Impact of Corporate Governance on Performance of Microfinance Institutions: A Case from Pakistan

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Abstract: *The determinants of economic/financial, social performance and productivity of twenty five MFIs are estimated for the period 2005 to 2009 in case of Pakistan. The panel data estimation technique is applied and random effect model better describe the performance models The economic and financial performance is measured by return on assets, operational social self-sufficiency and portfolio yield ; the social performance and outreach measured by average loan size , number of credit clients (CC) and number of branches. The results of the study indicate that governance variables influence the performance (economic and social) and productivity of the MFIs in Pakistan. Larger boards inversely effect economic performance but have a positive effect on outreach and productivity. Female director do not play role in improving economic performance but effect positively outreach. Duality of chair with CEO is a negative contributor to performance, outreach and productivity The firm size, experience, regulated MFIs, non-profit activities in lending have positive effect on performance outreach and productivity. Urban lending relative to rural lending has no significant impact on the performance and productivity of MFIs in Pakistan*

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CHAPTER NO. 01

INTRODUCTION

This chapter provides the introduction of Microfinance and its importance. How this study will help its stakeholders is also explained in his chapter

1.1: What is Microfinance?

Provision of loans, savings and other basic financial services like insurance, to the poor and deprived segment of economy is referred as Microfinance. Microfinance facilitates poor and near poor households by providing them permanent access to not just credit but also savings, insurance, and fund transfers against no collateral. (Christe,R.P. ,Roseberg, R. and Jayadev,V.,2004).

Major reason of poverty in developing economies is lack of credit availability to poor. Two major reasons for non availability of loans to poor are: Inability of poor clients to provide acceptable collateral and banks find it more costly to screen the poor customers i.e. problem of adverse selection and to monitor the repayment by poor i.e. problem of moral Hazard.

Survey conducted by UN in 2002 has found that almost one fifth of world population is living in extreme poverty and their earning per day is less than dollar .Microfinance is considered to be important instrument to combat with extreme poverty. UN put lots of emphasis on microfinance for achievement of Millennium development goals which aims at halving the extreme poverty. Concept of solidarity group lending is playing boosting role in development of MF sector. It facilitates both the micro entrepreneurs as well as credit providing institute. Peer pressure and mutual support of the entire group members encourage each individual of group to put in best efforts for loan repayment as inability of repayment will forfeit the chance for further loan. Pay back rates of group loans is approximately 98% which is higher than individual loan repayment rate.

In evolution of MF sector two factors have brought tremendous progress. First, poor people have very good repayment rates especially women and secondly, it is found that poor people are ready and able to pay subsidized interest rate for survival and better performance of MFI's. Further more studies have shown that most of the loans are given to women by MFI's that not only reinvest their earnings but also spend on their families. It helps to improve their standard of living as well as community get benefit due to job creation and knowledge sharing.

1.2: Objective of study

MF sector of Pakistan has well developed legal, regulatory and strategic framework. MFIs have been working since late 1980's but mentionable efforts of MFIs have started after period of 2000. This sector plays an important role in alleviating poverty, improving living standards of individuals and providence of health and education to deprived segment of society. Lots of researches has been conducted to evaluate the performance of MFIs in Pakistan which came up with guiding results. But up till now there is lack of studies which cover CG impact on MFI performance. Literature has recognized good CG as key element for success of MFI. Importance of CG mechanism is alike for both developing and developed sophisticated economies. Now long- term capital growth is not possible for countries that lag behind in adoption of CG practices.

Concept of corporate governance was introduced globally in late 1990s. In Pakistan code of corporate governance was applied to business firms in year 2002.For designing CG framework of different type of business, it requires to cover different areas. MF entities are of various types depending on variations among their institutional structures. Some NGOs are incorporated and SEC regulates them, some work as societies registered under societies act and some are governed by Ministry of Industries and work as Trust. So they do not have a single transparent and formal governance structure and processes to follow.

