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Ownership and technical efficiency of microfinance institutions: Empirical evidence from Latin America

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ABSTRACT

By using stochastic frontier analysis, this article examines the technical efficiency of different types of microfinance institutions in Latin America. In particular, it tests whether differences in technical efficiency, both intra- and interfirm, can be explained by differences in ownership. With a focus on non-governmental organizations, cooperatives and credit unions, non-bank financial intermediaries, and banks, the data set contains 1681 observations from a panel of 315 institutions operating in 18 Latin American countries. The results show that non-governmental organizations and cooperatives have much lower interfirm and intrafirm technical efficiencies than non-bank financial intermediaries and banks, which indicates the importance of ownership type for technical efficiency.

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1. Introduction

Microfinance Institutions (MFIs) provide financial services to poor people who have no access to commercial funding. Until recently, many people adopted extremely positive views about the potential role of microfinance. Greater access to microfinance seemed to provide an important instrument for reducing poverty in developing countries. Some observers even called the development of microfinance—which provides financial services including loans, deposits, insurance, and organizational help to poor households—one of the main innovations in the past 25 years.

Recent developments challenge this extremely positive view and question whether microcredit contributes to a true reduction in worldwide poverty in the short or long terms. Stories about loan shark-style MFIs driving borrowers to suicide in the Indian state of Andhra Pradesh took some of the shine off the rosy view of microfinance. These negative developments may result from governance failures, partly related to the recent trend of commercializing microfinance, and the expansion of services offered by MFIs.

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Whereas once they focused only on microcredit and small loans to the poor, today MFIs have shifted to microfinance, including savings and insurance. The funding situation also is changing: Whereas once MFIs relied mainly on private and public donors and aid organizations, an increasing number turn to the capital market for funding. The drive toward commercialization also has induced, and partly required, a change in ownership, such that some MFIs are moving away from their ownership structure as non-governmental organizations (NGOs) to become shareholding companies.

To explain why some MFIs are successful but others fail, and to preclude Andhra Pradesh-like events, we need a better understanding of governance issues. Unfortunately, literature on microfinance governance tends to be mainly anecdotal (Lapie and Mersland, 2011). Some research studies the relevance of certain governance characteristics (e.g., Hartarska, 2005); other studies focus specifically on the role of the type of ownership of MFIs (e.g., Mersland and Strøm, 2009). Noting the importance of ownership structure for MFI governance, several authors argue that nonprofit MFIs should transform into shareholder-held firms (SHFs), because SHFs can be regulated by banking authorities and benefit from superior corporate governance. Yet Mersland and Strøm (2009) reject this argument and suggest instead that SHFs and NGOs perform similarly in terms of both social and financial aims.

In line with Mersland and Strøm (2009), we examine the relevance of various ownership structures for MFI performance. However, we also adopt Lansink et al.'s (2001) focus on intra- and inter-type technical efficiency. We derive and compare the technical efficiency of four groups of MFIs in Latin America: NGOs, cooperatives and credit unions, non-bank financial intermediaries (NBFIs), and banks. These ownership types differ considerably from those of traditional commercial banks. In general, MFIs are smaller in size, limit their service provision to only poor households, and often provide small, collateral-free group loans. In addition, most MFIs have dual objectives, financial and social, and their source of income includes not only deposits but also donations (Gutiérrez-Nieto et al., 2009). Furthermore, a limited number of MFIs are regulated and may mobilize savings.

Our study estimates the technical efficiency of the four groups of MFIs. Other MFI efficiency studies focus solely on cost efficiency (Gregoire and Tuya, 2006; Hartarska et al., 2006; Hassan and Tufte, 2001; Hermes et al., 2011), whereas this investigation is the first to analyze the impact of the type of ownership on the technical efficiency of MFIs. We focus on technical efficiency for several reasons. First, for most MFIs, good price information is lacking, which makes profit and cost functions difficult if not impossible to estimate. Second, there are theoretical and methodological objections to a focus on profit and/or cost efficiency, in that these concepts assume that MFIs maximize profits and are price takers in input markets and, in the case of profit efficiency, output markets. Yet MFIs have multiple objectives, including both helping the poor and financial sustainability, and therefore do not necessarily maximize profits, which means they should not aim to become profit efficient. Moreover, most MFIs have at least some sovereignty in setting interest rates and can affect the costs of their capital, including the share and nature of subsidies, through lobbying. Technical efficiency instead requires that they achieve the maximum output, given inputs, and thus seems a more relevant concept for MFIs. To estimate the production frontier we use stochastic frontier analysis (SFA). Contrary to alternative methods like the thick frontier approach (TFA), the distribution-free approach (DFA), and data envelope analysis (DEA), SFA incorporates an error term that captures irregularities in the data and allows observed production to deviate from the efficient frontier due to either random events or possible inefficiencies.

