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GOVERNANCE MECHANISMS, SOCIAL PERFORMANCE DISCLOSURE AND PERFORMANCE IN MICROFINANCE: DOES LEGAL STATUS MATTER?

by

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ABSTRACT: *In this paper we examine diverse governance mechanisms implemented by microfinance institutions, as well as their relationships with both social and financial performance, using a database obtained from the MIX, consisting of MFIs reporting data both on financial and social performance. We find that some governance mechanisms are significantly different among MFIs depending on their legal status. MFIs with NGO status have more diversity in their boards, adhere more to fair practices related to their human resources, and pay more attention to training in social performance management. Furthermore, we find that NGOs perform better at a social level (serve more clients; reach more poor clients; a large fraction of their borrowers are women). We find that external governance mechanisms have little or no effect, while board characteristics consistently and significantly affect social performance.*

Governance-Mechanismen, Offenlegung der Social Performance und Mikrofinanz-Performance: Spielt die Rechtsform eine Rolle?

In diesem Beitrag untersuchen wir verschiedene Governance-Mechanismen, die bei Mikrofinanzinstituten eingeführt wurden, sowie ihre Beziehungen zu sozialer wie finanzieller Performance, wobei eine Datenbank verwendet wird, die von MIX (Microfinance Information Exchange) bezogen wurde und Datenmaterial aus der Rechnungslegung von Mikrofinanzinstituten (MFIs) bezüglich ihrer finanziellen und sozialen Performance enthält. Wir stellen fest, dass sich bei den MFIs, in Abhängigkeit von der Rechtsform, einige Governance-Mechanismen signifikant voneinander unterscheiden. MFIs mit NGO-Status weisen eine größere Diversität hinsichtlich ihrer Vorstände auf, halten sich mehr an faire Praktiken gegenüber ihren Humanressourcen und achten stärker auf Training in Social Performance-Management. Darüber hinaus stellen wir fest, dass NGOs auf sozialer Ebene eine bessere Performance erbringen; sie bedienen mehr Kunden, erreichen mehr arme Kunden, und ein großer Teil ihrer Kreditnehmer sind Frauen. Wir kommen zu dem Schluss, dass externe Governance-Mechanismen nur geringe oder gar keine Auswirkungen haben, während den Vorstand betreffende Charakteristika konsistent und signifikant die Social Performance beeinflussen.

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Mecanismos de gobernanza, transparencia del desempeño social y rendimiento en microfinanzas: ¿importa el estatus legal de las IMFs?

En este artículo se examina un conjunto de mecanismos de gobernanza implementados por Instituciones de Microfinanzas (IMFs), así como su relación con el desempeño social y el rendimiento financiero de las mismas. Para ello se utiliza una base de datos obtenida del Microfinance Information Exchange (MIX) formada por IMFs que proporcionan voluntariamente información sobre desempeño financiero y social. Nuestro estudio pone de manifiesto que algunos mecanismos de gobierno de las IMFs difieren significativamente en función su estatus legal. En particular, las IMFs constituidas como organizaciones sin ánimo de lucro presentan juntas directivas con una mayor diversidad de género, declaran haber establecido un mayor número de prácticas equitativas en la gestión de recursos humanos, y prestan más atención a la formación en gestión del desempeño social. Asimismo, constatamos que las ONGs logran mejores resultados a nivel social: dan servicio a un número mayor de clientes, tienen una proporción más alta de los más pobres y un porcentaje más alto de sus clientes son mujeres. Además, los resultados confirman que en nuestra base de datos los mecanismos externos de gobernanza tienen un efecto muy limitado, mientras que las características de las juntas directivas de las IMFs afectan de modo consistente y significativo su desempeño social.

Mécanismes de gouvernance, transparence de la performance sociale et de la performance de la microfinance : le statut légal des institutions de microfinance importe-t-il?

Dans cet article, les auteurs examinent divers mécanismes de gouvernance mis en oeuvre par des institutions de microfinance (IMFs), ainsi que leur relation avec leur performance sociale et financière. Ils utilisent une base de données obtenue auprès du Microfinance Information Exchange (MIX) constituée des informations communiquées par les IMFs sur leurs impacts sociaux et financiers. L'étude montre que certains mécanismes de gouvernance diffèrent significativement parmi les IMFs selon leur statut légal. En particulier, les IMFs ayant le statut d'organisations non gouvernementales (ONG) ont plus de diversité au sein de leur Conseils d'administration, font preuve de plus d'équité dans leurs pratiques de gestion des ressources humaines et accordent plus d'attention à la formation dans leur objectifs sociaux. Les auteurs constatent ainsi que les ONG obtiennent de meilleurs résultats au niveau social (rendent des services à un plus grand nombre de clients, touchent une proportion plus élevée de clients pauvres et qu'un pourcentage plus élevé de leurs clients sont des femmes). Les résultats confirment en outre que les mécanismes externes de gouvernance ont peu ou pas d'effet, tandis que les caractéristiques des Conseils de direction des IMF affectent invariablement et significativement leur performance sociale.

1 Introduction

This paper analyzes governance mechanisms in the microfinance sector. Our goal is twofold. First, we explore differences in corporate governance between institutions with different legal status. Although traditionally microfinance institutions (MFIs) operated as non-governmental organizations (NGOs), internal and external pressures resulted in many MFIs changing from charities to profit-seeking business, adopting the status of regulated commercial financial institutions (Epstein and Yuthas 2010).

