

Governance Practices in Financial Services Associations in Kenya*

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The purpose of this study was to investigate governance practices in Financial Services Associations (FSAs), more specifically, the roles of the outreach model, Board of Directors, Shareholders and Financial Reporting in the governance of FSAs in the Rift Valley Province of Kenya. The descriptive research design was employed. Stratified and simple random sampling techniques were used in selecting a sample of 121 shareholders, 7 managers and 22 directors. A questionnaire and focus group discussions were the main data collection instruments. Both quantitative and qualitative data analysis methods were used. The findings show that the outreach model is participative in nature and this effectively promotes good governance in FSAs. In addition, the shareholders too are effective in promoting good governance practices, while, the board of directors as a governance practice is ineffective due to the directors' conflict of interest. Given the low level of reporting, financial reporting too, was not one of those practices that promote good governance in FSAs. Based on the study findings, a few conclusions and recommendations were made. The failure by the shareholders to recognize that they own their respective FSAs leads to their passive participation in the management of FSAs which in turn makes them unable to control the Boards of Directors. Due to their active involvement in loans recovery, the shareholders are actively engaged in governance activities. They should therefore be trained and educated on their rights and roles so that they can be more active in the governance of FSAs. Because the Board of Directors are not actively engaged in the governance of FSAs, independent non executive directors with the necessary technical competence should be incorporated in the board. This move, it is assumed will boost the board's oversight role and in turn, good governance. In conclusion, this study recommended further research so as to test the relationship between governance and the overall performance of FSAs. In addition, there is need to study the role of the legal and regulatory structures in FSAs.

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Introduction

Corporate governance principles have imposed themselves as the basic rules for any well run company to follow. The trend now affects more than just the traditional business companies and is often seen as a tool for standardizing the controlling vision for any major organization in the world (Labie 2000). Corporate governance principles are also an important ingredient in the development of effective, credible, accountable and successful microfinance institutions in the establishment of appropriate structures and process governance (Fowler and Kinyanjui 2004). Chu (2000) laid emphasis in microfinance institutions in providing clear and solid answers to the critical issue of governance if these institutions aspire to create a true link with the capital market.

FSA's are a microfinance model invented by Jazayeri (1998) whose approach is the provision of financial services through rural banking. FSA's mobilize capital from investors by offering high returns while providing cost effective and accessible financial services to the local community thereby contributing to poverty alleviation (Jazayeri 2000). In this regard, FSA's are microfinance institutions that provide "a broad range of financial services such as deposits, loans, payments services, money transfers, and insurance to the poor and low income households and their farm or non-farm micro enterprises" (Charitonenko and Campion 2003; Fowler and Kinyanjui 2004). FSA's are occasionally referred to as village banks and they have two basic approaches. First, there is the *finca* approach where funds are received from the implementing agency to lend to the members. Second, there is the *FSA's*

approach where equity financing from shareholders is used to encourage local capacity development and ownership (Chao 2003). This paper addresses the roles of the outreach model, board of directors, shareholders and financial reporting in the governance of FSA's.

Role of FSA Outreach Model in the Governance of FSA's

Rural households have a high for saving facilities, especially in areas where there is an inflow of cash in the form of cash crops and others (Jazayeri, 1998). The lack of such financial services can encourage the storage of wealth in non-financial forms such as livestock, jewellery which block the savings in a non liquid form and do not increase the volume of investible resources. In this regard, FSA's combine the principles of an investment company that focuses on risk capital, financial returns and shareholders value and that of the community finance that focuses on proximity, social capital, user ownership and outreach to the poorer segments of the community (Jazayeri 2000). This contrasts FSA's from the traditional credit only donor driven non governmental organizations (NGOs). That is, local ownership and high returns allow the rapid expansion of the equity base that serves as deposit mobilization. It can therefore be argued that user ownership brings commitment and loyalty to the institution, provides better incentives for good management and nurtures social capital that contributes to raising equity and improving loan recovery (Jazayeri 2000).

There is a general recognition within the microfinance industry the present prudential regulation for the banking sector is inappropriate and inadequate for the Micro finance Institution (MFI)

portfolio (Jazayeri 1998). The user owned MFIs like FSAs are assumed to be self regulating either as stand alone units or as being an apex organization. The experience with self regulation however, is poorly documented and at best very mixed. Self regulation also offers no teeth for the apex organization to enforce compliance (Berenbach and Churchill 1997; Jazayeri 1998).

However, the outreach model has also been found to face various challenges of governance (Chaves 1994; Jazayeri 2000; Miller 2000). Learning to self govern effectively has been identified as a long and difficult process. For instance, once the FSA reaches a substantial size, there is a danger of capture by local politicians (Jazayeri 2000). However, experience has shown that the large shareholders have been instrumental in replacing ineffective boards and managers and the rule allows the large shareholders greater say in the general meeting. This has been a positive factor in ensuring good governance (Jazayeri 2000).

