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# Internationalization of the microfinance industry

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## **Introduction**

Over the past four decades, microfinance has grown from small local initiatives into a global phenomenon practiced in many markets, mostly in low-income economies but also in well-developed markets like the US and the EU. Interestingly, microfinance institutions (MFIs), that is, providers of financial services to end customers, often have several cross-border stakeholders, including shareholders, donors, lenders, and providers of technical assistance and advanced IT systems. Moreover, important “think tanks” like the CGAP provide the industry with global policy guidelines. Thus, microfinance is a very international industry and empirical evidence shows that international stakeholders as well as policymakers influence the performance of MFIs (Mersland et al., 2011; Mersland and Urgeghe, 2013).

The purpose of this chapter is therefore to give an overview of the internationalization of the industry and to suggest relevant theories when studying cross-border microfinance partnerships. Moreover, we present initial statistical evidence of how internationalization can influence MFIs’

performance and the type of services they offer. Based on our initial results, we suggest a research agenda for future studies.

The microfinance industry is subject to various international influences. In most cases, the influence comes in the form of donations (Hudon and Traca, 2011), subsidized and commercial debts (Mersland et al., 2011; Mersland and Urgeghe, 2013), and, increasingly, equity investments (Swanson, 2008; responsAbility, 2017). Other sources of international influence on MFIs are the extensive international networks, such as Accion International, Women's World Banking, Vision Fund, FINCA, and Opportunity International (Armendáriz and Morduch, 2010).

An important part of international influence comes from the increasing number of international investment funds that are targeting MFIs. Examples include responsAbility Global Microfinance Fund, Wallberg Global Microfinance Fund, and Triodos Microfinance Fund. Currently it is estimated that there are more than 120 international microfinance investment vehicles (MIVs) with assets valued at more than \$12 billion (Symbiotics, 2017). While some of the MIVs are so-called "impact funds" that offer funding to MFIs at subsidized rates, others are commercial lenders or equity investors. However, MIVs concentrate mostly on offering loans (Reille et al., 2009; Brière and Szafarz, 2015) and their choice of investee MFIs is influenced by MFIs' size, portfolio quality, and social orientation (Dorfleitner et al., 2017).

Overall, the international influence comes mostly from external stakeholders and investors and not from the management or operation of the MFIs. This is probably because most microfinance initiatives grow out of social development organizations, with the aim of strengthening local

capacity and competence (Mersland and Strøm, 2012). Hence, within the microfinance industry, it is often believed that international influence on MFIs should aim to build domestic financial market solutions (CGAP, 2006).

To date, a number of stakeholders in the microfinance community consider international participation in MFIs to be a transition phenomenon (Hendricks, 2003; Swanson, 2008). As some observers have noted, the main goal of any bilateral donor project is to develop domestic MFIs as an integral part of the national financial system and focus on the relations with domestic stakeholders (Mersland et al., 2011). In the words of Hendricks (2003, p. 78), the “ultimate aim of a microfinance intervention is to ensure that after the donor’s withdrawal the microfinance organization created will become autonomous and capable of achieving financial self-sufficiency without further external assistance.”

The outcome of this view is that the continuous inflow of international capital and expertise can run counter to the central objective of international microfinance stakeholders, namely, to exit after building a self-sufficient institution. To us this is a shortsighted view. Globalization and internationalization are global trends that increasingly influence emerging and developing markets, where most MFIs operate. Moreover, several international microfinance actors now operate like traditional investors and seek rent for their involvement. In this landscape we therefore consider it important to contribute to the literature on how internationalization affects MFIs. After all, it is not clear-cut how international stakeholders contribute to the building of financially sound institutions (Hendricks, 2003) while at the same time boosting their social efficiency (Gutierrez-Nieto et al., 2009).

