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des méthodes
de développement



HANDBOOK FOR THE ANALYSIS OF THE **GOVERNANCE** OF MICROFINANCE INSTITUTIONS

This guide is the result of previous work on governance carried out by CERISE members and based on field experience done by microfinance partners. IFAD and GTZ provided follow up support which focused on devising a simple, practical and user-friendly operational tool which would be of use to people involved in microfinance.

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CERISE (Comité d'Echange, de Réflexion et d'Information sur les Systèmes d'Epargne-crédit) is a network of France-based, leading MicroFinance support organizations: CIDR (Centre International de Développement et de Recherche, Autrèches), CIRAD (Centre de Coopération Internationale en Recherche Agronomique pour le Développement, Montpellier), GRET (Groupe de Recherche et d'Echanges Technologiques, Paris), and IRAM.

The objective of CERISE is to capitalize and exchange on micro finance experiences (synthesis, publications and meetings with practitioners, researchers, MFIs, donors, etc.). The main themes of capitalization are the following: governance in microfinance, impact and social performance, financing of agriculture, intervention in microfinance, MFIs in remote rural areas.

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FOR EVALUATING
GOVERNANCE

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MICROFINANCE is going through a critical phase. While it has proved capable, through a variety of approaches, of providing financial services to populations excluded from the traditional banking sector, most microfinance institutions (MFIs) face the challenge of institutionalization and achieving sustainability. While recent history offers some successful examples, there are nonetheless many others that are not so successful, and are indeed failures. The sustainability of an MFI demands not only financial viability and the ability to adapt to existing legal frameworks, it also requires a clear strategic vision and an organization that is transparent, efficient and accepted by all the stakeholders involved. These issues are often grouped together under the concept of “governance.”

A. GOVERNANCE IN MICROFINANCE: FROM SHAREHOLDERS TO STAKEHOLDERS

The term governance, while relatively new to the development sector, became in the early 1990s an unavoidable concept when discussing economic and social development issues. First used with reference to governments and companies, the term governance is now applied to microfinance.

In microfinance literature, the term governance first appears in 1997 (CGAP) and usually refers to the relationships between the board of directors and the management of an MFI. However, the “good functioning” of the board of directors is not enough to guarantee the mission and assets of an MFI. When discussing governance, it is necessary to broaden the scope of study to include all stakeholders involved (employees, managers, elected officials, clients, donors, bank partners, shareholders, the government, etc.) as well as any organizational form with a “governing” role that may have been set up at the onset of the institution. Furthermore, it is critical to understand how these elements can change in different socio-economic contexts.

Microfinance institutions must achieve a balance between operating as a financial sustainable business and pursuing a mission of general interest: reducing financial exclusion. Governance in microfinance is situated at the crossroads of two approaches: a political/ethical approach, which emphasizes the strategic vision of the institution, the legitimacy of its decision-makers and the integration of the institution into its environment; and an economic/managerial approach, which regards governance as a way to improve efficiency, reduce costs and optimize means.

This guide approaches governance from the point of view of “stakeholder analysis” rather than taking a more restrictive approach, that in which governance is limited to “relationships between shareholders and directors.” One has to comprehend governance as a whole and identify what is at stake for all the stakeholders involved.

Definition

- ▶ For the purposes of this guide, governance - which is necessarily based on an institution's ownership structure - encompasses all the mechanisms by which stakeholders (elected officials, employees, others) define and pursue the institution's mission (namely who is the target public, what are the services offered, what geographic coverage is intended) and ensure its sustainability by adapting to the environment, preventing and overcoming crises.
- ▶ The mission can change over time, but stakeholders must be sure to accompany these changes. Governance should be approached from an overall perspective of sustainability (especially financial) of the MFI.

B. THE APPROACH: HIGHLIGHTING DIVERSITY RATHER THAN BEST PRACTICE

This guide is designed to accompany an analysis of the governance of a microfinance institution. The approach used is based on the following three principles:

- ▶ Governance can take on many forms and there is no “best practice” approach. This guide seeks to present the foundation of good governance, comprised of six fundamental elements.
- ▶ Crises and dysfunction can be a rich source of learning and hence should be examined as an independent element when evaluating an institution's governance. The inherent crises of microfinance institutions should not be ignored but rather analyzed to understand the institution better and thus judge whether or not the form of governance is appropriate.
- ▶ It is possible to analyze all types of microfinance institutions without necessarily ignoring the specificities of different institutional forms. The guide distinguishes between several types of institutions: cooperatives, non-profit organizations, private companies and public institutions. It examines themes that are relevant to all these institutions (mission drift, risks related to growth and maturation) and a few issues that are specific to one particular institutional type (for example, the relationship between technical assistance providers and elected officials in the case of cooperatives; the degree of insertion into the environment, in the case of microbanks). These questions are addressed broadly, followed by illustrations of specific cases.

C. ■ ORGANIZATION

The guide is organized in two modules:

- ▶ The first is a diagnostic tool for evaluating the governance of a microfinance institution. It utilizes an approach based on analysis of stakeholders, decision-making processes and crisis/problem management. With the use of this guide, the reader should be able to appraise an institution's governance and evaluate its position on an analytical matrix made up of the six fundamental elements comprising the foundation for good governance.
- ▶ The second module is designed to guide reflection on the strategic choices and governance challenges that microfinance institution's face. These questions will be addressed broadly, and then illustrated by examples to understand better the issues at stake.
- ▶ The two modules are complementary. They are organized around five themes (Mission/Vision; Financing; Institutional Type; Stakeholders; Organization) to enable the reader to choose an area of interest and pass from one module to the other.

D. ■ READERSHIP

This guide is written for anyone interested in working on the governance of a microfinance institution, be they elected officials, directors or donors. Nonetheless, it primarily targets microfinance institutions and their directors to help them identify the strengths and limitations of their institution's governance structure. This guide should respond to the needs of all microfinance institutions, regardless of their stage of development or legal status (project, private company/commercial bank, cooperative, village bank, etc.).

The guide can also be used by donors, evaluators or external consultants. When developing a project, it can be used as the basis for practitioner-donor dialogues for setting objectives that will encourage good governance; it highlights the risks surrounding particular contexts and stakeholders, and helps clarify the responsibilities of each stakeholder.

The guide also addresses the key aspects of monitoring, including how to analyze and interpret these aspects. This part of the evaluation serves to complement the analytical matrix, to evaluate the medium and long-term solidity of an institution's governance.

Finally, the guide can provide a framework for regulators (central banks, bank supervisory committees, ministries of finance, national microfinance networks, etc.) to reflect more generally on the elements of regulation that may encourage or constrain good governance.

E. ■ FINAL CONSIDERATIONS

The guide is for microfinance institutions of a certain level of maturity. Nonetheless, the issues discussed here may also serve as the basis for reflection when laying the foundations and building an institution.

The guide should be appropriated by its users. It should be considered a starting point, to be added to and enriched with the comments and examples that each user is invited to communicate to the authors.

MODULE

1



DIAGNOSTIC TOOL FOR EVALUATING GOVERNANCE

OBJECTIVE ► Identify issues at stake in the MFI

Module 1 is divided into three parts:

PART 1 **THE STAKEHOLDERS:
WHO HAS THE DECISION-MAKING POWER?**

OBJECTIVE ► Identify and qualify the institution's governance by examining texts (to determine the legal status, ownership and formal decision-making powers) and analyzing what goes on in practice (to determine who has real decision-making power).

TOOL ► Decision-making matrix.

RESULT ► A typology of forms of power.

PART 2 **CHARACTERISTICS AND MECHANISMS OF
GOVERNANCE: HOW IS THIS POWER EXERCISED?**

OBJECTIVE ► Analyze the characteristics of the institution's governance by looking at the mechanisms that influence decision-making (strategic vision, the management information system, decision-making processes, capacity to implement decisions, internal and external monitoring).

TOOLS ► Key Questions.

RESULT ► An assessment of the decision-making chain, from defining strategy to audit and control.

PART 3 **CRISIS AND PROBLEMS MANAGEMENT:
HOW ARE THEY DEALT WITH?**

OBJECTIVE ► Analyze the effectiveness of the governance structure during crises or problem periods.

TOOLS ► Key questions about the specific problem or crisis.

RESULT ► An illustration of how governance works, how stakeholders are positioned and how decisions are made at the time of a crisis.

By the end of this module, the reader should be able to evaluate the type of governance at work in the institution and its degree of efficiency, in order to identify issues at stake and strategic choices to be made.

1.1 ■ WHO HAS DECISION-MAKING POWER?

- OBJECTIVE** ▶ Identify the form of governance, legal status, ownership and the power and role of different actors in the decision-making process.
- TOOLS** ▶ Decision-making matrix.
- KEY CONCEPTS** ▶ Do not confuse legal status with form of governance.
- ▶ Analyse any discrepancies between formal decision-making procedures and the way decisions are made in practice.
- ▶ Take note of the diversity of actors involved in the decision-making process.
- ▶ Two levels of analysis are used: what appears on paper and what occurs in practice. Discrepancy between the two levels should be noted with particular attention.

1.1.1 ■ Institutional form: who is the owner?

a. ■ What is the legal status of the institution?

The legal status of an institution determines who has ownership and who has decision-making power. Analysis of the founding texts of the institution will reveal the different decision-making bodies and their respective roles.

Microfinance institutions come in a variety of institutional forms (project, non-profit organization, cooperative, private company). The choice of form will determine organizational type, decision-making procedures and thus the institution's governance.

Institutional statutes may be more or less formal (ranging from bank to project status). An institution may be part of the public, private or non-profit sectors.

- ▶ **Project:** The institution is not formalized at the time of creation. Its status is one of a development project, most often funded directly by donors.
- ▶ **Non-profit organization/Foundation:** Non-profit organizations cannot mobilize savings. In cases where savings services are offered, it is simply tolerated, usually because of the absence of a legal framework for microfinance (example: the Sanduk in Comoros).
- ▶ **Cooperative:** An institution owned by its members (example: FECECAM in Benin) who are the direct beneficiaries of the savings and credit services offered.

INSTITUTIONAL FORM

See Module 2

§ 211 b

"Ownership structure
and mission"

§ 212 a

"Funding structure /
Legal form"

§ 214

"Institutional type
and governance:
what makes
the most sense?"

§ 221 a

"Mission drift
and institutional
transformation"

- ▶ **Private company:** A company (commercial bank or finance company, for example with limited or unlimited liability) with a variable capital structure, depending on the origin and motivation of the shareholders:
 - **private capital:** local (local banks, employees, clients, etc.) or international (commercial banks, social investment funds, donor investment funds, private commercial funds).
 - **public capital:** local and/or national government.
- ▶ **Public entity:** A public entity is state-owned or belongs to local governments (like the Cajas municipales in Peru) and might be a shareholder company with public shareholders - in some cases ruled by banking law, in other cases ruled by a special law (e.g. development banks).

b. ■ What motivated this choice?

Analyzing the reasons that led to the choice of a particular institutional form can offer insight into the institution's approach and potential limitations.

Several different elements may influence the choice of an institutional type:

- ▶ **Level of institutional development:** project/non-profit status is often an intermediary institutional form that is a precursor to formalization.
- ▶ **Legal constraints:** choosing an institutional type will depend on the existence of a microfinance-specific legal framework. It is possible to distinguish between countries with a legal framework and those without. Among those that have a framework in place for microfinance, some allow institutions to choose their statute (private company, cooperative, non-profit organization) while other offer little or no choice. In countries with no regulatory framework, all institutional types are possible, although it is important to make sure supervisory authorities will accept the legal form chosen in order to avoid problems should microfinance-specific regulation be introduced.
- ▶ **Degree of social cohesiveness:** a high degree of cohesiveness of the group that will make up the client base of the MFI often lends itself to a cooperative form, if the potential members are involved in setting up the institution.
- ▶ **The funding structure:** the source of funds – savings or outside investors – will influence whether the institution will choose a cooperative form or private company status.
- ▶ **The government's role:** The role of the government and its capital participation will influence whether the institution will be public or private. A non-profit or association status is sometimes also a way for the government to maintain some control over resources available for the institution.

FINANCING
STRUCTURE
See Module 2

§ 212

"Financing and
governance:
what role should
the funders play?"

§ 224 b

"Maturity and investors'
exit strategies"c. ■ Who owns the capital?

A detailed analysis of the balance sheet reveals the sources of funding and the funding structure (equity/debt ratio), thus exposing other potentially influential stakeholders who may be situated outside the institution.

Analysis of the funding structure

- ▶ **Equity:** percentage of available resources (and source of equity: member shares, shares of private, public, national or international investors)
- ▶ **Reserves:** percentage of available resources
- ▶ **Subordinated debt:** percentage of available resources
- ▶ **Credit lines:** percentage of available resources (commercial banks, donors, government)
- ▶ **Savings:** percentage of available resources

STAKEHOLDERS
See Module 2

§ 211 a

"Different priorities for
different stakeholders"

§ 212 c

"Investors' profiles"

§ 213

"Concentrate or
disperse governing
powers: which
stakeholders
should be involved?"

§ 223

"Multiple stakeholders:
how to reconcile
contradictory
interests?"1.1.2 ■ The power of stakeholders over strategic
and operational decisionsa. ■ Who are the stakeholders?

Analysis of governance is often limited to a study of the relationships between key stakeholders in the institution who are directors (members of the board). However, it is important to encompass the other categories of stakeholders who have a role either inside or on the periphery of the institution. The following is a checklist of the different actors that may participate in the life of an MFI, categorized according to their internal or external involvement and their level of influence.

The stakeholders involved and their positioning in relation to the MFI

- ▶ **Employees - male and female** (distinction should be made between directors, management, employees at headquarters, employees in branch offices, etc.).
- ▶ **Members or clients - male and female** (distinction should be made if there are members who are also elected representatives in the institution).
- ▶ **Technical Assistance Providers/Promoters/Founders.**
- ▶ **Government/Ministries (representatives of the state).**
- ▶ **Donors** (there may be several).
- ▶ **Banks** (especially if there are credit lines).
- ▶ **Local government.**
- ▶ **External shareholders** (institutional investors, private individuals, etc.).

In addition to identifying the stakeholders involved, it is important to define each one's role and responsibilities inside the institution. One should examine, in particular, their own understanding of their role, the extent to which this perception is shared by the other stakeholders and the role of women in the institution (to what extent are they represented in decision-making processes?).

What is the role of each stakeholder within the institution?

- ▶ Comparative presentation of the role of each stakeholder (as seen by the actors themselves and those around them).
- ▶ Analysis of discrepancies between each stakeholder's role in theory, in reality and as it is perceived by others.

b. ■ Where is their place within the institution?

For each of the stakeholders identified, it is important to determine who is directly represented in the institutional structure, and where: on the board of directors? In the administrative department? On the management committee? In the general assembly?

An analysis of stakeholders within different parts of the organization may examine:

- ▶ The role of each stakeholder in each department;
- ▶ How people are recruited;
- ▶ How positions are renewed.

c. ■ Which stakeholders make which decisions?

Besides analyzing the stakeholders' profiles and how they are represented within the organization, it is useful to explore each one's role in the decision-making process, taking care to separate strategic decisions from management decisions.

The decision-making matrix [▶ **Table 1**] should be adapted to each institution, depending on the stakeholders involved and whether decisions are strategic or management. It will enable an analysis of how decisions are really made, according to stakeholder, gender and type of decision.

- ▶ **Example of a decision-making matrix:** in the examples of decision-making matrices, [▶ **Appendix a & b**], it is possible to observe, in the first case, the significant power wielded by actors who are outside the institution (technical assistance providers and donors). This type of distribution of power is often seen in new institutions or in institutions which are still in the project phase, and whose internal actors have not yet found their place or role in the institution. Elected representatives often work under technical assistance providers who themselves are the people who deal with the directors and outside actors. In the second case, the distribution of power is more internal and shared; decision-making, especially strategic, is conducted by both the employees and elected representatives.

Using examples: see [▶ Appendix a & b]

[▶ Table 1] Decision-makers matrix

Stakeholders	MEMBERS/CLIENTS (male & female)		EMPLOYEES (male & female)			EXTERNAL STAKEHOLDERS				
	Members or clients in General Assembly	Elected reps.	Directors	Managers	Other employees	Donors / Funders	External shareholders	TA providers	Local government	Government / banking authorities
Decisions	Mission/Vision (target public, financial services offered, etc.)									
	Geographic outreach									
	Growth strategy / New product development									
	Choice of director									
	Interest rate									
Management choices	Salary policy									
	Financial services available									
	Lending and reimbursement policies									
	Use of profits									

1.1.3 ■ Analyzing decision-making power

With the information that has been collected thus far and the decision-making matrix filled in (Table 1), it is possible to categorize the institution based on a typology of forms of power.

The main attributes of this typology are:

- ▶ **Degree with which power is concentrated or distributed** among the stakeholders (expressed with “X’s” in the decision-making matrix); the role of women in decision-making (is it representative of female membership?);
- ▶ **Extent to which power is external** (coming from the technical assistance provider, donor, government, external shareholder) **or internal**;
- ▶ **Distribution of power** between employees and elected representatives;
- ▶ **Degree of clarity** (or lack thereof) regarding distribution of responsibilities (determined based on the ease with which the matrix can be filled in).

Other attributes could of course be examined depending on the institution. The goal is to get a feel for the institution and how power is distributed within it. It is also possible to evaluate the nature of the power exercised by the various stakeholders during different developmental stages. While forms of decision-making may differ depending on the phase of development, sometimes they persist and influence the institution over time.

1.2 ■ HOW ARE DECISIONS MADE?

OBJECTIVE

- ▶ Analyse the characteristics of the institution’s governance in order to identify the positive aspects and limitations that contribute to or impede good governance.