Liberalization in many developing countries has not improved the outreach of formal financial institutions in rural areas. Many banks have in fact closed their branches as a direct result of liberalization. The evidence shows that in fact after liberalization, it is the informal sector that has expanded due to the increased circulation of cash and the need for financial services (Steel, Aryectey, Hettige and Nissanke 1997). Informal financial arrangements are now extremely widespread (Harper 1999). These arrangements perform well while small but because of management and governance problems have difficulty in gaining scale and institutionalizing themselves. Once they move away from the instant redistribution of funds on the

table and as soon as there is an accumulation, then the members face a permanent verification problem that cannot be resolved without proper accounts, procedure and accountability (Wright 2000).

The building of FSAs encourages the development of local management capacity since the local people manage it with transparent and simple rules, a simplified but professional accounting system and internal controls hence resolving the verification problem. The FSA being locally owned, financed and managed, also addresses some of the key issues of ownership and governance in microfinance through the introduction of checks and balances in its governing and management bodies (Jazayeri 2000).

The objective of a microfinance program is to reach a large number of poor people. According to Gibbons (2000) achieving scale in both lending and savings operations is one of the most important key factors in achieving financial sustainability in microfinance. There is a growing recognition that returns to micro enterprises in developing countries are quite high and the poor involved in such micro and small businesses constitute a major market for financial services (Harper 1998). Although different methodologies and organizational frameworks have been developed to provide or promote microfinance through NGOs, the strategic question for the future is whether or not micro credit NGOs are the most appropriate vehicles for having the best outreach at the lowest cost and what are the alternatives to this model. An analysis of micro credit programs has revealed that the evidence does not always substantiate the claims (Murdoch 1999). Others have revealed some negative effects of the credit led

paradigm (Hulme 2000). The pressure to lend by the providers and the constant renewal of loans has led to over indebtedness and social tension (Rahman 1999). FSA model has therefore been developed as an alternative to this traditional credit only donor driven NGOs.

The Role of the Board of Directors in the Governance of FSAs

Corporate governance is related to the issue of accountability which every country and society has had to deal with over the years (Longeneck and Prinkle 1981). The recent wave of high profile corporate collapses and scandals in the United States of America, Australia and New Zealand over the past few years have highlighted the enormous implications of governance and its potential for massive destruction of shareholders' wealth. According to Healy (2002) governance effectiveness of Board Leadership in building and maximizing shareholders' wealth should be emphasized as a solution to current crises in corporate governance rather than just looking at risk on regulation, policies and procedures.

In developing and transition economies, a healthy and competitive corporate sector is fundamental for sustained and shared growth. In many developing countries, poverty persists not only because of slow economic growth but also because of the uneven distribution of the benefits of growth and poor governance (Webster and McGrath 1997). As micro finance institutions expand their outreach and increase assets and as more become regulated entities that can capture savings and deposits, clear articulation of their boards of

directors is essential for effective governance.

The modern company is characterized by a separation of ownership from control. Due to this separation, shareholders have minimal influence upon company affairs. The gap that results between the shareholders and the management is filled by the board of Directors that arbitrates between them (Melvin 1986). This mandate makes the board a governance agent. Though the role of the board of directors has been an important area of study, little attention has been given to smaller sized firms (Bennet and Robbinson 2004). However, studies based on the integrative models of board involvement; incorporating different theoretical perspectives and various board attributes, provide inconclusive results, suggesting that corporate governance has at least an indirect effect on company performance (Zahra and Pearce 1989; Jonnergard and Svenson 1995; Maassen 1999).

The basic responsibilities of a board in micro finance comprise of four specific roles, namely, the fiduciary, strategic, supervisory and management development (Berenbach and Churchill 1997; Chao 2003; Miller 2000). As a fiduciary, the board of directors has several legal obligations. In this regard, the board of directors must ensure that the institution complies with its articles of incorporation, bylaws and internal policies and procedures (Otero 1998) as well as maintain its legal status. For instance, as a microfinance institution becomes regulated, it becomes subject to new regulatory requirements that the board must understand. According to Overton (1993), the standards of conduct applicable to individual board of

directors include duty of care, duty of loyalty and duty of obedience.

Hiring a competent Chief Executive Officer (CEO) is one of the primary functions of the board of directors. According to Duca (1996) the board can only be as effective as the CEO it appoints. In addition, the board of directors' vision must be clearly defined and the steps of achievement well conceived. This requires the board therefore to specify the targets for scale operation, market penetration, level of sufficiency, quality of assets and level of efficiency (Carver 1990). Underlying this is the ability of the microfinance institutions to survive and prosper as they grow exponentially to meet the huge demand for their services (Chu 2000). The ability to do this, thus, depends on the board's ability to balance vision and management. Ensuring that an organization maintains proper course is a board responsibility. Although studies in this area reveal that the boards of directors in MFIs are involved in strategic planning and policy decisions, they are not involved in operational decision making (Campion and Frankiewicz 1998). This negates their responsibility in providing governance plus guidance.

