The Effects of Governance on Institutional Sustainability and Outreach of the Poor in Microfinance Institutions (MFIs) in Bangladesh

by

Mohammad Delwar Hussain
(1442611395)

A thesis submitted in fulfillment of the requirements for the degree of Doctor of Philosophy

School of Business Innovation and Technopreneurship
UNIVERSITI MALAYSIA PERLIS

2017

UNIVERSITI MALAYSIA PERLIS

DECLARATION OF THESIS

Author's full name : Mohammad Delwar Hussain

Date of birth : 1st February, 1980

Title : The Effects of Governance on Institutional Sustainability and Outreach of the Poor in Microfinance Institutions (MFIs) in Bangladesh

Academic session : 2014-2015

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AG7077966	Dr. Mohd. Subri Bin Ab. Halim
(PASSPORT NO.)	NAME OF SUPERVISOR
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ACKNOWLEDGEMENT

First and foremost, I convey my deepest gratitude to the Almighty Allah, the most merciful and most gracious, for giving me the guidance, patience, knowledge and determination to complete this research. This thesis is the result of work whereby I have been accompanied and supported by many people. It is a pleasant aspect that I have now the opportunity to express my gratitude to all of them.

I would like to express my sincerest gratitude, regards and thanks to my supervisors Dr. Mohd Suberi Bin Ab. Halim, Dr. Abul Bashar Bhuiyan, and Associate Professor Dr. Jamaliah Said for the continuous support of my research and for their excellent guidance, patience, motivation and enthusiasm with my work. Their interest and confidence in me were the reasons for all the success I have achieved during this research. Besides my supervisors, I would like to thank Prof. Dr. Rafiqul Islam Molla, Professor Dr. Shawkat Alam as well as Dr. Afzalur Rashid for their insightful comments and encouragement.

My debt to School of Business Innovation and Technoprenuership, Universiti Malaysia Perlis is unplayable for providing an atmosphere for the pursuit of excellence in research. I would also like to utilize the opportunity to thank all the fellow researchers for their heartiest cooperation.

My sincere thanks also go to Malaysian Technical Cooperation Programme (MTCP) under Scholarship Division, Ministry of Higher Education in Malaysia, who provided me financial support to finish this wonderful research.

Last but not the least, I would like to thank my family: my mother and to my brothers and sister for supporting me spiritually throughout writing this thesis. Finally, I would like thank my closest friends for always being there as an inspiration and for their continuous support and encouragement throughout all my studies and works.

Thanks to Almighty ALLAH.

Mohammad Delwar Hussain
Universiti Malaysia Perlis (UniMAP)

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LIST OF ABBREVIATIONS

ACCA	Association of Chartered Certified Accountants
ASA	Association for Social Advancement
BRAC	Bangladesh Rural Advancement Committee
BURO Bangladesh	Basic Unit for Resources and Opportunities of Bangladesh
CEO	Chief Executive Officer
CG	Corporate Governance
CGAP	The Consultative Group to Assist the Poor
CGN	Corporate Governance Notes
CLEPR	Council on Legal Education for Professional Responsibility
CSE	Chittagong Stock Exchange
DSE	Dhaka Stock Exchange
ED	Executive Director
FEM	Fixed Effect Model
FSS	Financial Self-Sufficiency
GDP	Gross Domestic Product
GLS	Generalized Least Squares
GNI	Gross National Income
ICB	Investment Corporation of Bangladesh
IDB	Islamic Development Bank
IMF	International Monetary Fund
LSDV	Least Squares Dummy Variable
MFIs	Microfinance Institutions
MD	Managing Director

OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Squares
OSS	Operational Self-Sufficiency
PKSF	Palli Karma Sahayak Foundation
RDT	Resource Dependence Theory
SECB	Securities and Exchange Commission Bangladesh
UNDP	United Nations Development Programme

LIST OF SYMBOLS

$[y]$	Dependent variable
$[i]$	Number of MFIs
$[t]$	Number of years
α	Constant
β'	Beta value
x	Independent variables
μ	Error term
μ_i	The unobservable individual specific effect
V_{it}	The remainder disturbance
$OSS_{i,t}$	Operational self-sufficiency
$BoD_{i,t}$	Vector of board of directors
$Mgt_{i,t}$	Vector of top level management
$Ext_{i,t}$	Vector of external governance
$Con_{i,t}$	Vector of control variables
$FSS_{i,t}$	Financial self-sufficiency
$Breadth_{i,t}$	Breadth of outreach
$Depth_{i,t}$	Depth of outreach

