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Corporate Governance in Microfinance Organizations: Review and Agenda

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ABSTRACT

This study provides a comprehensive review of scholarly research on corporate governance in microfinance organizations during the last 20 years and elaborates an agenda for future research. The article used a systematic literature review process for the different online databases including EBSCOHost, Emerald, JSTOR, SAGE Knowledge, ScienceDirect, Scopus, SpringerLink, University Library WorldCat, Wiley and Web of Science database over the period 2000–2019. This research has identified three major factors which are the most important for the microfinance governance studies, these are, (i) board of directors who set strategic directions for the organization, (ii) top-level management who implements decisions and manages risks, and (iii) external governance who works to ensure compliance with standards, policies, and procedures. The paper contributes through synthesizing and pinpointing standing as well as evolving research streams.

Keywords: *corporate governance, microfinance, sustainability, outreach*

INTRODUCTION

Microfinance organization is an alternative financial intermediary that has noble intention to provide credit services to the entrepreneurial poor while bear its expenses through interest income (Abed, 2000; Armendáriz & Morduch, 2005; Mersland & Strøm, 2013). Several microfinance organizations (MFOs) are still struggling to be financially self-sufficient while achieving social goals by serving the poorest clients (Labie & Mersland, 2011). In 2010, the microfinance practitioners raised an important debate between the *"financial sustainability vs. poverty lending"* approach or *"institutionalist vs. welfarist"* approach (Ahmed, 2018; Armendáriz & Szafarz, 2011; Cull, *et al.,* 2011; Hermes & Lensink, 2011). The financial sustainability approach emphasizes the importance of monetarily sustainable MFOs. According to this approach, the MFOs should be able to cover its operational and administrative cost from the money lending operations. Conversely, the poverty lending approach assumes MFOs to provide credit services to the productive poor at a subsidized interest rate and encourage them in entrepreneurship. By self-employment, the poor will be able to bring themselves out of poverty. The proponents of this approach argued that poor people are not

capable to pay the higher interest charges. Therefore, institutional sustainability eventually in contradiction to the approach of the poverty landing approach. As a result, a debate on mission drift took the attention of scholars (Ahmed, *et al*., 2016; Quayes, 2012).

It was estimated that only 1-2 percent of the MFOs around the world are monetarily sustainable (Hermes, *et al.*, 2011). Presently, there are a significant number of microcredit programs that are depending on donor grants to meet the higher expenses meaning those institutions are not financially sustainable (Ahmed, *et al.*, 2018; Cull, *et al.*, 2011; Hermes, *et al.*, 2011). On the other hand, a significant number of MFOs are transformed from non-profit to profitable financial intermediaries (Gutiérrez-Goiria & Goitisoio, 2011; Ibrahim, *et al.*, 2018), simultaneously, enhancing well being of the poor through the social mission (Ahmed, *et al.*, 2016). According to the Microcredit Summit Campaign's annual report, MFOs should patronize their social objective over profit orientation (Daley-Harris, 2007). Therefore, the microfinance industry is often referred to as a double bottom-line industry with the mission of providing credit to the lowest strata of poor while secure financial sustainability to cover its cost (Bassem, 2009; Cull & Morduch, 2007; Lam, *et al.*, 2020). However, ensuring balance performance in a dual mission is nearly impossible without placing a well-structured governance strategy (Ibrahim, *et al.*, 2018).

Recently microfinance governance has gained lots of attention from both scholars and practitioners (Hasan, *et al.*, 2019; Hermes & Lensink, 2011). The practice of corporate governance (CG) has been superseded the theoretical developments and the industry has reached a cross-road where one cannot ignore the others (Christen, *et al.*, 2003). Given these developments, the study on CG for MFOs is important for the following reasons; (1) the microfinance industry had some bitter experiences with certain failures. However, among the other reasons, it is evident that the lacking of good governance practices in MFOs was the key aspect of those failures (Mersland, *et al.*, 2011a; Varottil, 2012). (2) The substantial development and institutionalization progress of the microfinance are most importantly aligned with the internal control mechanisms, board actions, and functions of the top-level management (Hartarska, *et al.*, 2013). (3) Given its tremendous outreach in recent years, future growth and sustainability depend on how it is governed— the institutional framework, legal framework, transparency, accountability, etc. (Otero & Chu, 2002; Reynolds, 2014). (4) To attract further fresh capital into this industry requires a thorough understanding of the CG practices of MFOs (Islam, 2011). (5) MFOs have hybrid nature of objectives, such as double bottom-line which require considerable trade-offs between institutional sustainability and reach out to the poor (Kar & Sarker, 2014; Mersland & Strøm, 2013; Pinz & Helmig, 2014).

