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AN EVALUATION OF CORPORATE GOVERNANCE ON THE PERFORMANCE OF MICRO FINANCE INSTITUTIONS IN NIGERIA

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Abstract

Microfinance banks (MFBs) are the most prominent providers of financial services to low-income people, their economic and social performance is subject to debate. How MFBs are governed is likely to affect their efficiency, outreach to the poor, sustainability, and impact on poverty alleviation. This study examines the effects of corporate governance on the performance of MFBs. Specifically, it examines the characteristics and diversity of people who sit on boards of MFBs. It also examines the effect of board size on performance of MFBs. Secondary data were employed and analyzed through panel regression using both fixed and random effect model. The study established that board size and years of experience of the board members have a positive effect at 5 percent level of significance on performance of MFBs. Hence, increase in the board size in person would lead to improved performance. Similarly, the more experienced the board members, the better the performance of the micro finance banks. The study recommended among others that management of micro finance banks should consider a large pool of board members with diverse background and relevant experience for appointment in order to achieve the banks objectives. If the above recommendations are implemented, there is likelihood that the performance of MFBs will be enhanced greatly.

Keywords: Corporate Governance, Performance, Sustainability, Outreach, Board Members.

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1.0 Introduction

Although Microfinance Institutions (MFIs) deal with the provision of loans and other financial services for low-income people, their ability to impact poverty as well as their economic efficiency are subject to debate. These institutions serve more than 200 million customers worldwide. In contrast to the formal banking sector, a Microfinance Institution (MFI) face a dual mission since it has to provide financial services to the poor (outreach) while simultaneously covering its operating costs (sustainability). Furthermore, as the competition for funding sources (donations and investment capital from outside creditors) has enhanced due to an increasing number of MFIs, profitability becomes more important, even for those MFIs that are operated as not-for-profit organizations. Consequently, a growing number of larger MFIs pursue the strategy of turning into formal banks, hence facing competition with traditional commercial banks which in turn have recently started financing MFIs or providing microfinance themselves. The extent to which microfinance banks seek to maintain the dual focus of profitability and outreach to poor clients is directly shaped by the composition of the boards of directors, and by the priorities established by the board. From a developing country's government perspective, proceedings of microfinance as described above provide an opportunity, but even more the necessity to strengthen local institutions and governance outcomes. As it is well accepted that theories on institutional development and governance quality in developing countries apply to microfinance as well, a theoretical framework is offered suggesting that microfinance banks operating under high-quality local institutions and governance are more likely to achieve social and economic success. Therefore, this study evaluates the role of corporate governance in the performance of Microfinance Institutions. Specifically, it has the under listed objectives. To:

i. Examine the salient characteristics and diversity of people who sit on MFB board.
ii. Examine the effect of board size on the performance of MFB.
iii. Examine the impact of education and experience of board members on performance of MFB in Nigeria.

A growing number of studies are stressing the importance of MFI's corporate governance as a key factor to succeed. Hence, these studies focus on what is commonly accepted as a firm's corporate governance and recommend that the constitution, experience, monetary compensation and independence of the board of directors as well as the establishment of an oversight board and a control of the MFI's management should strengthen the microfinance bank's performance and amend its sustainability and outreach.

Unlike other prior studies, this study is not restricted to the framework of the Organization for Economic Cooperation and Development principles, which is based primarily on shareholder sovereignty. It analyzed the level of compliance of code of corporate governance among MFIs in Nigeria. Finally, while other studies on corporate governance neglected the operating performance variable as proxies for performance, this study employed the accounting operating performance variables to investigate the relationship if any, that exists between corporate governance and performance of MFIs in Nigeria.

This study employed panel data methodology to provide evidence on the relationship between Microfinance banks' performance and corporate governance. The study covers all the microfinance banks in Ilorin between from 2010 to 2013. However, it was not possible to obtain all the financial statements of MFBs in Ilorin because most of them do not publish their annual reports. To this end, only five (5) MFB released their annual statements and therefore used for the purpose of this study.

2.0 Literature Review

2.1 Conceptual Issues

What is Microfinance?