The Effects of Governance on Institutional Sustainability and Outreach of the Poor in Microfinance Institutions (MFIs) in Bangladesh

ABSTRACT

Microfinance is the only financial sector where the stakeholders can acquire double benefits, sustainability as well as poverty reduction. Microfinance practitioners claim that this dual mission is absent due to the lack of governance practices within microfinance institutions (MFIs). Therefore, the purpose of this study is to examine the effects of governance on double bottom-line performances of MFIs in terms of institutional sustainably as well as outreach out of the poor. This study concentrates on data from a frontier market economic country. Thus, it uses a database of 80 microfinance institutions with 10 observations years, operating in Bangladesh. The research framework considers a multi-theoretical approach, which includes the economic-based agency theory as well as three management-based theories of stewardship, stakeholder, and resource dependence theories. It applies a quantitative approach to incorporate the results. The descriptive statistical analysis tool is applied for identifying the individual variables' outcomes. The panel data regression model with pooled OLS, fixed effects, and random effects GLS estimation techniques are applied for classifying inferential statistical results for within and between the variables. The results indicate that the average board size in Bangladeshi MFIs is eight persons and it has significant positive effects on institutional sustainability, with conversely, negative effects on outreach performance. The CEO duality has significant positive effects on institutional sustainably and the depth of outreach, while demonstrating the opposite for the breadth of outreach. This result supports the stewardship theory, but not the economic-based agency theory. The stakeholder participation on board has mixed results; however, it found a similar relationship from past studies. This study claims that it is the first time consideration of the efficiency of the top-level management and risk management attitude into microfinance governance research based on resource dependence theory and it identified that in Bangladesh the capacity of risk management are significantly effects on MFIs double bottom-line performances. Therefore, this study claims that the resource dependence theory is appropriate for microfinance governance studies. Finally, the external governance mechanisms have non-significant effects on institutional sustainability performances; however, it has significant effects on outreach performances. At the time of the study, data are limited to a single country. However, for future studies could take initiatives with more data from different cross countries. Meanwhile, this study develops an applicable governance structure based on multi-theoretical approach with relevant factors by using Bangladesh as a case study. Considering 'social-welfare and commercial logic' it found that MFI's services to the poor are non-linearly influenced by its profitability. If MFIs pursue high profit it tends to decrease the outreach. Therefore, the findings of this study suggest that to develop governance manual which increases MFIs services for poorer clients by placing a higher priority considering the social-welfare logic. It is also necessary to generate institutional structures and separate governance guideline, based on the social welfare logic. The MFIs can appoint a social director, as the microfinance board of directors; have to make sure that the MFIs follow the social mission. This kind of directors has been representing the clients for the MFIs.

Kesan Tadbir Urus Kelestarian Kelembagaan dan Pendampingan Orang Kurang Baik di Institusi Kewangan Mikro (MFI) di Bangladesh

