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Governance Challenges and Possible Solutions for Small to Mid-size BPRs

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Introduction: In recent years BPRs[1] have assumed a significant role in providing microfinance services to low end market segments in Indonesia. BPRs face several challenges in the process of growth and expansion; two important ones being (i) ability to raise resources and (ii) ensuring effective governance.[2] Of the two, effective governance is often seen as the most challenging and important one as it establishes a strong foundation for the future and guides the management in achieving its objectives in a sustainable manner.

In both the 2008 and 2009 Microfinance Banana Skins reports, corporate governance was ranked as one of the topmost pressing risks facing the sector. The Banking Banana Skins report 2012 also recognised the need of stronger governance and risk management practices. Key industry players including regulators, donors and investors highlighted the need for appropriate governance structures and processes. This Note addresses the most common challenges faced by small to mid-size BPRs and highlights possible solutions.[3]

Key Governance Challenges: The following are the most common challenges faced by small to mid-size BPRs when addressing governance:

Board Composition: BPRs often find it challenging to form an appropriate board, with suitably skilled members. The board usually has representation from promoters and is closely held, and yet is often made accountable for supervisory and fiduciary functions. A balanced board typically needs investor representation, representatives with deep understanding of the industry and maturity of vision, others with strong community ties or who are strong believers in the mission of rural banks, and others with a sound legal and financial background. However the need to find appropriate members to serve on the board is often not felt by BPRs. Moreover, when BPRs do feel the need, finding such people proves to be a difficult task as very few individuals qualified for the role want to associate with small BPRs, or are too expensive for BPRs to pay for their time.

Leadership: The functioning of a small to mid-size BPR is usually heavily dependent on institutional leadership, which (in most cases) depends on the promoter with highest shareholding. Often these leaders do not see value in practicing good governance. They put their personal goals like profit maximisation, increase in asset size and unencumbered decision-making power above everything else, thereby undermining the governance system and increasing dependency on management.

Lack of Engagement: The biggest problem for BPR boards today is lack of engagement by board members. *MicroSave* has frequently observed that board members of small BPRs are not meaningfully engaged with the institution. This could be due to multiple reasons. In the early stages, many board members are reluctant to take on fiduciary[4] responsibility as they find it risky. The second possible cause is that many board members are often pulled from the same pool of luminaries, which means that they serve on the boards of multiple BPRs/MFIs and therefore do not have enough time to dedicate to individual institutions because of these diverse engagements, and other personal and professional activities. Another reason is the choice of board members who live too far away to be able to attend board meetings regularly or spend quality time with the institution. Finally, many board members often do not understand their roles and responsibilities clearly. This is because they are given inadequate induction or refresher training, and (in many cases) are not given adequate opportunity by the CEO (who is often the promoter and major shareholder) to participate in deliberations.

Balancing Management Interest and Profitability: The balancing of employee interest with shareholder business interest is a significant challenge for a BPR as its for-profit structure works for the maximisation of shareholders' money. Most of the time promoters use their judgment on matters of significance to the BPR in the best interest of themselves, ignoring management say and staff interest.

Most small to medium BPRs confine employee benefit to profit sharing under compensation plans to reward individuals for their contribution to the BPR's operations and achievement of targets.

[1]The term BPR (*Bank Perkreditan Rakyat*) represent secondary banks in Indonesia, which are regulated and supervised by the central bank. They usually operate at the sub-district level. BPRs are locally based and mostly privately owned rural banks. They cater to lower to middle income clients; they are not part of the payments system; they face strict branching restrictions; and they are subject to different regulations than commercial banks.

[2]Governance is the process by which a board of directors guides an organisation in fulfilling its corporate vision, mission and protects the institution's assets. Effective governance requires that a board provides proper guidance to management regarding the strategic direction for the organisation and oversees the management's efforts to move in this direction (Rock, Otero and Saltzman, 1998).

[3] See *MicroSave*'s Board Governance in Microfinance Institutions toolkit.

[4] Fiduciary: serves as a check and balance to provide confidence to the company's investors, staff, customers, and other key stakeholders that the managers will operate in the best interests of the institution.

A more than twenty year old BPR with operations in East Java has five board members, who are also its promoters. Three board members stay quite far from the bank's location and also have fulltime and demanding businesses to run. Due to their business engagements and other areas of interest, they rarely devote adequate time to the BPR. Whenever they find time to attend the monthly board meetings, they confine their discussions to increasing profits, reducing costs and pursuing stakeholder interests.

