Review

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Corporate Governance Practice and Financial Performance of Microfinance Institutions: Contemporary Literature

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Review

Corporate Governance Practice and Financial Performance of Microfinance Institutions: Contemporary Literature

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Abstract: The main purpose of this paper is to review systematically both theoretical and empirical literature about the relationship between corporate governance variables and the performance of microfinance institutions. The theoretical reviews were: agency theory stakeholders' theory, resource dependency theory, stewardship theory, and social contract theory which deal with corporate governance mechanism and their effect on the performance of the firm. Empirical studies carried out in different countries at different times together with different findings were reviewed to compare the effect of corporate governance mechanisms on the performance of microfinance institutions and to establish areas of gaps for further studies. Board characteristics which include size, education, meeting frequency, board composition, and board independence, and their effect on the financial performance of microfinance institutions were discussed. The findings of different scholars show a lack of consistency on the effect of corporate governance variables on the financial performance of Microfinance Institutions so further investigation is required from potential scholars. Finally, theoretical, measurement and methodological drawbacks of previous studies were identified, and significant recommendations were forwarded for future studies in this area.

Keywords: microfinance institutions; corporate governance; agency theory; resource dependency theory; financial performance; board characteristics

JEL Classification: M14; M4; M1

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1. Introduction

Corporate governance is a system of administering the company in which the manager is responsible to control and run the day-to-day activities of the business. Besides, it can be defined as a system that defines the relationship between corporate managers and the owners who invest in the corporation in the market economy by introducing laws, regulations, and acceptable business practices for both public and private institutions (Charles, 2001). It commonly seems like the way that an enterprise is controlled and directed so that it plays a substantial role in enhancing the performance of institutions (Ssekiziyivu et al., 2018). The concept of corporate governance has become the main dialogue issue, particularly over the last two decades all over the world. Countries give prominence attention to this issue since careful management of the company leads to an increase in the wealth of the corporations (Reed, 2014).

According to Gupta and Mirchandani (2019), corporate governance requires managers to exhibit transparency, responsibility, accountability, and high performance to maximize owners' wealth. As such, it safeguards the interests of multiple stakeholders in the organization by demonstrating the efficacy and efficiency of the board of directors, internal control, manager, and the dependability of financial reports. Good corporate governance lowers the likelihood that the authority will not follow through on its decision to lower capital costs, which benefits the corporation's economic activities (Emre & Boyacioglu, 2014). This suggests that the efficiency of the market environment, which is ensured by the effectiveness of corporate governance mechanisms, impacts the financial performance of the companies. As a result, the effective and efficient application of corporate governance principles plays a vital role in maximizing the market value of stocks.

A microfinance institution offers savings and loans to its clients, especially those with low incomes who do not have access to larger financial institutions. It is a type of lending organization to assists extremely impoverished individuals and groups of people with profitable projects and endeavors to generate income for themselves and their families (Asif et al., 2018). In addition, this organization seeks to offer lower socio-economic classes collateral-free microcredit (Chenuos et al., 2014). These put forward that they offer financial options to populations that are not served by big banks. This indicates that by providing funding for smallholders' investments, microfinance institutions contribute significantly to the economy.

Microfinance institutions can be established by NGOs, government, and private in the form of a company or partnership. Consequently, the application of corporate governance principles is more difficult since intensive research is needed in this area. Given the industry's economic contribution, it is advised to look into the impact of corporate governance on microfinance institutions' financial performance. The socio-economic development of poor social class requires the consideration of microfinance institutions to achieve health improvement, housing, child schooling, gender equality, and women's empowerment goals. Moreover, this institution contributes to the promotion of micro and small business enterprises through supplying loans that sustain their business, so that it creates employment opportunities, and alleviates poverty (Rasel and Win, 2020).

The distribution of rights and responsibilities among the company's stakeholders, which include managers, the board of directors, equity holders, and other bodies with an interest in the business, as well as the provision of rules and guidelines for making decisions on business-related matters, are two advantages that a strict corporate governance structure provides to firm (Murya, 2010). This implies sound corporate governance creates accountability and paves the way for efficient utilization of resources that the main concern of the owners of the company.