ABSTRAK

Pembiayaan mikro adalah satu-satunya sektor kewangan di mana pihak berkepentingan boleh memperoleh faedah berganda, kemampanan serta pengurangan kemiskinan. Pengamal pembiayaan mikro mendakwa bahawa misi ganda ini tidak hadir kerana kekurangan amalan tadbir urus dalam institusi kewangan mikro (MFI). Oleh itu, tujuan kajian ini adalah untuk mengkaji kesan-kesan tadbir urus ke atas prestasi dua peringkat MFI dari segi institusi secara mampan serta jangkauan orang miskin. Kajian ini menumpukan pada data dari negara ekonomi pasaran sempadan. Oleh itu, ia menggunakan pangkalan data 80 institusi kewangan mikro dengan 10 tahun pemerhatian, yang beroperasi di Bangladesh. Rangka kerja penyelidikan menganggap pendekatan multi-teoretis, yang merangkumi teori agensi berasaskan ekonomi serta tiga teori berasaskan pengurusan pengawalan, pemegang kepentingan, dan teori ketergantungan sumber. Ia menggunakan pendekatan kuantitatif untuk memasukkan keputusan. Alat analisis statistik deskriptif digunakan untuk mengenal pasti hasil pembolehubah individu. Model regresi data panel dengan OLS yang disatukan, kesan tetap, dan kesan rawak GLS estimasi teknik digunakan untuk mengklasifikasikan keputusan statistik inferensial untuk di antara dan antara pembolehubah. Hasilnya menunjukkan bahawa saiz papan rata-rata dalam MFI Bangladeshi adalah lapan orang dan ia mempunyai kesan positif yang signifikan terhadap kemampanan institusi, dengan sebaliknya, kesan negatif terhadap prestasi jangkauan. Duality Ketua Pegawai Eksekutif mempunyai kesan positif yang signifikan ke atas institusi secara mampan dan kedalaman jangkauan, sambil menunjukkan kebalikannya untuk keluasan jangkauan. Hasil ini menyokong teori pengawasan, tetapi bukan teori agensi berasaskan ekonomi. Penyertaan pihak berkepentingan di papan mempunyai hasil yang bercampur; Walau bagaimanapun, ia mendapati hubungan yang sama dari kajian lepas. Kajian ini mendakwa bahawa ia merupakan pertimbangan pertama untuk kecekapan pengurusan peringkat tinggi dan sikap pengurusan risiko ke dalam penyelidikan tadbir urus mikro berdasarkan teori pergantungan sumber dan ia mengenal pasti bahawa di Bangladesh kapasiti pengurusan risiko memberi kesan yang ketara ke atas MFI yang mempunyai dua bahagian bawah dasar- persembahan garisan. Oleh itu, kajian ini mendakwa bahawa teori pergantungan sumber sesuai untuk kajian tadbir urus mikro. Akhirnya, mekanisme tadbir urus luar mempunyai kesan tidak signifikan terhadap prestasi kemampanan institusi, namun ia mempunyai kesan yang signifikan terhadap persembahan jangkauan. Pada masa kajian, data adalah terhad kepada satu negara. Walau bagaimanapun, kajian masa depan boleh mengambil inisiatif dengan lebih banyak data dari negara-negara bersilang yang berlainan. Sementara itu, kajian ini membina struktur tadbir yang sesuai berdasarkan pendekatan pelbagai teori dengan faktor-faktor yang berkaitan dengan menggunakan Bangladesh sebagai kajian kes. Memandangkan 'kebajikan sosial dan logik komersial', didapati bahawa perkhidmatan MFI kepada golongan miskin tidak dipengaruhi secara lancar oleh keuntungannya. Sekiranya MFI mengejar keuntungan yang tinggi ia cenderung untuk mengurangkan jangkauannya. Oleh itu, penemuan kajian ini mencadangkan untuk membangunkan manual pemerintahan yang meningkatkan perkhidmatan MFI untuk pelanggan yang lebih miskin dengan meletakkan keutamaan yang lebih tinggi memandangkan logik kebajikan sosial. Ia juga perlu untuk menghasilkan struktur institusi dan garis panduan tadbir urus yang berasingan, berdasarkan logik kebajikan sosial. MFI boleh melantik pengarah sosial, sebagai lembaga pengarah kewangan mikro; mesti memastikan bahawa MFI mengikuti misi sosial. Para pengarah seperti ini telah mewakili pelanggan untuk MFI.

CHAPTER 1

INTRODUCTION

1.1 Background of the Study

1.1.1 Corporate Governance and Microfinance Institutions (MFIs)

Economists, as well as the financial practitioners are emphasizing development of the financial services sector. The reason is that this sectors has major influential forces on the development of the economic growth of a country (Thrikawala, Locke, & Reddy, 2013). Moreover, the economic development or well-being of the people mostly depends on smooth financial operations, income savings maneuvers, and investment opportunities (Ductor & Grechyna, 2015). The financial services sector also affect the economic, social, and most importantly the political environment of every country (Thrikawala et al., 2013). Therefore, a nation state requires sound monetary systems to obtain a better standard of living by offering appropriate accessibility of money inflow or outflow (Kurronen, 2015). Prior microfinance or microcredit was introduced by Mohammad Yunus, the poor people have not access to this services, particularly in the developing countries, due to collateral requirements and burdening presure of interest and charges (Barr, Kumar, & Litan, 2007).

