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Book Part — Accepted Manuscript (Postprint)

Corporate Governance Challenges in Microfinance

Suggested Citation: Labie, Marc; Mersland, Roy (2011) : Corporate Governance Challenges in Microfinance, In: Armendáriz, Beatriz Labie, Marc (Ed.): The Handbook of Microfinance, ISBN 978-981-4465-57-1, World Scientific, Singapore, pp. 283-298, https://doi.org/10.1142/9789814295666_0013

This Version is available at:

<https://hdl.handle.net/10419/323850>

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Corporate Governance Challenges in Microfinance**Introduction**

Good corporate governance can improve firm performance and help assure long term firm survival (Thomsen, 2008). Most providers of microfinance struggle to become financially self-sufficient and to achieve their social objectives of servicing with quality the poorest clientele possible. The issue of corporate governance has therefore been of increasing interest for microfinance as it is today considered to be one of the weakest areas in the industry (CSFI, 2008). This chapter aims to: inform the reader about what constitutes governance in relation to microfinance; identify the reasons why it is of such high importance for the industry; review existing academic research on microfinance governance; and highlight ideas on how to tackle corporate governance issues in microfinance properly. Moreover, a new research agenda is proposed.

Recent research by Mersland and Strøm (2009a) and Hartarska (2005) has found that best practice governance mechanisms for firms in mature markets generally have little influence on the MFIs. Therefore, there is a need for a different and more specific approach to identifying and understanding the governance system better, which can help MFIs to reach their goals and enhance their long-term survival. However, searching for a “one-size-fits-it-all” solution will certainly be of little use. Rather than looking for standard best practices, it may thus be more rewarding to identify a general framework that can be adapted to different situations and different types of MFIs, and that can inform policy makers and other stakeholders in their respective microfinance markets.

In order to contribute to this debate, this chapter is structured as follows. Section 2 introduces the topic of corporate governance and identifies the various reasons why it deserves attention in the microfinance industry. Section 3 reviews the literature on microfinance governance and argues that there is a need to move beyond the traditional agency theory and board management best practices in this industry. Section 4 lays out the need for a broader and deeper approach to microfinance governance. Section 5 proposes a new framework for the analysis of microfinance governance. Finally, section 6 concludes and presents a new agenda for researchers who are interested in exploring the complex issue of microfinance governance.

Why governance matters for the microfinance industry

Microfinance, which is understood as the means and institutions created in order to provide financial services to people excluded from traditional banking, has a long history. Modern microfinance in particular, which has emerged since the 1970s, owes much to the cooperative movement and to traditional “informal” financial practices – for instance, Rotating Savings and Credit Associations (ROSCAs) – that have been popular for centuries across the world (Lelart, 1990; Bouman, 1995). From an international development perspective, microfinance has attracted increasing interest due to a wide variety of new institutions. Some of these have directly

emerged from the credit unions movement (such as the major credit and saving cooperatives networks in Africa); some have their roots in NGOs (such as the celebrated cases of the Grameen Bank in Bangladesh, Prodem-Bancosol in Bolivia and the K-Rep Bank in Kenya); while others have emerged from public bank restructurings (such as the emblematic case of Bank Rakyat in Indonesia). Together these initiatives, along with hundreds more, have received a great deal of attention from national authorities, as well as from international donor and development communities. During the last decade, we have also seen increased interest from the international banking and investment communities (Reille and Foster, 2008). The wide variety in origins and the many different stakeholders, with their often competing interests and competencies, together form one of the reasons why corporate governance in microfinance is an interesting research area, but remains demanding in terms of formulating public policy.

There are several reasons for governance to be at the forefront of the microfinance policy debate. Among the major ones are, Firstly, the tremendous growth in service providers of various types translates to a greater number of clients and assets, as well as more elaborate structures to manage. Secondly, there have been numerous institutional and legal changes, with credit unions building more and more elaborate networks and many NGOs turning into (shareholder-owned) regulated financial institutions. Thirdly, institutions are evolving, from focussing mostly on a single product (usually credit) to becoming more complete banking institutions that provide not only credit, but also savings, and sometimes other types of financial services such as money transfers, remittances, payment systems and insurance, therefore reinforcing the risks assumed by these institutions. Fourthly, liabilities management, which had not received much attention at first, when donors were often the main source of funds, is now increasingly important. Local depositors, national public funds and the many international Microfinance Investment Vehicles (MIVs) spur on microfinance growth and are becoming important stakeholders of MFIs. Fifthly, the behaviour of public authorities towards microfinance is also changing. Their original neglect is being replaced by more pro-active policies that create regulatory and supervisory frameworks supposed to favour a sound development of the industry. Sixthly, the international attention given to microfinance has been incredible, culminating with the United Nations naming 2005 as the “Year of Microcredit” and the Nobel Peace Prize being awarded to the Grameen Bank and Mohammad Yunus in 2006. Today, most people in Europe and the US know about microfinance, and thousands of international NGOs, politicians and celebrities have joined in extolling microfinance, motivating more actors to become involved.

