# Regulation and Performance of the Microfinance Industry

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# Abstract

In the last decades, microfinance has received considerable attention from social scientists, policy makers, governments and is considered one of the most effective development tools to combat poverty. While the objectives of microfinance program are poverty alleviation and women's empowerment, it has also been effective in delivering the provision of access to financial services to low income and disadvantaged groups at an affordable cost. The exponential growth of the microfinance industry has brought with its important question on the need for monitoring, supervising, and regulating microfinance institutions (MFIs) which deliver these services.

Thus, the regulation of microfinance has received considerable attention from both government and Microfinance practitioners around the world. Researchers claim that the need for regulation and supervision of MFIs arises from several considerations, including, protecting the interests of small depositors (MFI clients), ensuring proper terms of credit and financial discipline, and institutionalising a proper reporting system to ensure transparency, appropriate disclosures and the orderly development of the organisation. These issues may entail regulatory changes within the microfinance industry, including MFI registration, reserve requirements, compliance with prudential accounting norms, on and off-site supervision for efficient operation, accountability, good governance and overall sustainability of MFIs. Unless regulation can be enforced by effective supervision, the most cautiously perceived regulation would be useless, or even worse.

Bangladesh is best known for the largest microfinance industry in the world, and it represents the hub of MFIs around the world. However, Microfinance in Bangladesh remained unregulated from the 1970s until 2006. Despite various non-government organisation (NGO) led MFIs offering different products and services, e.g. savings, pension schemes, and microinsurance offerings in addition to compulsory savings products, there was no accountability of MFIs by the government or any other authority. Thus, regulation and monitoring of Microfinance had received considerable attention from the Bangladesh Central Bank, multilateral development organisations (e.g. ADB, WB, and UN), policymakers, government and felt a strong need to introduce an appropriate regulatory framework for the microfinance industry.

The action came in the formation of the Microcredit Regulatory Authority (MRA) through the passage of the *Microcredit Regulatory Authority Act, 2006* as a means to achieve effective regulation and supervision of the microfinance industry. MRA was formed with the mission to ensure the transparency and accountability of microfinance operations. This new regulatory regime changed activities within MFIs and the relation between MFIs and their clients in Bangladesh. Having a licence from the MRA become mandatory for NGOs that wanted to practise microfinance in Bangladesh. However, a large number of MFIs remained unregulated and continue to operate without a MRA licence, leaving them unaccountable to any authority in Bangladesh.

This research aims to examine differences, if any, between regulated and unregulated MFIs and associated outcomes from an organisational perspective, as well as client perspective. It

forms hypotheses based on a theoretical model that is developed. From an organisational perspective, the investigation is focused on *governance, outreach, and financial sustainability*, while from a client's perspective; it is focused on clients' *knowledge and awareness about their loans, savings and their financial institutions*. The major contribution of this study is to propose models that explain the complex relationship between MFIs' governance, outreach and financial sustainability and their clients' financial literacy, considering MFIs' regulatory status (regulated/unregulated). The models propose that regulated MFIs exhibit superior discretionary governance practices, superior outreach, and superior financial sustainability, compared with unregulated MFIs. The models also propose that governance of regulated MFIs is associated with positive outreach and financial sustainability. On the other hand, from a client perspective, clients of regulated MFIs have comparatively better financial status and higher financial awareness. Moreover, clients with better financial awareness on loans and savings are associated with higher financial status than their counterparts. The findings support these hypotheses.

This research utilises, stratified random sampling to select 86 from 706 registered (*approx. 12 per cent*) MFIs which had operated for at least the last 10 years reported in the MRA database (MRA, 2018). Additionally, the Mix Market and CDF databases were used to randomly select 63 unregistered MFIs from the 500 (*approx. 12 per cent*) listed as operating for a similar duration. Structured and unstructured (open-ended) interview instruments were developed and utilised for the study as the principal data-gathering instrument. Secondary data were drawn from annual reports and published audited financial statement data from the MIX Market database, Credit Development Forum (CDF) reports (2006–14), the MRA head office, and individual MFI websites and other communication channels used by MFIs. Various quantitative techniques are used for testing the hypotheses and models.

Proposed relationships between microfinance regulation and MFIs' governance, outreach, and financial sustainability and the inter-relationships between governance, outreach and financial sustainability are supported. From a clients' perspective, the analysis also supports relationships between MFIs' regulatory status and their clients' financial literacy and financial intermediation. Consistent with prior research, the results show a positive association between microfinance regulation and governance, outreach and financial sustainability of the MFIs. To the author's knowledge, there is no prior study conducted in the area of microfinance regulation from a client perspective.

This study fills a research gap given that very few studies examine the microfinance industry at both institutional and client level. This study provides in-depth understanding and significant insights for policymakers, governments, and donors with respect to regulation of MFIs. It does this by providing a clear and comprehensive picture of both organisations and client-level perspectives. This research will be assisting effective decision making for designing and implementing policies to achieve an effective regulatory system for the microfinance industry. From a client perspective, this study provides an evidence-base that can help governments address MFI clients' interests and optimise social welfare, as well as the overall sustainability of the microfinance industry.

## Dedication

*To the blessed memory of my beloved*

*Parents*

*(Zahanara Parveen*

*and*

*Hasan Morshed)*

*for the great strength and courage,*

*you lifted me up*

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First and foremost I would like to thank and acknowledge the care and support of Almighty God who strengthened me to pursue the successful completion of this doctoral journey. It has been a long journey with many challenges.

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## Swinburne University of Technology

## Declaration

I, Zakir Morshed hereby confirm that the thesis entitled

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Submitted for the degree of

Doctor of philosophy

is the result of my own work. This research does not contain any material that has been accepted for the award of any other degree or diploma to the candidate. Reference is made to the work of other researchers in this current study, a proper acknowledgement is given.

I also certify that to the best of my knowledge, this research does not contain any material that is published previously or written by another researcher.

**Zakir Morshed**

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## Acronyms and Abbreviations

| | |
|---|---|
| ASA | Association for Social Advancement |
| ATO | Australian Taxation Office |
| BBVA | Banco Bilbao Vizcaya Argentaria |
| BRAC | Building Resources Across Communities |
| BRDB | Bangladesh Rural Development Board |
| BSB | Bangladesh Samabaya Bank |
| BSBL | Bangladesh Samabaya Bank Ltd |
| CAC | Corporate Affairs Commission |
| CBE | Central Bank of Egypt |
| CBN | Central Bank of Nigeria |
| CBRC | China Banking Regulation Commission |
| CDF | Credit and Development Forum |
| CGAP | Consultative Group to Assist the Poor |
| CMAC | Cajas Municipals de Ahorro y Crédito |
| CMEF | Council of Microfinance Equity Funds |
| CNBV | Comisión Nacional Bancaria y de Valores |
| CPRU | Children's Policy and Regulation Unit |
| CRDB | Cooperative Rural Development Bank |
| EDPYME | Empresas de Desarrollo de Pequeña y Microemp |
| EU | European Union |
| FEPCMAC | Federación Peruana de Cajas Municipales de Ahorro y Crédito |
| GFEP | Global Financial Education Program |
| GHAMFIN | Ghana Microfinance Institution Network |
| IMF | International Monetary Fund |
| InM | The Institute for Inclusive Finance and Development |
| IRDP | Integrated Rural Development Program |
| KSS | Krishak Samabaya Samity |
| MCC | Micro Credit Company |
| MFRC | Microfinance Regulatory Council |
| MRRU | Microfinance Research and Reference Unit |
| NABARD | National Bank for Agriculture and Rural Development |
| NCR | National Credit Regulator |
| NRIC | National Risks Information Centre |
| PKSF | Palli Karma Sahayak Foundation |
| RRF | Rural Reconstruction Foundation |
| SBV | State Bank of Vietnam |
| SRI | Stanford Research Institute |
| TCCA/UCCA | Thana or Upazila Central Cooperative Associations |
| UN | United Nations |
| UNCDF | United Nations Capital Development Fund |
| UNDP | United Nations Development Programme |
| USAID | United States Agency for International Development |

