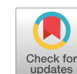
Journal of Business Research 94 (2019) 1–17

Contents lists available at ScienceDirect

Journal of Business Research

journal homepage: www.elsevier.com/locate/jbusres

The effect of loan approval decentralization on microfinance institutions' outreach and loan portfolio quality[☆]



Hubert Tchakoute-Tchuigoua[a,*], Issouf Soumaré[b]

[a] Department of Finance and Accounting, KEDGE Business School, 680 Cours de la Libération, 33 405 Talence cedex, France
[b] Department of Finance, Insurance & Real Estate, & Laboratory for Financial Engineering (LABIFUL), Faculty of Business Administration, Université Laval, Building Palasis-Prince, Office 1204, 2325, rue de la Terrasse, Quebec, Quebec G1V 0A6, Canada

ARTICLE INFO

JEL classifications:
G21
G32
G39

Keywords:
Loan approval
Decentralization
Loan portfolio quality
Loan portfolio risk
Microfinance
Outreach

ABSTRACT

We study the impact of loan approval decentralization on MFI portfolio quality and outreach, and the effects of alignment mechanisms when loan officers combine information production and decision functions. Using an independently pooled cross-section of 374 MFI-year observations for 280 MFIs in 70 countries, we find that effective incentive schemes and internal control systems help mitigate agency problems within MFIs, and thus increase the outreach of MFIs without altering the quality of their loan portfolio. Our results are robust after controlling for alternative portfolio risk and outreach measures, outreach threshold effect, crisis period, selection bias and endogeneity.

1. Introduction

Microfinance institutions (MFIs) are double-bottom-line organizations and hybrid organizations (Battilana & Dorado, 2010; D'Espallier, Hudon, & Szafarz, 2013). They are now part of the financial landscape of most developing and emerging countries, and their primary goal is to provide financial services to low income people and to small and informal businesses. As reported by some recent studies (Armendáriz de Aghion & Morduch, 2010; Dixon, Ritchie, & Siwale, 2007; Tchakoute Tchuigoua, 2012), decision-making authority is allocated to the loan officer in many MFIs. Merging resource allocation and information production functions provides the loan officer with incentives to produce and use soft information when approving loans (Stein, 2002). The loan officer, whose role in the loan approval process is now evidenced in microfinance literature (Agier, 2012; Agier & Szafarz, 2013), becomes more powerful when information production and loan approval decisions are concentrated in his or her hands. In this study, we first investigate whether allocating decisional authority to the loan officer improves outreach without deteriorating loan portfolio quality.

However, a decentralized credit decision or a powerful loan officer can expose the MFI to a principal-agent problem and thus induce agency conflicts between the loan officer and the lending organization (Berger & Udell, 2002; Stein, 2002). A loan officer may make credit decisions contrary to the interests of the MFI or without complying with current loan approval procedures. Implementing appropriate incentive schemes (better human resource management), strong internal controls, and audit procedures are thus crucial for microcredit portfolio performance and the overall financial health of MFIs (Basel Committee on Banking Supervision (BCBS), 2010). Appropriate incentive mechanisms and internal control procedures may ensure that loan officers who approve loans undertake allocation decisions that improve MFI efficiency. The effect of loan approval decentralization on risk and outreach will be especially important if the agent who received authority is subject to incentive systems and controls that would tend to limit the risk associated with decentralization. The second objective of this study is to investigate whether incentive schemes and internal control systems are effective in reducing agency conflicts within an MFI.

To date, the microfinance literature has not sufficiently addressed the issue of agency costs induced by delegation. More specifically, the question of whether well-designed incentives and an effective internal control system – whether perceived or assessed as such by a third party – could limit the risk associated with loan approval decentralization is

☆ We are grateful to participants at the seminar organized by the Department of Finance, Insurance and Real Estate and the Research Chair in Governance of Laval University in April 2016 for their helpful comments and suggestions, especially Jean Bédard. All errors and omissions are the authors' sole responsibilities.

* Corresponding author.
E-mail addresses: hubert.tchakoute@kedgebs.com (H. Tchakoute-Tchuigoua), issouf.soumare@fsa.ulaval.ca (I. Soumaré).

https://doi.org/10.1016/j.jbusres.2018.09.021
Received 9 May 2017; Received in revised form 19 September 2018; Accepted 20 September 2018
0148-2963/ © 2018 Elsevier Inc. All rights reserved.

not well documented.[1] Some recent microfinance papers investigate the risk associated with decentralization in microfinance lending in developing countries, including subjective preferences of the loan officer and the impact of loan officer behaviors on risk and MFI outreach (Agier & Szafarz, 2013; Labie, Méon, Mersland, & Szafarz, 2015; Sagamba, Shchetinin, & Yusupov, 2013). Agier (2012) emphasizes the role of credit officers on microloan performance and Tchakoute Tchuigoua (2012) examines the effect of decentralization on loan contract terms. This empirical literature on microfinance then suggests a link between decentralization and adverse selection and provides evidence that granting authority to loan officers may bias the selection process because of subjective loan officer preferences. The effectiveness of existing alignment mechanisms in MFIs can therefore enable MFIs to overcome this principal-agent problem arising from decentralizing the loan decision, and also align loan officer interests with those of the MFI.

To analyze the effectiveness of alignment mechanisms on the risk and outreach of MFIs, we study an independently pooled cross-sectional sample of 374 MFI-year observations for 280 MFIs from 2001 to 2012 across 70 countries and make at least two main contributions to the existing microfinance literature.

