The Quarterly Review of Economics and Finance 50 (2010) 436–442

Contents lists available at ScienceDirect

The Quarterly Review of Economics and Finance

journal homepage: www.elsevier.com/locate/qref

Is there a difference in performance by the legal status of microfinance institutions?

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ARTICLE INFO

Article history:
Received 25 September 2009
Received in revised form 15 April 2010
Accepted 31 July 2010
Available online 11 August 2010

JEL classification:
G21
G32
G38

Keywords:
Microfinance
Performance
Efficiency
Legal form
Governance

ABSTRACT

Based on some cases of notable successes in Latin America, some microfinance practitioners advocate a transformation of non-profit microfinance organizations into private and regulated companies. The performance of the latter is supposed to be higher than those of non-profit organizations. From this point of view, there is a relationship between the legal status of MFIs and their performance. This article's main objective is to test this relationship from the comparison of performance of 202 MFIs in the period from 2001 to 2006. Rather than restricting the comparison to NGOs and private companies, cooperatives have also been taken into account to compare the performance by the dominant legal forms of MFIs. The results show that the performance of private corporations is better than that of NGOs only when portfolio quality is used as an indicator for measuring performance. Also, our results show that for profit MFIs are more socially efficient than not-for-profit MFIs. The commercial approach of microfinance does not seem inconsistent with the social mission of MFIs.

Awarding the Nobel Peace Prize to Muhamad YUNUS in 2006 is a form of recognition by international organizations of the contribution of microfinance in the development of financial markets in developing countries. Through the provision of responsive and specific financial services, microfinance institutions (MFIs) allow the financial inclusion of poor entrepreneurs who, for economic reasons, are excluded from the traditional banking system. They allow 'the poor and the near-poor' (CGAP, 2004) to have access to credit in favorable conditions. This "microfinance promise" (Morduch, 1999) does not exempt the search for financial efficiency, considered by a stream of microfinance literature as a prerequisite for a sustainable social efficiency of MFIs (Mosley & Hulme, 1998).

In microfinance, social and financial performance is explained either by lending methodology (Armendariz de Aghion & Morduch, 2000; Cull, Demirgüç-Kunt, & Morduch, 2007; Stiglitz, 1990), or by governance mechanisms (Hartarska, 2005; Hartarska & Nadolnyak, 2007; Mersland & Strøm, 2008; Mersland & Strøm, 2009). Evidence resulting from the comparison of MFIs by geographical zone[1] (Gutiérrez-Nieto, Serrano-Cinca, & Mar-Molinero, 2009; Lafourcade, Isern, Mwangi, & Brown, 2006) and by their degree of integration into the networks (Desrochers & Fischer, 2005; Fischer, 2000) has been shown. However, the comparison of performance by the form of ownership has received very little attention in MFIs, contrary to banking organizations where this has been tackled (Ory, Jaeger, & Gurtner, 2006; Valnek, 1999). It seems therefore important to investigate, because cases of notable successes in Latin America such as BancoSol, 1992; FFP Caja Los Andes, 1996; Banco Ademi, 1998; MiBanco, 1998; Compartamentos, 1999 (Fernando, 2004), allow some microfinance practitioners to advocate the transformation of non-profit making MFIs into regulated private companies.

The paper aims to verify the existence of a significant difference in performance by the legal status of MFIs. Contrary to previous research (Hartarska, 2005; Mersland & Strøm, 2008, 2009) who specifically focus both on social and financial performance, and on NGOs and private companies, we widen the research area of legal

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[1] With a sample of 163 African MFIs, they show that African MFIs have a better level of social performance than other regions around the world. However, although the African MFIs are profitable, their overall financial performance remains lower than other regions.

1062-9769/$ – see front matter
doi:10.1016/j.qref.2010.07.003

forms to cooperatives. We also use a multidimensional approach to performance. Performance refers to portfolio quality, profitability, social performance and commercial and organizational performance. This paper constitutes the first step of a research work whose purpose is to verify whether differences in performance of MFIs can be explained by the choice of organizational architecture. Given that the organizational architecture is built on the three delegation – control – incentives, it seems difficult to separate the choice of an organizational architecture of the legal form of MFI, and therefore the specificities of each of these legal forms of governance. The analysis of rating reports of a hundred MFIs available on the website of the rating fund (www.ratingfund2.org) tends to confirm this observation. Hence the need to respond, above all, to the question of whether any difference in performance between IMF is related to their legal status. In this sense, this research follows an exploratory approach. Based on a sample of 202 microfinance institutions from different geographical zones (Latin America, Africa, Asia and Eastern Europe) between 2001 and 2006, we show that private companies' performance is better only when portfolio quality is used as an indicator for measuring performance. Our results also show that for profit MFIs are more socially efficient than not-for-profit MFIs. The commercial approach of microfinance does not seem inconsistent with the social mission of MFIs.

