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The governance of Micro Finance Institutions: Lessons from history

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Microfinance, MFI, non-profit organisations, governance, savings banks, history

Abstract:

Microfinance is high on the public agenda and better corporate governance has been identified as a need to enhance the viability of the industry. Guided by stakeholder and agency theories the paper makes use of an historical parallel found in savings banks in order to present corporate governance lessons for today's microbanks. The findings indicate that monitoring by bank associations, depositors, donors and local communities were important in securing the survival of the savings banks. The willingness to expand their mission to server wealthier customers alongside the poor helped the banks to become financially viable. These findings could prompt a rethink of microfinance governance, in which regulation and traditional vertical board control are stressed. The paper argues that a broader and more stakeholder-based understanding of corporate governance is necessary.

1. INTRODUCTION

Microfinance, the supply of banking services to the poor, is high on the public agenda and is attracting increasing interest from academics. The development-enhancing aspect of microfinance has been recently recognised with the Nobel Peace Prize awarded to Mohammed Yunus and Grameen Bank. Increasingly, microfinance is also becoming an investment opportunity. Between 2004 and 2006 the total stock of foreign capital investment in microfinance more than tripled to US\$4 billion, and 40 new specialised international investment funds were established (Reille and Forster 2008).

For the delivery of microfinance services a new type of firms called Micro Finance Institutions (MFIs) has come into being. A typical characteristic of an MFI is that it has a dual mission of serving the poor and being financially sustainable. Most MFIs are sponsored by donors and they are often not-for-profit organizations. Strong MFIs are considered key to the further development of the microfinance industry (C-GAP 2004). In a recent report, corporate governance was identified as a major risk facing microfinance as a business and social service (CSFI 2008). However, Mersland and Strøm (2008) find that best practice governance mechanisms from regular firms in mature markets are of small importance in MFIs. There is therefore a need to learn more about the specific corporate governance mechanisms that can enhance MFIs' long-term survival. In line with the recommendation in Mersland (Mersland Forthcoming), this paper makes use of an historical parallel found in savings banks in order to identify and present corporate governance lessons for today's MFIs.

Microfinance is not a recent invention, and several pro-poor banking systems have preceded microfinance. Some, like savings banks and savings and credit cooperatives, continue to be important banking organisations throughout the world, while others, like Irish and English

loan funds, have disappeared (Hollis and Sweetman 1998). Caprio and Vittas (1997) explain how the financial systems in developing countries today have several features in common with the financial systems of Western countries in the nineteenth century. They indicate that lessons from the past have policy implications for today.

Corporate governance is a system of mechanisms by which organisations are directed and controlled (Cadbury-Commission 1992). A system of good corporate governance enables the survival of firms. Adams and Mehran (2003) report systematic differences in governance between banking and manufacturing firms and indicate that good governance systems are industry-specific. A challenge in the governance of many MFIs is that managers who are agents are supervised by donors who are also agents (Varian 1990). Thus, vertical board governance may be more effective in commercial microfinance banks compared to non-profit MFIs (Glaeser 2002).

Overall, it is important to identify those governance mechanisms that enhance the survival and growth of a pro-poor banking system. Since the aim of the original savings banks was developmental, similar to modern microfinance, and since the banks continue to be competitive banking organisations today (Crespi, Garcia-Cestona et al. 2004; ESG 2004), this paper suggests that MFIs today can learn important lessons from savings banks. Moreover, the non-profit ownership structure found in most savings banks is similar to the many non-for-profit MFIs of today. The aim of the paper is therefore to identify those governance mechanisms that have enabled the survival and growth of the savings banks, and to analyse whether the MFIs of today can learn something from them.

Modern microfinance was born as a response to the frustrated development resulting from subsidised rural credit in the 1950s and 1960s (Adams and Fitchett 1992). Thus, learning from history is inherent in microfinance. However, the importance of learning from banking history is generally unexplored in the microfinance literature. Exceptions do exist: Fälting et al. (2006) draw a parallel between the early development of the Swedish savings banks; (Hollis and Sweetman 1998) identify lessons to be learned from six different historic European pro-poor banking systems; (Hollis and Sweetman 2004) draw parallels between the seventeenth-century Irish loan funds; and (Seibel 2003) and Guinnane (2002) draw attention towards how financial history teaches us the need for appropriate legal frameworks in order to support the development of pro-poor financial systems. Moreover, Cull and Davis (2006) explain how an impressive variety of providers, including savings banks, were important in providing small and medium-sized enterprises in the US and Europe with capital during the nineteenth century. However, no former historical study has drawn attention to the relationship between corporate governance and microfinance.

Besides member-owned cooperatives, the microfinance industry is dominated by non-profit non-governmental organisations (NGOs; (Mersland Forthcoming). Similarly, most of the savings banks are non-profit organisations. Several stakeholders may influence a non-profit organisation, yet no particular group or person can legally claim ownership or receive residual earnings from one (Hansmann 1996; Mersland Forthcoming). Thus, legally and economically speaking, savings banks and NGOs are similar organisations. The corporate governance mechanisms affecting one type of organisation may therefore affect the other.

In order to identify the important governance mechanisms that enable the survival of the savings banks, this paper reviews the historical literature on the subject. The findings indicate

that bank associations, mismatch in liability/asset maturity (deposits on demand), local communities, and donors risking their personal reputation were important in disciplining managers and securing the survival of the banks. The banks operated under a friendly regulatory regime or no regime at all. In the initial years the banks didn't face much competition, but gradually this became a major factor in disciplining the managers, and is today considered to be one of the main causes for the savings banks' continued success in most markets. The banks' willingness to expand their mission to serve wealthier customers alongside the poor has helped them to become financially viable organisations.

These findings could prompt a rethink of microfinance governance, in which regulation and traditional vertical board control are stressed. The lessons from the savings banks indicate that a broader and more stakeholder-based understanding of corporate governance is necessary in order to secure the long-term survival of a pro-poor banking system. A pragmatic attitude in pursuing financial objectives should also be tolerated.

This paper proceeds as follows. Section 2 explores the early history of savings banks; section 3 discusses theoretical views on microfinance governance; section 4 identifies potential corporate governance mechanisms in pro-poor banking and discusses their relevance to historic savings banks and modern microfinance; section 5 discusses previous findings in order to identify lessons for today; section 6 concludes.

