

THE FLETCHER SCHOOL OF LAW & DIPLOMACY, TUFTS UNIVERSITY

Impact of Corporate Governance Practices on Financial Performance of Microfinance Institutions in India

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6/10/2014

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Ownership
Leadership
Transparency
Microfinance
Profitability
Corporate Governance
India
Best Practices
Agency Theory

Abstract

Corporate Governance practices of MFIs (Microfinance Institutions) across different economies have been known to affect the firm performance. This study explores the practices and key board features (Audit Committees, Independent Directors, International Directors, CEO-Board Chairman duality, Board Size and Director's Skills) that may have effect on the financial performance of 'for profit' MFIs in India. The study identifies Board Size and presence of International Directors to have negative impact on the profitability of MFIs while the Directors' financial skills are found to have a positive impact on the profitability. No effect of CEO-Board Chairman dual role and audit committees was found on the MFI profitability.

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I. Introduction

The objective of this paper is to investigate and discuss the key corporate governance mechanisms and its effect on financial performance of the Microfinance Institutions (MFIs) in India. The idea is to identify the specific governance mechanisms such as board size, proportion of independent, international and skilled directors, independent audit committees and separation of role of CEO and Board Chairman, which help the firms improve their financial performance.

Since last decade, research on microfinance firms has gained pace, reflecting increasing interest on the business of providing financial services (credit, savings, insurance, remittance and payments) to the working poor of the world, especially in developing countries. Microfinance has emerged as a potent tool to alleviate poverty and has been feted by the development sector. United Nations declared 2005 as the International Year of the Microcredit with a view to draw attention to the microfinance sector and to encourage participation in the enterprise of financial inclusion. In the year 2006, Muhammad Yunus, a social entrepreneur from Bangladesh was awarded Nobel Peace Prize along with the Grameen Bank for his pioneering work in microfinance.

Along with increase in popularity of microfinance, the concern among investors and donors for better corporate governance has also increased. As the microfinance business scaled up and attendant commercialization of microfinance took place, the need for a systematic approach to Corporate Governance has been felt. Numerous industry led studies and consulting reports have recommended a set of governance practices to achieve the financial and social objectives of the firm. But the recommendations have not been country specific and not entirely based on empirical evidence. There is evidence that different types of regulatory regimes have distinct

implications on the cost of operations and varying effects on the profitability and outreach of MFIs¹. Hence, country specific studies are warranted. Empirical research on corporate governance of MFIs in India has been scant. The existing body of empirical research using a global or a multi country dataset invariably ignores the effect of national level regulations, consumer behavior, business practices and culture, aggregating the information of different markets, with the assumption that the information on Corporate Governance practices is comparable. Hence, there is a need for country level empirical research on MFIs.

This paper begins with a discussion on the existing literature on Corporate Governance of firms in general and the relevant theoretical framework of agency theory. It then discusses the literature specific to Corporate Governance mechanisms of MFIs.

The data on growth of loan asset size and profitability trend from 2009 to 2012 is presented under the section Descriptive Statistics. The data on financial parameters (Return on Equity- RoE, Operational Self Sufficiency - OSS and Portfolio Yield) of 26 Indian MFIs has been pulled from an industry database (www.mixmarket.org) and combined with information on board and management from the ratings and audit reports of the MFIs. This self constructed dataset was used for the panel regression. The panel regression was done using ‘random effects’ methodology.

¹Cull, R., Demirgüç-Kunt, A., & Morduch, J. (2011). Does regulatory supervision curtail microfinance profitability and outreach?. *World Development*, 39(6), 949-965.

II. Literature Review Part 1: Theoretical framework

Corporate Governance of the firms has been studied under the lens of the Principal-Agent relationship of The Agency Theory. The Principal-Agent problem in the firm's context is defined² as "the problem arising when agents (firm's managers) pursue their own goals rather than the goals of principal (shareholders)". It assumes that the managers are self interested individuals whose incentives are not aligned to the wealth creation goals of the shareholders. Agency theory is the theoretical framework that has been a handy tool to explain the dynamics of the relationship between the board directors who represent the shareholders and the management.

This theory explains two issues that can occur in agency relationships. a) The divergent goals of the principal and agent, and b) Costly and non-fool proof monitoring of the agent by the principal.³ In order to reduce opportunism by the managers and mitigate the above mentioned problems, the firm owners typically deploy certain mechanisms such as a BoD (Board of Directors), audit reporting and decision making committees. These mechanisms have been likened to an information system by the economic scholars⁴. As per the *Positivist Agency Theory*, the agent is more likely to act in accordance with the principal's expectations when the agent's actions can be verified (quality of information) by the principal⁵. This is a good reason for shareholders to have an effective board.

² Pindyck Robert and Rubinfeld Daniel; *Microeconomics* (New Jersey: Prentice Hall, 2009), 631.

³ Eisenhardt Kathleen; "Agency Theory: An Assessment and Review," *The Academy of Management Review* 14, no. 1 (1989): 58

⁴ Fama, Eugene F., and Michael C. Jensen. "Separation of ownership and control." *Journal of law and economics* (1983): 301-325.

⁵ Eisenhardt Kathleen; "Agency Theory: An Assessment and Review," *The Academy of Management Review* 14, no. 1 (1989): 60

Various indicators have been suggested that likely attest to the quality of the information that is gathered by the BoD, such as the duality of CEO and board chairman, frequency of the board meetings, number of board members, tenure of the board members, proportion of independent board members and proportion of board members that have suitable industry knowledge.⁶ A survey of Corporate Governance studies highlight the focus has been on following aspects of the governance: compensation, board size, independence and diversity⁷.

There are however, dissenting voices about what characterizes an effective Board. The ‘one size fits all’ model doesn’t seem to fit firms of different sizes in a variety of sectors and geographical markets.