TOOLS

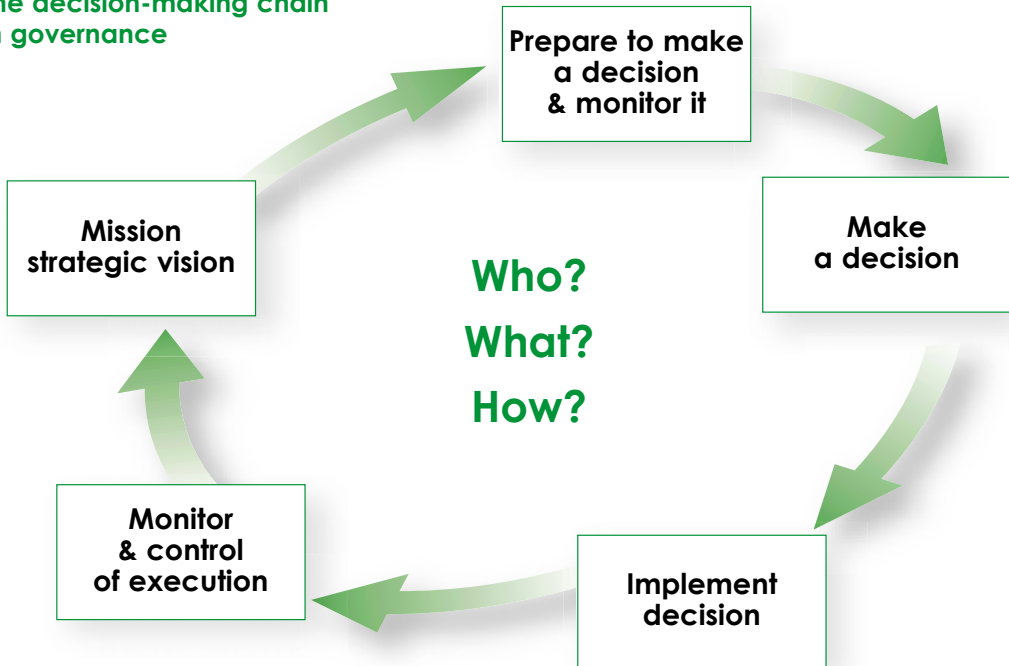
- ▶ Key questions about the decision-making chain.

KEY CONCEPTS

- ▶ The governance of an institution is based on a continuous chain that extends from the definition of the institution’s mission to the work of external auditors. One missing link will make the whole system vulnerable. The means employed must match the needs of the stakeholders involved. [▶ **Diagram 1**]

What mechanisms can the stakeholders identified in Part one use to define and pursue the institution’s mission? To ensure sustainability by adapting to the environment? To prevent and overcome crises?

[▶ Diagram 1]
The decision-making chain in governance



MISSION
See Module 2

§ 211

"Defining the mission: socially or commercially-oriented?"

§ 221

"Clarifying and pursuing social objectives: how to avoid mission drift?"

1.2.1 ■ Mission and strategic vision

a. ■ Definition

An institution's strategic vision is made up of the guidelines and general philosophy that govern its development. It is usually at the foundation of an institution's creation. The strategic vision will encompass the definition of the target public, outreach goals, financial services offered and organizational form. It is the fundamental element that serves as the basis for all activities. An institution's strategic vision is usually laid out in the founding texts and will be reflected in the business plan. Strategic vision can evolve over time depending on internal changes and external context. However, any modification to the vision should be decided and led by the institution's stakeholders. If changes are involuntary or uncontrolled then the institution will face "mission drift."

b. ■ Strategic vision and governance

Strategic vision helps an institution set and maintain its course. The governance structure of an institution is there to help it serve its mission, which must be understood and shared by all. In microfinance, the mission is often dualistic: on

the one hand, it is socially-oriented (proposing services to those excluded from the formal banking sector); on the other, it is financially-driven (offering enough products and services to be financially viable). The way these two aspects come together over time depends on the governance structure.

c. **Five key questions for a strategic vision**

- ▶ Does the institution have a strategic vision (explicit choices regarding the target public, financial products, geographical outreach, organizational type, etc.)?
- ▶ Are these choices explicit in the institution's founding texts? Which choices?
- ▶ Are these choices expressed in the business plan? How do they materialize in the activities of the institution? Do the objectives match up with means used to achieve them?
- ▶ Are these choices known and shared by all the stakeholders in the institution?
- ▶ Are the choices coherent with the institution's context (competitive environment, social and economic context, etc.)?

1.2.2 **Preparing to make a decision and monitoring its execution: the management information system**

a. **Definition**

The management information system (MIS) refers to the manual and computerized data concerning an institution's activities and the procedures used to collect this data. This information is processed and disseminated to stakeholders within the institution for decision-making and monitoring.

b. **MIS and governance**

Before any decision can be made, there must be preparation and documentation of the decision. Access to reliable and up-to-date information is thus a very important condition for the good governance of an institution. Among other things, a MIS contributes to monitoring efforts by making sure decisions are implemented and ensuring there is an accurate view of the current situation of the institution. Analysis of the MIS is essential because, depending on the institutional type, different stakeholders may retain, select, hide or widely disseminate certain information. Furthermore, as things can change quickly in the microfinance sector, it is important to have quick access to reliable information.

c. **Five key questions to prepare decision**

- ▶ Availability of information: what information is collected (accounting, financial transactions, impact monitoring) at each institutional level? Under what form?

ORGANIZATION

See Module 2

§ 222

"Growth: a virtuous or vicious circle?"

§ 225 b

"Monitoring and evaluation"

For whom is the information produced? Does it provide information on only the institution or on the environment as well?

- ▶ How operational is the information? Is it reaching the right people?
- ▶ How reliable is the information? Is it available quickly?
- ▶ Who has access to the information? (How often? For what purpose?)
- ▶ How is information used? (For strategy? Making provisions? Monitoring?)

ORGANIZATION

See Module 2

§ 215

“Centralize or decentralize: what relationship between different levels of a MFI?”

1.2.3 ■ Making operational decisions**a. ■ Definition**

All decisions are made based on information available, knowledge of the environment and how it evolves. Decisions make it possible to turn strategic guidelines into reality. Decision-making may be more or less centralized depending on the governance structure.

b. ■ Decisions and governance

Analyzing the stakeholders and the mechanisms that guide decision-making, as well as the role of different departments within an organization, makes it possible to assess whether the decision-making process is coherent. These mechanisms should be clearly described in the procedures manual and should permit the allocation of roles and responsibilities. Depending on who is involved, conflicts of interest can emerge and should be noted by the evaluator. Decision-making processes and conflict management are at the heart of a governance assessment.

c. ■ Five key questions for decision-making

- ▶ What are the decision-making processes at work? Are they formalized, simple, accepted by all? Are they respected?
- ▶ At what level are decisions made? What types of decisions (strategic, operational, management)? Why are decisions made at this level?
- ▶ Considering what the decision entails, does it make sense for the decision to be made at that level? By that department? (Is it a coherent process?)
- ▶ What are the potential conflicts of interest? How are they taken into account? What attempts are made to make compromises and achieve a shared vision?
- ▶ To what extent are stakeholders held accountable for decisions they make? Are the decision-makers assessed on their ability to orient? How? By whom?

1.2.4 ■ Implementation: ability to execute decisions

a. ■ Definition

The implementation of decisions is based on the stakeholders and their skills as well as the means at their disposition. Making a decision is not enough; it must be transposed into action. Implementation refers to this transformation of a decision into action.

b. ■ Execution and governance

Good governance make sure there are adequate human resources available to implement decisions. Hence, an analysis of how decisions are implemented necessarily brings up issues of training, motivation and incentives.

c. ■ Five key questions for implementation

- ▶ What are the human resources available? What is the level of training at time of recruitment?
- ▶ How are human resources and skills promoted? Is there a training program? How does training currently take place (Top-down? Is it technical training only? Is there training in critical analysis?)
- ▶ What other motivational incentives (compensation policies, promotions, bonuses, career advancement) or disincentives (sanctions) exist for implementing decisions?
- ▶ What kind of technical and financial means are at the institution's disposal? Are they appropriate given the institution's decisions and strategy?
- ▶ What tools are used for programming and monitoring decisions? What is the relationship between decision-makers and decision-implementers?

1.2.5 ■ Monitoring and control

a. ■ Definition

The decision-making chain ends with monitoring, an element that determines and guarantees good governance. Here, monitoring of management activities (financial viability, fraud, repayment, etc.) can be distinguished from the monitoring of strategic orientation (maintaining mission, growth strategy, etc.).

The monitoring chain in an institution starts with the self-monitoring carried out by the cashier and ends with external audits carried out by supervisory authorities.

ORGANIZATION

See Module 2

§ 213

"Concentrate or disperse governing powers: which stakeholders should be involved?"

§ 223 b

"Striking a balance between technical staff and elected representatives"

ORGANIZATION

See Module 2
 § 22
 "Managing the main risks in governance"
 § 224 b
 "Maturity of governance"

b. ■ Monitoring/control and governance

An institution's capacity to develop effective monitoring methodology with a rapid warning system in case of dysfunction is one of the fundamental elements of good governance.

c. ■ Five key questions for monitoring and control

- ▶ What kind of monitoring system is in place (internal and external), from the cashier to the central bank authorities?
- ▶ Who has the final word?
- ▶ What is the institution's capacity to identify problems and anticipate risk? What kind of surveillance system has been set up?
- ▶ Is internal monitoring conducted on a regular basis by legitimate and competent stakeholders within the institution? Is the hierarchical position of the person doing the monitoring coherent with what is being monitored?
- ▶ How independent, how legitimate, how competent and how regular are the external audits?

1.2.6 ■ Decision-making matrix

The following matrix helps analyze the decision-making process. It can be used to analyze one or several decisions (for example: defining a financial product; opening a new branch office; changing interest rates, etc.). It illustrates all the points of the monitoring chain addressed by the key questions. [▶ Table 2]

[▶ Table 2] **Decision-making matrix**

	Preparation	Decision	Execution	Monitoring
Who?				
Which information?				
How long?				
With whom?				
Who's supervising?				

1.3 ■ HOW ARE CRISES OR PROBLEMS MANAGED ?

- OBJECTIVE** ▶ Analyse the effectiveness of governance during crisis or problems periods.
- TOOLS** ▶ Key questions to assess the specific problem or crisis.
- KEY CONCEPTS** ▶ A mature governance structure can help avoid and manage dysfunction: post-crisis analysis can help identify the strengths and weaknesses of governance.

“Good governance does not necessarily mean an institution will avoid crisis, but it can limit damage.”

“The quality of governance is most apparent during a crisis.”

An analysis of stakeholders and decision-making processes can be completed and validated by studying how dysfunction is managed within the institution. In any system, internal changes or changes to the outside context can bring on tension, dysfunction or even a crisis, which should be quickly identified and analyzed. Good governance does not necessarily mean the institution will avoid the crisis, but it does help get through it. The ability to make good decisions that help avoid and overcome crisis at crucial moments is a sign of maturity of a governance structure.

Crises and problems in an MFI are the manifestation of risks that can usually be identified beforehand and thus prevented. Being aware of and attentive to these risks can prevent crises.

The ways crises are managed can be analyzed by taking a concrete example of dysfunction. The situation studied should not have happened too long ago otherwise it may not be relevant for evaluating the current governance structure. This analysis will help validate the evaluation conducted thus far, and can accompany the findings with a concrete illustration of the decision-making process.

The proposed analytical approach is as follows:

Identify the stakeholders who discovered the problem:

- ▶ Who are they? (management team, board of directors, TA provider, donor, etc.)
- ▶ Are they internal or external stakeholders?
- ▶ Are they part of the governance structure? Is it clearly their responsibility to sound the alarm?

▶ **ORGANIZATION**
See Module 2
§ 22 - Table 7
“Types of risk”
§ 224
“Governance: an evolving structure”
§ 225
“Governance and institutional context”

Sources of information:

- ▶ How was the problem discovered (management information system, external audit, by accident, etc.)?
- ▶ Was the information immediately available or was it ignored/hidden at first? Why?

The procedures that led to finding a solution:

- ▶ On what information were procedures modified?
- ▶ Were changes made quickly enough? Did they involve concerted efforts of the stakeholders?

The solution:

- ▶ To what extent are the new rules or procedures efficient, in light of the initial problem?
- ▶ Do they have any other consequences?
- ▶ Have these measures led to a consensus or have they exacerbated tensions?

1.4 ■ THE FOUNDATION FOR GOOD GOVERNANCE

Upon completion of module 1, the evaluation of the institution's governance should reveal:

- ▶ the stakeholders involved;
- ▶ characteristics of the form of governance in effect;
- ▶ the solidity and maturity of the model when confronted with crises and problems.

The institutions should be able to make sure that the foundation for good governance is in place.

This foundation is made up of six fundamental elements:

- ▶ A shared strategic vision;
- ▶ A reliable and quick management information system to make decisions and aid monitoring;
- ▶ Decision-making processes that are clear, well-adapted and coherent with the governance structure;
- ▶ A level of staff training, capacity and involvement that ensures decisions are executed;
- ▶ An efficient monitoring system;
- ▶ Ability to prevent and overcome internal and external crises.

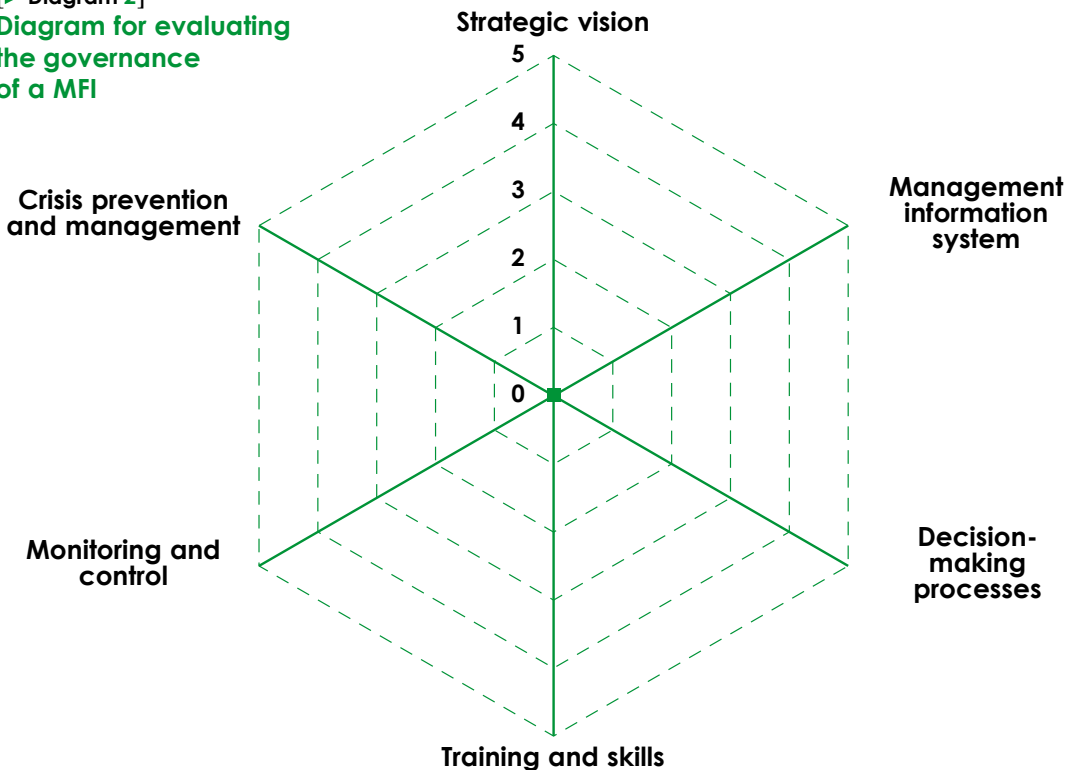
While each of these basic elements is essential, the way they materialize in an institution’s governance varies since strategies to meet governance challenges necessarily depend on the context, history and workings of each institution. Institutions must integrate into their environment by constantly adapting to ever-changing contexts (changes to the economic sector, the institution’s competitive positioning within the financial system, social relationships, etc.). Good governance can help them do this, thus making the institution socially viable.

Module 2 will propose elements to guide strategic decision-making when it comes to choosing a form of governance.

Using the evaluation matrix [► Diagram 2] that concludes this module, it is possible to rate the performance of an MFI on a scale from 1 to 5 in the six fundamental areas that make up the foundation of good governance. Evaluation criteria are proposed [► Table 3], but may be reviewed and adapted depending on the institution, its organizational form and specificities. The strengths and weaknesses that emerge make it possible to identify the issues currently facing the institution as well as determine what is at stake in the medium or long-term when it comes to improving and strengthening the governance structure.