2. THE EARLY HISTORY OF THE SAVINGS BANKS

In order to understand the birth of the savings banks, one must analyse the context within which this banking system was born. The ideological movement out of which the savings banks were born was a search for new initiatives to improve poor people's living conditions

(Horne 1947; Rønning 1972; Tucker 1991). Thrift and savings were introduced as means to avoid poverty and become rich (Tucker 1991). The establishment of the first savings banks was therefore a response to a new doctrine of self-help (Horne 1947). However, at the same time, this doctrine was also convenient for the wealthy and the local authorities, who could continue a policy of *laissez faire* in poverty assistance (Fishlow 1961; Clemmensen 1985).

Another driving force behind the establishment of the savings banks was industrialisation, whereby low wage earners who came to the cities needed a safe and convenient place to deposit their money. The existing commercial banks showed little interest in serving the wage earners with savings facilities (Teck 1968). At the same time, the lack of regulation in combination with banks' reputation for speculation and exploitation of customers made contracting with investor-owned commercial banks too risky for poor depositors (Hansmann 1989; Hansmann 1996).

The first savings banks emerged in the late eighteenth century in Europe. By the second half of the nineteenth century, most European countries as well as the US had hundreds of banks (Horne 1947; Teck 1968; Pampillon 2003). The pattern was the same in all countries: the first banks were established in the cities, and after some decades even smaller villages often had their own banks (Rønning 1972; Clemmensen 1985). The banks were not organised by the poor themselves, but by the upper classes, often in coordination with the local authorities and the priesthood (Horne 1947; Rønning 1972; Clemmensen 1985; Pohl 2003). The initiators were motivated by a combination of altruistic philanthropy and a self-interest in letting the poor help themselves. During the initial years, the management of the savings banks was typically based on voluntary work by their promoters, and they were only open a few hours

during the month (Horne 1947; Rønning 1972; Clemmensen 1985). This low-cost operational mode made it possible for the savings banks to rapidly become financially sustainable.

The different governments actively supported the establishment of savings banks in their countries, and subsidies in the form of sponsored earnings on public bonds, exemption of stamp duties or permission to charge loan interest above the legal ceiling were common and probably benefited most of the new banks. To the banks these subsidies were important, but at the same time not imperative in securing the banks' operations as most operations were carried out by volunteers, and operational income covered other costs (Horne 1947; Rønning 1972; Pampillon 2003).

The investment policy of the savings banks followed two main patterns, referred to as the Continental and Atlantic models. The Continental model canalised the captured savings into loans like mortgages, business loans, short-term loans and different types of public bonds, while the Atlantic model canalised all the funds into public bonds and did not carry out any loan operations (Pampillon 2003). While the Atlantic model was efficient in canalising funds into public investments, the Continental model was efficient in serving local needs for credit.

The model followed by different European countries is presented in Table 1. The Continental model is divided in two: the guaranteed model and the pure model. In the guaranteed model a public entity (normally the local municipality) guarantees the deposits, while the pure model does not contain a public guarantee scheme.

Table 1: Savings banks models in different European countries (adapted from Pampillon 2003)

Atlantic	Continental	
	Guaranteed	Pure
United Kingdom	Germany (municipality)	Germany (private)
Belgium	Austria (municipality)	Austria (private)

Ireland	Denmark (municipality)	Denmark (private)
France		Spain
Portugal		Finland
Luxemburg		Holland
Greece		Italy
		Portugal
		Sweden
		Norway

The claim by the savings banks that they were successful in reaching the poorest members of the community has been criticised (Rønning 1972; Ograda 2003; Fälting, Liljefrost et al. 2006). For example, Fishlow (1961) presents evidence that in some of the UK savings banks in 1830, only 11.2% of the deposits were mobilised in accounts of less than £20, which represented nearly one year's wage for a manufacturing operative or agricultural labourer. The vast proportion of the savings came from the middle class, and the lower classes represented were often female house servants of the upper class, together with retailers and handicraftsmen (Fishlow 1961; Ograda 2003; Fälting, Liljefrost et al. 2006). However, (Horne 1947) argues that most of the customers did belong to the poorer classes.

Guinnane (2002) claims that in Germany, the savings bank was able to fulfil its mission to reach the poorer classes relatively well, which ran parallel to serving the middle class. Also, in the Scandinavian countries the banks attracted deposits from many poor people, though perhaps not the poorest, and penetrated rapidly into society. In 1884, 18.8% of the Norwegian population, 19.8% of the Swedish population, and 32.3% of the Danish population had their own savings account (Egge 1972).

In the banks where deposits were recycled into loans, emphasis was placed upon safety. Most of the initial lending was therefore supplied to relatively wealthy borrowers who could offer formal collateral (Rønning 1972; Clemmensen 1985; Vittas 1997; Fälting, Liljefrost et al.

2006). However, over time, more investment opportunities became available and banking competition increased. Gradually borrowing was extended to include mortgages as well as farming and manufacturing loans to less wealthy customers (Guinnane 2002; Fälting, Liljefrost et al. 2006). (Hansen 2001) reports that in Denmark loans from the savings banks were particularly important for farmers.

In most savings banks in most countries, it's clear that the poor were served side by side with the wealthy. Thus, instead of arguing that the inclusion of wealthier customers led to a drift away from the savings banks' mission, one can argue that such an inclusion policy was necessary in order for the savings banks to survive as a financial system. Through the inclusion of wealthier customers, the savings banks managed to increase their assets, thereby improving their operational costs and financial efficiency. Besides, loans funded by the poor's deposits were more secure in the hands of those who could offer formal collateral. The inclusion of wealthier customers was therefore necessary to enable the long-term sustainability of this new banking system.

Comparing the historic savings banks with today's MFIs

A brief description of the origins of the savings banks invites a comparison with today's non-governmental MFIs. First of all, both types of organisation have a mission to fight poverty, operating non-profit without any legal owners. As in the savings banks, the doctrine behind MFIs is self-help, and the promoters are people outside the target population. However, while the savings banks were promoted by the local elite, MFIs are mainly promoted by international NGOs (C-GAP 2006; Helms 2006).

A major difference between the organisations is that in the savings banks the focus of the financial services was savings, whereas for non-governmental MFIs it is credit. Thus, in the savings banks, capital for on-lending stems from local depositors, while in the MFIs it stems from international donors and lenders. To many in the microfinance industry, the lack of savings mobilisation and the dependency upon outside funding is a major concern (Helms 2006). MFIs struggle in reaching the poorest customers (Helms 2006; Johnson, Malkamaki et al. 2006), but compared to the savings banks they have been more successful in issuing credit to the target population. The level of financial sustainability was high in the savings banks thanks to the low cost of operations. Most non-governmental MFIs struggle to become financially sustainable (Aghion and Morduch 2005). A recent survey of 704 MFIs by the Microbanking Bulletin (2007) reveals that 41% are not financially self-sustainable and rely upon donor support to remain afloat. Table 2 summarises the main similarities and differences between the two types of organisations.