Bhagat and Black (1999) investigate the correlation between the board characteristics (presence and proportion of independent directors and size of the board) and financial performance of US public companies.⁸ The empirical evidence points to non correlation between the presence of independent directors in the board and the financial performance. The study also finds no relationship between board size and financial performance.

The study of banks in Nigeria indicate that the board size does affect the financial performance, although negatively and independent directors are found to have a positive and significant effect on the financial performance.⁹

⁶ ibid

⁷ Shleifer, A., & Vishny, R. W. (1997). A survey of corporate governance. *The Journal of Finance*, 52(2), 737-783

⁸ Bhagat, S., & Black, B. (1999). The uncertain relationship between board composition and firm performance. *The Business Lawyer*, 921-963.

⁹ Adeusi, S. O., Akeke, N. I., Aribaba, F. O., & Adebisi, O. S. (2013). Corporate Governance and Firm Financial Performance: Do Ownership and Board Size Matter?. *Academic Journal of Interdisciplinary Studies*, 2(3), 251.

While examining the concept of '*separation of control and ownership*', the study by Jensen and Fama¹⁰ (1983) hypothesizes that small organizations may need board duality, where board chairman is also the CEO, for the firm to be efficient and more nimble in decision making. Perhaps, the boards of the firms in the study exhibited efficient principal agent relationship, with minimal information asymmetry and good alignment of the incentives.

Although the studies highlight the importance of effective governance, the mixed and conflicting results of the above mentioned studies point to futility of having a uniform standard for corporate governance of firms across industries and around the world. As far as the microfinance industry is concerned, there is a diversity of opinion on what characterizes best corporate governance practices.

Various industry reports recommend certain governance features and 'best practices' for microfinance firms. A study by ACCION International¹¹ proposes greater number of independent directors and emphasizes the positive role that international directors may play in introducing good corporate governance practices in MFIs. The study assumes that since these firms operate in developing or least developed countries characterized by insufficient regulation, inadequate human capital and management systems (information & risk management) they therefore require technical assistance, especially in corporate governance policy.¹² A study by *Calmeadow* that

¹⁰ Fama, Eugene F., and Michael C. Jensen. "Separation of ownership and control." *Journal of law and economics* (1983): 301-325.

¹¹ Kaddaras James and Rhyne Elisabeth. "Characteristics of Equity Investment in Microfinance", ACCION International, April 2004 Accessed February 10, 2014

¹² *ibid*

investigated MFI failures in Latin America¹³, identified both internal and external factors for the MFI failure. Following were the identified internal causes of failure; concentration of too much power into the hands of CEO, lack of independence of internal audit team and the audit team that was found to reporting to the CEO rather than the board.

III. Literature Review Part 2: Corporate Governance and Performance of Microfinance Institutions (MFIs)

In the context of MFIs, governance can be defined as *the process by which a board of directors, through management, guides an institution in fulfilling its corporate mission and protects the institution's assets over time*¹⁴.

As per the *Grameen Foundation*, risk due to lapses in corporate governance is one of the top ten risks for MFIs¹⁵. One of the initial studies in this area by Marc Labie (2001), utilizing the agency theory, emphasizes the role of internal control in controlling the NPA¹⁶, points to risk of management entrenchment and recommends a coalition of independent directors in the board to safeguard the interests of shareholders. The study underlines the fact that the inadequacy in governance has been a common reason for failure of many MFIs.¹⁷ A recent literature survey on

¹³ Marulanda, B., Fajury, L., Paredes, M., & Gomez, F. (2010). "Taking the good from the bad in microfinance: lessons learned from failed experiences in Latin America", Calmeadow, June 2010 Accessed June 09, 2014

¹⁴ Rock R, Otero M, Saltzman S. "Principles and Practices of Microfinance Governance", USAID, ACCION International, 1998

¹⁵ Grameen Foundation, *Microfinance Banana Skins 2011: What Does This Mean for People Practices?* (Washington D.C, 2011)

¹⁶ Non Performing Assets

¹⁷ Labie, M. (2001). Corporate governance in microfinance organizations: a long and winding road. *Management Decision*, 39(4), 296-302.

Corporate Governance practices of MFIs, identifies several corporate governance factors that influence the financial performance and the social impact of MFIs.¹⁸ The significant factors that have been mapped by the study are:

a) Independent Internal and External Auditors reporting to the board, b) Board Diversity c) Board Size d) Independent Directors e) Ownership Types f) Corporate Mission g) CEO/ Board Chairman Duality.

CRISIL, a subsidiary of Standard & Poor in India believes that following are the characteristics of an ideal board; high degree of board independence (proportion of independent board members and CEO/Chairman duality), internal controls, quality of disclosures, board composition and diversity¹⁹. It has embedded these governance characteristics in the rating template that it uses to rate the MFIs. A study by Indian Institute of Management (Ahmadabad) of four large MFIs in India pointed out poor governance practices at these firms²⁰. Promoters of three out of the four firms skimmed economic surplus in form of higher compensation and undervalued stock options. They compromised board independence by appointing close family members in the board, even though the firms were initially donor funded non-profit entities. The boards had international directors and other external directors but they were passive to the prevalent corporate governance practices and failed to prevent expropriation by the management.

