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MFIs IN INDIA: ROLE OF INDEPENDENT DIRECTORS IN ENSURING THE TRADE-OFF BETWEEN SOCIAL AND FINANCIAL GOALS

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ABSTRACT

A company is managed by Board of Directors (BODs) on behalf of its shareholders. To check whether the board of directors are working for the interest of the company and its stakeholders or for their own self-interest, a proper monitoring is required. To meet the purpose of proper monitoring, need of Independent Directors (IDs) arises around the world. These IDs are outsiders to the company and are independent in their perspectives, views and decision making. They monitor the Executive Directors (EDs) who take decisions related to policy making and day to day business affairs. This paper attempts to depict the role of independent directors in Micro Finance Institutions (MFIs) in India. The concept of IDs was introduced late in India. Role and provisions related to IDs didn't get much attention earlier and its need was realized in recent past. When SEBI made their appointments mandatory, IDs were misused by the companies resulting into many scams for which the society faced critical consequences and Microfinance Institutions (MFIs) are one of the examples. MFIs failed to monitor Executive Directors (EDs). Despite of the fact that MFIs in India recorded a rapid growth, failure of corporate governance in MFI sector is evident from the losses faced by them and its clients committed suicides when failed to pay back the loans. Findings of the paper show that the regulatory bodies of India impose conflicting and differing compliance requirements pertinent to Independent Directors (IDs) i.e. appointment of independent directors, remuneration etc. which lead to destitution and increased cost of compliance to the company and ultimately created loopholes in the corporate governance practices. This paper concludes that if theoretical concept of Independent Directors (IDs) is sincerely adopted and practiced in reality, it will surely bring radical changes in catering the financial services at reasonable price to poor clients and profits to institutions of Microfinance Sector in India.

KEYWORDS : *Independent Directors, Corporate Governance, Companies Act 2013, SEBI, MFIs.*

INTRODUCTION :

India coped safely from financial crisis of 2008 and businesses in India were running fine but some serious concerns were there which appeared in later on. The year 2009 witnessed Satyam Scam

which was so huge that it created a question mark on corporate governance practices in India. Role of Independent directors which once considered as independent and fair in decision making came under the purview of enquiry. The importance of appointment of Independent Directors (IDs) was not recognized earlier therefore there is no provision given in the Companies Act, 1956 which is also referred as "the Act, 1956". The companies Act, 2013 first time mentioned and introduced the concept of IDs therefore one can understand how much India was lagging behind in acknowledging its worth. Although, SEBI appointed Kumar Mangalam Birla Committee (2000) for Corporate Governance practices, brought the term 'Independent Director'. This term was further given more thought by Government appointed committee headed by Naresh Chandra (2002) and finally SEBI appointed Narayana Murthy Committee (2003) declared the appointment of Independent Directors (IDs) on the board mandatory by affecting changes in clause 49 of listing agreement. This was done to make the act globally compliant and for protecting the interest of investors and customers.

Microfinance Institutions (MFIs) are established with the objective to cater the range of financial services to poor and marginalized population. MFIs act as an intermediary to channelize their savings and provide them loan, insurance etc. Although they charge a high rate of interest for their services but it is still less than what they pay to moneylenders.

The governance framework of the MFIs in India is suffering from severe deficiencies. There are many MFIs which are dominated and controlled by promoter shareholders and hence Board of Directors' decision making related to internal control, remuneration, connected lending are affected and influenced by them. Some of them are trying to attain high growth at the cost of best corporate governance practices and ignore the basic objective of meeting the need of financial requirements of poor at reasonable rate. This mismatch causes suffering to them and also resulting into some major frauds and scams which we have seen in the recent past.

LITERATURE REVIEW

Some studies showed that the firms having high proportion of independent directors may perform worse. Patton and Baker (1987) argued the tenacity of outside directors to keenly monitor the top management is mostly biased. This is due to the fact that Board often recruit and select these outside directors on the board. Rosenstein and Wyatt (1997) claimed that as compared to the outside directors, the insiders have more knowledge pertinent to the firm and its industry. Jacobs, Mbeba and Harrington (2007) found in their study that Board members whose primary loyalty is to the CEO may hesitate to challenge him or her or demand accountability, particularly if these members lack technical qualifications.

