Independent Directors can help MFIs in Sustainable Value Creation

Introduction

MFIs where decision making ensures that expectations of stakeholders are met to a reasonable extent, and stakeholder concerns are adequately addressed, can be considered to be moving along a path that leads to sustainable value creation. Independent Directors, ie, those Board members who do not represent the executive-management, or investors and lenders, can play a vital role in sustainable value creation by ensuring a virtuous alignment of diverse expectations and concerns[1]. In this note we discuss three essential characteristics for Independent Directors to create sustainable value for MFIs – Ability-interest, Role clarity and Access to information – and call for sector level initiatives for greater dissemination of best practices in this regard.

MFI Stakeholders: Expectations and Concerns

Microfinance Institutions (MFIs) have multiple stakeholders. These include the elected government, regulators, promoters, investors, lenders, managers, employees and clients. These stakeholders have diverse expectations – from provision of low priced financial services, to quick scale up and profits. In addition to having expectations from the organization, every stakeholder also has concerns. At the basic level the concern is that their expectations will not be fulfilled. However, beyond this, there is a deeper worry regarding losses of a higher magnitude, such as loss of reputation or popularity as not all the stakeholders are involved in organizational decision making to the same extent and those stakeholders that are primarily responsible for organizational decision making, may choose to act in a manner that leads to fulfilment of their own expectations, without necessarily taking into account the effect of these decisions on the other stakeholders.

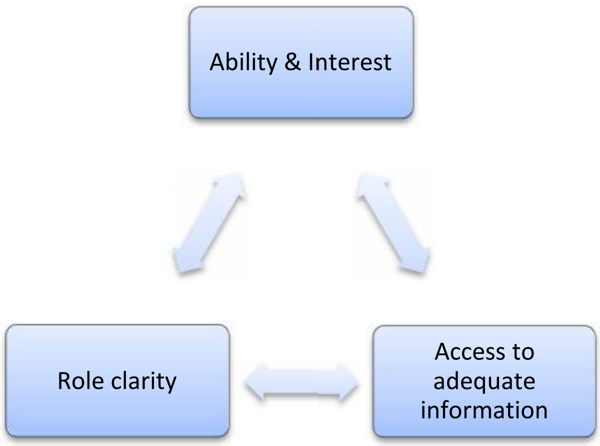
Stakeholder	Expectations	Concerns
Elected Government	Provision of low priced financial services, especially credit	Loss of popular support in case MFIs are perceived to be charging high prices or following coercive practices
Regulator	Provision of reasonably priced financial services in a sustainable manner	Unfair trade practices, accumulation of bad debts, failure of MFIs, financial sector instability
Founder/Entrepreneur	Quick operational scale-up leading to financial returns and achievement of socially desirable outcomes through provision of financial services	Losing out to competitors. Low growth, loss of investment and time. Inability to fulfil obligations and associated loss of reputation.
Early/mid stage equity investors	Rapid growth leading to financial returns and exit within 3 to 5 years	Loss on investment
Public or minority shareholders	Competitive financial returns	Loss on investment

[1] See appendix 1 for the criteria presented in the Indian Companies Act, 2013 for Independent Directors.

Lenders	Meeting priority sector loan portfolio targets	Loan loss
Managers	Sound remuneration, career progression and good status in society	Stagnation
Field staff	Remuneration, learning new skills, career progression	Inability to earn the high remuneration because of performance issues
Clients	Continued access to reliable and customer friendly credit and other financial services	Inability to borrow, refusal of loans by lenders, inappropriate conduct by lenders, high loan prices

When and How can Independent Directors Create Sustainable Value

Independent Directors have a fiduciary duty towards those stakeholders who may not be in a position to safeguard their interests in the organization themselves. Effective Independent Directors provide a necessary balance to organizational decision making. We discuss three conditions below that enable Independent Directors to be effective – Ability-Interest, Role clarity and Access to adequate information.