Different scholars pointed out the importance of corporate governance and its effect on the financial performance of microfinance institutions (Rock et al., 1998; Hartarska, 2004; Hartarska & Nadolnyak, 2007; Mersland & Strøm, 2009; Asif et.al, 2018; Ssekiziyivu et al., 2018). Those scholars argued that the issue of corporate governance and microfinance institutions' performance did not receive sufficient attention, and they recommend that more studies on this issue be undertaken to examine the effect of corporate governance on the performance of microfinance institutions. Corporate governance is mainly expressed by board characteristics which include board size, board independence, educational quality of the board, meeting frequency of the board, CEO gender, and CEO duality. The result obtained from previous studies on the issue of corporate governance and microfinance's performance is not consistent. Maximum attention needs to be given to this issue even though meaningful and valuable findings that can be used by owners, managers, and policymakers were obtained from preceding studies.

This paper aims to review both theoretical and empirical literature about corporate governance issues and their effect on microfinance institutions' performance which can be used as an alternative approach to enrich their performance. The present study posits that the effectiveness of microfinance institutions is positively impacted by robust corporate governance mechanisms.

There are multiple sections to the review. Section 2 presents the scope and limitations of the review process. Section 3 discusses the criteria of inclusion and exclusion of both theoretical and empirical literature. Section 4 outlines related theoretical and empirical literature reviews of the paper. Section 5 explains the major critique of the existing literature, and finally, section 6 provides a conclusion and recommendations forwarded by the researcher.

2. Scope and Limitations

A multitude of instruments are available for evaluating MFI performance. These include operational performance, financial performance, efficiency, and outreach. The factors that have an impact on the performance of this institution can be categorized as internal factors (i.e., specific to the firm) external factors (industry factors), macroeconomic factors many other determinants. In this

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study, the financial performance of MFIs was found to be influenced by corporate governance variables, particularly board characteristics were used as determinants of the financial performance of MFIs. Finally, the review considered the study conducted on large microfinance institutions registered nationally as Share Companies.

3. Criteria for Literature Inclusion and Exclusion

The purpose of this paper is to review theoretical and empirical research on the relationship between microfinance institution's financial performance and corporate governance. In line with the objective of the study, the studies conducted on the issue under study were searched globally in known databases and included in the review. Besides, to be included all articles have to be published in the English language. The year of publication was not used as a criterion to be included or to be excluded.

4. Literature Review

4.1. Theoretical Reviews

The modern business world needs a separation of ownership and business in which the manager is responsible for running the day-to-day activities of the firm. Nonetheless, conflicts can occur between managers and the company's owners over who gets to keep the wealth the business creates, as well as between managers for control and influence within the organization (Mudambi & Pedersen, 2007). Besides, the objective of maintaining and increasing shareholder value and satisfaction of other stakeholders is found in the context of its corporate mission (Chenuos et al., 2014). Therefore, corporate governance theories: agency, resource dependency, stakeholders, stewardship, and social contract theories were used to investigate the disagreement among stakeholders of the firm.

Historically, agency theory was developed by Alchian and Demsetzin in 1972. Besides, this theory was upgraded by Jensen and Mecklingin 1976 to indicate the relationship between principals and agents. Agency theory concentrates on the relationship between the owners of the firm and the manager of the firm. The Manager is expected to act on behalf of the owners and do activities according to the interests of the owners. Perhaps, the owners face the problem that managers are likely to act according to their interests rather than the owners' interests (Fama & Jensen, 1983). This argues that agency theory reduces the firm's administration into two participants: managers and shareholders, and it also implies that managers may have different interests from the shareholder's goal (Daily et al., 2003). The theory suggests that board composition is important for effectively monitoring top management (Kagema, 2017). Boards have to be diverse in terms of skills, experience, and gender balance. Consequently, boards can be balanced and lead to effective monitoring of the successful performance of the firm.

Resource dependency theory deals with the role of the board of directors in providing the company with resources that are used for operations. The theory shows the relationship between the firm and the outside environment on the issue of necessary resources (Yusoff & Alhaji, 2012). In corporate governance, the board of directors is responsible for bringing skills, information, and access to key constituencies that include buyers, suppliers, public policymakers, social groups, and other important resources that are valuable to the firm (Hillman et al., 2000). Furthermore, competent and qualified members of the board can be viewed as strategic assets that offer a strategic connection to various outside resources. Consequently, this management team provides expertise, skills, information, and potential linkage with the environment for the company. To provide the aforementioned contribution, both agency and resource dependency theories advocate that the members should constitute a diversified and competent board that supervises and controls the top manager.