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Commercial banks have also more recently entered the sector, and currently there are at least two types of commercially oriented organizations – banks and non-bank financial intermediaries (NBFIs) – with organizations of the social economy – cooperatives and NGOs. Second, we aim to contribute to the study of the relationship between identified governance mechanisms and the performance of the missions of the MFIs. We take into account that the mission of an MFI is often defined in a dual form; its primary mission of providing banking services to poor families and micro-entrepreneurs, and the ability to attain and maintain the financial sustainability that allows the MFI to continue to fulfil its original mission. However, the pursuit of financial sustainability, i.e. generating sufficient income to cover all operating and financing expenses over time, is seen as the principal cause for mission drift in the microfinance sector (Copestake 2007). Accordingly, the identification of the governance mechanisms that can influence the former and or the latter is also of interest.

There is a limited number of previous academic studies on governance mechanisms in the microfinance sector, and of their impact on MFIs missions. The paper of Harstarska (2005), which focused on MFIs in Central and Eastern Europe, examines the impact of management remuneration, board independence and diversity as well as of external mechanisms of control. Using three different datasets with observations ranging from 46 to 144, she found that not all governance mechanisms affected the performance of the MFI, and that different factors have differential effects on outreach and sustainability. Her study highlights the importance of the board composition, with more independent boards improving financial results. Audit, rating, and supervision by central bank authorities play only a limited role. In her study the difference in financial performance and outreach between various ownership types was found to be negligible.

Mersland and Strøm (2009) analyze the effects of owner-board relationships, firm-customer relationships, and external corporate governance mechanisms, on four measures of financial performance and two measures of outreach. The paper used a database of 270 MFIs from 60 countries, configured through risk assessment reports from five different microlender rating agencies over a period of several years between 2000 and 2007. Their results show that composition of the board, as well as gender of the CEO affect financial performance, while external mechanisms had little impact. They also found that very few governance variables were significant for outreach. Ownership type, in particular, had no effect whatsoever.

It is somewhat surprising that ownership type has been found to have little effect on performance according to the above mentioned studies. In contrast, Gutierrez-Nieto et al. (2007) found the NGO status of an MFI to be relevant. Using data envelopment analysis to assess MFI performance on a database of 30 Latin American MFIs, they suggest that NGOs try to offer a large number of loans and operate as cheaply as possible, while non-NGOs rely on their specialized staff to build a profitable portfolio of loans. A possible explanation of these differences can be found in Mersland (2009), who studies the cost of ownership in the microfinance sector. With a database obtained from the Microfinance Information eXchange (MIX) 2006 Benchmarks, the paper compared different types of cost between MFIs owned by shareholders with those with an NGO or Cooperative status. According to the results, COOPs and NGOs can more effectively mitigate the costs of microfinance market contracts (cost related to limited competition or due to diverse asymmetries in information); while shareholder MFIs are able to

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lower cost of ownership-practice (monitoring, managerial opportunism, access to equity capital).

In a related paper, Cull et al. (2011) study the effect of prudential supervision on MFI profitability and outreach, using data from 245 MFIs in 67 developing countries collected by the MIX in 2003 and 2004, adding self-constructed variables on the type of supervision facing each MFI. They found that profit-oriented MFIs that have to comply with prudent supervision respond by curtailing their outreach to those clients that are costlier to serve, whereas MFIs that rely on non-commercial sources of funding (e.g. donations) do not adjust loan sizes or lend less to women when supervised, but their profitability is significantly reduced.

Our study shares some characteristics with the above mentioned ones, but also differs from them in several aspects. We use a database collected by the MIX, consisting of data reported by 709 MFIs in 82 countries in 2011. The MFIs selected were all reporting data both on financial and social performance, including specifics pertinent to the analysis of governance mechanisms. Some of these such as board composition have been previously studied but others such as internal incentives and behavioural standards are new. Due to the larger number of MFIs on our sample, we hope to effectively contribute to the debate. We are aware that considering only MFIs reporting on social data may introduce a bias in the study, since social performance reporting is not yet a widespread practice among the microfinance sector. It must nevertheless be pointed out that for 2011 60% of the MFIs reporting to the MIX did report at least some data on social performance, a figure far from negligible, considering that this was the first year of systematic collection of this type of information.

Our results suggest that ownership matters in several aspects: some governance mechanisms are significantly different among MFIs depending on their legal status. Comparatively more MFIs with NGO status have established mechanisms targeting their staff (incentives, fair practices in labour). Their boards are also more diverse and pay more attention to training in Social Performance management. Furthermore, we found that NGOs in our sample perform better at social level (serve more clients; reach more poor clients; a large fraction of their borrowers are women). Our results also indicate that external governance mechanisms such as regulation have little or no effect on performance. Type of ownership and board characteristics are nevertheless consistently and significantly affecting social performance.

The rest of the paper is organized as follows. Section 2 provides details on the research objectives and methodology, including the description of the variables used to perform the analysis. Section 3 delves on the details concerning the governance mechanisms in use in the microfinance sector. Section 4 provides the results of the regressions to test the relationship between governance and performance. Section 5 concludes.

2 Data and research objectives

To study organizational practices in the microfinance sector we follow a three dimensional structure similar to that proposed by Mersland and Strøm (2009). The first dimension is related to the effective governance of the institution in pursue of

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its goal through the axis ownership-board; the second one focuses on the relationship between the MFI and its customers (loan borrowers); and the third one considers external governance mechanisms.