Therefore, this study aims to scrutinize the possessions of good governance for the performances of MFOs specifically in terms of operational effectiveness, institutional sustainability, and outreach of the poor. The paper contains four major parts. The first part presents the research background and reasons why good governance principles and practices are important in MFOs. The second part describes the methods used for the review process with justification. The later section examines and describes

the existing literature regarding CG and performance in MFOs. Finally, it accomplishes by elaborating on a further research agenda considering the current issues of CG in MFOs' dual performance.

METHODOLOGY

This study starts with a basic question: what are the elements of CG that play a role in the performances of MFOs? This attempt reviews the academic journals, generic works as well as relevant literature using keywords of governance, corporate governance, microfinance governance, microfinance institutions (MFIs), and microfinance performance. The study applies a structured search by quoting those keywords separately in academic journals and book series across EBSCOHost, Emerald, Google Scholar, JSTOR, SAGE Knowledge, ScienceDirect, Scopus, SpringerLink, University Library WorldCat, Wiley and Web of Science (WOS) database over the period 2000–2019. The structured process of reviewing the literature is drawn in Figure 1.

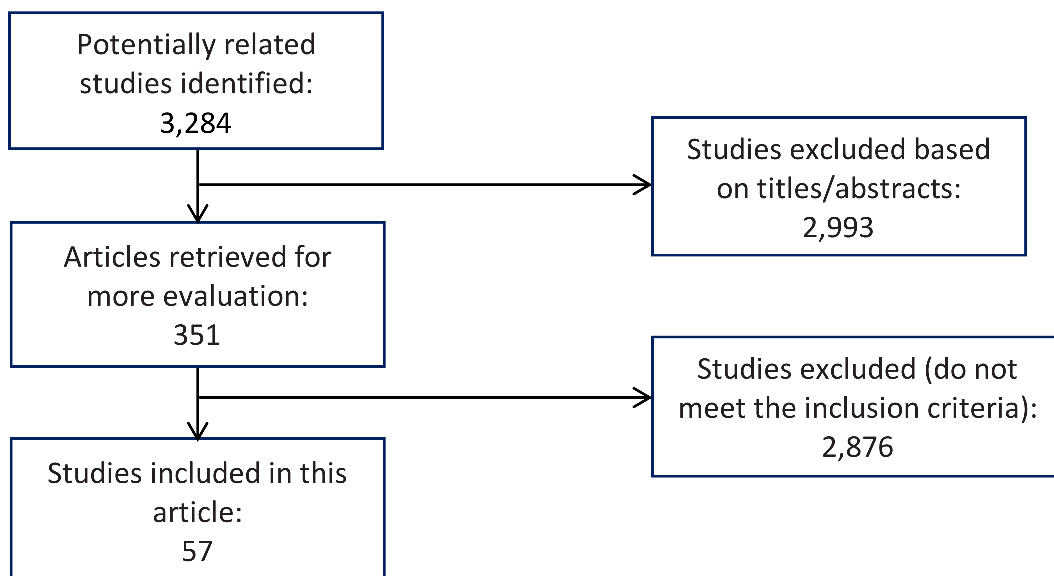

Figure 1: A search strategy adopted by the authors

Furthermore, this study also adopts the criteria for inclusion. Complying to the framework, the paper incorporates only those articles which appeared to treat microfinance performance as a dependent variable. Besides, it includes the research published after the year 2000 to ensure the focus on microfinance performances and capture the trend of commercialization and transformation issues. To authenticate the relevance of the articles this article also checks in the journal rating published by the Institute for Scientific Information (ISI) and Scopus. Later the list of recognized periodicals was presented to the microfinance professionals for endorsing the relevance and significance. The study then applies five keywords to search literature in the database, those are governance, corporate governance, microfinance governance, microfinance institutions, and microfinance performance.