Table 2: Comparison between the savings banks and non-governmental MFIs

Issue	Savings Banks	Non-governmental MFIs
Mission	To fight poverty	To fight poverty
Doctrine	Self-help	Self-help
Promoters	Local individual philanthropists	International philanthropic organisations
Type of ownership	Non-profit	Non-profit
Dependence on subsidies	Low, but some	High, but decreasing
Level of sustainability	High	Low/Medium, but improving
Financial service in focus	Savings first and credit later	Credit only due to regulation
Capital for on-lending	From local depositors	From international donors and lenders
Success in reaching the poorest	Questioned in credit delivery. Relatively good in savings	Relatively good, but don't reach the very poorest

3. CORPORATE GOVERNANCE IN MICROFINANCE

Recently rigorous studies on corporate governance in relation to microfinance have become available. Hartarska (2005), Hartarska and Nadolnyak (2007), Mersland and Strøm (2008), and Hartarska and Mersland (2008) all study the effect of different corporate governance

mechanisms on the social and financial performance of MFIs. In these studies the effect of board composition, managerial incentives, ownership type, regulation and competition is explored. The findings indicate the following: competition drives down the interest rates, the costs and the ROA in the MFIs (Mersland and Strøm 2008); regulation has no effect upon performance, but may indirectly be a benefit as it may allow MFIs to mobilise deposits (Hartarska and Nadolnyak 2007; Mersland and Strøm 2008); a larger board means a lower average loan size (Mersland and Strøm 2008); performance-based compensation of managers is not associated with better-performing MFIs (Hartarska 2005); ownership type does not determine the financial or social performance of MFIs (Mersland and Strøm 2008); MFIs where the positions of CEO and Chairman are merged are less efficient, and efficiency increases with board size up to 8–9 members and decreases over 10 (Hartarska and Mersland, 2008). All these recent studies are important in identifying the effect of different mechanisms on MFI performance. Nevertheless microfinance governance still remains generally unexplored particularly when it comes to the influence of other stakeholder relationships besides the traditional vertical owner/board – manager relationship.

Most of the practitioner oriented literature on governance in microfinance emphasis mainly the composition and role of the boards (Rock, Otero et al. 1998; Campion and Frankiewicz 1999; Otero and Chu 2002; Jansson, Rosales et al. 2004; Council-of-microfinance-equity-funds 2005). The governance structures typically recommended are those recommended for Western, developed for-profit firms, for instance in OECD (2004). Such recommendations are based on the agency costs stemming from the vertical relationships between owners and management (Jensen and Meckling 1976; Fama and Jensen 1983; Fama and Jensen 1983). MFIs are recommended to set up governance systems in order to mitigate agency costs by aligning top management with owners' goals and putting controls into place (Rock, Otero et

al. 1998; Otero and Chu 2002; Helms 2006). These recommendations are well and good, but do not sufficiently account for the fact that most MFIs are not shareholder owned, have multiple goals, and do not have an inherent profit motive. Moreover, different to regular firms, MFIs encounter horizontal agency problems between the bank and its customers (Adams and Mehran 2003), and donor-funded MFIs face agency costs in the relationship between the MFI and the donors.

Following the logic of traditional Western-style governance, several policy papers recommend the transformation of NGOs into shareholder-owned MFIs. One of the arguments is that this is necessary to establish a clear and effective governance structure (White and Campion 2002; Ledgerwood and White 2006). However, Mersland and Strøm (2008) show that NGOs can be as efficient and profitable as shareholder-owned institutions in microfinance markets. There must therefore be other governance mechanisms that can facilitate the viability of MFIs.

Hansmann (1996) suggests that the importance of having owners monitor management has generally been overstated. The degree of product market competition and customer-firm relationships seems far more important than owners in disciplining managers (Hansmann 1996). The problem is perhaps exacerbated in microfinance since the customer has little or no collateral and credit history, and has generally low education and little knowledge of the MFI. Moreover, the regulatory ability of local regimes is generally low. Issues such as closeness to the customer and mutual trust are paramount under such conditions. Better knowledge of a broader set of governance mechanisms, which take account of agency costs stemming from multiple stakeholders, is therefore needed.

Stakeholder theorists widen the approach of agency costs as they argue that not only need managers to respond to owners' interests, but they also have to balance the needs of several stakeholders like employees, customers, local communities, authorities and debt holders (Freeman 1984; Mitchell, Agle et al. 1997). We consider that for the MFIs, as for the savings banks, stakeholder theory helps to establish a broader understanding and to identify who and what really count in the governance of these organisations (Mersland Forthcoming). Thus, when searching for corporate governance mechanisms that helped to facilitate the viability of the savings banks, we consider stakeholder theory to be important.

4. GOVERNANCE MECHANISMS IN THE SAVINGS BANKS AND THE MFIs

In this section we use theory in order to understand corporate governance mechanisms in pro-poor banking. For each of the mechanisms we study historical literature on the savings banks in order to analyse its effect upon governance. We conclude the analysis of each mechanism by assessing whether it has an effect today in the governance of MFIs. The mechanisms or stakeholders covered are as follows: the organisation's mission, boards, donors, public regulation, apex associations, market competition, mismatch in liabilities/assets, and the influence of local communities and governments.

The mission of the organisation

Non-profit organisations don't have owners and are accountable to their missions (Weisbrod 1988; Hansmann 1996). Stakeholders influence a non-profit organisation's mission and monitor its fulfilment (Speckbacher 2008), hence the mission becomes an important governance mechanism in organisations like savings banks and MFIs. However, since stakeholders' expectations of a non-profit organisation differ, not all stakeholders will be fully

satisfied. Those stakeholders with most bargaining power over time are those with the most influence over a non-profit organisation's mission. Having a clearly defined and well-informed mission reduces the cost of disagreements and bargaining (Speckbacher 2008).

The mission in the savings banks

One of the most striking features in the history of the savings banks is the ability of the banks to change their orientation, or their mission, at an early stage of development. Vittas (1997) explains how the savings banks were created to serve the poor with saving services, but quickly reoriented their services to include the middle class and facilitated credit when legislation allowed. Thus, the inclusion of the middle class in a customer relationship with the banks brought in stakeholders with the power to expand the mission of the banks.