Ability-Interest

Independent directors should be capable of questioning dominant opinions within the organization to ensure that interests of unrepresented stakeholders are balanced against considerations of quarterly growth and profit. They should also take sufficient interest in the affairs of the organization to be able to express unpopular opinions. In the context of public corporations in the US, Roberta S. Karmel, Centennial Professor of Law at Brooklyn Law School, identifies the following qualities in an excellent Board Member – intelligence, integrity, experience, competence and a willingness to question herd decision-making, strong sense of ethical responsibility, someone who does not destroy the collegiality of the board room[2]. In her paper, *Is the Independent Director Model broken?*, Professor Karmel questions the model of corporate governance that gives primacy to shareholder interests and argues that the interests of employees, customers, and creditors should be balanced against a duty to shareholders, especially when those shareholder interests are short-term. Professor Karmel goes on to add that, “a public corporation should not be some battleground where executives, directors and shareholders are adversaries. Neither should the board of directors become a super compliance committee, more concerned about government regulations than a corporation’s operations and strategy”. These points are relevant in the context of the Indian MFIs, given the nature of their financial liabilities and their clients. RBI’s directions require Independent Directors to assume leadership roles in key committees of the Board such as Audit committee, Risk Management committee and Nomination committee in systemically important MFIs.

[2] Is the Independent Director Model broken?
July 29, 2013, Roberta S. Karmel, Brooklyn Law School, accessed on 2 Jan 2015.

Role Clarity

The second factor that determines the effectiveness of Independent Directors is the clarity of their roles towards the organization. While there may be regulatory requirements regarding their participation in various affairs of the Board, the contribution that they are expected to make to organizational decision making needs to be formalized and documented. Terms of reference, with details of the responsibilities of Independent Directors, should be drafted and approved by the Board.

Their role should not be limited to voting on resolutions and issues required by law or presented by the executive. Rather, independent directors should play a proactive role in providing guidance to the organization on critical issues that may lead to misalignment of stakeholder expectations and concerns. In the box below, we present some issues which require balancing views of Independent Directors for sound decision making.

Box: Situations that lead to misalignment of stakeholder interests

<u>Lending practice under conditions of easy liquidity</u>: When the availability of funds is easy, MFIs accelerate their growth plans. In this situation, sound credit origination principles become secondary to achieving fast growth. This has the effect of concentration of microfinance in certain geographies, where there are multiple MFIs providing services to essentially the same set of clients. The microfinance crisis in Andhra Pradesh exemplifies the risks posed by this tendency.

<u>Inadequacy of assessment of debt capacity of clients</u>: MFIs branches are responsible for loan sales as well as sanctioning. With the exception of a few MFIs, staff members who are responsible for credit decisions also have business targets relating to loan portfolio growth. The credit decision is mostly a function of the potential client fulfilling a minimum set of criteria which include:

1. Satisfactory credit bureau report
2. Age and gender
3. Income eligibility for qualifying assets, primarily based on clients own declaration
4. Clients verbally agreeing to joint liability arrangements
5. Awareness of MFI product and processes

The emphasis is more on ensuring moral and peer pressure for repayment performance and less on ascertaining debt capacity. The latter is assumed to be taken care of through self-assessment performed by clients themselves – the reason quoted often is difficulty in accurately assessing the cashflows of households of clients. While repayment performance of microfinance clients has been sound, it is also a fact that deterioration in loan portfolio quality of MFIs is often rapid. Also, as the loan sizes given to clients have become larger, the corresponding risks have also gone up.

<u>Existence of hidden delinquency</u>: Under the group guarantee mechanism, in case an individual is unable to pay her loan installment, other members of the group pool monies and pay up on the individual's behalf. As a result the individual's installment is paid and her loan shows up as being regular, hiding delinquency. This constitutes a risk event for the MFI as a borrower had not been able to pay her installment and guarantee mechanisms had to be enforced in order to make up for the shortfall. However, the MIS of most MFIs today do not catch data pertaining to such events. This results in Hidden Delinquency. Significantly, Hidden Delinquency is not reflected in credit bureau reports.

<u>Dependence on foreign equity</u>: Foreign equity capital forms a significant proportion of the equity structure of MFIs. MFIs will need to find ways to provide an acceptable exit to this capital. Inability

to do so may lead to litigation with foreign investors. Indian firms with foreign investments are witnessing such litigations. The financial daily Mint reported on 8 Sep 2014, “Many private equity funds that have invested in real estate and infrastructure companies such as BPTP Ltd, Fourcee Infrastructure and Equipments Pvt. Ltd and Krishnapatnam Port Co. Ltd are currently embroiled in legal battles. For instance, Citi Property Investors (now known as Apollo Global Management Llc.) and JPMorgan Chase and Co. have initiated separate arbitration proceedings against BPTP claiming the developer hasn’t been able to provide options to the funds to sell their holdings”[3]. More recently, the Economic Times reported on 6 January 2015, “NTT DoCoMo files arbitration request to sell $1 billion Tata Teleservices stake”[4]. The news report stated, “NTT DoCoMo has moved the international court for arbitration in London to ensure that the Tata Group finds a buyer for the Japanese telco's 26% stake in their Indian joint venture, Tata Teleservices, setting the stage for a potentially bitter separation for the six-year-old JV which was once emblematic of the promise of the country's telecom sector.”