Finally, a systematic article screening procedure yielded more than a

hundred potentially relevant academic articles, books with generic works for the analysis. This study recognizes not all of those works belonging to the enactment of microfinance governance research. After examining the particular studies the authors pursue a deeper investigation and consequently evaluate the full manuscript. Two aspects were carefully distinguished, either those studies are qualitative or quantitative, and investigative or confirmatory. The prime section of this exploration is contained with constructing knowledge on the microfinance performance. Rendering to the theoretical reasoning delivered by the microfinance governance research as well as exploratory dimensions of microfinance performance was addressed in this revision. In a final note, this study assembles the outcomes and identifies what is pragmatic in placing good governance in MFOs. Thus, the research reveals several key elements relating to the state of the art for microfinance governance, and its impacts on MFOs' dual performance which are discussed in the later sections.

REVIEWING CORPORATE GOVERNANCE IN MFOs

The word *governance* is derived from the Latin word *gubernare* which means *"to lead"* (Balc, *et al*, 2013). *To lead* or *to govern* means to administer, commend, control, direct, guide, handle, lead, manager, order, rule, superintend, supervise, discipline, master, regulate, etc. (Alcántara, 1998). Narrowly it can be defined as the relationship of an organization has with its stakeholders or, more broadly, as its relationship with society. The study regarding CG instigated from the work of Berle and Means (1968) by the work of *'the modern corporations and property rights, 1932'*. A vital problem of principle–agent conflict was described and an emphasis was given on the separation of control of the organization as well as the ownership matter. However, the point of the argument is that the professional agents (managers) operate the organization while they are accountable to the dispersed principals (shareholders) (Eisenhardt, 1989).

Indeed, owners (principles) are facing twofold choices at any point in time. Worrying on adversarial selection, treaties with a selection of the most capable managers (Kyereboah-Coleman & Osei, 2008). Upsetting the right pays and incentives intended for the managers for the alignment of objectives which comply with the proprietors (Bhagat & Bolton, 2008). However, in the biggest sense, CG reels on the stewardship duty for the corporation. It also provides the directors to set the goals and strategies for any organization as well as to foster the implementation (Fama & Jensen, 1983). It includes all the processes, systems, and controls that are used to safeguard the interest of all the stakeholders and the growth of assets (Donaldson & Preston, 1995; Kooskora, 2006; Scholes & Johnson, 2002).

The Organization for Economic Co-operation and Development (OECD) has been emphasizing the comprehensive view on CG and defines *"the corporate governance as the full set of relationships among a corporation's management, its board, its shareholders and other stakeholders. It provides the structure through which the objectives of the corporation are set, and the means of attaining those objectives and monitoring performance determined"* (OECD, 2004). As referring to the OECD's report, CG comprises two dimensions; first, the

performance of the organization, which can be achieved by the accountable approach of the board and top-level management in setting up appropriate corporate strategies, predict and manage potential risks. The second dimension is compliance with legal requirements for corporation standards, besides liability to the significant stakeholders.

By adopting an alternative approach of credit supply to the long excluded segment of the demography, MFOs have substantial diverse features with the divergent appearances of the owners (Hussain, *et al.*, 2020). The success of MFOs depends on a *mixed-profile* of stakeholders who are not only driven by profit-orientation but also carry values of social impact and sustainability (Varottil, 2012). A combination of such diverse stakeholders has been leading to a certain degree of incoherence and it should be a key priority for any MFO since the situation could raise potential tension among different interest groups (Kyereboah-Coleman & Osei, 2008). Board compositions in MFOs is mixed with different stakeholders with various personality and background, including internal and external governance (Hussain, *et al.*, 2020; Mori & Mersland, 2014). Such as internal directors are linked with and controlled by stakeholders and hold senior positions. They possess intimate knowledge about corporation activities without which the board may lose their control over monitoring roles (Navajas, *et al.*, 2000). On the other hand, external directors are not employees of MFOs (Mersland & Strøm, 2013), however, they owe their position due to specific expertise which could be valuable to the organization (De Gobbi, 2003).

Moreover, microfinance governance issues become more pronounced in line with the increasing number of MFOs. Presently the source of capital is shifting from being donor-dependent to retrieving financial markets over and done with complex means (Ahmed, *et al.*, 2018; Gutiérrez-Goiria & Goitisoio, 2011). The current emergence of private equity investments in MFOs rises key issues regarding the features and accountability of the governing bodies in the organizations (Hermes & Lensink, 2011). However, the fiduciary obligation of the board of directors and top-level management is to ensure the financial soundness of MFOs (OECD, 2004; Strøm, & Mersland, 2013). External governance ensures such outputs of financial soundness should comply with all compliance measures.