Most of the founders of the banks accepted that a larger scale and scope of operations was necessary in order to make the banks sustainable. As a result, the provision of credit and the inclusion of wealthier customers became part of the savings banks' mission. However, most of the savings banks continued to serve the poor, so they didn't depart from their mission but rather expanded upon it. This shift made the savings banks more financially sustainable, and at the same time helped them to reach out to larger markets. Unfortunately this shift in mission did not come without a cost. Some banks reduced their activities with their poorer clientele, and some of the early advocates of the banks lost their motivation.

Figure 1 illustrates how the banks went through a reorientation from enthusiasm to realism to pragmatism. In the beginning the belief was that savings and thrift could eliminate poverty and that the poor would be easily recruited. The enthusiastic stage was soon replaced by a more realistic understanding of the possibilities. Many poor weren't able or willing to save.

Handling only small customers led to high transaction costs, and loans had to be issued to wealthier clients in order to be secured; only this could make the banks viable in the long run. There was no lack of critical voices as the savings banks expanded their mission, but the pragmatic approach was approved by all the surviving banks.

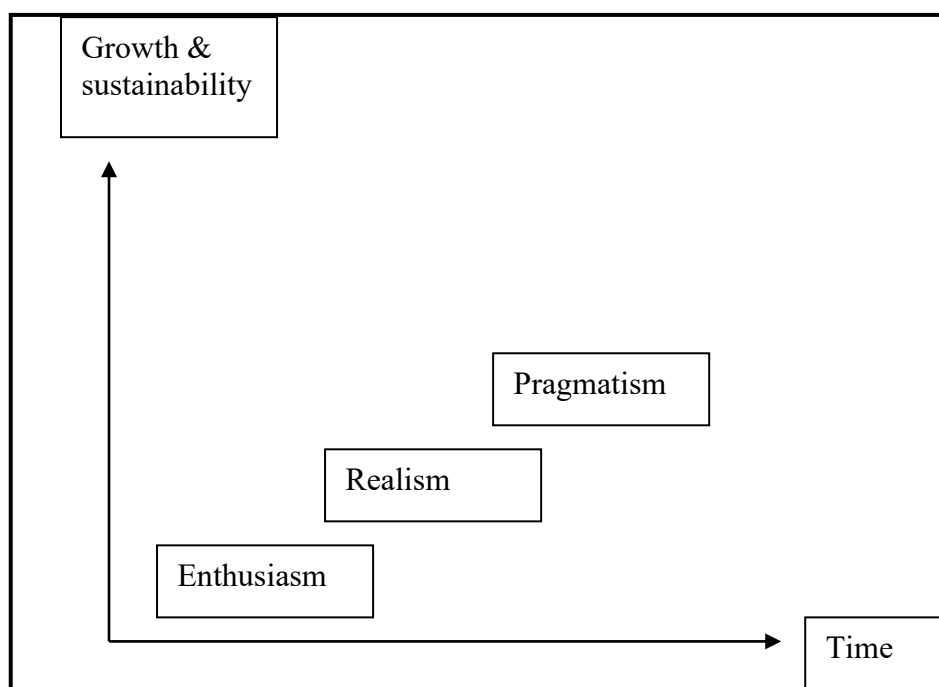


Figure 1: The development of the savings banks' poverty mission

Mission in the MFIs

Similar to the savings banks, modern microfinance has experienced an enthusiastic first stage, culminating in the Nobel Peace Prize being awarded to Mohammad Yunus and Grameen Bank. However, insiders in the industry have long been aware of the limitations (Dichter and Harper 2007). Reaching the poorest is a struggle, and the impact from access to services is often low, especially for those with limited access to assets, knowledge and networks before contracting loans (Hulme 2000). Some MFIs are comfortably serving some wealthier clients, but as a whole the industry has still not reached the pragmatic stage.

The debate regarding whether MFIs are drifting away from their mission of serving the poor in their struggle to become financially viable banks has been described as a schism within the industry (Morduch 2000). In order to stay true to their mission, some policymakers advocate that MFIs polish their mission statements and maintain a poverty focus. For example, in their handbook on corporate governance in MFIs, Lapenu and Pierret (2005) place strong emphasis upon the importance of having a clear mission in order to guide management and avoid mission drift.

However, Mersland and Strøm (2008) present global evidence that MFIs are not experiencing mission drift, and that serving wealthier customers is not related to higher overall profitability. This should indicate that in contrast to the savings banks, MFIs today do not necessarily have to expand their mission in order to become financially viable. However, the lesson from the savings banks is that if the market conditions require, pragmatic expansion of the mission doesn't have to lead to the overall exclusion of the poor. The wealthy and poor can be served side by side.

Boards

Boards are a generic corporate governance mechanism to minimise agency costs stemming from the separation of owners/donors and management (Fama and Jensen 1983). Boards monitor, replace management, ratify major decisions, and bring in important networks and knowledge. Well-functioning boards are supposed to reduce agency costs and enhance organisational performance. However, the empirical evidence from for-profit firms indicates that boards, on average, do not matter much (Thomsen 2008). Speckbacher (2008) argues that since non-profit organisations lack owners with monetary incentives to monitor their investments, their boards play a more important role than those in for-profit firms. Board

members of non-profit organisations offer their reputation as collateral to the public and try to minimise the risk of losing it (Handy 1995).

Boards in the savings banks

From their origin, the savings banks have had boards to oversee their operations (Fishlow 1961; Teck 1968; Rønning 1972). Normally the banks adopted a two-tier structure where an overseeing board would control and a management board would carry out the daily operations. The overseeing board would typically consist of a large group of founding members, while the management board was smaller. Initially, board members would not have any direct or indirect business relationship with the bank, so the boards were fully independent. Later, however, in some banks it became normal to provide loans to board or founding members, and their children and servants were often important depositors (Horne 1947; Rønning 1972). Those belonging to the management board would dedicate important time to the bank. A board position was fully voluntary and any type of payment was uncommon; indeed, board members often donated part of the start-up capital of the banks in addition to volunteering their time (more on this below).

In all countries where the savings banks were established they were promoted by the local elite, and upper-class people formed the boards (Horne 1947; Fishlow 1961; Rønning 1972; Ograda 2003; Fälting, Liljefrost et al. 2006). Often the local pastors and teachers were active in establishing and governing the first banks (Horne 1947; Rønning 1972; Clemmensen 1985; Ograda 2003). What all board members had in common was an active philanthropic interest and they often participated in several social foundations or activities (Clemmensen 1985). As time went by the bourgeoisie on the board were gradually replaced by professionals like lawyers, accountants and business managers (Rønning 1972; Clemmensen 1985). During the

initial years it was unthinkable to allow members of the target group, the poor, to participate on the boards.

