governance of MFIs. It should serve as a useful tool for MFI board members to alert them to issues that should be on their radar screen, and to provide them with a basic understanding about what is important from a governance perspective. The report should also help board members to ask the right questions. As such, board members will be better placed to properly oversee the development of their institution's organizational and control systems.

Several important topics have been excluded from this exercise, such as the art of financial monitoring and business planning. In this context, the authors are of the view that many board members have sufficiently mastered these skills, and that there is adequate literature and training available for those who seek it. This report attempts to provide a unique contribution to the microfinance sector by focusing on the myriad of topics that regularly appear on the agenda of MFI board members. These topics are related to technical and practical issues, ranging from the establishment of the board to crisis management.

In creating a practical guideline, the authors have, to a certain extent, avoided a few key issues and traits that are highly critical of the proper functioning of a board, but cannot be broken down into a practical process flow or step-by-step procedure. These are the "soft skills", that is, a board member's personal attributes, that enable them to interact effectively and harmoniously with other people. An MFI board should ultimately be comprised of people with complementary qualities. A diverse team can galvanize the required passion to motivate the group as a whole. Such a team can build the attentiveness required to foresee trouble on the horizon. It can also include a mix of toughness and collegiality, allowing for tricky issues to be effectively dealt with while avoiding conflict escalation. In this regard, it is important that proper board evaluations also measure these soft skills to alert the board about any specific imbalance or skill deficiency

One final note is that the work of the board is always ongoing, and ever evolving. Even strong boards with years of experience as a group ought to be concerned if their quarterly meetings tend to get shorter with less discussion. Every strategic and significant technical or operational change a MFI makes requires active board involvement. Every material change in the economic, financial, or legal environment necessitates board engagement. More importantly, every MFI action involving change requires board participation. The environment in which MFIs and their directors operate is very dynamic, and all board members can understand that it is never "business as usual". Also, new business sometimes requires new members. Indeed, boards are fluid and a change of members allows them to evolve with the times.

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Annex I: Practical Aspects and Board Responsibilities[25]

1. Define Board Role

1. The responsibilities of the board should be defined in writing. According to local regulations, these are defined within the company's registration or in separate company documents, such as the Articles of Association, or a specific document defining the MFI's "Corporate Governance Principles". The document should cover: aspects of the board's organization; roles and composition; committees; relationship with management; audit and risk management functions; performance -evaluation; board insurance; promotion of the MFI's mission and values; and external representation of the MFI.

2. Define Regular Board Activities

2. The regular work of the board includes setting the business and risk strategy in collaboration with senior management,[26] and executing oversight of: business performance; financial soundness; corporate culture; the effectiveness of the MFI's risk management and control systems; the appointment of external auditors; and the scope of services and setting of standards, such as the Code of Conduct. The board should also perform a critical self-assessment regularly to evaluate its own performance.

3. Clarify Board versus Management Duties

3. The Board's relationship to management, including the board's authority regarding strategic decisions, must be defined. This includes clear guidelines regarding how the Board is to monitor management performance on a regular basis. This would also include principles for evaluating managers; setting their compensation; determining their selection, replacement and discharge; as well as succession planning. Regular board meetings should be convened, at which management reports to the board. The board critically reviews the MFI's business and management performance, as well as its adherence to strategic targets. It is very important that many board meetings are in person as opposed to via teleconference.

4. Rules for Conflicts of Interest and Board Approval

4. Actual, potential or perceived conflicts of interest at the board and management level, which can be of a personal or external nature, should be clarified, including related party transactions, and other business decisions requiring board approval.

5. How Many Members

5. Board Composition. Limits on the number of board members and nominees are defined by local regulations, as well as the composition of shareholders and their strategic role. The number of board directors should provide a good balance of workload distribution, including membership on standing committees, and a place for independent directors. It also allows for a diversity of views and personality, and a wide spectrum of expertise and Board efficacy. Other factors are the size and development stage of the MFI, and the number of shareholders requiring representation at the board level.