The Board of Directors has a duty to attend to all relevant meetings and other committees' meetings. However, in his evaluation of the K-Rep supported FSAs Miller (2000) found that most boards are not generally aware of their rights and responsibilities. In addition, most boards were not meeting regularly and that some did not have sufficient understanding of their roles or of the complexities of managing an FSA. In support of this, Chao, (2003) found out that the board of Directors attendance rates varied from 100 percent in a young

FSA to a low of 60 percent turnout at monthly meetings. She also found out that there is a correlation between the level of fraud and the strength of management among various FSAs.

Shareholders and the Governance of FSAs

The ownership and structure in many MFIs has affected the effectiveness of governance in most of these organizations (Otero 1998). For instance, where we have had public ownership government structures, policies have failed due to political interference and corruption. Balancing the social and profit objective in microfinance has been one of the major challenges. Whereas it has been found that purely profit driven shareholders improve control and governance efficiency, there are few purely profit driven shareholders in microfinance. Also, it is possible that purely profit driven shareholders may drive an organization away from its objectives focusing only on financial return indicators (Labie 2000).

According to Clarkson and Deck (1997), there is a conflict where a microfinance institution transforms and combines a social mission with that of profitability. Where the transformed institution comes from the parent company which is an NGO, the board and shareholders will project a governance approach of not for profit in the new institution. While this presents an opportunity to build the NGO's social mission into the governance process, the relationship between the MFI and the NGO needs to be kept at arm's length and include transparency and clear transfer pricing.

Members of shareholders of the MFIs have a duty of protecting, preserving and actively exercising their

supreme authority in annual general meetings (AGMs). However, most of the MFI shareholders do not understand this role and thereby do not attend the AGMs (Miller 2000). This poses one of the challenges for shareholders in creating and strengthening financial services by shareholders and others (Dieter 2001) who, among their many responsibilities have a decisive role in the governance of FSAs. Corporate shareholding is a useful weapon in checking managerial self-dealing on the part of managers (Ricardo 2005). By enforcing adequate corporate governance standards and a quality regulatory and legal environment, shareholders can counterbalance the power of managers who may want to act in connivance with the board (Ricardo 2005).

Financial Reporting and the Governance of FSAs

Research reveals that institutional investors identify a key investment criterion to be financial performance and growth potential. A survey carried out in this regard found out that those investors pursuing a growth strategy did not worry about corporate governance, whilst those who pursued a value strategy are willing to pay for good governance (Agrawal, Findley, Greene, Huang, Jeddy, Lewis and Petry 1996). This means that investors who hold the latter view believe that good governance can reduce risk and attract further investment.

However, a dominant issue in all themes related to corporate governance is the vital importance of disclosure. The more transparent the internal workings of an organization and cash flows, the more difficult it will be for managers and controlling shareholders to expropriate the organization's assets or

mismanage it (International Institute of Finance 2002). Good information is needed for in order for boards and investors to make good decisions (Eccles 2004). At the same time, good corporate governance can improve financial reporting when directors and investors demand the information that is rightfully theirs. In addition, qualitative indicators in terms of financial reporting are an important yardstick in which microfinance organizations can be measured (Ames 2000).

There is a critical need for transparent reporting, industry standards and an opportunity for boards to benchmark their institution against that of similar organizations. This requires a transparent reporting framework, third party verification of information and an understanding of the institution's performance in the context of the broader microfinance industry (Otero 1998). However, where there is a low capacity to understand financial performance reports by board members leads to ineffective supervision of the management which results in low overall FSA performance (Mbole 2004).

Effective financial reporting enables MFIs to compete in mainstream capital markets and interact seamlessly with each other and with other potential business partners (Robinson 2001). To do this requires the definition of standards for financial reporting and information exchange so that MFIs can effectively be documented, analyzed and audited. Weaknesses in ownership and governance should therefore be acknowledged and minimized through the establishment of clear lines of responsibility, staff incentives that promote sustainable outreach and adequate systems to monitor progress towards commercialization.

Accountability and transparency need to be built in through integrated systems and practices and a culture of professional management. This study was an attempt to address these issues especially in MFIs which have received scanty attention with regard to governance. Previous studies have focused mainly on the role of innovative lending practices for improving outreach and sustainability and the impact of MFIs on borrowers but not on governance practices. In Kenya, FSAs have faced various problems such as high default rates, fraud in some, a lack of accountability by the board of directors and disinterest of shareholders in the annual general meetings (Miller 2000). This study was to establish whether the practice of corporate governance had any relation with these problems through four variables; role of the outreach model, role of the board of directors, the role of shareholders and the role of financial reporting.