According to the literature on governance, the key mechanisms of an effective governance framework are ownership structure, board structure, CEO and director roles, auditing, information disclosure and the market for corporate control (Keasey et al. 1997, cited by Hartarska 2005), although typically governance studies focus on the individual impact of one of this mechanisms. In our study we shall consider ownership structure and board structure. Ownership is captured through a dummy variable identifying MFIs with NGO legal status. Board composition and role is considered using four variables: board size, board diversity, and two variables related to the role of the board in managing and monitoring the social performance of the MFI.

The introduction of the MFI-customer dimension is justified by the extended governance paradigm, where stakeholder theory has been argued as necessary to complement agency theory by offering a more inclusive approach to corporate governance (Solomon 2007, Christopher 2011). Literature on governance suggests that there is an associated governance responsibility to operationally manage stakeholders on a day-to-day basis through an appropriate set of skilled managers and governance processes. Our variables capture this through different perspectives, taking into account fair practices related to employees and ethical codes related to clients. Furthermore, organizations use performance-based compensation to align the behaviour of managers and employees with the organization's main objectives (Speckbacher 2013), a governance mechanism that is captured in our model using the number of staff incentives declared by the MFIs. The dimension is complemented by the introduction of parameters related to the structure of management (ratio of managers versus total personnel, gender diversity on management).

Finally, we include three different and complementary variables in the external governance dimension: regulation, deposits and donations. Regulation and supervision of MFIs has been increasingly introduced by governments, mainly in order to protect the safety of deposits from relatively poor depositors, thus justifying its inclusion as external governance mechanism. Nevertheless, most MFIs face some form of non-prudential regulation (Cull et al. 2011) even if they don't accept deposits from the public (e.g. because of some form of savings programs organized for their own clients). Therefore we shall also take into account the fact that an MFI is taking deposits, to screen the stringent forms of regulation that could likely have a greater impact in the performance of the institution. Additionally we include a dummy variable to recognize MFIs accepting donations. Donors monitor organizations to verify that their donations are used in accordance with their wishes (Fama and Jensen 1983). Similarly to the deposit taking variable, donations should be considered external governance mechanisms because MFI boards generally do not include stakeholders like donors, customers, employees and debt holders (Mersland 2011).

Table 1 summarizes the independent variables considered in our study, with their explicit definitions. We have also included three variables to control for specific characteristics of the MFIs: the size of the organization, a measure of risk, and a dummy variable to take into account the level of specialization of the organization in the microfinance sector.

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Table 1 – Definition of the independent variables included in the analysis

Dimension	Variable	Defined as
Ownership-Board	Board size	Number of board members
	Female board	Percent of female board members
	Focus on SP	Dummy variable with value 1 if the board members have training in SP management
	Monitoring SP	Dummy variable with value 1 if the MFI has a formal committee monitoring Social Performance
	NGO	Dummy variable with value 1 if the MFI legal form is NGO
MFI-customer dimension	Mgmt Ratio	Number of managers / Personnel
	Female managers	Percent of female managers
	Client-related ethical code	Number of standard client protection principles in use in the MFI (see appendix)
	HR fair practices	Number of HR policies that the MFI declares to adhere (see appendix)
	Staff incentives	Number of staff incentives the MFI has put in place (see appendix)
External governance	Regulated	Dummy variable with value 1 if the MFI is regulated by country authorities
	Deposits	Dummy variable with value 1 if the MFI takes deposits
	Donations	Dummy variable with value 1 if the MFI has a positive value for donations in its annual income statement
Control variables	Organization size	Natural logarithm of assets
	Portfolio at risk	Fraction of the portfolio with more than 30 days in arrears
	Main activity	Dummy variable with value 1 when the MFI has microfinance as its main activity

Our analysis relies on data from microfinance institutions in 82 developing countries all over the world reporting both on financial and social performance to the Microfinance Information eXchange (MIX). The MIX is a nonprofit organization established in 2002 aiming to promote transparency and information exchange in the microfinance sector. Through its web-based platform, MIX Market, it provides performance information on MFIs, information that is voluntary disclosed by the MFIs, which are also invited to provide some form of third-party validation.

The database was assembled during February and March 2013 – when complete statements for 2011 were available – collecting both financial data and social data – quantitative and qualitative information – for all MFIs that did provide a Social Performance Profile Data on 2011. Some of the MFIs had to be disregarded because their annual 2011 report or social profile was not available when the MIX database was consulted, and some others due to lack of essential information (e.g. regarding the loans disbursed by the institution). Furthermore, for the purpose of this paper we have not considered MFIs with cooperative status since part of our goal is to compare governance in NGOs and profit maximizing MFIs.

The final sample has 592 observations,[1] 261 with NGO as legal status, 239 non-banking financial intermediaries (NBFI) and 92 between banks and rural banks. It

1 Regional distribution is as follows: 57 MFIs in Sub-Saharan Africa; 25 in Middle East and Nord Africa; 67 in East Asia and Pacific; 113 in South Asia; 117 in East Europe and Central Asia; and 213 in Latin America and the Caribbean.

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constitutes 71.1% of the total number of MFIs reporting on social performance, and 42.8% of the MFIs that did report to the MIX on 2011. According to the quality information score used by the MIX Market, 76.2% of the MFIs in our sample had indeed provided external validation, either audit financial statements or also rating or due diligence reports.