- 1: bad
- 2: below average
- 3: average
- 4: good
- 5: very good

[► Diagram 2]
Diagram for evaluating
the governance
of a MFI



▶ **Table 3** Matrix for evaluating the governance of a MFI**A shared strategic vision**

- ▶ Explicit strategic vision (target public, products and services, geographical outreach)
- ▶ Strategic vision formalized in founding texts
- ▶ Strategic vision consistent in founding texts and business plan
- ▶ Strategic vision understood and shared by all the stakeholders (elected members and staff; male and female)
- ▶ Strategic vision coherent with the institutional context

A reliable and timely management information system

- ▶ Information is complete at all levels of the institution (branch and headquarters)
- ▶ Immediate availability of portfolio and financial indicators (how long does it take?)
- ▶ Quality and reliability of MIS
- ▶ Accessibility of information
- ▶ Use of information in decision-making

Clear, well-adapted and coherent decision-making processes

- ▶ Formalized decision-making processes in a procedures manual
- ▶ Coherency between the formal decision-making processes and decision-making in reality
- ▶ Coherency between the stakeholders and the level of decision-making
- ▶ Prevention and good management of conflict of interests
- ▶ Accountability of decision-makers

Presence of adequate training and skills

- ▶ Coherency between training/specialization and responsibilities held
- ▶ Existence of an internal training program
- ▶ Existence of incentives/disincentives for executing decisions
- ▶ Coherency between technical/financial means available and institutional strategy (training budget)
- ▶ Ability to execute decisions without external assistance

An efficient monitoring system

- ▶ Clearly defined monitoring chain (see procedures manual)
- ▶ Widespread understanding of the monitoring chain by all the stakeholders
- ▶ Ability to detect problems and anticipate risks
- ▶ Independent, competent and regular audits
- ▶ Availability of monitoring and auditing reports (written documents)

Effective crisis prevention and management

- ▶ Internal capacity to detect problems
- ▶ Efficient warning system (time lapse between beginning of problem and its discovery)
- ▶ Ability to react quickly and proportionately to the problem (time lapse between discovery and reaction)
- ▶ Existence of a response plan (probation, redistribution of power, etc.)
- ▶ Ability to modify rules and procedures

MODULE

2

KEY ISSUES AND CHALLENGES IN GOVERNANCE

OBJECTIVE ► Understanding the issues at stake through illustrations and examples

Module 2 looks at some of the common challenges facing microfinance institutions.

The diagnostic tool in Module 1 will enable the assessor to identify the strategic choices and challenges the institution faces. Module 2 can be used to complement this tool. Each chapter of Module 2 can be read and used independently, depending on the issues at hand.

This module is divided into two parts:

PART 1 ■ **STRATEGIC CHOICES**

- ▶ Defining the mission: socially or commercially oriented or both?
- ▶ Financing and governance: what role should funders play?
- ▶ Concentrate or disperse governing powers: which stakeholders should be involved?
- ▶ Institutional type and governance: what makes the most sense?
- ▶ Centralize or decentralize: what relationship between different levels of a MFI?

PART 2 ■ **THE FIVE MAJOR AREAS OF RISKS**

- ▶ Mission drift;
- ▶ Risks related to growth;
- ▶ Risk related to conflicts of interest;
- ▶ Risks related to institutional evolution;
- ▶ Risks related to the changing socio-economic context.

Each chapter describes what is at stake for the MFI, illustrates the point with examples and offers suggestions to guide further reflection on the issue.

The list of challenges addressed here is in no way exhaustive, nor is this an effort to offer ready-made solutions to these problems. This module is primarily a tool to encourage reflection.

2.1 ■ MICROFINANCE INSTITUTIONS' STRATEGIC CHOICES

- OBJECTIVE** ▶ Identify the main governance issues confronted by MFIs.
- TOOLS** ▶ Examples - Suggestions to guide reflection.
- KEY CONCEPTS** ▶ Resolving the governance problems addressed in this chapter will have a significant impact on the internal organization of the institution. Making relevant and timely choices can build efficient governance that will help an institution pursue its mission and preserves its interests.

2.1.1 ■ Defining the mission: socially or commercially-oriented?

Microfinance is characterized by a dual mission or double bottomline: one of social responsibility (offering services to those excluded from the formal banking sector, fighting against poverty) and one that is financially-driven (becoming sustainable). Microfinance in practice has shown that social responsible institutions can be viable. However, one should be aware of the fact that a trade-off effect can also exist between these two aims. Tensions can become obvious, when a microfinance institution has to take a decision whether to develop new innovative SME or agricultural credit products or e.g. consumer lending facilities. The definition and evolution of an institution's mission depends on the stakeholders' role within the institution, the structure of the institution and its organizational model.

a. ■ Different priorities for different stakeholders

Defining the objectives of the institution will depend on the stakeholders. Thus, for example, donors, non-profit organizations and technical assistance (TA) providers may be particularly vigilant of the MFI's social mission, while private investors and employees may be more interested in financial sustainability, in view of generating dividends and improving working conditions. Employees who take part in general assemblies and management committees of rural cooperatives may be tempted to use their "intellectual capacity" to get more power, while if they become allies of the TA providers, there is a risk of them managing the cooperative in a way that prioritizes their personal interests to the detriment of the rural population. Yet, they could also use this capacity to achieve a balance between elected representatives and the TA providers.

Training and incentive schemes can help reconcile stakeholders with the MFI's social mission (for example, offering bonuses for reaching rural clients or a particular target market).

[▶ Box 1]

MISSION
See Module 1
§ 121
"Mission and
strategic vision"

[▶ Box 1] PPPCR: a conflict of vision

THE PROJET de Promotion du Petit Cr dit Rural (PPPCR) began in 1988 in the Sahelian region of Yatenga, Burkina Faso, a test of the Grameen Bank model in Africa. At first, the main objective was to show it was possible to offer credit to marginalized populations at market rates and with 100% repayment.

From the start, the "developmentalist" approach (small loans for poor women) of the project's founders was confronted with another "vision" of sustainability and professionalization. These two visions did not mesh well among the loan officers who helped launch the project (residents of the villages served they were very familiar with each one of their clients), and the newly-trained managers who were capable of growing the institution technically, but from a commercial perspective. The latter vision, reflective of the evolution of the microfinance sector as a whole, was brought to the project by the development bank (CNCA) associated with the PPPCR, by the newly-recruited managers

and loan officers, by part of the TA team and later by the donors. This vision led to choices to increase loan officer productivity and centralize the institution's activities.

The two visions were nonetheless in constant confrontation, since part of the staff (mainly the founders) actively objected to the growth strategy that had been adopted. Not surprisingly, the confrontation of visions reappeared center stage when PPPCR hit a crisis that ultimately led to the project's bankruptcy in 1998. It would seem that the inability to define a strategic vision was a major stumbling block for PPPCR. And because the tensions were never recognized as a serious governance problem, the project staff and other institutions involved were not able to defuse the situation in time.

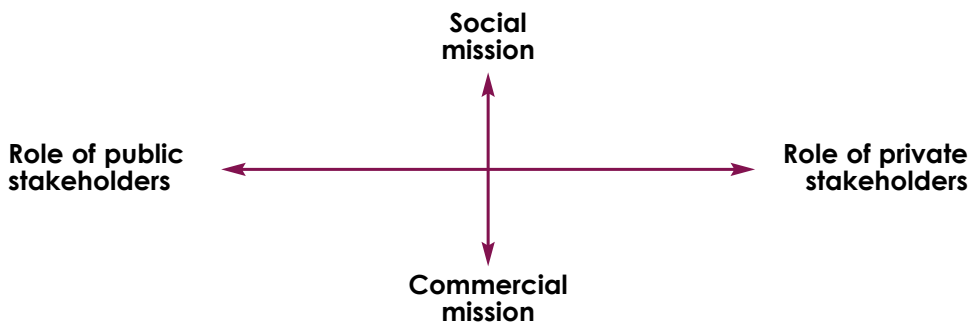
A conflict of vision and the excessively simplistic desire to maintain the initial mission without permitting evolution can also impede an institution: a balance acceptable to all must be found...

Source: CERISE, 2002 ■

Striking a balance between the different stakeholders in an institution and their role in directing and decision-making is fundamental for preserving the social mission.

b. ■ Ownership structure and mission

An institution's mission and the choices it makes in terms of institutional type and ownership structure are closely linked and influence each other mutually. Indeed, the ownership structure can be influenced by the mission and vice versa.



That said, there is not necessarily a link between an institution’s mission and its legal status. An institution that is subsidized or generally “supported” (nationally or internationally) will more likely be forced to pursue a mission of public interest than one that is financed by private investors. Similarly, private investors expecting dividends will not have the same demands as e.g. private social investors affiliated with an international organization. Congruence between the mission, target public, products offered and the ownership structure are necessarily linked to the institution’s history and its environment.

[▶ Table 4] Connections between the missions and ownerships status of the MFI

	Social mission	Commercial mission	Definition of the mission
Non-profit organizations	+++	+	The mission will likely be primarily socially-oriented.
Cooperatives	++	++	The mission of a cooperative is, above all, to offer the best service at the best price to its members. Its social nature will therefore depend on its members. The democratic principles that guide the functioning of cooperatives make it possible to defend the interests of the majority.
Private company	+	+++	The mission will depend on the type of investors: commercial investors (who might seek to maximize profits) or social investors (who might include non-financial criteria in their objectives).
Public entity	++	+	Direct or indirect subsidies widespread in public entities are usually provided based on non-commercial objectives. However, public institutions can fail if they do not balance public interest with commercial objectives.

As Rosengard (2004) notes, sustainable microfinance proves that commercial banks as well as non-profit organizations can combine financial and social success instead of opposing them: both types of institutions can create social value and apply banking principles very unconventionally (“downscaling” in the case of banks, “up scaling” in the case of non-profit organizations). Yet despite this possibility, non-commercial microfinance still plays an important role. There are many models for microfinance (bank, finance company, cooperative, non-profit) and it is fundamental that the model matches the mission. Sometimes, the most appropriate model is a rural cooperative if significant gains can be made from the financing of collective storage and marketing activities. If the activity is very high risk, for example, targeting extremely marginalized

populations, a subsidized non-governmental organization (NGO) might be the most suitable model. The guiding principles [to match the appropriate institutional model with the MFI's mission] should be institutional diversification, product differentiation, and market segmentation.

c. **■ The decision-making structure**

Decision-making processes may change across institutional types, but should be designed to help follow the strategic orientations (ex.: target group; geographic objectives) as laid out in the mission.

► **Box 2**

In some cases, diverse interests can be preserved by making sure each stakeholder has representation on the board of directors. Respecting the multiplicity of stakeholders can be a way to maintain an institution's initial strategic orientations.

► **Box 3**

► **Box 2** **Maintaining the agricultural vocation of the CECAM network (Madagascar)**

FIFATA is a peasant organization established in Madagascar in 1989 to improve the agricultural productivity of its members. Initially, FIFATA managed three main activities: financial (credit and savings services through village banks), commercial (input supply and commercialization), and technical (training). An increase in volume of activities and the introduction of a new law concerning credit and savings led FIFATA to separate the three activities in 1994 and manage each one independently.

Thus the CECAM (Caisse d'Epargne et de Crédit Agricole Mutuelle) network was established. It was unique in that its loan portfolio was heavily biased towards agricultural and animal husbandry activities. This bias obviously had to do with the network's origins and the fact that the founding members were farmers. Growth and diversification of members led the network to question this bias, and it was decided to open up to other professional categories. The increased profitability from lending to non-agricultural sectors and the influence of traders, civil servants and small

business owners that came with this decision very quickly modified the balance between the activities financed and the social groups that managed and directed the network.

To maintain the agricultural vocation of the network, now independent of the mother-organization FIFATA, an institutionalization process is underway. The process foresees the creation of shareholder categories that will guarantee the majority voice to the farmers. Members belong to one of three categories:

- 1) farmers (at least 50% of income must come from agricultural activities) who have the majority on the management committees;
- 2) other professional categories;
- 3) legal entities (production/commercialization cooperatives, purchasing centers).

The presidents of the local CECAM management committees and boards of directors must be farmers. The directors of FIFATA have the right to three seats out of the fifteen available on CECAM's board of directors. Their presence is meant to safeguard the agricultural vocation of CECAM.

Source: Rasolo, et al., 2002 ■

[▶ Box 3] Crédit rural de Guinée: a shared management model

THE OWNERSHIP structure of CRG is the fruit of an extensive consensus-building process among the actors involved, and aims to exemplify the philosophy of “shared management” that is unique to this network. Two shareholder groups representing the main stakeholders at the institution’s base constitute the “pillars” of the governance structure and consult on the main strategic directives that guide the network. Joint training sessions with the two groups have proved especially useful for helping achieve consensus. The community banks group, representing the borrower-members, holds 40% of the capital and nominates five candidates to the board of directors. According to the statutes, the president of the network’s apex structure, CRG, S.A., is elected by this group of directors. The other group is

comprised of employees, who hold 35% of the capital and nominate four candidates to the board of directors. These two groups work together to create a shared strategic vision. To facilitate compromise among stakeholders with, at times, contradictory interests, there exists a third minority group of external partners who provide technical and financial expertise and play the role of mediator. This group consists of the former project implementer (IRAM), a socially responsible investor (SIDI) and the Government of Guinea, which carries the commitments of future private national investors, commercial banks or professional organizations that may be interested in developing the services of the network (producers federations, cooperatives, etc.).

Source: CERISE, 2002 ■

d. ■ Reflecting on defining the mission

An institution’s strategy is not necessarily rigidly set out. However, a number of issues need to be addressed for an MFI to choose its course and maintain it.

Based on the analysis of actors and strategic vision carried out in Module 1, the evaluator should have the necessary data to reflect on:

- ▶ **The actors**, especially the extent to which their roles make sense given the institution’s mission and strategic vision. It should also be possible to identify which ones are best suited to preserving the mission.
- ▶ **The texts**: do they reflect the institution’s mission? Have they been modified in light of the MFI’s evolution?
- ▶ **The funding structure**: is there a balance between the financial objectives and social objectives? What are the possible points of tension that could lead to mission drift?

2.1.2 ■ Financing and governance: what role should the funders play?

a. ■ Funding structure/Legal form

The legal form adopted by an institution will strongly affect its funding structure, and especially its capital structure.

- ▶ **Non-profit institutions:** Characterized by a lack of equity, non-profit institutions do not have owners. Reliance on external funding varies and some non-profit institutions borrow from banks. Nonetheless, institutions of this type primarily rely on grants and subsidies. Another characteristic of these types of institutions is the dissociation between the funding source and the decision-makers.
- ▶ **Cooperatives:** Cooperatives usually have a capital base made up of members' shares, generally a multitude of small amounts. The most important resources of a cooperative is its members' savings. However, cooperatives may also negotiate credit lines and benefit from donor funds. What characterizes cooperatives is their funding structure which draws on their members (shares and savings), whose power is not based on what they contribute but on their member statute.
- ▶ **Private companies:** Capital in a private company is composed of shares; ownership is in the hands of investors. The number of investors may be few, as is the case for a limited liability company; a limited liability company is less rigid in terms of organization. In the case of corporations, the law may require a certain number of investors (e.g. in France the minimum is seven). Depending on the case, private companies may be able to mobilize savings, borrow from commercial banks or international organizations.

It is clear that the way an institution's funding structure evolves and opens up to new sources of financing will also strongly impact its governance. [▶ Box 4]

FINANCIAL
STRUCTURE
See Module 1
§ 111c
"Who owns
the capital?"

[▶ Box 4] Funding sources and institutional types

THE ISSUE of funding is crucial to financial institutions, regardless of whether they operate as commercial banks, finance companies, credit unions or non-profit foundations. They all need to refinance their loan portfolio in one way or another, either through debt, deposits or equity. However, as far as microfinance is concerned, the issue of funding is likely to be of little concern to downscaling commercial banks, since they already have established savings programs and longstanding access to financial and capital markets. MFIs that operate as non-profit foundations generally obtain their funds from donors, retained earnings and, in some cases, from public second-tier financial institutions. Some of the more successful

non-profits have managed to obtain funding from commercial banks, but rarely in amounts exceeding their own equity. At some point therefore, growth oriented non-profits typically find themselves constrained by lack of funding. More donor funds can be sought, but over the long term, the main solution is to transform into a licensed and supervised financial institution, which can more easily access funding through savings accounts as well as from financial and capital markets. This is the fundamental reason behind the appearance of an increasing number of specialized and supervised MFIs in Latin America.

Source: Jansson, 2003 ■

b. ■ Funding sources: internal or external

Funding sources differ depending on the MFI. An institution may finance itself with funds from members' shares, reserves or client savings. Or, it may rely on external sources of funding such as subsidies or credit lines offered by donors or commercial banks.

The funding structure and source of funds (internal or external) greatly influences an institution's governance and the stakeholders involved. The way the owners of the institution and its creditors relate with each other will also play an important role in the form of governance.

[► Box 5]

c. ■ Investor profiles

The profile of an investor – private, public, commercial, socially-responsible, national, international – is an important factor that will influence the preservation of an MFI's mission.

[► Box 6]

[► Box 5] Funding sources: the role of creditors

GOVERNANCE and autonomy are influenced by different sources of power: owners, external regulations, but also creditors that form a considerable influence on decision making.

There is no doubt that equity is the most crucial funding source as far as direct governance is concerned. Equity provides a right of disposal. Not only the owners create corporate identity and exert control on institutions, major creditors also have this power. An institution relying basically on just one creditor may well have to adhere to its conditions. Whether this creditor is part of the board or not it might be decisive in setting an overall policy.

Concessionary funds usually involve a high degree of external intervention in the financial institution's management. In particular, in directed credit schemes, pre-defined decisions on targeting of beneficiaries, lending purposes, lending terms (regulated interest rates and margins, loan duration, collateral requirements, loan repayments, etc.), lending

procedures and reporting requirements limit the scope of managerial autonomy.

Both donors and government funds are associated with many regulations which often cut the financial institution down to an executing agency. Success is defined as complying with rules and externally set conditions.

Commercial funds are only accessible for well-performing financial institutions. In other words, exposure to market forces leads indirectly to a specific management approach that is conducive to building up the image of the institution and enhancing the confidence of the general public including depositors, other creditors as well as borrowers.

On the other hand, financial institutions that mobilize commercial funds are more autonomous in their lending decisions and operations, provided they comply with the market rules and maintain the value of their mobilized resources.

