**Governance and Microfinance Institutions**

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**1. Introduction**

During the last decade, much has been written on microfinance (see for recent overviews, e.g. Hermes and Lensink (2007, 2011) and Armendariz and Morduch (2010)). The literature on microfinance is diverse. It includes theoretical studies on the design of optimal contracts and, more recently, the testing of these theories through randomized control experiments. It also includes impact studies that try to find out whether microfinance measurably improves the lives of the poor. Finally, there are macro studies that study how MFIs are effected by the macroeconomic environment in which they operate and how they trade-off outreach and financial sustainability. Yet, comparatively little has been written on the corporate governance of microfinance institutions (MFIs); most of the existing studies on MFI governance consist of consultancy reports that assume that MFIs are comparable to regular commercial firms (Labie and Mersland, 2011).

The lack of scientific studies on microfinance governance is unfortunate, because a number of recent MFI failures have been attributed to bad governance systems. Until recently, researchers and policymakers considered microcredit as an important instrument to lift poor people, especially women, out of poverty. An enormous amount of anecdotes and simple empirical analyses support the positive view on microcredit. Policy makers became almost euphoric about the possible role of microfinance as a development instrument after Mohammad Yunus received the Nobel Peace Prize in 2006. Yet, recently the rosy view of microfinance has started to come to an end, especially after stories about loan-shark-style MFIs who have driven borrowers to suicide in the Indian state of Andhra Pradesh. Bateman (2010) even suggests that microfinance is the main obstacle to sustainable development. To explain why some MFIs are successful where others fail, we need a better understanding of governance issues. These include ownership and board-level decisions on important areas like staff incentives and attracting funding. Good governance is important since it can support the viability of MFI operations in terms of both performance and risk management.

According to agency theory, microfinance governance should deal with ways in which suppliers of finance–donors and investors–ensure that they get a return on investment and the MFI reaches its social mission. In many organizations, which include most MFIs, there is a separation of ownership and control. Even though nonprofit MFIs have no owners, in almost all MFIs the suppliers of funds are different from those who manage the MFI. Because managers and suppliers of funds have different interests and there is information asymmetry, there are agency problems and thus a need to control managers. The main function of governance is to control self-interested managers to solve agency problems. When sufficient oversight is lacking, managers are likely to enrich themselves or pursue other self-interest at the MFI’s expense. This is illustrated by the collapse of the Colombian Corposol, where a powerful CEO that did not receive proper board oversight played a large role in Corposol’s eventual bankruptcy (Steege, 1998).

Some MFIs have the legal status of banks, which makes their agency problems very comparable to those of banks. Oddly, very little theoretical governance literature has been written specifically for banks. Instead, corporate governance perspectives are usually directly applied to banks, which is unfortunate for banks face very specific governance problems (Macey and O’Hara, 2003). A problem with bank governance is that deposit insurance and capital controls give much stronger incentives to shareholders to push banks to take more risk (Laeven and Levine, 2009). Deposit insurance removes the incentive for depositors to push the bank to take less risk and banks tend to hold little debt such that there are no other fixed claimants that incentivize the bank to take less risk. Most MFIs do not have the legal status of banks and are typically unregulated, so they are not allowed to take deposits. Instead, they rely much more on other sources of funds like commercial borrowing, noncommercial borrowing and donations (Cull et al., 2009). A greater dependence on debt holders and a lack of deposits make unregulated MFIs more similar to corporations in which debt holders prevent an organization from taking too much risk. So, depending on their funding sources, MFIs face different governance problems.

According to a more broad definition of governance, microfinance governance is the determination of how an MFI uses its resources and resolves conflicts of interest of the organization’s myriad participants (Daily and Cannella, 2003). Good directors can bring valuable resources to the firm and advice and council CEOs. For instance, they can provide experience from other MFIs, banking knowledge and a network of possible donors. The initial survival of non-profits depends very much on whether they can attract sufficient donations. In this process the connections of board members to donors could be an important asset. So, instead of a sole focus on the board’s task of controlling executives, other roles of the board deserve investigation as well. Such a broad definition could be more appropriate to MFIs because they have both financial and social objectives. Setting a proper social mission and achieving it is not as clear-cut as maximizing profits, but involves other stakeholder’s active involvement in the decision-making process.

