ELSEVIER
www.elsevier.com/locate/worlddev

World Development Vol. 58, pp. 1–20, 2014

0305-750X/$ - see front matter

http://dx.doi.org/10.1016/j.worlddev.2013.12.006

The Impact of Governance and Institutional Quality on MFI Outreach and Financial Performance in Sub-Saharan Africa

THIERNO AMADOU BARRY and RUTH TACNENG *
Université de Limoges, LAPE, 5 rue Félix Eboué, 87031 Limoges Cedex, France

Summary. — This paper examines whether shareholder-owned MFIs financially and socially perform better than NGOs in sub-Saharan Africa (SSA). We also investigate the role of institutional quality in altering MFIs' incentives and behavior in determining outreach. Our results indicate that NGOs are more profitable and have better outreach than banks and cooperatives. While a weak rule of law favors relationship-based exchanges and thus, results in NGO superiority, stronger institutional quality may encourage banks to cater to more borrowers, hence, shareholder-owned MFIs do not socially perform differently from NGOs. Overall, this study shows that NGOs are the best conduits of microfinance in SSA.

Key words — sub-Saharan Africa, microfinance, NGOs, governance, institutional quality, outreach

1. INTRODUCTION

Microfinance has increasingly become a popular tool in the fight to reduce poverty especially in developing countries. Over the past 20 years, microfinance institutions (MFIs) have generally been viewed as an important conduit to expand access to finance especially among the poor, in order to improve their welfare (Armendáriz de Aghion & Morduch, 2005; Morduch, 1999). The Microcredit Summit Campaign reports that in 2011, 3,703 MFIs cater to 200 million customers of which, over 60% were among the poorest when they joined.

The OECD (2009) and ILO and WIEGO (2012) estimate that more than 50% of the world's working population, on average, are employed in the informal economy. For these groups of workers, the informal economy is their primary and most often, their sole source of income and livelihood. Informal financial markets thrive in most developing countries, which could be attributed to their underdeveloped financial systems. MFIs, however, have emerged at least partially, in providing financial services to the informal economy. They have done this by imitating informal finance structures such as using group lending methodologies that rely on social collateral and peer pressure, which are largely based from the practices of rotating savings and credit associations and moneylenders (ILO, 2009).

Although microfinance has gained its stature as one of the most visible anti-poverty policies (Banerjee & Duflo, 2011), many policymakers as well as academicians question its impact on the social and economic situation of the poor and the sustainability of MFIs in the long term (Hermes & Lensink, 2007, 2011; Morduch, 1999). Several risk factors facing the microfinance industry challenge its ability to transform peoples' lives in the future. The findings of a survey conducted on a sample of MFI practitioners, investors, regulators, and observers worldwide (CSFI, 2012) show over-indebtedness and corporate governance to be the topmost concerns facing the industry. Other than borrower and lender-specific factors, over-indebtedness may be suggestive of deeper problems in the industry, such as excess lending capacity created by competition saturating the market, and other external factors. Meanwhile, problems relating to corporate governance include failure to provide leadership on the MFIs (CSFI, 2012) and lack of operational framework wherein investors can manage risk and supervise performance (McKee, 2012). Moreover, there are also concerns pertaining to the potential deviation, particularly of socially-oriented MFIs from their mission by extending larger loan sizes (Armendáriz & Szafarz, 2011; Mersland & Strøm, 2010) and by charging higher lending interest rates compared with more profit-oriented MFIs (Cull, Demirguç-Kunt, & Morduch, 2009). Additionally, legislative changes have triggered transformations of non-government organizations (NGOs) into for-profit companies, in order to provide a wider array of financial services and at the same time, increase access to capital (Lauer, 2008). Thus, it is just fitting to study whether socially-oriented MFIs, particularly the NGOs, are indeed waning in their commitment to the mission of increasing outreach, especially to the poor compared with their more profit-oriented counterparts.

In sub-Saharan Africa (SSA), weaknesses in corporate governance and management quality remain high level concerns (CSFI, 2008, 2009, 2011, 2012). Although several empirical studies in the literature examine the differences in terms of financial performance, efficiency, and outreach between non-profit and profit MFIs or unregulated and regulated MFIs using a worldwide sample or other regions (Mersland & Strøm, 2008, 2009; Gutiérrez-Nieto, Serrano-Cinca, & Mar-Molinero, 2007, 2009; Hartarska, 2005), only one has looked into SSA (Tchakoute Tchuigoua, 2011).

Mersland and Strøm (2009) who examine the effects of corporate governance mechanisms and regulation on MFI performance in 60 countries and Hartarska (2005), investigating the rated and unrated Eastern European MFIs using three surveys, generally, do not find difference between shareholder firms and non-profit organizations in either outreach or financial performance. Moreover, Périlleux, Hudon, and Bloy (2012) show that NGOs behave more like shareholder firms

* We thank three anonymous referees, Isabelle Distinguin, Laetitia Lepetit, Céline Meslier, Philippe Rous, and Amine Tarazi for their valuable suggestions and advice in improving the paper. We also thank Trond Randøy and the participants of the Second European Research Conference on Microfinance held in Groningen, Netherlands for their helpful comments on earlier versions of the paper. Final revision accepted: December 19, 2013.

than cooperatives in terms of keeping a larger part of their surplus as self-financing margin, which they can use to further their goals. Investigating the mechanisms of external governance, Hartarska and Nadolnyak (2007) examine whether regulated MFIs financially and socially perform better compared with unregulated MFIs. Using a dataset that includes 114 MFIs in 62 countries, they do not find a direct effect of regulation on both operational self-sufficiency and outreach. Studying the impact of different organization types on MFI efficiency, Haq, Skully, and Pathan (2010) find banks to be the most efficient organization type under an intermediation approach while NGOs fare better under a production approach. Moreover, Gutiérrez-Nieto *et al.* (2009) find albeit low, a positive relationship between social efficiency and financial efficiency and in addition, show that NGOs are more socially efficient than other MFIs. Tchakoute Tchuigoua (2011), analyzing a sample of 94 MFIs in SSA from 2001 to 2005, finds cooperatives to be more financially-efficient than private MFIs and NGOs but shows no significant difference among the MFI ownership types in terms of profitability. The study, however, mainly relies on statistical analysis and thus, it is not able to take into account differences in the level of development across countries, MFI-specific and other external factors that may affect the performance of MFIs.