# Table of Variables

## Organisation level

| | |
|---|---|
| Registered_MFI | Registration status of MFI |
| Director_Selected | Is the council of directors elected? |
| Director_Attendence | Is it mandatory for the directors to attend board meetings? |
| Director_Voting_Right | Does the council of directors have voting rights to the executive committee? |
| Internal_Audit | Is a yearly internal audit conducted for the organisation? |
| Publish_Annual_Report | Do you publish your annual report along with the financial report (every year)? |
| Inform_Clients | Do you inform your members about their rights and responsibilities at the beginning of the loan disbursement? |
| Council_Directors | Does your organisation have a council of directors? |
| CEO_Chair | Is there any familial relationship (parents/children/spouses/siblings) between the CEO and chairman of the organisation? |
| Independent_Board_mem | Do you have independent board members? (at least 50%) |
| Board_Qualification | Do your board members have qualifications or experience in banking/business/ finance/law/management? (for at least one of the board members) |
| Emergency_Safety_Fund | Do you carry any type of emergency or safety fund other than a depositor's safety fund? |
| Loan_Classification | Do you practise loan classification? |
| Decline_Balance_Method | Do you calculate monthly interest on average balance determined on the basis of the balance of deposits at the beginning and end of every month (declining balance method)? |

| | |
|---|---|
| Committee | Presence of committees (executive/risk/audit/HR/corporate governance) (at least three) |
| Policy_Change_Upgread | In the past year, did the board change/upgrade policies concerning product range/product distribution network/source of capital/client protection/internal control/regulatory compliance? (any two) |
| Member_External_Authority | Is the organisation member of PKSF, CDF, or any other external authority for guidance, monitoring, supervision, or accountability |
| External_Audit | Is there a yearly external audit carried out by MRA or any other authority? |
| Board_Member_Evaluation | Does a yearly evaluation of board members occur? |
| Board_Member_Training | Is there training for board members? |
| Recovery_Rate | Recovery rate |
| Total_net_savings | Total net savings |
| Female_CEO | Female CEO |
| CreditProgramAge | Year (age) of credit program as at 2014 |
| No_Of_Branch | Number of branches |
| Avrg_Loan_Balance | Average loan balance |
| Credit_Borrower | No. of credit borrowers |
| OSS | Operational self-sufficiency |
| ROA | Return on assets |
| Portfolio_Yield | Portfolio yield |
| Interest_Rate_Spread | Interest rate spread |
| Total_Outstanding_Loans | Total outstanding loans |

## Client level

| | |
|---|---|
| Registered | Registration status |
| Knowledge interest rate | Do you know the interest rate (per month) on your loan and savings charged by and paid by your MFI? |
| Maintain loan pass book | Do you maintain any loan or savings passbook given by your MFI? |
| Receive promissory note | Do you have a copy of the promissory note for your records? |
| Loan Info from branch | If you require, can you get 'loan and savings information' from your branch office on any working day? |
| Knowledge about saving | Do you have savings with your MFI? |
| Knowledge service charge | Do you know what your service charge is? |
| Knowledge savings interest | Do you earn any interest on your savings? |
| Knowledge loan type | Do you know the types of loans and other facilities available from your MFI? |
| Knowledge terms of loans | Do you know the terms and conditions of the loan? |
| Knowledge insurance Services | Do you know about the fees, premium, and settlement of the claim of your insurance service? |
| Knowledge withdrawing savings | Can you withdraw your savings (partially or fully) from your MFI (if your loan is cleared)? |
| Knowledge voluntary savings | Do you have any other voluntary savings in your MFI? |
| Education | What is your highest education degree? |
| Client_Business | Do you have a business? |
| Client_Age | What is your age? |
| Married | What is your marital status? |
| Children | How many children do you have? |

# CHAPTER ONE

# Why investigate the role of regulation in the microfinance industry?

## 1.1 Introduction

Microfinance[1] is considered one of the products of new developmental thinking and strategy making (Ahmeit, 2014; Habib, 2008; Hatta et al., 2016). For the last few decades, it has engaged the attention of economists, social scientists, policymakers, and governments (Ahmeit, 2014). The principal aim of microfinance is not to maximise profit or even to cover lending institutions' management or organisational costs. Its fundamental aim is to alleviate poverty, empower women, and enable financial inclusion by ensuring access to appropriate financial products and services needed by vulnerable and low-income groups at an affordable cost (Habib, 2008; Harper, 2002). One of the most important characteristics that distinguishes microfinance from other financial intermediations is what has come to be called the 'dual mission' of balancing a social objective (Campion and Frankiewicz, 1999) with a financial objective by driving microfinance institutions to achieve self-sufficiency and thereby accomplish sustained service delivery (Rock et al., 1998). But how do MFIs best reach and combine these two goals? In a review of 170 papers, Hermes and Hudon (2018) found that the direction of the relationship between these two goals depends on country-specific contexts. Hermes and Hudon (2018) claim that MFIs achieve outreach by focusing on very poor clients and MFIs' focus on profit maximisation may co-exist in the industry. That is, there is space for

[1] In the literature, the terms 'microfinance' and 'microcredit' are often used interchangeably, but it is crucial to recognise the distinction between these two terms. In a broad sense, 'microcredit' is the act of providing small loans to the poor who have been disqualified by commercial banks' demand for collateral. In contrast, microfinance is the act of providing small loans to the same borrowers together with some other financial services, such as different types of loans (small enterprise loans, home and education loans, agriculture loans, etc.), different types of insurance policies, saving institutions, different types of development services and training, health education services, awareness programmes, and social development services (Baten, 2009). The following section on the development of microfinance services in Bangladesh highlights the period 1971 until present. In the beginning, the concept of microfinance was only about providing credit to the non-banker poor, but not any other financial services, so here the appropriate term is 'microcredit'. Since 1983, after the concept of modern microfinance, which includes all other types of services, came into being, the term 'microfinance', not 'microcredit', is applicable.

both types of MFIs. Some MFIS are very profitable and tend to compete with traditional financial institutions, while others focus on serving the poor segment of the population by maximising outreach. Microfinance is thus a popular development tool in developing and developed countries.