Without doubt, these changes have been significant. However, critical voices are being raised that question the impact, efficiency and ethics of microfinance,¹ the business models that are used and favoured by the international community and the long-term survival and apparently noble objectives of microfinance providers (e.g. Dichter and Harper, 2007). This is where the corporate governance debate comes in. Basically, corporate governance in microfinance is about assuring the long-term survival of service providers without them losing track of their missions. Some institutions have experienced major crises, showing the high importance of controlling institutional development. This can be illustrated by the much cited case of Corposol/Finansol, now better known as Finamerica, in Colombia. This was created as an entrepreneurial NGO, dominated by a CEO who was strongly supported by the chairman of a passive board. At its conception, the NGO culture and cross-control between the different members of the staff allowed for great success. Later on, the organisation got into trouble because of a more pyramidal and bureaucratic organisational structure, setting wrong incentives to the staff and being weakly controlled by the board and stakeholders (international cooperation agencies and microfinance networks on the one hand, private banks providing debt on the other) (Austin, Gutierrez, Labie

¹ We will not discuss these issues here, as they are clearly central to some other chapters of this handbook. For instance, on impact, see chapters ; on efficiency, see...; and on ethics, see....

and Ogliastri, 1998). Other more recent crises are happening in major institutions in countries like Benin or Marrocco.

Corporate governance is typically defined as a system, or a set of mechanisms, by which organisations are directed and controlled (OECD, 1999). Governance mechanisms can be defined internally by the MFI itself (boards, auditing, CEO characteristics and incentives, etc.) or externally (through market competition, public regulation, etc.). Two major points should be highlighted in this definition. Firstly, the idea that “corporate governance is a system” means that it involves a variety of mechanisms that act together in directing and controlling the firm. There is thus no single relationship based on a single tool, as is advocated by many experts when they focus exclusively on the role of boards. Secondly, the definition stresses the fact that governance is not just about “ex-post controls”, but also about how organisations are directed. In a way, this comes close to Gérard Charreaux’s definition of corporate governance as, “*the set of mechanisms that aim at limiting the discretionary power of the executives*”² (Charreaux, 1997, 1). However, one point remains poorly defined in these definitions: the ultimate aim of the control – the objective of the firm. Indeed, in a field like microfinance, where organisations are usually characterised by multiple objectives (mostly financial and social), it is not always clear where the priorities should lie. This is why, by modifying slightly the phrasing of the OECD, we suggest the following definition: “*corporate governance is a system, or a set of mechanisms, by which an organization is directed and controlled in order to reach its mission and objectives*”. The advantage of this slightly expanded definition is that it provides a benchmark for strategic planning and control (i.e. the objectives), and it provides a specific benchmark for each institution rather than “a standard for the industry”. After all, as illustrated by Mersland (2009) for example, microfinance is practiced by a wide variety of organisations, not all of whom have the same priorities. Not only are MFIs different in terms of their organisational forms, but they are also different in terms of products, methodologies, social priorities and profit-seeking behaviour, not to mention subsidy-dependence and historical roots. It can thus be argued that microfinance governance does not only need an industry-specific approach (Mersland and Strøm, 2009a), but also an ownership-specific, objective-specific and even a situation-specific approach.

Reviewing the literature on microfinance governance

Most of the literature on corporate governance in the microfinance industry consists of consultancy reports and guidelines on how to regulate the industry, how to structure boards and board procedures and warnings against the “weak governance structures” found in cooperatives and non-profit organisations like NGOs (Campion and Frankiewicz, 1999; Council-of-microfinance-equity-funds, 2005; Rock et al., 1998; Otero and Chu, 2002 Jansson et al., 2004; Clarkson and Deck, 1997). What these reports have in common is their point of departure, which seems to be that MFIs are not greatly different from western firms. Governance recommendations from regular firms in mature markets are thus “translated” to the microfinance industry, and are in most cases supported by limited empirics.