Sources: Giehler, 1999 ■

[▶ Box 6] **Types of investors**

THE MICROFINANCE sector has brought together a wide variety of investors to mobilize funding: government or multilateral organizations, private sector foundations, NGOs, private individuals, commercial investment companies. The issue of sustainability – both financial and social – is obviously a fundamental criteria on those considering investment. The relative importance given to either social or financial aspects is directly

related to the type of investor but also the disbursement conditions of the funds: are they loans or grants? The type of investor and investment (equity investments, loan, guarantee) are thus important elements to consider. The loan arrangement can play an important role in the strategic vision of the institution and defining its priorities.

Source: ADA, 2003 ■

d. ■ **Reflecting on the funding structure**

When it comes to the funding structure, an MFI should primarily reflect on the following:

- ▶ **The relationship between its legal status and the financial resources** at its disposal: it is easier to bring in external investors when registered as a private company, or mobilize members' savings if registered as a cooperative.
- ▶ **The type of funding sought** (shareholder capital, credit lines, loans from commercial banks, savings, etc.): the type of funding will have an impact on the governance structure and the owners' autonomy.
- ▶ **The profile and objectives of the investors** will be decisive, as their influence over the institution will differ, depending on whether they are commercially-oriented or socially responsible.

2.1.3 ■ **Concentrate or disperse governing powers: which stakeholders should be involved?**

Microfinance institutions may have more or less participatory policies, which greatly influence the governance model. In MFIs with a salaried workforce, power is generally concentrated among a few key actors; In participatory models, power may be dispersed among a wide variety of actors. This diversity can help maintain cohesion among the many stakeholders. However, if it is badly managed, it can become a stumbling block for an institution wrought with diverging interests. Where do the many stakeholders of an MFI fit in? What balance can be struck between internal and external actors?

a. ■ **Stakeholders directly involved: clients, members and/or employees**

Because microfinance is often seen as a vehicle for development, the issue of stakeholder participation is raised frequently.

▶ **STAKEHOLDERS**
See Module 1
§ 112
"The power of stakeholders over strategic and operational decisions"

In some cooperative models and mixed models (like the CVECAs, see box 7) client or member participation is used as a tool to make sure the supply of financial services matches the demand; this way, the financial system is effectively used to further the economic and social strategies of the population. Participation can help to reduce transaction costs and better manage operational risk.

[► Box 7]

[► Box 7] **Community participation in the *Caissees Villageoises d'Epargne et de Crédit Autogérées***

THE CAISSES *Villageoises d'Epargne et de Crédit Autogérées* (CVECA) model prioritizes decentralization and self-management: the base unit is the village and all members can participate in the institution, which is managed by its members. Technical assistance and auditing is carried out by a private, external structure called the Service Unit. In the formalized CVECAs, the village community is the owner of the bank; managers and auditors are selected by bank members. The community banks are federated into Regional Associations. These Associations have legal status that gives them the power to make

strategic and operational decisions; they negotiate funding for the community banks and can exclude banks with financial delinquency. The Service Unit supplies technical assistance to the banks and Associations, via a contract that is renegotiated annually. It has no decision-making power. In this structure, the power is very much in the hands of the beneficiaries, although the community banks are subject to oversight by the Associations, which negotiate prudential regulation with the supervisory authorities and refinancing.

Source: CERISE, 2002 ■

Employee involvement in governance (i.e. participation in the capital structure) is one way of having staff participate actively in the strategic orientation of the institution, encourage risk-sharing and employee motivation. However, it also raises a number of issues: is letting only a few managers into the capital structure coherent with a corporate culture where collective management may be highly valued? Or inversely, is it possible for all employees to participate in the institution's capital, through an employee association, with the risk of creating an unmanageable structure? How can a large association be represented or reach consensus? Will the employees see their participation as an opportunity to prioritize profitability (engage in a profit-sharing scheme) rather than a way to be involved in governing the institution? Are they clear on what is at stake in these two options?

An MFI cannot decide to become “participatory” at the last stage of the institutionalization process. Cultivating participation requires specific technical and organizational skills; it also requires strong corporate identity and leadership capacities. Its costs should be accounted for in an institution's development and institutionalization strategy. Even volunteers come with costs (stipends, material advantages, etc.), which are difficult to maintain over time, especially when the work load gets heavy. The savings that can be made should be considered

against the costs it takes to train volunteers and replace their skills when they leave. A professional association could represent employees while limiting costs of training.

Associating and involving the beneficiaries and/or employees in an institution's governance takes time and sustained efforts of monitoring and training. Problems can arise. The governance structure should be designed to limit the risks of misappropriation of services by any one group and to maintain the institution's openness to marginalized social groups.

b. ■ The evolving role of promoters and TA providers

As a general rule, microfinance practitioners and TA providers have seen their roles evolve, often getting involved at levels that they never would have expected from the outset. Indeed it was not unusual for TA providers in the past to get involved in projects for a fixed period of time, divided into phases (feasibility, pilot, expansion, preinstitutionnal, institutionnal and exit). Today the need for long-term sustained support is felt. Support needed is not necessarily financial (a number of institutions have achieved sustainability), but technical (analysis of the environment, defining strategic directives, respecting the institution's social mission, representing the MFI at the government or sector level, etc). There are several alternatives for offering this support, such as participation on the board of directors or creating new support structures outside the institution.

[► **Box 8**]

c. ■ Bringing in new stakeholders

When microfinance institutions formalize, they often open up to new stakeholders that have not necessarily been involved from the beginning. These new participants may be private investors, local governments or professional organizations. The decision to bring in new stakeholders can greatly influence the governance structure, depending on their level of participation (minority or majority) in the institution.

[► **Box 9**]

How to involve private investors in microfinance institutions is a recurring question among practitioners. When analyzing investors, it is important to distinguish the different types (traditional investors, social investors, etc.). Not all investors have the same objectives. Some are more concerned with the social responsibility of the company they invest in, while others put more emphasis on financial performance.

[▶ Box 8] The TA provider's role after institutionalization

GRET-supported microfinance institution AMRET (previously EMT) in Cambodia was transformed into a formal financial institution in 2001. Clients had never participated in the institution's governance, and thus it did not make sense for them to be part of the ownership structure. The challenge was to define who would be the shareholders. The difficulty of finding shareholders whose motivations

were not purely financial and who could contribute with a certain expertise (or at least be seen as endorsing the institution, in relation to future shareholders and refinancing partners) is why GRET ultimately positioned itself as a majority shareholder in the institution. Later, it will become a minority shareholder.

Source: CERISE, 2002 ■

[▶ Box 9] Bringing in a private investor: the case of SEMISOL (Chiapas, Mexico)

FUNDACHIAPAS, is an organization founded by the ex-managers of a coffee cooperative in Chiapas, Mexico. It has received assistance since it started from GRET to set up sustainable microfinance operations in the Tapachula region. Donor subsidies, which complemented a donation from the Fondation Pro Victimis, were cut back early on (after only one year, due to budget restrictions at the French Ministry of Foreign Affairs) and the institution started considering the option of private investors to fund expansion. GRET contacted a private investor specialized in microfinance, Investisseur et Partenaire (I & P), on behalf of Fundachiapas. I & P first agreed to lend funds to the institution, which enabled its survival after the donor withdrew.

By the end of 2003, it became necessary to transform Fundachiapas into a formal institution so it could access new funds to meet the increasing needs of its clients. Institutionalization took place in 2004; the stakeholders opted for a private company, which seemed to best suit the institution's way of working and the local context. I & P holds a majority of the new company, SEMISOL, with 65% of the shares, and the rest is distributed among the Mexican founding partners (15%) and GRET (20%).

The involvement of the private investor as a majority shareholder was possible because of its knowledge of the microfinance sector. Moreover, it had a pre-existing relationship with

GRET, the two having invested together in the Cambodian institution, AMRET (ex-EMT). It is an investor who has proved willing to invest in MFIs over the long-term with no intention of quickly selling off its parts.

I & P considers GRET its "co-pilot," and recognizes the NGO's technical expertise as a complement to its own investment capabilities. It has clearly expressed the desire (as have the Mexican partners) for GRET to become involved as a co-investor, at least symbolically. GRET ultimately decided to invest in 20% of SEMISOL so its presence as a shareholder translated into a real capacity to contribute to strategic decisions.

There is the potential for a conflict of interest for both I & P (lender and investor in SEMISOL) and GRET (investor/TA provider), which is common in MFIs and practically inevitable in very young institutions. The partners are aware of this, and the good governance of the institution (decisions made by the board of directors) must be relied upon to deal with potential conflicts.

Today, the case of SEMISOL seems atypical, with the involvement of a private investor very early on. However this configuration will undoubtedly be necessary in the future, in countries where legislation imposes institutionalization very quickly, and given that donors are increasingly reticent about subsidizing MFIs in the start-up phase.

Source: GRET, 2004 ■

- ▶ **A shareholder pact can be useful for creating a diversity of stakeholders in the institution.** A shareholder pact is a document to complement the founding texts of a company that enables some or all of the shareholders to organize their relationships within the company (exit conditions, protection clauses or capacity to intervene in the company's management). This type of pact goes beyond the legal statutes by defining the conditions required for the good management of the business, the mutual commitments of the various shareholders and a common vision. It is a useful tool in institutions with a diversity of actors.

Opening up an institution to stakeholders beyond those traditionally involved (employees, clients, TA providers) may be the result of a desire to integrate the institution more fully into its environment and work directly with local stakeholders who have a vested interest in the role a financial institution may play in their community.

▶ **Box 10]**

▶ **Box 10] Local governments and microfinance: municipal savings and credit banks in Peru**

THE MUNICIPAL savings and credit banks network, founded in 1981 and supported since 1985 by GTZ, offers an interesting example of MFIs created at the impetus of local governments. The banks are also illustrative of some key governance challenges.

The result of municipal credit lines that evolved over time, the network has some 145 banks and reaches more than 500,000 clients, making it the leader in Peru's microfinance sector.

The network aims to mobilize savings to use as a stable source of funds (currently, deposits cover roughly 88% of loans) and promotes the decentralization of its operations outside of the capital, Lima.

Registered as a private company, the network has a unique governance structure with one shareholder: the local provincial government. The municipality is represented on the board by a delegation of seven members who are local representatives with diverse backgrounds (a religious figure, local representative of the Central Bank, local representatives of the Chamber of Commerce and small and medium enterprise trade organizations, city councilpersons from the ruling and opposition parties).

This collegial management structure makes it possible to administer the banks in accor-

dance with local development objectives while avoiding political interference. The banks are monitored systematically (internal controls, bank supervision, network federation, etc.).

Nevertheless, the ownership structure and governance model appears to present a number of difficulties, according to an analysis by the World Bank (1999).

The development of some banks has sometimes been impeded by the politicization of the network and the reinvestment of a large portion of the profits into social projects has limited capitalization.

Also, the network's public nature slows down the management process, due to the administrative authorizations necessary for expenses.

Finally, the lack of social control over the delegation has led a few banks to shift towards a more commercial approach, to the detriment of the social objectives that had been laid out initially. Now that the network has been authorized to offer a complete range of banking services and open branches in Lima (thus opening itself to competition from Mibanco and commercial banks), it must weigh the risks and opportunities these options offer, and reflect on its municipal character in order to create a long-term strategy.

Source: based on Brinkmann and More, 2004 and Burnett et. al., 1999 ■

d. **Minority and majority stakeholders:
what impact do they have on governance?**

Within management structures, minority and majority stakeholders have to strike a balance based on the weight of their participation and their interests. It is possible to identify the pros and cons of the involvement for each type of stakeholder.

[► Table 5]

e. **Reflecting on roles of different stakeholders**

While a diversity of stakeholders can contribute a lot to an MFI, the benefits are limited if there is a loss of cohesiveness and compatibility between the different actors. New stakeholders should have the intention of pursuing the dual objective of the institution (social and financial).

Main issues to reflect on include:

- ▶ The choice of stakeholders to be involved in decision-making;
- ▶ Motivation behind this choice; level of complementarity (financial, technical, political) and compatibility of interests among the stakeholders;
- ▶ Weight accorded to each shareholder; how they are involved;
- ▶ How to incite or facilitate the involvement of desired stakeholders (ex.: peasant organizations, local governments);
- ▶ What type of investors to bring in; motivations, limitations, demands of the investor;
- ▶ The relationship between the financial strategy of the institution and the role of the stakeholders in funding the institution.

When there is a diversity of stakeholders the degree to which power is concentrated or dispersed is inevitably an issue. Dispersing power too much can result in watering down the responsibilities of each group, which in turn can cause problems. The advantage of concentrating power is that those who have the power are necessarily interested in what goes on in the institution. It is also possible to have few stakeholders but who represent many individuals (employee or client groups, for example), which can make decision-making difficult.

Solutions depend on how the MFI positions itself in relation to the government, donors, clients/members, external partners (foreign shareholders, banks, professional organizations, etc.) and its own employees. In sum, when composing the governance structure of an institution, many elements must be considered in order to create a structure that is professional and capable of making the right decisions at the right time.

[▶ Table 5] Advantages (😊) and disadvantages (😞) of the different MFI actors

	Minority Shareholder	Majority Shareholder
Employees	<ul style="list-style-type: none"> 😊 Employees are motivated. 😊 People are involved in making decisions that they themselves will implement. 😞 Difficult to set up. 	<ul style="list-style-type: none"> 😊 Employees are heavily involved in and identify with the institution. 😊 Opportunity to participate in long-term growth. 😊 Employees always represented through a professional organization. 😞 Risk of differentiating between employees (who should be represented and how?) 😞 Requires training efforts. 😞 Risk of mission drift (employees interests overtake the social mission of the institution). 😞 Internal conflicts risk creating bottlenecks.
Clients	<ul style="list-style-type: none"> 😊 Clients are motivated. 😊 Balance between elected client representatives and employees with technical background. 😞 Difficult to set up. 😞 Requires training clients in their position and role as shareholders. 	<ul style="list-style-type: none"> 😊 MFI's strategy matches clients' objectives. Information about the evolving needs of clients is constantly available, which helps avoid routine and mission drift. 😊 Client owners and managers help reduce transaction costs. 😞 Conflicts of interests. 😞 Requires training efforts regarding what is at stake in the institutionalization process, defining the strategic vision, risk management, adapting to the context, etc.. 😞 Compatibility with other forms of local social organizations. Difficult in de-structured societies (ex.: Cambodia).
Promoter / TA provider	<ul style="list-style-type: none"> 😊 Can play mediator role in times of crisis. 😊 Power to advise and orient. 	<ul style="list-style-type: none"> 😊 Can help make sure the mission is respected. 😊 Brings stability, congruence, professionalism, knowledge of institution. 😊 Inspires confidence of potential shareholders. 😞 Conflicts of interest. 😞 Risk of institutionalizing the project instead of taking advantage of the institutionalization process to make changes or introduce innovations. 😞 Could weaken involvement of internal shareholders (employees, clients).

[► Table 5 - rest] Advantages (😊) and disadvantages (😞) of the different MFI actors

	Minority Shareholder	Majority Shareholder
Private external shareholders	<ul style="list-style-type: none"> 😊 Outside control, perspective, support, mediation. 😊 Sources of funding and expertise 	<ul style="list-style-type: none"> 😊 Professionalism. 😊 Openness to diverse shareholders. 😞 Weak knowledge of institution and/or country => risk of not evaluating risk correctly. 😞 Risk of mission drift. 😞 Could weaken involvement of internal shareholders (employees, clients).
Government	<ul style="list-style-type: none"> 😊 A way to bring in the government when it has been heavily involved during the project phase. 😊 Facilitates the transfer of ownership if the government is the official project manager and has the possibility of relinquishing shares to national private investors. 😞 Does not necessarily create value added to the MFI (the government can be a partner without participating in the capital structure or holding a seat on the board) 	<ul style="list-style-type: none"> 😞 Risk of conflict between public policies and institutional strategy; institution's independence may be at risk. 😞 Lack of incentives for employees.
Locals governments	<ul style="list-style-type: none"> 😊 Local appropriation of institution. 	<ul style="list-style-type: none"> 😞 Risk of politicization of institution. 😞 Bureaucracy slows down decision-making.
Professional organizations	<ul style="list-style-type: none"> 😊 MFI embedded in local social fabric. 😊 Possibility of exchange, knowledge sharing and technical collaboration with other organizations. 	<ul style="list-style-type: none"> 😊 Technical endorsement of the profession. 😞 Tendency to be corporatist and prioritize the interests of one profession. 😞 Usually have few resources to invest in the MFI.

2.1.4 ■ Institutional type and governance: what makes the most sense?

Choosing an institutional type is necessary when sustainability is the goal. The choice is usually made when setting up an institution, when formalizing a project or when a project experiences especially strong growth.

The country's regulatory framework will play an important role in making the choice since institutional options are often limited in microfinance (NGOs, cooperatives, commercial banks, finance companies).

However, even with the same institutional type, different forms of governance are possible, depending on the initial choices of the institution's founders.

a. ■ One institutional type, many governance models

Making choices based on the regulatory framework

Choosing an institutional type often depends on the existing regulatory framework. Each institution has to elaborate its governance model based on its history, context and strategic vision; nonetheless, institutional structure does not define governance. The same types of institution can have very different governance structures.

[► Box 11]

For a private company, the governance model can not only be very different depending on the shareholders (national, international, internal or external to the structure, socially responsible or commercial investors), but also the history and identity of the institution.

[► Box 12]

Evolving institutional types

Although current institutional types available for MFIs by law are quite limited, there are certain statutes that take into account a wide diversity of stakeholders.