In non-profit MFIs that have the largest focus on social objectives, other stakeholders have much more influence. Glaeser (2003) shows that due to the fact that non-profit governance is weak, workers and donors have much more influence. Nonprofits have boards but these boards are ultimately not accountable and they are very difficult to incentivize because of their opaquely defined mission and lack of stock ownership by managers. The results is that the CEO and the board have an almost unparalleled degree of autonomy. One the one hand this calls for more board oversight and incentive structures that align the board’s interests with those of donors and debt holders. On the other hand, given that many nonprofits operate with very weak governance structures without managers appropriating all the resources, suggests that there are other factors that explain their success. It would be worthwhile to investigate what determines MFI success, instead of a sole focus on incentive issues. It is likely that managers and board members of nonprofits are very much intrinsically and socially motivated. To the extent that this is key to an MFI’s success, giving too much incentives could undermine people’s natural motivation. Therefore, a more broad view on governance that includes the resources the board provides to the MFI could provide additional insights to what extent microfinance governance would benefit from incentive structures.

The aim of this chapter is to review the microfinance performance and governance literature and provide an agenda for future research. In reviewing the microfinance governance literature two issues stand out: First, most papers concentrate on the relation between corporate governance and financial and social performance. Section 2 provides an overview of this literature. It also introduces the different organizational types, which all have a very different ownership structure and performance. Although MFI performance literature is interesting and important, at the same it covers only a limited number of questions related to microfinance governance. With the exception of Galema et al. (2011) and Galema (2011), issues related to governance and risk management are virtually uncovered. Therefore, section 3 deals with governance and MFI risk taking. It presents an example of an empirical study that links governance with MFI risk and gives suggestions for future research in this area. In the empirical study we try to find out whether larger boards make less extreme decisions by testing whether the larger boards are associated with less return variability (Cheng, 2008).

Second, empirical microfinance governance studies are guided by agency theories developed for corporations and western nongovernmental organizations. Corporations maximize profits, whereas MFIs have dual objectives, which theories on optimal incentive structures have to take into account. Within the microfinance industry, there are many different types of MFIs ranging from the most commercial banks to the least commercial NGO. They all decide on a different trade-off between their financial and social objectives. Moreover, one-size-fits-all governance arrangements do not exist. MFIs’ funding structures are very different, which creates a very heterogeneous set of governance problems. Section 4 pleas for new theory on how optimal incentives throughout the institution can stimulate the MFI to reach its dual objectives, and shows how different funding structures create different governance problems.

**2. Governance, ownership and Microfinance Performance: a survey**

An important topic in the microfinance governance literature deals with the question whether the type of ownership of MFIs explains the performance. The microfinance sector is characterized by various organization types, such as banks, Non-Bank Financial Institutions (NBFI), credit unions and non-Governmental Organizations (NGO). The category banks includes rural banks and banks which can be both publicly owned or privately owned (Mersland, 2009). Also among banks in developed countries we observe various organizational types. For example, the Dutch cooperative bank Rabobank ranks among the world’s 25 largest banks and in Germany the ownerless Sparkassen holds more than 40% of the banking market. Nevertheless, the many organizational types in microfinance can be a particular challenge since they operate in markets with normally limited competition and under different regulatory regimes (Merland, 2009). Table 1 presents a characterization of different MFI ownership types.

[INSERT TABLE 1 ABOUT HERE]

Banks are formal, for-profit financial institutions, usually regulated by central banks that offer savings accounts. Although NBFIs are comparable to banks, they are limited by law in the range of services they can offer; some cannot provide savings accounts. Among the nonprofit institutions, credit unions are owned and controlled by their members, who obtain and supply its funding. Finally, NGOs were the pioneers in the microfinance industry and usually are the first to start offering services to the poor in a particular region or to a particular segment of the population. They are often supported by donors and should thus be better able to serve the poorest segments of the population.

