GOVERNANCE AND PERFORMANCE OF MICROFINANCE INSTITUTIONS IN SRI LANKA

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Abstract- This paper establishes facts to evaluate the governance factors affecting the performance of micro finance institutions in Sri Lanka, in terms of outreach and sustainability. Through literature, five independent variables under governance having an impact on performance was identified, namely: remuneration (fixed / variable) of managers, size of the board, independence of the board via the presence of non affiliated board members, the diversity of the board, and the availability of an independent auditor within the organization. The study is carried out based on a purposively selected sample of 42 microfinance institutions operating in Sri Lanka, which have been in operation for more than ten years. Data was collected via a self administered questionnaire and published financial data of these selected institutions It was determined as evidenced in data that the type of compensation received by the managers is not associated with performance of the sampled Institutions. The results identify trade-offs between micro finance institution's outreach and sustainability, based on the board size, and on the proportion of unaffiliated directors. Moreover, the study shows that a higher representation of female members on the board (diversity), leads to better performance. The study also reveals that availability of an internal auditor does not indicate a significant relationship on the performance of these Institutions.

Keywords- Microfinance institutions, Governance, Performance, Outreach, Sustainability

I. INTRODUCTION

Financial potential is an essential requirement in developing a country's entrepreneurs. However, obtaining financial assistance from the formal banking institutions has not been an easily available option for the rural entrepreneurs. The formal institutions generally viewed them as a financially unviable segment; thus forcing them to seek financial assistance from the informal money markets. These markets generally lend at exorbitant rates which lead to market exploitation. In this context, the concept of microfinance that adheres to the principle of both financial and social capital emerged to help ease this constraint.

At the early stages of microfinance development, programs were focused on credit distribution based on administrative criteria by state owned and development banks. Minimal concern for program efficiency resulted in poor performance of these programs, eventuating political intervention. This forced most organizations to become insolvent and unviable, causing denial of further donor support (Pischke 1991, p.225)

While having the main social goal of financing the rural entrepreneurs and alleviating poverty is a valid effort, majority of Micro Finance Institutions (MFIs) claim having two priorities; that is to increase the outreach to the rural segment and being financially sustainable (Outreach and Sustainability). However, the governance structure within the industry will have an impact on the performance of financial institutions and in turn on their sustainability. As per Labie (2001, p.296), during the last decade corporate governance principles have been ear marked as the primary rule of running a corporate well. Further, along with the process of globalization the world is being considered as a "Flat surface" for conducting business. This concept has since become important in standardizing and controlling the vision of many major organizations in the world (Friedman 2005, p.67).

With regard to MFIs, it is instrumental to have good governance practices in order to achieve success within institutions. The concept essentially indicates that they need to reach out to more clients and attempt to alleviate poverty (Helmas 2006) but also should ensure that they achieve financial stability (Johnson, Malkamaki & Wanjau, 2006,p.107). Several studies have attempted identifying the relationship between factors of good governance and successful management of MFIs (Campion 1998; Rock et al. 1998; Labie 2001,p.296; CGAP 2006; Helmas 2006). In spite of same, a very limited number of studies have explored the relationship between various mechanisms of corporate governance and performance (McGuire 1999, p.717). Therefore, it is pertinent to establish and determine the relationship between diverse governance mechanisms in practice and success of MFIs.

The studies conducted by Hartarska (2005,p.1627), and Mersland & Strom (2007), and Cull et al (2007,p.107), has shed light on the relationship between governance and performance of MFIs. In the context of Sri Lanka, in a study conducted by Damme, Wijesiri & Miyoli (2016,p.82) on governance and efficiency of microfinance institutions, it has been revealed that smaller and gender diverse boards have a positive impact on financial efficiency. Results also show that MFIs in which the Chief Executive Officer (CEO) chairs the board and a woman holds the CEO position, are less efficient in terms of poverty outreach. The study has been conducted on data envelopment analysis based on a sample of MFIs in Sri Lanka.

The micro finance act of Sri Lanka was enacted in 2016, with a view to boost the outreach and sustainability of MFIs. Although it is evident that micro finance institutions are actively participating in Sri Lanka's economic development and such active players should concurrently pursue the most effective way of realizing their social objective while achieving greater levels of profitability, there is no clear evidence of researches attempting to analyze the relationship between governance and performance of such institutions.