The Study

This study adopted a descriptive research design that used both quantitative and qualitative data. A questionnaire and focus group discussions were used to collect the necessary information to address the objectives of the study. Three sets of questionnaires were developed and administered to the board of directors, shareholders and the FSA managers. One focus group discussion was held with the board of directors in order to triangulate and invalidate the information from the questionnaires. Data was analyzed using both qualitative and quantitative techniques.

The Sample

The location of this study was the Rift Valley Province of Kenya that has the highest number of FSAs with a total of 12,026 shareholders and varied in terms of formation and clientele. In order to increase the sample's statistical efficiency, non-proportional stratified sampling was applied categorizing membership into Shareholders, Directors and Senior Management. Systematic random sampling was used next leading to a selection of 121 shareholders, 7 managers and 22 directors representing one percent of the total.

Results

In addressing the key variable, role of the outreach model in the governance of FSAs respondents were asked about the ownership, products/services of the FSAs and what they perceived to be the benefits of FSAs. Findings about ownership showed that of the 121 shareholders, only 10 percent acknowledged that they owned the FSAs while the rest, 90 percent were not aware who the owners of the FSAs were. However, all the managers and board of directors knew that FSAs were owned by their respective shareholders. However, regarding the services/products provided by FSAs, a majority of the shareholders, at 90 percent knew these although with variations.

Because shareholders, managers and board members make contributions to the FSAs in the form of shares for safe keeping, it was important to establish the number of shares they held in the FSA. Table 1 illustrates these findings.

Table 1: Number of shares by Shareholders

Shares	Frequency	Percent
One share	25	20.7
Two to five	33	27.3
Six to ten	28	23.1
Eleven to twenty	17	14.5
Twenty one to fifty	12	9.9
Over fifty	6	5.0
Total	121	100.0

These findings show that 95 percent of the shareholders held 20 shares and less. In comparison, the board members of the FSAs had varying shares and it seemed that membership to the board did not depend on the shareholding capacity of each member. A majority of the board members, 27.3 percent owned 11 to 20 shares with only one board member owning more than 50 shares. On the other hand 66 percent of the managers held between 21 and 50 shares.

74 percent of the shareholders were saving with FSAs while 26 percent were making regular contributions in the form of savings with their FSAs. Regarding the frequency of saving, 42.1 percent of the shareholders were saving once a

month in comparison to 33.3 percent of the managers who had saved once a month, 50 percent who were saving weekly and 16.7 percent were saving daily. In this respect, 74 percent of the shareholders had received loans from their FSAs while 26 percent had not borrowed from the FSAs. However, 33.3 percent of the managers had borrowed between one and three times and 66.7 percent of them had borrowed between four and ten times. The findings showed that 22.7 percent of the board of directors were not borrowing loans while 36.4 percent of them had borrowed one to three times and 40.9 percent had borrowed between four and ten times. Table 2 illustrates this.

Table 2: Borrowing from FSAs

Respondents	Directors Percent	Managers Percent	Shareholders Percent
Never Borrowed	22.7	-	26.0
Borrowed Loans 1-3 times	36.4	33.3	74.4
Borrowed Loans 4-10 times	40.9	66.7	-

From these findings, 30.6 percent of the respondents had not borrowed from their FSAs, 50 percent had borrowed one to three times while only 24.8 percent had borrowed between four and ten times. Those who had borrowed between 11 and 20 times accounted for only 1,7

percent. This means that the level of utilization of loan products from the FSAs was low and this affected the survival and sustainability of the FSAs. This could be attributed to the level of awareness generated by the board of

directors and managers in the marketing of FSAs.

Other services/products offered by the FSAs included micro leasing, money transfer and salaries. 82 percent of the shareholders were not using the micro leasing service indicating that only 18 percent were using this service. Only 15 percent accessed the money transfer service while 85 percent did not access this service. 16 percent of the shareholders received their salaries through the FSAs while 84 percent did not. In comparison, managers and the board members were also not accessing the money transfer service. However, the managers received their salaries through the FSAs that they managed. Only one of the managers accessed the micro leasing service.

These findings clearly show that savings and loan products/services were the only popular ones among the shareholders. This also indicated that FSAs have not developed products that are highly marketable and valued by the

shareholders. This could partly be attributed to the limited knowledge and skills in product development and refinement among managers and the board of Directors.

Regarding dividends, only 67 percent of the shareholders earned dividends while 33 percent did not. It thus became important to establish the share prices and the last time dividends were declared. Following this, the findings revealed that the dividends declared in 2004 at Ksh. 10 per share registered were given to 20.7 percent shareholders. This registered the highest percentage that had been given by the FSAs at the time of this study. Dividends declared in 2003 at Ksh. 50 per share were given to 16.5 percent of the shareholders. This was followed closely by those declared in 2005 at Ksh. 13 per share given to 15.7 percent of the shareholders. The infrequency of failing to declare dividends necessitated the need to establish the reasons for this. Table 3 illustrates the findings.