On the other hand, Sahin, Basfirinci and Ozsalih (2011); Dunn and Sainty (2009) in their study stated that the Agency Theory and the Resource Dependence Theory argue that a large number of independent board members may contribute to the decision process, enhance the firm's image and lead to better performance.

Former Governor of Reserve Bank of India (RBI) Dr. Y V Reddy in an article titled 'Microfinance Industry in India: Some thoughts' in Economic and Political Weekly (EPW) (October 8, 2011) described that how situation got worsen in Andhra Pradesh due to failure of good corporate governance framework.

Arunachalam (2010) found that the ownership structure of Indian MFIs is dominated by family and friends groups, thus the board structure is characterized by inadequate checks and balance of executives, lack of transparency in reporting, lack of independent board nomination, insufficient transparency about ownership and conflict of interest at various levels of management. In many Indian

MFIs, it is practiced that the promoter (most of the time) also assumed the position of the CEO. In such cases, the promoter hires the board instead of board hiring the CEO, which should be the desired practice. In such situation, the independence of Independent Directors (IDs) is questionable.

Marr and Tubaro (2011) pointed out that the excessive growth in the microfinance sector was resulted due to inflated interest rate which is blamed for increased over-indebtedness of clients. The over-supply of microcredit is made with little control on clients' creditworthiness and without much consideration of the fragility of the poor people. Also, lack of diversification and concentration of the MFIs in few areas intensified the crises. Arunachalam (2011),Franke et al (2011) and Marr and Tubaro (2011) on the other hand revealed that core cause of the crisis lays on lack of control and monitoring of operational activities by board and management. It was aggravated because boards were not truly independent not even institutional nominee directors who were inactive and lack diligence in controlling the activity of the MFIs. These directors turned ignorant when MFIs disbursing excessive loans and selling of IPOs.

OBJECTIVE

To understand the role of Independent Directors (IDs) in ensuring trade-off between social and financial goals of Micro Finance Institutions (MFIs) in India.

RESEARCH METHODOLOGY

This study is based on secondary data. Extensive literature review was done and data were collected from various sources like, research papers, newspaper articles, media reports and websites of RBI, Ministry of Corporate Affairs to develop this theoretical study.

INDEPENDENT DIRECTORS (IDs)

America's Sarbanes-Oxley Act (2002) defined Independent Director as "A member who, other than in his capacity as a board member may not (a) accept any consulting, advisory; or other' compensatory fee from the company; or (b) be an affiliated person of the company or any subsidiary thereof and other advisers, as it determines necessary to carry out its duties."

"Independent Directors are those directors do not own any shares in the company."

"The Companies Act, 2013 restricted independent directors to hold office for a tenure up to two consecutive terms, each term of upto 5 years and would be eligible for appointment only after a cooling period of 3 years."

ARE INDEPENDENT DIRECTORS REALLY INDEPENDENT?

Being independent means the decisions and contribution made to the policy making are free from bias and for the sole purpose of shareholders and stakeholders welfare. Seeing the loopholes it is debatable that how much these Independent Directors are actually independent. There was a research conducted in 2013 by proxy advisory firm 'InGovern' for corporate governance structure which included top 100 companies of the country. The details of the report revealed that large proportion of the independent directors on the board of a company spent several years.

List of few Independent Directors (IDs) are given below:

S.N.	Name of Independent Director	Company on which they	Tenure
1	Keshub Mahindra	HDFC	36 years
2	J K Setna	Colgate Palmolive's board	35-year
3	Nusli Wadia	Tata Steel	34-year
4	C M Maniar	Hindalco Industries' board	31-year
5	R A Shah	Colgate Palmolive	30 years
6	H R Manchanda	Cipla	30 years
7	M L Bhakta	Ambuja Cements	28 years
8	T K Balaji	Titan Industries	27 years
9	M L Apte	Grasim Industries	26 years
10	Yogendra P Trivedi	Reliance Industries	21 years

Source: InGovern, 2013

No one can call a member 'independent' if that person spent so many years on the same board. Some other results are:

The average tenure of independent directors (top 100 companies selected for study).	About 7 years
Attendance of directors in board meetings (top 100 companies selected for study).	17 % of directors on an average had less than 75 % attendance, In spite of the fact that Ministry of Corporate Affairs (MCA) allowed attendance by video or telephone.
Independent directors (IDs) serving the company boards for a tenure of 20 years or more.	At least 10
Independent directors (IDs) who hold on boards of ten or more companies.	10

Source: InGovern, 2013

Under the Companies Act 2013, listed companies and some specified classes of companies are required to constitute a remuneration and nomination committee. Even though, the law gives the shareholders the right to appoint directors but in practice, the dominant shareholder used to appoints directors including independent directors. These shareholder manages the company through its nominee managers and the Board has very little say in the appointment of CEO, directors or senior management.

The Corporate sector in India is dominated by Public sector enterprises, family businesses and group companies. In Public Sector Enterprises (PSEs), the government, which is the dominant shareholder appoints independent directors (IDs) and indirectly formulates corporate strategies while autonomy to decide on investment up to specified limits is given to them. Independent directors are nominees of the government and it can remove them at will which makes it evident that independent directors in PSEs are not independent of the government. In case of family-managed company, family governance takes priority over the governance of the company. Company belonging to business group, group policy assumes priority in decision-making.

There is a need to bring clarity in the definition of Independent Director and it should be in line with globally-accepted standards. The independent directors should be appointed without any bias. The independent directors should always ensure that the chances of inefficient, extra, overestimated expenses and diversion of funds are avoided in the decisions. There should be a database of people who can be appointed as Independent Directors. There could be specially designated independent directors who oversee the interest of the clients. There is a need to overcome the shortage of independent directors in the sector and to reduce the supply-demand gap as none of the regulatory bodies in India has clearly mentioned the extent of their liability.

There is a need to decide the maximum number of MFIs on which a person can serve as an independent director as holding a position of independent director on several boards at any one point in time affect the quality of directorship. As the purpose of Microfinance Institutions (MFIs is to serve the poor and unbanked people therefore care should be taken by the board members in demanding higher remuneration which ultimately will be bear by the poor in the form of high interest rates and competition of over selling of credits to compensate remuneration payment.

The eligibility requirement such as age, expertise and experience for independent directors should be clear and it should be ensured that the they devote at least minimum number of hours at certain interval of time to understand the business, which they monitoring. This will help in understanding micro-finance business and will bring insights of the MFIs to them. This will make them to actively participate in the board decision making and help them to provide guidance on strategic aspects, as and when required.

CONCLUSIONS

Dominance of either management or board should be avoided and functions should be balanced. Good governance is a must for long run profitability and sustainability of the MFIs. The use of independent directors should be a priority for improving governance among MFIs. The CMA (2002) and BBVA Microfinance Foundation (2011a) recommended that the board should include at least one third of independent directors. Mere fulfilment of minimum number of Independent Directors criterion on the board will not be able to bring good governance in the MFIs. Instead, other criteria of the independent directors such as their duration on one board, their experience and exposure to microfinance principles and operations should also be considered. As directors other than independent directors signify specific interests and they might overlook the larger interest of the company and also the interest of those stakeholders who do not have a voice on the board. One cannot ignore the fact that the need for independent directors is more acute in MFIs as the customers are abundant and vulnerable. Being significant stakeholder and the purpose for which MFIs came in existence, customers' interest should be a priority which need to be protected. Generally, they do not have the reach to top level management in the company. In spite of having Independent directors on the boards, severe situations were witnessed in the past. It should not be concluded as they are not effective and cost enhancer, as our regulatory bodies have conflicting and incomplete definition and provisions related to them. It is also evident that due to poor governance standards and practices of the MFIs, independent directors also suffer reputation risk. This is because, they are appointed for being independent, fair and unbiased in their decision making and decisions taken under their monitoring should be free from any influence of the top management. Although, no amount of regulation will help to eliminate frauds altogether. There is a need for stricter, stronger and quick law enforcement by regulatory bodies so that it will act as a deterrent for others.

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