The other very important theory about corporate governance is stakeholder theory which concentrates on issues about the stakeholders in an institution. The theory instructs that corporations

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always try to keep the balance among their diversified stakeholders so that the interests of different owners can be achieved (Yusoff & Alhaji, 2012). The theory was first developed by Edward Freeman in 1984 with a broader overview concerning corporate governance than agency theory so that it enhances the company's performance from a corporate governance perspective (Binh & Anh, 2017). One of the best arguments of stakeholder theory is the parties who have a direct interest should take in other stakeholders such as political groups, communities, trade unions, governmental bodies, prospective employees, the general public, and trade associations since the involvement of these parties could improve the market performance of the firm (Yusoff & Alhaji, 2012). The prominence of stakeholder theory was increased when most of the scholars acknowledged that the action of a business entity has an impact on the environment within which they are operating that needs accountability that is beyond the organization's shareholders. This is because companies exist within the communities and are also responsible for them (McDonald &Puxty, 1979).

Legitimacy theory is another corporate governance theory that deals with the way that corporate entities should be supported in executing and raising voluntary social and environmental disclosures that achieve the organization's social contract that help them the recognition of their aims and the subsistence in an agitated and unsettled environment (Burlea-schiopoiu & Popa, 2013). Legitimacy theory can be defined as "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate with some socially constructed systems of norms, values, beliefs, and definitions." (Suchman, 1995). The theory depends upon the belief that an organization can operate its activities based upon the social agreement between society and an organization so that a firm can be permitted by society to function and be directly accountable to society for how to run its entity since society is the source of natural resources and labor that an organization uses to produce goods and services (Yusoff & Alhaji, 2012). This implies organizations are required to obey the current national as well as international laws and conventions about the relationship between their firm and society which forces them to operate according to the new economic, social, environmental, and governmental rules, values, and norms by disclosing both social and environmental information that prove their compliance (Burlea-schiopoiu & Popa, 2013).

4.2. Empirical Reviews

Corporate governance becomes the main discussion issue in the world especially if the owners of the firms are not involved in controlling the day-to-day activities of the business. The Board of directors assigns a manager to run the daily operations of the business. However, in doing so the problem of divergences of interest between shareholders and corporate managers may arise caused of the manager's conflict of interest which results in agency costs that include the entire residual loss, monitoring cost, and bonding costs (Jensen & Meckling, 1976). Many scholars have been studying the importance of corporate governance for the microfinance industry. This is because mismanagement of this industry leads to failures of different stakeholders directly and indirectly. Microfinance which maintains good corporate governance practices will be financially and socially sustainable. Good corporate governance practices related to both the internal and external areas of Microfinance activities including for example fiduciary responsibility and social impact of funded activities. It is important to determine those corporate governance practices that have the greatest impact on Microfinance performance and accordingly afford the potential to contribute the greatest significant impact on improving Microfinance performance in the long run (Thrikawala et al., 2013).

The purpose of this study is to review the findings of numerous experts from different nations on the topic of corporate governance. The variables that were taken into consideration were CEO duality, CEO gender, board size, board composition, board competency, and frequency of board meetings. The findings of the study conducted by Chenuos et al. (2014) in Kenya about the relationship between corporate governance and the performance of MFIs indicate that diversified board members, moderate board size, board members with a considerable number of women, and board independence enhance the financial sustainability and profitability of MFIs. According to their study board size has a positive and significant (Akpan & Amran, 2014; Ammari et al., 2014; Bassem, 2009; Chenuos et al., 2014; CMEF, 2012; Macharia, 2017) effect on the performance of microfinance institutions. Their finding indicates that larger boards have their benefits and when board size increases company performance increases since greater board members are expected to forward greater advice, better monitoring, and create a smooth relationship with the external environment.

According to Hartarska (2004), board size has a positive and significant effect on the financial performance of MFIs which the finding of the above researchers (Ammari et al., 2014; Durgavanshi, 2014; Gohar & Batool, 2015; Maina et al., 2013; Moenga, 2015). Their argument shows that larger boards are known for delayed decisions, which leads to a reduced capacity for monitoring. But according to Rodriguez, (2015), the linear relationship between size and financial performance should not be assumed even though both theories–agency and resource dependency show a positive relationship between the two concepts. Besides, applying corporate governance principles codes periodically is used to respond to the changing economic, social, and financial conditions guarantees that standards are continuously responsive to the vagaries of the marketplace. Furthermore, Lawal (2012) contended that there has to be a continuing, contentious discussion in the corporate governance literature about the appropriate size of the board. In addition, the studies conducted on corporate governance found mixed results regarding the correlation between the number of boards and MFIs' financial performance (Manini et al., 2014).