Table 3: Reasons for No Future Dividends

	Frequency	Percent
Increase in defaults	3	2.5
Poor Management	2	1.7
None	96	79.3
Increase in defaults/Poor Management/ High Exit/Low Members	1	0.8
Increase in defaults/high exit/few members	5	4.1
Increase in defaults/Poor management/ High exit	5	4.1
Poor Management/high exit/few members	3	2.5
Poor management/high exit	6	5.0
Total	121	100.0

Seventy-nine percent of the respondents did not expect to earn dividends in future. These findings put to test what the respondents perceived to be the

benefits of FSAs to the community. However the findings here indicated that 88 percent of the shareholders perceived the FSAs to be beneficial to their

communities, leaving only 12 percent who did not. Asked why this was the case, the shareholders who found the FSAs beneficial attributed it to varied reasons. Table 4 illustrates these findings. The 12.4 percent who did not find the FSAs beneficial to their communities felt that the FSAs were beneficial to a few people. A follow up

through focus group discussions showed that due to high rates of default, the FSAs had confiscated their assets so as to offset the loans they had. This negates the purpose of FSAs of contributing more effectively towards poverty reduction. Table 4 presents these findings.

Table 4: Ways in which FSAs Benefit the Community

	Frequency	Percent
1. Cheaper to transact on money transfers and salaries	8	6.6
2. Safety	4	3.3
3. Mobilization of community resources	6	5.0
4. Creates employment	5	4.1
5. Stimulates local economic development	4	3.3
6. None	15	12.4
7. Cheaper to transact/safety/employment economy	31	25.6
8. Cheaper transaction/safety/employment/ stimulates development	14	11.6
9. Safety and creates employment	9	7.4
10. Cheap transactions/mobilization of resources/employment/economic dev	9	7.4
11. Safety/create employment/econ dev.	16	13.2
Total	121	100.0

Asked about what they felt were the determinants of FSA failure and success, 90 percent of the shareholders felt that good leadership would make their respective FSAs more successful while at the same time, poor leadership would lead to failure. Eighty six shareholders who accounted for 71 percent were of the opinion that for the FSA to be successful there had to be growth in the client base. 29 percent noted that the success of their FSAs did not depend on increasing the clientele base but depended on ensuring quality of services and products delivered to members were poor and thus could not attract new clients to join their respective FSAs as members.

To identify their role in governance, twenty two board members responded to the questionnaire and were also involved in a focus group discussion. The key variables here included length of membership held, role of board of directors focusing on fraud management and performance review. On the other hand, seven FSAs managers responded to the questionnaire. Each FSA had one manager who was in charge of the daily operations. The manager was in charge of the budget and human resources and ensured that clients were well served. The role of the FSA manager was to guard and support FSA activities and articulate interests of shareholders in the daily affairs and the management of the

FSA. The manager provided policy guidance to board members and ensured that the board plays its oversight function effectively.

22.7 percent of the board members had been FSA members for a period less than 12 months, while 50 percent had been members for 49 months leaving 27.1 percent who had been members for a period of 13 to 48 months. In comparison, 33.3 percent of the managers had been members of the FSA for more than 49 months and the other 33.3 percent had been members of the FSA for 37- 48 months. Only 6.7 percent of the managers had been members of the FSA for 7 -12 months. Those that had been members for a longer time also happened to be the most preferred in being appointed as managers.

91 percent were aged between 31 and 50 years, while 4.5 percent were aged above 50 years and a similar number were younger than 30 years. 33.3 of the managers fell between the ages of 21 to 30 years while 50 percent were between 31 to 40 years of age. Only 16.7 percent fell in the age bracket of 41 and 50 years of age. This shows that the FSA management was composed of young energetic people who are also economically active in the population. This means that FSAs only target those who are economically active leaving out sections of the population. This marginalizes other community members and the social capital of those marginalized is not tapped for sustainable poverty reduction. In comparison, Managers were also members of FSAs for a substantial time.

Sixty percent of the board members and the managers had attained an education beyond the secondary school. This meant that a majority of them had received good education that qualified

them to be FSA board members or managers. However, regarding the skills acquired, 36.4 percent had the teaching skills followed by 18.2 percent who had legal skills and a similar number with accounting skills. This was a variety of skills that the board members and managers needed in order to fulfill their responsibilities.

In contrast to the board members, after being recruited, all managers underwent orientation. 66.7 percent respondents underwent orientation for one week or less, 16.7 percent of them went through orientation for two weeks and 16.7 percent underwent a one month orientation. The areas covered during orientation for all the respondents were loan policies, financial procedures and FSA operations. Other areas covered were human resource management which was attended by three respondents. Four respondents went through orientation on board requirements by reviewing the board manual and one respondent received orientation on the role of the credit committee. This orientation was weak as it did not touch on the performance targets and the good governance practices to be adopted.