Theoretically, banking governance is generally studied from four perspectives: ownership control, board management, regulation and supervision, and market pressure (Adams and Mehran, 2003). Recently, a few specific studies regarding microfinance governance have been conducted. As with the consultancy reports, these have taken a traditional approach in “translating” banking governance, and to some degree NGO-governance, to microfinance governance. The aim of these studies is first and foremost to identify those governance mechanisms that influence the

² The sentence was translated from French into English by the authors .

financial or social performance of MFIs. Interestingly, the studies struggle to identify important mechanisms, and those that are recommended in the industry guidelines are often not important.

For example, Hartarska (2005) and Mersland and Strøm (2009a) explore the effect of traditional governance mechanisms such as board composition and size, managerial incentives, ownership type and regulation. However, consistency in the findings both within and across the two studies is rare, and both studies struggle to identify significant governance influence. Mersland and Strøm (2009a) found that having a female CEO and an internal auditor reporting to the board is associated with better financial performance, while international directors on the board increase costs and reduce operational self-sufficiency. Other governance variables were judged insignificant or inconsistent. Hartarska (2005) found support for independent boards with limited employee participation. None of the variables that were deemed significant in the two studies were explored in both.

Two non-findings in these studies are actually the most interesting. Hartarska (2005) and Mersland and Strøm (2009a) both found that neither regulation nor a for-profit ownership structure advanced the performance of MFIs. Hartarska and Nadolnyak (2007) confirmed the finding that regulation has no effect, while Mersland and Strøm (2008) confirmed that ownership of MFIs is not greatly significant. Both Hartarska (2005) and Mersland and Strøm (2009a) concluded that governance does matter, but found that traditional governance mechanisms seem to matter less in MFIs compared to firms in mature markets. They called for better data and a study of alternative governance mechanisms in order to understand the effect of corporate governance in the microfinance industry better.

Two recent studies that have taken an original approach are particularly interesting. Firstly, Hartarska and Mersland (Forthcoming) evaluate the effectiveness of several governance mechanisms by taking into account *the dual objectives* of MFIs simultaneously. While other studies estimate the impact of governance separately for social and financial dimensions, they use stochastic cost frontier analysis to capture the duality of objectives in MFIs. This study is thus the first that adapts to the overall mission of most MFIs – the struggle to reach both social and financial objectives simultaneously. Their findings indicate that MFIs are less efficient in reaching the dual objectives when the positions of the CEO and the board chair are combined, and when MFIs have a larger proportion of insiders (employees) on the board. They also find that the efficiency of boards is non-linear, and is best between eight and nine members. These findings confirm some of the advice that has been provided by the consulting reports already mentioned, but with a stronger theoretical academic base. However, Hartarska and Mersland (Forthcoming) do not find consistent evidence that product market competition improves efficiency, although they do find weak evidence that MFIs in countries with mature regulatory environments could reach more clients by operating as a unit that is regulated by the banking authorities.

Another recent study was conducted by Mersland and Strøm (2009b), with the assumption that governance mechanisms may act as substitutes for or may complement each other (Demsetz and Lehn, 1985). They thus search for any interconnection between governance mechanisms and assume that they will find different governance set-ups in non-profit and for-profit MFIs. The findings confirm their assumptions. Board and CEO characteristics act as substitutes and complements in the formation of board composition and size, the existence of external governance mechanisms influence the set-up of internal mechanisms and the type of ownership influences the set-up of internal governance. They conclude that researchers should include interaction effects when studying the effect of governance on microfinance performance.

Beyond agency theory and board management

Although the aforementioned studies represent a step forward, there remains considerable ground to cover and a need to broaden the theoretical perspectives. Most MFIs operate in markets with limited competition, where the manager labour market is thin and very few MFIs are publically quoted. These facts limit the possibility of “market discipline”, an underlying mechanism in traditional governance studies. In addition, the influence of regulators, which is normally strong in the banking industry, is limited in the microfinance industry because of inadequate regulation and/or a huge gap between the regulations and the ability of the regulator actually to supervise what is being regulated.