According to Corporate Law Economic Reform Program Paper (CLERP) paper (1997), Organization for Economic Co-operation Development (OECD) report (2004 & 2015) and the Association of Chartered Certified Accountants (ACCA) report (2008) that there are three principal actors, the board of directors for setting strategic directions, the top-level management for implementing strategy and managing risks, and the external authority from the government or autonomous body for ensuring compliance with standards, policies, and procedures.

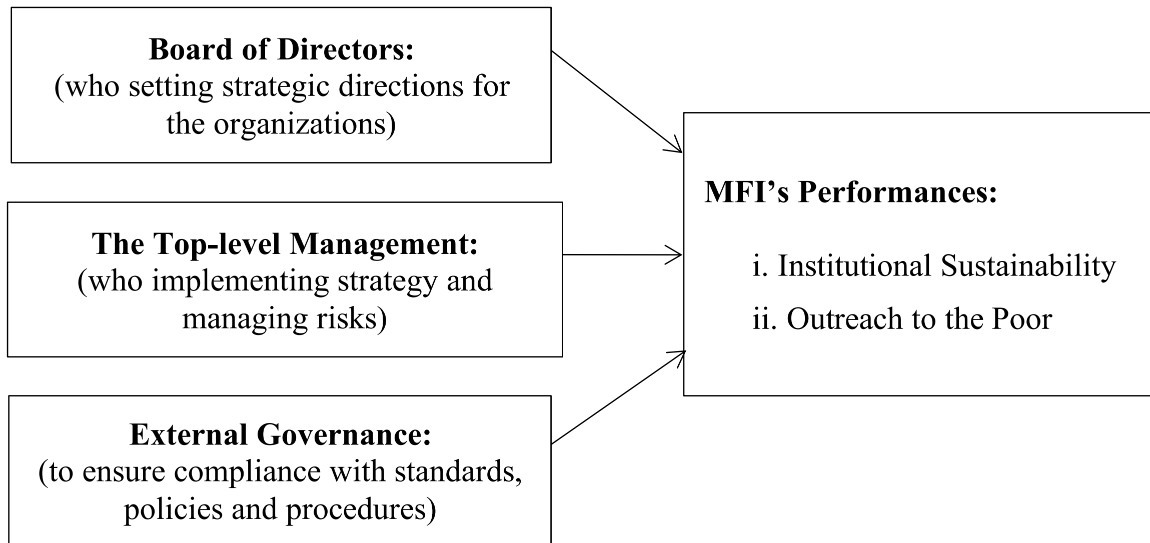

Figure 2: Development of a conceptual model

The board of microfinance organization has had major responsibilities, for instance, the legal compulsions which comprise understanding about a regulatory charter for microfinance as well as compliance with bylaws (Davis, 2005). The board must be accountable for ensuring management responsibilities by employing experts as administrators as well as creating clear goals, monitoring performance diligently, and taking corrective measures (Otero & Chu, 2002). Setting strategic direction, making policy, and providing overall guidelines based on the organization's objective, mission and vision are also the prime roles of the board (Mwasi, 2011). Board of directors works as a fulcrum among owners, investors, donors, supervisors of the corporation and is a crucial link between the stakeholders who are providers of assets (Daily, *et al*, 2003). Besides, the board of directors is predictable and takings due regard for dealing fairly with supplementary stakeholders. These are the wellbeing of customers, creditors, suppliers, employees, and local communities (Zeller & Meyer, 2002). Also, environmental observance and social values are significant in this context (Quayes & Khalily, 2013; Zeller & Meyer, 2002).

Besides the issues, in microfinance organizations, the fundamental management resolutions must be made via more than a single person *"four-eyes principle"* (CLERP, 1997). The top-level management comprises of the chief executive officer or executive director and senior management team. Their primary responsibility is maintaining day to day operation of the organization, ensure the sustainable performance of the organization, and comply with rules and regulations (Mwasi, 2011). The top-level management commonly comprehends the progression of ascertaining key risks for the institutions. However, measuring disclosures for the risks and observing risk exposures as well as defining the equivalent capital necessities, such as monetary planning, taking controlling steps or taking exposures for mitigating

risk, and finally reporting to the board (OECD, 2004). They also evaluate the level of institutional compliance with the organization's policies and procedures, along with legal and regulatory policies (ACCA, 2008).