Moreover, the general consensus claims that access to financial or banking facilities is essential for poor people to generate income, create assets, raise productivity, and/or attain food security (Thapa, 2010). Until the 1970s, the public sector’s formal financial institutions had been the foremost providers of monetary facilities to poor people. They provided loan specifically to marginal and small farmers typically at a subsidized interest rate (Kim, Lin, & Suen, 2013). This financial service failed due to high risks associated with lending money to these farmers' groups as well as other institutional weaknesses (Claessens, 2006). During the period of 1971 to the 1990s, an alternative financial services system was developed by focusing on women entrepreneurship development with the establishment of semi-formal fiscal institutions with no collateral (Zaman, 2004). In 1976, Muhammad Yunus developed a novel lending approach in a small village in Bangladesh, which is collectively known as microfinance (Mia & Chandran, 2016; Yunus, 2004). During this period, these lending approaches flourished through non-government organizations and banks which have distinctive features (e.g., the Grameen Bank from Bangladesh, Village Banks under the Bank Rakyat of Indonesia) (CGAP, 2003). At present, these financial services are commonly known as microfinance institutions or MFIs (Tchuigoua, 2015).

MFIs mainly target poor people through a variety of innovative approaches, which has helped maintain high repayment rates. It includes group lending approaches with cumulative loans over time and consistent repayment schedules, as well as collateral substitutes (Kayastha, 2010). On the contrary, formal financial services, such as banks or non-banking financial institutions have two main obstacles to offering their services to the mass populace, first is the collateral system and the other is the burden of interest and charges. As such, microfinance has been building an alternative financial service. The prime aim of microfinance is to change the direction of financial services to encounter the various financial necessities to the under-served populace (De Aghion & Morduch, 2004; Hermes & Lensink, 2011). It has emerged with a noble vision to eradicate poverty especially in the developing countries (Thrikawala et al., 2013). In developing nations, formal financial institutions only provide services to around twenty percent of the populace. While, the rest of the people use MFIs' services (Benedetta, Lieberman, & Ard, 2015).

MFIs provide a small amount of credit plus savings that meet the requirements of underprivileged entrepreneurs. Some MFIs has been providing skill-based training, consciousness-building training, and organizational support to enhance productivity and to empower the underprivileged. It has developed a significant tool for reducing poverty in numerous parts of the world, specifically in the Asia Pacific region (Armendáriz & Labie, 2011). Current studies show that the MFIs contribute towards the eradication of poverty particularly among women entrepreneurs at the rural community (Kundu, 2016; Mia & Chandran, 2016). Moreover, the prime objective of microfinance is to provide small scale loans to women of the rural society (the poorest) and educate them to participate in income generating activities (Bebchuk, Cohen, & Ferrell, 2009; Mia & Chandran, 2016). The microfinance later flourish through extending clients based financial services for the poor and developing innovation in its products (Cull, Demirgüç-Kunt, & Morduch, 2011). It has considered as one of the most widely used development tool (Quayes & Khalily, 2013). The continuous development in microfinance aim to achieve its prime objective to help poverty reduction and that emerges the importance its vision (Hartarska & Nadolnyak, 2007).

On the other hand, microfinance operations are tough job since loan officers need to visit microcredit beneficiaries physically (Halouani & Boujelbene, 2013). It is also expensive because the poorest population live in the very rural area (Hudon, 2010). Thus, the institutions can only hire self-motivated personnel for the work, but the limitation of funds can slow down the operations (Bateman & Chang, 2009). Though external donors are the greatest source of financial and technical assistance for MFIs, but a hidden dread of funding dry or complete halt is always alive (Armendáriz & Labie, 2011). MFIs therefore, intend to find a different path to boost their financial self-reliance that will secure their long term existence. Hence, the major potential approach applied was the self-sustainability or profitability of the MFIs (Pinz & Helmig, 2014). As a result, microfinance industry identified as profit seeking business venture. It has been attracted more institutional investors to invest in microfinance business (Ahmed, Bhuiyan, Ibrahim, & Said, 2016). Eventually, microfinance has classified as double bottom line industry. Therefore, MFIs now have two missions, such as to attain the financial self-sufficiency or sustainability (financial performance) (Hermes, Lensink, & Meesters, 2011) as well as the social impact or poverty outreach (outreach performance) (Brière & Szafarz, 2015; D'Espallier, Goedecke, Hudon, & Mersland, 2017).