The Managing Director (who is also one of the promoters) of the BPR is now thinking how to get the "right people on the bus", as Jim Collins suggests in "Good to Great", as a corrective strategy. He has plans to constitute an advisory board with members who are dedicated, competent and willing/able to devote time. This underscores the need for selecting the right board members - with the right experience, capacity to provide time and interest in the organisation.

Separating Governance from Management: In most BPRs, the roles of the board and day-to-day management often overlap. Boards are run by the promoters, who in turn are also often the institutional heads. One person is often looking to play three different roles simultaneously: 1) strategic guidance; 2) implementation; and 3) monitoring. This is not only difficult to manage, but also generates issues related to monitoring and control. More importantly, this negatively impacts the effectiveness of the governance system by preventing checks and balances through the division of governance, risk management and compliance.

At one of *MicroSave*'s strategic business planning workshops, the BPR staff members strongly recommended lowering the loan interest rate to improve client coverage and fulfil the institution's social mission. However, the governing board ruled this out as it would lead to loss of income. Eventfully, this decision not only hampered BPR business, but also affected staff morale.

In year 2011, *MicroSave* conducted HR climate survey at the BPR to understand staff satisfaction level, also to know the viewpoint of employees on various aspects so that a new HR system could be developed. The survey touched areas such as: board versus management relationship; job satisfaction; growth opportunities; benefits and remuneration; the performance management system; and brand consciousness. The survey produced shocking results – more than 75% of staff members commented that they did not feel committed to the BPR and they did not see a good future in it.

Potential Solutions: BPRs should build good governance processes from the beginning to foster growth and ensure sustainability. The following are some potential solutions for the key challenges identified in this note:

Board-Membership Composition: People with diversified experience should form the board (or advisory board) including those with backgrounds in finance, legal, risk management, and operations. Consider engaging local talent rather than luminaries from afar. The Managing Director should preferably have extensive microfinance or banking experience. Advisory board members should not receive any personal or material rewards other than the approved remuneration and benefits which go with their position on the board.

Lack of Engagement: Board members must understand they are expected to play an active role in exercising governance, as well as be involved in capital raising activities. They should attend training/refresher programmes on board membership. Board meetings must actually take place - consistently and regularly. Importantly, the governing board should have the authority and comfort to question management.

Leadership: Roles and responsibilities should be diversified and clearly defined and not concentrated in a single person, usually the CEO. An efficient compliance monitoring and internal control system should be in place and regular, independent reporting to the board should be ensured.

Separating Governance from Management: BPRs should clearly define and communicate the roles and responsibilities of all personnel, including board members. Annual self-assessments should be conducted to remind board members of their commitment and responsibilities. The Board should have the necessary subcommittee functions: internal audit, finance, social performance, compensation & benefits etc.

Balancing Management Interest and Profitability: The mission and strategic vision of the BPR should be shared at all levels along with responsibilities for performance. BPR management team and board should be realistic about operational expectations, avoiding excessive and unrealistic goals. The Board should not reject or avoid employee concerns simply because of cost considerations. Addressing their concerns may involve additional cost, however in the long run these costs may well be offset by increased business, staff productivity or improved customer service and thus loyalty.

BPR Mekar Nugraha provides an excellent illustration of a balanced board with good governance practices. The board comprises five individuals with diverse professional experience, including members from the fields of microfinance, law and banking. The board is largely locally based, which ensures close coordination between Mekar's President Director L. Arum Riyana and board members. As a result of this close relationship, the board has, on many occasions, helped management find solutions to problems in an effective, timely and transparent manner.

Conclusion: For a small to mid-size BPR good governance can establish the right long-term foundation (guiding principles, vision, mission and so on) to ensure that the institution stays on track to achieve its business and social goals. BPRs face increasing governance challenges to address issues such as rapid growth, sustainability and formalisation. Without a governance structure designed so that the institution's stakeholders (board of directors, managers, owners, regulatory authorities, etc.) can adequately oversee the effective management of the institution, financial solvency and long-term sustainability will be at risk. Establishing a good governance system requires an appropriate combination of board members and their full participation. Promoters, governing board members and the chief functionary have to work in collaborative coordination to ensure effective governance.