¹⁸ Thrikawala, S., Locke, S., & Reddy, K. (2013). Corporate Governance--Performance Relationship in Microfinance Institutions (MFIs). *Asian Journal of Finance & Accounting*, 5(1)

¹⁹ Venkatraman S. and Sekhar Raj T., "Guest Opinion: For India's Microfinance Institutions, Governance is the key to Sustained And Scalable Growth", CRISIL, Standard & Poor's, November 10, 2008

²⁰ Sriram, M. S. (2010). Commercialization of Microfinance in India: A Discussion on the Emperor's Apparel

As per the agency theory and current industry literature, the board must retain independence from the management, especially when the management is run by a charismatic promoter, who can dominate the board and may be difficult to fire. In case of larger MFIs in India, the above mentioned study has indicated that promoter led management can be entrenched and be detrimental to the interests of stakeholders. But does this hold for small Indian MFI too? Jensen and Fama found that small firms can benefit from CEO/Chairman duality from quick decision making through better board and management coordination.²¹

In the microfinance literature, the CEO/Chairman duality has been found to be a significant factor for a positive financial performance. Mersland and Strom (2009)²² found that the duality increases the portfolio yield and the outreach (number of clients) but has no effect on RoA (Return on Assets) of the firms. A subsequent study by Hartarska & Mersland (2012)²³ with a similar data set concludes that the duality of CEO and Board Chairman position increases the volume and number of loans. The arguments lead to the following hypothesis:

Hypothesis 1. CEO and chairman duality does not lead to superior decisions and better MFI performance.

Agency theory considers the board independence and its leadership a critical success factor for the firms and a mitigating factor for excessive risks. In microfinance industry where the loans are

²¹Fama, Eugene F., and Michael C. Jensen. "Separation of ownership and control." *Journal of law and economics* (1983): 301-325.

²²Mersland, R., & Øystein Strøm, R. (2009). Performance and governance in microfinance institutions. *Journal of Banking & Finance*, 33(4), 662-669

²³ Hartarska, V., Mersland, R., Nadolnyak, D., & Parmeter, C. (2013). Governance and scope economies in microfinance institutions. *International Journal of Corporate Governance*, 4(1), 74-96

of shorter tenor (1 to 2 years) and can go bad very quickly, the senior management is always under pressure to maintain a tight vigil against defaults and at the same time achieve the growth. As the case of *Sahayata Microfinance* (Box 1) indicates, the senior management can suppress the information about the financials performance. The board's independent supervision and leadership of the management therefore is critical for transparency and to balance the trade-off between the risk taking for higher growth and risk management. Hartarska (2005)²⁴, Bassam (2009)²⁵ Hartarska & Mersland (2012)²⁶ have all found the evidence of a positive impact of independent directors on the financial performance of the MFIs. The effect of presence of international directors has not been investigated widely in the microfinance literature. Mersland and Strom (2009)²⁷ find that the local board members are more effective compared to the international directors when it comes to achieving the financial performance, in fact as per the authors, international directors have a negative effect on the MFI's financial performance. But the presence of international directors may have a significant effect on the decision making as they bring state of the art managerial expertise, skills and help in raising capital.

Hypothesis 2. A higher proportion of Independent and International directors in the board can take objective decisions and lead the boards that facilitate better firm performance.

²⁴ Hartarska, V. (2005). Governance and performance of microfinance institutions in Central and Eastern Europe and the newly independent states. *World development*, 33(10), 1627-1643.

²⁵ Bassem, B. S. (2009). Governance and performance of microfinance institutions in Mediterranean countries. *Journal of Business Economics and Management*, 10(1), 31-43.

²⁶ Hartarska, V., Mersland, R., Nadolnyak, D., & Parmeter, C. (2013)

²⁷ Mersland, R., & Øystein Strøm, R. (2009)

Financial mismanagement or frauds and subsequent loss of reputation are one of the most common causes for MFI failures. Such incidents result in loss of credibility of the leadership team and the board. Independent Audit Committee, a committee comprised mostly of independent directors that is responsible for internal control and compliance, is an important corporate governance feature to mitigate the risk of fraud and misrepresentation of information²⁸. Microfinance practitioners and academicians have been advocating certain measures for a stronger risk management system. The recommendations include, higher proportion of independent directors in the audit committee, internal auditors and risk management team reporting directly to the board's audit committee instead of the management. It is expected that the independent audit committees are essential for detecting and controlling the financial mismanagement and therefore achieve good financial performance.

Hypothesis 3. Independent Audit Committee is expected to improve monitoring and transparency in operations and lead to timely and accurate reporting of the loan defaults and poor performance. A superior reporting mechanism results in better decision making and financial performance.

There is empirical evidence to prove that the board size has a direct bearing on the MFI's performance. Hartarska (2005), Mersland & Strom (2009) and Bassem (2009) studied the effect of board size on the financial performance of the MFIs. Board size is shown to have a positive effect on the financial performance of Mediterranean MFIs by Bassem (2009). Hartarska (2005) finds evidence of negative effect of board size on the Eastern European MFI. While the overall

²⁸ GTZ, Division 41, Financial Systems Development, *A Risk Management Framework for Microfinance Institutions* (Washington, D.C: Microfinance Network, 2000)

world data used by Mersland & Strom (2009) points to a negative impact of board size across multiple financial parameters (Return on Assets, Operational Self Sufficiency and Portfolio Yield).

Taking a cue from the Agency Theory, I hypothesize that the Board size should have a positive effect on the financial performance of the Indian MFIs. This is because larger boards can offset the influence of a dominant CEO and reduce the information asymmetry between the board and the management. A larger board is also more likely to have higher number of resourceful directors, who can bring in expertise and capital to the firms.

Hypothesis 4. Board Size has a positive impact on the financial performance of the MFIs

Skillful board members are always a strategic resource for a firm. They can provide guidance on nuanced operational aspects (retail financial services, product development and customer relationship management) and make the firm competitive. Board members with financial and banking skills can contribute to the improvement of internal controls and operational processes. Such members can also utilize their professional network to hire talent on time to help the MFIs expand. Microfinance Network, a think tank for financial inclusion, lists banking and financial skills as one of the recommended skills for a board member²⁹.

Hypothesis 5. A banker in the board will bring the financial services industry's expertise and professional network to the MFI and will drive the performance of the MFI.