Our research aim is to study the relationship between performance and different dimensions of CG for regulated MFIs of Pakistan. So that results of research can be used to make a clear, well defined and formal CG structure to MFIs which ensure success of MFIs in terms of both outreach and sustainability.

1.3: Significance of the Study

First time for Pakistan , this study is evaluating relationship of economic and social performance of MFIs with corporate governance .The study helps to understand the current scenario of MF sector regarding to economic and social performance, outreach and productivity and also suggests that how MFIs in Pakistan can be improved if good governance practices are introduced. The study also investigates that firm specific characteristics such as type of lending, firm size, lending status (profit or non-profit) and years of experience also contribute to performance and productivity.

1.4: Organization of the Study

The study is organized as follows. After introduction the overview of MFIs in Pakistan is provided in chapter 2. Chapter3 gives Importance of Corporate Governance in MF sector. The brief literature review of studies is given in Chapter 4.

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CHAPTER NO.02

OVERVIEW OF MICROFINANCE IN PAKISTAN

This chapter presents the origin and development of MF sector in Pakistan. Over view of MF sector and different types of MFIs operating in Pakistan are also discussed in this chapter. Challenges faced by various operational levels of MF sector are also presented in this part.

2.1: Origin and development

GNI per capita of Pakistan is $2780 by year 2010.With this figure Pakistan is ranked as low income country. Almost 22.3% of total population is living below poverty line and 20.5% is living on the 100-125 % of poverty line. Pakistan is facing problem of poverty since its independence. Microfinance is considered as one of the important tool for eradicating the poverty as well as it increases women empowerment. In Pakistan, microfinance is first introduced by development of Agha Khan Rural Support Program (AKRSP) and Orangi Pilot Project (OPP) in early 1990s.These MFI's were setup with the purpose of providing credit to poor and alleviate poverty. In 1990's GoP and Central Bank realized that MF is key component of financial sector. At that time large number of institutions was developed with the objective of offering micro credit on group lending basis. Grameen model of lending has been adapted by many institutions to serve urban localities. With passage of time increase in number of new entrants, products, practices and growing clientele showed expansion of Pakistan MF sector. In year 2000 MF sector experienced rapid growth with establishment of KB, first specialized microfinance bank and Pakistan Poverty Alleviation Fund (PPAF) an apex funding body. Moreover, in year 2001 formulation of Microfinance Ordinance, invites commercial players to take part in MF activities

The empirical methodology and data is discussed in chapter 5. Chapter 6 presents the empirical results and last section chapter 7 concludes the study.

and bring some expansion in the sector. State bank of Pakistan also takes different initiatives for the florishment of MF sector. In year 2007, SBP and MF stake holders together have designed a strategy named "Expanding Out reach of Microfinance"(EMO).Main objective of study was to achieve target of three million borrowers by year 2010 and for year 2015 target of 10 million borrowers was set out.

2.2: Overview of Pakistan Microfinance Sector:

Due to its well-developed legal, regulatory and strategic frame work MF sector of Pakistan is globally recognized. In terms of both outreach and asset base MF industry of Pakistan is still very small. Currently MF sector is serving 2.07 million borrowers representing that only 7% of potential market is served. Penetration level is lowest in Pakistan.56% of target market is totally excluded and 32% are served through informal ways. Microfinance institutions are operating in country through 1379 branches and serving almost 2.07 million borrowers with gross loan portfolio of PKR 26.4 billions. MF sector is mainly operated by few major institutions (NRSP, KBL, KF, FMFB, KMFB, PRSP, and TMFB) jointly serves 85% of the market. These are fastest growing players of MF sector. Most of MFI's are operative in provinces of Punjab and Sindh. Most of specialized MFIs are operative in Punjab due to its infrastructure and higher population density.60% of active borrowers are from Punjab and 23% of them are from Sindh. These provinces attract maximum business of MFIs due to their dense population. By year 2009, 56% of credit clients are women. Among the other peer groups, MFI peer group is serving maximum women and its 90% of clients are women. Asset base of MF sector reached to PKR 35 billion. Seven major MFIs hold 85% of total industry's assets. Industry improved its profitability in year 2009.Globally, industry was less profitable but some RSPs and MFIs have positive

ROA. One of the prominent reasons for low profitability is high personnel ration for Pakistan. Group lending methodology is adapted by most of MFIs for providing loans which are primarily used for agriculture, livestock and trade businesses. Typical size of loan is from $100 to $500. Individual loans are also offered by some MFI's as most of them wants to avoid the risk associated with non social collateral in case of individual loan.