The restriction to MFIs reporting on social data is structural, since a substantial part of the information on governance used in our analysis comes from this source. Furthermore, the database had to be limited to MFIs reporting on 2011, because this was the first year of systematic collection of such information.[2] Although reporting to the MIX Market is voluntary and looking only at MFIs reporting social performance introduces a selection bias, we note that the sample size is larger enough to achieve significant conclusions.[3]

Our first goal in this paper is the study of the governance mechanisms implemented by the MFIs in the pursuit of their organizational missions. Prior literature suggests that type of ownership plays a role, because of the intrinsic differences among for-profit firms and non-profit organizations and the different paths followed by the MFIs in their legal structure (Labie 2001). Several results indicate that NGOs need larger boards to compensate the lack of shareholders with incentives to monitor their investments (Speckbacher 2008). The use of more businesslike incentive schemes, in particular performance related payments, can also be significant, because NGOs traditionally have tended to avoid them (Steinberg 2010, Young 1987). Our first hypothesis concerns therefore the expected differences:

H1. *NGOs' governance mechanisms have some distinct features compared to those used in MFIs with other legal status*

Our second goal concerns the relationship between governance and performance in the microfinance sector. From an economic point of view, the objective of a corporate governance system is to facilitate cooperation among stakeholders, that is, to make it more efficient (Speckbacher 2008). However efficiency – or performance – is generally considered twofold in the microfinance sector. As Labie (2001) puts it, there can be some traditional commercial banks that have decided to move towards microfinance for strategic reasons. In that case, shareholders are essentially profit-driven. But many MFIs with current NBFI status come from NGO microcredit programs. Their shareholders – although profit driven – are also largely interested in the social accomplishment and prospective viability of the organization. The later also holds for MFIs with NGO

2 The set of social performance indicators reported to the MIX Market consist of 7 performance categories, including mission and social goals, governance, range of products and services, social responsibility to clients, human resources and staff incentives, social responsibility to the environment and poverty outreach; and include both qualitative process indicators and quantitative result indicators (MIX 2011). The indicators were developed by the MIX and the Social Performance Task Force (SPTF), an organization grouping over 1,300 members from diverse microfinance stakeholder groups, aiming to 'develop, disseminate and promote standards and good practices for social performance management and reporting' (www.sptf.info/sp-task-force).

3 Taking as the universe the number of MFIs reporting to the MIX in 2011, our sample achieves statistical significance with a margin of error of 4%, considering maximum indeterminacy (p = q = 0.5) and a confidence level of 99%.

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status.[4] Therefore both financial and social performance have to be taken into account when studying the effectiveness of the considered governance mechanisms.

We shall take three different measures to assess each part of the twofold corporate goals of the microfinance institutions. Social performance include the use of the total number of active clients (borrowers) of the MFI to measure its *breadth of outreach* (Navajas et al. 2000), together with the average loan size – used to appraise its *depth of outreach* – and the number of female borrowers. The later assesses the *female focus* of the MFI, since the targeting of the female customers is one of the innovations in microfinance (Armendariz de Agion and Morduch 2005). Breadth and depth have to be considered as dual measures of outreach, since in fact it is not only the number of borrowers what matters but also how many of them are poor. This second aspect can be captured by the size of the loans: the smaller the size, the more likely the client is poor. The three measures are usually found in the literature on governance and performance in the microfinance sector (e.g. the first two are used in Hartarska (2005) and Mersland and Strøm (2009), while the first and the last ones in Cull et al. (2011)).

Financial performance is assessed in terms of overall financial performance through return on assets (ROA), efficiency (through operational costs) and revenues (portfolio yield). Again these are usual measures in the microfinance literature (Mersland and Strøm 2009). Table 2 summarizes the definition and descriptive statistics of these measures, which shall be considered the dependent variables in our analysis.

In considering table 2, it has to be taken into account that there are some very large MFIs in our sample. In fact the top 10 – three of them banks, two NGOs and the remaining five NBFI – account for half of the total clients (68 millions) reported by the 592 MFIs of our sample. Therefore, although the mean of our sample indicates an average of 116,000 clients per MFI, standard deviation is also very large. The median, 14,000 clients, is a better indicator in this case. We control for a possible bias introduced by this differences in size through a variable capturing the organizational size of the MFIs in our sample (see table 3 below). Note also that the female focus does not significantly change with the size of the MFI, since mean and medium are very similar in this case, with approximately 68% of female clients.

The average loan reflects just how 'micro' microloans are. Adjusted to purchasing power parity GDP, the lowest loan amount is US$ 18.03; the average is US$ 1,516 and the median in US$ 574.5. The maximum amount of approximately US$ 51,000 is a very extreme case, since the third quartile is found at US$ 1,368. Portfolio yield has been adjusted for inflation, because nominal portfolio yield is usually high in the microfinance sector (an average of nearly 33% in our sample).

Previous studies on the relationships between governance mechanisms and performance in the microfinance sector report mixed results. On the ownership-board dimension, for instance, Mersland and Strøm (2009) do not find any significant impact of board size, while Hartarska (2005) finds both board size and diversity to be positive and significant both on financial performance (ROA) and on social performance (depth

4 As one of the reviewers has pointed out, the trade-off between shareholders and other stakeholders can be different in profit maximizing MFIs and NGO MFIs. This can be observed through their respective lending rates, since NGOs do not have to transfer value from borrowers to shareholders. Unfortunately our database does not have information on lending rates.

