Corporate Governance of the Deposit Taking Microfinance Institutions (MFIs) in Ethiopia

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Introduction

Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a company is directed, administered or controlled and defines the relationships among the various stakeholders.

The term corporate governance has come to mean a process by which companies (where separation of ownership and control prevail) are directed and controlled.

Corporate governance for deposit taking MFIs is drawn from best practices of any organization or share company, particularly commercial banks.

Corporate governance is the process by which a board of directors, through management, guides an MFI in fulfilling its corporate mission and protects the institution’s assets over time.

Effective governance occurs when a board provides proper guidance to management regarding the strategic direction for the institution, and oversees management’s effort to move in the direction of the approved strategy.
Good governance in the Ethiopian deposit taking MFIs plays an important role in increasing outreach, improving transparency, accountability, sustainability, profitability, efficiency, effectiveness, responsibility and responsiveness to the changing environments.
The board, which plays a critical role in ensuring good governance of MFIs, has five major responsibilities, namely,

- Legal obligations:
- Relationship between board and executives
- Setting policy and providing strategic direction consistent with the MFI, mission, vision and objectives;
- Fiduciary obligation to ensure that the financial solvency of MFIs maintained.
- Board assessment of its own performance
The key elements of sound corporate governance in an MFI include:

A) A well articulated corporate strategy against which the overall success and the contribution of individuals can be measured.
B) Setting and enforcing clear assignment of responsibilities, decision making authority and accountabilities that is appropriate for the risk profile.
C) A strong financial risk management function, adequate internal control system, and functional process design with the necessary checks and balances.
D) Corporate values, codes of conduct and other standards of appropriate behavior and effective system used to insure compliance.
E) Financial and managerial incentives to act in an appropriate manner offered to the board of management and employees including compensation, promotion and penalties.
F) Transparency and appropriate information flows internally and to the public.
As the size of the outreach and saving mobilization of MFIs from the public increases, there is a dire need to ensure transparency, accountability and good governance, involving both the board and management and the regulators.

However, governance issues have not been given due attention by owners or shareholders, regulators, and board members.
Corporate governance of MFIs in Ethiopia involves three major elements, namely:

(a) prudential regulation;
(b) shareholders, board and management; and
(c) policies, systems and procedures.

The three key dimensions of governance indicated above are used as the conceptual framework of this study.

The key stakeholders in corporate governance include the regulators, shareholders, board of directors, executive management, audit committee members, internal auditors, external auditors and the public.
Objective of study

- Examine the main regulatory features affecting good governance of MFIs in Ethiopia;
- Assess the performance of the board of directors of MFIs and executive management; and
- Study the outcome and challenges of governance of MFIs in Ethiopia.
Il Review of the prudential regulation affecting effective governance of MFIs in Ethiopia

There is consensus among practitioners in Ethiopia that enabling prudential regulation and supervision of MFIs has been effective in promoting and guiding effective governance of MFIs.

Prudential regulation is very critical in ensuring the sustainability and viability of MFIs. It also plays a key role in ensure effective governance.

The high-risk profiles of MFIs increase the importance of prudential regulation, and strict supervision, and effective governance.
The prudential regulatory framework criteria and supervision methods of MFIs in Ethiopia are based more or less on the core principles for effective supervision established by Basel Committee on banking supervision.

Proclamation 40/1996 and the 19 directives of the NBE currently serve as the basis for prudential regulation affecting good governance.

The main regulations that have a direct impact on the governance structure MFIs in Ethiopia are summarized as follows:
2.1 Minimum Capital Required of New MFI Entrants
2.2 Ownership of MFIs
2.3 Board Structure and the Requirement to be appointed as Executive Director
2.4 Re-registration of MFIs
2.5 Interest Rates
2.6 Reporting
2.7 External Audit
2.8 Minimum Provisioning Requirements
2.11 Restriction on investment, single borrower limit and penalty for non-compliance
2.2 Outcome of Prudential Regulation on Governance

Prudential regulation has improved the performance of MFIs and encouraged them meet minimum performance standards and increased their commitment to operational and financial sustainability.

The prudential regulation, particularly the requirement of annual external audit report and the on-site and off-site supervision of NBE has improved transparency and governance of MFIs.

