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Determinants of the governance quality of microfinance institutions

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ABSTRACT

The objective of this article is twofold: identify the primary board characteristics that drive the quality of MFI governance and link governance quality to microfinance institutions' outreach performance. We measure governance quality with the governance rating score provided by Planet Rating, one of the agencies that specialize in the rating of microfinance institutions. The study focuses on an independently pooled cross-section sample of 178 MFIs rated by Planet Rating from 2001 to 2011. Findings obtained after controlling for selection bias suggest that board expertise, board activity, and ownership type are the main board characteristics that significantly determine the quality of MFI governance. Findings seem to be robust when we change the measurement of board size and ownership type. Moreover, MFIs with an effective governance system tend to serve large numbers of customers.

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1. Introduction

In developing and newly industrialized countries, microfinance institutions (MFIs) provide financial services to people and micro entrepreneurs who are economically excluded by the banking sector. The financial inclusion by these organizations of the poor and micro and small entrepreneurs is now undeniable and has been evidenced in recent reports by the Microcredit Summit (Reed, 2011) and through Muhammad Yunus's Nobel Peace Prize award in 2006. MFIs play their role in the financing of the economy, and today microfinance is a major component of the financial system in most developing countries. The proven success of microfinance, though, seems to be diminished by some scandals linked to a series of suicides in India's Andhra Pradesh state and to some unsuccessful cases in Latin America. A recent case study on 10 unsuccessful MFIs in Latin America documents that governance was the primary differentiating factor between MFIs that managed to overcome a crisis and those that did not (Marulanda, Fajury, Mariana Paredes, & Gomez, 2010). Moreover, the result of the Centre for the Study of Financial Innovation [CSFI] survey of microfinance banana skins from 2008 to 2012 ranks corporate governance issues in the top 10 risks facing the microfinance industry. In a recent survey (CSFI, 2012), concerns about the strength of corporate governance in the microfinance sector is ranked as one of the major risks that limits MFI efficiency, after over-indebtedness. The microfinance scandals seem to be attributed largely to the ineffectiveness of MFI governance and mainly that of the board of directors, which is the apex body of an organization's internal governance system (Fama & Jensen, 1983; Jensen, 1993; Rock, Otero, & Saltzman, 1998). According to Jensen (1993), the board of directors plays a central role in the governance system in that it advises and monitors the manager and implements mechanisms that can reduce managerial discretion. A better internal control system contributes to preserving organizational assets. A problem in the internal governance mechanism can explain the failure of certain institutions.

The corporate governance literature highlights that the effectiveness of the board of directors in its monitoring and advising roles depends on its independence, size, expertise, and motivation. In the microfinance sector, the creation of subcommittees, the board expertise, the activity of the board of directors and board subcommittees, and the separation of CEO and chairman functions are among MFI governance best practices (Council of Microfinance Equity Funds [CMEF], 2012; Marulanda et al., 2010; Pistelli et al.,

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2012; Rock et al., 1998). Implementing these governance best practices may help avoid suboptimal behaviors and lead managers to undertake decisions in favor of MFI financial and social performance.

Previous empirical research on microfinance governance investigates whether better governance improves MFI financial and social performance (Hartarska, 2005; Mersland & Strøm, 2009; Mori, Golesorkhi, Randøy, & Hermes, 2015; Tchakoute Tchuigoua, 2011), risk taking (Galema, Lensink, & Mersland, 2012), and efficiency (Hartarska & Mersland, 2012). Hartarska (2005) studies a sample of MFIs based in Eastern Europe and Central Asia and finds no relationship among board size, financial expertise, and financial performance. Except for local directors and the presence of an internal board auditor, Mersland and Strøm (2009) find inconsistent results regarding the effect of other board-level variables, such as board size and CEO–chairman duality. Hartarska and Mersland (2012) link governance and efficiency. They highlight a nonlinear relationship between board size and efficiency and show that MFIs with CEO–chairman duality are less efficient. Galema et al. (2012) focus on the relationship between CEO–chairman duality and risk taking and studied a sample of 280 rated microfinance institutions. Their results suggest that powerful CEOs of microfinance NGOs have more decision-making freedom than powerful CEOs of other types of MFIs. This induces them to make more extreme decisions that increase risk. Microfinance literature that relies on board characteristics yields no conclusive evidence regarding the role played by board size and composition, ownership structures, and incentive mechanisms. Tchakoute Tchuigoua (2012) uses individual governance mechanism to explain MFI ratings, that is, performance assessment ratings. Being better governed tends to increase the likelihood of MFIs enjoying a better rating. Common to all these previous studies on the governance of MFIs is that they use single governance indicators. In addition, the results of these studies do not always converge and suggest that the relationship between the quality of governance and performance of MFIs is difficult to establish and weak when it exists. MFI governance structure would not be effective. Yet the general literature on corporate governance suggests that corporate governance is relevant to understand firm performance and efficiency. The inconsistent results on the link between governance and performance of MFIs could result from a problem of measuring the quality of governance. Larcker et al. (2007) rightly note that the use of single corporate governance indicators leads to measurement errors yielding biased and inconsistent results. In this article we proxy the effectiveness of the governance system of microfinance institutions by the governance rating score (index) provided by Planet Rating, one of the rating agencies specialized in MFI ratings.