“Market discipline” and regulation are seldom part of the microfinance governance “toolbox”, which is generally limited to boards and “professional” owners (Campion and Frankiewicz, 1999; Council-of-microfinance-equity-funds, 2005; Jansson et al., 2004). We argue that this is short-sighted. The real effect of the corporate governance impact of boards often turns out to be minor in most industries (Thomsen, 2008), and type of ownership tends to be a poor predictor of bank (Altunbas et al., 2001) and MFI (Mersland and Strøm, 2008) performance. For example, a case study by Labie and Sota (2004) is interesting in this respect. Analysing a Colombian microfinance NGO, they show that, even in an organisation where the board is highly active and supportive, strategic direction and control may come more from a fine-tuning balance between key executives than from board supervision. This indicates again the need for a more integrative approach to the governance of MFIs.

How can the approach to microfinance governance be broadened? There are at least three ways that may be used. Firstly, we propose taking a historical perspective and looking for lessons to learn. Microfinance is not a recent phenomenon. Several pro-poor banking systems have been around for centuries (Hollis and Sweetman, 1998). In a recent study by Mersland (Forthcoming), he reviews historical literature to identify the governance mechanisms that enabled the survival of the 19th century savings banks in Europe and the USA. The findings in this paper indicate that boards did not have much influence. What mattered were bank associations (similar to, but more advanced than, the MFI networks today), mismatches in liability/asset maturity (deposits that could be withdrawn on demand) that forced managers to manage the banks well, local communities monitoring “their banks”, and donors risking their own personal reputations. Boards, regulation and market discipline were less important.

Secondly, we propose focussing on risk analysis. Institutional governance issues often receive a large amount of attention when a crisis is emerging or unfolding. Indeed, when everything seems to be running smoothly, there is usually little concern about ways of improving governance. But when balance sheets, access to funds, shareholders’ value and staff are at stake, governance rises higher on the agenda. This should lead us to the following consideration: for many stakeholders, governance is first and foremost a “crisis avoidance tool”. In this regard, a recent paper by Galema et al. (2009) helps to set the agenda. The dependent variable in this paper is the *variability* of performance. The assumption is that, for many MFI stakeholders such as the employees, one main objective is to avoid going out of business. Galema et al. (2009) show that having a powerful CEO is risky because it increases performance variability.

Thirdly, adopting a real stakeholder approach could help broaden the perspective. Paying attention to all of the potential stakeholders in the MFIs (and there are usually many) may give a broader vision of what the most influential governance mechanisms can be. As part of this, a clear focus on where “real authority” stands – to use the term suggested by Aghion and Tirole – would clearly contribute to a wider understanding of how MFIs are really managed (Aghion and

Tirole, 1997). A first step in this direction is to be found in the type of analysis promoted by CERISE.³ This proposes a framework that is based on the idea that good governance should not only be based on its ability to ensure financial sustainability and regulatory fitness, but also on a clear strategic vision and a high level of transparency. All of this would appear easier in a stakeholder approach that includes all of the key actors of an organisation (workers, elected representatives, clients, communities, fund providers and/or shareholders) (Lapenu, 2002). Based on this, CERISE suggests that analysing governance may be done through three steps. The first consists of finding out who really has the power in the organisation based on two major criteria (who is the owner and who makes the decisions). The second step focuses on the way that power is exercised, looking at the information that is provided in order for a decision to emerge. The third step focuses on dysfunctions and risk analysis.⁴

The CERISE framework is certainly interesting as it focuses on questions (regarding power, transparency and stakeholder participation) which can be considered as relevant to MFIs. Indeed, microfinance methodologies are normally based on highly decentralised procedures, which supports the idea that transparency and stakeholder participation make sense for this type of organisation. As a broad approach, it is therefore useful. Nevertheless, we may wonder whether it is possible to suggest a more detailed framework that would allow us to identify what the prime mechanisms are for each type of microfinance organisation at each stage of its existence (Labie, 2001).

A new framework for microfinance governance

Charreaux (1997) suggests an analysis framework which classifies the Corporate Governance mechanisms. Although this was not established for microfinance, it can be used as a first approach to identify a broad list of potential governance mechanisms.