Based on information compiled from microfinance institutions in Sri Lanka and relevant secondary sources of information, this paper aim to establish and determine the impact of governance mechanism on the performance of Sri Lankan MFIs, in the context of outreach and sustainability. As stated by Rock et al (1998) "Governance mechanisms are the key to guiding management in strategic issues". The empirical model adopted, tests the impact of management compensation, size of the board, board independence, board diversity and the availability of internal auditors, on the MFIs outreach and sustainability. It also analyses the depth and breadth of outreach. The results indicate that the performances of the MFIs are not positively impacted by the performance based compensation. These results also indicate that the MFIs with larger boards perform better.

A. Study objective

This study is carried out with the main objective of ascertaining the impact of governance mechanism, tested under five identified variables, on the performance of MFIs in Sri Lanka.

B. Literature Review

Achieving better governance practices within the institutions engaged in microfinance has always been considered as imperative. The biggest barrier encountered by practitioners of micro finance is that they need to balance the two mutually exclusive objectives of outreach and sustainability. The ever changing environment of microfinance has forced institutions engaged in micro lending to adopt new principles of corporate governance, thus ensuring sustainability is achieved whilst maintaining the principles of good governance. It is of utmost importance to analyze the relationship between the performance of MFIs in terms of outreach, sustainability and good governance. This is due to the fact that good governance would guide the institutions in attaining the corporate goals and ensure asset protection over a long period of time. However, there is only a limited amount of researches conducted based on the area, especially in the Sri Lankan context, mainly due to lack of data. Apart from the study stated herein, which has been conducted by Damme, Wijesiri & Miyoli (2016,p.82) in the context of the Sri Lankan market, no major studies have investigated the relationship between governance and efficiency of microfinance institutions.

In reviewing the literature available on the captioned subject, it could be noted that Hartarska (2005,p.1627) has investigated the relation between governance mechanism and financial performance of the MFIs in East Europe. In that study, dependent variable dimensions comprise of financial performance and outreach, while the governance mechanisms include board characteristics, managerial compensation, and external governance mechanisms such as rating, availability of audited financial statements, and supervision. It has been concluded that performance based compensation provided for managers does not have an impact with the performance of MFIs. It has also been identified that better Return On Assets (ROA) are recorded with organizations having boards with better independence. However, a board consisting of employee directors has recorded lower outreach and financial performance. The final outcome of that study concludes that there is a moderate relationship between the external governance mechanisms and performances of the sampled MFIs.

A study conducted by Mersland & Strom (2007), has established the relationship between board characteristics, ownership type, competition and regulations on the MFIs performance and their outreach to rural entrepreneurs. A sample of MFIs across 57 countries has been used to collect data for the research. It has been concluded that a female CEO, performing a split role of CEO and chairman has a strong relationship to performance. Furthermore, it has been found that larger board size has a negative relationship with the average loan size, while individual guaranteed loans has a positive relationship with same. As the final finding, it has been stated that nonprofit organizations and shareholder firms does not show a difference in terms of performance measured by outreach.

In another research undertaken by Cull et al (2007,p107) to establish the relationship between financial performance and the outreach of MFIs, focusing on lending methodology (the way loans are given i.e.; individual loans, group loans, and village banks which are bigger groups that often have wider objectives than to serve as a guarantee mechanism only), authors have found out that among the 124 MFIs used as the sample, the organizations focusing on giving loans to individuals indicates a better profitability. However, theses MFIs recorded a lower exposure to low income earning borrowers and female borrowers in comparison to the organizations focusing on group lending. Theses authors also talk about a "mission drift", where increased profitability shifts MFIs focus to wealthier clients. However the variables of board type and governance mechanisms have not been checked under this study.

Therefore, the inadequate research findings, especially in the Sri Lankan context, investigating the impact of governance mechanisms on performance of the MFIs measured by outreach and sustainability, indicates that the study undertaken is academically important and aims to build a gap in theoretical knowledge.