In this paper, we examine whether more profit-oriented MFIs such as banks and non-bank financial institutions, and cooperatives perform better than NGOs in terms of financial performance and outreach in sub-Saharan Africa, where there is still a large number of non-profit financial service providers in the microfinance industry (MIX, 2011). We focus on SSA for several reasons. First, the impact of microfinance may work differently across regions around the world where enterprise development, attitudes toward debt, financial literacy, and population density vary (Armendáriz de Aghion & Morduch, 2005; Van Rooyen, Stewart, & De Wet, 2012). Second, although the microfinance industry in SSA is small compared with other regions, SSA is set to be the fastest growing market for microfinance investment vehicles (MIVs), which is a major source of foreign funding for MFIs (MicroRate, 2012). Third, there is an increasing need of understanding the evidence from SSA, which is one of the poorest regions in the world and where the informal sector is large—informal employment comprises 66% of non-agricultural employment and average share of the informal sector in non-agricultural gross value added is 50% (ILO & WIEGO, 2012). [1] Moreover, surveys conducted on informal firms by the World Bank on SSA from 2009 to 2011 show that in eight out of 11 countries, informal firms have relied more on MFIs than banks to finance their day-to-day operations (World Bank, 2009, 2010, 2011). Lastly, despite the series of financial sector reforms since the 1980s (Senbet & Otchere, 2006) and the proliferation of mobile banking in recent years, financial inclusion in SSA remains to be a challenge (Demirgüç-Kunt and Klapper (2012b)). Based on the access to finance composite index developed by Honohan (2008), SSA obtained the lowest value among the regions in the world, with only an average of 20%. Moreover, according to recent financial inclusion data in Africa from the Global Findex database (Demirgüç-Kunt and Klapper (2012a)), only 24% of the adults have an account with a formal financial institution. [2]

Moreover, we contribute to the literature not only by examining the financial and social performance of for-profit MFIs and cooperatives in comparison with NGOs in SSA but also by investigating how institutional quality can affect outreach across MFI ownership types. We study the institutional quality in each economy, more specifically, government effectiveness, rule of law and information sharing. Although SSA operate within weak institutional environments (Anayiotos & Toroyan, 2009), there are still variations in terms of institutional quality within SSA. [3] To our knowledge, this is the first study that examines the impact of institutional quality on the ownership type-MFI outreach relationship. "Institutions" [4] are the "rules of the game" and firms and organizations are bound by these rules (North, 1990). The institutional environment where the MFI operates matter by altering the incentives and behavior not only of the MFIs, but of the borrowers as well. It affects the relevance of relationship-based exchanges and hence, stimulates the development of relationship capabilities (Boehe & Cruz, 2013), of which NGOs seem to work more effectively compared with banks and other financial companies because of their social embeddedness within multiple informal networks (Webb, Kistruck, Ireland, & Ketchen, 2010). A weak institutional environment may tend to rely more on relationship-based exchanges than rule-based exchanges, and hence, NGOs may have the advantage vis-à-vis the more profit-oriented MFIs such as banks. Moreover, because a weak rule of law may indicate a large informal economy (Quintin, 2008), profit-oriented MFIs may be dissuaded especially in catering to the poor because of their financial fragility and because they face a limited set of opportunities in such an environment. NGOs may thus, fare better in terms of outreach because arguably, their social goals precede financial goals. Higher institutional quality may especially benefit the shareholder-owned and regulated institutions because with a stronger rule of law, relationship-based exchanges are less crucial.

Working on a panel of 200 SSA MFIs from 30 countries over the period 2001–07, we highlight two main results from our econometric investigation. First, we find that NGOs socially and financially perform better than other MFI ownership types, implying that they may be the best conduits in attaining the ultimate goal of microfinance, which is to reduce poverty. Second, our results indicate that better institutional quality cancels out the information and network advantage of NGOs over banks and cooperatives. When the government is highly credible, and the economy is governed by a strong rule of law and characterized with good information infrastructure, banks, cooperatives, and non-bank financial institutions, in general, do not perform differently from NGOs in terms of outreach. This suggests that an improvement in institutional quality may encourage more profit-oriented MFIs and cooperatives to cater to more borrowers, including the poor. In SSA, however, where we generally observe weak enforcement of law and lack of government credibility across countries, banks, and cooperatives are generally deterred, particularly from catering to poorer households.

The remainder of the paper is structured as follows. Section 2 discusses our research framework and objectives, emphasizing on the relationship between governance, institutional quality, and MFI success. Section 3 presents the sample of MFIs and variables used in the study along with the descriptive evidence in SSA. The next section discusses the method used while Section 5 shows the results of our econometric investigation. Section 6 meanwhile reports the robustness checks implemented and examines further issues. We conclude in Section 7.

2. RESEARCH FRAMEWORK

We examine whether other MFI ownership types—banks, cooperatives, and non-bank financial institutions, vary in terms of financial performance and outreach compared with