6. Key Qualities of Board Members

6. Board Qualifications. Key areas should be covered when selecting the members of the board, including: functional expertise, independence and personality. Board qualification criteria for proposed nominees should also include relevant experience in: (1) corporate governance; (2) regional economic and industry understanding; (3) microfinance and bank operations; (4) risk management; (5) strategy and business planning; (6) accounting and finance; (7) audit and internal control; (8) technology; and (9) management and legal knowledge. A lack of functional expertise among the available candidates can be covered by external advisors and relevant training for board members.

25. IFC CG Training, Nov 2014, "The Role of the Director."

26. Center for Financial Inclusion, 2012. "Microfinance—A Risky Business. A Time for Strong Leadership."

7. Board Compensation

7. Board Compensation. The best way to attract qualified members and ensure their engagement is to clearly specify the desired qualifications and provide adequate financial compensation for the member's board and committee activities. Board members are less effective when employed in an honorary capacity. Appropriate compensation and time allotment for the board role will maximize the likelihood of board members fulfilling their responsibilities.

8. Independent Board

8. Establish an Independent Board. Establishing a balance between the board's independence (as much as possible) from that of management control is fundamental to good governance. MFIs can be management driven, and are often based on a founding CEO who also serves as Board Chair. The CEO appoints a board of convenience, whose members have been selected largely due to their loyalty to management. Boards can also be board driven, largely by a strong board chair and a powerful controlling investor(s). Achieving a proper balance between management-driven and board-driven governance is at the heart of good governance. This balance of control strengthens the quality and composition of the board. Indeed, it is critical to enabling the board and management to gain strategic foresight, especially in managing risks.

9. Board Chairperson

9. Board Chairperson. The Chairperson is appointed from and by the board members. In order to efficiently lead the MFI, the board delegates to the Chairperson all powers inherent to this position (including all external legal representation unless delegated; call and execution of board meetings; spokesperson for the MFI; first among equals (primus inter pares) at Board meetings, and so on). The chairperson typically is not a member of any of the board committees, but does attend those meetings if he/she wishes as an ad hoc member of the committee. The role of the Chairperson should be clearly defined, and be very distinct from the role of the CEO.

10. Board Secretary

10. Board Secretary. The Secretary helps the Board Chairperson in all his/her duties. The Secretary may or may not be a board member. If not a member, the Secretary should have the right to speak, but not to vote at board meetings. The board will appoint the Secretary and terminate his/her term of office, selecting a competent successor with proven integrity and identity for the MFI. Given the importance of related duties (the Secretary enforces legal, statutory and regulatory requirements), the person should be independent (and not a member of executive management) and have stability in his/her post. In addition to the special duties assigned by the Board of Directors, the Secretary often serves as the Secretary for the Annual General Meeting, and is a permanent interlocuter with general management. In smaller MFIs, this role is generally covered by the Chairperson, who can be supported by an administrative assistant.

11. Board Committees

11. Board Committees. The board should establish the appropriate Board Committees to provide key oversight over important areas of MFI operations to ensure that the strategy is being properly implemented. Committees should be the "work horses" of the board. They are the fora at which the board can focus on issues in more detail than during a half or one-day formal board meeting. Board members should generally serve on no more than two board committees. Committees should have charters delineating their responsibilities. The charters should be reviewed annually. Committee meetings should have formal minute records, to be reported to the board by the committee chair. Senior management should attend board committees as appropriate. For instance, the Managing Director (CEO) should attend all committee meetings. The Chief Financial Officer should attend the Audit and ALCO Committees. The typical standing or permanent committees established by the board should include: (1) an Audit Committee to review the MFI's audited financials. It should meet with the External Auditors (independently of management) to review the audit and audit findings (including internal audits, external audits, compliance, and internal controls); (2) a Risk Committee[28] for a review of the risk situation, and to ensure that a risk management system is in place; (3) a Governance or Nomination Committee, as needed for recruitment and vetting of new board members; (4) a Compensation Committee for the setting of performance benchmarks, review of compensation for the Managing Director and other senior staff, and annual compensation awards (salaries, bonuses, management share options, and other HR high-level matters); (5) an ALCO to review and decide on new financing, investments and financial risk assessment; and (6) additional temporary committees as may be useful, such as a Transformation Committee for dedicated guidance through transformation phases. As with the board meeting, committee meetings should be held with regularity. They should also have a pre-defined agenda to ensure all important topics are covered.