II. METHODOLOGY AND EXPERIMENTAL DESIGN

Good governance of an institution could be defined as the process of achieving the objectives of an organization while taking care of its asset base. According to Hatarska (2005) this is the process via which the equity investors and other forms of fund providers ensure that their funds are being used for the intended purpose. The mechanism aligns the interest of mangers with the organizational objectives and ensures that the delegated authorities are working best to increase the Return On Investments (ROI). This is a crucial control mechanism. This is originally found in the work of Jensen and Meckling (1976,p.305) which routes from the agency perspective. As stated by Jensen & Meckling (1976,p.305) "agency relationship is a contract under which one or more persons (principal) engage another person (agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent". Information asymmetry and conflict of interest are two major issues which are mentioned under the concept of agency, named as "agency cost". In accordance with the theorist of agency, "an organization is considered efficient if it minimizes the agency costs" (Jensen & Meckling 1976,p.305).

Keasey, Thompson & Write (1997) has indicated that the most important attribute of an effective governance framework is the ownership structure. Usually the research literature in this field uses the impact of various variables separately. However, it was noted that in a later study conducted by Hermalin & Weisbach (2003,p.7), they have indicated the complementarities and correlations between these factors. This paper aims at establishing the impact of mainstream governance mechanisms, identified based on previous theoretical findings, on the performance of the Sri Lankan MFIs. However, the ownership structure has been excluded from the study due to the fact that no sufficient data is available. Estimating of the impact of governance mechanisms on both aspects of micro finance, namely sustainability and outreach , has been achieved by testing constructed hypotheses based on the insights to former literature by Hartarska (2005,p.1627), Mersland & Strom (2007),Cull et al.(2007.p107),which has investigated governance mechanisms of banks and non-profit organizations.

Hypotheses 1: *Receipt of a fixed remuneration by managers does not have a relationship with the performance of the MFIs.*

According to John, Mehran & Qian (2004, p.55) the remuneration acts as the fact aligning the interest of shareholders and managers. However, with regard to financial institutions, high incentives may lead to high risk, thus endangering the depositors in case of an institutional failure (John & John 1993, p.949).

Hypothesis 2: *Board size has a relationship with performance of MFIs*

The board and it's structure has an expressed, direct behavior towards corporate governance. The board has the responsibility of making sure that its top management is working towards enhancing the firm's value (Coles, Mc Williams & Sen 2001, p.23). Although the notion is that larger boards are preferred due to diversified exposure, Jensen (1993,p.831) and Lipton & Lorsch (1992,p.59) argue that smaller boards are more effective due to effectiveness in coordination. This supports the view of Yermack (1996,p.185) who states that United State (U.S) industries with smaller boards record a higher market value. A negative relationship between the board size and profitability of firms has been established by Eisenberg, Sundgren & Wells (1998,p.35) in their research. A study conducted on MFIs in Ghana by Kyereboah-Coleman & Biekpe (2005) also agrees with this view.

Hypothesis 3: *Proportion of non-affiliated members on the board (Independence) has a relationship with the performance of MFIs*

The previous studies undertaken indicate that as a result of an increased percentage of external directors on the board, the performance of firms would increase (Adams & Mehran 2003, p.123). This is supported with the results found in a study conducted by Byrd et al (2001) confirming that there is a positive aspect of having board independence. Kyereboah-Coleman & Biekpe (2005) also confirms that there is a positive relationship between the two factors.

Hypothesis 4: *Board diversification and the presence of women have a relationship with the performance of MFIs.*

According to previous literature it is noted that there is a positive impact of women and minority representation on the boards to the firm's performance. A positive correlation between board diversity, performance and better control has been established as a result of the research carried out by Robinson & Dechant (1997,p.21) as well as Fondas & Sassalos (2000,p.13). A study by Kyereboah-Coleman (2006,p.19) undertaken in the field of micro finance indicates that availability of female CEO's participating in the governing board leads to enhanced performance.

Hypothesis 5: *Availability of internal auditors reporting directly to the board has a relationship with the performance of MFIs*

As per Steinwand (2000) another principle of effective governance, especially in financial institutions, is internal audit. Accordingly, reporting matters timely and accurately is critical for the current status evaluation of the institute. This would also lead to evaluate the requirements of strategy changes at the top level.

C. Sample and Data

Out of the registered institutions at the Sri Lanka Microfinance Practitioner's Association (76 institutions as at end of 2016), 42 institutions which have been in operation for more than 10 years and had audited financials as at end of 2017, were selected as the sample.

Data was collected via a close ended, self administered questionnaire and published financial statements of the selected MFIs and analyzed using Statistical Package for Social Sciences software (SPSS).