As the savings banks became not only an anti-poverty instrument for the poor, but also more of a regular bank for the wealthier classes, some banks struggled to maintain the interest of their initial philanthropic founders (Rønning 1972). As a result, attendance at board meetings declined and management of the banks was increasingly put in the hands of paid professionals. The first annual report of the Cork Saving Banks in Ireland (founded in 1817) provides insight into how the frustration of serving wealthier customers influenced the governance of the banks:

'this species of deposits [high amounts], if continued, could eventually close the Bank, as no gentleman could be got to give their time gratuitously as managers to conduct the money dealing of their equals and in many cases their superiors in rank and property' (cited in Ograda 2003, p. 35).

However, even if the savings banks struggled to maintain the interest of their board members and gradually became more and more management dominated, it seems likely that they indirectly continued providing some basic monitoring in order to protect their own reputation. Moreover, it seems likely that the banks capitalised upon the reputation of their founders in order to generate the necessary public trust.

In several countries like Spain, Germany, Norway and Sweden, other stakeholders beside the initial philanthropic founders were gradually given a position on the board (Guinnane 2002; Fälting, Liljefrost et al. 2006). First came representatives from the local government, who at that time were controlled by the local elite, but still had a more representative role as they were not directly controlled by personal interests. Later came representatives of the customers

and employees. Today the savings banks in Europe often have typical stakeholder representation on their boards as they are formed by representatives from the customers, employees and local communities.

Boards in non-profit MFIs

MFIs today follow a traditional separation of management and board, where the former manage and the latter oversee the operations. Generally, board members in MFIs are upper- or middle-class professionals, and similar to the early savings banks, many MFIs struggle with identifying board members with an appropriate background who are able and willing to dedicate the necessary time to effectively monitor management (Labie 2001; Labie 2003). The Council of Microfinance Equity Funds (2005) recommends having a board of 7–9 directors, and (Mersland and Strøm 2008) find that most MFIs practice this recommendation. They also find that the CEO and the Chairman are normally separate persons and stakeholders like donors, customers, employees, the church and the local community are generally absent in MFI boards.

From the struggles of organising the boards in both the early savings banks and today's MFIs, it seems likely that board governance has not significantly contributed to the survival of either. Other governance mechanisms probably play a more important role.

Donors

Some firms receive their capital from donors, not investors. Similar to investors, donors need to monitor firms in order to secure that their donations are used in accordance with their indications (Fama and Jensen 1983). Donors are therefore major stakeholders with the potential to control and influence firm performance. When donors are individuals they have a

direct agency relationship with the firm. However, when donors are organisations funded by back-donors or taxpayers, the firm is monitored by an agent and not a principal (Varian 1990).

Donors to the savings banks

The savings banks were founded by wealthy philanthropists who donated the initial capital. However, this initial capital was rarely substantial (Hansmann 1996). Still, donor involvement was important and they often took seats on the board. More important than the financial capital they brought in was the monitoring, social capital and reputation they brought along (Fälting, Liljefrost et al. 2006). Donation to the savings banks was confined largely to the formation of the banks. After becoming established, the banks fully depended upon operational income and voluntary work (Hansmann 1996). Thus, after their initial donations the donors contributed knowledge, reputation and governance, but not additional cash.

Donors to the MFIs

While the non-profit ownership of the savings banks was chosen in order to protect customers (Hansmann 1996), most MFIs seem to have chosen non-profit ownership in order to tap into donors' pockets (Mersland Forthcoming). The term 'briefcase NGO' is well known in the industry, indicating non-profit organisations formed by private individuals in order to tap into donors' funds. The term also indicates that several donors practice slack control, permitting personal benefits to private individuals.

Donors play a major role in the microfinance industry (C-GAP 2006). MFIs, particularly non-profit MFIs, receive at least initial donations to support operations. These donations stem from international NGOs and the bilateral and multilateral donor community. All these organisations are funded by back-donors, either private philanthropists or taxpayers. It is

therefore a particular challenge in the governance of MFIs that managers who are agents are supervised by donors who are also agents (Varian 1990). This is different from the savings banks, where the ones who actually donated the initial capital were private individuals who often also took a board position. In the MFIs, few donors take seats on the board (Mersland and Strøm 2008).

Regulation

Public law influences firms and bank regulation has the potential to seriously affect the performance of a bank or MFI, whether positively or negatively. However, developing economies suffer from very weak institutional frameworks, imperfect markets and incomplete information. Under such conditions, regulatory ability and public trust are generally weak (Todaro and Smith 2006). When regulation is weak, mutual banks attract smaller customers and take on less risk than stock banks (Rasmussen 1988). Weak regulatory ability is therefore a major reason why non-profit organisations like savings banks and MFIs exist. While privately-owned banks have strong incentives to invest in risky projects, a non-profit bank is less likely to engage depositors' money in risky endeavours (Hansmann 1996). Hansmann (1996) argues that since regulatory ability was weak in the nineteenth century, the savings banks were non-profit organisations in order to protect their customers from exploitation.

Regulation in the savings banks

During their early years the savings banks were often unregulated or operated under a friendly regulatory regime. The necessary trust was generated not by law, but by the reputation offered by the local elite who actively promoted the banks. The main exceptions to this pattern were those countries where the banks were obliged to invest in public bonds, but the legal

framework supported the banks as autonomous institutions with the liberty to make local decisions on other non-investment issues.

For example, in Germany the first Savings Bank Act was introduced in 1838, 60 years after the establishment of the first savings bank in the country, in order to permit the banks to operate as they wished, subject to a few basic rules to insure that the banks concentrated their operations on non-wealthy customers (Guinnane 2002). In several countries like England, the main purpose of regulation was to allow the banks to subsidise interest on public bonds (Fishlow 1961). In other countries like Norway, one of the main purposes of the regulation was to allow the banks to charge loan interest above the legal ceiling and to exempt the banks from stamp duties (Rønning 1972).