## **Are international MFIs different from non-international MFIs?**

### Theory

International stakeholders through the various activities they perform can influence MFIs to enhance their social as well as financial efficiency. The international business literature suggests that international firms can benefit from scale economies (Dunning, 2000; Manolova et al., 2010), lower agency costs (Buckley and Casson, 1998), lower funding costs (Bekaert and Harvey, 2000; Oxelheim et al., 2001; Hearn et al., 2010) and improved governance (Coffee, 2002; Oxelheim and Randøy, 2003). Our interest is to study whether MFIs with international partners can potentially gain from these or other benefits of internationalization. For example, can international partners help MFIs to enhance their social performance?

We suggest three theories, which are often used in international business, to explain the performance effect of microfinance internationalization (see also Chapter 2 by Hathaway and Wry in this volume). These are agency theory (Fama and Jensen, 1983; Eisenhardt, 1989), resource-based theory (Barney, 1991), and the theory of liability of foreignness (Zaheer, 1995).

Agency theory postulates that when corporate ownership and management are separate from each other, then managerial incentives and control systems should be put in place to induce managers to act in accordance with the owners' goals (Fama and Jensen, 1983; Shleifer and Vishny, 1997). In terms of governance, international stakeholders control managerial behavior directly by investing in equity shares of the institution (Berger et al., 2009) or indirectly by

offering loans or holding board seats in the MFI (Gulamhussen and Guerreiro, 2009; Mersland et al., 2011). Moreover, in order to maintain its affiliation with a renowned international network, an MFI is often compelled to follow strict managerial guidelines and a code of ethics. Thus, an MFI's affiliation with an international network can act as a disciplinary mechanism for ensuring that management acts in the collective interest of all stakeholders.

The resource-based theory of the firm (for example, Barney, 1991) explains how firm-specific resources are the basis of business competitiveness. This theory has been widely used in international business research (for example, Meyer et al., 2009), and has also been applied to the microfinance industry (for example, Mersland et al., 2011). The fundamental question in this framework is how internationalization affects an MFI's ability to utilize resources effectively. Specifically, past literature underscores the importance of resources and capabilities such as the ability to raise external funds, corporate culture, and the deployment of managerial capacity (Hall, 1992). In this chapter, we explore a number of resources and capabilities (international initiation, international debt, international board membership, and international network membership) and argue that MFIs with access to such resources and capabilities gain a competitive advantage over MFIs without such access.

The literature, however, suggests that there are costs and other disadvantages associated with being international due to liability of foreignness (Hymer, 1976; Zaheer and Mosakowski, 1997). Liability of foreignness is the result of differences that exist between countries, such as geographical distance, a complex local business environment, discrimination against foreigners, cultural differences, and government regulations in one's home country as well as in host

countries that favor native over foreign investors (Zaheer, 1995; Mezias, 2002). Miller and Parkhe (2002) argue that liability of foreignness might exist in the banking industry as well as in other industries. Thus, whereas the agency and resource-based theories generally predict a positive correlation between internationalization and firm performance, liability of foreignness suggests a negative one.

In the international business literature, the distance between international partners is typically measured along geographical, institutional, and cultural dimensions. Longer distances are normally associated with a sizeable liability of foreignness. In a recent study using data from international microfinance partnerships, Golesorkhi et al. (2019) confirm that longer institutional and cultural distances are indeed correlated with diminished MFI performance. However, at very long distances MFI performance is strengthened probably because the partners are more aware of their differences and therefore take it more into account in their joint endeavors.

There are at least three reasons why studying internationalization in the microfinance industry is more complex compared to other traditional industries typically researched in the international business literature. First, most MFIs operate in emerging markets with less stable and clear formal institutions. MFIs typically operate in unstable and changing institutional environments. Second, the institutional differences between international stakeholders and MFIs are normally much greater than those typically observed between international partners in regular businesses. For example, it is more complex for a Danish investor to operate in Malawi than in Germany. Third, most of the international partners, as well as the MFIs, involved in microfinance are organizations with dual objectives. Both the international stakeholder and the MFI normally

seek, at least to some degree, both financial and social returns from their involvement. Nevertheless, the goals of the international stakeholder may not be perfectly aligned with those of the MFI. In such cases, incentive and monitoring systems motivated by traditional agency theory for firms with unidimensional objectives may not suffice in hybrid organizations like MFIs (Battilana and Dorado, 2010), where agents, typically, have multiple tasks (Holmstrom and Milgrom, 1991).