D. Conceptual Model

Following the work of Hartarska (2005,p.1627) and Basseem (2009,p.343),the below conceptual model was developed and used to test the hypotheses.

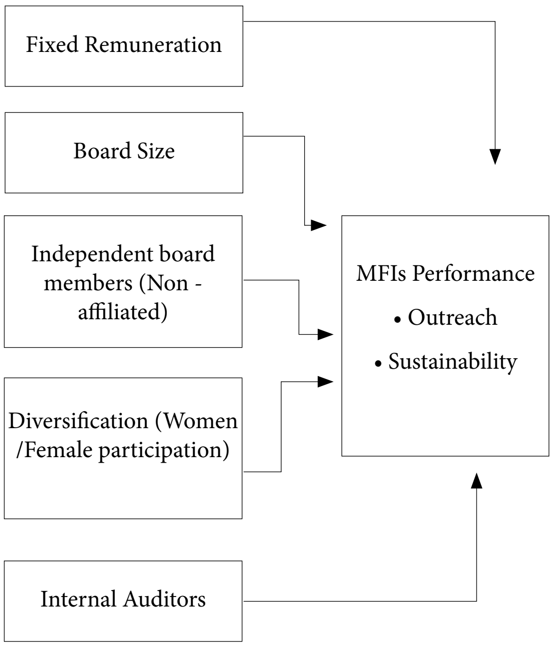

Figure 1. Conceptual Model

The country specific and macroeconomic variables used in the study by Hartarska (2005,p.1627) has been excluded as the study population and sample was based on Sri Lankan MFIs only and there is no difference in the macro / country specific data related to the MFIs used as the sample.

As the dual mission of MFIs is outreach and sustainability, the researcher measures their performance with these two factors. Outreach is measured in breadth and depth. Breadth of outreach (NAB) is the logarithm of active borrowers; depth of outreach (DEPTH) is the average loan size on GDP per capita. Return On Assets (ROA) and Operational Self Sufficiency (OSS) is used to measure sustainability. OSS indicates how well the MFIs bear it's costs through revenues generated via operational activities.

The independent variables built in are; Fixed remuneration - indicating pay not based on performance, Board size- measured by the number of members on the board, Independent - measured as the proportion of non affiliated board members present in the board, Diversification- measured as the proportion of women representing the board, and Internal auditors - from the availability of independent internal auditors reporting directly to the board.

III. RESULTS

E. Descriptive Statistics

Notably, the researcher has considered only 42 MFIs operating in Sri Lanka. The performances of micro finance institutions are widely spread. On average, the MFIs indicated a return on assets of 5.935%. A wide spread performance was indicated with a minimum of 7.58% and a maximum of 33%.

In case of operational self sufficiency, the sample under consideration has indicated an average of 85.41% of OSS. Data indicates a minimum and a maximum of 20.345% and 143.33% respectively. In the case of DEPTH, it was indicated that the borrowers were served well with an indicative average value of weak 220.

The average experience of managers of the MFIs under consideration was recorded as 8.4 years. It revealed that 82.4% of the managers received a fixed wage and average 5 persons serve on the board. In considering the number of board members, a standard deviation of 3.32 was recorded. The maximum board size of 16 members and a minimum board size of 4 members recorded suggest that these boards are widely dispersed. Average 45% of the board members are represented by unaffiliated directors. The descriptive statistics also confirms that as an average a percentage of 39% of board members were represented by women.

In the sample considered for the study, approximately 82% of the institutions reported having an internal auditor reporting directly to the board. The findings also confirm that 42% of the selected institutions are being regulated and 73% of the sample is constituted with individual lending technology.

F. Hypotheses Testing

As indicated in Table 1, the Hypotheses 01 stipulating there is no relationship between the remuneration system (fixed salary) and performance is accepted. With any of the specifications tested, the fixed remuneration does not show a significant correlation. This result supports and confirms the previous findings of Hartarska (2005,p.1627). It could be determined that the MFI managers have not responded to performance based compensation offered during the period of this study.