In contrast to NGOs, cooperatives and credit unions, NBFIs and banks are shareholder firms who in theory have clear financial objectives and distribute excess profits to their shareholders (Glaeser, 2003). However, their objectives are often not clear cut, because many banks and NBFIs are still fully or partly owned by NGOs. Cooperatives and credit unions are allowed to distribute profits to their members, but in practice they tend to do this by decreasing lending rates or increasing deposit rates. NGOs are subject to a so-called non-distribution constraint: they cannot distribute profits to their stakeholders .

The non-distribution constraint may create organizational slack and managerial discretion, because any excess profits are returned to the organization (e.g., Glaeser and Shleifer, 2001; Hansmann, 1980). Moreover, NGOs’ non-executive board members do not have a financial stake in the organization, so they have less incentives to monitor. (GTZ, 2000). These board members are generally independent persons who may wish to support the organization but in practice lack the technical knowledge and the time needed to assure proper board oversight and control. Sometimes NGO boards also include donors and clients, who do have a stake in the organization but seldom have financial knowledge and experience with risk management. In addition, NGOs are less affected by external governance mechanisms like public banking regulation and hence are normally not allowed to offer savings products. Because they do not offer savings products and cannot issue equity, they are more limited than other MFIs in obtaining funding. However, NGOs are better able to obtain donor money; due to their non-distribution constraint donations cannot be expropriated (Mersland, 2009). Donations shield NGOs somewhat from competition, which is another external governance mechanism.

Many authors argue that nonprofit MFIs should transfer into shareholder owned firms (SHFs) (see Mersland and Strøm 2009 for references). SHFs can be regulated by banking authorities, accept deposits, provide a larger range of better quality services, are independent from donors, attract private equity capital and benefit from superior corporate governance because they are privately owned. However, a recent study by Mersland and Strøm (2008) contradicts this hypothesis. They compare NGOs and Shareholder MFIs (SHFs) on five aspects of the MFI performance dimensions: Cost, Depth, Breadth, Length, and Scope. Cost is defined as the sum of monetary costs and transaction costs to clients, Depth is defined as clients’ poverty level or other social preferences like for instance the percentage of women reached, Breadth is defined as the number of clients served, Length is defined as the time frame of the supply of services and Scope is defined as number of types of financial contracts supplied. They use a dataset containing 200 non-government or shareholder MFIs in 54 countries. Surprisingly, their results suggest that the difference in social and financial performance between SHFs and NGOs is minimal.

Some recent studies use stochastic frontier analysis (SFA) to examine the effect of corporate governance on MFI efficiency. Servin, Lensink, and van den Berg (2011) examine whether MFIs with different ownership types differ in technical efficiency and technology. Using a sample of 315 MFIs from 18 Latin American, and applying the methodology of Lansink et al. (2001) they estimate separate production functions for MFIs characterized as NGOs, Cooperative/Credit Union, NBFI and Banks. The study suggests that the technology of NBFIs and Banks is better than that of NGOs and Cooperatives/credit unions. This is probably due to the facts that NBFIs and banks offer larger loans to richer clients, which allows them to use more efficient technologies. Moreover, they find that NBFIs and Banks are more technically efficient than NGOs and cooperatives, which implies that given their own technology, NGOs and cooperatives perform worse than NBFIs and Banks. Servin, Lensink and van den Berg (2011) argue that this may be due to a suboptimal monitoring system in non- shareholder MFIs. In contrast, Gutiérrez-Nieto et al. (2007), in a study on 30 MFIs in Latin America, find that NGOs were more efficient than MFIs. The reason for the difference in outcomes is not clear. What is clear, however, is that both studies clearly show that ownership type, and thus governance, matters for the MFI efficiency.

The dual mission of financial sustainability and outreach to the poor could create a trade-off, because serving the poor is costly. Hermes et al. (forthcoming) demonstrate that there is trade-off between these objectives. They use data for 435 MFI for the period 1997-2007 to provide new evidence on the existence of the trade-off between sustainability and outreach, using. In particular, the study focuses on the relationship between cost efficiency of MFIs (as a measure of sustainability) and the depth of outreach measured by the average loan balance, average saving balance and percentage of women borrowers. Clearly, clients have very different interests than employees or investors, so the trade-off between financial and social performance, makes microfinance governance extra challenging.