²⁹ Campion Anita and Frankiewikz Cheryl, Guidelines for the effective governance of Microfinance Institutions, MicroFinance Network Occasional Paper No.,1999

BOX -1

Caselet: Sahayata Microfinance, Udaipur, India

In 2011, the board of Sahayata Microfinance led by Caspian Advisors (shareholder) fired the founder and CEO of the firm along with some members of senior management for allegedly misrepresenting financial and operational information (misrepresenting delinquency rate, number of customer accounts, mis-appropriation of funds and misstatement of expense accounts)³⁰. Sahayata had received favorable comments about its governance and management systems by the rating agency (M-Cril) that rated it in 2010, just a few months before detection of fraud by the board. Sahayata's governance characteristics were characterized by dual CEO-Board Chairman roles held by the single person (founder) and founder as the central figure of the organization. The audit sub-committee and auditors could not detect the fraud till November 2011. Although the nature of reporting to the audit committee by its staff and then by audit committee to the board is not clear, the case of Sahayata Microfinance indicates management entrenchment and failure of Principal – Agent relationship; CEO and Board's chairman's role was not split, which led to suppression of information on the part of the management.

³⁰ Abhijit Lele, "Sahayata Microfinance sacks top management for irregularities", *business-standard.com*, November 18, 2011

IV. Description of the MFIs, Data & Methodology

Data on financial ratios (RoE, OSS and Portfolio Yield) have been mainly sourced from www.mixmarket.org (an industry database) and partially from the rating reports for ratings conducted between 2009 to 2012. Data on the mixmarket.org website is self reported and is perhaps the only database for both commercial MFIs and non-profit MFIs. Data on board characteristics is constructed from annual reports, MFI firm's websites and rating reports. Most of the ratings of the MFIs in the study have been conducted by the following India based rating agencies; M-Cril, CRISIL and ICRA. The dataset has 26 Indian MFIs.

The study is focused on the 'for profit' or regulated non-banking financial firms for the following reason: regulated and shareholder owned firms have governance structures that are similar to a traditional financial firm, that there is a separation of ownership and management, cooperatives don't have such an ownership structure while non-profit microfinance organizations have non microfinance developmental projects that may be cross subsidized through microfinance operations. As per the CRISIL rating agency of India, the legal form and related regulatory requirements have a bearing on the governance practices and transparency.³¹ Empirical studies have also shown that the legal form of a firm is an important factor for

³¹ Venkatraman S. and Sekhar Raj T.

financial performance and that the shareholder owned MFIs outperform the non-profit MFIs, except on the asset quality parameter.³²

MFIs that operate in the southern state of Andhra Pradesh have been excluded from the dataset to avoid the effect of state level regulatory shock to Microfinance sector. The state had witnessed stringent regulations after customer suicides due to unethical recovery practices of MFIs came to light. The stringent regulations on loan recovery process led to few MFI failures and deterioration of their financial health³³.

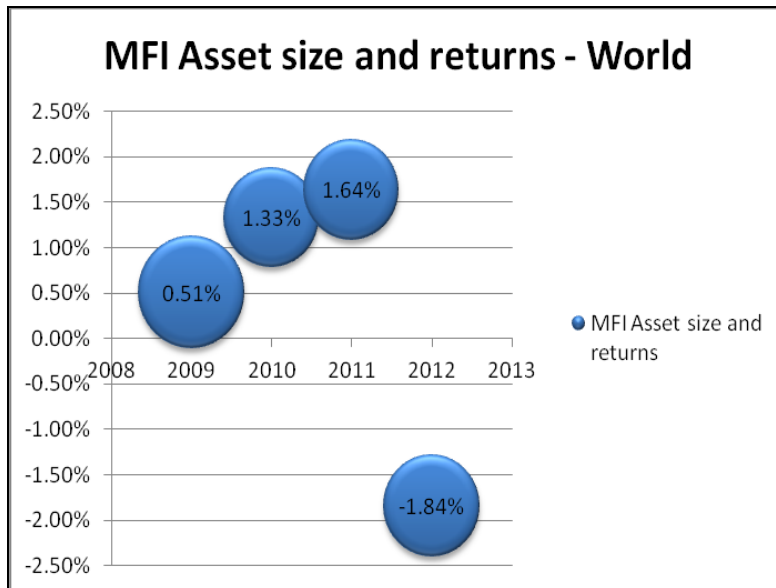
Descriptive statistics

The mean of the financial performance variables; RoE, OSS & Yield for Indian MFIs are lower than the mean for rest of the world MFIs (Graph 2 & 4). This could be due to the cataclysmic decline of loan recovery in the state of Andhra Pradesh, India in later half of 2010 (Graph 1 & 2).

³² Tchakoute-Tchuigoua, H. (2010). Is there a difference in performance by the legal status of microfinance institutions?. *The quarterly review of economics and finance*, 50(4), 436-442.

³³ CGAP (the Consultative Group to Assist Poor), *Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance*(Washington, D.C., 2010)

Graph 1: As per the Mix-market data, Return on Equity across the world have declined while the median asset size (bubble size) remains stable