However, as the level of savings grew and investment in less secure assets became more common, the legislator gradually responded with regulation (Rønning 1972; Fälting, Liljefrost et al. 2006). Yet, the regulatory framework that was installed was friendly, intended to strengthen the public trust in the banks. Few difficult conditions of operation were introduced. In Denmark the savings banks were not regulated until 1880. The motivation was to enhance public trust and give the banks competitive advantage over their commercial peers. However, during the years after regulation the savings banks did not expand upon the cost of the commercial banks. In fact the opposite was the case (Hansen 2001). Hansen (2001) considers this to be evidence that regulation does not necessarily generate trust from the public. (Martinez 1998) tells a similar story from Spain, where the legislators intended to install regulation and public control. This resulted in massive withdrawals of deposits, the new law was put on hold, and the Spanish savings banks went on nearly unregulated until the 1920s.

Regulation in MFIs

Regulation is a hot topic in microfinance and many are issuing calls for the more prudent regulation of MFIs (C-GAP 2003). Generally, unregulated MFIs are not allowed to intermediate deposits. The main argument is that since non-profit organisations don't have owners with monitoring incentives, they are weaker and riskier structures (Jansson, Rosales et al. 2004). The argument is therefore totally the opposite to that of the savings banks. While the response to weak regulation was to organise the savings banks as non-profit organisations, the response for MFIs today is to involve individuals with high-powered incentives in order to induce efficient operations. As a consequence, non-profit MFIs are motivated to transform themselves into shareholder banks in order to become regulated. However, Hartarska and Nadolnyak (2007) and Mersland and Strøm (2008) find that regulation has no direct effect upon MFI performance. It may only be an indirect benefit if it allows the MFI to mobilise deposits and thereby expand the scale and scope of operations (Hartarska and Nadolnyak 2007; Mersland and Strøm 2008).

Apex associations

Moore and Stewart (1998) suggest that the use of collective self-regulation can help remedy agency costs in NGOs. The idea is that national voluntary associations of NGOs can improve managerial practices and organisational performance through self-policing. Since non-profit organisations lack owners with strong monitoring incentives, Speckbacher (2008) argues that they are in special need of external reporting systems in order to reduce informational asymmetry between management and the various stakeholders. Such external reporting systems can be organised through auditing or self-regulation systems.

Apex associations in the savings banks

The history of savings banks suggests that the Moore and Stewart (1998) recommendation was practiced and had an important influence upon the performance of the banks. In most countries the banks formed their own apex associations. The aim was often threefold: first, to increase their overall power of negotiation towards the authorities and their commercial competitors; second, to help the banks achieve economies of scale in service provision (e.g., money transfer systems across the savings banks); and third, to act as a bank for the banks, that is, a lender of last resort and a place to deposit excess cash (Guinnane 2002; Comin and Torres 2003).

In order to uphold membership in the association, minimum performance standards and self-regulation carried out by the apex were common. Seibel (2003) points out that effective auditing carried out by the apex associations was an important mechanism in the governance of the savings banks. With the help of the apex, the banks maintained local trust and monitoring, but at the same time the institutions benefited from a wider network and scale economies. The apexes were also important in policy creation and acting as one group towards authorities (Hansen 2001; Guinnane 2002; Comin and Torres 2003).

Apex associations in the MFIs

The formation of apex associations for MFIs is common. In most countries at least one member network for MFIs exists and most of the larger MFIs participate (SEEPnetwork 2005). Most countries have special apexes for cooperative MFIs, and in some countries like Bolivia there are special apexes for non-profit MFIs (FINRURAL) and shareholder-owned MFIs (ASOFIN).

Similar to the associations of the savings banks, MFI networks serve a representative role, and to some degree they are also active in building the professional capacity of their members. In some networks, like Red Financiera Rural in Ecuador and FINRURAL in Bolivia, they have installed a self-reporting monitoring system, but formal types of self-regulation are uncommon. The argument is that self-regulation cannot be prudent because the problem of free riding is too obvious (C-GAP 2003). Also, different from the associations of the savings banks, the networks of MFIs seldom serve their members with tangible services like wholesale lending, IT or giro systems. As a consequence, the network becomes less important in the governance of the MFIs compared to the governance role of the associations of the savings banks.

Competition

Market competition is an external governance mechanism. In general, the more intense the competition, the less the owners need internal governance mechanisms (Hart 1983; Schmidt 1997). Hansmann (1996) argues that in markets where trustworthy regulation and deposit insurance are in place, the ownerless savings banks can continue being competitive organisations thanks to the disciplinary effect of market competition.

Competition in the savings banks

In their first years the savings banks did not encounter much competition. In urban areas people didn't trust the commercial banks, and in rural areas the local savings banks were generally alone in offering banking services. Thus, in their initial years competition was not a major disciplinary mechanism in the governance of the banks. But gradually, especially in the urban markets, competition increased (Hansen 2001). More savings banks were established and became competitors of their peers (Clemmensen 1985), and at the same time more

trustworthy regulation of the commercial banks made them an alternative for poorer customers (Hansmann 1989). Besides, from the mid-nineteenth century, the member-based savings and credit cooperatives in many countries became important competitors to the savings banks (Wolff 1919; Hansmann 1996). Competition gradually became a dominant force in the governance of the banks. Today, several observers argue that market competition is probably the number-one mechanism enabling the savings banks to continue as competitive organisations (Altunbas, Evans et al. 2001; Crespi, Garcia-Cestona et al. 2004; Bøhren and Josefsen 2007).

Competition in today's microfinance markets

Many microfinance markets, especially those in rural locations, still have no formal supplier of financial services (Robinson 2001; Christen, Rosenberg et al. 2004). Where MFIs exist, the markets are often characterised by a severe lack of competition, and most clients have limited bargaining power vis-à-vis microfinance providers. However, exceptions exist. In Bolivia, where competition has been increasing, the average annual yield has decreased during the last decade from 50% to just above 20% in the leading MFIs (Porteous 2006). Mersland and Strøm (2008) find that in more competitive microfinance markets, the interest rates and operational costs are driven down, confirming that competition has a disciplinary effect in the microfinance markets today.

Demand deposits

Most savings in banks are in accounts where the depositor can withdraw money on demand. Most theoretical models assume that the role of such demandable debt is to provide flexibility to the depositors (Freixas and Rochet 1997). Calomiris and Kahn (1991) offer an alternative explanation. They point out that by allowing withdrawals on demand, there is a mismatch

between the maturity of assets and liabilities. Such a financial structure is an optimal instrument to exercise management control. In case of trouble at the bank, depositors can immediately withdraw their money and the bank will fall. Calomiris and Kahn (1991) also point out that monitoring doesn't have to take place from all depositors. Since withdrawal is on a first come first served basis there is compensation for those depositors who choose to invest in monitoring. Demandable debt therefore becomes a mechanism to discipline bank managers. Calomiris and Kahn (1991) also point out that deposits don't necessarily have to be in demandable accounts. As long as the maturity on the liabilities is less than the maturity on the assets, the mismatch becomes a disciplinary mechanism. (Hollis and Sweetman 2007) tested Calomiris and Kahn's (1991) theory on an historic case from Ireland and found that institutions with more deposits were better at controlling expenses than those with less funding stemming from deposits.