Since regulatory interventions usually arises only after the MFI
showed external signs of distress, the institution should rely on its own system of evaluating its risks and selecting the appropriate tools to mitigate risks.

For deposit taking MFIs with relatively higher risks, there is a need of using additional risk management policies and procedures, enhance security and staff trainings, and adopt management information systems to address the additional risk exposure.
III. The scope of the board and executive management of MFIs

Governance is a system of checks and balances whereby a board is established to manage the managers.

It is also conceived as a virtuous circle that links the shareholders to the board, to the management, to the staff, to the customer, and to the community at large.

Effective governance requires empowered boards which understand their duties and responsibilities.
On top of the board, the CEO, executive managers and internal and external auditors are accountable for the effective governance of MFIs.

On behalf of the shareholders, boards delegate responsibility to management and hold management internally accountable to a set of objectives and performance standards that the board has defined.

Shareholders or owners of MFIs play a key role in implementing effective governance and oversee their affairs.

The shareholders, through the general assembly meeting, appoint competent board of directors, audit committee and external auditors.

However, unlike non-financial institutions, the responsibilities of the board and executive management of MFIs and banks are not only to shareholders but also to depositors, who provide leverage to owners’ capital.
However, in the case of Ethiopian MFIs, board members are selected all shareholders (20%), vote of majority shareholders (50%), the members of the old board (12.5%) and other processes (12.5%) (Mekonen 2007). Both the board of directors and executive management must adhere to high ethical standards and be fit and proper to serve an MFI.

Experience in Africa and other countries indicate that the failed MFIs had deficient senior management and board members who either lacked financial knowledge or were uninformed and passive regarding the supervision of the MFI’s affairs.
3.2 Duties and responsibilities of the board

Although the board should leave day-to-day operations to management, it should retain overall control of the MFI.

The board should oversee and support the efforts of management and make sure that adequate controls and systems are in place to identify and address the major risks of an MFI.

The board should have a sound understanding of the risks of MFIs and ensure that management has established strong systems to monitor those risks.

The board should ensure that the MFI has adequate internal audit arrangements in place.

It should also ensure that microfinance regulations are strictly followed by the executive management.
3.3 Responsibilities of management

The CEO and the management team should be directly accountable to the board, and their relationship should be supported by robust structures.

The CEO and management team of an MFI should run the day-to-day activities in compliance with board policies, laws, and regulations, supported by a sound system of internal controls.

Management should provide the board with the information they need to meet their responsibly, and should respond quickly and fully to board requests.
The management should involve in placing adequate policies and procedures to increase the accountability of management and identify innovative interventions to improve the performance of an MFI.

The executive management should appoint efficient middle-level management positions; establish adequate performance incentives and personnel management systems; provide staff training; and implement adequate management information system.
3.4 Performance of the board of directors of MFIs in Ethiopia

The performance of the board is critical to the success or failure of an MFI.

The boards of MFIs can be classified into four categories, namely, rubber stamp board, representational board, hands – on board, multi-type board.

The performance and effectiveness of the board of Ethiopian MFIs varies from one MFI to another.
In most of the Ethiopian MFIs, enormous responsibilities and power are placed in the hands of the CEO or the general manager. This is quite alarming trend which could lead to mismanagement and fraud.

On the other hand, there are boards which are involved in micro management and hinder management’s ability to perform effectively or management’s accountability.

Some CEOs of MFIs depend and wait for a go ahead from the board and request the intervention of the board chairperson for decisions which are outside of the board’s domain.

Some board chairpersons act as CEOs, denying the management independence and accountability.
Some of the MFIs in Ethiopia have very influential board chairpersons and members who helped the MFIs to establish key linkages with the government, and banking sector which allowed the MFIs to be more effective in achieving their objectives.