Board meetings were held monthly and the board members indicated that they had a timetable for board meetings, although in most cases this was not followed. During their meetings, the board members acknowledged that they were informed about various issues regarding FSA governance and performance. Both the chairperson and the manager set the agenda for discussion during board meetings. In some FSAs, it was the responsibility of the manager to generate the agenda to be discussed in every staff meeting. Managers in this case were active

participants in setting the FSA staff agenda to be discussed. It is argued that the quality of FSA governance depends on the degree of participation of the board members and managers in the meetings called by their respective FSAs. However, low participation by the board members and managers in their FSA monthly meetings was recorded. This negatively affected the governance of FSAs. In addition, FSA staff meetings were irregularly held. Only 33.3 percent of the managers indicated that staff meetings were held fortnightly while 66.7 of them indicated that staff meetings were held monthly. Yet it is through these meetings that the governance of FSA is realized. In addition, it was observed that the meetings did not provide forums for learning and sharing lessons to improve the FSA performance. Discussions and agendas were only centered on loans and savings received from shareholders. This was corroborated by the shareholders who indicated that they attended meetings when discussions revolved around savings and loans which they considered a critical FSA activity. This accounted for 65 percent of the shareholders who participated in *Kikundi Cha Mkopo*³ (KCM).

Although 65 percent shareholders participated in the KCM meetings, 35 percent of them indicated that the quality of these meetings was low since the meetings did not always result in minimizing default since the sanctions passed during these meetings were not imposed by the management. 78 percent of the shareholders attributed their

failure to participate in FSA meetings and activities to bad leadership

Board members were involved in the activities of the credit committee. 36.4 percent were ordinary members, 31.8 percent were chair persons of the credit committees, while 4.5 percent were secretaries of their respective FSAs. 27.3 percent did not occupy any position in the credit committees of the FSAs. In addition to providing oversight functions, the board members also ensured that the decisions that were made were implemented. 50 percent were required to approve changes in the loan disbursement or credit policy or even changing the interest rates. However, the majority of board members, 59.1 percent were not in the credit committees. Table 5 illustrates these findings.

³ “Kikundi cha Mkopo” is a Swahili phrase meaning a group of shareholders who either took or were eligible to take loans from their respective FSAs

Table 5: Roles of Credit Committees

		Frequency	Percent
1.	Loan appraisal	1	4.5
2.	Loan appraisal/approval/disbursement/ follow-up/review/ application/training	3	13.6
3.	Loan appraisal/approval/follow-up/review application/training	3	13.6
4.	Loan approval/loan follow-up/review of loan application	2	9.1
5.	Not in credit committee	13	59.1
	Total	22	100.0

36.4 percent were ordinary members of the audit committees, 31.8 percent were chairpersons, and 4.5 percent were secretaries while 27.3 percent did not play any role in the audit committees. The most important role of the audit committee was to ensure adherence to policies, detect fraud and identify system weaknesses. This was supported by 50 percent of the board members who indicated that they used audit to detect fraud. However, with 45.5 percent not belonging to or playing a role in the audit committee, weakened adherence to policies and in turn influenced the governance of FSAs.

The role of the executive committee included recruiting staff, supervising managers, providing strategic leadership, fund raising, reporting to the shareholders, ensuring adherence to the mission, acting as bank signatories and enforcing agreements with third parties. Only 41 percent of the board members were playing all these roles while nine percent were involved in nearly all of them except the bank signatory role. Five percent were involved in all except

fund raising. However, 45 percent of the board members were not members of the executive committee. These findings indicate that the executive committee was not playing its roles effectively in the respective FSAs as only 45 percent were performing their roles in the executive committee satisfactorily. Roles and membership to this committee were also not clearly defined and there were conflicts of interest.

There were limited incentives to motivate board members. 40.9 percent became board members due to their interest in serving people, while 27.3 percent was a combination of their interest in serving people and pressure from the community. Pressure from the community accounted for 18.2 percent with 9.1 indicated that it was due to their professional qualifications. Only 4.5 percent became board members by virtue of being major shareholders coupled with their experience. Table 6 presents these findings

Table 6: Reasons for interest in serving on the board

	Frequency	Percent
1. Pressure from the community	4	18.2
2. Professional qualification	2	9.1
3. Interest in serving people	9	40.9
4. pressure from the community and interest in serving people	6	27.3
5. Major shareholder and past experience	1	4.5
Total	22	100.0

However, the findings from the shareholders indicated that 56.2 percent of them participated in the elections of board members. A high percentage therefore did not participate in the elections. The reasons for non participation were varied. However, 27.3 percent of them were not available and 8.3 percent were not informed while 5.8 percent were not interested. The process used to elect board members can greatly affect ownership and accountability. Board members who are elected have a status that gives them an enhanced legitimacy and credibility in the minds of their board colleagues and shareholders. In this regard, 65 percent were satisfied with the performance of their board members, leaving 35 percent who were not satisfied. This latter group attributed their dissatisfaction to lack of

feedback, inaccurate reports, poor loan appraisal, poor default management and poor timings for AGMs.