However, there was always concern about mutual coexistence of financial and social motives which represented as a mission drift (Uddin Ahmed, 2013). Generally, mission drift refers to the situation when the institution incessantly drives into a new direction (Im & Sun, 2015). In the case of MFIs, mission drift takes place when the institution emigrates away from its original objective of poverty eradication to scale up its profit (Quayes, 2012). If institutions perform more financially by any mean and social outcomes found negative or disappointing, then the mission drift concern will be alive (Bassem, 2009). Achieving the financial performance is important, but it was never been the ultimate objective of microfinance operations (Yunus, 2004). The evidence shows that the MFIs tend to be more profit oriented than socially performing (Cull, Demirgüç-kunt, & Morduch, 2007). The 17th Micro Credit Summit in 2014 admitted that MFIs continued to express downfall of the number of the poorest clients, though the total number of clients reinforced its swelling trajectory (Rogers, 2014). MFIs can be still profitable and sustainable while its social impact and outreach to the poor is not clearly visible (Cull et al., 2007). The 17th Microcredit Summit Campaign also admitted that there was a lacking of social impact and they have given priority to social objective issues of microfinance program (Rogers, 2014).

The previous studies claimed that the MFIs can achieve dual missions only through the governance practices inside the microfinance organization, because governance is the righteous activities, which linked to the investors through the board, then the management, and finally to the general staff (Bakker, Schaveling, & Nijhof, 2014; Benedetta et al., 2015; Estape-Dubreuil & Torreguitart-Mirada, 2015; Hartarska, 2005; Mersland & Strøm, 2013; Tchuigoua, 2015; Varottil, 2014).

Furthermore, the awareness of microfinance has increased tremendously. The number of MFIs around the world until 2005 was at 3,133, whereas after 2010, it had spread to more than 10,000 (Thrikawala et al., 2013). Subsequently, the investments in this industry were more than USD 15 billion after the year 2010 (Kim et al., 2013). A recent report from the World Bank hosting organization on ‘Consultative Group to Assist the Poor (CGAP)’ documented that approximately ninety percent of the funds were mainly collected from taxpayers of the developed countries and donor agencies (Helms, Littlefield, & Porteous, 2015). Those investors, such as donors and creditors as well as the other stakeholders (i.e. clients, employees, civil society, and most importantly the governments) are demanding accountability and transparency of the funds used in these activities (Beisland, Mersland, & Strøm, 2015; Thrikawala et al., 2013). The burdening pressure has increasing after the global economic crisis which started in 2007 (Halouani & Boujelbène, 2015; Kurronen, 2015). It also reduces the funding availability as well as the donations that have become more difficult to attain (Hartarska, Mersland, Nadolnyak, & Parmeter, 2013; Müller & Uhde, 2013).

Conversely, after the suicide of a farmer in the Indian state of Andhra Pradesh in the year 2010 as well as the loan-shark-style of MFIs around the world, which has created a negative image for microfinance good governance issues, while the glowing view of microfinance has started to come to an end especially in developing countries

(Galema, Lensink, & Mersland, 2012b). Thus, microfinance practitioners claimed that the MFIs may reduce their sufferings from the loss of reputation by governance practices (Augustine, 2012; Gauri & Galef, 2005; Hermes & Lensink, 2011).