The remainder of the paper is organized as follows. Part one describes the conceptual framework of the research. Part two presents the methodology and part three describes and discusses the results.

1. Theoretical and conceptual considerations

Several types of financial institutions are engaged in microfinance (Jansson, Rosales, & Westley, 2004): (1) commercial banks and other financial institutions opting for a strategy of 'Downsacling',[2] (2) commercial banks and non-bank financial institutions specialized exclusively in microfinance, (3) cooperatives, and (4) Non-Governmental Organizations (NGOs). These organizations can be grouped into three categories according to their legal status: private companies or shareholders firms (SHF) (microfinance banks and other non-banking financial institutions), cooperatives and mutual organizations, and non-profit making organizations. These institutions are different in terms of ownership, agency problems, and governance. According to Fama and Jensen (1983a,b), the comparative analysis of performances by the legal form cannot be done independently of the question of governance. From this perspective, research is rooted in contractual organization theories. Agency theory is mobilized as a framework for comparing the performances of different institutional forms of MFI.

The main objective of private microfinance companies is the maximization of shareholder[3] wealth. They are characterized by the 'one share-one vote' rule. In private companies, shareholders have rights of ownership and privileges that can be transferred in a financial market as long as it exists. The owners are the residual claimants. They are responsible for the control of management decisions. This separation of ownership and control leads to agency problems between shareholders and management. NGOs are non-profit oriented organizations. They are also characterized by a lack of ownership and therefore less control of the managerial discretion of the manager. As private companies, they are characterized by the separation of management and control (Fama & Jensen, 1983a). The board plays the same role as private organizations, namely controlling the managerial power and reduces organizational inefficiencies (Andrés-Alonso, Azofra-Palenzuela, & Romero-Merino, 2009). The managerial power seems to be greater in NGOs because managers have greater autonomy in decision-making. The lack of independence (Fama & Jensen, 1983a) and motivation of directors can therefore reduce the effectiveness of the board of directors and expose the organization to expropriation by managers. According to Peck and Rosenberg (2000), the low involvement of board members in monitoring the management of NGOs is due to the fact that they are not investors. Therefore they pay very little attention to the viability and the sustainability of their organization. In contrast, Hansmann (1980), Fama and Jensen (1983a) and Barr, Fafchamps, and Owens (2005) indicate that major donors or their representatives in the board of directors and other governance bodies can lead to a better control of the opportunistic behavior of the manager. Callen, Klein, and Tinkelman (2003) study a sample of 119 NGOs and come to the conclusion that, the presence of major donors in the board of directors enhances the effectiveness and the efficiency of NGOs. From this perspective, the NGOs would be at least as much performance as other organizational forms, what remains to be demonstrated.

In microfinance, some private companies result from the transformation from non-profit making microfinance organizations (NGOs) into regulated MFIs. This transformation, considered as 'a natural progression' and supported by institutionalists (Ledgerwood & White, 2006; White & Campion, 2002). They hypothesize that the system of governance in non-profit organizations is less efficient than the regulated MFIs. Assuming that the system of governance is effective, i.e. that its organs are competent, efficient and motivated, SHFs have a better control of managerial discretion and are therefore more efficient than cooperatives and NGOs. Thus, non-profit making microfinance organizations perform less well than private companies, when focus is placed on financial performance. However, the social performance of non-profit making organizations is better than those of other organizational forms (Jansson et al., 2004).

Research results about the transformation theory seem contradictory. Fernando (2004) studied 39 cases of transformation around the world. Results indicate that most transformation improves both the governance system and the financial performance of MFIs. However, the case study of the Corposol shows that the transformation of MFIs does not always have the expected positive effects on the governance system and therefore the efficiency of MFIs (Labie, 1998; Steege, 1998). Moreover, empirical work studying the comparative performances of MFIs through their legal form, do not support the idea that private firms are the property form the most effective and most efficient. Results contrast with the theory of transformation. Mersland and Strøm (2008) did not find any significant difference in social performance between NGOs and private microfinance companies. From a sample of 132 ONGs and 68 private MFI companies, they show that the legal status does not influence the social performance. Over the period from 2000 to 2007, Mersland and Strøm (2009) draw the same conclusions as in 2008 from a sample of 278 microfinance institutions. In addition, they find that the financial performance of NGOs does not differ significantly from private companies. According to Mersland (2009), cooperatives and NGOs are more efficient than private microfinance companies, if the design of the contracts is taken as the basis for comparison. The amount (number) of credit granted is more (less important) than those granted by private companies. In addition, operating costs are lower in these institutions because the

[2] These organizations favor the creation of an internal unit specialized in the area of microfinance, and microcredit becoming a banking product able to reach a niche target of low income clientele. The microfinance activity is additional and secondary for these organizations.

[3] As most of these MFIs are not quoted, the concept of maximization of shareholder wealth is more pertinent than value creation.