Also researchers that study the influence of governance on MFI performance need to take into account the double objectives. Mersland and Strøm (2009) regress governance mechanisms on financial and social performance separately and generally find little effect of governance on MFI performance. Hartarska and Mersland (forthcoming) take the research one step further as they apply stochastic cost frontier analyses to capture simultaneously the cost minimization goal and the goal of serving many poor clients. Their study suggests that MFIs are less efficient if the positions of the CEO and the board chair are combined, and when MFIs have a larger proportion of insiders (employees) on the board.

**3. MFI governance and risk taking**

This section deals with the impact of MFI governance on risk. Governance risk is an underestimated topic in the banking literature. The current financial crises shows that bank governance did not protect banks from taking excessive risks, so good governance is especially important for investors. The success of microfinance has induced more commercial debt and equity holders to invest in microfinance. Commercial investors are typically more concerned about investment risks than traditional, non-profit–driven microfinance investors. In addition, there are strong indications that the current financial crisis has severely affected MFI performance, which in turn has induced managers in MFIs to take excessive risks.

Within the field of corporate finance some recent papers have emerged on the relationship between corporate performance variability and board member characteristics. When board members have different opinions, decisions depend on the decision-making power of different members. For example, some firms have very large boards in which the decisions are outcomes of consensus, while other firms have boards in which the CEO makes all the major decisions. Regarding the first, Cheng (2008) looks at the relationship between board size and variability of performance and finds a negative relation. The explanation is that firms with larger boards make less extreme decisions and therefore have lower performance variability. Regarding the latter, Adams, Almeida and Ferreira (2005) investigate the relationship between CEO power and the variability of performance. They find that when CEOs have more power, their companies have higher performance variability. The explanation offered for this is that CEOs that have more power can make more extreme decisions, which leads to higher performance variability.

Although governance appears to be very relevant for MFI risk taking, with the exception of Galema, et al. (2011) and Galema (2011), there are almost no studies that look at this. Galema, Lensink and Mersland (2011) develop a framework that substantiates that MFI managers have sufficient managerial discretion, such that CEO power leads to more extreme decisions. Their main finding is in line with the results of Adams, Almeida and Ferreira (2005): CEO power is associated with more MFI risk taking. Galema, Lensink and Mersland (2011) also find that the increase in risk is especially pronounced for NGOs. They explain this by arguing that (1) an NGO’s non-distribution constraints creates more organizational slack, (2) the double bottom line objectives make it hard for the board to practice active oversight and (3) NGOs typically are not regulated by a central bank. Therefore, compared to other MFI types, an NGO offers executives the most managerial discretion

In this section we contribute to the literature on governance and MFI risk taking by examining whether, in line with Chen (2008), a larger board reduces MFI risk taking. We argue that the same relationships between board size and performance variability may also exist for MFIs, even though they typically have different objectives and different boards than regular firms. In general, their main objectives are reducing poverty while simultaneously being financially sustainable. Due to this double bottom line, boards of MFIs are typically composed of many different types of board members, such as employees, donors, clients and in particular independent board members. These board members all have different interests, which have to be balanced. For instance, employees might be more interested in financial returns, while donors would be more interested in achieving higher poverty reduction. Due to the higher diversity of board members, it is even harder for MFI boards to reach consensus. This suggests that MFIs with larger boards have less performance variability.

For the analysis we use the data set as has been developed and explained in Mersland and Strom (2009). This dataset contains information from risk assessment reports on MFIs from five microfinance rating agencies, MicroRate, Microfinanza, Planet Rating, Crisil, and M-Cril. The dataset contains a maximum of four years of MFI data, including information on their financial position, and MFI governance characteristics, such as board size and board composition. The sample contains 278 MFIs from 60 countries over the 2000-2007 period, with the vast majority from the last four years. The dataset primarily provides information on commercial and professionally oriented institutions that have decided to be rated to improve access to funding. For more information on the dataset, the reader is referred to Mersland and Strom (2009).