Demandable debt in the savings banks

The core service of the savings banks is to offer deposit accounts to its customers. However, the banks didn't open every day and the deposits were sometimes unavailable for withdrawal without prior notice. Nevertheless, the maturity on the liabilities (the savings) was still much less than the liability on the assets (the bonds or loans). Historians have long recognised the importance of demandable debt in disciplining the managers of the savings banks:

'if the saver had any dissatisfaction with the way the organization was being managed, he simply terminated his relationship by withdrawing his funds' (Teck 1968, p. 33).

Thus, since deposits could be withdrawn on demand, depositors had an incentive to monitor the bank. This is recognised by (Hollis and Sweetman 1998), who point out that the importance of depositor monitoring in the sustainability of pro-poor banks should not be underestimated.

Savings in MFIs

Non-profit MFIs are generally not allowed to intermediate deposits. As mentioned previously, the argument today is that due to their non-profit status, MFIs lack monitoring by owners with pecuniary incentives. The argument is therefore the opposite to that of the savings banks, who allowed the intermediation of deposits thanks to their non-profit status. The consequence is that the non-profit MFIs are excluded from offering savings and funding their portfolios locally. Moreover, since micro-credit is lent on short terms, the MFIs generally have a much longer maturity on their debt compared to their assets. The result is that MFIs totally lack the disciplinary effect stemming from monitoring by depositors or very short-term debt holders.

Local governments and communities

From a stakeholder perspective, local governments and communities are important influencers upon the firm's opportunities and behaviour.

Local governments and communities' influence on the savings banks

From their origin, the savings banks have been tied to and promoted by the local communities in general, and by the local authorities in particular. In most countries the local authorities helped to organise the banks, and often also provided part of the initial capital. In several local communities the savings banks merged with the social services. In Spain the banks joined forces with the Montes de Piedad, a relief fund for the poor (Sanchez 2003), and in Norway several savings banks were merged with the community corn chambers intended for lean years (Rønning 1972). At the same time, however, it was important for the banks to remain as private rather than public entities. Hence, the local authority was only one stakeholder alongside others, and attempts to tie the banks more closely to the public sector were punished by massive withdrawals of deposits (Martinez 1998).

Another feature of the savings banks that has tied them to local communities has been the banks' active involvement in and funding of charity work and community projects (Sanchez 2003). Ever since their origin, the banks have returned part of their profits to the community. Today this habit is regulated by law in most countries where savings banks are active. In Norway, for example, as much as 25% of the profit can be channelled back into funding local projects. Institutionalising the return of part of the profits to local communities has created a mechanism that has motivated the local community to help steward the banks, creating a feeling of belonging and ownership. Similar to dividends in for-profit firms, this reduces the bank's free cash flow and management's power, creating a mechanism of government (Jensen and Meckling 1976).

Local governments and communities' influence on MFIs today

Today, few non-governmental MFIs relate closely with the local authorities. More often the local authorities are seen as obstacles, creating difficulties in issuing permits or imposing taxes. The fear of being politicised, or the traditional non-governmental position of being part of a civil society with a role to monitor authorities rather than closely cooperate with them, may be part of the reason for the lack of more formal cooperation and relationship with local government. In Peru, however, the Cajas Municipales represent an interesting exception. Even though the Cajas are not non-governmental organisations and can be considered public entities, they are relatively autonomous. Thus, they do not significantly differ from some of the savings banks, who in their initial years were part of the local municipalities. Over the last couple of decades most of the Cajas have been relatively successful MFIs (www.ratingfund.org).

When it comes to local communities, most MFIs enter into a traditional bank-customer contractual relationship. Seldom is the community a driving force behind the establishment of an MFI or invited to take a more active stake in its governance. However, exceptions exist. For example, some Catholic priests are actively involved in some MFIs, and in the MFI Diaconia FRIF they have a conscious strategy of being part of the Aymara community. Most of the staff are Aymara and several of them are involved in different Aymara organisations. According to Diaconia FRIF this close relationship with the Aymara community has been instrumental in securing the success of the MFI. Moreover, when rioting swept El Alto and La Paz, the branches of Diaconia FRIF were spared.

5. DISCUSSION

The difference in governance mechanisms between the historic savings banks and today's non-profit MFIs invites deeper discussion. The findings of the previous section are summarised in Table 3.

Table 3: The governance mechanisms of the historic savings banks and today's non-profit MFIs

Governance mechanism	Historic savings banks	Today's non-profit MFIs
Mission	Pragmatic willingness to broaden the mission and include wealthier clients	Mission drift debate still ongoing
Boards	Composed of upper-class people who also took part in the management. Gradually the board became less important	Composed of upper-/middle-class professionals. Are considered important, but still most MFIs struggle to have active and competent boards
Donors	Took an active role in governance through board seats and personal reputation	Monitoring efforts vary, but few donors are willing to take on an active governance role
Regulation	Either unregulated or operated under friendly regulatory regimes	Unregulated because of non-profit ownership. Low willingness to adapt regulatory regimes to non-profit MFIs' needs
Competition	Low or no competition in the beginning, but today this is considered to be the number-one governance mechanism	Still low competition, but increasing. Evidence indicates that competition disciplines MFI managers
Local communities and authorities	Were important stakeholders in the banks and took active part in their governance	The interaction with local authorities is generally low and the relationship with the communities is normally only of the customer-firm type
Mismatch in	Mismatch in liability/asset maturity	Non-existent due to the regulatory

liability/asset maturity	important in disciplining the managers	environment
Apex associations	Were important in monitoring the banks and functioned as a kind of self-regulation. Also provided important services	Important, but still much less than in the savings banks. Don't provide much self-regulation and tangible services

One of the most puzzling questions is why the non-profit ownership structure for the savings banks was seen as a guarantee to avoid excessively risky behaviour, while today it is considered inappropriate and too risky (Jansson, Rosales et al. 2004). Hansmann (1996) argues that with no regulation, an investor-owned bank would have the incentive and the opportunity to behave opportunistically toward its depositors. Since non-profit organisations have a non-distribution constraint they are generally more trustworthy than for-profit firms (Hansmann 1996). Part of the answer is probably found in the fact that many non-profit organisations today have simply become 'briefcases' of their founders or managers. Another part of the answer is probably that donors today are often too generous in their funding and too slack in their monitoring. Nevertheless, this does not fully explain the low status of non-profit organisations in the microfinance industry.