### Initial empirical evidence

#### *Does international MFIs' performance differ from non-international MFIs'?*

In what follows we present some initial empirical evidence on the relation between whether an MFI has international partners and its performance. The data we use is a self-compiled dataset based on rating reports including 607 MFIs from 87 countries. The dataset is an unbalanced panel spanning the years 1998 to 2015. Reports from the following rating agencies are included: Microfinanza, Planet Rating, Microrate, CRISIL and M-CRIL. The dataset is an updated version of the one used by Mersland et al. (2011) and Golesorkhi et al. (2019). Rating of MFIs is a rising international trend and one of several global transparency initiatives in the industry (Beisland et al., 2014). Table 11.1 presents descriptive statistics of five internationalization variables studies in this chapter. The table shows that about 54 percent of the MFIs in our sample have international commercial debt, 49 percent have international subsidized debt, 39 percent were originally initiated by an international organization, 37 percent are members of an international network and 31 percent of the MFIs have at least one international director in the board. Thus, the international influence in MFIs is considerable.



**Table 11.1** Descriptive statistics of international variables included in this study

	Description	Mean	St. Dev.	Obs.
International commercial debt	Dummy variable: 1 if the MFI holds international commercial debt	0.5369	0.4989	907
International subsidized debt	Dummy variable: 1 if the MFI holds international subsidized debt	0.4886	0.5002	874
International initiation	Dummy variable: 1 if the MFI was originally initiated by an international agent	0.3926	0.4884	3645
International network	Dummy variable: 1 if the MFI is member of an international network	0.3719	0.4834	3506
International director	Dummy variable: 1 if at least one of the MFI's board members is international	0.3142	0.4645	678

Are MFIs with international stakeholders different than non-international MFIs? Indeed, they are. Table 11.2 confirms Mersland et al.'s (2011) finding that internationalization improves the social performance of MFIs. Specifically, international MFIs are associated with smaller loans and a higher percentage of female clients compared to non-international MFIs. In terms of their financial performance, the results are mixed. International MFIs carry higher costs and higher yields but they also have lower risk and higher profits compared to their non-international counterparts. The higher costs suggest diseconomies of scale, which on the one hand contradicts the international business literature (Dunning, 2000; Manolova et al., 2010) but on the other hand is consistent with the concept of liability of foreignness (Zaheer, 1995). Whether the international partners bring along business models that are not suitable for local markets, or they bring along a culture of higher costs, or they push MFIs to improve their social performance, the fact remains that international partners make it costly for MFIs to do business in local markets. In order to compensate for the higher costs and ensure their sustainability, MFIs with

international partners charge higher interest rates<sup>1</sup> than non-international MFIs (Battilana and Dorado, 2010; Hardy et al., 2003).

Moreover, the results in Table 11.2 suggest that international MFIs report higher profits than non-international MFIs. Additionally, international MFIs also perform better than non-international MFIs in terms of loan asset quality, suggesting that perhaps their exposure to international resources (for example, knowledge sharing in international networks; Barney, 1991) helps to control loan defaults. Therefore, in spite of the higher costs associated with international operations, MFIs with international stakeholders are better off in terms of profitability and asset quality. The question naturally arises whether the higher income and the superior loan portfolio signal mission drift among international MFIs. The answer is no: international MFIs also outperform their non-international counterparts socially. For example, international MFIs have a smaller average loan size and a higher percentage of female clients. Overall, the results in Table 11.2 suggest that internationalization of the microfinance industry is associated with higher operational costs and superior social performance, profitability, and asset quality.

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<sup>1</sup> The portfolio yield is a commonly used proxy for the average interest rate charged by MFIs (Cull et al., 2009a).