	Specific Mechanisms	Non-Specific Mechanisms
Intentional Mechanisms	<ul style="list-style-type: none"> • Direct shareholders control (assembly) • Board of directors • Salary and bonus mechanisms • Formal Structure & organization chart • Internal Auditors • Ownership structure 	<ul style="list-style-type: none"> • Legal Environment (Regulation and supervision procedures) • Legal Auditors • Consumers Associations • National and international associations and networks
Spontaneous Mechanisms	<ul style="list-style-type: none"> • Informal (relationship) Networks • Managers cross-control • Corporate culture • Reputation (among the employees) 	<ul style="list-style-type: none"> • Depositors • Financial Providers (MIVs and others) • Labour Market • Political Market • Media Environment • Business Culture

[Adapted from Charreaux, 1997, 427],

³ CERISE (Comité d'échanges, de réflexion et d'information sur les systèmes d'épargne-crédit) is a group of French research centers (CIDR, CIRAD, GRET & IRAM).

⁴ This last step allows for a parallelism with the second approach previously mentioned.

“Specific mechanisms” refer to those created for a “specific firm” whereas “non-specific” are created for a whole set of similar firms (for instance all the MFIs or all the cooperatives) .
 “Intentional mechanisms” are created for a corporate governance purpose whereas “spontaneous mechanisms” exist but were not established with a “corporate governance” goal in the first place.

Charreaux’s framework is based on two criteria: the intentionality of the mechanism, and its specific or non-specific character. A mechanism is said to be “intentional” if it was originally designed to improve corporate governance. A mechanism is said to be spontaneous if its role in governance is an “indirect effect” of this mechanism, rather than being a prime reason for its existence. In terms of being specific or non-specific, a mechanism is said to be “specific” if it was “designed for a specific firm”, while it is considered “non-specific” if it was created for a whole set of institutions.

Of course, this table does not suggest that all mechanisms are relevant in all cases. On the contrary, Charreaux (1997) favours looking through the whole table in order to identify the key mechanisms for any given organisation. It is thus possible to use the framework to understand how corporate governance is structured for a specific organisation.

In our opinion, this type of framework constitutes an interesting first step for the following three reasons. Firstly, the governance mechanisms which are often advocated, such as boards and market competition, are only part of the whole set. Secondly, the mechanisms that are usually analysed in literature and advocated by policy makers are intentional ones such as regulation and supervision (non-specific & intentional) or board management (specific & intentional). There is thus a whole set of mechanisms that may (and do) play a role that are widely underestimated – the so-called “spontaneous mechanisms”, those whose role is not intentional but rather derives from unplanned externalities.

Thirdly, although the framework does not mention this explicitly, the results may show that some mechanisms are highly relevant at certain stages (e.g. the birth and infancy of an organisation), while others may only play a role further down the road. This framework of analysis could therefore create a potentially dynamic perspective. For instance, after its conception, an NGO may rely on spontaneous and specific mechanisms (such as corporate culture or cross-control between managers); later on, as it grows and develops a more elaborate structure, intentional and specific mechanisms may play a greater role; further down the road, when local competitors and regulations have emerged, non-specific mechanisms may be of more importance.

Adapting Charreaux’s (1997) framework can help to obtain a better view of the mechanisms that have the potential to provide good governance to the various types of MFI. A first attempt has already been made in the case of credit unions, showing the importance of network management (Labie & Périlleux, 2008; Périlleux, 2008). However, this still lacks one dimension: a way of identifying the key stakeholders at certain times in order to identify the type of mechanism most likely to play a major role in maintaining good governance over time.

Identifying the key stakeholders is therefore fundamental. Indeed, without this there is a risk of free riding, where everyone joins a bandwagon in believing that someone else is monitoring whatever is happening. This is one of the lessons learned from the Corposol saga, where many actors were involved (microfinance international networks, major donors, banks, Colombian authorities, wealthy businessmen, academics), giving everyone a sense of confidence (Labie, 1998; Austin et al., 2000). In order to avoid this situation, it is important to identify at each stage the type of stakeholder that may be the most efficient for ensuring good governance and, from then on, to pay specific attention to the type of mechanism usually associated with this type of stakeholders.

This could be achieved by analysing the surplus distribution (rent extraction) in the organisation. Indeed, property theory states that the true owner (and therefore the stakeholder to whom governance should matter most) is the one who benefits from the residual earnings (Hansmann, 1996). Some research is in progress using this approach, but it is not yet clear the extent to which it will help in identifying key mechanisms for good governance (Hudon & Périlleux, 2008).