Similar to Adams, Almeida and Fereirra (2005) and Cheng (2008), we define within-firm, over-time variability as the standard deviation of MFI performance over the sample period. We regress the standard deviation of performance on a set of independent variables, which are averaged over the sample period:

 (1)

Where y is either return on assets, portfolio yield or operational costs. The explanatory variables are similar to those used in Mersland and Strøm (2009). Ceochair indicates that the CEO and the chairman of the board of directors is the same person. INTboards indicates the number of international board members. Femceo is a dummy indicating that the CEO is female. Indiv indicates that an MFI uses mainly individual lending. Regulated is a dummy stating whether the MFI is being regulated by banking authorities in the country. Urban is a dummy indicating that the geographical area the MFI is emphasizing is mainly urban. Boardsize indicates the number of board members. Age indicates the MFI age. Par (Portfolio at Risk) is the percentage of the gross loan portfolio that is more than 30 days in arrear. Size is the natural logarithm of assets. Compet is microfinance market competition, as indicated by the rating agencies. Writeoff is the ratio of loans that has been written off and accounted as a loss in the MFI. Roa is the return on assets and is incorporated to control for the mean effect of the left hand side variable. Leverage is the debt-to-equity ratio.

All explanatory variables are averaged over time, as indicated by the bar on top of each variable, so every sample MFI has only one observation. The independent variables chosen are similar to those used in performance regressions by Mersland and Strøm (2009). In addition, we include the write-off ratio and leverage since we believe they capture MFI risk.

In performing regression (1) with return on assets, we find that the results are very much influenced by outliers. To get an indication of these outliers, we use the graphical tool proposed by Rousseeuw and Van Zomeren (1990). We construct a graph (not presented for reasons of space, but which can be obtained on request) by plotting on the vertical axis the residuals, standardized by their standard deviation. We plot on the vertical axis a measure of the (multivariate) outlyingness of the explanatory variables, known as the Mahalanobis distance. This is a measure similar to the Euclidean distance, but it also takes into account the correlation structure between the explanatory variables. In order to control for the outliers, we drop the 4 observations with the largest Mahalanobis distance.

The results of the performance variability regressions are reported in Table 2. Consistent with Cheng (2008), we can confirm our hypothesis that larger boards are associated with less performance variability. Also consistent with Adams et al. (2005) and Cheng (2008) we find that older MFIs have less variable return on asset performance. A novel finding we report is that MFIs that face less competition, have less performance variability. A straightforward explanation is that markets with higher competition are more mature and therefore show less growth and have more stable lending rates over time. The finding that international board members increase performance variability could at first sight be considered surprising. However, this finding support a recent finding in Mersland et al (forthcoming) showing that international directors in MFIs have a negative influence on financial performance while they have a positive influence on the MFI’s social performance. Probably international directors in MFIs are there to control poverty outreach and don’t have the knowledge needed to enhance financial performance and reduce MFI risk. Finally, in line with Galema, Lensink and Mersland (2011) we find some evidence for the hypothesis that more CEO power is associated with more performance variability, with significance just below 10 percent.

**Table 2**

**Return on Assets Variability and MFI Characteristics**

|  |  |  |
| --- | --- | --- |
| Ceochair | 0.021 | [0.106] |
| Intboards | 0.013\*\* | [0.034] |
| Boards | -0.003\* | [0.052] |
| Femceo | -0.002 | [0.869] |
| Indiv | -0.008 | [0.347] |
| Bregul | -0.009 | [0.223] |
| Urban | 0.012 | [0.217] |
| Age | -0.001\*\*\* | [0.005] |
| par30 | -0.022 | [0.460] |
| Size | -0.003 | [0.364] |
| Compet | -0.009\*\*\* | [0.005] |
| Writeoff | 0.201 | [0.138] |
| ROA | -0.141\* | [0.074] |
| Leverage | -0.002 | [0.687] |
| Constant | 0.157\*\*\* | [0.001] |
|  |  |  |
| Observations | 76 |  |
| R-squared | 0.511 |  |

\* significant at 10%; \*\* significant at 5%; \*\*\* significant at 1%. P-values between brackets.