The board is enhanced to institutional performances because there is an array of expertise that has been attending for making thriving decisions (Boyd, 1990; Donaldson & Davis, 1991). It has been found that the present corporate structure is more complex and wider stakeholder base (Mori & Mersland, 2014; Thrikawala, *et al*, 2013). Meanwhile, the top-level management accordingly should be fitted out with the knowledge, expertise and skills for being able to build operational external relationships in addition to securing adequate possessions for addressing the importance of multiple stakeholders plus wider stakeholder environmental effects in current operational conditions (Balc, *et al*, 2013; Hartarska & Mersland, 2012; Mersland & Strøm, 2013). Considering the said issues regarding the effects of executives' pays, their qualifications, financial skills along the performance of microfinance organizations have been necessary to contemplate.

In many countries, MFOs need to fulfill regulatory requirements (Ahmed, *et al.*, 2018). Regulation and supervision from the state provide guarantees to small and dispersed vulnerable depositors to protect their savings (Van Greuning, *et al.*, 1999). Private investors and donors are more concerned about regulation and supervision, audited financial statements, rating agencies, and information disclosures to ensure greater transparency in their investments (ACCA, 2008; CLERP, 1997; OECD, 2004). However, the external factors such as the level of by-laws in the microfinance sector as well as from the commercial environment impact the method in which microfinance deals with their enactment (Thrikawala, *et al.*, 2013). Although the right governing environment can rationalize the microfinance undertakings. The existing evidence specifies that it rises the budget of operation, but then again it is not clear whether it is impacting the viability of microfinance (Cull & Morduch, 2007; Hartarska, *et al.*, 2013). Studies mentioned that this increase costs for maintaining the regulatory requirements. Hartarska & Nadolnyak (2007) founds that external governance factors are linked with deeper outreach and microfinance with recovering protection of property privileges is more able to reach out of the poor.

Several studies have identified external governance helps microfinance to access savings, local currency deposits and commercial loans that result deeper outreach and operational self-sustainability (Barry & Tacneng, 2014; Bassem, 2009; Cull, *et al.*, 2011; Hartarska & Nadolnyak, 2007; Varottil, 2012). Recently, specialized independent rating agencies were established for helping donors, institutional investors, creditors as well as the stakeholders for making informed decisions (Bassem, 2009; Hartarska, 2005). The internationalization of microfinance programs has been supporting transfer the knowledge, best practice mechanisms, policy guidelines, software, training, strategic planning, and better access to funds (Mersland, *et al.*, 2011b). The international orientation enhances social performance, but financial performance (Mersland, *et al.*, 2011b). It also helps in lobbying, internal-external dialogues, training, exchanging information, and resolving national conflicts (De Gobbi, 2003).

There are several external control mechanisms intended for self-serving agents amongst them are rating agency, external audits, government supervision, or international affiliation (Bassem, 2009; Kyereboah-Coleman & Osei, 2008; Mersland & Strøm, 2013). These external stakeholder dimensions show a mixed picture. The majority of the studies do not find a significant positive impact of external governance functions in terms of financial performance however a positive impact on the outreach of MFOs is identified (Cull, *et al.*, 2011; Hermes & Lensink, 2011). Meanwhile, regulations and supervisions do not help increasing profitability, rather it sometimes increases costs in organizations due to fulfilling supervisory and regulatory requirements (Hossain, 2013; Thrikawala, *et al.*, 2013). However, it has indirect benefits, and diversified external governance mechanisms help in a better strategic decision, better risk management, capital inflow, and long term survival of MFOs (Hossain, 2013; Quayes, 2012).

CONCLUSION AND RECOMMENDATION

It is evident from this review that the microfinance organizations face inimitable challenges in order to achieve double bottom line, providing credit access to the poor while ensure institutional sustainability through minimizing expenses. Thus, the microfinance practitioners proclaimed that good governance practices are the key to balance the two bottom line mission to the successes. Most of the studies regarding corporate governance and organizational performance were conducted focusing on the bank and financial institutions. This study identified the lack of studies examining the impacts of governance on the performance of microfinance organizations, particularly in terms of institutional sustainability and reach out to the poor. Besides, studies of corporate governance are mainly addressing issues related to large corporations and in most circumstances in advanced economies. Most of the authors have been emphasized that the main problem of corporate governance studies is the concept of separation of ownership and control which is ensuring the corporation to operate in the concern of owners not the betterments of stakeholders.