With the increased interest in microfinance as a poverty alleviation tool, its regulation has been added to the agenda of microfinance practitioners, researchers and other stakeholders. Several researchers claim that there is a possibility of financial instability and non-sustainability if the need for regulation is marginalised (Chaves and Gonzalez-Vega, 1994; Christen and Rosenberg, 2000; Robinson, 2001; Wood and Sharif, 1997). Jackson and Islam (2005) also revealed that the need for regulation and supervision of microfinance institutions (MFIs) arises from several considerations, including protecting the interests of small depositors, ensuring proper terms of credit and financial discipline, and institutionalising an appropriate reporting system for orderly development (Jackson and Islam, 2005).

Over the last one and a half decades, regulatory issues have received considerable attention from central banks, multilateral development organisations (e.g., the Asian Development Bank, the World Bank, and the United Nations), policymakers, governments and the requirement for regulation of microfinance has been increasing in both developed and developing countries (Islam and Mamun, 2011; Staschen, 2010). It is important to note that this need for regulation is contingent on country-specific microfinance issues, and the nature of claims (Haq et al., 2008). Bangladesh, which is the scope of this current study, is considered to have one of the oldest and most mature microfinance industries in the world (Sinha, 2011), and has not been an exception from calls for regulation.

Since the formation of the Microcredit Regulatory Authority (MRA), registered MFIs in Bangladesh have received guidelines and training materials for improving good governance and transparency in their financial and operational systems; guidance about proper terms of credit and financial discipline; as well as encouragement for provision of social and enterprise development services for clients (Ahmed, 2013; Rashid, 2010). Despite the positive steps taken by the MRA, several MFIs in Bangladesh choose to remain unregistered with the Authority. This study investigates the role of regulation by examining whether differences exist in the area of MFIs' governance and performance between regulated and unregulated MFIs and their clients' financial literacy and the nature of any differences that do exist.

This introductory chapter of the thesis highlights the background, purpose, significance, and rationale for this study. The chapter commences with the background and purpose (Section 1.2), followed by an overview of the research problem (Section 1.3) and the research questions (Section 1.4). The chapter then summarises the key theoretical concepts (Section 1.5) used in this thesis. Then the chapter discusses the research method and the key findings (Section 1.6), followed by an explanation of the significance of this study and its contribution (Section 1.7). The structure of the remainder of the thesis is explained in Section 1.8. Finally, Section 1.9 presents a summary of the chapter.

## 1.2 Background and purpose

### 1.2.1 Background

Bangladesh is best known for pioneering microfinance and is well known for hosting the largest microfinance industry in the world (CDF, 2006). With one of the largest microfinance industries (Bedson, 2009) and the hub of MFIs around the world (Hossain and Bayes, 2015), microfinance in Bangladesh remained unregulated from the 1970s until 2006[2]. In 2006, the

[2] Grameen Bank, the first microfinance institution in Bangladesh, is regulated by the Grameen Bank Ordinance 1983, and it remained beyond the surveillance of the country's Central Bank until 1997 as per Clause 4(3) of this Ordinance, which restricted application of the then banking law, Banking Companies Ordinance, 1962 (Ahmed, 2013). The Grameen Bank did not come under the Central Bank's supervision until the late 1990s (Cracknell, 2012). This is so despite the fact that, from achievement of independence in 1971 until 1989, other than the Grameen Bank, financial institutions such as government-owned agricultural banks, state-owned commercial banks, and cooperatives, were delivering some microfinance services among the landless poor in rural areas of Bangladesh. Agricultural banks and six other state-owned commercial banks were regulated by the Banking Companies Ordinance 1962 (Ahmed, 2013).

MRA (Microcredit Regulatory Authority) was established as a regulatory and supervisory body with oversight of the industry (MRA Act, 2006).

The mission of the MRA is to ensure the transparency and accountability of microfinance operations (MRA, 2018). Bangladesh microfinance statistics (CDF, 2014; MIX Market, 2018) show that a large number of MFIs either choose to remain unregulated or have failed to achieve registration with the MRA. These unregulated MFIs continue to practise microfinance without an MRA licence and hence without any monitoring or supervision from the government or any other authority in Bangladesh. Furthermore, these unregulated MFIs are not accountable to any authority and are not required to submit financial or other information to any authority or regulatory body. Examining why these unregulated MFIs choose to remain unregulated while others conform, and the impact of this choice is an important issue. This current research investigates the role of regulation by examining the differences (if any) between regulated and unregulated MFIs in the area of their governance and performance.

### 1.2.2 Purpose of this study

Since the establishment of the MRA, regulated MFIs in Bangladesh have received various discretionary guidelines to improve good governance, and directions to improve financial and operational transparency (MRA 2018). These guidelines often include instruction or training materials for clients on various topics, e.g. financial and enterprise development, empowering women initiatives through financial literacy training, women's and children's healthcare programmes, women's rights and domestic violence (Ahmed, 2013; Badruddoza, 2013). It is important to note that even for registered MFIs, these guidelines and directions are not mandatory to follow. These guidelines and resources are publicly available on the MRA website, however unregistered MFIs do not receive any encouragement from the MRA or any other organisation to engage with client financial literacy or enterprise training programs, or social, cultural or health development programs for the welfare of their clients. The mission statement of the MRA (MRA, 2018) states that these guidelines and resources are available for the clients' capacity building and welfare and the overall sustainability of the microfinance industry in Bangladesh. In contrast, the unregulated MFIs continue to provide microfinance services to the poor and vulnerable population without any oversight. Consequently, the savings and welfare of poor and vulnerable clients of unregistered MFIs are left unmonitored and unprotected.

The purpose of this research is to investigate whether there are differences between regulated and unregulated MFIs in Bangladesh in terms of governance and performance outcomes. The thesis examines differences (if any) from an organisational perspective (MFIs' discretionary governance practices) and operational performance (outreach and financial sustainability). The term "discretionary" refers to the non-mandatory governance practices required for MRA registration. This thesis also investigates the differences (if any) between regulated and unregulated MFIs in terms of their clients' awareness and knowledge about their respective MFI, clients' financial literacy, and clients' overall financial status. The motivation for and rationale behind investigating the role of microfinance regulation in its association with outcomes for Bangladesh MFIs and their clients are highlighted in the following section.

## 1.3 Why investigating microfinance regulation is important

Good governance is one of the important elements to achieve MFIs' key objectives and promote further development of the industry (Cull et al., 2007; Hartarska, 2005). The literature also discusses how many MFIs struggle to achieve financial sustainability while providing quality services to their poor and vulnerable clients with appropriate accountability (Barry and Tacneng, 2011; Chiumya, 2006; Cull, et al., 2011; Pati, 2015; Tchuigoua, 2010). Therefore, external monitoring and regulation of MFIs need careful examination to better understand the role of regulation in outcomes for MFIs and their stakeholders (especially clients) and the overall development and sustainability of the industry. The following sections highlight the rationale of and motivation for this study.

### 1.3.1 Influence of microfinance regulation on MFI governance and performance

The motivation for this research stems from the lack of prior research that investigates the role of microfinance regulation in MFI performance at both organisational and client levels. Table 1.1 (page 13) lists 17 studies published between 1999 – 2018 that examine the role of regulation in MFIs' corporate governance and performance and in MFI client outcomes. This Table also reveals that only three studies (Afonso et al., 2017; Banerjee and Jackson, 2017; Ghosh et al., 2014) examine microfinance regulation from a client perspective for regulated MFIs. However, no study has investigated the financial literacy of clients of unregulated MFIs and differences in financial literacy between clients of regulated and unregulated MFIs is unknown.