Micro finance is the provision of financial services to low-income earners and very poor self-employed people. Otero (2000). It involves provision of financial services to the poor who are traditionally not served by the conventional banks. Microfinance has evolved as an economic development approach intended to benefit low income earners. The term refers to the provision of financial services to low income clients, including the self-employed. Financial services generally include credit, savings, micro-leasing, money transfer and payment services. However, some micro finance institutions also provide insurance and payment services. Its definition also includes both financial intermediations, social intermediations such as group formation, development of self-confidence, and training in financial literacy and management capabilities among members of a group.

What is Corporate Governance?

Corporate governance is a uniquely complex and multi-faceted subject. Devoid of a unified or systematic theory, its paradigm, diagnosis and solutions lie in multidisciplinary fields i.e. economics, accountancy, finance among others Cadbury (2002). As such it is essential that a comprehensive framework be codified in the accounting framework of any organization. In any organization, corporate governance is one of the key factors that determine the health of the system and its ability to survive economic shocks. The health of the organization depends on the underlying soundness of its individual components and the connections between them. According to Morck, Shleifer and Vishny (1989), among the main factors that support the stability of any country's financial system include: good corporate governance; effective marketing discipline; strong prudential regulation and supervision; accurate and reliable accounting financial reporting systems; a sound disclosure regimes and an appropriate savings deposit protection system. Corporate governance has been looked at and defined variedly by different scholars and practitioners. However they all have pointed to the same end, hence giving more of a consensus in the definition. Coleman and Nicholas-Biekpe (2006) defined corporate governance as the relationship of the enterprise to shareholders or in the wider sense as the relationship of the enterprise to society as a whole. However, Mayer (1999) offers a definition with a wider outlook and contends that it means the sum of the processes, structures and information used for directing and overseeing the management of an organization.

A broad range of actors have an active role in MFI governance. We can see these actors broadly as external or internal according to their roles in the governance process.

"Internal" actors are:

a. The board of directors
b. Senior management
c. Internal auditors, as they interact with the board

"External" actors are listed below

a. Entities that oversee the institutions' financial health: regulators and auditors
b. Providers of financing: shareholders, lenders, and depositors
c. Communities served by the institution
d. Employees
e. Clients

Although governance takes place in this broad context, the board of directors is the pivotal point through which all these players connect. OECD (1999)

Relationship between Corporate Governance and Performance

Better corporate governance is supposed to lead to better corporate performance by preventing the expropriation of controlling shareholders and ensuring better decision-making. In expectation of such an improvement, the firm's value may respond instantaneously to news indicating better corporate governance. However, quantitative evidence supporting the existence of a link between the quality of corporate governance and firm performance is relatively scanty (Imam, 2006).

Good governance means little expropriation of corporate resources by managers or controlling shareholders, which contributes to better allocation of resources and better performance. As investors and lenders will be more willing to put their money in firms with good governance, they will face lower costs of capital, which is another source of better firm performance. Other stakeholders, including employees and suppliers, will also want to be associated with and enter into business relationships with such firms, as the relationships are likely to be more prosperous, fairer, and long lasting than those with firms with less effective governance.

Challenges and Issues in MFI Board

MFIs have some issues and challenges affecting the board from achieving their objectives to which they are set. Some of the challenges highlighted by CMEF (2011) are discussed below.

i. **The difficulty in finding the right board members.** Microfinance Institutions CEOs and board members often experience difficulties in finding the right board members. It is even more difficult to arrange a board with a balanced skill set. According to Smith (2013) the reasons given include shortage of board members with the right background who are prepared to contribute their time and are willing to work without full compensation.

ii. **Multiple board membership.** Partly as a result of the shortage of good board members, some board members belong to many boards, including several MFIs; CMEF (2011). According to the banking and financial institutions regulations in Nigeria, a person cannot belong to more than one board of a regulated financial institution. However, this rule does not apply to unregulated MFIs, which are the majority. Yet belonging to several financial institutions presents a challenge in terms of conflict of interest.

Board members are too busy to contribute their full potential. It was also reported that some board members are very competent, but have no time to make a meaningful contribution to their board because they are extremely busy. Some have no time to thoroughly read board papers, while the attendance of others is erratic.

Some board members are not assertive. On rare occasions it was reported that some board members lack the confidence to question management or to raise controversial questions. Others are said to perceive their role as that of advisers and therefore desist from asking questions or following up on matters they feel management or other influential or internal board members are not comfortable discussing.