Microfinance governance is more challenging and totally different from other types of organizations. There are distinctive characteristics, which make it different from other financial organizations in terms of corporate governance issues. Firstly, the ownership matters, most of the MFIs around the world are endorsed by donor-supported NGOs in line with their social obligation to reduce poverty (Ledgerwood & White, 2006). As a result, the MFIs have evolved and expanded their outreach and have started to emphasize on achieving financial sustainability by thinking of alternative measures if the donor money or subsidies are removed (Aghion & Morduch, 2005). NGOs do not have real owners (MRA, 2009). Therefore, the investment for non-profit NGOs is generally provided by the foundations or donor agencies (Campion, 1998; Vogel, Gomez, & Fitzgerald, 2000). However, the ownership of MFIs does not extend expressively under the public sector establishments or even NGOs. The microfinance practitioners focus on commercial proceedings based on earnings maximization. However, the lack of microfinance representatives in the board denotes a structural weakness (McGuire & Conroy, 2000; Morduch, 2000). Conversely, the cooperative societies or credit unions and divergent stakeholders with different priorities also face conflicts of interest (Labie, 2001). Recognizing the diversity of stakeholders can help the MFIs to sustain the organization's initial strategic directions. The different types of MFIs reveal that there is a structural weakness associated with the ownership difficulty; it may influence a negative impact on the efficiency of the MFIs (Ledgerwood, Earne, & Nelson, 2013).

Secondly, there are diversified stakeholders who have dissimilar intentions from different MFIs; for instance, NGOs, donor agencies, non-bank financial institutions or technical support benefactors underline the microfinance social mission (Chakrabarty & Bass, 2014). Yet, private ownership firms or inside employees might have different intentions, such as profitability or institutional sustainability (Thapa, 2010). Therefore, the dual missions of MFIs appear contradictory. The previous studies regarding microfinance governance already proven that there is a contradictory situation regarding MFIs' sustainability as well as its attempt at poverty reduction (Cull, Demirgüç-kunt, & Morduch, 2007; Cull, Demirgüç-Kunt, & Morduch, 2009, 2011; Im & Sun, 2015; Kar, 2013; Quayes, 2012). Thirdly, the fiduciary responsibility of the organization should be held by the board, however in MFIs most of the board members are freelance outsiders and mostly dependent on the internal top level management, such as its chief executive officer or his team (Beck, 2015; Lapenu & Pierret, 2006). In the meantime the fiduciary responsibilities of the MFI's are greater than other entities (Christen, Lyman, & Rosenberg, 2003). The top level management has an obligatory duty to maintain and ensure that the donors' funds secure. Moreover, this responsibility is higher whenever the MFIs are generating their funds through institutional investors, or mobilizing the clients deposits or primary instruments from the securities and exchange commission (Dorado & Molz, 2005).

Moreover, there is no collateral system and the management has limited capacity to manage future uncertainties and bad debts (Rao & Fitamo, 2014). Safeguarding capital from risks is the main responsibility of the microfinance administration (Aghion & Morduch, 2005). While, establishing the mechanisms to manage the risks is fully related to good governance (Ledgerwood & White, 2006). Therefore, the administration of MFIs must be conscious of a variety of risks. It may include information-related risks, operational risks or untrustworthy board information structure, credit default, risks with internal control processes, organizational risks, competitive environment, strategic risks, country risk, environmental risks or political risks (Boehe & Barin Cruz, 2013; Kayastha, 2013; Rosenberg, 2009; Zeller & Meyer, 2002).

Finally, the MFIs should be reducing their expenditures and increasing revenues in order to achieve its financial sustainability. It usually comprises higher interest rates, loaning to specific sectors, which have collateral potential, differentiating products as well as staff efficiency (Gutiérrez-goiria & Goitisoio, 2011). These procedures may lead to readdressing the financial services for changes in the clients of MFIs. It may include a less in-depth or less proximity knowledge about the clients (Lapenu & Pierret, 2006). As a result, governance practices have been acknowledged as being critical to the success of the MFIs. Therefore, this study took an initiative to do microfinance governance research, because 'governance' is the process of decision-making and it has a significant effect on its double bottom-line performances.

1.1.2 Microfinance in Bangladesh and Motivational Issues of the Study

The official name is 'People's Republic of Bangladesh' taken Independence from Pakistan in December 16, 1971 (The World Bank, 2016a). Geographically it is located in South-East Asia (it is bordered by India on all sides except for a small border with Myanmar to the far southeast and by the Bay of Bengal to the south). Its land area is only 147,570 square kilometre, however it have more than 163 million population (in the world's tenth and Asia's sixth most populous country) (infoplease, 2016). Population growth rate is around 1.48 percent per year (Trading Economics, 2017). Moreover, it is the one of the most growing up developing countries as well as most