Microfinance clients are vulnerable and sometimes do not know or understand their rights and responsibilities (Chaudhury and Matin, 2002). There are a number of examples of abuse, mistreatment, and exploitation of loan collection from poor vulnerable clients in Bangladesh (Banerjee and Jackson, 2017; Maˆıtrot, 2018). Hammill et al. (2012) provide support for this view, finding that poor clients of MFIs often go without nourishment to pay back their microloans in countries like Bangladesh and other parts of the globe.

In a study of the Bangladesh microfinance industry, Banerjee and Jackson (2017) observed incidences of abuse and malpractice by MFIs and their employees with adverse effects on vulnerable, poor clients. This malpractice, humiliation and mistreatment of clients by MFI staff ultimately questions the existing MFI dual mission theory and the strategy of financial inclusion, poverty alleviation and empowerment of women practiced by MFIs in Bangladesh.

Another study by Maˆıtrot (2018) found the same picture of malpractice by MFI staff, which included push selling of loans and forceful loan renewals, no or very little follow-up about the use of loan money, poor client selection, exploitation and violent client-retention and repayment collection strategies. Maˆıtrot (2018) termed this picture as 'practice drift' by MFI field level officers, which is distinct from 'mission drift[3]' at the head office or branch level. Maˆıtrot (2018) argues that these malpractices in MFIs are enabled by too much decentralisation in their structure, an insufficient social performance monitoring framework, and overall poor management and governance practices.

Banerjee and Jackson (2017) also found the same picture. That is, MFIs in Bangladesh often use aggressive loan recovery strategies that create humiliation and disrespect, and finally demotivate MFI clients in their commitment to repayment. These authors also found everyday practices involving negligence, violence and abuse of clients by MFI branch level and field level staff. A statement from a farmer in Bangladesh describes how MFI staff arrived at a funeral to collect debts, revealing a picture of abuse:

> "*His dead body was in front of the house and the family was shedding tears at his sudden death. In the meantime, the field representative [for the MFI] was asking to pay the dead man's loan and suggesting that the relatives collect the money for him. Then the people get very angry and he left. He came back after one week and the relatives continued his loan*" (Banerjee and Jackson, 2017, p.79).

Another MFI client in Bangladesh, who failed to repay her weekly repayment because of a family crisis was blacklisted by her MFI as a defaulter. She stated:

> "*When we can't pay the NGO enter our house to see if they can take anything. Once they took my only water bucket. And my sheelnoda [mortar and pestle]. They say once I repay the loan they will return it. Once they even brought police to my house*" (Banerjee and Jackson, 2017, p.79).

Maˆıtrot (2018) reports that clients with regular repayments faced forceful loan renewal. A statement from a client reveals that:

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[3] This is a tendency by MFIs to extend large average loan sizes in the process of scaling up. Unfortunately this phenomenon is not driven only because of transaction cost minimisation but the social objectives (by providing financial and other welfare services to the poor) of poverty-oriented MFIs could potentially deviate from their goal by extending larger loan sizes because of the shifting of the objective of MFIs towards profit maximisation, like other commercial financial institutions.

"*Once clients manage to repay their loan, credit officers force them to borrow larger amounts regardless of their needs, income or ability to repay: Then at times they try to exert force. They knock down the doors and slam doors, such kind of pressure . . . they coerce us into taking loans. They say that if we do not take loans then they shall take inappropriate action and even violence*" (Maˆıtrot, 2018, p.21).

These abuses and exploitation by MFI staff welcome social vulnerability, insult, disappointment and shame, as well as negative social consequences that jeopardise the dual mission strategy of microfinance.

Unfortunately, these abuses and malpractices are observed not only for the poor clients of MFIs but are also seen within MFIs' governance practices for their employees. A statement from a MFI field staff member (loan collection officer) reveals:

"*When I do not get an instalment then I inform my boss that 'sir, there is a problem in this house and they cannot repay today'. Then my boss orders me to sit in that house until my clients give the money, up to 12 or 1 o'clock at night. 'If you have to sit there throughout the night you will, but do not come back without the instalment' he says. And we are not authorized to enter the office without the instalment. Whatever happens I have to collect the instalment and then can go to the office So if I leave without the money and I face this kind of mental and physical torture I feel like quitting the job*" (Maˆıtrot, 2018, p.24).

Another field staff member states that:

"*Working during the night and on weekends to collect repayments is compulsory to avoid disciplinary measures such as personal financial sanctions and the loss of promotion prospects. It is also necessary to circumvent the negative collective implications that non-repayment could have for their branch, which would threaten their relationships with their manager and colleagues. Credit officers are strongly incentivized to solve problems by themselves, and do 'what works', since involving members of staff higher up in the hierarchy reflects negatively on their capabilities and often generates resentment among colleagues*" (Maˆıtrot, 2018, p.24).

Also, MFIs' desire to mobilise client deposits (Jackson and Islam, 2005) needs careful observation and monitoring for safeguarding of clients' deposit money and protection from financial loss. A case study by Ahmmed (2003) reveals that some NGOs in Bangladesh commit fraud on their clients by escaping with large savings deposits. This malpractice by MFIs creates not only financial loss for poor clients, but also a loss of confidence in the dual mission of microfinance by the general population and particularly by the stakeholders of the microfinance industry.

Given this evidence, there are strong reasons to believe that these everyday practices of abuse, negligence, and violence affecting MFI clients and staff need proper monitoring and regulation by an external regulator in order to create MFI accountability and good governance practices and protect the rights of poor, vulnerable MFI clients. As the MRA is the regulatory authority with overall monitoring and supervisory responsibility for the microfinance industry in Bangladesh, the foregoing discussion triggers questions about the role of microfinance regulation from both client and organisation perspectives. This investigation of differences between regulated and unregulated MFIs and their clients may help the government, regulator and practitioners to take more effective decisions in policy formulation and guide conduct to pursue the welfare of MFIs and their clients and enhance the overall sustainability of the industry.

### 1.3.2 A comprehensive picture of regulation of MFIs

Although there are numerous studies that have investigated the impact and role of regulation in the microfinance industry, these studies do not provide a comprehensive picture of the role of regulation in MFIs' corporate governance practices and performance. Referring again to Table 1.1, the table classifies regulation (R) of MFIs' governance practices and performance into three categories: governance (G), outreach (O), and financial sustainability (F). Of the 17 studies, six examine regulation and outreach and financial sustainability (R/O/F) (Ayayi and Peprah, 2018; Chiumya, 2006; Cull, et al., 2011; Estape-Dubreuil and Estape-Dubreuil, 2015; Hartarska and Nadolnyak, 2007; Pati, 2015), one examines regulation and governance and financial sustainability (R/G/F) (Barry and Tacneng, 2011), one examines regulation and governance and outreach (R/G/O) (Khalily and Khaleque, 2014), one investigates regulation and governance (R/G) (Okoye and Siwale, 2017), three examine regulation and financial sustainability (R/F) (Ghosh, et al., 2018; Islam et al., 2013; Tchuigoua, 2010) and three examine microfinance regulation from a client perspective (R/C) (Afonso et al., 2017; Banerjee and Jackson, 2017; Ghosh, et al., 2014).