Limited awareness of their role. Some board members, particularly external ones, are not sure what their role is. MFIs that have provided the board with training on governance or the role of the board members reported that there has been a substantial improvement in the contribution of board members.

Theoretical Framework

There are several theories that can be used to underpin the study of boards and corporate governance, depending on the research objectives. This includes Agency theory, resource dependency theory. To achieve the objectives of this research, this study is built upon the Agency theory and resource dependency theories. These theories suit this study since board roles broadly consist of monitoring (grounded in the agency theory) and advising (grounded in the resource dependence theory) (Dorado & Molz 2005).

Empirical Review

Several studies in other fields (other than microfinance) have examined the effect of board composition on the performance of organizations. Although these studies have been conducted in other fields and other countries, they make an important contribution as they show how board composition can benefit or harm performance. Hermalin and Weisbach (1991) studied the effect of board composition on the financial performance of listed companies in the United States. They defined board composition in terms of the percentage of board members who are employees of organizations (internal board members) and of board members who are outsiders. Their sample consisted of 142 companies listed on the New York stock exchange and used pooled data of five years. Their results indicated that there was no strong relationship between board composition and firms' financial performance. The major explanation for this was that board composition simply does not matter. Inside and outside directors are equally bad (or possibly good) at representing shareholders' interests.

Another related study was conducted by (Sanda, Mikailu, and Garba 2005), who examined corporate governance mechanisms and the financial performance of organizations in Nigeria. The authors looked at board size (defined as number of board members), board composition (defined as proportion of external board members), and top management experience (defined in terms of whether the CEO comes from another country). Their sample consisted of all companies listed on the Nigerian stock exchange. Their results regarding board composition were found to partially and positively influence organizations' financial performance. They also reported that small size was effective up to certain numbers, after which it becomes ineffective. This implies that large boards (with more than ten members) are not very efficient. They further found that organizations with international CEOs who are part of the board outperformed those which did not have international CEOs. This finding is similar to Oxelheim and Randoy (2003), who studied the influence that foreign board members have on organizations' values. These authors studied organizations in the Scandinavian countries and analysed the relationship between foreigners on boards and organizations' values. They found that organizations which had at least one foreign board member outperformed those which did not have a foreigner on their boards. The authors concluded that foreign board members are able to bring a variety of experiences and expertise, which can benefit the organizations.

Research Gaps

The theoretical and empirical literature reviewed above shows that boards have an important role to play in MFIs. Similar to organizations, MFI boards are required by both law and microfinance governance codes1 to monitor and advise managers so that the goals and mission of their institution are met accordingly (CSFI 2011; Sabana 2006). Resource provision is also significant as boards consist of people with different experiences, skills, and backgrounds. Board members bring different types of resources, such as advising, counselling, facilitating access to resources such as funding, and linking the organization to important stakeholders and/or other important entities. As argued by the agency and resource dependence theories, the diversity of board members is crucial for the attainment of good performance by organizations. Empirical evidence shows that board composition is important and has both positive and negative implications. However, most of these studies examined board composition in terms of the percentage of external versus internal board members. These studies did not simultaneously look at other compositional factors such as gender, international exposure, characteristics and diversity, and educational background and experience of board members. These aspects neglected by other studies are also significant, as it was argued as a better measure of the monitoring and resource provision of board members (Sabana 2006; Thomsen 2008).

3.0 Methodology

Model Specification

The model specification for this study was based on the hypothesis of the study. This model was adopted from Oyediran (2014) which examined the effect of corporate governance (Board size, board composition, ownership concentration, firm size) on firm's performance (ROA, ROE, and Profit margin -PM) in Nigeria, using ordinary least squares regression for the analysis. This study thus employed a modified version of the econometric model of Oyediran (2014), by making use of different governance and performance proxies.