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Table 2 – Definition and descriptive statistics for dependent variables used in the analysis

Variable	Mean	Median	Std Dev	N	Indicating	Defined as
Clients	116,821.7	13,939.0	542,969.6	582	Breadth of outreach	Number of active borrowers of the MFI
Loan Size	1,516.3	554.5	3,587.8	576	Depth of outreach	Gross Loan Portfolio/Number of active Borrowers adjusted using GNP per capita
Female borrowers	0.6792	0.6806	0.2530	551	Female focus	Percent of female borrowers
ROA	0.0110	0.0244	0.1309	516	Overall financial performance	Return on assets: (Net Operation Income – Taxes)/Average Total Assets
Operational Costs	237.27	149.31	420.40	497	Efficiency	Cost per borrower: Operating Expense/Average Number of Active Borrowers
Portfolio Yield	0.2480	0.2039	0.2029	513	Revenue	Financial revenue from Loan Portfolio/Average Gross Loan Portfolio adjusted for Inflation Rate

Table 3 – Descriptive statistics for independent variables

Variable	Mean	Median	StD	N	Mean for MFIs with Legal Status of NGO (N = 261)	Mean for other MFIs (N = 331)	ANOVA p-value
Board size	6.367	6	3.5306	491	6.77	6.02	0.0182**
Female board	0.310	0.2857	0.2537	425	0.35	0.27	0.0008***
Focus on SP	0.546	1	0.4983	592	0.60	0.50	0.0238**
Monitoring SP	0.289	0	0.4536	592	0.31	0.27	0.4007
NGO	0.441	0	0.4969	592	–	–	–
Mgmt Ratio	0.108	0.0879	0.0890	498	0.11	0.11	0.9627
Female managers	0.345	0.2857	0.3052	455	0.37	0.32	0.1314
Client-related ethical code	7.424	8	2.3895	592	7.38	7.46	0.7122
HR fair practices	2.780	3	1.4222	592	2.92	2.67	0.0297**
Staff incentives	2.686	3	2.0648	592	2.75	2.63	0.4959
Regulated	0.607	1	0.4888	588	0.35	0.81	0.0000***
Deposits	0.461	0	0.4989	584	0.40	0.51	0.0048***
Donations	0.311	0	0.4635	514	0.42	0.22	0.0000***
Organization size	16.396	16.2919	1.8796	529	15.77	16.91	0.0000***
Portfolio at risk	0.065	0.0338	0.1180	530	0.07	0.06	0.4956
Main activity	0.713	1	0.4528	592	0.70	0.72	0.5775

*$p < 0.1$; **$p < 0.05$; ***$p < 0.01$.

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of outreach). However, she also finds that smaller boards achieve better operational self-sustainability. Ownership type is usually considered relevant, with NGOs often believed to be weaker structures in terms of corporate governance, thus leading to lower financial performance; but more effective at reaching poor clients. Nevertheless, many MFIs are not run according to the shareholder model, since they may also be committed to reaching the poor (Labie 2001), thus explaining the findings of Mersland and Strøm (2008) that NGOs perform as well as NBFIs. This leads us to the following:

H2. *Both NGOs and MFIs with boards monitoring social performance are expected to achieve better results in terms of social performance, and not to be affected in their financial performance.*

One of the characteristics of the microfinance sector from its beginning is the targeting of female clients (D'Espallier et al. 2010). As a consequence, the study of the impact of women at diverse organizational levels is also of interest. Mersland and Strøm (2009) find positive effects on financial performance of having a female CEO, but not significant relationship with social performance. Along with them, we expect more positive results associated by larger gender diversity, because it is likely that the better knowledge of the problems faced by women, naturally acquired by women in top management of microfinance institutions, is associated with better performance of such institutions.

H3. *MFI performance will be positively affected by larger gender diversity in the management.*

Furthermore, since both staff incentives and the issue of behavioural standards are generally considered governance mechanisms designed to align the behavior of managers and employees with the organization's main objectives (Merchant 1981, Speckbacher 2013), we hypothesize that:

H4. *MFI performance will be positively affected by the proportion of staff incentives and behavioural standards adopted by the institution.*

Empirical evidence of the effect of various external governance mechanisms has also been reported. Mersland and Strøm (2009) do not find any significant relationship between regulation and performance; while both Hartarska (2005) and Cull et al. (2011) found stringent supervision resulting in lower ROA. Hartarska (2005) does not find any effect of regulation on social performance, but Cull et al. (2011) report non-prudential regulation to have negatively effects in the fraction of borrowers that are women. Alongside with those results, we postulate that:

H5. *MFIs taking deposits, and thus facing non-prudential regulation, may not achieve better social performance. Regulation per se will not be related to performance.*

3 The use of governance mechanisms in the microfinance sector

Table 3 summarizes the descriptive statistics for all governance mechanisms considered in our analysis. We have tested for differences between the legal forms of the

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MFIs. Average values for each variable in the two subsets considered (NGOs and other MFIs, grouping NBFI, banks and rural banks) are also reported in the table, as well as the p-values for the ANOVA tests for statistical significance.

Average board size of our sample is 6.367, and median is 6, low figures based on international standards (Mersland and Strøm 2009). In mean, one third of the board members are women, amounting to an average of 2 female members per board. Considered together, it seems a promising trait for the governance of the MFIs according to the results of Torchia et al. (2011) that women on the board make a difference to organizational innovation and strategic tasks only if there is a critical mass of at least three women on the board. The figure for the percent of female managers is a bit higher, 35% in mean for the MFIs in our sample.