Also, Table 1.1 reveals that most microfinance regulation studies examine issues from either the organisation level (supply side) or client level. None examine microfinance regulation from both perspectives concurrently. Even from an organisation perspective, none of the studies investigates microfinance regulation using all three traditional measures of MFI performance (governance, outreach and financial sustainability) concurrently. Table 1.1 also shows that although three studies (Afonso et al., 2017; Banerjee and Jackson, 2017; Ghosh, et al., 2014) examine the role of regulation from a client perspective, the data used comes from only regulated MFIs. Any difference between regulated and unregulated MFI clients' financial literacy and status remains unexplored.

This current study is based on the belief that for a comprehensive understanding of the role of microfinance regulation, the inclusion of all three aspects (governance, outreach, and financial sustainability) and all key stakeholders (the regulator [MRA], regulated MFIs, and MFI clients) is crucial. In this regard, another motivation for this study comes from filling the gap in prior studies by investigating the role of microfinance regulation for all these key stakeholders (the regulator [MRA], regulated and unregulated MFIs, and their (MFIs') clients) in order to contribute to our knowledge and better understanding of effective microfinance regulation.

### 1.3.3 Traditional command and control vs responsive regulation

Another motivation for this study comes from the type of microfinance regulation investigated within the existing literature. Most prior studies (Table 1.1) investigate the impact of prudential regulation (command and control) in the area of governance and performance (outreach and financial sustainability). The role of responsive regulation and application of stakeholder theory in a microfinance context are left underexplored.

Prior research (Afonso et al., 2017; Barry and Tacneng, 2011; Chiumya, 2006; Cull et al., 2011) shows that traditional command and control regulation is cumbersome, inflexible, costly, and inefficient (Sinclair, 1997), making it inappropriate given the innovative nature of microfinance where trust, bonding, relationships and commitment between stakeholders play the key role in the success of the microfinance practice ((Maˆıtrot, 2018). On the one hand, responsive regulation engages with regulatory spaces in terms of the negotiation 'responsiveness' between regulators, the regulated, and the wider community, and is enforced through rational strategising and self-regulatory techniques (Ayres and Braithwaite, 1992; Wright and Head, 2009). On the other hand, stakeholder theory has provided fundamental theoretical support for researchers over the last few decades, facilitating understanding of and ways to address the relationships between organisations and stakeholders from different perspectives (Uribe et al., 2018). These relationships are crucial for achieving a balance between the economic, social, and environmental dimensions of an organisation, which is a precondition for the overall sustainability of the organisation (Hung, 2011; Uribe et al., 2018).

Previous, researchers have investigated of the impact of responsive regulation (Braithwaite, 2016; Choi et al., 2016; Schell-Busey et al., 2016) and the use of stakeholder theory (Hung, 2011; Uribe et al., 2018). However, it is important to note that examining responsive regulation using stakeholder theory in the context of the microfinance industry has not been studied before. This investigation is necessary for a better understanding of the role of regulation in

MFIs, in protecting the rights of vulnerable MFI clients, as well as in enhancing the overall welfare and sustainability of the microfinance industry. This analysis addresses this gap by adopting responsive regulation and stakeholder theory in the context of the microfinance industry to explain the behaviour of key stakeholders (MFIs, clients, MRA). This study is likely to provide insights for microfinance practitioners, regulators, governments, and policymakers in implementing policies and recommendations concerning regulation for the benefit of MFIs and their clients.

**Table: 1.1 Studies of microfinance regulation and its impact on MFIs' governance, performance (outreach and financial sustainability), and clients' financial and awareness status[4]**

| No. | Study | Coverage | Analysis technique used | MFI type | Microfinance Regulation type (NR/ SR/ EBR/ SWR/ PR) * | Organisation level analysis | | | Client level analysis |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Governance (G) | Outreach (O) | Financial sustainability (F) | (C) |
| 1 | (Afonso et al., 2017) | Dominican Republic | Qualitative. Semi-structured interview. Database Central bank, REDOMIF, FondoMicro, Global Findex Database. (2012–2014) | Regulated | SR, Prudential (command control) regulation | **C (-):** High-standard microfinance service provision within a regulated (prudential) expanding industry does not necessarily bring about positive social outcomes for clients. | | | |
| 2 | (Ayayi and Peprah, 2018) | Ghana | Quantitative. Structured questionnaire. Database: MIX Market database (2000-2013). | Regulated/ unregulated | Prudential (command control) regulation | **O (-), F (-):** Prudential regulation increases business costs. MFIs pass this increased cost to their clients as interest. The regulation also has an adverse effect on MFIs' outreach | | | |
| 3 | (Banerjee and Jackson, 2017) | Bangladesh | Qualitative. Interview. (2017) | Regulated | | **C (-):** Microfinance or unguided and unmonitored microfinance led to an increasing level of indebted communities and exacerbated economic, social and environmental vulnerabilities | | | |
| 4 | (Barry and Tacneng, 2011) | 34 Sub-Saharan African countries | Quantitative. Database: MIX Market database. (1996–2008). | Regulated/ unregulated | Prudential (command control) regulation | **G (-), F (-):** Regulation of MFIs increases the risk for their sustainability. Regulation has a negative impact on the overall performance of MFIs | | | |
| 5 | (Chiumya, 2006) | Zambia | Qualitative. Analytical, descriptive, case study. Semi-structured interviews and documentary review. Interviews, data, survey data. (2004). | Regulated | Prudential (command control- EBR) regulation | **O (-), F (-):** Regulation of the microfinance industry has a negative impact on the development of the industry. The cost of regulation outweighs the benefit to stakeholders | | | |
| 6 | (Cull, et al., 2011) | 67 countries (not | Quantitative. | Regulated | Prudential (command | **O (-), F (-):** | | | |

[4] These microfinance regulation studies are discussed in detail (population, analysis technique, regulation impact) in chapter two of this thesis.