A new legal form: a public interest cooperative society

► A public interest cooperative society (*société coopérative d'intérêt collectif*) is a tool of local and sustainable development used in France, but has been a source of inspiration for some MFIs. This type of structure attempts to create, consolidate, develop and render sustainable the activity throughout a region by respecting the interests of all those involved. As a commercial structure, it generates profits; but as a public interest cooperative, it will reinvest them in research and development. This legal form ensures all the institution's stakeholders (employees, beneficiaries, public and private local actors) benefit. The different socio-economic partners of a region become co-managers of an economic structure in which each one has a role to play. (Source: Margado, 2004)

The evolution of legal form can also be linked to changes within an MFI, mainly when it comes to funding. It is not uncommon to hear about the “de-

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FORM
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§ 111
“Who is the owner?”

▶ **Box 11] Same cooperative status, different models of governance**

COOPERATIVES (also referred to as savings and credit cooperatives and credit unions) share a set of common principles: start by mobilizing savings, only lend a fraction of the savings collected, be member managed and independent, especially from the government. In practice, there is huge diversity among cooperative governance structures, which generally stems from two opposing viewpoints: the importance of building a large and strong economic base by diversifying members, or maintaining a certain homogeneity and local proximity that makes it easier to exercise social control.

The reasons for this diversity include:

- **Different scales of outreach.** Some networks prioritize local cohesiveness through small community banks at the inter-village level (Kafo Jiginew in Mali) while others seek to make the most of the economic dynamism in certain regions (FECECAM in Benin organizes community banks at the sub-prefecture level);
- **More or less restrictive membership criteria.** While many cooperatives in Latin America prioritize a homogeneous public (of the same trade, for example), others are open to diverse populations residing in a given territory (Luzzati cooperatives in Brazil);

- **More or less professional managers who are more or less subordinated to local elected representatives.** Depending on the size of community banks, some cooperative networks recruit managers locally, with little formal education, while others use highly qualified personnel who are specialized in bank management. Depending on the status of this personnel and their management role in the network, they may be more or less subordinated to the local elected representatives, or on the contrary, carry out the directives of the federations (FECEAM in Benin);

- **A varied mix of services offered and resources available.** Some networks prioritize savings and recycle only a small amount into loans. Others use the majority of their savings to grant loans and combine this resource with external sources of funds, especially when diversifying to include new categories of members (women, for example) or new products (medium-term credit). This form of refinancing can upset internal balances and increase the outside influence of certain donors over the institution's governance (the TIAVO network in Madagascar with their education loan, for example).

Source: IRAM, 2004 ■

▶ **Box 12] Two private companies, two models of governance: AMRET and CRG**

AMRET (ex-EMT) is registered as a Private Limited Company owned by external shareholders. AMRET made the choice to involve a small number of shareholders in order to ensure cohesiveness and strong technical capacity. The current shareholders are 100% French and relatively homogeneous: three French TA providers and a branch of the French Development Agency. The introduction of employees into the capital structure is planned for 2005.

Crédit rural de Guinée is a private company whose shareholders are directly involved in the institution. CRG chose to strive for a diversity of shareholders in order to reflect the diversity of the institution's stakeholders. The capital is

divided into three groups: representatives of the community banks (40%), representatives of the employees (35%) and other partners (25% divided among the government of Guinea, TA provider IRAM and social investor SIDI).

So while the two institutions share the same legal status, their governance structures are very different. In AMRET's case, access to certain external investors (and not other) essentially defined the governance structure; in the case of CRG, the governance structure sought to create a balance between the institution's main stakeholders: the community banks (i.e. clients) and employees.

Source: CERISE, 2002 ■

mutualization” of savings and credit cooperatives that are forced to abandon their mutualist vocation for financial reasons.

The importance of initial choices: “path dependency”

While institutional type determines how an institution is organized, it does not determine the governance model. The institution’s trajectory has to be taken into account. Most often, the decisions made early on regarding organization or decision-making procedures greatly influence an institution’s development. Initial choices will have an impact on the future, especially in terms of training costs and the uncertainties linked to change. Changing the course of an institution is not always possible, transitions must be prepared and programmed. As such, it is impossible to transform a project that started with a management model run by employees with no client involvement into a member-owned and run cooperative, without significant transition, training and information dissemination.

b. ■ Building a governance structure without a pre-established legal form

The microfinance sector is relatively new and not every country has an established legal and regulatory framework. Sometimes, local projects are forced to fit into to a legally accepted model in order to formalize their role or simply to be allowed to continue operations.

[► Box 13]

When organizations are federated under a new structure, they are not necessarily ready to give up their independence, especially if the federative structure was not planned initially. Nor do they necessarily want to delegate their representative capacity. Furthermore, the question of how to fund a structure over the long term that offers assistance but also controls, is often crucial for accepting a new configuration that could dilute the independence of the SHG.

c. ■ Building an MFI in the presence of a strict regulatory framework

In some countries, microfinance legislation is strict and imposes the choice of institutional type (cooperative, private company or non-profit). The institution is faced with the challenge to conform to an imposed model, while trying to maintain its strategy and mission. For example, it is not easy to take on a cooperative status if during the project phase clients were not involved in decision making (see § 213a on participation).

[► Box 14]

d. ■ Reflecting on institutional types and governance models

Once a project or institution has made a choice about the institutional type it will adopt, it must begin the process of defining its governance structure.

[▶ Box 13] Conditions for the institutionalization of Self-Help Groups in India

AN INITIATIVE to strengthen Self-Help Groups (SHGs) undertaken by the National Bank for Agriculture and Rural Development (NABARD) involves creating a governance model and legal status appropriate to their operations. In March 2002, there were more than 460,000 SHGs and 7.8 million people served through these groups by Indian banks.

The support role of SHGs and linkages with banks

While some partner banks have played an active role in promoting SHGs and have managed to maintain linkages over time (such as “graduating” select members of SHGs to become clients), the relationship between banks and SHGs poses a number of challenges.

Some banks still see loans to SHGs as something they are forced to do by the government, in order to meet their quota of lending to the poor. Banks have also shown resistance to assuming the transaction costs related to training and group monitoring, which raises questions regarding banks’ incentives to maintain and develop loans to SHGs over the long term. Nonetheless, some banks like ICICI Bank have proceeded with a different approach, internalizing training costs and the follow-up of SHGs in their operations. It will be interesting to observe the long term effects of the minimalist approach of creating and training groups (like that of ICICI) compared to the more holistic and extensive training approach used by NGOs.

The role of federations

In order to structure SHG networks, SHG federations have developed in recent years with the aim of consolidating groups to ensure institutional viability.

These federations bring SHGs into an organizational structure that is crucial for their viability, given they are such small organizations. Through federations, individual SHGs can benefit from economies of scale for services like accounting and auditing. They can reduce their transaction costs with the financial insti-

tutions that on-lend to them and promote links with banks. They can also reduce delinquency by improving follow up and monitoring. Finally, they can also lobby the government more effectively.

Depending on the NGO that supports the SHG, strategies for building federative structures differ. Some promote apex level institutions in order to strengthen the group learning process (more group members = greater exchange of information) and solidarity among groups. Others favor the creation of many smaller federations to carry out tasks like information dissemination, training and conflict resolution, so that the NGO no longer has to intervene and the groups can function by themselves.

There is also the strategy of creating a federative structure that will play the role of financial intermediary (in the other two cases, the federation plays no financial role; the SHGs have a direct linkage to banks). In this case, the decision to become a financial intermediary should be based on the comparative advantage this role could offer (given that the alternative would be to develop more direct linkages between SHGs and banks), the potential capacities of the federation and the costs of transforming into a federation, as well as the federation’s capacity to generate income to cover the cost of non-financial services offered to the SHG affiliates. Efforts are still being made to find an appropriate legal status for SHGs and their federations. As such, banks continue to assume the risk for funding groups and federations. But who is responsible for the bankruptcy of a group, the bank who funds it or the federation?

To create a federation, the roles and responsibilities at each level have to be well-defined. Affiliates must be willing to accept a new supervisory authority, and an analysis and distribution of the costs and required technical capacities involved is required at each level (especially for a management information system that monitors activities). How can a cohesive network be built from the consolidation of independent units?

Sources: IFAD, 2003-2004; Palier, 2004 ■

[▶ Box 14] **Microcredit associations in Morocco**

MICROFINANCE legislation in Morocco obliges MFIs to adopt non-profit status. It is not possible to offer microcredit under any other institutional form. While this regulation may help MFIs maintain their social mission, it is often constraining for growing and maturing MFIs. These institutions very quickly have problems accessing funds. They are not allowed to mobilize savings and their non-profit status does not allow them to attract private

investors. They are also limited in their ability to negotiate credit lines with commercial banks. Moreover, non-profit status implies a certain kind of governance that breaks the connection between clients and donors on the one hand, and donors from decision-makers, on the other. Moroccan MFIs are faced with very specific governance issues due to the imposition of an institutional type.

Source: IRAM, 2005 ■

The institutional options are often imposed by the environment, and choices are frequently limited to cooperative, commercial or non-profit status. Other than the strictly legal aspects, the history and source of funding for an institution (equity, savings, external funds) influence the choice of governance model and the roles given to the different actors.

Main issues to reflect on with regard to institutional types

- ▶ **Cohesiveness between the legal status and the type of governance desired:** the institutional type will of course influence governance but it is not the only determining factor;
- ▶ **The relationship between the optimal legal form and the context:** the institution will probably have to bow to legal constraints; it is rare an institution manages to change the law – more often than not, the institution must adapt itself to the existing legal framework;

A forward-looking perspective of governance that involves the possibility of change (addition of an apex structure to a local village bank network, for example) which can help avoid shifts in power that may not be welcome by the stakeholders.

[▶ Table 6]

2.1.5 Centralize or decentralize: what relationship between different levels of an MFI?

When building an MFI, choices have to be made about the scale of operations: will services be offered locally, regionally or nationally? Decisions regarding outreach may also have to be made during a growth or expansion phase.

The way an institution is organized (at a neighborhood, village or inter-village level, for example) and the way the different levels work together (between branches and headquarters, for example) influence not only its financial viabil-

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ity but also the social relationships that frame the institution's operations. An MFI that decides on a multi-levelled structure introduces a certain level of complexity, and should consider how this choice will impact the institution's objectives (appropriation of the institution by the clients, rigorous management practices, financial sustainability, etc.)

a. ■ **Choosing the scale of outreach and level of decision-making**

By carrying out operations at a local level, the MFI can benefit from hands-on knowledge of client needs and very close monitoring. This is what characterizes informal systems like ROSCAs and itinerant bankers. This approach is none the less limited when it comes to expansion and diversification. Decisions are made on a local level.

Operating at a regional level makes it possible to work in relatively homogeneous areas (socially and economically) which ensures that services are well-adapted to the population.

Country-wide operations can meet needs that have been identified at the national level. Risks are diversified, but costs can be high and efforts to coordinate decision-making difficult. In addition, large scale operations make it possible to set up mechanisms of financial compensation in zones that are very diverse (branches with an excess of liquidity from savings can lend to those in need of resources for on-lending). They also present an organized demand for national-level programs or services (for example, remittance payments or money transfers).

Financial viability

Supporters of decentralization emphasize how much it can reduce costs. Collecting information on borrowers, borrower selection, loan recovery, deposits and withdrawals all happen at the local level, minimizing travel and opportunity costs for clients. A local committee can manage day-to-day operations, often on a voluntary basis initially, then remunerated based on volume of activities and/or profits. Local level operations can thus break even quite easily within a few years. But this does not mean much, since community/village banks do not develop spontaneously, and need assistance, supervision and training. It may also become necessary to create a federative or apex structure (or structures) to deal with funding issues or to represent the local structures at a national level. Thus, financial viability must refer to the network as a whole. The way an institution is organized (for example at the village, inter-village, regional level) and the number of levels it has will greatly influence financial viability. Some questions that may be asked when considering a network's costs include: To what extent are local volunteers used and how much are they paid? How is it possible to decrease the number of levels in an institution's structure, or to focus on structures at regional rather than national level? What economies of scale are possible?

[► Table 6] Relationship between institutional form and governance

Institutional Form	Ownership	Financing Structure
Non-profit/NGO	No assets ; only reserves. Undefined ownership.	Funding mainly from public sources and credit lines negotiated from donors.
Cooperative	Social capital held by members. Members are owners.	Connection between savings mobilization and credit. Opening up to outside investors possible but limited.
Private profit-making company	Capital held by shareholders. Owners are shareholders.	Financing comes from private investors (commercial or socially responsible, local or international) and loans from commercial banks.

[► Table 6 - rest] **Relationship between institutional form and governance**

Definition/ Respect of Mission	Stakeholders involved in decision-making	Key Questions
Socially-oriented mission.	Disconnection between donors, beneficiaries, members and decision-makers (employees and elected representatives)	Access to funds. Representativeness of the General Assembly and Board of Directors (risk of a "private club"). Relationship between elected representatives/ local authorities and employees/ technical staff.
Mission is to defend the interests of the members.	Heavy involvement of members, bottom-up structure with representation of the membership base on the centralized governing committees. One person/one vote principle. Equality among members regardless of their investment. Cost of membership share minimal so as not to be an obstacle to membership. Unlimited number of membership shares.	Desire of members to be involved. Relationship between elected representatives and employees who may have diverging interests. Relationship between the central structure and branches, especially issues of autonomy and financial solidarity. Relationship between different levels of decision-making.
Primarily commercially-oriented mission if commercial investors, socially-oriented if socially responsible investors (SRIs). Shareholder pact enables definition of mission among shareholders.	Diversity of stakeholders will depend on how they are represented in the capital structure (private investors, SRIs, national or international investors, employees, beneficiaries, etc). Relationship between number of shares held and influence in decision-making. Number of shares can be limited and as a consequence not offered to everyone. Possibility of organizing shares in groups of shareholders.	Possibility of mission drift due to shareholder pressure to be profitable. Role and influence of different shareholders. Evolution/introduction/ exit of shareholders. Level of centralization of decision-making

Social relationships

The scale of an MFI not only influences its financial sustainability; it can also have an impact on social relationships, depending on the social context.

Working on a local scale seems to be most effective for maintaining social control (especially with regard to selecting borrowers and putting pressure on defaulters). In rural areas, the farther away decision-making takes place from the village, the harder it is for women to participate (with the exception of some categories of traders), due to their schedules and transportation difficulties.

However, purely local institutions also lead to a concentration of power with a handful of elite, a certain routine, difficulties in finding local technical staff and difficulties with resolving internal conflicts.

Decision-making

There are two main options for making decisions:

- ▶ In a way that is centralized, with the central structure giving orders to the local banks.
- ▶ In a way that is decentralized, which gives autonomy to the local banks.

In some cases, product delivery may be the only thing decentralized. In others, more strategic decisions like product development or outreach choices may be decentralized. This way, limitations like distance and isolation of certain branches can be compensated for by the decentralization of decision-making.

With decentralization, the cohesiveness of the network must be observed carefully. Decisions that are the responsibility of the central structure and are fundamental to the institution should be defined up front, as should the decisions that are delegated to the local level. Decentralization of decision-making implies that the decision makers are stakeholders in the institution and participate somehow in the ownership structure. Indeed, the decentralization of decision-making is frequently correlated to the participation of local stakeholders in the ownership of an institution.

[▶ **Box 15**]

b. ■ The relationship between levels of an institution

MFI networks, especially cooperatives, must constantly manage tensions between their social and financial objectives, between their strategy and operational activities, between the independence they desire and the cohesiveness of the network.

[▶ **Box 16**]

The roles and responsibilities at each level of the network must be well defined. Statutes need to be precise in order to avoid confusion over who has a decision-making role (in the general assembly or among the elected representatives) and who is in charge of operational tasks. The latter must stay focused on executing

[► Box 15] The various centers of power in the FECECAM network (Benin)

THE FECECAM network has a three-tiered structure composed of community banks at the base, followed by regional unions and the federation. The banks are owned by their members who elect representatives to hold positions on the management bodies. The banks are their own profit centers: they collect savings and make loans. They have their own legal status. The regional unions are essentially service centers for the community banks. The federation represents, coordinates and supervises the network. Policies and management norms and procedures are defined at this level. The federation also coordinates training activities, deals with resource mobilization and manages relationships with donors. The federation centralizes and manages the network's liquidity. It carries out inspections and internal

audits on the whole network. Since each of these three entities is relatively independent, there is a tendency to disregard the overall strategic directives that are supposed to guide the network. Sometimes, consensus on strategic decisions is superficial, which makes it hard to apply them. Too much independence at each level can have negative effects on the cohesiveness of the network. Problems with human resource management and credit have been observed at the local level, without any way for the upper levels to intervene. However, since 1998, efforts to reaffirm the network's operational rules and put the regional technical team under the federation's supervision have helped reduce problems.

Source: Adéchoubou, 2004 ■

[► Box 16] Independence and its limits

INDPENDENCE is a daily battle; it should never be taken for granted.

Independence depends on:

- **Organizational capacity:** the institution must be able to clearly define its mission, operational procedures. Independence is a sign of an institution's maturity.
- **Management capacity:** independence is also a sign that the institution is able to define and implement decision-making mechanisms to face challenges.
- **Performance capacity:** the capacity of an institution to transform its purpose into objectives and results, to measure its efficiency, effectiveness and impact.
- **Capacity to internalize:** independence is more than just a question of financial profitability. It also involves all that an institution does to manage its costs, manage risks and internalize (both technically and organizationally) its learning.

Independence is...

- **A question of internal organization,** i.e. an institution's capacity to deal with challenges as well as maintain its capital base and grow.
- **A question of external organization,** i.e. an institution's capacity to negotiate, to study its environment and draw from it in order to improve and develop the institution.

Independence is built on internal dynamics and the way an institution relates to its environment. It is in the midst of this building process that an approach based on solidarity comes into play. It can be of a technical or advisory nature. The dynamic within cooperative networks is guided by the drive for independence and solidarity, and solidarity should take priority in the event of problems.