Behavioural standards related to client protection principles are most generally implemented by the MFIs in our sample, 7.424 in average, with a median of 8, out of the 9 principles considered. The specification of those 9 principles can be found in the appendix, showing also that each individual principle is endorsed by at least 70% of the MFIs, with three of the principles adopted by more than 90% of the MFIs. Similarly, in mean the MFIs declare to have put in place 2.78 of the 4 fair practices on human resources considered in the MIX questionnaire, being equality measures (anti-discrimination, equal payment regardless of gender) the most widespread. Furthermore, most MFIs declare having established at least some form of staff incentives, with 74% of them have implemented rewards related to the quality of the portfolio built by their employees (see appendix).

Local authorities regulate 60.7% of the MFIs of our sample, and 46.1% accept deposits. A surprisingly high number of MFIs, 31.1%, have received donations during the year, regardless of its legal status. Indeed, broken by legal type, the figures are: 22.3% of the NBFIs, 21.9% of the banks and rural banks– on top of 42% of the NGOs. Average values for such donations are a bit more than US$ 110,000 per NGO and US$ 36,000 per NBFI.

The analysis of the differences in means shows that governance mechanisms adopted by NGOs in the microfinance sector have some specific characteristics. Compared to MFIs with other legal forms, boards in NGOs are larger, more diverse and pay more attention to training on Social Performance management. They also tend to adopt more fair practices in human resources. Although the number of staff incentives implemented is similar, incentives related to outreach to women and client retention are significantly more widespread among NGOs. Regarding external governance mechanisms, NGOs tend to be less regulated (only 35% of them are) and fewer MFIs with this legal status take deposits (40% of them).[5] Furthermore, they are smaller in size (measured in terms of their total assets) and accept more donations than MFIs with other legal status. Hence our first hypothesis H1 concerning expected differences between governance mechanisms has been confirmed in our sample.

5 These figures seem to contradict our earlier argument that MFIs taking deposits are usually regulated. As pointed by Cull et al. (2011), this can be explained considering that the regulation faced by the MFI within a given country often depends on their legal status. In their sample they found 14% of MFIs with NGO status taking deposits and not facing onsite supervision.

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Table 4 – Regressions for social performance measures

	Clients (breath of outreach)	Loan Size (depth of outreach)	Female focus
Board size	0.0903***	−62.1518*	0.0145***
Female board	0.2410	−559.7921	0.1454***
Focus on SP	−0.2365*	120.1966	−0.0521*
Monitoring SP	0.4396***	−333.2322	0.0861***
NGO	0.3611**	−469.8375*	0.1711***
Mgmt Ratio	−1.3888*	523.9720	0.7463***
Female managers	−1.2147***	776.1126**	−0.0227
Client-related ethical code	0.0163	−11.1637	0.0144*
HR fair practices	−0.0509	44.4075	−0.0080
Staff incentives	−0.0022	−42.5595	0.0043
Regulated	−0.0253	216.7588	−0.0084
Deposits	0.4551***	−299.9204	0.0575**
Donations	0.0067	−414.5242*	0.0085
Organization size	0.5531***	138.9044***	0.0136***
Portfolio at risk	−0.0621	211.4813	−0.2203*
Main activity	0.3175**	−395.9074	0.0702**
R^2	0.989	0.396	0.911
Adjusted R^2	0.988	0.365	0.906
N	335	335	330

Clients is adjusted using the natural logarithm of the number of active borrowers. *p < 0.1; **p < 0.05; ***p < 0.01.

4 Governance mechanisms and performance

We report here the results obtained using OLS regressions to test the relationships between the governance variables described above and several measures of performance for the MFIs of our sample. We shall start with social performance and then turn to financial performance.

4.1 Social performance

Table 4 shows the results from regressions on the social performance of the MFIs. It gives the regression coefficients measuring the rate of change of the diverse dimensions of governance on the three measures of social performance considered: breadth of outreach, depth of outreach and female focus. Goodness of fit in all regressions is high, with a relatively large number of variables statistically significant for social performance.

Examining results on table 4, the first prominent point relates the ownership-board dimension of governance. We find two mechanisms that are consistently significant and positively correlated with all three measures of social performance. The first one is the legal status of the MFI: NGOs serve more clients, reach more poor clients – using as proxy the average loan size, which is lower for MFIs with NGO status – and a larger fraction of these clients are women. The second one is the board size, indicating that larger boards should be recommended at this stage. Additionally note that board diversity also affects positively social performance, at least taking into account the female focus of the MFI. Similarly, having a formal committee in the board monitoring social performance not only increases the female focus but also the total number of clients.

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On the client-MFI dimension we have found that MFI performance, measured by the breadth of outreach, is affected negatively by increases in the proportion of managers over the total personnel of the MFI, whereas it is positively affected by the same proportion when the female focus is taken into account. The first relationship seems straightforward, since larger proportion of managers implies having lesser personnel in direct contact with clients. The second one can be explained considering that clear management directions to target women can be more effectively implemented by the staff in the case of more direct supervision.

However, we also find that female managers are negatively related with two measures of outreach and not significant for the third one. According to the regressions, more female managers will result in fewer clients; while depth of outreach could be enhanced by reducing the number of women in managerial tasks. A possible explanation – that has to be further explored – can be found relating this result to gender differences in managerial attitude towards risk. If we take the more traditional empirical research results concluding that women are more risk averse than men (Johnson and Powell 1994, Corman 2001), our result could indicate that women managers would tend to rely on already known trustworthy clients to lend progressively larger imports thus restricting the portfolio of the MFI. But other recent studies also suggest that managerial women's attitude towards risk is context sensitive, and factors like desire for influence or self-efficacy can be strong predictors of risk-taking attitudes in women (Maxfield et al. 2010). In this context, female managers' willingness to take more risk could result in backing-up riskier projects with larger possible returns in need of larger loans.