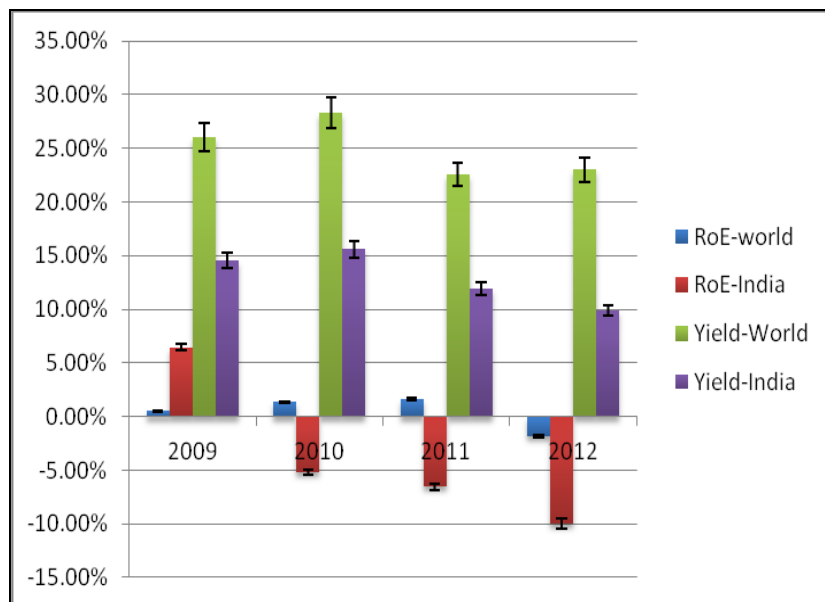
Data Source: www.mixmarket.org

Table 1: Median Asset size of MFIs in India and in Rest of the World

As of Date	Gross Loan Portfolio -GLP (median) - US Dollars	
	GLP-World	GLP-India
2009	5,518,760	149,090
2010	4,413,216	16,721,775
2011	4,413,177	17,506,436
2012	4,501,468	7,284,644

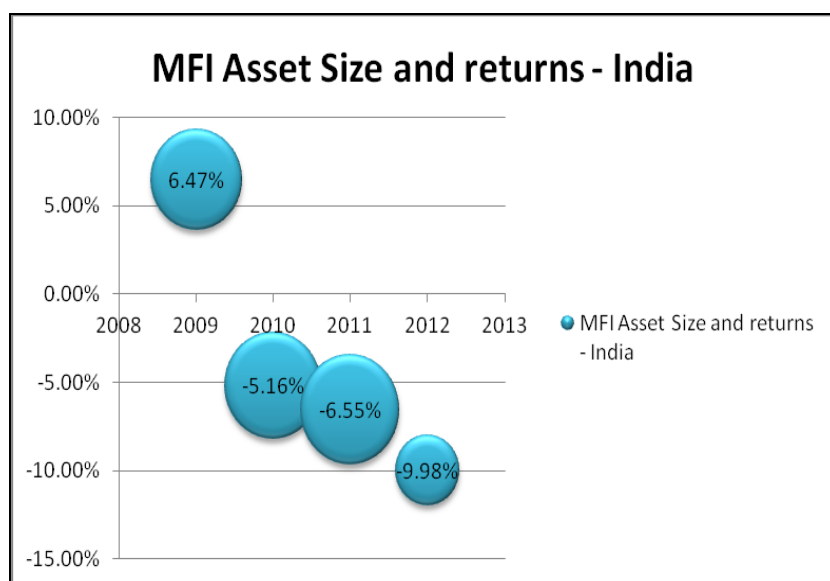
Data Source: www.mixmarket.org

Graph 2: Mean of Return on Equity (RoE) (India) & Yield (India) have trended lower than world mean figures for RoE and Yield



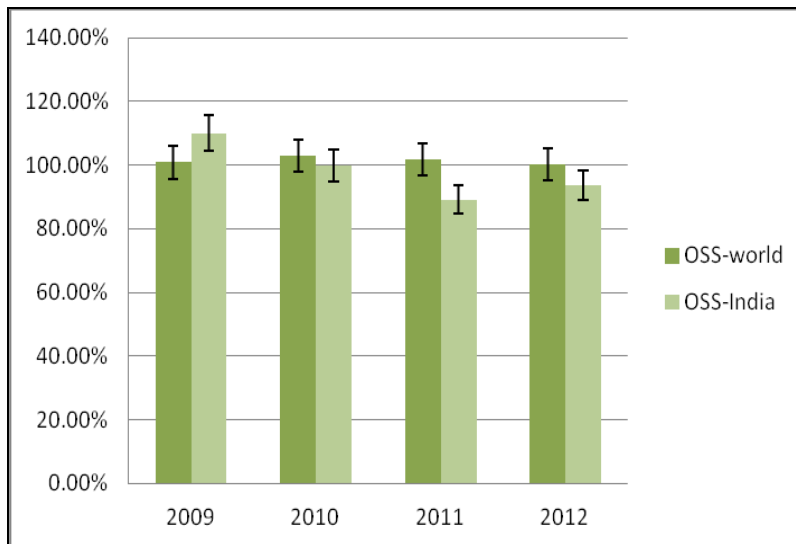
Data Source: www.mixmarket.org

Graph 3: Median Asset size and Return on Equity (RoE) both have declined precipitously



Data Source: www.mixmarket.org

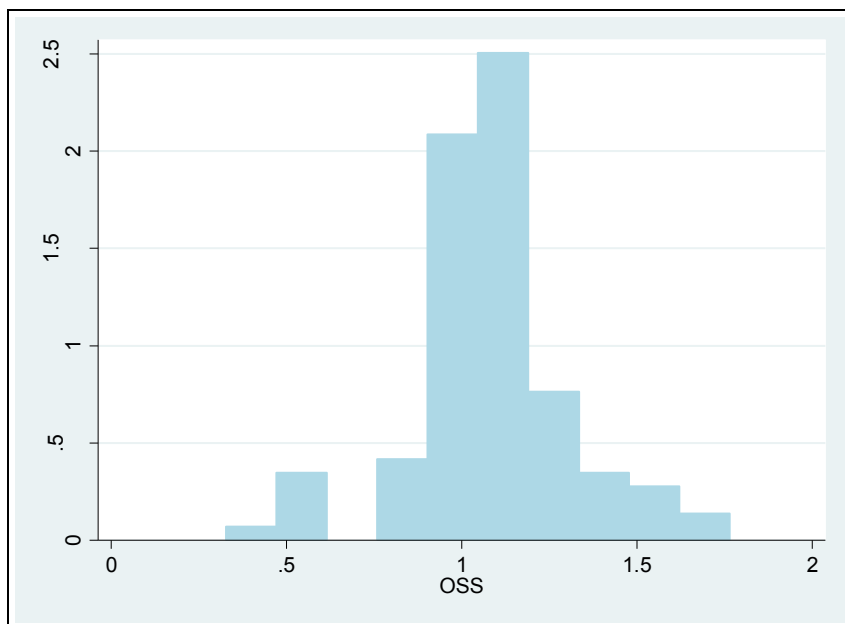
Graph 4: India's mean Operational Self Sufficiency (OSS) has been trailing behind the world mean since 2010.