Source: Ouedraogo, 2004 ■

and overseeing operations, and use their knowledge to provide decision makers with necessary information.

► **Box 17**

It is not uncommon to observe a local cooperative wishing to break away from the network. Whether or not disaffiliation actually happens depends on the relationship between the local cooperatives and the apex structure.

► **Box 18**

c. ■ **Reflecting on the choice to centralize or decentralize governance**

The number of levels an institution has will depend on the context (intervention area, population density, economic potential), the target public, the desire/need to set up a service that is close to the populations, the history and the institution's means.

► **Box 17** **Re-appropriating power - a practice used in the Réseau des caisses populaires (Burkina Faso)**

INDPENDENCE has its limits. "When a village cooperative is unable to meet its own needs, it jeopardizes the network as a whole. Solidarity must come into play and make up for the lack of autonomy. It is a question of survival. The practice of re-appropriating power is a strategy meant to protect, share and regulate. It involves the other levels of the network in problem resolution."

The practice of re-appropriating power "provides networks with a self-disciplinary mechanism that enables the upper levels (union, federation) to intervene as quickly as possible in the event of fraud, conflict of interests, administrative incapacity or any other situation of risk."

The problems with this practice are usually twofold:

- **Applying it democratically:** "The monopolization of power by the elite and the weight of social responsibility and solidarity can result in the incapacity to react."
- **Maintaining a management ethic:** "Keeping the doors to the cooperative open can lead to an increasingly heterogeneous institution. Trust and solidarity that were once the strength of an institution collide with problems of fraud and conflicts of interest, and the decision making bodies do not necessarily have the possibility to solve them."

The key to the process of re-appropriating power lies with the task of control and auditing, thanks to inspections and financial supervision. When information is available on deficiencies that have been observed, "the power machine turns on." As soon as the village bank in question is unable to ensure its own autonomy and manage problems, there is a shift in power to the level above.

It is a preventive strategy that has been developed based on problems encountered in the network and has been formalized in the institution's statutes. The statutes must "determine the situations in which the body that is situated at the level above the one being called into question will have the power to authorize or refuse certain actions."

The re-appropriation of power is a fundamental element for the network's solidarity. It raises issues of balancing and sharing power, the clarity of the network's mission and the roles and responsibilities of the different structures that constitute it. Nonetheless, the way power is shared is not set in stone. It must be "questioned periodically in order to create complementarity and avoid redundancies... The dynamic that governs cooperative networks is in fact a power dynamic."

Source: from Ouedraogo, 2004, Gentil, 2004 ■

► **Box 18] Disaffiliation - Cooperative networks in West Africa**

THE APEX structure of a cooperative network has some authority over its members at the base, but at the same time, these members have a position at the "summit" of the institution, since they participate in the general assembly. This is a point of tension: on the one hand, the grassroots members are subjected to rules of the federation, on the other, they are also stakeholders in the general assembly which is sovereign.

The three main requirements demanded by a federation of its local affiliates (good management, rules of financial performance and invoicing services) can be the source of conflict between an apex and its members. The federation has to ensure good management to avoid endangering the savings of its members, and by extension, the network's image. Often the same rules of financial performance are imposed on all the local cooperatives, without taking into account the dynamism and management of each one. Some local cooperatives do not accept them willingly, especially if they have not been debated in the general assembly.

There are also rules, required for a network's security, that are not well accepted by members who put their personal interests first. The third requirement has to do with invoicing services that the federation or regional union provides to the local cooperatives. If there is a lack of transparency in the invoicing process, whether the cost has been calculated approximately or in the form of a forfeit, the elected representatives of the local cooperatives tend to think the federation is taking advantage of its power.

There are a few identifiable characteristics of a local cooperative or regional union that may lead it to want to break off from the network:

1. Elected representatives or technical staff with a tendency to take advantage of the cooperative to garner personal benefits. If this is the reason behind a desire to secede, the cooperative is essentially condemned to failure. The role of the federation in this case is to inform the general assembly of the problems identified.

2. A feeling of being exploited by the federation. This feeling can stem from a lack of understanding of the rules that are necessary to the federation's operations, due to lack of transparency or training. Tensions can usually be diffused with dialogue, explanations and maybe the revision of certain rules.

3. Dissatisfaction among some members if the rules of the federation are not adapted to crisis situations (like an agricultural disaster). If the federation reacts too rigidly in these cases, it may lead to misunderstandings and a desire for the local cooperative to break off.

4. A safe with significant amounts of savings and capital. Those in charge have the impression they are paying for the others and usually harbor a feeling of power. Splitting the cooperative into two structures to avoid "monster cooperatives" and to continue offering a service of proximity can reduce the risk caused by a cooperative particularly awash with funds, but obviously this goes against the drive for profitability, which favors large structures for their economies of scale.

It is important to be a part of the general assembly and to listen to the debates in the local banks; it is also crucial to understand that a network can work at different speeds (i.e. the same rules do not necessarily apply to everyone) and to know how to adapt.

Source: From B.Taillefer, Espace Finance list-serve, message from 21/08/2003 ■

Centralization offers advantages like economies of scale (mainly for training, auditing, management) especially if the network is somewhat homogeneous, as well as a powerful lobbying force and greater visibility. On the other hand, it also makes monitoring quite difficult in zones that are particularly distant from the apex structure, and complexifies the information system and auditing.

Decentralization allows for much stronger social control, a close relationship with beneficiaries, a certain connectedness between branches in different geographical regions and greater participation, mainly of women. This translates into a need for more human resources (the same tasks must be performed in each decentralized structure) and a risk of reduced cohesiveness, due to very different, even contradictory development and decision-making from one area to the next.

The challenge is thus to create a good relationship between the upper and lower levels, and depending on the institution, its geographical, logistic, socio-political characteristics, define the level of participation from the base up to the apex.

2.2. ■ MANAGING THE MAIN RISKS IN GOVERNANCE

- OBJECTIVE** ▶ Stay focused on common risks MFIs face which can endanger the governance structure, indeed the institution.
- TOOLS** ▶ Concrete examples of situations confronted by MFIs; Ideas for reflection.
- KEY CONCEPTS** ▶ Every MFI faces crises that must be anticipated. Surveillance and preventive management of this risks will allow an institution to avoid crises and dysfunction, and overcome problems more easily.

Preventing risk is the responsibility of the management of an MFI. Setting up mechanisms that make it possible to manage risks is thus directly related to how governance works. Microfinance is subject to a variety of risks that institutions should be aware of.

[▶ Table 7]

Risk management has a lot to do with information sources and identifying stakeholders that will have the power to sound warnings and make the strategic decisions necessary. An institution must therefore encourage within its corporate culture a culture of risk management that involves all stakeholders at every level. Elements of this culture of risk management include understanding the environment, analysis of indicators, reactivity in making decisions and internal control procedures.

▶ See Module 1
§ 13
"How are crises or problems managed"

[► Table 7] The types of risks to which MFIs are exposed

Types of risks	Source : From Beth, 2002 ■
Operational risks	<ul style="list-style-type: none"> • Credit risks (default, liquidity, new clients) • Criminal risks (fraud, theft, etc.) • Transactional risks (transportation of funds, branch security) • Personnel risks (work accidents, civil liability, etc.)
Information-related risks	<ul style="list-style-type: none"> • Management information system (not reliable, delays, uninformed staff) • Accounting system (inadequate procedures, implementation problems, poor quality) • Decision-making procedures (reliability, relevance, regularity)
Organizational risks	<ul style="list-style-type: none"> • Personnel risks (clarity of responsibilities, positions) • Management risks (maintaining good managers, encouraging loyalty) • Risks related to internal control procedures • Communication, relationships with outside stakeholders (cohesiveness, quality)
Strategic risks	<ul style="list-style-type: none"> • Legal texts (institutional type, management and representative bodies) • Funding (savings, refinancing, equity, shareholders) • Product development policy products match clients' needs) • Competitive environment (saturation, competition) • Vision and mission (contradictions between this discourse and the reality)
Environmental risks	<ul style="list-style-type: none"> • Climate/Political/Economic

MISSION
See Module 1
§ 121
"Mission and strategic vision"

2.2.1 Clarifying and pursuing social objectives: how to avoid mission drift?

a. Mission drift and institutional transformation

Mission drift is when an institution evolves without the accord of its stakeholders, or when this evolution is not explicit or clearly chosen. The risk of mission drift frequently appears when an MFI transforms from a project with strong social objectives to a formal institution with a strong pressure of mobilizing financial resources and achieving sustainability quickly. Funding sources and costs of these funds, as well as the capital structure and shareholder demands, can all push an institution to commercialize and seek profits. All institutions face this risk, regardless of their status, and usually to the detriment of the social objectives that are officially stated in the mission. Respecting the initial mission thus depends on identifying early on someone to "safeguard" the mission.

To achieve financial sustainability it is necessary to reduce costs and increase revenues. This involves higher loan amounts, guarantees to limit risks, lending to sectors with strong economic potential, diversifying products and increasing

loan officer productivity. These efforts can lead to redirecting services towards a different type of clientele or changes to the client-MFI relationship (for example, less proximity with clients or less in-depth knowledge of clients).

Is this mission drift or just a necessary evolution of the relationship between clients and the MFI? Do the changes call into question the MFI's fundamental philosophy or simply respond to clients' expectations? These evolutions and their impact on governance need to be analyzed through the lens of the strategic vision set up by the institution.

Preserving the initial mission takes constant work, and changing stakeholders can at disturb the balance between an institution's social and financial mission at any time.

► **Box 19**

The risk of mission drift exists, regardless of institutional type. Nonetheless, depending on the institutional form, the risk may take on different forms:

► **Table 8**

b. ■ Risks related to mission drift

Risk of mission drift is particular strong when an MFI transforms into a formal institution or when shareholders are changing, but it is also present during other moments of the institution's evolution.

► **Table 9**

► **Box 19** The commercialization of microfinance in Latin America: mission drift?

In 2000, the Consultative Group to Assist the Poor (CGAP) undertook a study of the trend towards commercialization of microfinance in Latin America, where average loan sizes in regulated institutions are substantially larger than unregulated ones. The study finds that average loan size in unregulated NGOs (US\$ 322) is roughly one-third of that in regulated institutions (US\$ 803). In terms of percentage of per capita GDP, unregulated NGO loans represent 23.6%, which is about half that of regulated institutions, 47.2%.

The study analyzes the choice of clients in the two categories of institutions (poor populations vs. microentrepreneurs) as well as the "generational factor" that can explain trend: the first generation of NGOs that transformed into regulated institutions have grown with their clients. The study also notes that the success of

some of the first microfinance experiences had a demonstration effect, bringing in new actors to the sector. Banks and consumer lenders in particular now see microfinance as a new market niche. These institutions are competing for the same, primarily urban clientele, as MFIs, which has had some negative effects in places where saturation is extreme, like Bolivia. The study does not conclude that commercialization is driving MFIs off their initial mission of serving poorer clients, but rather that there is a need for increased market segmentation. Nonetheless, it intimates questions about the development of a sector geared towards poor population in a competitive environment where regulated, profit-seeking institutions predominate.

Source: Christen, 2001 ■

[► Table 8] **Risks of mission drift**

	Mission	Risks of mission drift
Non-profit organization	<ul style="list-style-type: none"> • The mission will likely be primarily socially-oriented. 	<ul style="list-style-type: none"> • absence of mechanism to balance power between members/clients and decision-makings; • risk of working like a “private club”; lack of connection between the user, decision-makers and investors; • lack of business culture and fiduciary responsibility risk endangering the social mission of the institution if it cannot become financially sustainable.
Cooperatives	<ul style="list-style-type: none"> • The mission of a cooperative is, above all, to offer the best service at the best price to its members. Its social nature will therefore depend on its members. The democratic principles that guide the functioning of cooperatives make it possible to defend the interests of the majority. 	<ul style="list-style-type: none"> • Appropriation of the institution by the more influential (often wealthier) members, mainly due to the role of savings in cooperative; • risk of becoming “corporatist” and excluding certain segments of the population; • risk of salaried staff taking on too much power leading to weak participation of members and elected officials.
Private company	<ul style="list-style-type: none"> • The mission will depend on the type of investors: commercial investors (who seek to maximize profits) or social investors (who include non-financial criteria in their objectives). 	<ul style="list-style-type: none"> • A change in shareholders or an uncontrolled offering of shares can lead to mission drift. Introduction of new shareholders can cause a shift in alignment among the investors, thus disrupting any previous balance that may have been achieved.
Public entity	<ul style="list-style-type: none"> • The mission is to provide services (including public goods) which usually the private sector is not able to provide. 	<ul style="list-style-type: none"> • Lack of rigorous financial management and excessive bureaucracy can derail efforts to achieve the mission.

► Table 9] Elements for maintaining the mission

	Risks that can lead to mission drift	Elements for maintaining the mission
Stakeholders	<ul style="list-style-type: none"> • Conflicts of vision between stakeholders with different interests. • Departure of original founders (donors, founders, practitioner). 	<ul style="list-style-type: none"> • Involve actors in analyzing what is at stake when defining the social mission. • Build consensus among the different actors (joint capacity building, etc.) • Allow the founder partners a role in defining strategy. • Gain stakeholders who will guarantee the mission.
Funding Structure & Financial Objectives	<ul style="list-style-type: none"> • Introduction of private investors, employees, etc. in the equity structure . • Diversification towards less poor clients, sectors with strong economic potential, introduction of new products, etc. 	<ul style="list-style-type: none"> • Ensure that the interests of the new investors are compatible with the interests of the institution. • Limit the part of the portfolio for new products; create ceilings for loans. • Identify social performance indicators that will help maintain the mission (see for ex. documents CERISE, 2005 and Zeller et al 2003). • Develop a corporate culture around the MFI's mission (training, incentives, etc.). • Define and discuss the mission in the business plan.
Institutional structure	<ul style="list-style-type: none"> • Change in members/client base or shareholders (introduction of civil servants, people from outside the community, traders rather than farmers, urban populations rather than rural, etc.). • Limiting the power of the original "owners". • Arrival of new employees that do not know the institution's history. • Falling into a routine: loss of sense of mission; less attention given to target clients. 	<ul style="list-style-type: none"> • Prepare for change. • Inform each actor of their new roles to come. • Limit the introduction of certain actors, offer possibilities to save or borrow but not decision-making powers; keep the majority voice in the hands of those who will preserve the mission. • Take the time to train new arrivals and transmit the institution's corporate culture. • Develop incentives mechanisms; remind staff regularly of institution's mission

c. ■ Reflecting on mission drift**An MFI should be particularly vigilant when:**

- ▶ **Institutional changes** (change in legal status, institutionalization) may bring about questioning of the mission.
- ▶ **There are changes in personnel** (founding partners leave, new shareholders are brought in) or changes in the socio-economic context (evolution of social links, new clients, etc.).

In order to maintain the original mission, it is necessary to:

- ▶ **Prepare for changes beforehand**, particularly when a country's regulatory framework requires a change in legal status.
- ▶ **Maintain a common culture** among all the stakeholders involved in the MFI, via training and providing information to new arrivals (be they employees, shareholders or elected officials).
- ▶ **Identify persons who will guarantee the mission** of the institution, perhaps even keeping place for the founding partners in the strategy.
- ▶ **Create mechanisms** (ex.: representation by categories such as employees, members, elected officials) that will help preserve the mission set forth by one category of stakeholders.
- ▶ **Help unite the interests** of the different stakeholders (through group training, for example).

2.2.2 ■ Growth: a virtuous or vicious circle?

Rapid growth at one level of a network or of local branches is almost always considered positive by both employees and clients. It is a sign of success, and can even create a feeling of euphoria. However, it can also lead to increased delinquency and, in the medium-term, problems that can even result in bankruptcy.

a. ■ Elements that contribute to growth

There are essentially two kinds of growth: extensive growth (growth of clients, portfolio size, geographical expansion) and growth that comes from diversification of financial products (loan types, kinds of savings, payment facilities, international wire transfers, etc.)

There are many elements that lead to growth, such as the search for profitability and financial sustainability, a desire to meet client needs, development opportunities or competition.

[▶ **Box 20**]

ORGANIZATION
See Module 1

§ 122
"Preparing to make
a decision
and monitoring
its execution:
the management
information system"

[► Box 20] PPPCR's growth strategy - Burkina Faso

THE PROJET de promotion du petit crédit rural (PPPCR), began in 1988 in Burkina Faso, offering credit to women in the Sahel.

The choice to pursue a growth strategy came about gradually, as the desire for financial sustainability increased. The model adopted for the project-solidarity groups with centralized management and an emphasis on salaried workers resulted in very high transaction costs due to low population density. In light of this, growth seemed to be the quickest and most effective way to achieve sustainability.

In addition to this structural reason for pursuing growth, several other factors came into play:

- Good performance, high demand and gradual dissemination of a media image of microfinance as a panacea led to a "growth euphoria" that was shared by all the partners involved;
- Growth was considered proof of methodological success: it was necessary to show that the experimental phase could be surpassed and the PPPCR model was viable

at a scale that was "significant" enough to engender development;

- With the development of microfinance in Burkina Faso, competition intensified and stimulated geographical growth strategies. This competition was generally more favorable to those MFIs that sought sustainability;
- A bigger institution could increase PPPCR's institutional and financial negotiation capacities (whether to access more resources from financial markets or obtain legal recognition from the government). Growth increased the task load of managers and limited the follow-up they could do with clients. Since the PPPCR did not have enough human resources, skills or tools, growth made the system vulnerable. This combined with governance failures, technical problems and the difficulty to adapt the Grameen Bank model to the Sahelian socio-economic context ultimately brought PPPCR to bankruptcy.