In terms of Hypotheses 02, the hypothesis is accepted, with the positive relationships indicated with ROA, OSS NAB and DEPTH with the board size. This is in agreement with and supports the views of Kyereboah-Coleman (2006,p.19). These studies state that larger boards are better for corporate performance due to the fact that members are equipped with diverse expertise which leads to better decision making, thus making it more difficult for the powerful CEOs to dominate the decision making process. However, this presents a contrasting finding to Jensen (1993,p.831),Lipton & Lorsch (1992,p.59), Eisenberg, Sundgren & Wells (1998,p.35), Sanda, Mukaila & Garba (2003,p.555).

One of the crucial findings of the study was the fact that under Hypotheses 03, which was accepted, it was confirmed that MFIs with a larger proportion of unaffiliated directors were better performers, with reference to both outreach and sustainability. These results agree with and confirm the findings by Hartarska (2005,p.1627) and indicate that MFIs would clearly benefit by independent boards.

According to data, Hypotheses 04 was accepted. It shows that the board diversity characterized by a higher female representation positively impacts performance. This supported the recent concept that having more gender diversity in the board room enhances the effectiveness of the board. This concept has been widely accepted and it is believed that a larger talent pool in the board room results in a more diversified board, thus paving the way for having better relations with other stakeholders such as customers, suppliers, and employees (Ellis & Keys, 2003). This unavoidably leads to an increase in performance, in turn leading to an increased firm value (Kyereboah-Coleman 2006,p.19).

The results reject Hypotheses 05 and indicate that there is no significant relationship with the availability of an independent internal auditor reporting to the board and performance of MFIs. A very weak positive relationship was indicated only with DEPTH. This agrees with the findings of Mersland & Strom (2007).

Table 1. Summary of correlation analysis between variables

	Hypotheses Testing			
	Sustainability		Outreach	
	ROA	OSS	NAB	DEPTH
Fixed wage	.276** (0.600)	.138** (0.700)	.157** (0.501)	.356** (0.600)
Board Size	.986** (0.000)	.546** (0.000)	.664** (0.000)	.724** (0.001)
Independent board	.797** (0.001)	.692** (0.000)	.579** (0.000)	.528** (0.000)
Board Diversity	.234** (0.000)	.810** (0.001)	.434** (0.000)	.710** (0.000)
Internal auditor	.440** (0.701)	.610** (0.500)	.280** (0.501)	.110** (0.000)

***. Correlation is significant at the 0.01 level (2-tailed).*
(Sig - 2 –tailed)

Therefore, Hypotheses 1-4 has been accepted and Hypotheses 5 has been rejected.

The multiple regression value on the study's dependent variable indicated a value of 0.82, suggesting that the factors taken into consideration have a contribution of 82% to the performance of the MFIs in terms of sustainability and outreach. A further study is to be carried out in order to identify further factors affecting same.

IV. DISCUSSION AND CONCLUSION

The paper tests empirically the relationship between corporate governance and performance of MFIs in Sri Lanka. The performance is measured in terms of outreach and sustainability. The data has been of two types; primary data collected via a self conducted survey and secondary data collected via published annual reports of the MFIs considered as the sample. With the assistance of both sets of data, the researcher examines the impact of management remuneration, board size, board independence, board diversity, and internal auditor reporting directly to the board on performance of MFIs.

Results indicate that except internal auditor reporting to the board and the remuneration of the managers, the other tested governance mechanisms have a positive relationship with the performance of the MFIs.

The results also indicate the explicit and implicit incentive schemes such as compensation, perks, etc… have been indicated as less powerful, which agrees with Dewatripont & Tirole. (1994, p.1027). It was also proven that due to members being equipped with a range of expertise, larger boards are better for the performance of MFIs. In such cases, powerful CEO's find it difficult to dominate member decisions.

Furthermore, the results conclude that organizations with a larger percentage of unaffiliated directors in the board achieve better results. Thus, it is important to promote independence of microfinance boards.

Elemental findings from this study are that a diversified board (featuring a higher proportion of females) supports enhanced performance, indicating that more females on the board, the better the performance. Therefore, it is concluded that board diversity is vital for enhancing performance of micro finance institutions in Sri Lanka.

G. Limitations

Even though the study undertaken has been able to shed light on the impact of governance mechanisms on the performance of MFIs, a number of governance mechanisms such as CEO duality, graduate board members, international directors, ownership structure has not been considered under the study. Therefore, it is of importance to conduct further studies to understand the impact of other factors on outreach and sustainability of the Sri Lankan MFIs.

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