The second corporate governance variable is board gender composition which indicates the male-female proportion of the board. Mersland and Strøm, (2009) found that female CEOs is a significant and positive effect on the financial performance of MFIs (Bassem, 2009; CMEF, 2012; Erhardt et al., 2003; Hartarska, 2004; Hussein & Kiwia 2009; Macharia, 2017; Mori & Olomi, 2012 & Moenga, 2015). The authors argue that since microfinance institutions serve mostly female customers, female CEOs are more likely to acquire significant information that is suitable for making decisions so that greater company performance can be achieved. This implies that the Presence of gender diversity on boards indicates that boards have a broader perspective and have a positive significant effect on the performance of MFIs.

Agency theory suggests that board composition is important for effectively monitoring top management (Hussein & Kiwia, 2009). To achieve the desired result, boards need to assume various skills, experiences, and gender balance. Consequently, boards are balanced so that effective monitoring can be achieved which leads to the successful performance of the company. Board educational qualification is another factor that is expected to affect the financial performance of microfinance institutions since education is important for building people's skills in any field. According to Thrikawala et al. (2013), the financial performance of MFIs is positively correlated with board educational status (Bassem, 2009; Mori & Olomi, 2012). Hartarska (2005) and Mori and Charles (2019), argue that the skills board members bring to the MFI board matter. Moreover, Chenuos et al. (2014) found that there is a negative correlation between the performance of MFIs and board members with less education than a bachelor's degree, indicating that these individuals made little to no contribution to the expansion and financial success of microfinance institutions. Therefore, board members need to be well educated which can be obtained through formal education which results in improved financial operation of microfinance institutions.

To solve the existing problems that the company is facing, boards have to meet regularly. However, meeting the frequency of the board may have a significant impact on the financial performance of the firms. This implies that quickly designing board meetings allows the board to investigate and supervise the day-to-day operation of MFIs without involving the management report. A few studies conducted in different countries concluded that more meeting frequency harms the performance of microfinance institutions (Akpan, 2015; Akpan & Amran, 2014 & Danoshana & Ravivathani, 2013). However, there were also studies conducted with findings of a positive relationship between meeting frequency and financial performance of the firm (Karamanou & Vafeas, 2005; Macharia, 2017; Mangena et al., 2011 &Ntim & Osei, 2011). This suggests that microfinance institutions tend to have better financial success when their board of directors meets more frequently.

The other corporate governance variable is board independence which means the director has no direct or indirect material relationship with the company other than membership on the Board. External board members (non-employees, not related to the organization) are expected to act as better monitors and advisors to MFIs compared to internal board members (Hartarska, 2004 &Mori et al., 2015). According to Al-Sahafi et al., (2015), Hermalin and Weisbach (2013); Johnson and Daily (1996), and Rock et al.,(1998) there is a positive and significant relationship between outside directors and the financial performance of microfinance institutions. This implies boards from outside have sufficient skills to supervise the manager of MFIs. Similarly, Hartarska (2004), used rated and unrated MFIs in Eastern Europe to investigate the relationship between corporate governance and MFI success, and his results show that more independent boards give a better return on assets (ROA) whereas lower financial performance and outreach showed for the boards with employee directors (Thrikawala et al., 2013). This implies that there is a positive relationship between firm performance and the proportion of outside directors. In contrast to this Hartarska (2005) and Maina et al., (2013) found that there is a negative relationship between the internal board and the financial performance of MFIs. However, the result obtained by Mori and Olomi, (2012) reveals that it does not matter whether the members of MFI boards are either externally or internally (employees and affiliates) sourced.

The study conducted in Germany indicates that the involvement of family management in the executive board decreases both accrual and real earning management activities through flexible spending (Franzoi et al. 2021). On the other hand, according to the study conducted by (Stender and Rojahn, 2020) while external governance has a positive effect, internal governance hurts the firm value. As indicated by (Braendle et al., 2020), different cultures from which the board members are included hurts the financial performance of the firm. The study conducted on corporate governance in Italy shows that the financial performance of the firm is negatively affected by executive female directors; though non-executive female directors have a positive impact on the firm’s financial performance (Basuony et al., 2023).