Data Source: www.mixmarket.org

The MFIs covered under the study, show better performance compared to the overall dataset of Indian MFIs on the financial parameters and is comparable performance to the global average. The average OSS for the MFIs under study is 108% (Graph 5 and Table 2) compared to less than 100% for rest of India (since 2011) and around 100% for rest of the world. The average RoE for MFIs in the sample study is 2.9% (Graph 6 and Table 2) compared to the median RoE of Indian MFIs that range from 6.5% to 10% with a declining asset size, confirming the effect of decline of microfinance on the financial health of MFIs in the state of Andhra Pradesh.

Graph 5: Operational Self Sufficiency (OSS); Mean: 1.08 or 108% (sample dataset)



Graph 6: Return on Equity (RoE); Mean: 2.9% (Sample dataset)

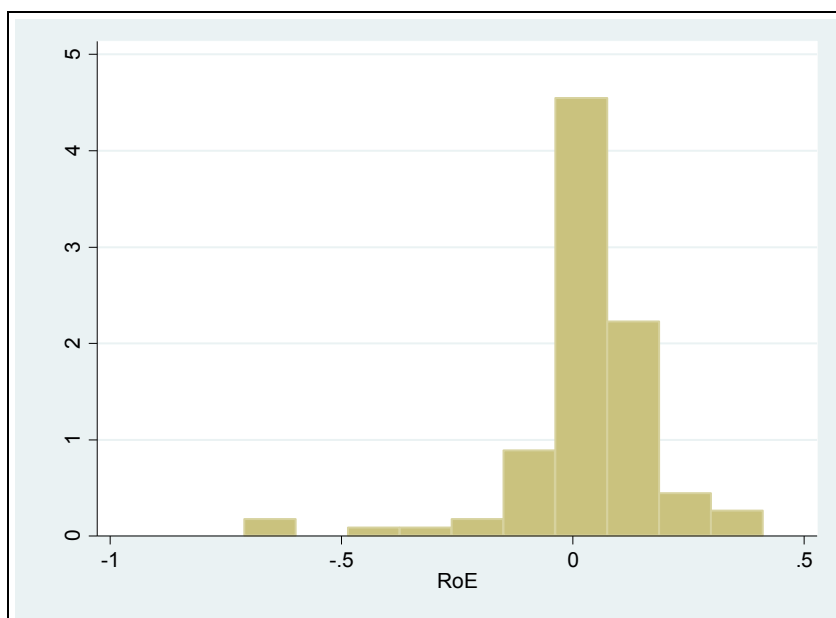


Table 2: Figures for Indian MFIs in the sample dataset

	RoA	RoE	OSS	Yield
Min	-20.75%	-71%	33%	3%
Max	13.46%	41%	177%	41%
Mean	0.27%	2.97%	108%	24.24%

Most of the MFIs in the study operated both rural and urban branches, are on average 7 years old, with an average of 7-8 board members, 35% independent directors, 13% international directors and 21% of directors with banking experience (**Table 3**). A total of 66% of the boards had an independent auditor reporting to the board directly (**Table 3**) and 73% of the MFIs have separation of CEO and Board Chairman role in the study. Most MFIs in the sample data seem to have adopted the global best practices of corporate governances. A typical ‘for profit’ Indian MFI is more likely to have a separation of CEO and board chairman role, an audit committee reporting to the board and a significant number of independent directors, this in line with recommendations of microfinance investors and donors.

Empirical model

The empirical model specified in equation below is broadly based on (Hartarska, 2005)³⁴ and Bassem (2009)³⁵ study of effect of governance on performance of MFIs in Eastern Europe and across the Mediterranean region, respectively. The causal relationship between the governance mechanisms and the MFI performance has been established in the microfinance literature³⁶ and

³⁴ Hartarska, V. (2005). Governance and performance of microfinance institutions in Central and Eastern Europe and the newly independent states. *World development*, 33(10), 1627-1643.

³⁵ Bassem, B. S. (2009). Governance and performance of microfinance institutions in Mediterranean countries. *Journal of Business Economics and Management*, 10(1), 31-43.

³⁶ *ibid*

the evidence of governance mechanisms being endogenous has not been found in the microfinance industry³⁷.

Empirical model

$$Y_{it} = \text{constant} + \alpha B_{it} + \beta F_{it} + \varepsilon_{it} \quad \text{eq. (1)}$$

Where Y_{it} is a dependent variable for financial performance of firm 'i' at time 't', B_{it} captures board variable of firm 'i' at time 't' and ' F_{it} ' captures the firm level variables. Since the study is only on one country's data, country specific macroeconomic variables have not been considered. The dependent variables for financial performance are; Return on Equity (RoE), Operational Self Sufficiency (OSS) and Yield on Portfolio. RoE measures the overall profitability to the shareholders, the yield measures the profitability at the loan portfolio level and OSS measures the financial sustainability of the lending operations.