| No. | Study | Coverage | Analysis technique used | MFI type | Microfinance Regulation type (NR/ SR/ EBR/ SWR/ PR) * | Organisation level analysis | | | Client level analysis |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Governance (G) | Outreach (O) | Financial sustainability (F) | (C) |
| | | including Bangladesh) 2003 and 2004 | Empirical, Database: MIX Market database | | control) regulation | Commercially oriented MFIs which are under non-prudential regulation are not less profitable compared to prudential-regulated MFIs, whereas non-commercial oriented MFIs with regular supervision are significantly less profitable than unregulated MFIs | | | |
| 7 | (Estape-Dubreuil and Estape-Dubreuil, 2015) | 82 countries (excluding Bangladesh) | Quantitative. Database: MIX Market database (2011). | Regulated | Prudential (command control) regulation | **O (+), F (±):** The regulation does not have any impact on social performance or overall MFI performance, but it has a significant effect on ROA | | | |
| 8 | (Ghosh, et al., 2018) | India | Quantitative. Structured questionnaire | Regulated | Prudential (command control-RBR) regulation | **F (±):** Transformation of NGOs to Non-Banking Financial Company (NBFCs) may not improve the performance of Indian MFIs | | | |
| 9 | (Ghosh, et al., 2014) | India | Qualitative and quantitative approach. Database: MIX Market, MFIN, M-CRIL databases. Survey. (2008–2011). | Regulated/ unregulated | Prudential (command control-EBR) regulation | **C (+):** Policies, supervision, and regulation need to drive consumer-centric behaviour on the part of MFIs, as well as encourage innovation, growth, and sustainability of MFIs | | | |
| 10 | (Hartarska and Nadolnyak, 2007) | 62 countries (excluding Bangladesh) | Quantitative. Database: MIX Market database. Multiple regression analysis. | Regulated | Prudential (command control) regulation | **O (±), F (±):** The regulatory environment does not directly affect the performance of MFIs. MFIs collecting savings have better outreach, which indicates the indirect effect of regulation when regulation is the only way for MFIs to access savings | | | |
| 11 | (Islam et al., 2013) | Bangladesh | Quantitative. Empirical, data from MRA for 215 MFIs for 2009 MRA database. | Regulated | Prudential (command control-SWR) regulation | **F (+):** MFIs that have a lower proportion of administrative costs and a larger interest rate spread are more likely to gain financial sustainability | | | |
| 12 | (Khalily and Khaleque, 2014) | Bangladesh | Quantitative. Database: MRA and PKSF databases (2005–2011). | Regulated | Prudential (command control-SWR) regulation | **G (+), O (+):** Because of external regulation (MRA), a substantial improvement is observed in average loan per staff and average loan size. Member savings and institutional borrowing increased, showing increased confidence by both savers and lenders | | | |

| No. | Study | Coverage | Analysis technique used | MFI type | Microfinance Regulation type (NR/ SR/ EBR/ SWR/ PR) * | Organisation level analysis | | | Client level analysis |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Governance (G) | Outreach (O) | Financial sustainability (F) | (C) |
| 13 | (Maˆıtrot, 2018) | Bangladesh | Descriptive | Regulated | SWR | **G (-), C (-):** Without proper monitoring and follow-up supervision, an external regulatory system (MRA) is unsuccessful. It may welcome poor governance practices, such as too much decentralisation in MFIs' governance structure, an insufficient social performance monitoring framework, and overall poor management and governance practices. | | | |
| 14 | (Nyanzu and Peprah, 2016) | 30 Sub-Saharan African countries. | Qualitative and Quantitative. Database: World Bank Data Indicators and Worldwide Governance Indicators. (2002–2012). | Regulated | Prudential (command control) regulation | **O (-) (+):** Regulated MFIs decrease the depth of outreach but increase the breadth of outreach and offer a larger loan size than non-regulated MFIs. Also, regulated MFIs serve fewer women compared to non-regulated MFIs | | | |
| 15 | (Okoye and Siwale, 2017) | Nigeria and Zambia | Quantitative. Secondary data from MIX Market database. | Regulated | Prudential (command control) regulation | **G (-):** Regulation has a negative impact on board composition for both countries (Zambia and Nigeria). The ownership requirement in the regulation has resulted in differing governance implications. A weak regulatory structure in both countries has a negative impact on risk management of MFIs | | | |
| 16 | (Pati, 2015) | India | Quantitative. Empirical, panel data, MIX Market database (2008–2009 and 2012–2013). | Regulated | Prudential (command control) regulation | **G (-), F (-):** External regulation or maturity of MFIs has no impact on MFIs' performance. Regulation is negatively related to MFIs' ROA. | | | |
| 17 | (Tchuigoua, 2010) | Latin America | Quantitative. Database: MIX Market database. 202 MFIs. Univariate analysis – One-way ANOVA (2001-2006) | Regulated/ unregulated | Prudential (command control) regulation | **F (-):** Performance of private corporations is better than that of NGOs only when portfolio quality is used as an indicator for measuring performance | | | |

**Legend:** No regulation (NR), Self-regulation (SR), Existing Banking Regulation (EBR), Special Window Regulation (SWR), Prudential Regulation (PR), Non-prudential Regulation (NPR). Notes: +indicates a positive impact of regulation, ± indicates no impact of regulation, - indicates a negative impact of regulation.

## 1.4 Research questions

The foregoing discussion implies that the role of microfinance regulation in terms of MFIs' governance practices and performance, and their responsibility and accountability to their clients, needs careful investigation. As such, the following research questions are posed:

**Organisation level:**

***Research Question 1:***

*What, if any, are the differences in governance practices, the institutional outreach, and financial sustainability between regulated and unregulated MFIs in Bangladesh?*

***Research Question 2:***

*What is the nature of the relationship between good governance and outreach for MFIs?*

***Research Question 3:***

*What is the nature of the relationship between good governance and financial sustainability for MFIs?*

**Client level:**

***Research Question 4:***

*Do clients of regulated/registered MFIs exhibit higher awareness of information about their loans and savings and knowledge of their financial institution compared with clients of unregistered/unregulated MFI clients?*

***Research Question 5:***

*Do clients of regulated/registered MFIs exhibit higher financial status compared with clients of unregistered/unregulated MFI clients?*

***Research Question 6:***

*Is there an association between the awareness of MFI clients in terms of information about their loans and savings and their financial status?*

## 1.5 Linking the key theoretical concepts and model testing

This study develops a theoretical and a conceptual model as forerunners to testing the proposed complex relationship between the governance, outreach, and financial sustainability of registered and unregistered MFIs (from an organisational perspective) and the relationship between MFI clients' financial status and their awareness about their rights and knowledge about their financial institutions (from a client perspective).

The theoretical model for this study incorporates stakeholder theory and regulation theory (responsive regulation) in order to predict expected outcomes of investigating differences between regulated and unregulated MFIs and their clients. The conceptual model extends beyond prior studies that have investigated either only the organisational perspective without considering the key stakeholder group (MFI clients) or only the client perspective. It does this by acknowledging the complex interrelationships that exist between MFIs and their clients.

The current study is based on the belief that researchers, governments, policymakers and donors can further utilise development and testing of the theoretical and conceptual models, to better understand the role of microfinance regulation for all key stakeholders (regulator, MFIs and their clients) within the industry.

## 1.6 Methodology and key findings

The extant theories discussed in the previous section (Section 1.5) and Section 1.3.3, provide potential explanations for the phenomena being examined in this current study, namely, the application of combined responsive regulation theory and stakeholder theory in order to reveal a comprehensive picture of microfinance regulation. From this theoretical foundation, constructs predicting regulated and unregulated MFIs' governance practices and performance, and MFI clients' awareness and financial status are developed in the form of eight hypotheses.

A structured and open-ended interview guide for use with MFI executives and a highly structured guide for use with MFI clients were designed to collect primary data. Secondary data was collected from the MIX Market database, the MRA website (MRA, 2018), and the CDF database (CDF, 2010; CDF, 2012; CDF, 2014). Longitudinal MFI performance data for registered versus unregistered MFIs and cross-sectional data for registered MFIs' governance practices and clients' financial and awareness status is used for testing of the hypotheses.