**4. Distinctive features of microfinance: dual objectives and funding structures**

There are many features that make banks and corporations different from MFIs. This section discusses two of these features and its implications for governance. First, MFIs have dual objectives which greatly complicates setting optimal incentives to loan managers and the board. Second, MFIs funding structures are very different. Commercialized banks rely mostly on deposits, whereas NGOs rely very much on donations. This has important implications for the board’s fiduciary duties.

*Incentive schemes: a plea for new theory on MFI governance*

To ensure that the MFI achieves both objectives, it needs properly designed incentive schemes. The main question is how incentives should be designed such that financial sustainability is stimulated while social goals are not undermined. The current theoretical literature almost exclusively focuses on incentive issues between borrowers and lenders, mostly in the context of group lending, like explaining how joint liability lending solves asymmetric information problems (see e.g. Banerjee et al., 1994; Ghatak, 2000; Gangopadhyay, Ghatak, and Lensink, 2005; Ghatak, and Guinnane, 1999; Laffont, 2003; Stiglitz, 1990). Group lending is a lending contract in which group lenders are required to guarantee each other’s loan repayments; they have joint liability. When lender’s are jointly liable, to peer monitoring and peer selection help overcome adverse selection and moral hazard problems, which reduces a lender’s agency costs. There are also some papers that focus on other characteristics of group lending schemes. Chowdury (2005, 2007) and Guttman (2008), for instance, deal with the dynamic incentive aspects of group schemes. So the existing “incentive” literature on microfinance focuses almost entirely on reducing asymmetric information problems in the context of group lending, while it hardly pays attention to the incentive schemes the board gives to loan managers.

Another distinguishing feature is that most MFI clients lack a wage earner’s stable income. They often operate in the informal sector, which offers variable and uncertain income flows. Moreover, most MFI clients lack collateral, which implies that MFIs need to develop other instruments to ensure repayment. Usually, the microcredit methodology is based on a field evaluation of the client’s character and ability to pay. Related to the type of clients, the products that most MFIs traditionally offer are very different from normal bank loans. In particular, lenders typically take repeated loans which are unsecured, small and short term.

When there are many MFIs operating in a region, staff incentives can have perverse consequences like overindebted clients and excessive peer pressure. The theoretical literature lacks analyses on the adverse effects of peer pressure in group lending. While group lending theories help explain why poor customers repay their loans to MFIs, the theories make little attempt to explain how excessive peer pressure could push non performing group members into increased misery. For MFIs that want to improve the lives of the poor excessive intra-group peer pressure constitutes a governance problem which existing theories fail to explain. How can the MFI design incentive structures for its staff and its credit groups that assure loan repayment without introducing excessive enforcement methods? This is especially important for lenders that take uncollateralized loans in markets where customer protection is inexistent. Under such condition an unpaid loan can easily lead to excessive peer pressure.

Probably the most important distinction of MFIs with obvious implications for the governance system is that most microlenders pursue both financial and social objectives. On the one hand, they try to contribute to development and poverty reduction, which involves reaching more clients and poorer clients. On the other hand, MFIs want to be financial sustainable and become independent from donors. Controlling an organization with dual objectives is more difficult than controlling one solely dedicated to profits, especially when we take into account that Hermes et al. (2011b) find that there is a trade-off between these objectives.

A difficulty MFIs face in designing optimal incentive schemes is that their two aims often conflict. The trade-off between the social and financial performance implies that MFI managers can justify their bad performance on one criterion by referring to the other; poor financial performance could be attributed to the MFI’s social mission, especially because social performance is so difficult to measure. This problem is well known in multitask agency theory but difficult to solve. Holmstrom and Milgrom (1991), for instance, show that it is suboptimal to offer variable incentive schemes to the CEO when the firm has dual objectives, one of which is difficult to measure. It is, however, not clear to what extent the insights of Holmstrom and Milgrom (1991) directly apply to MFIs. Relatedly, Hartarska (2005) reveals that performance-based compensation schemes are not associated with better performance. In addition, variable incentive schemes are often forbidden by NGOs, so that even if social performance could be measured easily an optimal incentive scheme cannot be developed (Hartarska, 2005).