Besides that, the MFI-client dimension of the governance mechanisms seems to have little effect on social performance, with only a positive significant effect of the behavioural standards related to client protection principles on the fraction of borrowers that are women. This result can be explained in the context of more trust gained by institutions implementing more protection principles, because women are usually the less empowered part of the society, and consequently more favoured by such principles in use. This partially confirms our H4 hypothesis.

With respect to the external governance mechanisms, our results indicate that both breadth of outreach and fraction of women borrowers will be enhanced in MFIs taking deposits; depth of outreach is only significantly affected, with a positive sign, by donations. The first result is somewhat expected: regulated institutions should generate larger levels of trust among potential customers, which in turn affects positively the number of clients among the MFIs taking deposits. The latter seems to support the vision that donations are likely used to reach the poorest of the poor, since this is the only performance measure in which donations are significant. Note also that regulation per se does not appear to have any effect on social performance, thus partially confirming hypothesis H5.

Finally, note that some characteristics of the MFIs, namely size and focus on microfinance, are also relevant for these results. In particular both the number of clients and the fraction of clients that are women are positively correlated with the above mentioned characteristics. In contrast, larger MFIs tend to serve less poor clients.

We can also derive some further insights by looking at the coefficient magnitudes of our regressions. Breadth of outreach will be most enhanced on MFIs taking deposits, on those having a formal committee on the board monitoring social performance and on

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Table 5 – Regressions for financial performance measures

	ROA	Operational costs	Portfolio yield
Board size	0.0009	−8.1743	4.1953E-05
Female board	0.0452	−31.1925	0.0199
Focus on SP	0.0076	42.5845	−0.0029
Monitoring SP	0.0138	−107.9826**	−0.0145
NGO	−0.0072	−55.0804	0.0281
Mgmt Ratio	0.0104	−34.8525	0.1520
Female managers	0.0098	82.9007	0.1380***
Client-related ethical code	−0.0036	1.7897	−0.0065
HR fair practices	−0.0019	20.7969	0.0093
Staff incentives	−0.0008	−13.6956	−0.0006
Regulated	0.0029	−22.6679	−0.0450**
Deposits	−0.0177	−70.6635	0.0394**
Donations	−0.0521***	−41.5070	−0.0080
Organization size	0.0030	21.2775***	0.0089***
Portfolio at risk	−0.1887***	80.5673	−0.2312***
Main activity	0.0092	−40.5083	0.0666***
R^2	0.108	0.302	0.750
Adjusted R^2	0.062	0.265	0.737
N	332	326	330

*p < 0.1; **p < 0.05; ***p < 0.01.

MFIs with NGO status. Additionally, shareholder MFIs would need to add four (five) members to their board, nearly doubling its actual mean size, to be compared favorably to NGO MFIs concerning their total number of clients. Similarly, NGOs and MFIs accepting donations reach more poor clients than any other type of MFI, and profit maximizing MFIs would need to add at least 7 or 8 members to their boards to reach similar standards. Furthermore, female focus is best served in NGO MFIs, doubling the effect of having a formal committee on the board monitoring social performance or tripling the effect of accepting deposits. A similar effect could be obtained in a shareholder MFI only by substantially incrementing the diversity on its board together with the number of its members.

4.2 Financial performance

Table 5 shows the results from regressions taking ROA, operating expenses and portfolio yield, respectively, as dependent variables. In this case we find less explanatory value in the regressions, which also exhibit less significant variables and with more disperse effects than those found for the social performance results.

Financial performance seems to be mainly unaffected by the first dimension of governance. Board size is not significant for financial performance in our sample, just as in Mersland and Strøm (2009). This is also the case concerning diversity on the board, which here is not associated with ROA, contrary to the findings of Hartarska (2005).

In addition, our results show no differences in profitability between NGOs and other MFIs, in line with previous results (Mersland and Strøm 2008). Summing up our previous results concerning social performance, NGOs MFIs appear to have better outreach but do not show higher profitability, thus confirming the first part of our H2

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hypothesis. On the contrary, there is a positive effect derived from the existence of a formal committee in the board monitoring social performance, pointing at the reduction of the operational costs of the MFI. Therefore the second part of our H2 hypothesis is only partially confirmed.

Financial performance is likewise unaffected by the MFI-client dimension of the governance mechanisms. We obtain positive effects only related to the percentage of female managers in the organization. MFIs with more female managers seem to have better portfolio yield. This result partially confirms our H3 hypothesis in what relates the financial performance of the MFIs, although it is not the case concerning social performance, as we have already commented.

With respect to external governance mechanisms, we find no significant results concerning the impact of regulation on ROA or operational costs, in line with previous similar results (Hartarska and Nadolnyak 2007, Mersland and Strøm 2009). However, regulated MFIs seem to exhibit reduced portfolio yields, an effect that can be explained when such regulation is associated with caps in interest rates.

On the contrary, deposit taking MFIs achieve better portfolio yields, while those accepting donations seem to achieve worse results on financial performance, measured by ROA. The first result can be explained taking into account that deposit taking MFIs have financial resources at lower costs, thus attracting more clients (in line with the result obtained in the social performance measures) and raising their revenue. The latter can be in fact due to a problem of reverse causality, since it is possible that lower return on assets because of low profitability require donations (or public subsidies) in order for the MFI to be financially sustainable.