**Table 11.2:** Comparison between international and non-international MFIs: t-test results

Variable	Cost	PaR30	Yield	ROA	ALS	Women
Int. com. debt	0.240	0.036**	0.368***	0.043***	441***	0.615*
No int. com. debt	0.240	0.042	0.323	0.032	329	0.579
Int. subsidized debt	0.238	0.035***	0.345	0.036	402	0.605
No int. sub. debt	0.239	0.044	0.341	0.036	369	0.589
Int. initiation	0.276***	0.035***	0.360***	0.036	361***	0.615**
National initiation	0.235	0.044	0.339	0.035	397	0.581
Int. network	0.274***	0.035***	0.376***	0.043***	358***	0.649***
No int. network	0.241	0.044	0.333	0.032	395	0.557
Int. director	0.267***	0.031***	0.394***	0.039	416	0.613
No int. director	0.229	0.044	0.320	0.037	398	0.589

**Notes** This table compares means between international and non-international MFIs on the basis of product offerings, lending method, and bank regulation. The variables used in the comparison include the following: *Cost* is total operating costs divided by gross loan portfolio; *PaR30* is portfolio at risk (30 days), that is, the proportion of the loan portfolio in arrears after 30 days; *Yield* is interest income divided by gross portfolio; *ROA* is return on assets; *ALS* is average loan outstanding, calculated as gross outstanding portfolio divided by number of active credit clients; and *Women* is the percentage of female clients. The international dimensions include: *Int. com. debt* (whether the MFIs holds international commercial debt); *Int. subsidized debt* (whether the MFIs holds international subsidized debt); *Int. initiation* (whether the MFI was initiated by an international actor); *Int. network* (whether the MFI is a member of an international network); and *Int. director* (whether the board of the MFI has at least one international director). \*, \*\*, \*\*\* indicate that differences in means are significant at the 10, 5, and 1 percent levels, respectively.

### *Do international MFIs provide different financial services than non-international MFIs?*

The next table, Table 11.3, compares international and non-international MFIs along two service-related dimensions. The first dimension is a binary variable that indicates whether the MFI offers financial services only or whether it also offers “plus” services like vocational training or health services (Sievers and Vandenberg, 2007; Lensink et al., 2018). The second dimension is a variable, also binary, that indicates whether the MFI offers voluntary savings. While all MFIs in the dataset offer credit to their clients, a considerable percentage also offer saving services. Offering “plus” services and/or voluntary savings increases the complexity of the MFI’s operations.

The results presented in Table 11.3 suggest that international MFIs have a lower tendency to offer strictly financial services to clients compared to non-international MFIs. This implies that international stakeholders generally favor the maximalist view when it comes to the practice of microfinance (Morduch, 2000). This finding fits well with the superior social performance of international MFIs reported in Table 11.2.

There is a significant difference between international MFIs and non-international MFIs with respect to voluntary savings. That is, fewer international MFIs provide voluntary savings services compared to non-international MFIs. This is not surprising because it is often costly to maintain savings deposits and international MFIs can cheaply access donor and subsidized funds instead (Cozarenco et al., 2016). Generally, the availability of cheap sources of funds tends to discourage MFIs from mobilizing savings (Morduch, 2000; Akanji, 2006). Moreover, the mobilization of local deposits normally requires being regulated by national banking authorities. In less advanced economies, which is where most MFIs operate, regulations may be difficult for outsiders to understand. Nevertheless, the finding that international MFIs are less involved in mobilizing voluntary savings is interesting. After all, being funded by local deposits and regulated by local banking authorities have often been seen as the ultimate proof of whether an MFI is financially sustainable (Akanji, 2006; Dokulilova et al., 2009).

**Table 11.3** Comparison between international and non-international MFIs: chi-squared test

Variable	Pure financial	Voluntary savings
Int. com. debt	51.33 **	44.71***
No int. com. debt	48.67	55.29
Int. subsidized debt	45.77***	43.08***
No int. sub. debt	54.23	56.92
Int. initiation	39.84	29.68***
National initiation	60.16	70.32
Int. network	33.33***	28.40***
No int. network	66.67	71.60
Int. director	34.76***	25.42**
No int. director	65.24	74.58

**Notes** This table compares relative frequencies (%) between international and non-international MFIs on the basis of services provided. The variables used in the comparison include: Pure financial (= 1 if the MFI specializes in financial services only and 0 otherwise) and Voluntary savings (= 1 if voluntary savings are available and 0 otherwise). The international dimensions include: Int. com. debt (whether the MFI holds international commercial debt); Int. subsidized debt (whether the MFI holds international subsidized debt); Int. initiation (whether the MFI was initiated by an international partner); Int. network (whether the MFI is a member of an international network); and Int. director (whether the board of the MFI has at least one international director). The test used is chi-squared. \*, \*\*, \*\*\* indicate that differences in frequencies are significant at the 10, 5, and 1 percent levels, respectively.