In specifying the model for this study, two (2) models on the relationship between corporate governance and microfinance banks performance will be adopted. The first model is specified as:

ROE= (BD, BS, EE, EB OPI, OPE).. (1)

This model is then transformed into a linear equation as below

$$ROE_{it} = \beta_0 + \beta_1 BD_{it} + \beta_2 BS_{it} + \beta_3 EE_{it} + \beta_4 EB_{it} + \beta_5 OPI_{it} + \beta_6 OPE_{it} + u_{it} \quad \text{............ (2)}$$

The second model is specified as below:

ROA= (BD, BS, EE, EB, OPI, OPE).. (3)

This is transformed into a linear equation as:

$$ROA_{it} = \beta_0 + \beta_1 BD_{it} + \beta_2 BS_{it} + \beta_3 EE_{it} + \beta_4 EB_{it} + \beta_5 OPI_{it} + \beta_6 OPE_{it} + u_{it} \quad \text{.............4}$$

Where;

ROE_{it}, ROA_{it} represents the performance variable /dependent variable

ROE_{it} = Return on equity for the microfinance bank i in time t

ROA_{it} = Return on asset for the microfinance bank i in time t

U = Error term

$\beta_0, \beta_1, \beta_2, \beta_3, \beta_4$= Parameter estimates.

The independent variables are specified as below:

BD_{it}= Board diversity for the microfinance bank i in time t.

BS_{it}= Board size for the microfinance bank i in time t.

EE_{it}= Experience and education of board members for the microfinance bank i in time t.

EB_{it}= External board members for the microfinance bank i in time t.

OPI_{it} = Operating income of microfinance bank i in time t.

OPE_{it} = Operating expense of microfinance bank i in time t.

Panel regression model using both fixed and random models was adopted in analyzing the relationship between corporate governance and performance of microfinance banks in Kwara State. This is because the study examines time series data across different firms. Hausman test which is used for comparison of fixed and random effect models in panel data analysis was conducted to choose between the models.

This study used secondary data which was obtained from the corporate offices of the microfinance banks in Ilorin. The study was carried out on five (5) selected microfinance banks in Ilorin, Kwara state, using their annual financial reports over a period of four (4) years to examine the relationship between the corporate governance variables and their performance. The population for this study includes all microfinance institutions in Kwara State. According to Kwara State Bureau of Statistics records as at March 31 2014, there were 21 licensed Microfinance banks in Kwara State which forms the population for this study. Purposive sampling technique was employed in selecting the five (5) microfinance banks based on availability of their required annual financial reports for the study.

The data used for this study were collected from the annual financial report of the microfinance banks. Both the corporate governance variables and the performance variables were also obtained from the financial reports. Corporate governance variables such as board diversity, board size, experience and education of board members and external board members form the independent variables while Returns on Earnings (ROE) and Returns on Asset (ROA) form the performance variables and dependent variables. Information on these variables were obtained from the banks financial statement between 2010 and 2013.

4.0 DISCUSSION OF FINDINGS

4.1 *Hausman Specification Test*

Since the models of this study are not normally distributed which led to the use of panel data regression, the conduct of Hausman specification test will specify the most suitable model between the random or fixed effect models (Gujarati, 2003).

Table 1.1 Hausman test

	Coefficients (b) fixedroe	(B) randomroe	(b-B) Difference	sqrt(diag(V_b-V_B)) S.E.
bos	.1090567	.0497138	.059343	.
yre	.115313	.0416086	.0737044	.
lnopi	-.3856102	.0010108	-.386621	.0247888
lnope	.005059	-.0035795	.0086386	.

```
            b = consistent under Ho and Ha; obtained from xtreg
 B = inconsistent under Ha, efficient under Ho; obtained from xtreg

Test:  Ho:  difference in coefficients not systematic

            chi2(4) = (b-B)'[(V_b-V_B)^(-1)](b-B)
                    =       21.24
          Prob>chi2 =      0.0003
          (V_b-V_B is not positive definite)
```

Source: Author's Computation, 2015.

The result of the Hausman test with chi-statistics (21.24) and probability value (0.0003) is presented in table 1.1 above. Since the chi-statistics (21.24) is significant, it implies that the fixed effect model is preferable. Hence, the result of the fixed effect model is therefore preferred and used for this study as basis for conclusion.

