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Governance and Performance of Microfinance Institutions in Central and Eastern Europe and the Newly Independent States

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Summary. — This paper presents the first evidence on the impact of governance on outreach and sustainability of microfinance institutions (MFIs) in Central and Eastern Europe and the Newly Independent States. The results indicate that performance-based compensation of managers is not associated with better-performing MFIs; lower wages suggested for mission-driven organizations worsen outreach, while managers' experience improves performance. The results also identify tradeoffs between MFI outreach and sustainability depending on stakeholders' representation on the board and provide strong support for independent boards with limited employee participation. In the study region, external governance mechanisms seemed to play a limited role.

Key words — microfinance, governance, Central and Eastern Europe and the Newly Independent States, board, rating, audit, regulation

1. INTRODUCTION

Microfinance is the provision of loans and other financial services to the poor. The *microfinance institution* (MFI) has evolved as a result of the efforts of committed individuals and assistance agencies to reduce poverty by promoting self-employment and entrepreneurship. The MFI faces unique challenges because it must achieve a double bottom line—provide financial services to the poor (*outreach*) and cover its costs (*sustainability*). Microfinance is a significant and growing industry, yet few studies explore the link between governance and performance. Previous studies focused on the main strengths of MFIs, namely, how innovative lending technologies enabled lending to the poor, and how microfinance affects borrowers' welfare (Conning, 1999; Navajas, Schreiner, Meyer, Gonzalez-Vega, & Rodriguez-Meza, 2000).

Microfinance practitioners have recognized that good governance is critical for the success of MFIs (Campion, 1998; Rock, Otero, & Saltzman, 1998), but only few studies on regulation in microfinance have touched upon governance issues (McGuire, 1999). Closer examination of the role of various governance mechanisms is important because MFI managers control significant resources. In Central and Eastern Europe and the Newly Independent States (CEE & NIS), the asset base of these organizations is estimated to be 1.2 billion dollars (Foster, Green, & Pytkowska, 2003).

While the impact of property rights and government behavior on institutional development in postcommunist countries has attracted

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attention, the performance of nongovernmental organizations (NGOs) and their contribution to institutional development is less understood. As the nonprofit sector in these countries grows and becomes important in microfinance and other areas, understanding what governance mechanisms strengthen these organizations becomes important.

The lack of studies on the effect of MFI governance on performance is to a large extent due to scarcity of data. Performance data are considered proprietary and are hard to obtain. Although the majority of MFIs are funded with public funds channeled through large international development agencies, until recently the practice was to withhold performance information from the general public. [1]

In addition, the microfinance industry is quite diverse in terms of organizational types, with MFIs organized as NGOs, banks, credit cooperatives, or nonbank financial institutions. This diversity makes it difficult to choose an appropriate conceptual framework for the analysis of MFI governance. However, a 1998 survey of the microfinance industry shows that the objectives and performance of MFIs organized under different legal forms do not differ substantially (Campion, 1998). [2] Therefore, to identify the impact of various governance mechanisms, the empirical analysis will use insights from the governance literature on for-profit firms, nonprofit firms, and banks that are relevant to MFIs.

This paper uses unique data from the recently conducted surveys in CEE & NIS to study the relationships between MFI performance and governance. The empirical model explores the joint and individual influence of management compensation, board effectiveness and diversity, and external governance mechanisms on both MFI sustainability, and the depth and breadth of outreach while controlling for individual MFI characteristics, as well as country-specific institutional and macroeconomic factors. Results indicate that while performance-based compensation does not improve performance, underpaying managers diminishes outreach. More independent boards are more effective, but the differences in emphasis on outreach and sustainability by various stakeholders represented on the board seem to have differential impact on performance (e.g., MFIs with more donor representatives have better outreach but worse sustainability). External governance mechanisms such as auditing, rating, and regulation, have a limited impact.

The rest of the paper is organized as follows. Section 2 presents theoretical considerations, Section 3 describes the data and the empirical model, Section 4 discusses the results, and Section 5 offers conclusions.

2. THEORETICAL CONSIDERATIONS

In microfinance, *governance* refers to the mechanisms through which donors, equity investors, and other providers of funds ensure themselves that their funds will be used according to the intended purposes. [3] Such control mechanisms are necessary because managers and providers of funds may have diverging preferences and objectives. For example, MFI managers may work toward fulfilling the mission of the MFI, but they may also have preferences for nonpecuniary rewards. In the corporate governance literature, this problem is known as the agency problem. This literature refers to the manager as an Agent, who unlike a Principal, does not own the resources of the firm. The Principal bears the residual risk and is the residual claimant of the firm's wealth (Jensen & Meckling, 1976). Costs associated with this problem are called agency costs and represent costs that residual claimants bear in order to benefit from the professional services of managers. The goal of many governance mechanisms is to minimize agency costs by aligning the objectives of the owner-Principal with the objectives of the manager-Agent.

The key mechanisms of an effective governance framework are ownership structure (including institutional and managerial ownership), CEO (manager) and director (board member) remuneration, board structure (size and composition), auditing, information disclosure, and the market for corporate control (Keasey, Thompson, & Write, 1997). Typically, governance studies focus on the individual impact of one of these mechanisms (e.g., compensation, board size, independence and diversity, and external market forces, Shleifer & Vishny, 1997). Some recent studies have recognized that some of these mechanisms may act to complement each other and may be correlated with each other (Hermalin & Weisbach, 2003). This paper explores the impact of all mechanisms except ownership, because the database does not contain ownership data.

MFIs have some unique characteristics that complicate the study of their governance. For example, apart from financial sustainability,