<u>Dependence on funds marked for “Priority Sector”</u>: In order to grow, MFIs accept a lopsided liability structure, with overwhelming dependence on bank funds which are categorized as priority sector by the Reserve Bank of India. This leaves them vulnerable to disruptions in funding, in case there is a modification in this classification.

Access to adequate information

Independent Directors need to have adequate and structured information in order to participate in the strategic decision making process within the organization. Conventionally discussion around growth and profitability tend to dominate Board deliberations, as these are the areas which are highlighted in management presentations made to the Board. However, sustainability of growth and profitability can only be ensured if decisions made to achieve growth and profitability take into account the expectations and concerns of all the stakeholders of the organization. Consequently, it becomes important that Independent Directors guide MFIs on issues related to client relationships, risk management, social performance, employee concerns and regulatory compliances. This is possible only when they get timely structured reports from the management on these aspects. It is also important that these reports have an organization wide coverage. For example, risk reports should include all risk categories – credit, operations, liquidity and funding, and market risk. Similarly, client satisfaction reports presented to the Board should have an organization wide coverage. Specifically, Independent Directors should provide leadership and direction to MFIs on issues related to client complaints.

Independent Directors should also have access to reports by qualified outsiders. Reports such as Code of Conduct Compliance Assessments, Independent Institutional Assessments, Portfolio Audits, which may be commissioned by lenders or investors should be presented to the Independent Directors. They should also meet assessors, lawyers, bankers for better information on the MFI.

---

[3] http://www.livemint.com/Companies/r2zRRIAnYAfGSazpLRKqcO/Over-3000-crore-PE-investments-stuck-in-legal-battles.html

[4] http://economictimes.indiatimes.com/industry/telecom/ntt-docomo-files-arbitration-request-to-sell-1-billion-tata-teleservices-stake/articleshow/45756688.cms

Sector Level Initiatives for Dissemination of Best Practices

Sector level initiatives can help to guide organizations towards adopting better governance practices. Trainings for Independent Directors can help them in better understanding their roles and responsibilities. Such trainings should include the following aspects, given the criticality of role played by them:

1. Code of Conduct for Independent Directors
2. Regulatory directions for Independent Directors
3. Role and responsibilities vis a vis different stakeholders of the organization
4. Key areas where Independent Directors must play a role - Role played in
   a. Organizational Strategy and Policy Formulation
   b. Risk Management
   c. Financial reporting and integrity of financial information
   d. Compensation structure of key executives and directors
   e. Grievance handling mechanism and conflict resolution
   f. Client relationship management
   g. Corporate Social Responsibility
5. Effective participation in Board meetings
6. Seeking information and clarifications from qualified outsiders and expert insiders

It is pertinent to note that the Indian Companies act of 2013 presents a code for independent directors, which lists the duties of Independent Directors. One of the duties listed is, "The independent directors shall undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company". The full list of roles, functions and duties listed for Independent Directors is presented in Annexure 2.

In addition to trainings an annual surveys of MFIs regarding the participation of Independent Directors in providing strategic guidance to the company may also help in the dissemination of best practices in the microfinance sector. Such surveys can be based on data reported by MFIs themselves as well as interviews with the Independent Directors. This can cover aspects like

1. Board constitution and number of Independent Directors
2. Whether a declaration has been obtained from the Independent Directors that they fulfil the criteria of independence
3. Role of Independent Directors in various committees of the Board
4. Participation of Independent Directors in Board Level Committees
5. Format of reports provided to the Independent Directors (so that they can provide informed guidance to the MFI)
6. Whether the organization held a Board Meeting where only Independent Directors held discussions
7. System of performance review of Independent Directors
8. Selection process of Independent Directors

Conclusion

MFIs, being niche financial organizations, have assets comprising primarily of loans given to low income clients. The liabilities of MFIs, similar to any other organization, comprise of borrowings, notes, debentures. However, MFIs enjoy high debt to equity leverage. A major proportion of their assets are funded by borrowings from a variety of sources, including public money. Therefore given the nature of their clientele as well as their liabilities, it is important that decision making at the highest levels of such organizations is in line with the long term interest of all stakeholders, particularly those who do not have a say in the organization's management. Given that there are many stakeholders with diverse interests, the challenge of Governance in MFIs is to find optimal balance, taking into account the expectations and concerns of all stake holders. Capable, interested Independent Directors with clearly defined roles, who have access to adequate and timely information, can help MFIs create sustainable value.