63.6 percent board members noted FSAs experienced fraud committed by staff members whereas 9.1 percent noted that fraud was committed by board members. About 27.3 percent board members noted that their respective FSAs had not experienced fraud as shown in Table 7. These findings indicated that fraud management in FSAs was weak since punishment did not go beyond sacking of the staff or board members involved. For instance, 63.6 percent of the sacked staff/board members, only 9.1 percent were taken to court. This means that money lost through fraud was not recovered by FSAs.

Table 7: Person involved in Fraud and the deterrent mechanisms

	Frequency	Percent
Staff	14	63.6
Board member	2	9.1
Have not experienced fraud	16	27.3
Total	22	100.0
1. Impromptu audits intensified	1	4.5
2. Revised policies/training of staff/ impromptu audits/segregation of duties/	4	18.2
3. Impromptu audits intensified/segregation		

of duties	3	13.6
4. Training of staff/board and impromptu visits and segregation of duties	4	18.2
5. None	6	27.3
6. Training of staff/board and impromptu audits intensified	3	13.6
7. Revised policies and training of staff/board	1	4.5
Total	22	100.0

Mechanisms for deterring further fraud were weak as indicated in the Table 7 with 27.3 percent respondents acknowledging that there were no mechanisms that had been put in place to deter fraud. Only 4.5 percent of the board members noted that impromptu audits were intensified to deter fraud, 18.2 percent noted that policies were revised staff trained, impromptu audits intensified and duties segregated, while 13.6 percent noted that staff and board members were trained, impromptu audits intensified and 4.5 percent noted that policies were revised and staff and board members trained to deter fraud. In addition, shareholders did not actively participate in the process of following up defaulters as accounted for by 71 percent. Fraud, coupled with loan defaulting puts the FSAs at risk. These findings indicated an abdication of responsibility by the management.

Findings indicated that though managers received a variety of trainings, they were insufficient and did not address the felt needs of the respective FSAs. Training is important in drawing the attention of the managers to critical

governance practices. However, training in the FSAs was never used for this cause. The findings indicated that trainings did not address the needs of the respective FSAs, took very short time and were implemented haphazardly without a systematic or clear policy.

Regarding the review of performance the board members noted that the review of the managers was done four times a year. Only 27.3 percent noted that performance review was done monthly, 4.5 percent noted that it was done bi-annually and 14.2 indicated that performance review was done once a year. However, it was noted that this performance review was not based on any benchmark or threshold.

Board members were weak safeguarding the FSA mission. Only 45.5 percent indicated that they adhered to FSA policies/secured target group/focus on geographical area as indicated in Table 9. Only 40.9 percent adhered to FSA policies, 4.5 percent adhered to policies and focused on their geographical locations and 9.1 percent adhered to their policies and continued to secure their target groups.

Table 8: Board's ways of ensuring adherence to FSA Mission

	Frequency	Percent
1. Adherence to policy/secure target group/ focus on geographical area	10	45.5
2. Ensure adherence to policy /continue to		

secure target group	2	9.1
3. Adherence to policies/focus on geographical locations	1	4.5
4. Ensure adherence to policies	9	40.9
Total	22	100.0

The boards of all the FSAs reviewed the overall budget. However internal audits did not function well in detecting frauds and final audits reports at times, and did not reflect the true picture of the financial position of the FSA. 50 percent of the board members indicated that it was the shareholders who appointed external auditors during the annual general meeting (AGM). 31.8 percent noted that it was the board members and the promoting organization which is K-REP that appointed auditors. 4.5 percent noted that it was only the promoting organization that appointed and 13.6percent noted that it was the board of directors that appointed auditors. These findings indicate that there was no proper procedure in appointing external auditors which contributed to the weakness in detecting and deterring fraud.

90.9 percent of the board of directors indicated that they participated in developing a strategic plan for their respective FSAs whereas 9.1 percent did. Out of those who did, 37.8 percent of them indicated that those included in the process consisted of staff, board members and shareholders and 22.7 percent indicated that developing the strategic plan was carried out by board members, staff and the promoting organizations.

The criteria that FSA board members used to recruit staff was to advertise, short list and interview based on qualifications. Based on the findings of FGDs, some staff members were

recruited without following this process. Over 68 percent noted that they had developed procurement policies, while 32 percent did not have a procurement policy. Despite the existence of the procurement policies in most of the FSAs, implementation of the same was weak. Only 4.5 percent maintained an inventory of suppliers, 63.6 percent implemented the policy through audit while 31.8 percent had not implemented their procurement policies.