Another method would be to rely on Mintzberg's framework of analysis (Mintzberg, Quin & Ghoshal, 1995). In Mintzberg's model, the key to analysing an organisation is identifying where the true power for decision making lies. Mintzberg suggests considering the organisation as a balance between an internal and an external coalition of interests. He identifies categories of stakeholders that may be susceptible to assuming power in the organisation. For the internal coalition, five types of stakeholders are identified: the strategic apex (top management team), the middle line (the intermediary staff), the operating core (the people actually in charge of operations), the techno-structure (the specialists in charge of planning and organising) and the support staff.⁵ Mintzberg shows that the actor or stakeholder who is dominating the organisation plays a major role in imposing the type of supervision mechanism and the level of centralisation or decentralisation that will maintain their control on the organisation. For the external coalition, he lists a whole series of potential stakeholders, the main ones being the different types of publics addressed by the organisation, the different levels of public authority and the more direct "partners" of the organisation (clients, suppliers, associates, trade unions, competitors). Mintzberg suggests that the external coalition may be either *passive* (leaving the power to the internal coalition), *dominated* (by one of the actors of the external coalition) or *divided* (when various actors of the external coalition tries to dominate the organisation). Therefore, using the categories suggested by Mintzberg, it may be possible to identify, for any type of organisation at any stage of its life, who are the stakeholders dominating the organisation and, from this, to question the type of mechanism that should help to ensure good governance.

A new research agenda

The purpose of this chapter is to outline microfinance governance and to stimulate a broader search for the mechanisms that actually control and direct MFIs. Based on the analysis of the former sections, we suggest a new research agenda. This agenda should be driven by a multi-theoretical approach and move beyond agency theory (Dennis, 2001). The following eight patterns may help to stimulate new research:

Firstly, we suggest historical studies. What were the governance mechanisms that helped prior microfinance systems to survive and what were the ones failing when systems disappeared (Hollis and Sweetman, 2001)? By identifying these historical important mechanisms researchers can study their influence in MFIs today. For example, following Mersland (Forthcoming), it is time to investigate how MFI networks today influence the governance of MFIs, how depositor monitoring and liability maturity discipline managers, whether MFIs that are more embedded in their communities are different from other MFIs and whether MFIs with donors who take a more active governance role perform differently from other MFIs.

⁵ Please note that Mintzberg's framework also mentions a sixth element that Mintzberg calls the 'ideology', which is the whole set of values that organisation members may share. We do not mention this in our list because it does not match a category of individuals.

Secondly, there is a need to understand governance in relation to risks. A natural step in this would be to identify the various risks (performance, survival, environmental) of an MFI, and to search for governance mechanisms that can help to control or alleviate each of these risks.

Thirdly, because of their nature and the fact that MFIs generally operate in contexts with limited “market discipline” and public regulation, we believe that MFIs should be analysed from the stakeholders’ points of view. Microfinance corporate governance is more than simply a question of good board management, or having the right shareholders providing the right incentives to the right staff. Microfinance corporate governance is a complex issue because microfinance institutions are diverse, multi-purpose organisations. However, they are also organisations in which many people put their trust. There is thus a need to understand better which are the stakeholders who truly influence the governance of MFIs.

Fourthly, as illustrated in Charreaux’s (1997) framework, there is a need to look at microfinance governance as *a set* of mechanisms that can substitute for and/or complement each other. Which mechanisms substitute for and which are those that complement each other?

Fifthly, also using Charreaux’s (1997) framework, we need to know more about the specific and spontaneous governance mechanisms, such as corporate culture or the cross-control of managers. These remain, to a large extent, unexplored in the literature on microfinance governance. This may be combined with Mintzberg’s organisational framework.

Sixthly, MFIs differ greatly in terms of ownership structures, legal incorporations and organisational objectives. There is definitely a need to understand better how the differences between MFIs influence their governance structures. This could be further broadened through studying what are the most efficient mechanisms for the different types of institutions at the different stages of their lives.

Seventhly, studies may help to understand how local contexts and institutions influence the governance of an MFI. For example, a recent paper by Seibel (2009) shows that the governance of an MFI depends on the local culture. Similar papers are needed, as are papers studying the effects of other institutional/contextual factors, identifying what key contingencies should be taken into consideration when analysing the corporate governance of MFIs.

Eighthly, and finally, microfinance is an international business, where alliances and cooperation across borders is common. Greater efforts are needed to understand how international actors such as donors, networks, investors and policy advocates influence the governance of MFIs.

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