Source: CERISE, 2002 ■

b. ■ Risks of uncontrolled growth

Uncontrolled growth can be dangerous for an MFI. It usually translates into increased delinquency either because procedures are no longer followed correctly (lack of time or control) or they turn out to be ill-adapted to the new level of operations. This kind of problem occurs when internal and external control procedures are not applied and an early warning system has not been activated.

[► Box 21]

Growth can lead to certain slackness in applying procedures, an excessive workload or saturation of information and control tools.

Further, the signs that can alert a crisis are not necessarily visible, and rapid growth can have the effect of "sedating" the stakeholders who should be on the look-out: growth can hide internal problems (fraud, problems with the cost structure); it can hide external issues as well (saturation, over indebtedness, etc.). Again, these risks can be managed provided information and control systems are in place and functioning, and a culture of risk prevention is prevalent.

[► Box 22]

► **Box 21** The risks of growth: the case of Corposol

COLUMBIAN NGO Corposol (and its subsidiary Finansol) began operations in 1988 with a handful of employees and the equivalent of US\$ 20,000. Growth was spectacular, and brought the institution to 600 employees and a loan portfolio of roughly US\$ 35 million seven years later. Yet only a few months, Corposol went through a serious crisis that led to its bankruptcy in early 1996.

Growth has been cited as the main cause of the Corposol crises. "The spectacular growth of Corposol and Finansol was for the most part the result (and at the same time the cause) of a loss of influence over the initial methodology. Loans were granted to solidarity groups without respecting the criteria that should have been used. Good clients were offered several loans simultaneously, resulting in over indebtedness. Delinquent loans were refinanced. Some credit lines were granted at zero interest; late repayments were not accounted for."

Growth was detrimental to portfolio quality, which quickly suffered a decline with a new lending policy that was even more lax and the refinancing of delinquent loans, which hid the reality.

"Corposol developed and diversified its products and services much too quickly, without taking the time to test these new products. This led to several problems: statistics were not reliable and loans no longer corresponded to the needs of the clients...".

In the case of Corposol, the combination of these factors with an ineffective early warning system that revealed the problems much too late led to the institution's near-bankruptcy.

"A few lessons in achieving sustainability:

- It is possible to lose control of the loan methodology;
- The sustainability of an institution goes far beyond the financial aspect; to focus only on subsidy dependency or profit margins is not enough. Sustainability depends, above all, on how the men and women manage the institution, and this at all levels of the organization. Ability to adapt to growth and change are crucial elements to take into consideration.
- Supervision and control are essential in microfinance."

Source: Labie, 2002 ■

An increased workload for loan officers can also weaken the relationships they have with their clients and lead to changes in how guarantee mechanisms are applied.

Uncontrolled growth can weaken governance due to lack of loan officer monitoring, non-transparent client selection and an "instrumentalization" of procedures rather than a true appropriation of them by the officers or clients.

c. ■ Reflecting on growth risks

As a general rule, one of the most important aspects of efficient governance is to maintain moderate growth and help stakeholders internalize the risks of runaway expansion. It is important to identify:

- **the type of growth necessary for the MFI** (loan size, number of clients in existing branches, new branches, new products);
- **compatibility of this growth with the context;**
- **the means available** to monitor growth and limit risks (information system, control system, employee incentives, etc.).

► **Box 22** **The risks of growth: savings in the Sanduk Network of Anjouan (Comoros Islands)**

THE SANDUK Union of Anjouan experienced rapid growth in savings mobilization between July 2001 and March 2002; volumes jumped 50%, from 1.6 million Euros to 2.4 million Euros.

Following the political events that took place during the embargo period, the Sanduk Union became very popular and earned the trust of the population, which resulted in spectacular growth in savings. The rapid growth, in turn, led to an increased risk of fraud, given the local branches were becoming flush with liquidity. The risk was even greater, since the branches' capital had practically not increased at all.

With greater amounts of cash available and the need to invest these remunerated savings, the Union started feeling pressure to increase volume of credit, even though the branches were not solvent enough, nor consolidated enough (in terms of respecting procedures) to do so. By the end of 2001, fraud had been detected in certain branches and clients were pressuring loan officers to grant loans that were over the proscribed limits.

Besides increasing risk, growth of savings also led to an increase in savers and operations (of withdrawals and deposits), which increased

the number of financial registry entries. The information system was quickly saturated, which made internal control difficult because the numbers were not available quickly enough, and data entry errors were increasingly common.

Once the growth-related problems were uncovered, measures were taken to get things under control in early 2002. An extraordinary general assembly voted to stop remunerating savings, to start charging for transactions (beyond a fixed limit), to establish a moratorium on new accounts and to close inactive accounts with balances of less than 10 Euros. In addition to these measures that aimed to slow down growth of outstanding savings (growth dropped from 6% to 1% per month), the team worked several months to introduce a new information and management system adapted to the Union's new size. The management team was reorganized to include staff specialized in facilitating and inspection. One year later, growth of savings and the union as a whole was able to recommence, under more secured and controlled conditions.

Source: Interview with IRAM and Mission reports from 2001/2002 ■

2.2.3 ■ **Multiple stakeholders: How to reconcile contradictory interests?**

A microfinance institution can bring together stakeholders with very different interests. Even if this is obvious from the start, a goal of good governance is to reconcile these differing interests over time. The institution's directors must establish procedures and themselves act in a way that will make everyone in the institution accountable, as well as create an environment of mutual trust between the various stakeholders.

a. ■ **Conflicts of interests between savers and borrowers**

Savers want high interest rates on their deposits; borrowers want low interest rates for their loans. In an institution where members – whether borrowers or savers – are decision-makers, there is bound to be a conflict of interest between the two groups.

► **Box 23**

► **STAKEHOLDERS**

See Module 1
§ 112
"The power of stakeholders over strategic and operational decisions"

[► Box 23] Savers and borrowers: shareholders in Financial Service Associations in West Africa

FINANCIAL Service Associations (FSAs), set up by IFAD nearly 10 years ago in West Africa (Mauritania, Benin, Guinea), are village-level microfinance organizations that are self-financed by the shareholders and self-managed. Each FSA is controlled by the village population and villagers may be owners in an individual capacity or through a solidarity group. The owners are the only clients. By encouraging members' appropriation of the institution, this innovative approach aims to ensure the social viability of the FSAs. It also strives for financial viability through a lower cost structure. As such, the model satisfies IFAD's objectives of improving the standard of living of the poorest.

Individuals and members of the solidarity groups are shareholders. The number of votes accorded to each shareholder is proportional to the number of shares they have. The number of votes is limited to 10. As self-managed institutions, decisions regarding interest rates policies and product and services are decided by the general assembly. The largest shareholders thus have the tendency to increase the cost of credit so that their shares are worth more.

In Mauritania, the *Mutuelles d'Investissement et de Crédit Oasien* (MICO) are based on the FSA model and equity is divided into two types of shares: "A" shares come with the right to vote but are limited to one share per member; "B" shares do not come with the right to vote but holders receive dividends. A member can have as many B shares as s/he wishes, and dividend distribution is done on a pro rata basis depending on the number of shares held by each member. This mechanism embodies the two divergent objectives of FSAs: (a) for the shareholders: profitability, implying interest rates should be kept high and, (b) for the local population: rural development and financing of income generating activities for the target population, mainly women and the poorest, which implies keeping interest rates low. The principle of equality in the right to vote makes it possible to impede the largest shareholders from taking over the general assembly; their interests are served in the distribution of dividends provided to B share holders.

Source: Ould Bessid et al. 2002; diverse documents from IFAD on FSAs ■

b. ■ Striking a balance between technical staff and elected representatives

The main actors in a member-based institution are the elected representatives-owners of the institution and guarantors of its vision-and employees, in charge of operations and providers of technical expertise. These actors work together, but their interests and motivations are not the same: elected representatives/beneficiaries want to optimize the services provided by the institution while limiting their cost, while employees seek decent work conditions by limiting operational risks. It is the balance between these different motivations and concerns that will guarantee an institution's controlled growth.

[► Box 24]

[▶Box 24] The balance of power between elected officials and technical staff: the case of FECECAM in Benin

IN A COOPERATIVE network, power belongs to the elected representatives. At FECECAM, the elected representatives have a great deal of influence in the management of the network, unlike most other cooperative networks in West Africa. This arrangement evolved following the bankruptcy of the *Caisse Nationale de Crédit Agricole (CNCA)* in 1987 and the rehabilitation of the network in the 1990's. Early on, as soon as CNCA announced bankruptcy, the Presidents of the Board of Administration of the local cooperatives established a Presidential College that adopted a number of measures designed to save the network. These initiatives aimed to make members more accountable, strengthen the network's independence and introduce more rigorous management. They were pursued throughout the rehabilitation phase and led to the creation of the Federation in 1993.

This firm position was very helpful during the rehabilitation phase, but turned out to be too pervasive during the network's consolidation phase. What was FECECAM's strength from 1988 to 1995 – a nucleus of very active representatives who were committed to the institution – became one of its weaknesses; among

the problems observed were inadequate loan management, slow decision-making and a lack of sanctions.

Since 1998, the role of the technical staff has been reaffirmed: they are to ensure procedures are implemented and make decisions on what to do if they are not. To minimize operational costs and to avoid power struggles, the local cooperatives opted to subcontract support services, follow-up and auditing. This helps avoid the pitfalls common to networks, but has the drawback of not involving these subcontractors as stakeholders in the life and management of the network.

There appears to be a balance that has formed inside the network in which the elected representatives bring their knowledge of members and the environment and the employees offer their technical expertise. History of cooperative networks shows that this balance is very unstable. It is very possible that employees will once again be dominated by the elected representatives, or that the salaried technical staff lead the institution towards more a technical orientation.

Source: Adéchoubou, 2004 ■

c. ■ Striking a balance between shareholders and employees

The relationship between shareholder owners and employees is a recurring issue when analyzing the governance an institution, be they MFIs or regular businesses. It is very much dependent on the types of shareholders, their expectations (profitability, social mission, etc.), as well as on the role of employees on the management team. It is the famous opposition between the “shareholder approach” that defends the role of shareholders and the “stakeholder approach” that considers the role of all the actors involved. It would appear that strategic decisions cannot be made independently of all the stakeholders involved. The most successful MFIs will achieve profits to satisfy investors while finding a way to remunerate the contributions of all the other people involved in making the institution work.

d. ■ Reflecting on conflicts of interest

Conflicts of interests and power struggles are important aspects of governance. The more diverse the actors, the more chances of having significant conflicts of interest.

The issues to consider are:

- ▶ The balance between shareholders and managers;
- ▶ Consistency between the role and the responsibilities of each actor;
- ▶ The existence of contradictory interests in the short and long term;
- ▶ The place of employees and clients in managing structures (and the relationship between the interests of the institution and those of their social group);
- ▶ Compromises and tools that can help reconcile differing interests.

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2.2.4 ■ Governance: an evolving structure**a. ■ History and the need to evolve**

For the first few years, the success of an MFI often depends on one person or a small group of people (TA providers, donors, management, etc.) who are committed over the long term, to defining the institution’s mission and its strategy. This central figure is usually the most committed to the institution’s success, and is putting his or her reputation on the line to make it happen. When this person or group is absent or neglectful, there is a crucial piece missing in the governance structure: there is no one at the helm, or its control is being debated among groups with diverging interests.

As the institution develops, new skills become necessary and the management team may need to expand and reinforce its skills. The challenge is for actors with historical credibility to merge with actors bringing technical legitimacy.

Adapting the governance model over time

Founding partners (the person who may be called “the visionary”, TA providers, the first employees, the first elected representatives, etc.) are the champions of the MFI’s initial vision. They have been the ones to lay the groundwork and consequently have developed a certain *savoir-faire*.

As the institution evolves, these founding visionaries will be supported or supplanted by managers. The original elected officials and employees are gradually surrounded by newcomers. It is their duty to “pass the flame” to the new arrivals, and make sure the strategic vision of the institution is maintained.

[▶ **Box 25**]

[▶ **Box 25**] **The evolution of the Regional Development Fund in Togo**

THE REGIONAL Development Fund in Togo went gradually from a support project for peasant organizations to a formal microfinance institution known as the Regional Union of Local Credit and Savings Banks. Changes over time to the composition of the board of directors reflect the institution's gradual transformation.

When it began, the Fund's board was composed of representatives of government departments like the regional directorate of agriculture. Over time, a decision was made to integrate members of the civil society (NGOs, local associations, etc.). A few years later, representatives of peasant organizations that used the institution's services were brought on to the board out of a desire to see certain stakeholders appropriate more fully the institution.

Finally, a decision was made to strengthen the institution's structure by bringing in representatives of peasant organizations at the village bank level and change the composition of the apex level advisory board to no longer include representatives of producer groups but rather representatives of the local banks.

These gradual changes to the board show how the structure of an institution can evolve over time along with its strategic vision and institutionalization perspectives. In the case of the Regional Development Fund, there were many changes, but cohesiveness was maintained by the director. Indeed, when such changes are necessary, preserving cohesiveness of the whole is critical.

Source: IRAM, 2003 ■

The stakeholders are not the only ones to evolve, however; the structure itself must evolve in accordance with the MFI's development and the skills that become necessary to govern the institution.

[▶ **Box 26**]

b. ■ Maturity of governance

Maturity and autonomy of an institution

When is it possible to say that an institution has a “mature” governance structure, capable of making strategic decisions, managing day-to-day operations, foreseeing and overcoming crises without turning to the external TA provider that helped set up the institution?

Autonomy does not necessarily mean contacts with actors outside the institution must be relinquished. After all, the development of an MFI is conditioned by its capacity to innovate. And, innovation is only possible if the institution is part of a larger dynamic that enables it to progress independently, yet without being entirely alone when it comes to facing challenges.

[▶ **Box 27**]

Maturity and the risk of falling into a routine

Once it reaches “cruising altitude”, an independent institution can sometimes fall into a routine. Practices and procedures stay the same while the socio-economic context changes and new needs, social groups or norms appear. Falling into a routine can lead management to become too attached to their

► **Box 26** A history of the governance models implemented by TA provider CICM

LOOKING back on the governance models used by TA provider Centre international du crédit mutuel (CICM), it is possible to identify three distinct forms, each one corresponding to a given moment in the project cycle. While a certain model of governance can be effective and legitimate at a given moment, it can also become, at a later date, an obstacle to a project's development.

- **"Project" governance** in networks launched with the support of donors, at the impetus of local governments. The governance model set up at the beginning of these kinds of projects emphasizes a collective approach and usually involves "pilot committees" that includes CICM, the main donors and supervisory authorities. This form of governance, in which no one stakeholder has a majority voice, has its limits. Serious strategic differences usually emerge among the stakeholders. This form of governance also slows down considerably decision-making procedures.
- **"Centralized" governance** in projects that have been restructured. This model substitutes the project one and aims to resolve leadership crises, usually caused by power being too

dispersed. It is mainly characterized by the limited role of donors in funding projects, the limited role of CICM (present only through an expatriate General Director, since centralization makes it possible to increase efficiency and reduce reaction time on decision-making) and the development of support services for the central CICM structure. This phase of centralized governance makes it possible to put in place rigorous management procedures and work methods, to computerize the network and to contribute to making the project financially stable.

- **Governance involving elected representatives and employees**, with the goal of achieving greater autonomy for the institution. This model is a move away from the centralized model and involves more systematically the members in decision making procedures and managing operations. CICM's vocation is not to forever substitute employees and members. Taking control of a cooperative network necessarily involves handing over power to the elected officials, representatives of the MFI.

Source: CICM, 2004 ■

► **Box 27** Maturity and autonomy: the example of regional CVECA networks

SEVERAL regional CVECA networks in Mali are autonomous and function with very mature governance structures: the CVECAs in the Pays Dogon (since 1997), the CVECAs of the 1st Region (1998) and the CVECAs in the Office of Niger area (2000). In each network, the Village Bank Unions have signed a convention with the Ministry of Finance and sub-contracted a consulting firm, created by some of the former project managers, to carry out auditing, MIS, training and to look for commercial funding. The TA provider CIDR no longer plays any role in the governance, nor does it participate in setting operational guidelines or decision-making. However, when a crisis emerges, the internal and external stakeholders of the CVECAs call on CIDR for advice and assistance.

The autonomy of these regional networks, which are limited in size and quite isolated from innovations in the microfinance sector, makes it necessary to provide long-term follow-up to help the local technical assistance provider evolve both technically and institutionally. This follow-up has changed over time and currently is a contractual relationship.

With this in mind, CIDR has set up the Participative Microfinance Group for Africa to offer technical and financial support to the autonomous MFIs in the region needing support to grow and develop, whether they are networks or other types of institutionalized MFIs.

Source: CIDR, 2004 ■

power, or, on the contrary, result in a certain lassitude. Rules and procedures may be gradually relinquished; correcting problems may become difficult because branch managers and internal controllers have become too friendly; truly new ideas are hard to come by and what appear to be new ideas are not thought through carefully enough. Often an outsider's perspective and on-going training can help stimulate an institution.

▶ **Box 28**

▶ **Box 28** Term limits for elected officials

THE ANALYSIS of a governance crisis in a cooperative network comprised of 26 local affiliates offers some interesting lessons about the importance of renewing elected representatives. Signs of the crisis were obvious when it became clear none of the elected representatives on the management bodies (advisory board, credit committee, supervisory committee) had ever been changed. They had worn out their power: after having done a good job managing their local cooperatives for several

years, many of the representatives ultimately picked up some bad habits. This was made possible because they were systematically re-elected to their positions at each general assembly, since there was no rule regarding term limits. As a result, procedures were not respected, accounting rules ignored, there was a lack of transparency and management bodies did not work democratically.

