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# The Association between microfinance rating scores and corporate governance: a global survey

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ABSTRACT

The global microfinance industry has experienced high growth rates over the past decades, and the World Bank foresees a future market with billions of customers. However, the industry's continued growth is contingent on its ability to create a governance structure that supports microfinance institutions' long-term performance. Because microfinance institutions' performance is multidimensional and difficult to measure, prior research has not been successful in establishing consistent associations between governance structures and microfinance institutions' performance. We apply microfinance rating scores – a unique innovation of the microfinance industry – as a summary performance metric and find that several governance metrics are related to microfinance performance. Specifically, we find that CEO/Chair duality has a negative relation to rating scores, whereas the number of international board directors, the presence of internal auditors and the level of competition intensity are positively associated with rating scores. These findings should prove useful in an industry in which there is no established 'best set-up' for governance mechanisms.



## 1. Introduction

Poor corporate governance has been identified as one of the main obstacles to the performance of the microfinance industry (Mersland & Strøm, 2009). However, given that microfinance institutions (MFIs) commonly focus on social outreach *and* financial survival, it is difficult to assess such institutions' 'true' performance, and prior research has not been successful in establishing consistent associations between MFIs' corporate governance structures and their performance. Therefore, to improve MFIs' corporate governance there is an urgent need for more research on how various governance mechanisms relate to overall microfinance performance (Armendariz & Morduch, 2010; Labie & Mersland, 2011). Another factor motivating our research is the scale and growth of the microfinance industry, which provides microcredit to more than 200 million individuals (Maes & Reed, 2012) with yearly growth rates of more than 40% (Mersland & Strøm, 2010). Moreover, microfinance is becoming an asset class in its own right, particularly for investors pursuing both financial and social returns (cf. Renneboog, Horst, & Zhang, 2008).

Until recently, microfinance has been celebrated for its development effects (Goldberg, 2005; Odell, 2010). However, the industry has come under public scrutiny and media attack (Bateman, 2010; Cull, Ehrbeck, & Holle, 2014). There has been a critical focus on interest rates (too high) and collection methods (too harsh), and one major concern has been whether microfinance truly reduces poverty. A recent study by the Consultative Group to Assist the Poor (CGAP), a branch of the World Bank, has reviewed the microfinance impact literature and concluded that although microfinance is not a magic bullet in the fight against poverty "developing inclusive financial systems is an important component for economic and social progress on the development agenda" (Cull et al., 2014, p. 1). Thus, by addressing the link between MFIs' corporate governance and their performance, we are focusing on an issue that concerns the ability of microfinance to contribute to economic and social progress.

Despite the critiques of microfinance, the World Bank-supported CGAP[1] highlights that support for microfinance remains high on the international development policy agenda. Cross-border funding of microfinance continues to grow, reaching at least USD 25 billion in 2011; two-thirds of those funds were public (www.cgap.org). In light of the high growth rate and strong public attention to microfinance, it has repeatedly been highlighted that one of the industry's major risk factors is the lack of well-governed MFIs (Buchanan, Le, & Rishi, 2012; CSFI, 2011).

What constitutes "good corporate governance" of industrial and financial firms is not well established (Thomsen & Conyon, 2012), and the same holds true in the microfinance industry (Labie & Mersland, 2011). When measuring the impact of corporate governance on firm performance the results are often confusing (Adams, Hermanlin, & Weisbach, 2010). For example, when studying why some banks outperformed others during the credit crisis of 2007–2008, Beltratti

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[1] Using Cull et al. (2014) as an indicator of the World Bank's policy view.

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and Stulz (2012) have not found support for the claim that the failure of specific banks was *caused* by weak corporate governance. Conversely, Balachandran, Kogut, and Harnal (2010) have found that banks with managers who received equity-based pay, a major corporate governance mechanism, had a greater probability of default during the credit crisis compared to banks managed by CEOs who received cash bonuses. With respect to MFIs, corporate governance is a nuanced system of mechanisms that should satisfy multiple stakeholders, such as regulators seeking stability, owners and debt-holders seeking profit or financial sustainability, and donors seeking social returns to microbank customer and long-term institutional survival. These overlapping and conflicting goals of microfinance stakeholders make it particularly important to measure performance in a multidimensional fashion.

The literature on microfinance corporate governance tends to be primarily anecdotal (Servin, Lensink, & Berg, 2012). The few studies that have addressed the relationship between corporate governance mechanisms and MFI performance have arrived at inconclusive results and have not been successful in identifying a clear relationship between governance and performance (e.g., Hartarska, 2005; Mersland & Strøm, 2009). Thus, even if most microfinance academics and professionals would agree that the lack of high-quality corporate governance structures represents a major challenge to the microfinance industry, consistent linkages between MFI governance structures and performance have not been established in the literature. This implies that existing research offers little guidance as to which specific corporate governance structures are considered the most performance enhancing. By using MFI-specific third-party rating reports, a novelty in the microfinance industry, we are able to address the association between specific corporate governance characteristics and MFI performance.