Another main difference between this work and existing MFI efficiency studies is that previous studies have estimated a single frontier for all MFI types (NGO, cooperative/credit union, NBFI, and bank). The technology likely differs by ownership type, so a common frontier assumption may lead to biased efficiency estimates. We explicitly allow for differences in technology and test the appropriateness of this assumption with a likelihood ratio test.

Finally, our study focuses on Latin America, a region with a rich variety of MFIs in terms of ownership type. There are many small, nonprofit MFIs in Latin America, financially supported by international funders (Gutiérrez-Nieto et al., 2007). Miller (2003) also locates some of the most experienced, developed, and profitable MFIs in Latin America. On average, MFIs from Latin America have more assets, are more leveraged, and make use of a growing share of commercial funds compared with institutions in other regions.

Latin America is also interesting to study because many of its MFIs are under pressure to transform their organizational structure from an unregulated, nonprofit institution to a regulated, shareholder form (Mersland and Strøm, 2009). Competition in Latin American microfinance markets has triggered MFIs to make this transformation, for which they must cover their lending costs with income generated from the outstanding loan portfolio and reduce costs as much as possible. We focus on a single region to achieve a somewhat homogeneous sample of MFIs and attribute any

performance differences specifically to differences in ownership types, not regional disparities.

The remainder of this article is structured as follows. In Section 2 we survey literature on MFI ownership and derive hypotheses regarding the link between ownership type and technical efficiency. Section 3 contains the methodology, followed by a description of the empirical model in Section 4 and the data in Section 5. The estimation results appear in Section 6, and we conclude in Section 7.

2. Ownership structure and MFI technological efficiency

The main function of microfinance governance is to control self-interested managers and resolve agency problems.¹ However, corporate governance is one of the weakest features of MFIs (Hartarska, 2005; Mersland and Strøm, 2009). The early philanthropic status of many MFIs reduced demands for their accountability, such that they were able to attract funding at an increasing rate and keep growing without adjusting their governance system. Without sufficient oversight though, managers likely enrich themselves or pursue other self-interests, at the MFI's expense. In addition, corporate governance gets more complicated in MFIs due to their dual mission, namely, to be financially sustainable while reaching out to the poor. This dual mission, together with the lack of external control, provides managers with some managerial discretion, which affects both outcomes and efficiency. However, managerial discretion is not likely to be the same for all types of MFIs.

Ownership type is a key feature of the governance system within the MFI and ultimately determines MFI performance. Within the microfinance industry, various ownership structures exist, including banks, NBFIs, credit unions and cooperatives, and NGOs. Banks and NBFIs are shareholder firms that distribute excess profits to their shareholders, though unlike banks, NBFIs are legally limited in the range of services they can offer (e.g., some cannot provide savings accounts). Credit unions and cooperatives are nonprofit organizations, owned and controlled by members. Unlike NGOs, they may distribute profits to their members. Finally, NGOs are nonprofit organizations, characterized by a non-distribution constraint.

Although MFIs of all ownership types have social and financial motives, their relative weights differ by MFI type. As shareholder firms, NBFIs and banks have clearly defined financial objectives, whereas NGOs and cooperatives put much more weight on social objectives. These varying main objectives likely prompt differential technology use in each organizational structure, because the technology determines the optimal relationship between inputs and outputs. Organizations serving poorer clients, such as NGOs and cooperatives, have higher average costs than NBFIs and banks, because small loans are costlier to provide (Cull et al., 2009). Moreover, MFIs with a clear social orientation often combine loan provision with training, a labor-intensive activity that does not contribute directly to output in terms of loans provided. Finally, a poverty orientation may require targeting people in more remote areas and visiting them. These differences in orientation make it highly likely that the technology differs for the various types of MFIs: An appropriate technology for a NBFI or bank type may not be the best technology for a NGO or cooperative or credit union. This argument leads to our first hypothesis:

H1. MFIs characterized by different ownership types use different technologies.

The difference in technology use may be a deliberate choice based on objectives, such that an MFI focusing primarily on social objectives may decide not to adopt a technology focused on

¹ This section draws from Galema et al. (2009, 2012).

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