2.3: Structure of MF sector in Pakistan

Micro, Meso and Macro level activities collectively made MF sector in Pakistan. Activities at all these levels are distinct but integrated with each other. This model of MF structure was given by Helms (2006).

2.3.1: Micro Level

Micro level comprises of borrowers or microfinance clients and MFI`s or microfinance service providers. In Pakistan currently large number of MFIs are operative but out of them 31 are regulated one and all other are serving through informal ways Loans are used by borrowers for various purposes.34.2 % loans are used for trade, 37.5% are used for agriculture,11.2% for livestock / poultry and 17.1% are used for remaining other sectors. In MFI market, 30% of borrowers are linked with RSPs, 36% are linked with MFB and remaining 34% are associated with MFI-NGO. Source (Maheen Farooqi: PMN).

Almost 2/3 rd of Pakistani population lives in Rural area, but most of the MF services are provided to urban areas. Lenders find it costly to operate in remote, sparsely populated areas.

MFIs can be classified into the following three types (Classification based on PMN 2009).

2.3.1(A): MFI -NGO

Any non-government, non-bank institution engaged in the business of micro financing is called MFI- NGO.MFI- NGOs are regulated either by Societies Act, The Trust Act or by Companies Ordinance 1984.Local and multinational NGOs are included in this peer group. Currently there are 13 institutions which joined PMN as MFI- NGO with gross loan portfolio of PKR 59.7 billion.

2.3.1(B): Microfinance Bank (MFB)

Any commercial bank indulged in providing microfinance services exclusively and is regulated by SBP is referred as MFB. MFBs provide credit as well as accept and intermediate public deposits. By year 2009, there are 8 institutions which joined PMN as MFB with gross loan portfolio of 85.7 Billion.

2.3.1(C): Rural Support Program (RSP)

Non Government concern registered under section 42 of Companies Ordinance 1984 works as RSP. Target market of these programs is purely rural areas. SECP is regulatory body for registration and supervision of RSP. There are 4 RSPs currently working in country and are member of PMN with gross loan portfolio of PKR 57 Billion.

Government of Pakistan is playing very supportive role for development of MF sector. NGOs and RSPs receive subsidized loans from PPAF. Still there lots of challenges are present at Micro level.

- Non-Licensed MFIs are reluctant to be regulated by any authority. Such MFIs believed that objective of MFI is just to provide charity and not to involve in financial services. However, if MFIs get themselves licensed they can get benefit of tax exemption and access to subsidies funds.
- There is non-availability of Sharia based products by MFIs. There is only one MFB providing such products to customers.
- In MFIs management lacks financial expertise. They focus mainly on social objective i.e. charitable functions of MFI and overlook financial sustainability of programmes which results in MFI dependence of subsidies.
- Cost of operation in rural areas is too high and most of MFIs in Pakistan are not sound enough to extend their operations in rural areas.

2.3.2: Meso Level

Microfinance associations, credit bureaus and auditors exist on meso level of microfinance sector. They provide support services and infrastructure to microfinance sector. MFAs plays role of intermediary between macro and micro levels of MF sector. The Asia Foundation in their survey conducted in Pakistan (2009) found that MFAs play very important role in the improvement of Governance of MF Sector. In order to improve the sustainability and impact of MFIs, MFAs are engaged in wide range of activities .Major responsibility of MFA is to facilitate, coordinate, design or supervise (Ronald Gross, 2003)

Pakistan Microfinance Network is prominent MFA in country. It is the only national network for microfinance. Informally it started its operations in 1997, and in 2001 it was established as separate legal entity.PMN is performing following activities:

- Networking

- Information collection and dissemination
- Technical and organizational assistance
- Standards, regulation and supervision
- Lobbying and advocacy

Currently 24 MFIs are member of PMN and it accounts for 90% of MF business in Pakistan. (Aban Haq, 2009).PMN though the largest MFA of country, but still facing following challenges

- PMN has constrained resources and also problem of proper funding
- PMN is unable to provide empirically based rationales to SBP in support of policy recommendations.
- SBP has not given clear and well defined long term strategy which defines nature of relation between SBP and MFAs.
- Insufficient technical services and lack of specialized education is also affecting performance of MFAs

2.3.3: Macro Level

Macro level activities involve central banks, ministries of finance and government entities. MFI`s in Pakistan are facing contagious collapse due to inefficient policy makers. Macro level of microfinance sector is confronting with following challenges;

- There exists a need to refine some prudential regulations given in MF Ordinance. It includes
    - ✓ Restriction on amount of foreign exchange transaction
    - ✓ Exclusion of MFB from status of scheduled banks as they are not indulged in sound financial practices

In order to improve the overall performance of MF sector, there is need to disseminate and communicate benefits of being regulated among the non licensed mf providers. It will help to increase the outreach as well as sustainability of MFI.

Challenges of all three levels can be addressed by tool of good governance and regulation practices adherence to good governance and regulation helps fund providers to take moderate risk which results in excessive returns and ensures solvency of MFI, protection to fund depositors and make whole system sustainable.

CHAPTER NO.03

MF PERFORMANCE AND GOVERNANCE

Performance measurement criterion for MFIs and importance of Good Governance practices in MF sector are discussed in this part. Recent addition in literature regarding to Good Corporate Governance practices to be applied on any type of MFI by BBVA Microfinance Foundation is also presented here.

3.1: Evaluating MFI performance

Performance evaluation criteria vary from firm to firm depending on nature of firms operations and business. Higher rate of return may serve as indicator of success for a particular business concern but fails to serve the purpose for other concern. According evaluation criteria for performance of MFI is different from other institutions. Microfinance model is unique as it strives to achieve three things simultaneously, which makes it different from other existing rural credit facilities. J.D.Von Pischke, USAid refers three things i.e. financial sustainability, outreach and impact as golden triangle. Referring to "the Golden Triangle" effective MFI is one which targets poor members of community for giving them credit , makes sure that credit is used in effective way and having positive impact on lives of rural community individuals. Furthermore an MFI is ideal one when it ensures financial sustainability of programme over long run. Among three above mentioned dimensions MFI outreach and financial sustainability are most important and empirical evidences are available for them. In fact impact factor is mostly considered as part of outreach factor. By outreach we mean that how much underserved members are provided with the financial services. In literature it is assumed that once credit is provided it will definitely bring positive impact on lives of deprived people. Hence it is refers that outreach and financial sustainability are used to explain successful MFI. Outreach is considered as social objective, and financial sustainability is considered as commercial objective.

Financial sustainability of MFI has to face lots of challenges as there involves high transaction and information cost while dealing with poor clients. Even in the dependent as well as developing economies, mostly MFIs are dependent on donors fund for meeting their high cost which shows that they are still not financially sustainable. Many researches have been conducted to study the impact of trade off between outreach and sustainability. In 2001 Robbinson explained that there are two approaches under which MFIs design their operations. Financial system approach justifies charging interest to their credit clients, so that the MFI becomes free from its dependence on donors fund and long run existence of MFI programme. Followers of this approach argue that there are no researches which showed that higher interest rates cannot be borne by poor. Furthermore, there is no empirical evidence showing that lower will be poverty level of clients if MFI is not financially sustainable. On the other hand poverty lending approach focuses on the social objective of MFI i.e. Maximum outreach instead of its commercial objective. They justify subsidized interest rates to overcome poverty as according to them poor cannot afford higher rate of interest.

All these considerations make it very important to study mechanisms which can improvise financial performance as well as efficiency of MFI. So that social as well as commercial objectives of MFI can be achieved.