Ideological preference for Western, vertical governance is probably a reason for the low status of nongovernmental MFIs. Also important is the lack of a broader understanding of governance in general, and ownership in particular. The microfinance industry has many very strong performing nongovernmental MFIs, demonstrating that being a non-profit organisation doesn't have to mean slack performance and donor dependence (Mersland and Strøm 2008). The recent initiatives in Bolivia are interesting in this regard, where non-profit MFIs are probably about to become regulated and allowed to intermediate deposits.

Pragmatism and a willing to expand their mission enabled the survival of the savings banks. Several of the most commercial MFIs today will probably argue that this has also enabled

their viability. Some, for example Procredit in Bolivia, provide loans above US\$100,000 and are criticised for having left their original mission behind. However, Procredit states the opposite: most of their customers take very small loans, so they have expanded their mission, not left it. Few MFIs are as pragmatic as Procredit, so the lesson from the savings banks is that perhaps more MFIs should be pragmatic in order to survive in the longer term.

This study reveals that there is clearly much more to governance than boards. Of course boards are important in MFIs today as they were in the initial stage of the savings banks, but other mechanisms must substitute and reinforce boards in the disciplining of managers.

The Calomiris and Kahn's (1991) model is important in order to understand how agency costs in banking can be reduced, particularly where there is no takeover market (a non-profit organisation cannot be taken over) and in an unregulated environment or environments where the public has little confidence in the regulator's willingness and ability to closely monitor the bank. However, to many it will sound way too risky to introduce deposit intermediation in MFIs as a means to discipline managers through monitoring by depositors. And, of course, this would not be without any kind of pre-screening and monitoring of MFIs. However, what many tend to forget is that microfinance customers operate in a totally informal economy where they are already well acquainted with monitoring their deposits in informal rotating savings and credit associations (ROSCAs; (Bouman 1995) or pre-payments made to the local construction shop. They are also well aware of the risks involved. A study in Uganda, for example, revealed that 99% of the participants in ROSCAs had experienced losses (Wright and Mutesasira 2001). Still, poor people prefer these schemes because the alternative of keeping cash at home is worse due to countless claims and needs (Rutherford 2000). Thus, the alternative of allowing well-performing nongovernmental MFIs to offer deposit services,

thereby also introducing a new stakeholder to the MFI who will monitor its operation, sounds like a solid bet. The savings banks offer historical evidence that it might work.

The lessons from the savings banks also present a message to the donors. Their role is not only to donate but to monitor. Donors generally avoid board seats in MFIs, probably due to the culture of the donors, who generally consider their role to be supporting local civil society rather than being part of it. However, MFIs are not advocacy organisations fighting for people's rights. They are banks, and those who provide them with funds should monitor their operations. Moreover, dedicated donors risk their reputation. Unfortunately, today's microfinance donors are organisations acting on behalf of personal donors or taxpayers, which makes fleeing from difficulties easier.

Fostering competition is another lesson on how to enable good governance in MFIs. This should happen not only through the promotion of a single type of bank, but also through multiple types of providers. (Guinnane 2002) points out that the diversity in the type of bank was important in generating a type of competition that fostered sound management. Also Normark (1996) points out that a combination of organisational types operating in the same market enhances competition. Thus, a difference in missions and ownership stimulates competition and drives the actors towards different market segments (Mersland Forthcoming). However, for this to take place requires a supportive regulatory environment across organisational types.

An interesting aspect of the savings banks is their close relationship with local governments. Whether such a relationship is positive in today's politicised environment is uncertain, but it should definitely be a subject for further research efforts. So, should the MFIs' tie to local

communities. Will the geographical expansion observed in many MFIs be of benefit in the long run? Would they be better off in a more integrated relationship with major stakeholders in a more limited local community where monitoring is more likely?

The apex bank associations were instrumental in both governing the banks through self-regulatory efforts and improving economies of scope through service provision. Even today, spin-off companies like giro centrals or investment funds are important apex structures providing important services to the banks. Starting off with better self-regulation efforts, like they have done in Bolivia and Ecuador, could be a natural first step. Self-regulation cannot be a full substitute for prudent regulation by banking authorities, but it will be an extra mechanism that plays a role in the overall governance system of the MFIs. Besides, in the longer run, independent MFIs will need to come up with strategies to enable better economies of scope (e.g., in IT systems). Thus, in the years to come, apex associations could probably play an increasingly important role, as they did and continue to do in the savings banks.

6. CONCLUSION

Microfinance is high on the public agenda and better corporate governance in the MFIs has been identified as a need to enhance the viability of the industry. This paper makes use of an historical parallel found in savings banks in order to present corporate governance lessons for today's MFIs. The similarities between the 19teenth century savings banks and today's MFIs are several, and legally and economically speaking they are similar type of organisations due to their not-profit status and non-distribution constraint. The corporate governance mechanisms affecting one type of organisation may therefore affect the other. Guided by stakeholder and agency theories the paper reviews historical literature on the subject in order

to identify the important governance mechanisms that enabled the survival of the savings banks, and analyses whether today's MFIs can learn something.

The findings indicate that monitoring by bank associations, depositors, donors and local communities were important in disciplining managers and securing the survival of the banks. External governance in the form of public regulation was generally absent, while product market competition increasingly became a major factor in disciplining the managers. The willingness to expand their mission to serve wealthier customers alongside the poor has helped the banks to become financially viable.

These findings could prompt a rethink of microfinance governance, in which regulation and traditional vertical board control are stressed. The lessons from the savings banks indicate that a broader and more stakeholder-based understanding of corporate governance is necessary. Stakeholder like depositors, donors, local communities and bank associations can together provide a system of monitoring that can enhance the long-term survival of non-profit MFIs. The findings also indicate that the need for regulation could be calmed down, and a pragmatic attitude in pursuing financial objectives should be tolerated in order to improve financial viability of the MFIs.

The importance given to microfinance as a development instrument, and the increasing inflow of capital to the industry indicate a need to better understand governance systems for MFIs. Further studies are needed. These could particularly look into how a combination of organisational types enhances competition in the microfinance market, and how a mismatch in maturity on liability and asset influences management behaviour and MFI performance. Studies on donor monitoring are also needed.

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