A possible solution to the multitask-incentive problem is to make different staff responsible for different tasks and reward them accordingly, i.e. to seek for “functional specialization” (Dewatripont, Jewitt, and Tirole, 1999). In addition, functional specialization matches staff to the tasks in which they have a comparative advantage. For example, loan officers of ASA, one of the major MFIs in Bangladesh, only provide basic financial services; while better educated staff provides training sessions (see Armendariz and Morduch, 2010, p. 368).

Despite the importance of MFI incentive structures there is almost no scientific literature available that deals with topic. The only literature on staff incentives are case-studies from which it is hard to draw any general lessons. Many for profit MFIs have now introduced bonuses for their agents based on repayment rates. These bonuses are often based on individual incentives, such as bonuses related to the percentage of the portfolio not at risk, the number of clients, and the value of the outstanding loan portfolio. A drawback of individual monetary incentives may be that they can conflict with attempts to build social cohesion within an MFI. Therefore, sometimes incentives based on branch performance or performance of the entire institutions is introduced. Obviously, incentives at the higher level may lead to free-riding problems, and hence work less efficiently. For this reason, Bank Rakyat Indonesia (BRI) has introduced incentives at the individual, branch and institution-wide level. In particular, staff of BRI receives a bonuses that depends on the profit of their unit, the entire bank and the value of collected but already written off loans. (see Armendariz and Morduch, 2010, p. 364).

*How funding determines governance*

The standard view in economics regarding fiduciary duties is that directors owe fiduciary duties only to shareholders, as shareholders are the residual claimants with the appropriate incentives to make decisions in the corporation’s best interest. Still, in every corporation there is a conflict of interest between shareholders and debt holders. Shareholders are interested in increasing risk, while debt holders want to decrease risk as the extra risk gives them no additional returns. In microfinance there is potentially an additional conflict between those who provide funds with a social motive (e.g. non-commercial investment and donations) and those that provide commercial funds. Compared to corporations, microfinance boards face a more difficult task, because in their fiduciary duties they have to strike the right balance between multiple interests. Boards have some discretion in deciding which interests are more important, but logically they give priority to those that provide the most funds.

The funding structure of MFIs is very different than that of corporations and also within the population of MFIs there are large differences. Cull et all. (2009) show that equity represents only 13% of MFIs’ funding, whereas 26% consists of donations and 34% consists of borrowing (Cull et al., 2009), so unlike in corporations shareholders are much less important. Considering the different organizational types, banks and credit unions obtain most of their funding from deposits (71% and 64%, respectively). NBFIs are often not allowed to take deposits, so they obtain most of their funds from commercial borrowing (28%) and donations (23%). Finally, NGOs obtain most of their funds from donations (39%) and commercial borrowing (26%). Depending on its funding structure, each MFI type faces different governance issues.

First, we consider banks. Empirical contributions on bank governance are to a large extent based on agency theory (e.g. Laeven and Levine, 2009). Shleiffer and Vishny (1997) conclude that legal protection of investors and some form of concentrated ownership are essential elements of a good corporate governance system. Although this works for corporations, Macey and O’Hara (2003) argue that special governance problems of banks weaken the case for giving shareholders so much power. In a corporation, debt holders have an incentive to limit risk-taking, for instance, by demanding a higher return when the firm is more levered. Banks are different in that their capital supply consists mainly out of deposits. Deposit insurance removes the incentive of the depositors to reduce risk and thereby increases the room for shareholders to push for higher risk-levels. This is confirmed by Laeven and Levine (2009) who find that deposit insurance increases risk when the bank has a large equity holder that has the power to act on the increased risk-taking incentives created by deposit insurance. In response, capital requirements try to reduce shareholder’s risk-taking incentives by forcing owners to put more of their wealth at risk in the bank. Yet, Laeven and Levine (2009) find that capital regulations only increase bank risk, which they explain as being motivated by shareholder’s desire to compensate for the utility loss from capital requirements. Because of the excessive power of bank shareholders and the public’s desire for a save banking system, Macey and O’Hara (2003) argue that boards should weigh the interests of debt holders and depositors more heavily in their fiduciary duties.