There are few MFIs with hands-on boards in the industry
EFFECTIVE GOVERNANCE OF MFIS REQUIRES BOARDS TO PERFORM THE FOLLOWING FUNCTIONS:

- Define and uphold the mission and purpose of the MFI
- Develop and approve strategic directions (with management) and monitor achievement of strategic goals
- Oversee management performance
- Select, support and evaluate the CEO by maintaining a healthy balance between management and board
- Ensure that the MFI manages risks effectively, assuming fiduciary responsibilities
• Foster effective organizational planning, including succession planning
• Ensure adequate resources to achieve the mission, including the provision of assistance in raising equity and debt capital
• Represent the MFI to the community and the public
• Ensure that the MFI fulfils its responsibilities to the larger community
• Ensure that the MFI changes to meet emerging conditions particularly in terms of distress
• Uphold the ethical standards of the MFI
• Maintain transparency and avoid conflicts of interest
• Evaluate (or seek external evaluation) its own performance and commit to improving performance
IV. Developing systems and procedures to manage risks

The key responsibilities of the board and management of an MFI is to ensure that all major MFI functions are carried out in accordance with clearly formulated policies and procedures, and that the MFI has adequate systems in place to effectively manage risks and improve governance.

Effective systems underpin both the efficient implementation of governance and the management of an MFI.

Information technology (IT) has a potential role in increasing outreach, improving sustainability and governance of an MFI.
V. Governance issues of MFIs in Ethiopia

The challenges and effectiveness of governance in Ethiopian vary from one MFI to another, depending on type of ownership, level of growth, etc.

The critical issues which affect the effective governance of Ethiopian MFIs are categorized as follows:
Ownership of MFIs

Ownership is intrinsically linked to effective governance.

Ideally, the board of directors consists of owners of represents the interest of owners.

Many of the MFIs in Ethiopia are not-for-profit organizations where ownership is often unclear.

There are not clearly definable owners of the assets who can take actions where performance is poor.

Although lack of clear owners is a structural weakness of not-for-profit MFIs, this may not necessarily result in poor performance of these MFIs.

When different stakeholders are represented on a board, they usually have diverging objectives.

In Ethiopia, the ownership of MFI takes four types of structure.
Public sector entities as investors

In Ethiopia, the government has refrained from direct delivery of financial services using its structures and institutions.

However, the regional national states in the eight regions have been involved in initiating and supporting microfinance institutions in the last 12 years.

Although the regional governments have shares (which vary from one region to another), they are not interested in getting financial returns from these MFIs.

The MFIs are used as tools to implement the regional development plans and address the social and economic problems of regions.

Although there are no direct budget supports from the regional governments, the MFIs can count on the regional governments to get additional capital and support, when needed.
Unlike the experience of many countries, the government supported MFIs such as ACSI, DECSI and OCCSCO have been successful in registering high outreach and performance.

A good example is ACSI, which was ranked as the 6 best MFI in the world in 2007.

The result of the success these MFIs is partly attributed to good governance and management independence.

However, this does not mean that there are not governance problems in the above MFIs.
NGOs and donors as investors

Although international NGOs and donors in Ethiopia are prohibited, by law, from delivering financial services to households, local NGOs are shareholders in many of the MFIs.

The NGOs gave nominal shares to individuals working in the mother NGO and affiliated institutions.

The mother NGOs have been providing capital, expertise and technical support to these MFIs.
Clients as investors

Gasha MFI attempted to involve clients in the ownership of the MFI.

A significant number of clients bought shares (equivalent of 10 USD) from the MFI.

The clients who bought the shares were represented in the board.

Since the MFI did not distributing dividend to shareholders (clients), some clients who bought the shares demanded to get back their money invested as shares.

The experience of involving clients (shareholders) in the board was not found value adding.

Although this was an innovative initiative, the results were not encouraging.
Private sector investors

Ideally, private ownership in combination with an unrestricted profit orientation appears to be the basis for securing an efficient provision of financial services as long as MFI supervision functions properly and competition ensures that no single MFI is in a position to charge monopolistic prices.

Although there are two new MFIs on the pipe line, which are owned by individuals from the private sector, it is only Agar MFI which was established by selling shares to the public.

Agar MFI was expected to be a role model to attract private sector to the microfinance industry in Ethiopia.

However, Agar MFI has not yet distributed dividend to its shareholders and failed to meet the expectations of the shareholders.
It should be noted that Agar’s experience has nothing to do with the form of ownership structure.

The experience of Ethiopia reveals the contrary, where some of the government supported MFIs in Ethiopia registered a remarkable performance both in outreach and efficiency.

On the other hand, some of the MFIs initiated by NGOs have no real owners.

Although ownership in Ethiopia has not expanded significantly beyond NGOs and public entities, the experience of private and client ownership of MFIs has not proved to be effective in ensuring effective governance and performance.
The dual mission: Balancing the social and financial objectives

With the exception of Agar MFI, all microfinance institutions in Ethiopia have both the dual mission, reaching large number of poor clients while generating profits.