From experience, MFIs in a developing or transitional country with international investors are likely to have several board members traveling to meetings from abroad. An approach to providing adequate time for both committee meetings and the board meeting is to hold committee meetings on the first day of a scheduled board meeting. This could be followed by a board dinner with the senior management team, and then the Board meeting the next day. This arrangement would provide the committee chairs with an opportunity to report to the board meeting.

12. Board Information Packages

12. Board Information Packages. Another important condition for a functioning board and its committees lies with the requirement that they receive all necessary information to fully understand the true situation of the MFI. Board reports (packages) should be received by board members at least five working days in advance of the board meeting. Monthly reports can include a brief overview of the monthly performance compared to the previous month (and to projections), accompanied by a short narrative from the CEO. In addition, it is useful for board members to receive copies of relevant media coverage, as well as industry and sector reports.

In certain instances, the board may request additional information from management before taking a decision, whereas in other instances, issues may arise in between meetings that need immediate attention. As such, it is normal to have interim meetings by teleconference or approvals by circulation. It is important that all regular procedures are followed, for example, meetings must have a quorum, minutes should be taken, and so on. The adherence to these procedures is ensured by the board secretary.

ANNEX II – BOARD SELF-ASSESSMENT

This annex contains a sample Board Self-Assessment. It is an assessment of the Board as a whole and should complement an assessment of individual board directors/officers/chairs. This should not be considered exhaustive, or applicable in its entirety, to all MFIs. It is intended to support boards as they consider for themselves the issues that are most relevant to them given their particular circumstances and operating environments.

Structure and Meetings
The roles and responsibilities of Directors and Board Officers are documented and understood by all board members.
The Board has an appropriate structure of Committees in accordance with the regulatory authority, company Bylaws, and corporate governance best-practice standards.
The appointment process for Board Officers, Committee Chairs and Board Committee members is transparent and aligned with experience requirements and business strategy.
Each Board Committee has adequate and appropriate terms of reference, which are understood by all Board members.
The volume of business handled by each Committee is set at an appropriate level.
The length and frequency of Board/Committee meetings are adequate to fulfill their respective responsibilities, and their time is effectively used.
Board/Committee meeting minutes reflect a fair record of proceedings.
Business Knowledge and Understanding
The Board exhibits a willingness to devote time and effort to understand the company and its business, including overall workings of the marketing/delivery of its products/services.
The Board exhibits an understanding of the key variables driving value and sustainability, and the key performance indicators/ratios used to measure performance.
The Board exhibits an understanding of and compliance with relevant legal and regulatory requirements pertaining to the MFI's business and the Board's fiduciary responsibilities.
The Board is up to date with the latest developments in the areas of corporate governance, risk management, and financial reporting, as well as industry and market conditions.
The Board thoughtfully considers management's recommendations prior to making decisions.
The Board tests information and assumptions, and is not unduly influenced by individual Directors on specific matters.
Effectiveness
The Board prepares and approves, on a timely basis, an annual work plan for the Board and each of its Committees and monitors performance against the plan.
The Board exhibits a high level of commitment, as demonstrated by its preparedness, attendance, engagement, and participation.
The Board Committees execute their responsibilities in a timely and effective manner, have adequate human and other resources, and report in an efficient and effective manner to the full Board.
The Committees' work is done in an inclusive manner, and the Committees are used to their best advantage.
Committee work is not repeated by the full Board, and appropriate discussions of Committee recommendations take place at the Board level.