The findings show that regulated MFIs exhibit superior discretionary governance practices, superior outreach, and superior financial sustainability, compared with unregulated MFIs. The findings also reveal that the governance of regulated MFIs is associated with positive outreach and financial sustainability. On the other hand, from a clients' perspective, the analysis supports relationships between MFIs' regulatory status and their clients' financial literacy and financial intermediation. That is, clients of regulated MFIs have comparatively higher financial literacy and awareness and better financial status. Moreover, clients with better financial awareness about their loans and savings are associated with higher financial status than their counterparts.

## 1.7 Significance of the study

In the last decade, researchers and practitioners have recognised the importance of microfinance regulation. A number of reports and studies (e.g., Rashid, 2010; Jackson and Islam, 2005; Miah, 2006; Rahman and Luo, 2012; Ahmed, 2013; Akash et al., 2010; Yuge, 2011; Charitonenko and Rahman, 2002; Baten, 2009) have examined regulation of the microfinance industry across several countries. Studies examined several key issues relevant to regulation, for instance, registration requirements, reserve requirements, agreement with prudential accounting norms, and guidelines for and supervision (on-site and off-site) of operations and reporting systems (Ahmed, 2013; Rahman and Luo, 2012). The emphasis in these studies is on the significance and normative requirements of supervision and regulation of the industry, either from an organisational perspective or from a client perspective.

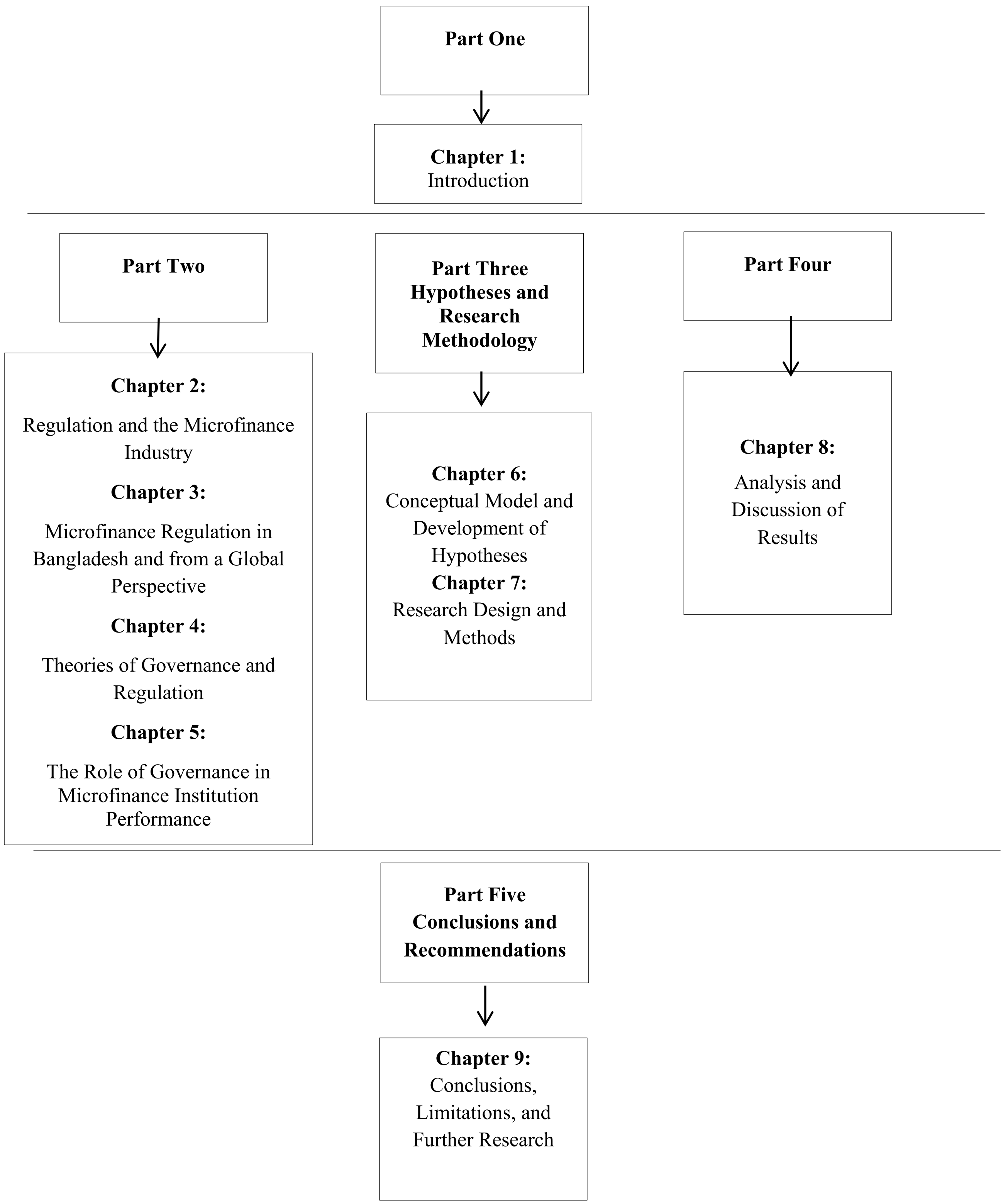
In this regard, as discussed earlier, the key contribution of this current study is to reveal the role of regulation of MFIs in their governance and accountability to their clients and also provide a comprehensive picture by incorporating both organisational- and client-level perspectives in investigating differences in outcomes (if any) that can be associated with microfinance regulation. Also, an adaptation of two theories (responsive regulation and stakeholder theory) to the microfinance context is argued to potentially provide new insights for better understanding of the relationship between regulated and unregulated MFIs and their key stakeholder group (clients). Given this, this study can be useful to researchers and may contribute to the literature on microfinance regulation through its application of the concepts of responsive regulation and stakeholder theory. This study may give a guideline and direction in implementing an effective regulatory structure for protecting the rights of poor and vulnerable MFIs' clients, enhance their (clients') awareness and knowledge, and encourage good governance practices by MFIs for the sustainability of the industry.

This research makes a significant contribution to the literature as it provides evidence and information for governments, regulators, MFIs, and other stakeholders of the microfinance industry. This is particularly important in relation to investigating MFIs' governance and performance and how these are influenced by microfinance regulation. Moreover, the study looks at the role of regulation with regard to the nature of the relationship between MFIs and their clients.

## 1.8 Thesis structure

The thesis is structured in five parts as illustrated in Figure 1.1. Part one comprises this current introductory chapter. Part two consists of four chapters in which the relevant literature is reviewed, microfinance regulation is explained from both global and Bangladesh perspectives and the relevant theories of entity governance and regulation are highlighted. Part three presents the hypotheses and methodology. Part four consists of the data analysis chapters, which include testing of hypotheses and presentation of results. Finally, part five presents a discussion of conclusions, limitations of this study, and future research areas.