When searching for what constitutes good corporate governance of MFIs, we argue that it is important to consider that a vast majority of MFIs pursue the dual objectives of financial sustainability *and* social outreach (Galema, Plantinga, & Scholtens, 2008). We argue that part of the reason why existing research has not been able to identify a stronger linkage between MFI governance structures and performance is the inherent challenge of measuring organizational performance according to both social and financial objectives. Regardless of the huge challenges related to attaching appropriate 'weights' to the two overall performance metrics, the performance measurement problems are amplified by the challenges related to evaluating the two components separately; it is always a considerable challenge to measure MFIs' social performance (Mersland & Strøm, 2010), and the existence of substantial grants and subsidies in the industry makes also assessments of mere financial performance difficult (Christen, Rosenberg, & Jayadeva, 2004; Hudon & Traca, 2011). Moreover, as demonstrated by several authors, including Hermes, Lensink, and Meesters (2011) there is a trade-off between the two objectives, which further complicates the identification of corporate governance mechanisms associated with strong MFI overall performance.

Thus, when searching for linkages between corporate governance mechanisms and MFI performance, one must account for the 'double bottom lines' objectives inherent to most MFIs (Labie & Mersland, 2011). The specialized third-party microfinance rating assessments, a unique innovation of the microfinance industry, attempts to summarize overall MFI performance into one collective grade or *rating score*. So far, however, the nature of the specific association between governance mechanisms and these rating scores, if it exists, remain unknown in the literature.

Rating assessment in the microfinance industry is much more extensive than a traditional credit rating of publicly traded firms; microfinance rating reports claim to measure MFIs' ability to reach their multiple sets of objectives simultaneously (Reille, Sananikone, & Helms, 2002). The purpose of the rating reports is to present independent information that various stakeholders – such as lenders, donors, investors, or managers – can use to make informed decisions. The characteristics of the MFIs are summarized through a rating score, which is an overall measure of performance or 'excellence'. Because of the microfinance industry's performance measurement challenges, donors, investors and other stakeholders rely heavily on the rating scores before contracting with an MFI (Beisland & Mersland, 2012). A signal of the importance given to microfinance rating assessments is that Mixmarket, an important microfinance industry-specific website[2] where MFIs present their profiles to funders and other industry actors, only assigns the maximum transparency score of five 'diamonds' to those MFIs for which an external rating report is available.

The rating agencies claim that they assess not only an MFI's conventional performance metrics but also aspects such as competitiveness, risk management, internal control procedures, IT systems, legal issues and governance quality (Beisland & Mersland, 2012). However, given the subjective judgment involved and the fact that prior research has struggled to identify significant relations between the rating scores and some of the metrics claimed to be relevant when constructing those scores (e.g., leverage, see Beisland & Mersland, 2012), it remains unknown whether a significant relationship between corporate governance measures and rating scores truly exists. The association has not been tested empirically in the prior microfinance research, and thus, our first research question is whether such an association can be identified.

Prior microfinance research has found that rating scores are associated with MFI characteristics such as efficiency, risk and size (Beisland & Mersland, 2012; Gutiérrez-Nieto & Serrano-Cinca, 2007). We believe that corporate governance structure is such an important issue for MFIs that governance not only should be related to the rating score but also should constitute a considerable proportion of the overall score. Thus, our second research question is the relative importance (to other MFI characteristics) of governance to the final rating score.

Our third research question evaluates alternative governance structures; given that governance is related to rating scores, what mechanisms do the professional rating agencies regard as 'good' governance structures? We view this final research question as the most important because the identification of specific, favorable corporate governance structures is a huge challenge to the microfinance industry (Labie & Mersland, 2011). Given the industry's entrepreneurial characteristics and novelty (Randøy, Strøm, & Mersland, in press), corporate stakeholders, such as managers and board directors, need to know which specific corporate governance mechanisms rating agencies consider valuable. In fact, such knowledge is a prerequisite for future efforts by executive and board members to improve rating scores. Moreover, because investors, donors and lenders use ratings as a basis for funding (Beisland & Mersland, 2012), they need a clear understanding of the information that a particular rating conveys. Because of large geographical and cultural distances, *international* capital providers, which in the microfinance industry possess the bulk of the available capital (Mersland, Strøm, & Randøy, 2011), are likely to pay special attention to the quality of governance structures (Buchanan et al., 2012).

This study applies CEO/Chair duality, internal audits, board size, international board members, type of ownership, regulation, type of initiator and competition as measures of governance structures. In addition, it briefly discusses other indicators for which the number of observations is limited. Furthermore, our research design controls for multiple country-specific and MFI-specific factors that prior research has shown to influence rating scores in the microfinance industry. The empirical evidence from our hand-collected global dataset of 405 MFIs in 73 developing countries indicates that several of the dimensions of the MFIs' governance structures are significantly related to their rating scores. Moreover, we document that the inclusion of governance variables causes a considerable increase in the explanatory power of our regressions, in particular, in the rating agency-specific analysis. With respect to the various governance measures, we find that CEO/Chair

[2] www.mixmarket.org.