First, we extend upon previous studies on loan officer role and behavior in MFIs. Contrary to Agier (2012) who limits the role of the loan officer to information production, we assume loan officer duality and the resulting principal-agent problem between the MFI and the loan officer who both produces information and allocates loans. By assessing the mitigating effect of incentive schemes and internal control mechanisms on loan officer behavior, our contribution also goes beyond the previous literature, which focuses on loan officer subjectivity (Agier & Szafarz, 2013; Labie et al., 2015; Sagamba et al., 2013). These studies assume or demonstrate that discriminatory behavior of a loan officer is partly because of inexistence of a control system or failures of existing internal control systems. The quality of the internal control system and the quality of incentive mechanisms are not taken into account from an empirical point of view. Our study accounts for this missing piece by considering the existence of effective internal control systems and incentive mechanisms. We measure the effectiveness of the internal control system and the incentive system using the rating scores produced by a rating agency, Planet Rating in this case, while controlling for the associated selection bias.

Second, by focusing on loan officer-MFI agency problems and on the effectiveness of alignment mechanisms within MFIs, we extend upon the previously mentioned microfinance studies and contribute to the existing microfinance corporate governance literature. Indeed, some studies have focused on the agency conflicts between MFIs executives and owners and on the effectiveness of incentive schemes and control mechanisms implemented by MFIs in order to align the interests of these two groups (e.g., Hartarska, 2005; Hartarska & Mersland, 2012; Mersland & Strøm, 2009; Tchakoute Tchuigoua, 2014). Based on previous studies in nonfinancial organizations (Adams, Almeida, & Ferreira, 2005), MFIs (Galema, Lensink, & Mersland, 2012) and banks (Pathan, 2009), some others have placed particular emphasis on CEO power, that is, the merging of Chairman and CEO positions into a single position, and examined its impact on performance and risk. Other studies focus on agency problems between the interest of borrowers and the interest of MFIs, and assess the effectiveness of incentive design for aligning the borrower and MFI preferences (Armendáriz de Aghion & Morduch, 2010; Stiglitz, 1990). However, except for a few theoretical studies that have examined the incentives designed for loan officers (Aubert, de Janvry, & Sadoulet, 2009; Besley & Ghatak, 2005; Conning, 1999), little is known from an empirical standpoint about a principal-agent problem involving MFIs and loan officers, and the effectiveness of alignment mechanisms designed to avoid information problems within MFIs.

Our empirical evidence supports the hypothesis that providing the loan officer with incentives such as performance-based pay and putting in place an effective internal control system may contribute to aligning the interest of the loan officer with that of the institution. Hence, implementation of human resource management practices and internal control systems, which are perceived as effective, mitigates the possible deterioration of loan portfolio quality following loan approval decentralization, without altering MFI outreach. This result links our study to the literature on organizational architecture (Berger & Udell, 2002; Stein, 2002) and to microfinance-specific literature which focuses on designing incentives for loan officers (Aubert et al., 2009; BCBS, 2010; Labie et al., 2015). We account for the effect of MFI ownership type, given that managerial discretion and profit distribution constraints are likely to vary across different types of ownership among MFIs. We find that incentive mechanisms and internal control system effectiveness increase MFI outreach without altering loan portfolio quality when loan approval is decentralized, in both not-for-profit and profit-oriented MFIs; the effects are much stronger in not-for-profit organizations and even tend to reduce risk.

The remainder of the article is organized as follows. Part two gives an overview of prior literature and develops the research hypotheses. Part three explains the research design. Part four presents the results and robustness tests, and part five concludes with an acknowledgment of research limitations and avenues for future research.

2. Background

2.1. Why is loan approval decentralization an important issue for microlending?

The corporate governance literature provides an explanation of why firms grant decision-making authority to agents (loan officers). Incentive-based theories (Aghion & Tirole, 1997; Stein, 2002) suggest that transferring the decision-making authority to agents who produce soft information is a way to recognize and reward their expertise in this field and enable the loan officers to make appropriate decisions. Sah and Stiglitz (1986) explain the choice of a decentralized decision-making structure in terms of the cost of acquiring and communicating information. Given information asymmetries between the person who gathers and processes information, and the one with the authority to make decisions, the data communicated by the former to the latter can be either partial or contaminated, thereby leading to flawed decision making.

Investigating decentralization of the loan approval process is of particular interest in the microfinance sector for at least two reasons. First, close ties between MFIs and their clients are one of the main features of microfinance (Stiglitz, 1990). Close proximity to the poor not only makes it easier for MFIs to understand their clients' needs but also enables them to develop trust with the communities in which they operate and develop and offer products and services in line with the financial needs of their intended target markets (see, for example, Ledgerwood, Earne, & Nelson, 2013). Proximity also enables loan officers to produce soft information and to grant loans efficiently. Given that loan officers usually live in the same local community as their borrowers and maintain direct and personal contact with them, they may build privileged ties with other small businesses and individuals who hold relevant information about potential borrowers and their businesses in the local community (Berger & Udell, 2002). In addition, daily interactions and personal relations between loan officers and local

[1] The existing banking literature emphasizes lending practices of large and small banks and their effects on credit availability, risk and profitability (Berger & Black, 2011; Berger, Cowan, & Frame, 2011; Berger, Miller, Petersen, Rajan, & Stein, 2005); loan officer's rotation policy in commercial banking and its effects on moral hazard, that is, the officers' reporting behaviors (Hertzberg, Liberti, & Paravisini, 2010); hierarchical distance of information use in large multinational banks (Liberti & Mian, 2009); and gender bias in bank lending markets (Beck, Behr, & Guettler, 2013; Bellucci, Borisov, & Zazzaro, 2010).

Download English Version:

https://daneshyari.com/en/article/11020421

Download Persian Version:

https://daneshyari.com/article/11020421

Daneshyari.com