The Board receives appropriate, timely and unbiased information of the right length and quality to prepare appropriately for Board/Committee meetings.
The Board has responded proactively and effectively to problems or crises that have emerged — and that could or should have been foreseen.
The Board understands when it needs to seek external advice or a professional independent opinion, and does so, as required.
Control Environment and Processes
The Board understands the principal risk factors related to the safety and soundness of the MFI's business, including those pertaining to liquidity, capital, credit, interest rates, foreign exchange, operations, and the balance sheet structure.
The Board sets risk tolerance levels in the Board/MFI risk policies, and confirms the capacity of the MFI to withstand risk exposure levels in all areas of risk.
The Board reviews and analyzes risk reports on a timely basis to ensure adherence to all Board risk policies, including the monitoring of inherent and residual risk levels.
The Board ensures the application of risk responses, and risk mitigation strategies that are appropriate to address risk variances/non-compliance issues.
The Board oversees an independent internal audit function to evaluate internal controls and management information systems; it ensures that management has mitigated any material weaknesses, as required.
Each Audit Committee Member participates in the annual performance management process pertaining to the Internal Auditor, providing constructive feedback and jointly setting future performance objectives on a timely basis.
Cohesiveness and Ethics
The Board works as a team, exhibiting good interpersonal skills that allow all Directors to contribute equally.
The Board has a decision-making process that strives for consensus, and is based on clear and honest communication, objectivity, independent judgment and reasoned debate.
The Board is robust in taking and sticking to difficult decisions, and all Directors actively support Board decisions.
The Board exemplifies the values of honesty, integrity and confidentiality, and Directors clearly understand and disclose potential conflicts of interest and related party transactions.
Board members have adequate informal time together to aid in team building.
The Board's morale is high, and the Board is valued within the organization.
Strategic Leadership
The Board keeps current on key developments in the sector, including the MFI's competitive environment, local economy and client profiles; it demonstrates an awareness of key issues and emerging trends that may impact operations.
The Board ensures that a robust business planning process is implemented, including appropriate performance indicators/metrics for monitoring purposes.
The Board regularly monitors actual operating, financial and social performance results in relation to the annual plan and budget; it also confirms the appropriateness of initiatives proposed by management to address variances, as applicable.
The Board ensures appropriate follow-up on all outstanding issues, including the findings and recommendations of the internal and external auditors.

Board/Management Relationship
The Board has established and exhibits an understanding of the difference between the governance role of the board and the role of management (for example, it leaves day-to-day management to the CEO).
The Board provides constructive advice/counsel to the CEO as well as direction; it clearly differentiates between advisory and directive comments.
The Board empowers and encourages the CEO, and promotes her/his personal professional development.
The Board provides direction to the CEO through the Chair; individual Directors (other than the Chair) do not give direction to the CEO.
The Board has established a succession/contingency plan for the CEO, which the Board reviews annually.
The Board and CEO jointly set annual performance objectives and criteria for the CEO in alignment with the annual operating plan and budget in a timely manner.
Each Board member participates in the annual CEO performance management process, providing constructive feed-back and ensuring that a competitive compensation package is in place.
The Board maintains a strong and healthy working relationship with the CEO.
Renewal and Development
Orientation sessions are formal and instructive and are conducted on a timely basis for newly-elected Directors.
An on-going Board education plan is developed and implemented through the year, and is in keeping with the needs and interests of the Directors.
Board processes provide Directors with the opportunity to serve on a variety of Board Committees (from year to year) for the purposes of professional/self-development.
The Board ensures that its composition is continually refreshed (through Board succession planning), taking into consideration the strategic needs of the organization.

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Annex III: Customer Risk Assessment for Responsible Digital Inclusion

The assessment is structured across core business functions, focusing on customer risks and mitigation measures that may be observed. The customer risk assessment is structured across governance, credit, operational and technology areas. The objective is to assess customer risks and mitigating measures across institutional operations systems, policies, and procedures in the context of the local market and digital ecosystems. This tool is intended to be used as a "living" and iterative process given innovations in DFS and fintech products and services.