5 Conclusions

In this paper we have studied diverse governance mechanisms implemented by MFIs, as well as their relationships with both social and financial performance, using a database obtained from the 2011 MIX benchmarks, consisting of 592 MFIs reporting data both on financial and social performance with diverse legal status (NGOs, NBFI, banks and rural banks).

We find that corporate governance has more impact on social performance than on financial performance. This result can be driven by the concern for social performance showed by the MFIs of our sample – since they are reporting on social data, which is a relatively new approach in the microfinance sector. Nevertheless, the size of the database is large enough to support the results of our analysis.

One of our strongest findings concerns the enhancement of all measurements of social performance by the instruments in the ownership-board dimension. This result seems to confirm the positive effects of part of the guidelines for Social Performance Management agreed between the main stakeholders of the microfinance sector. Indeed, we have found that governance mechanisms such as the recommendation of setting a committee on the board to monitor social performance, the development of standards for client protection or the promotion of gender diversity in the board result in MFIs serving more clients, reaching poorer clients and extending their services to more female borrowers.

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On the contrary, our results indicate that governance mechanisms targeting the staff of the MFIs (incentives, fair practices in labour) – also part of the guidelines for Social Performance Management – have no impact either in its social performance or in its financial performance.

Finally, we have to stress the positive effect of the NGO status of an MFI. Regressions show that social performance improves for this type of ownership as has no effect on financial performance. Therefore the call for transforming NGOs in the microfinance sector into shareholder-owned firms (Fernando 2004, Ledgerwood and White 2006) loses weight faced to evidence contrary such as the obtained in this paper and others (Gutierrez-Nieto et al. 2007, Mersland and Strøm 2008, 2009).

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Appendix

The following table provides detail on the particular type of (1) benefits and incentives for the employees and (2) client protection principles the microfinance sector recommends as standard practices,[6] with particulars of the level of adoption of each one for the MFIs of our sample.

Table A1 – Detail and descriptive statistics for various MFI-customer dimension variables included in the study.

Variable	Mean	Std Dev	N	Mean for MFI with Legal Status of NGO (N=261)	Mean for other MFIs (N=331)	ANOVA p-value
HR fair practices						
Transparency on salary (clear salary scale)	0.60	0.49	592	0.67	0.56	0.0061***
Benefits (medical insurance, pension contribution)	0.63	0.49	592	0.68	0.58	0.0176**
Protection at work (safety, anti-harassment)	0.73	0.44	592	0.74	0.73	0.8197
Equality (anti-discrimination, equal pay for men and women)	0.82	0.39	592	0.84	0.80	0.1965
Staff incentives						
Ability to attract new clients from target market	0.64	0.48	592	0.63	0.65	0.6079
Outreach to remote/rural communities	0.25	0.43	592	0.26	0.25	0.8032
Outreach to women	0.22	0.41	592	0.26	0.19	0.0529*
Quality of interactions with clients based on client feedback mechanisms	0.22	0.41	592	0.19	0.24	0.0967*
Quality of social data colleted	0.15	0.36	592	0.14	0.15	0.6764
Client retention/drop-out rate	0.46	0.5	592	0.52	0.42	0.0184**
Portfolio quality	0.74	0.44	592	0.76	0.73	0.3565
Client-related behavioral standards						
The loan approval process requires evaluation of borrower repayment capacity and loan affordability. Loan approval does not rely solely on guarantees (whether peer guarantees, co-signers or collateral) as a substitute for good capacity analysis.	0.91	0.29	592	0.92	0.90	0.6040

Continued

6 There is not a unique definition of the client protection principles shared by the whole microfinance industry. See for example the wording of The Smart Campaign (http://smartcampaign.org/about/smart-microfinance-and-the-client-protection-principles)

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Table A1 – Continued

Variable	Mean	Std Dev	N	Mean for MFI with Legal Status of NGO (N=261)	Mean for other MFIs (N=331)	ANOVA p-value
Internal audits check household debt exposure, lending practices that violate procedures including unauthorized re-financing, multiple borrowers or co-signers per household, and other practices that could increase indebtedness.	0.73	0.44	592	0.75	0.73	0.5470
Productivity targets and incentive systems value portfolio quality at least as highly as other factors, such as disbursement or customer growth. Growth is rewarded only if portfolio quality is high.	0.84	0.37	592	0.84	0.83	0.7666
Prices, terms and conditions of all financial products are fully disclosed to the customer prior to sale, including interest charges, insurance premiums, minimum balances, all fees, penalties, linked products, third party fees, and whether these can change over time.	0.92	0.27	592	0.93	0.92	0.5989
Staff is trained to communicate effectively with all customers, ensuring that they understand the product, the terms of the contract, their rights and obligations. Communications techniques address literacy limitations (e.g., reading contracts out loud, materials in local languages).	0.90	0.3	592	0.91	0.89	0.3444
Acceptable and unacceptable debt collection practices are clearly spelled out in a code of ethics, book of staff rules or debt collection manual.	0.78	0.41	592	0.75	0.80	0.1535
The organization's corporate culture values and rewards high standards of ethical behavior and customer service.	0.80	0.4	592	0.79	0.80	0.7516
A mechanism to handle customer complaints is in place, has dedicated staff resources, and is actively used (Suggestion boxes alone are generally not adequate).	0.70	0.46	592	0.65	0.75	0.0120**
Customers know how their information will be used. Staff explains how data will be used and seeks permission for use.	0.84	0.370	592	0.84	0.83	0.8644

Statistical significance: * p-value < 0.1; ** <0.05; *** < 0.01

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