Boards are expected to play a key role in assuring that these MFIs are responding adequately to both of these objectives.
**Fiduciary responsibilities of MFIs**

The fiduciary responsibility of the board of any financial intermediary, in general, is considered greater for other corporate entities. Protecting financial institutions and hence the financial system is a high priority for governments.

Moreover, liquidity is essential for the development of a financial institution and requires more stringent internal controls than non-financial entities.

In the absence of deposit insurance, as is the case in Ethiopia, the fiduciary responsibility of the board of an MFI should be seriously considered.

On top of maintaining the solvency of an MFI, the board has several additional issues to consider which relate to its fiduciary responsibility.

Oversight of the fiduciary responsibility of MFIs in Ethiopia by board members significantly minimizes the insolvency of an MFI.

For example, if ACSI in Amhara region is insolvent, it means that it will deny financial access to more than 600,000 clients in the region.

This will have also a negative impact on the development of the entire microfinance industry.
Transformation of MFIs

The major factors that need to be addressed in building the institutional capacity of MFIs in the process of transformation include good governance, developing systems, training the staff and developing new products.

The transformation-related governance issues include working with a strict regulatory framework, involving in international banking, raising equity funding, managing exponential growth, financial restructuring, training and retraining the staff, revisiting the mission and vision, etc.
Risk assessment in MFIs

MFIs in Ethiopia face many risks that threaten their operational and financial sustainability.

These risks come from external environment and internal operations of MFIs. All MFIs Ethiopia have given very little attention to identify and manage these risks.

We believe that the board and management of MFIs in Ethiopia should consider risk management as their priority.

This can be partly accomplished by involving the board in managing the risks through the implementation of internal control system.
VI. CHALLENGES OF EFFECTIVE GOVERNANCE OF MFIS

• Although prudential regulation in Ethiopia has contributed to improvement of governance of MFIs, governance is still a major issue of MFIs. The major challenges include:
• Many of the board members of MFIs are not formal owners with any capital investment to lose.
• In some of the NGO initiated MFIs, the mission and vision of mother-NGOs influence the decisions of the board of the MFIs.
• In some of the MFIs, regular board meetings do not take place which implies that these boards are inactive boards, placing huge responsibility on management.
• The competency of some board members in terms of diversified skills and effectiveness in guiding the managers of MFIs is questionable.
• Some board members are very busy to spare enough time and contribute to the effective governance of MFIs.
• Regular assessment and evaluation of the board, the CEO and the management team has been rarely practiced which affected the effective governance of MFIs.
• Many of the boards of MFIs did not have well-defined performance indicators to measure the effectiveness of management.
• Although many of the MFIs in Ethiopia are established as private share companies, dividends are not distributed to shareholders.
• The structure of ownership and governance makes the role of regulators much difficult in the microfinance industry compared with commercial banks.
• The owners of the larger government supported MFIs and some of the NGO support MFIs are not clear.
The experience of Ethiopian MFI, even the successful MFIs in Bangladesh, indicates that success in MFIs depends on key persons, usually the managing directors and board chairpersons. Many of the MFIs do not have fixed term for replacing board chairpersons and held the position since inception. With the exception of two MFIs, boards of MFIs do not have board committees to properly address specific issues of MFIs. The documentations and reports of MFIs are poorly organized, which is partly the result of weak management information system. The NBE has limited capacity to enforce prudential regulation.
VII. Conclusions

Effective governance in Ethiopia is a prerequisite for growth, improve performance and sustainability and managing the risks which requires effective prudential regulation, developed systems and procedures, and sufficiently empowered board and management to discharge its duties and responsibilities.

The prudential regulation in Ethiopia has given MFIs the basic guidelines to ensure effective governance.
The issue of good governance in the Ethiopian MFIs is a serious issue which needs to be addressed immediately.

Regulators and shareholders should assess the status of governance of MFIs in Ethiopia.

The regulatory framework should be revised to address the critical issues of governance of MFIs.

There is a need to develop an industry wide code of governance of MFIs to which every MFI should be required to subscribe and comply.

There is a need for a detailed research on the impact of governance on outreach, performance and sustainability of MFIs.
Thank You