4.2 *Analysis using fixed effect model*

Table 1.2 Regression result of fixed effect model for the impact of corporate governance on performance (Return on Asset)

```
. xtreg roa bos yre  lnopi lnope, fe vce(robust)

Fixed-effects (within) regression               Number of obs      =        20
Group variable: firmid                          Number of groups   =         5

R-sq:  within  = 0.4053                         Obs per group: min =         3
       between = 0.3036                                        avg =       4.0
       overall = 0.2166                                        max =         5

                                                F(4,4)             = 336551.65
corr(u_i, Xb)  = -0.8833                        Prob > F           =    0.0000

                                  (Std. Err. adjusted for 5 clusters in firmid)
```

roa	Coef.	Robust Std. Err.	t	P>|t|	[95% Conf.	Interval]
bos	.1683964	.0219114	7.69	0.002	.1075606	.2292323
yre	.0723501	.0925524	0.78	0.478	-.1846165	.3293167
lnopi	-.6816938	.1954832	-3.49	0.025	-1.224442	-.1389453
lnope	.0592365	.028439	2.08	0.106	-.0197229	.1381959
_cons	9.936199	4.185548	2.37	0.076	-1.684746	21.55714
sigma_u	.29782426					
sigma_e	.23375966					
rho	.61879111	(fraction of variance due to u_i)				

Source: Author's Computation, 2015.

Table 1.2 shows the estimates of fixed effect model with robust standard error investigating the impact of corporate governance on the return on asset (ROA). The value of coefficients of board size is 0.1684. This shows that board size is positively related to performance. The model shows that board size is a significant determinant of performance. The p-value (0.002) shows that the coefficient of board size is statistically significant at 2%. The average effect of increase in the board size on increase in performance across firms over time is 0.1684. This implies that one person increase in board size on the average will brings about 0.1684 unit increase in return on asset.

Table 1.3 Regression result of fixed effect model for the impact of corporate governance on return on equity.

```
Fixed-effects (within) regression               Number of obs      =        20
Group variable: firmid                          Number of groups   =         5

R-sq:  within  = 0.7050                         Obs per group: min =         3
       between = 0.0631                                        avg =       4.0
       overall = 0.0237                                        max =         5

                                                F(4,11)            =      6.57
corr(u_i, Xb)  = -0.8487                        Prob > F           =    0.0059
```

roe	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
bos	.1090567	.0272205	4.01	0.002	.0491448	.1689687
yre	.115313	.0633624	1.82	0.096	-.0241467	.2547726
lnopi	-.3856102	.1041423	-3.70	0.003	-.6148258	-.1563946
lnope	.005059	.046483	0.11	0.915	-.0972493	.1073674
_cons	5.809444	1.911383	3.04	0.011	1.602518	10.01637
sigma_u	.26698471					
sigma_e	.0792836					
rho	.91896153	(fraction of variance due to u_i)				

```
F test that all u_i=0:     F(4, 11) =     11.93             Prob > F = 0.0005
```

Source: Author's Computation, 2015.

Table 1.3 depicts the fixed effect regression estimates where return on equity (roe) is the dependent variable while board size (bos), years of experience (yre), operating income (opi) and operating expenses (ope) are the independent variables. The result shows that board size, years of experience and operating income are the factors that significantly affect the return on equity. While board size and years of experience positively affect return on equity, operating income is inversely related to return on equity. This is indicated by the values of the coefficients (0.1091, 0.1153 and -0.3856) for board size (bos), years of experience (yre), operating income (opi) which are statistically significant given their t-statistics (4.01, 1.82 and -3.70) with p-values (0.002, 0.096 and 0.003) respectively.

On the average, increase in the board size by one person will lead to 0.1091 unit increase in return on equity. Similarly, a year increase in experience of board members brings about 0.1153 unit increase in return on equity. However, one million naira decrease in operating income results to 38.56% increase in return on equity. The Within-R^2 is 70.5% implying that percentage of changes in return on equity within each firm is explained by the independent variables. The rho shows that about 92% of the variation is due to difference across firms and the F-statistics (6.57 with P-value 0.0059) indicates that the model has a good fit.

5.0 CONCLUSION AND RECOMMENDATIONS

Based on the research findings, the study concludes that board size and years of experience of board members, have a positive significant effect on performance of micro finance banks and therefore recommends the following:

Management of micro finance banks should consider a large pool of board members with diverse background, relevant experience and also include external board members to achieve the banks objectives.

Management must ensure strict compliance with all the corporate governance codes relevant to the operation of the micro finance banks.

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