The regression on panel data has been done using Random Effects estimation method since the panel data has time invariant governance variables; the independent variables such as board characteristics and lending methodology don't vary much over a period of three to four years. Therefore, fixed effects method is unsuitable for such a data. The independent variables to capture board level effects (B_{it}) are; audit committee reporting to the board, board size, presence of a former banker, proportion of international-nominee directors and independent directors in the board. The dummy variables have been assigned for 'audit committee reporting to the board'; MFIs with an audit committee have been assigned 1 and MFIs with no audit committee have been assigned 0 dummy variable.

³⁷ Hartarska, V. (2005)

A number of firm's characteristics can potentially be associated with its financial performance (RoE/OSS/Portfolio Yield)³⁸; therefore firm level control variables have been included to reduce potential omitted variable bias. The log of asset size (ln asset size) has been added to control for the effect of size of loan portfolio on the financial performance. The 'MFI age' variable is included to capture the effect of number of years of operations that may have facilitated stable and profitable operations. The control variable of CEO experience is a proxy for the managerial and leadership skills that would be helpful in successful execution of the strategy, leading to a favorable financial outcome.

V. Results and Discussion

The independent variable, *Duality of CEO-Board Chairman role* has been dropped due to its low statistical significance.

The values for constant in all the equations (**Table 4**) are significant and large; indicating that information from some unobserved variables is being captured. As per the Wald statistical test, the null hypothesis that all the coefficients are zero, in every specification, can be rejected. Therefore, model can be used to analyze the effect of some of the explanatory variables on the dependent variables.

Return on Equity (RoE) – Variables of Board size and 'ex-banker' board member are significant in the regression at the 95% confidence interval and with an R^2 of 48%.

³⁸ Refer to Table 3 for definition

As per the regression result (**Table 4**), a larger board is expected to negatively affect the return on equity (RoE). An increase in the number of board members by one individual is expected to reduce the return on equity by 1.48%. This seems counterintuitive but a possible explanation can be that the independent directors and/or nominee directors free ride and do not bring any incremental skills to the business of microfinance that can enhance the returns to equity or a larger board finds it difficult to come to consensus and is slow in decision making. Usually, the non-profit MFIs in India strive to transform themselves into a 'for profit' legal status after they reach a certain scale³⁹. In this study, the average age of MFIs is 7.25 years (**Table 1**) and for few MFIs in the data, this time period includes the event of transformation into a 'for profit' legal status. As an MFI transforms from a 'non- profit' to a 'for profit' legal status, its regulatory compliance burden board size and composition (example: minimum number of independent directors) substantially increases without simultaneous increase in the size of the loan assets. This could be an alternative and a more plausible explanation for the inverse relationship between the RoE and the board size. An inverse relationship of board size with the profitability is in confirmation with the results obtained by Hartarska (2005)⁴⁰ and Bassem (2009)⁴¹

Presence of a former commercial banker in the board has a large and significant effect (19.3%) on the Return on Equity. This confirms the hypothesis that a former commercial banker or a director with relevant financial skills would bring a host of technical and leadership skills that are essential for a successful financial services firm and that otherwise would be lacking in a

³⁹ Srinivasan N, Page 4, "Microfinance India: State of the Sector Report", SAGE Publications India Pvt. Ltd, 2008

⁴⁰ Hartarska, V. (2005). Governance and performance of microfinance institutions in Central and Eastern Europe and the newly independent states. *World development*, 33(10), 1627-1643

⁴¹ Bassem, B. S. (2009). Governance and performance of microfinance institutions in Mediterranean countries. *Journal of Business Economics and Management*, 10(1), 31-43.

microfinance institution. The relevant technical skills that can be critical to a microfinance firm are; product development, understanding of prudential norms for a credit portfolio and ability to bring human capital from one's professional network.

Operational Self Sufficiency (OSS) – Presence of a former commercial banker in the board has a significant and large effect on the OSS, every such additional member is expected to increase the OSS by 30%. When the board size of the MFIs increases by one member it is expected to reduce the OSS by 2.3%. Though not a large effect, it may indicate a trade-off between oversight and efficiency.

Yield on loan portfolio – Presence of international directors shows a small but negative effect of 3.4% on the portfolio yield regression. This is puzzling as it is expected that international directors would bring in best practices into the firm and that would add to the firm value. An explanation for this could be that the inclusion of an international director happens at the initial stages of the growth of MFI, post transformation from a 'non profit' to a 'for profit' entity and that may accompany increased costs related to hiring, training and adoption of new information systems. This result however is similar to the finding Mersland & Strøm (2009)⁴² where the presence of an international director has an inverse relationship with the profitability of the MFIs.

General Firm Level Control Variables - Only two board characteristics show a statistical significance when regressed with OSS; The MFI's age and CEO's experience in the microfinance sector. The MFI's age inversely impacts the OSS but with a small effect of 1.2%.

⁴² Mersland, R., & Øystein Strøm, R. (2009). Performance and governance in microfinance institutions. *Journal of Banking & Finance*, 33(4), 662-669

This is in conformation with the study by Mersland & Strom (2009)⁴³. This could be due to higher expenses due to provisions for bad loans. The asset size of an MFI is seen to affect the OSS by large 10.9% for every unit of increase in loan asset size , indicating importance of economy of scale in the profitability of an MFI.