Market Assessment	
Local Market Context, Regulations	• **Market and regulations:** Does a regulatory framework for financial consumer protection exist? If so, which regulatory agency performs this function? Is the market potentially evidencing risks of increasing numbers of NPLs, and consumer over-indebtedness?
	• **Industry and self-regulation:** If a regulatory framework is weak or nonexistent, are there any industry or self-regulation, voluntary codes of conduct that are being adhered to by financial service providers?
	• **Consumer perspective:** What is the perception of the company in the local market? Has it received any public consumer complaints from local media, consumer activists, NGOs, and/or government regulators?
Institutional Assessment	
Board Governance, Management	• **Role of Board and Management:** Assess board and management awareness of risks related to consumer protection issues. How are these addressed by management and the Board, given the local/market context?
Customer Acquisition	• **Customer acquisition:** Does the company assess multiple lending, potential over-indebtedness and/or debt/income thresholds? If so, how? What are the key indicators used? If credit bureaus exist, are they used by the company and how?
	• **Credit scoring:** If alternative data is used for credit scoring, what type of data is collected from customers? How is customer data used to assess creditworthiness and/or capacity to repay?
	• **Responsible pricing and comparators:** How is pricing defined by product (annual percentage rate [APR], effective interest rate [EIR], total cost of loan; flat or declining balance calculation method; or transaction fees)?
Pricing	• **Pricing comparison:** Provide relevant comparators from market competitors by product or transaction services, as relevant.
Transparency Disclosure	• **Transparency:** How is pricing indicated to clients? Does the company publicly disclose pricing by product? How does the company share this information? Through websites, digital/mobile means, receipts, contracts (product agreements, loan contracts, or insurance policies?
	• **Customer assistance:** Does the company provide contact details using multiple channels for customer help prior to closing a transaction/sale? How and what information is communicated?
	• **Terms and conditions:** Are terms and conditions for clients articulated in simple, local language? How are they communicated prior to a transaction/sale to inform customers about their rights and responsibilities? How is consumer data privacy communicated? Does it include information about how personal information will be used by the company, how data is collected, and who it will be shared with?
	• **Customer consent:** How is informed consent obtained from customers? Describe the process, for example, prior to automatic debit authorizations using digital/biometric devices. Is the client given any documentation and how (that is, from a contract, receipt, or email)?

Customer Services Customer Feedback and Complaints Resolution Process	• Do staff receive training about Consumer Protection Standards? Is financial education provided for customers? If so, how often and when? • Is there a written policy that requires customer complaints to be fully investigated until resolved? How are customer complaints handled, such as loss of funds, mistaken, unauthorized or incorrect transactions due to weak connectivity, system errors, fraud, platform instability, or IT security breaches? • How does the company monitor effectiveness of customer services? • Does the company analyze customer services/complaints data and provide regular reports to management? What are the key customer issues? How many issues are there? How many days does it typically take to address a customer complaint? • Are staff training and incentives provided to improve customer services?
IT/Systems Data Privacy and Security	• Who has primary responsibility for customer data privacy? Are there dedicated staff (legal experts, data protection officers) and/or board/management committees in place to handle such issues? • How does the company implement data privacy and security for its products and services across multiple countries/jurisdictions? • Does the company inform clients about how their private data/information will be used, including sharing their personal data, loan history with the credit bureau and other third-party providers, as relevant? • Does the company enable customers to opt-in or opt-out of using their personal data for marketing, third party or other purposes? Why, or why not? • In the event of a customer data breach and related security or fraud issues, when and how are customers informed? Is there a plan in place in the event of a breach, security or fraud? • What types of customer recourse are provided by the company in the event of data/security breach/fraud?
Risk and Audit Systems, Controls	• Does internal audit include Consumer Protection Standards? • How are audits performed to assess consumer protection? When and how often? • What consumer risk indicators does the company use/monitor? • What is the company doing to monitor and mitigate potential security issues or detect fraud? • How are risk/audit reports used? Are reports systematically provided to the board and management for review and policy considerations?

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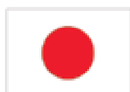

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