## A research agenda

Our results based on univariate statistics show that, generally, international MFIs perform better socially, are more profitable, and operate with lower risks and lower volumes of deposits compared to non-international MFIs. However, international MFIs carry higher operating costs and charge higher interest rates than non-international MFIs. These initial results raise questions that can serve as motivation for further investigations. First, why do international MFIs carry higher operating costs? After all, Meyer et al. (2009) suggest that international partners bring along resources that should benefit the local firm, in our case the MFI. Thus, a relevant research question is whether the higher operating costs of international MFIs are due to their social focus,

or liability of foreignness, or poor alignment between the MFIs' goals and those of their international partners.

Second, why do international MFIs have lower credit risk than non-international MFIs? Is it due to resources like superior credit models (Barney, 1991) or does long geographical and cultural distance reduce the risk appetite of MFIs with international partners?

Third, is the high percentage of female clients in microfinance due to international influence?

The focus on female clients has been high on the microfinance agenda ever since the inception of the industry in the 1970s (Armendáriz and Morduch, 2010). Lately, however, it has been reported that the percentage of female clients is dropping, particularly in commercial MFIs (Frank et al., 2008). Are international partners needed to maintain a high percentage of female clients in the industry or are international partners forcing MFIs to serve too high a percentage of female clients, which could actually endanger the sustainability of the MFI (D'Espallier et al., 2013)?

Fourth, is funding by local sources a long-term competitive advantage for MFIs, compared to funding by foreign sources? Hollis and Sweetman (1998), studying six historical microfinance institutions, show that the MFIs that depended on local deposits survived for much longer than those that depended on subsidies. This is in line with recent findings by Cozarenco et al. (2016) showing that subsidies crowd out the collection of local savings. It is therefore natural to ask whether international partners, in particular lenders, demotivate MFIs from tapping into local funding sources, including savings. Alternatively, however, one could ask whether international

funding has a role to play in MFIs' risk management. As MFIs grow, liability management becomes a challenge (Labie and Mersland, 2011). In this regard borrowing from international sources could help balance MFIs' liability risks.

Fifth, why are international MFIs less regulated than non-international MFIs? Are the international partners impeding MFIs from being regulated and better integrated in the local financial banking system? Cull et al. (2009b) and D'Espallier et al. (2017) show that regulated MFIs have a larger average loan size and a lower percentage of female clients compared to unregulated MFIs. Are the international partners preventing their local partners from becoming regulated because they fear that the MFIs will drift from their social focus?

Sixth, why don't international partners engage more in the management and daily operation of MFIs? Why do we observe few international CEOs and board members in MFIs? Why do international partners seem to keep their local counterparts at arm's length? Generally, there is need for more research on the management of MFIs (Randøy et al., 2015). In this regard, applying agency theory could be a natural starting point.

Seventh, what kind of regulatory, macroeconomic, and cultural factors facilitate microfinance operations? And, how does the geographical, legal, and cultural distance between the MFI and its international partners influence the effectiveness of the partnership? In these matters Ahlin et al. (2011) and Golesorkhi et al. (2019) have initiated interesting research that other researchers should follow up.

Finally, and importantly, future research is needed on the role of international partners in balancing the social and financial goals in the global microfinance industry as well as in individual MFIs. After all, whether there is a trade-off between social outreach and financial performance is an ongoing concern in the literature (Morduch, 2010; Hermes et al., 2011). Studying how internationalization influences this trade-off equation is thus of interest.

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