54.5 of the board members acknowledged that conflicts were discussed at the board level, 4.5 percent noted that conflicts were discussed during AGMs, and 18.2 percent noted that there were no policies in their respective FSAs that dealt with conflict resolution. 22.7 percent noted that conflicts of interest were discussed at both the board level and during AGMs.

Shareholders acknowledged receiving different reports from the board members during the AGMs. However, the level of understanding the technical/financial information by the shareholders was too low. This did not allow the shareholders control over the boards and managers. Managers enjoyed better access to information on the financial performance of the FSAs. 33.3 percent of the managers produced and gave the board the balance sheets monthly, 83.3 percent of them prepared monthly reports; however, 50 percent of them did not incorporate productivity reports to the board members. These findings show that managers also used this position to defraud the FSAs since it

was possible for them to hide information from the board members and the shareholders.

Discussion and Implications

The findings suggest that the governance of FSAs is fairly strong when looked at from the FSA perspective. These findings are consistent with those of Ngirini (2001) who concluded that shareholder-owned MFIs are typically owned by a small group of investors, with no one investor in a controlling position and most board members directly representing specific shareholders. The close link between owners and governance creates characteristic strengths and weaknesses among MFI boards. The greatest strength is that investors take governance seriously. Investor representatives tend to show high attendance at board meetings. In this regard, ownership structures play an important role in the operation of the FSA since the members accept full ownership and responsibility of the FSA.

The findings of this study showed that issuing loans is pegged on shares thus, boosting governance. This is consistent with Pucko (2004) who posits that problems such as adverse selection and moral hazard often associated with loans to rural people are addressed through village banks. The village bank's local knowledge ensures good borrower selection that reduces the risk of adverse selection and the identification of borrowers through the share-holding mechanisms reduces moral hazard. Since the loan amount is linked to a member's share value, these village banks have the potential to trigger increased participation from the villagers (DFID 2000; Jazayeri 2000; Pearce and Helms 2001). The focus of

these FSAs should be financing bankable activities and projects within the community. Such lending, it can be argued, will result in increased employment, development and overall improvement of the community. Thus, the success of the village bank could spill over to non-members who will eventually become members of the local village bank.

The findings of this study show that the boards of directors in the FSAs do not have adequate capacity to execute its oversight functions. The board's weakness is derived from the fact that the shareholding determines a slot in the board of directors. This is consistent with the findings of Mazerolle (2004) who researched the efficacy of FSA brands and concluded that when board representation is determined by shareholding percentages, little room is left for independent directors (defined as directors who are neither direct shareholder representatives, nor members of management) who can take an institution wide perspective, or who can bring the perspective of other stakeholders. The use of independent directors should be priority for improving governance among shareholder owned MFIs.

The findings did show that the board members have low levels of education with most of them lacking the relevant training in financial management. In addition, the findings revealed that most of the audit committee members were not qualified accountants nor was there an independent member in the committee, evidence of poor governance. This is consistent with Gillian and Starks (2002) who concluded that FSAs are ineffective because they lack human capacity in rural areas required to carry out the management

and operation activities necessary to provide financial services. For the board to effectively monitor solvency, liquidity and profitability while keeping the organization mission, at least some board members must be deeply experienced in banking and finance with the ability to make sound business judgments.

The findings did show that the structure in place does allow managers to contribute to good governance in the FSAs. The managers were also members of the FSAs and owned shares. This goes to reduce the propensity for managerial self dealing as it aligns their interests with those of the shareholders. Although this may not be a complete answer in addressing the governance problem, one way to control how managers use discretionary power over the firm's resources is to use contractual mechanisms – incentive and contingent-incentive.

The findings of this study showed that the shareholders took an active role in the governance of the FSAs. Their attendance of AGMs for instance, stood at 80 percent, and they participated in electing board members. The biggest shortcoming however, is the fact that the shareholders are individuals residing in the locality with the obvious absence of institutional shareholders. The use of independent shareholders should be a priority for FSAs. This is in line with the requirement in most counties that at least 25 percent be independent/institutional investors. These use their position as a large controller of voting rights and their presence on the board of directors helps to monitor and influence the management towards profit maximization (Ngirini 2001).

The findings also revealed that the FSAs studied were not up to the task in

as far as financial reporting is concerned thus pointing to some underlying poor governance. Shareholders were seldom given updates and the majority of those perpetuating fraud were merely sacked but were not taken to court to face the law. Although some research indicates that financial reporting should not be an end in itself (Otero 1998) some of it has confirmed an association between weaknesses in governance and poor financial reporting quality, earnings manipulation, financial statement fraud, and weaker internal controls (Agrawal et.al 1996; Ames 2000; Mbole 2004; Robinson 2001; Yetman 2004). It is the responsibility of governance to enforce an improved understanding of the three elements of financial reporting, to demand them from management and to incorporate them effectively into their governance practices.

Further research should be carried out to test the relationship between governance and the performance of FSAs operating in urban areas. Additional research could address the appropriate regulatory structures of FSAs.

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