Appendix 1: Independent Directors as Defined in the Indian Companies Act, 2013

An independent director in relation to a company, means a director other than a managing director or a whole-time director or a nominee director,—
(*a*) who, in the opinion of the Board, is a person of integrity and possesses relevant expertise and experience;
(*b*) (*i*) who is or was not a promoter of the company or its holding, subsidiary or associate company;
(*ii*) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;
(*c*) who has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;
(*d*) none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;
(*e*) who, neither himself nor any of his relatives—
(*i*) holds or has held the position of a key managerial personnel or is or has been employee of the company or its holding, subsidiary or associate company in any of the three financial years immediately preceding the financial
year in which he is proposed to be appointed;
(*ii*) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of—
(*A*) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or
(*B*) any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent. or more of the gross turnover of such firm;
(*iii*) holds together with his relatives two per cent. or more of the total voting power of the company; or
(*iv*) is a Chief Executive or director, by whatever name called, of any nonprofit organisation that receives twenty-five per cent. or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent. or more of the total voting power of the company; or
(*f*) who possesses such other qualifications as may be prescribed.
(*7*) Every independent director shall at the first meeting of the Board in which he participates as a director and thereafter at the first meeting of the Board in every financial year or whenever there is any change in the circumstances which may affect his status as an independent director, give a declaration that he meets the criteria of independence.

Annexure 2: Role, Functions and Duties of Independent Directors from the Code presented in Companies Act, 2013

Guidelines of professional conduct

An independent director shall:
(1) uphold ethical standards of integrity and probity;
(2) act objectively and constructively while exercising his duties;
(3) exercise his responsibilities in a *bona fide* manner in the interest of the company;
(4) devote sufficient time and attention to his professional obligations for informed and balanced decision making;
(5) not allow any extraneous considerations that will vitiate his exercise of objective independent judgment in the paramount interest of the company as a whole, while concurring in or dissenting from the collective judgment of the Board in its decision making;
(6) not abuse his position to the detriment of the company or its shareholders or for the purpose of gaining direct or indirect personal advantage or advantage for any associated person;
(7) refrain from any action that would lead to loss of his independence;
(8) where circumstances arise which make an independent director lose his independence, the independent director must immediately inform the Board accordingly;
(9) assist the company in implementing the best corporate governance practices.

Role and functions

The independent directors shall:
(1) help in bringing an independent judgment to bear on the Board's deliberations especially on issues of strategy, performance, risk management, resources, key appointments and standards of conduct;
(2) bring an objective view in the evaluation of the performance of board and management;
(3) scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance;
(4) satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible;
(5) safeguard the interests of all stakeholders, particularly the minority shareholders;
(6) balance the conflicting interest of the stakeholders;
(7) determine appropriate levels of remuneration of executive directors, key managerial personnel and senior management and have a prime role in appointing and where necessary recommend removal of executive directors, key managerial personnel and senior management;
(8) moderate and arbitrate in the interest of the company as a whole, in situations of conflict between management and shareholder's interest.

Duties

The independent directors shall—
(1) undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company;
(2) seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice and opinion of outside experts at the expense of the company;
(3) strive to attend all meetings of the Board of Directors and of the Board committees of which he is a member;

(4) participate constructively and actively in the committees of the Board in which they are chairpersons or members;
(5) strive to attend the general meetings of the company;
(6) where they have concerns about the running of the company or a proposed action, ensure that these are addressed by the Board and, to the extent that they are not resolved, insist that their concerns are recorded in the minutes of the Board meeting;
(7) keep themselves well informed about the company and the external environment in which it operates;
(8) not to unfairly obstruct the functioning of an otherwise proper Board or committee of the Board;
(9) pay sufficient attention and ensure that adequate deliberations are held before approving related party transactions and assure themselves that the same are in the interest of the company;
(10) ascertain and ensure that the company has an adequate and functional vigil mechanism and to ensure that the interests of a person who uses such mechanism are not prejudicially affected on account of such use;
(11) report concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy;
(12) acting within his authority, assist in protecting the legitimate interests of the company, shareholders and its employees;
(13) not disclose confidential information, including commercial secrets, technologies, advertising and sales promotion plans, unpublished price sensitive information, unless such disclosure is expressly approved by the Board or required by law.