⁴³ ibid

Table 3: Description of variables

Variable	Definition	Mean	St.dev
Independent Audit committee	A dummy variable of one if there is an audit committee, otherwise zero	66%	48%
Board Size	Total number of board members	7.73	2.62
Banker in the board	The proportion of board members that have commercial banking experience	21%	16%
International Director	The proportion of board members that are nominated by international investors	12%	13%
Independent Director	The proportion of independent board members	35%	21%
MFI's age	Number of years since the establishment of the MFI	7 .25	4.70
Asset Size	Logarithm of the size of the loan portfolio on the books of accounts of MFIs	16.76	1.69
CEO's Experience	Number of years of experience of the CEO in the microfinance sector	10.79	7.60
OSS	Operational self sufficiency; $\text{Operating revenue} / (\text{Financial Expense} + \text{Loan loss provision} + \text{operating expense})$; measures the efficiency with which the MFI covers the cost of operations	108%	23%
Yield on gross portfolio	Measurement of cash revenue from the interest, commissions and fees; $\text{Cash Financial Revenue from Loan Portfolio} / \text{Average Gross Loan Portfolio}$	24%	7%
RoE	Return on Equity; $\text{Net operating Income} - \text{taxes} / \text{Average Equity}$; Calculates the rate of return to the shareholders	2.9%	15.6%

Table 4: Random effects estimates (Coefficients)

Variable	OSS	RoE	Yield
Constant	-.505*	-1.02*	.268*
Audit committee reporting to the board	-.0968	-.025	-.016
Board Size	-.0234*	-.0148*	.004
Ex-banker in the board	.304*	.193*	.061
International Director	-.217	-.203	-.034*
Independent Director	-.0435	.008	-.126
MFI's age	-.0124*	-.003	.000
Asset Size	.109*	.070	.000
CEO's Experience	.0053	.001	-.002
R ²	52%	48.4%	15%
Wald F test	0.0000	0.0000	0.0000

* Significant at 95% confidence interval

** Significant at 90% confidence interval

Table 5: Correlations of the explanatory variables

	Audit committee reporting to the board	Board Size	Ex- banker in the board	International Director	Independent Director	MFI's age	Asset Size	CEO's Experience
Audit committee reporting to the board	1.0000	.3323	.1509	.3019	.3825	-.0459	<u>.409</u>	.2638
Board Size		1.0000	.1433	.0996	-.0617	.3825	<u>.5713</u>	<u>.5009</u>
Ex- banker in the board			1.0000	-.0767	.160	.087	.1537	.1689
International Director				1.0000	-.0617	-.2585	.1523	-.051
Independent Director					1.0000	-.0094	-.2359	-.0769
MFI's age						1.0000	.3752	<u>.5274</u>
Asset Size							1.0000	<u>.5919</u>
CEO's Experience								1.0000

High correlation among the variables highlighted in bold.

Joint ‘F’ test

The joint test for significance of independent variables in groups was done for board variables as a group and for firm level variables as a group. The null hypothesis that the coefficients of the board variables are zero could be rejected in the ‘F’ test (**Table 6**). The board variables are jointly significant and have an impact on the dependent variables (firm performance), implying that the model is correctly specified. The firm level variables (MFI years of existence, size of the loan assets, lending methodology and CEO’s experience) however, don’t seem to have a joint explanatory power for the variation in firm’s performance (**Table 7**).

Correlations

None of the independent variables grouped under the board characteristics are strongly correlated. Only the following variables are correlated to a moderate degree: CEO’s experience-asset size, CEO experience-MFI age, Asset Size-Board size.

Multicollinearity

As per a thumb rule (Kennedy, 2008), if the correlation between the independent variables is less than 70% then the problem of multicollinearity can be assumed to be negligible. The minimal effect of multicollinearity (**Table 2**) indicates that each significant variable is not being affected by its covariates and has an individual explanatory power over the dependent variable.

VI. Conclusion

In the context of Indian MFIs, board characteristics have been found to be important levers of financial performance. This thesis underlines the need for investors, donors and founders in the microfinance sector in India to continuously seek to refine governance practices and not adopt a standardized template of the so called global best practices or practices of the corporate sector.

Impact of the following Corporate Governance practices on financial performance was evaluated: Board size, Proportion of independent and international directors, presence of audit committee reporting to the board and proportion of skilled directors.

The study indicates that the separation of CEO and the Board Chairman does not have a statistically significant effect on the financial performance of MFIs. Increase in the Board size has a negative effect on the profitability. Presence of international directors surprisingly has a negative impact on the portfolio yield of MFIs and no significant effect on the other measures of the financial performance.

Skilled board members have the most significant and positive effect on the financial performance of firms under study. Microfinance industry all over the world, including in India has its roots in the non-profit sector. Still today, microfinance faces challenges to attract the kind of human capital that can make MFIs competitive financial services firms; in such a situation a skillful director's role becomes crucial in enhancing the performance of the MFIs.

MFIs should strive to source as much local capital as possible. Local creditors if present on the board would be more likely to be better informed than an international investor in a distant land.

This study however does not suggest that the board independence can be ignored by the MFIs or its investors but it implies that the priority must be given to the skills of the directors and on an optimal size of the board, especially during the growth stage of the MFI.

Firm profitability and long term survivability although intertwined are the two different measures of success of a firm. In the short term, concentration of power and decision making in the founder-CEO may help in reducing the turnaround time for decision making but in the long run investors should evaluate whether management is influencing board's decision making and if that is having any adverse effect on the financial sustainability of the MFI.

Future studies can focus on country level data as the aggregated Global MFI data or a cross country data may skew the average characteristics in favor of the countries that have more MFIs in the dataset. This study utilized a small dataset that was publicly available and the result could be different if a larger dataset with primary data of Indian MFIs is used.

Appendices

Table 6: 'F' test for joint significance of Board variables

Audit_com_brd = 0
Brd_size = 0
Ex_banker = 0
Inter_dir = 0
Inde_dir = 0
Chi2(5) = 19.48
Prob > chi2 = 0.0016 (Reject the null when > 0.05 at 95% confidence interval)
Source: STATA output

Table 7: 'F' test for joint significance of Firm variables

CEO_exp = 0
MFIage = 0
logasset = 0
Chi2(3) = 5.41
Prob > chi2 = 0.1442 (Reject the null when > 0.05 at 95% confidence interval)

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