To some extent, lessons can be learned from credit unions which are owned by their members–savers and borrowers–and who often also have other stakeholders like employees and donors on their board. Like banks, NBFIs are often for-profit institutions. Yet, their funding structure is very different: most of them are not allowed to take deposits, so they rely much more on debt and donations. To some extent this alleviates problems associated with deposit insurance and capital requirements, but it also creates possible conflicts between commercial debt holders and donors. Donors want MFIs to reach out to the poorest clients which involves extra costs and risks, whereas debt holders want a save return on their investment. This problem is more severe for debt holders of NGOs, who focus on even poorer clients than the NBFI.

**5. Conclusions**

This chapter shows that the existing literature on governance and microfinance is small, and conflicting. Some studies find that governance issues are rather unimportant for MFI performance, others come to the opposite conclusion. These results call for much more studies on governance and microfinance in order to come to a definitive view on how governance affects MFIs. We have made a first step by providing some new empirical support for the view that larger boards reduce risk taking of MFIs.

The unequivocal results of existing empirical studies could indicate that we currently lack good theoretical models that allow us to test the right hypotheses. Currently, most empirical studies are explorative and not based on theories tailored to microfinance. We plea for theoretical governance research that considers the specific features of MFIs we discussed in chapter 4. This includes how to set optimal incentive structures given microfinance’s the dual mission and how to determine governance arrangement given MFIs’ different funding structures.

We end this chapter by referring to some recent developments in microfinance that have important implications for the governance system and should be taken into account in new theoretical and empirical governance research. First, MFIs that traditionally have been funded mainly by subsidies from private and public donors and aid organizations, have started to commercialize and attract funds from private capital markets. Some microfinance institutions, such as Compartamos in Mexico and SKS microfinance in India, have even gone public. The transformation of a traditional NGO into a listed company obviously has important governance implications. Second, MFIs have started to become involved in other activities than lending. Whereas originally they were mainly focused on providing credit, nowadays they are involved in micro savings, micro insurance, and financial literacy trainings; and the list is growing. In addition, new banking technology, such as charge cards, ATMs, points of payments, the use of cell phones, and the internet has begun to enter the microfinance business. Finally, many governments in developing countries have started installing regulations to help improve the stability of the microfinance business, which has far reaching consequences for the governance policies of MFIs.

In many ways microfinance represents the future of banking. Already more than 150 million people are loan clients in MFIs ([www.microcreditsummit.org](http://www.microcreditsummit.org)) and many are starting to open savings account as well (Christen et al., 2004). In the years to come the number of microfinance customers will probably by far outnumber the number of customers in traditional banks. This implies important responsibilities for microfinance actors which need to be handled through proper governance systems.

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| **Table 1. Definition of Microfinance Institutions (MFIs) according to ownership type** |
| Non-Governmental Organization (NGO) | An organization registered as a nonprofit for tax purposes or some other legal charter. Its financial services are usually more restricted, usually not including deposit taking. These institutions are typically not regulated by a banking supervisory agency. |
| Non-Bank Financial Institution (NBFI) | An institution that provides similar services to those of a bank, but is licensed under a separate category. The separate license may be due to lower capital requirements, to limitations on financial service offerings, or to supervision under a different state agency. In some countries this corresponds to a special category created for microfinance institutions. |
| Cooperative/Credit Union | A non-profit, member-based financial intermediary. It may offer a range of financial services, including lending and deposit taking, for the benefit of its members. While not regulated by a state banking supervisory agency, it may come under the supervision of regional or national cooperative council.  |
| Bank | A licensed financial intermediary regulated by a state banking supervisory agency. It may provide any of a number of financial services, including: deposit taking, lending, payment services, and money transfers. |
| Note: Definitions based on MIX-Market Taxonomy ([http://www.mixmarket.org/mix-market-development-roadmap/inline-glossary)/http://www.mixmarket.org/en/glossary](http://www.mixmarket.org/mix-market-development-roadmap/inline-glossary%29/http%3A//www.mixmarket.org/en/glossary) |

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