Our study is part of a project whose purpose is to review the effectiveness of MFI governance systems and thus answers two questions. First, does implementing best governance practices increases the effectiveness of MFI governance systems? The main assumption is that MFIs that implement good governance practices at the board level will be perceived by rating agencies as effective in their missions. We thus highlight the individual governance mechanisms perceived as determinants by Planet Rating in the attribution of the governance score. This article emphasizes board size, activity, expertise, CEO–chairman duality, number of board committees, and the presence of an audit committee after controlling for MFI characteristics and the institutional environment. The second question is, do better governed MFIs have better outreach?

The article studies an independently pooled cross-section sample consisting of 178 MFIs rated from 2001 to 2011 and contributes to the microfinance and governance literature in at least three ways. First, previous studies have hypothesized that individual governance mechanisms are considered effective if they have a positive impact on the financial, market, or social performance of organizations. In this study we consider that an individual mechanism is effective if it increases the likelihood of a microfinance institution having a better governance rating. Second, to our knowledge, Hudon (2010) is one of the few studies that have used governance ratings. Hudon (2010) previously examines the determinants of the quality of MFI management, proxied by the governance score assigned by Planet Rating, and then answers the question of whether better managed MFIs receive more donor subsidies. He emphasizes MFI size, maturity, and legal status. To date, our study seems to be the first to estimate the effect of the implementation of best governance practices at the board level on the perceived quality of the MFI governance system. We thus extend Hudon (2010) in at least three ways: (1) we study a large sample that comprises 178 MFIs rated by Planet Rating; (2) we go beyond financial performance, size, and legal statutes and take into account governance variables (we assume that implementing governance best practices may increase the likelihood of an MFI enjoying a better governance rating); (3) in this study, we proxy the governance effectiveness by the governance quality index or perceived governance quality. However, unlike Hudon (2010), we control for selection bias, given that only MFIs that decide to be rated by Planet Rating can obtain a governance score. Third, by linking governance quality to MFI outreach performance, we also extend Hudon (2010) and previous studies that relate individual governance mechanism to MFI social performance (Hartarska, 2005; Mersland & Strøm, 2009; Mori et al., 2015; Tchakoute Tchuigoua, 2011). Findings obtained after controlling for selection bias suggest that board expertise, board activity, and ownership type are the main board characteristics that significantly determine the quality of MFI governance. Findings seem to be robust when we change the measurement of board size and ownership type. Moreover, MFI governance quality matters in explaining MFI outreach.

The remainder of this article is organized into five sections: Section 2 is devoted to hypotheses development, Section 3 describes the research design, Section 4 presents and discusses the empirical findings, Section 5 describes the sensitivity analysis, and Section 6 presents the conclusion.

2. Hypotheses development

2.1. Board size and governance effectiveness

From the literature on corporate governance, there is no consensus regarding the optimal size for the effective functioning of the organization's board. Small seems to be beautiful given that large boards are less effective because of agency problems. Jensen (1993) argues that the optimum board size for an efficient operation is eight members. Beyond this threshold, the board no longer works efficiently as a governance mechanism and is easier for the CEO to control. Agency risks appear to be more important in large boards. Free-riding behavior and conflicts of interest, coupled with information asymmetries between insiders and independent directors (Harris & Raviv, 2008), negatively affect board effectiveness. Resolving coordination problems or minimizing agency conflicts in large boards tends to distract this body from its main tasks and offers therefore wide managerial discretion to the manager. According to CMEF (2012), the MFI optimal board size, that is, a board that is large enough to ensure effectiveness and quorums for meetings, is between seven and nine members. A recent descriptive study (Pistelli et al., 2012) finds that the median board size is 7 members, the minimum being

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