5. Critique of the Existing Literature

Many studies tried to establish the relationships between corporate governance and financial performance of microfinance institutions which were conducted on different continents at different times. However, the effectiveness of corporate governance depends upon the level of economic development, knowledge, and skill in the application of corporate governance principles. Almost all of the scholars’ findings indicate that sound corporate governance plays a vital role in improving the financial performance of microfinance institutions (Bassem, 2009; Benedetta et al., 2015; Chenuos et al., 2014; Durgavanshi, 2014; Gohar & Batool, 2015; Hartarska, 2004; Hartarska, 2005; Maina et al., 2013; Mersland & Strøm, 2009; Mori & Olomi, 2012; Thrikawala et al., 2013). Even though the contribution of these studies to the existing literature is not negligible, the studies conducted in this area lack methodological and measurement appropriateness. Most of the researchers used ROA and ROE to measure the financial performance of MFIs, but the financial performance measurement tools are not confined to these two ratios. Nowadays, the firm’s financial strength can be measured by Tobin’s Q which is defined as the ratio of the market value of the assets to the replacement value of the assets and that applies to the value of the firm. The variable represents the company’s financial health and acts as a stand-in for how well a business performs in the financial markets (Awais & Siddiqui, 2020). Therefore, this implies evaluating the financial performance of MFIs needs the application of different financial ratios in addition to ROA and ROE.

The intention to analyze the performance of given firms must follow a holistic approach which means the overall activities of the firm have to be measured and have to be evaluated. Different studies were documented in the literature and argued about the relationship between corporate governance variables and the financial performance of MFIs. However, studies that try to examine the effect of corporate governance mechanisms on non-financial performance which include employee retention, customer satisfaction, and research and development are very rare. This is another drawback of the literature because the non-financial performance of the firm can also be affected by corporate governance mechanisms. In addition to the above limitations, most of the research undertaken used secondary data with a survey method especially since this problem is common in studies that were done in developing countries. Nonetheless, it is advised to use primary

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data in conjunction with the survey approach to gather precise information regarding the connection between corporate governance and MFIs' financial performance.

Finally, almost all of the studies indicate that thorough corporate governance practice plays a crucial role in the success of MFIs financially and outreach. However, corporate governance has variables that include board size, CEO duality, board independence, meeting frequency of the board, educational qualification of the board, and CEO gender. These are called board characteristics and affect the financial and non-financial performance of MFIs. The previous studies obtained controversial findings on the effect of corporate governance variables and the financial performance of MFIs. Consequently, the relationship between corporate governance variables and the financial performance of MFIs is inconclusive and is still open to further empirical studies.

6. Conclusions

This paper aims to review the existing literature on the issue of corporate governance mechanisms and their relationship with the financial performance of MFIs. Existing literature agreed on the importance of sound corporate governance mechanisms for the better financial performance of MFIs. However, there is no reasonable consensus agreement on the board's characteristics and firm performance. Besides, the previous studies lack methodological sufficiency and non-financial performance issues were not considered in the literature. Moreover, financial performance measurement tools were confined to ROA and ROE ignoring other tools like Net Interest Margin (NIM), and Efficiency Ratio (ER) to measure the overall performance of MFIs. Therefore, future researchers need to include other measurement tools such as Tobin's Q, efficiency ratio, net interest margin, liquid assets to deposit, loan to total deposit, and other methods to indicate clearer information about the firm. Conversely, more research in this field must demonstrate a connection between corporate governance practices and non-financial performance.

Furthermore, in the previous studies, most of the researchers used agency theory, resource dependency theory, and stakeholder theory. However, other theories including stewardship theory, institutional theory, transaction cost theory, and political theory to better understand the relationship between corporate governance and the financial performance of MFIs from a different theoretical perspective. Control variables such as firm size, age of the firm, and leverage need to be included as moderating variables. Last but not least, the researcher suggests that to generalize the research findings and offer suggestions for strategies for enhancing corporate governance in microfinance institutions, future studies should close knowledge gaps on the impact of corporate governance mechanisms on the financial and non-financial performance of MFIs through longitudinal studies using a probability sampling approach.

Ethical Consideration: The review of an article is entitled Corporate Governance Practice and Financial Performance of Microfinance Institutions: Contemporary Literature. This article is an original work, and it was carried out independently using various literatures. It has not been submitted to any degree/diploma in any other institution or it was not published in other journals. The reviewed literature was acknowledged and appropriately cited. Since the articles reviewed were scholarly written theories, empirical, and methodologies from different regions, it provides new ideas and new opportunities for further studies to fill the shortcomings of prior studies. Therefore, the paper is original.

Conflicts of Interest: The author declares that he has no competing interests.

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