It is whispered that good governance practices create stakeholder confidence and willingness. Accordingly, it has been recognized that good governance has weighty effects on the performances of the organizations. It has revealed that well-governed administrations have monetarist resources well girded in. The corporations with poor corporate governance structures disperse the excess of money more quickly. Equally, the view has been found that the board of directors is the prime decision-maker of the organization who setting strategic directions for the management. As part of internal governance, the board of directors is playing a key role in resolving the agency complications concerning of Principals and Agents. On the other hand, the panels are enhanced for corporate enactment because an array of expertise has been helping for making better resolutions. There are many dimensions making board functions effective, such as the size of the board, chairman or CEO duality, independent directors, stakeholder (e.g. donor, employees, creditors or client) representation on the board, and most importantly internal auditor reports straight to the board meeting. The studies of corporate governance also suggesting that the board can be more successful if it owing to do

willingly some added duties that are board members proceeds on managing fundraising on behalf of the organizations. There is a deficiency of empirical studies regarding board functions and microfinance performance in terms of institutional sustainability and reach out to the poor.

The present corporate structure is more complex and wider stakeholder base. This would necessitate the board of directors and senior management team to distinguish the manifold requirements of the several stakeholders plus tactically accomplish them. The interest of several stakeholders, as well as the wider environmental impacts under current working conditions the top level management accordingly, should be refreshed with the basic knowledge and expertise, work experiences & skills for building the operational and external connections as well as securing the adequate possessions of the organizations. Rendering to agency theory the performance-based remuneration and fixed salary with incentives is the finest mechanism for aligning in the best interest of the manager's motivation. However, in the case of the not-for-profit organization, the performance-based remuneration is unlawful. The lack of studies regarding the effects of management qualifications pays, financial skills, and the performance of microfinance organizations have been found after the review.

Moreover, the corporate governance studies cannot follow a single path; it has to follow quite a long winding road. According to stakeholder theory, there are several external control mechanisms for self-serving representatives amongst them are external audits, rating agencies, government supervision, or international affiliation. Based on the empirical findings of different studies and literatures these external stakeholder dimensions show us a mixed picture. The majority of the studies do not find a significant positive impact of external governance functions on financial performance but found a positive impact on the outreach of microfinance. Meanwhile, regulation and supervision do not help in increasing profitability, rather it sometimes increases costs in the organization due to fulfilling supervisory and regulatory requirements. However, it has indirect benefits and diversified external governance mechanisms help in the better strategic decision, better risk management, and long term survival of the organizations and sometimes helps in fundraising. Empirical study regarding the role of all external governance on the microfinance dual missions is still absent to understand microfinance governance.

Until recently, researchers and policymakers considered microcredit as an important instrument to lift the poor people, especially women, out of poverty. An enormous amount of anecdotes and simple empirical analyses support the positive view of microcredit. The policymakers became almost euphoric about the possible role of microfinance. Yet, recently the rosy view of microfinance has started to come to an end, especially after the fact about loan-shark-styles of microfinance authorities who driven defaulters to suicide in Andhra Pradesh, India. Moreover, several recent microfinance failures have been attributed to bad governance systems. On the other hand, it is important in explaining why some microfinance is prosperous, where others are failing, thus needed a deeper understanding of governance matters. Good governance is important since it can support the viability of microfinance in

terms of both financial performances and reach out to the poor.

Considering the importance of the fulfillment of dual missions of microfinance, there is a need for serious studies on microfinance governance around the world. So far there is a lack of reported study identified on the effects of corporate governance for the performance of microfinance organizations. A comprehensive review of literature disclosures that the empirical study is generally focused on the impact of corporate governance for the performances of organizations or on the effect of ownership structure for the organizational values. There is a great necessity for scientific research on the role of governance in all aspects of microfinance performances. Given the above-mentioned analysis, it is obvious that the microfinance sector has been playing a major role in eradicating poverty, economic improvement, particularly providing collateral-free credit to the prolific poor and enhance financial inclusion. Alongside with this condition and as an attempt to narrow this research and literature gap, this study considers it appropriate to investigate into the role and impact of corporate governance on the various aspects of performances of microfinance organizations specifically in terms of their operational effectiveness, institutional sustainability, and reach out to the poor.

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