Source: IRAM, 2004 ■

Maturity and investors' exit strategies

Governance evolves with the role of the investors. Often, international investors get involved in an MFI for a limited time period, to accompany it temporarily through the institutionalization process. After several years, investors start looking to exit the institution and sell their shares. It is likely that the new buyers will somehow contribute to a change in governance.

▶ **Box 29**

c. ■ Reflecting on how governance evolves

The governance structure of an institution is not set in stone. The level of activities, saturation, organization and the context will inevitably change, which implies regular adjustments to the governance model.

The issues to consider:

- ▶ Evolution of skills—those needed to build an institution and those needed to manage growth.
- ▶ Evolution of the institution's organizational structure and role attributed to each stakeholder
- ▶ The way the institution makes efforts to avoid falling into a routine and to update its governance structure (tools that can be used include bringing in an outsider's perspective, impact analyses, market research on client satisfaction).

[▶ Box 29] Different strategies, different investors

INVESTORS can be categorized into three groups:

- public investors
- private socially responsible investors
- private commercial investors

An investor's role, involvement in the governance structure and commitment in terms of time will depend on its profile and objectives. Some investors are "initiators;" their participation helps an institution get started. They are mainly public investors (e.g. IFC, the French PROPARGO, the German DEG, the Dutch FMO). They want to get the institution off the ground and put money into it to demonstrate its viability to eventual private investors. They are usually involved for a limited time and do not seek fully market-related returns on their investment. These investors will exit the institution by selling their shares to new investors.

In microfinance few exit cases of public investors have taken place until 2005.

However, the exit might cause mission drifts if the public investors will not search for the most suitable private investor taking over from them. New private investors usually become interested once an institution has gotten off the ground. Indeed, for an institution to access private funds, it usually must have demonstrated its financial viability. There are two kinds of private investors: purely commercial oriented and the

so-called social investors. An investor may limit its involvement to capital participation, or may position itself as a "supporter," choosing to accompany an institution's development and growth over time (e.g.: SIDI, ACCION, Oikocredit) in addition to providing funds. These types of investors are present in the decision-making bodies and play the role of "guarantor" of the institution's mission.

Currently, there are only few microfinance institutions with pure commercial oriented private investors. More often we find commercial banks in developing countries which have developed certain microfinance products (by downscaling their services).

The role of investors can evolve over time, and in some cases, the investor will pass from an "initiator" role to the "supporter" role. GRET's participation in AMRET (Cambodia) is an illustration. It has withdrawn partly from the institution, but intends to remain present until private investors can take over.

The exit strategy of "initiators" is not yet clear and experiences of new investors coming in to buy their shares are still too recent to observe the consequences. It is clear, however, that the shift of shareholders will have an impact on finding a balance in terms of governance.

Source : CERISE, 2005 ■

2.2.5 ■ Governance and institutional context

a. ■ Social viability

An important aspect of governance is the ability of an MFI to integrate into its environment, thereby ensuring its social viability. Integration requires the MFI to constantly adapt to changing contexts (government policies, legislation, fiscal regulations; the economic activities of clients; the financial sector; competition; social inequalities, values, norms, etc.).

Définition of “Social viability” (Source: GTZ, IRAM, 2001)

- ▶ Social viability has been achieved when different stakeholders can bridge differing interests and reach a compromise. Without genuine consensus or internalization of rules, one often observes that procedures are not be applied or respected – there may be an unofficial reinterpretation – which often leads to crisis.
- ▶ Internal social viability refers to compromises or agreements between stakeholders directly involved in the institution (borrowers, elected officials, managers, shareholders) while external social viability is when the MFI is no longer seen as a foreign body that has come in from the outside, but rather is seen as a genuinely local institution that serves the population and traditional, religious, or political authorities.

Hence, forms of power can be very diverse, more or less authoritarian, charismatic or democratic. What is important is that the power appears legitimate and that this legitimacy endures because the power has proven to be efficient on a permanent basis: able to maintain a shared vision in the long term, able to make quick and impartial decisions, able to prevent or manage crises, able to adapt to internal and external changes, etc.

Among the key issues to address, one must look at the compatibility between the new forms of power in the MFI (often consensual) and local conceptions (dominant in some cultures) of power, often authoritarian or hierarchical.

One of the pitfalls MFIs face is to think in very self-contained terms and forget that governance is embedded in pre-existing social relationships.

[▶ Box 30]

A MFI’s allies do not always have formal power. In some situations, traditional and informal forms of power can help resolve problems or play a mediating role.

[▶ Box 31]

Applying “democratic” organizational models in very hierarchical societies is possible, but at times problematic.

[▶ Box 32]

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[▶ Box 30] Cooperatives in Africa do not develop outside of existing social relationships

THE DEMOCRATIC principle of one person, one vote that gives each member sovereignty and establishes a principle of equality engenders a culture of shared responsibility and solidarity, but also a culture of gerontocracy, privileges and silence. "The image conveyed in our society is that responsibility comes with privileges. The person responsible is served first and benefits from special services and conditions." When problems arise, "the exercise of democracy is in vain... It is difficult

for a member or director to sanction other people in the community or an individual to whom they are bound by social proximity, especially if it the son of the village leader or cooperative's president... In extreme cases, a form of silence or tolerance will develop." Cooperatives must define their own internal and institutional mechanisms to resist these deviations.

Source: From Ouedraogo, 2004 and Gentil ■

[▶ Box 31] Mediating conflict with informal power - CRG Guinée

CRÉDIT RURAL de Guinée went through a serious internal crisis when inflation was particularly high (15% in 2003, 50% in 2004). Employees' purchasing power deteriorated and they began pressuring the institution for a wage increase that was incompatible with CRG's financial situation. Negotiations with the union could have led to a strike and crisis if the most senior employees, doubly legitimate because of their age and seniority, had not managed to reach a compromise between the management and employees.

Their involvement was particularly noteworthy because of the important cultural role "the voice of the elders" has in West Africa, and, given their hierarchy in CRG, they were not even supposed to participate in negotiations. This example illustrates the importance of informal power relationships that underlie organizational work charts; while not necessarily visible to the eye, they can play an important role in strengthening or weakening an institution.

Source: IRAM, 2004 ■

[▶ Box 32] Risks of member-based models: the SHGs of Asia

SELF-HELP Groups (SHG) are a microfinance innovation particularly developed in India. A group of twenty people can come together (under no legal statute) and form a rotating savings and credit association, to save regularly and make/take loans whose use, amount, terms and interest rates are set by the group. A relationship with a formal financial institution, sometimes brokered by an NGO, allows the group to access bank loans that the SHG then redistributes as it sees fit. SHGs are autonomous financial organizations that work like "microbanks" as they fulfill the task of financial intermediation.

In Indian SHGs, the model is participatory and democratic. Decision-making processes are supposed to be transparent, decentralized and take into account the grassroots-level members. But in some SHGs, leaders have gone beyond the role that was assigned to them. For example, in one SHG, although the leader had been in place for more than two years, the group decided not to change leadership since they were satisfied with his work. The group's leader had also been elected to represent the group in the SHG federation. But once the village facilitator (put in place by an NGO) left, after two years, decision-making

▶ **[▶ Box 32 - rest] Risks of member-based models: the SHGs of Asia**

ceased to be democratic and the leader started to make decisions for the group without consulting the members, and embezzling funds. Group members progressively relinquished their role of monitoring the group's activities. Confidence in their leader led them to become lax with control procedures. An authoritarian model slowly took over. Group members could have asked to consult the record books, open to all; they could have confronted their leader about the concentration of power. A few members were illiterate, but the majority were relatively well-educated. Despite this and the training they received, the members let themselves be guided with blind trust in an "indispensable" leader, capable of

managing everything. In addition, it appeared that the feeling of being part of a group was not very well developed. Members became lax in their role of preserving the group's interests. Their feeling of belonging to the group gradually faded. It is absolutely necessary that group facilitators evaluate the quality of training and the necessary group dynamics inherent in SHGs. Ultimately, the problem was resolved when the NGO facilitator intervened; the group leader had to return the money. Having realized the importance internal control, the members once again became vigilant of the financial transactions.

Source: MAVIM (Thekkekara, Mistri, Khobragade, 2004) ■

An institution must not only find a way to work with existing power relationships, it must also adapt to the many environmental constraints that exist, like client over indebtedness, fluctuations in market prices or particularly weak solidarity groups. Indeed an MFI must adapt to its environment, in all its diversity.

b. ■ Monitoring and evaluation

Monitoring and evaluation help complete information and control system. Using accounting and other sources of information (membership registration, savings passbooks, credit requests, etc.), it is possible to define indicators that will help keep track of developments or identify problems. Targeted research can help better understand specific situations and offer explanations for certain behaviors or problems. Based on problems that have been identified, monitoring and evaluation techniques can be used to test new financial products and organizational forms. Operational research as well as marketing tools can be carried out to respond to clients' demands or reach a new public.

Monitoring/evaluation and operational research together constitute a tool to guide an institution and its strategic thinking, and keep it in sync with its constantly shifting socio-economic environment.

▶ **Box 33]**

c. ■ Reflecting on integrating into one's environment

MFI's can be agents of change that make recommendations and modify, by demonstration, the practices and norms in other sectors. For example, an MFI's obligation to report on its operations and finances at the end of each year to the

[► Box 33] **Monitoring and evaluation mechanisms**

COOPERATIVE networks are often concerned with monitoring/evaluation and operational research, but there is rarely a formal, coherent system in place to help guide managers or technical staff.

Depending on the main problems that have been identified, it is possible to create a monitoring mechanism based on a few big issues. These problems and principles can be illustrated in the example of a cooperative network that federates local branches.

- Who are the members, depositors, non-members? What are the reasons for being a non-member?
- Which factors influence savings? Are savings concentrated on the local cooperative? Is there a need for new products to meet the demand?
- What impact is credit having? Are there unmet demands? A need for new kinds of loans?
- What are the conditions necessary to achieve financial sustainability at the local and network levels? Of the local cooperatives and the network?

- How are dynamics within the local branches? What information is available to members? Who are the elected officials of the governing body?

- What size should the local cooperatives be to guarantee proximity to their members while still enabling the cooperative to become sustainable? What is the most appropriate structure for the network? What are the levels and functions of the regional and/or national hierarchy?

Based on the answers to these questions, tools of differing degrees of complexity and with different objectives can be put in place:

- A monitoring system based on indicators, functional analysis charts and accounting.
- An evaluation system based on research. - An evaluation effort of any innovations that may have been introduced.
- Pilot testing of new ideas.
- Policy recommendations based on research results.

Source: European Commission, 2000 ■

general assembly may encourage local governments to be more transparent and work more “democratically.”

Governance must help an institution integrate into its environment, which means introducing new practices that will help the environment evolve, but not too new for them to be rejected as foreign.

It is important for an institution to be in phase with its social and cultural context, but also to position itself in relation to the competition and other actors, and thus have the tools that will permit the institution to maintain its integration in the context.

2.3 ■ GOOD GOVERNANCE: A PERMANENT CHALLENGE

An MFI's quest for efficiency cannot be resolved by a one-size-fits-all form of governance. Some forms are better adapted to certain environments than others. The foundation of good governance defined in Module 1 is absolutely necessary, but many of the strategic choices that make up this foundation will be rethought and revised throughout the life of the institution.

Building effective governance or making changes in light of governance problems are not challenges that can be resolved over night. It takes work to develop a common strategy, through sharing information, clarifying roles and responsibilities, making resources available.

Even when a form of governance works, it is not fixed in stone, and must evolve in parallel with the institution and its environment.

This module has attempted to address the most common governance challenges that an MFI is likely to face over time. There is no one ideal response to the questions raised here but rather a host of issues to keep in mind when making decisions that will take into account the relationships and specificities present in each institution.



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ACRONYMS

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■ Use of the decision-making matrix

How to use it?

- ▶ First define all the stakeholders involved in making the decision: the ownership structure, funding sources, relationships between the actors impact decision-making.
- ▶ Draw up a table of the stakeholders and the main decisions.
- ▶ For each decision, attribute the stakeholders a number of “X” (from 1 to 3) depending on their power in the decision making process.

How to analyze the matrix?

Analysis is based on the attributes of the typology presented in Module 1.

- ▶ Concentrated or distributed power among the stakeholders: is there only one column representing one type of stakeholder who concentrates all the power or does each actor identified take a part in the making decisions? The analysis should make a distinction between strategic and management decisions.
- ▶ Power is held externally (by the donor, TA provider, government, external shareholder) or internally (clients, employees): which columns have been filled in – only those on the left (internal power)? Those on the right (external power)?
- ▶ Distribution of internal power between employees and elected representatives: which columns are filled in or should be, according to the institution’s founding texts and the ownership structure?
- ▶ Distribution of responsibilities (clear or not): is it possible to identify stakeholders for each decision? Where are the X’s in the matrix, and where should they be, according to the texts and ownership structure?

■ Examples of decision-making matrices

See [▶ [Appendix a](#)] and [▶ [Appendix b](#)] next pages.

► **Appendix a** Microfinance institution strongly supported by technical assistance

Stakeholders		MEMBERS / CLIENTS		EMPLOYEES		EXTERNAL STAKEHOLDERS		
		Membres or clients in general assembly	Elected reps.	Directors	Managers	Donors/ Funders	TA providers	Government/ Banking authorities
Strategic choices	Mission/Vision (target public, financial services offered, etc.)		X	X X		X X X	X X X	
	Geographic outreach	X	X	X X	X	X X	X X X	X X
	Growth strategy/ New product development		X	X X	X	X	X X X	
	Choice of director					X X	X X X	
	Interest rate			X X			X X X	X X X
Management choices	Salary policy			X X			X X X	
	Financial services on offer		X	X X			X X X	
	Lending and reimbursement policies		X	X X			X X	
	Use of profits		X	X		X	X X	

Stakeholders		MEMBERS / CLIENTS		EMPLOYEES		EXTERNAL STAKEHOLDERS			
		Membres or clients in general assembly	Elected reps.	Directors	Managers	Donors/ Funders	External shareholders	TA providers	Government/ Banking authorities
Decisions									
Choix stratégiques	Mission/Vision (target public, financial services offered, etc.)	X	X X	X X		X X	X X		
	Geographic outreach	X	XXX	XXX	X	XX	XX		
	Growth strategy/ New product development		X X	X X	X	X	X	X	
	Choice of director		X X			X X	X X		
	Interest rate		X X	X X		X X	X X	X	X X X
Choix de gestion	Salary policy			X X			X X	X	
	Financial services on offer		X	X X				X	
	Lending and reimbursement policies		X	X X				X	
	Use of profits		X	X X X		X		X	

► Appendix b] Microfinance institution being institutionalized

ADA	Appui au Développement Autonome (Luxembourg)
AFD	Agence Française de Développement
BCEAO	Banque Centrale des Etats de l'Afrique de l'Ouest
CECAM	Caisse d'Epargne et de Crédit Agricole Mutuelle
CERISE	Comité d'Echanges, de Réflexion et d'Information sur les Système d'Epargne-crédit
CGAP	Consultative Group to Assist the Poor
CICM	Centre International du Crédit Mutuel français
CIDR	Centre International de Développement et de Recherche
CIRAD	Centre de Coopération Internationale en Recherche Agronomique pour le Développement
CLCAM	Caisse Locale de Crédit Agricole Mutuel
CMAC	Cajas Municipales de Ahorro y Credito (Pérou)
CNCA	Caisse Nationale de Crédit Agricole
CNEARC	Centre National d'Études Agronomiques des Régions Chaudes
CRG	Crédit Rural de Guinée
CVECA	Caisses Villageoises d'Epargne et de Crédit Autogérées
DEG	Deutsche Investitions- und Entwicklungsgesellschaft mbH
EMT	Ennatien Moulethan Tchonnebat (Cambodge) (Amret)
FECECAM	Fédération des Caisses d'Epargne et de Crédit Agricole Mutuelles (Bénin)
FDR	Fonds de Développement Régional (Togo)
FSA	Financial Service Association
FMO	Dutch Development Bank
GDP	Gross Domestic Product
GRET	Groupe de Recherche et d'Echanges Technologiques
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit (German agency for technical co-operation)
IFAD	International Fund for Agricultural Development
IRAM	Institut de Recherches et d'Applications des Méthodes de Développement
I&P	Investisseurs et Partenaires
MFI	Microfinance Institution
MIS	Management Information System
NGO	Non Governmental Organisation
PPPCR	Projet de Promotion du Petit Crédit Rural (Burkina-Faso)
PROPARCO	Financial Institution from French Development Agency for the private sector
ROSCA	Rotating Savings and Credit Association
SEMISOL	Semilla Solidaria
SFI	Société Financière Internationale (International finance corporation)
SHG	Self-Help Group
SIDI	Société d'Investissement et de Développement International
TA	Technical Assistance
UEMOA	Union Economique et Monétaire Ouest-Africaine

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While recent history of microfinance offers some successful examples, there are nonetheless many others that are not-so-successful, indeed failures. The sustainability of an MFI demands not only financial viability and the ability to adapt to existing legal frameworks. It also requires a clear strategic vision and an organization that is transparent, efficient and accepted by all the stakeholders involved. These issues are often grouped together under the concept of “governance”.

This guide is designed to accompany an analysis of the governance of a microfinance institution whatever its institutional type.

The guide is organized in two modules:

- ▶ The first is a diagnostic tool for evaluating the governance of a microfinance institution.
- ▶ The second is designed to guide reflection on the strategic choices and governance challenges that microfinance institution's face. The different chapters can be read independently.

This guide is written for anyone interested in working on the governance of a microfinance institution, be they elected officials, directors, donors, evaluators or external consultants. The guide can provide a framework for regulators (central banks, bank supervisory committees, ministries of finance, national microfinance networks, etc.) to reflect more generally on the elements of regulation that may encourage or constrain good governance.