**Figure1.1: Structure of the thesis**



## 1.9 Chapter summary

The study of microfinance regulation in terms of MFIs' governance and performance (outreach and financial sustainability) is not a new research topic, but prior studies are not comprehensive, leaving much to investigate about the role of regulation. The need to incorporate all key stakeholders of the microfinance industry within the rubric of a study has been under-emphasised in the past. No prior substantive microfinance regulation research investigates performance outcome issues from both the level of MFIs and their clients. This gap in scholarly work is in part attributable to an incomplete picture of microfinance regulation. A comprehensive picture of microfinance regulation considering all the key stakeholders is likely to enable understanding the role of microfinance regulation and contribute towards promoting good governance practices within MFIs, enhancing the financial literacy and awareness status of MFI clients, and promoting the overall welfare of the industry.

# CHAPTER TWO

# Regulation and the Microfinance Industry

## 2.1 Introduction

Microfinance institutions (MFIs) aim to attain double bottom line performance by delivering poverty alleviation and financial sustainability (Purkayastha et al., 2015). Over the last two decades, interest in the regulation and supervision of MFIs has arisen due to the exponential growth of the sector and MFIs' desire to mobilise client deposits (Jackson and Islam, 2005). As such, along with the widespread interest in microfinance as a poverty alleviation tool, its regulation and supervision have received increasing interest from researchers, scholars, donors, and governments in both developed and developing countries. Regulatory issues such as permission to lend, transparency, tax, consumer protection (other than depositor protection), and prevention of financial crime, have become the primary focus of their agenda (Battilana and Dorado, 2010; Cull et al., 20011).

The objective of this chapter is to provide an overview of the different approaches of microfinance regulation, informed by a review of the literature. The chapter commences with the background to regulation in the microfinance industry (Section 2.2). Section 2.3 highlights the different aspects of microfinance regulations and provides a brief discussion of the pros and cons of regulation. Section 2.4 introduces different potential approaches to microfinance regulation and also examines situations where regulation is absent. Section 2.5 discusses the legal framework of microfinance regulation. Section 2.6 elaborates on existing research in the area and identifies the gaps that this study fills. This section highlights the different types of regulation that researchers have analysed and the basis for the application of a particular type of regulation in specific contexts. An overall summary of the chapter is presented in Section 2.7.

Figure 2.1 depicts the structure of this chapter.

**2.1 Introduction**

**2.2 Regulation and supervision of the microfinance industry**

**2.3 Different aspects of microfinance regulation**

**2.4 Approaches to regulating the microfinance industry**

**2.5 Legal framework for MFIs' regulation**

**2.6 The literature on microfinance regulation**

**2.7 Chapter summary**

## 2.2 Regulation and supervision of the microfinance industry

'Regulation' can be defined as a set of enforceable rules that restrict or direct actions of participants, which alters the outcomes of these actions (Chaves and Gonzalez-Vega, 1994). Regulation of any financial institution is generally explained in terms of the need to protect depositors from the financial loss of their savings, develop operational and financial sustainability at the institutional level, protect against moral hazards, and preserve confidence in and reinforce the financial system (Haq et al., 2008). However, these objectives in the context of the microfinance sector are questionable (Chiumya, 2006), since regulation of this sector has often proven ineffective, especially in developing countries (Haq et al., 2008). The key reasons for this failure are high management costs, poor infrastructure and technology, poor accounting standards, information and data collection problems, lack of professionalism, and political interference (Haq et al., 2008).

Over the last one and a half decades, reform of microfinance regulatory frameworks has been increasing in both developed and developing countries (Staschen, 2010). In a majority of countries, the approach has been to introduce a 'special' microfinance law or laws. Unfortunately, many countries lack substantial practical experience in regulating the microfinance sector through specialised laws. There has been no or very little effective analysis of whether this type of regulation has been worth the effort (Staschen, 2010).

The literature identifies different approaches for regulating MFIs, including 'no regulation', 'self-regulation', 'deregulated supervision', and 'prudential and non-prudential' regulation (Berenbach and Churchill, 1997; Kirkpatrick and Maimbo, 2002; Staschen, 1999). Staschen (2010) argues that these types of regulatory reform lack systematic analysis relating to some key issues, such as the appropriate regulatory structure for developed and developing countries, whether the costs of regulation are justified by consumer and general public welfare, and the overall impact of regulation on the microfinance industry.

An important aspect of regulatory reform in developing countries is that many MFIs choose to remain unregulated (Gallardo et al., 2005). These MFIs have their own rationale for remaining unregulated. As a developing country in South Asia, Bangladesh is no exception. The microfinance industry in Bangladesh comprises both regulated and unregulated MFIs. The aim of this current study is to explore differences, if any, between regulated and unregulated MFIs in Bangladesh with respect to their governance practices and performance outcomes from both organisational and client perspectives.

The following section highlights the rationale for regulating MFIs. It explores the different approaches and issues involved in achieving appropriate and effective regulation of MFIs so that they remain or become efficient and competitive while fulfilling their target to serve low-income depositors.

### 2.3 Different aspects of microfinance regulation

Despite many success stories in microfinance regulation, the literature shows that the impact and outcomes of regulation have been mixed (Chiumya, 2006; Francis, 1993; Llewellyn, 1999; Meagher, 2002; Porteous, 2006; Rhyne, 2002; Smith, 2011; Steel and Andah, 2003; Theodore and Loubiere, 2002).

Chiumya (2006) claims that microfinance regulation is important for raising the minimum governance performance standards within MFIs, promoting sustainability of the organisation and thus contributing to financial sector development. Christen and Rosenberg (2000) and Robinson (2001) support this view and claim that large-scale, sustainable delivery of financial services to poor MFI clients can be achieved only in a regulated environment. On the other hand, it is also true that one of the important aspects of microfinance is its innovative nature. This characteristic makes microfinance distinct from the services of other financial institutions. An inappropriate regulatory system or over-regulation may hamper this innovative nature of MFIs. As a result, it may create a negative impact on the financial sustainability of organisations and limit their ability to reach poorer clients (Chiumya, 2006; Meagher, 2002). The burden of regulation can create a negative impact on outreach and sustainability by fostering unhealthy competition, which may hamper the mission and vision of microfinance (Porteous, 2006; Smith, 2011). A study conducted by Ayayi and Peprah (2018) on 25 MFIs in Ghana also shows a similar result; that is inappropriate prudential regulation has an adverse impact on outreach by reducing the percentage of female borrowers.

The cost of regulation has an impact on the sustainability of the organisation. A study by Theodore and Loubiere (2002) on 12 regulated MFIs operating in Latin America found that the benefits of regulation outweigh the regulation costs. However, Steel and Andah (2003) found the opposite result. Their study found that the cost of microfinance regulation in Ghana exceeded its benefits, and they recommended that MFIs should depend on traditional mechanisms (such as group lending policies[5]) for ensuring repayment rather than adding to costs through regulation. Porteous (2006) also found that MFIs aiming to service low-income borrowers not served by conventional banks face additional challenges with regard to regulation costs. Smith (2011) claims that if microfinance regulation proves too costly for certain MFIs, such organisations may be forced to reduce access to poorer and riskier borrowers, defeating one of the key objectives of microfinance. Additionally, regulation expenditure could increase on a per capita basis if the regulation cost is burdensome or impedes the capability of an MFI to respond to an increasingly competitive market (Smith, 2011). Also, because of its burdensome nature and the higher cost for suppliers, regulation can lead to declining competitiveness (Francis, 1993).

The cost of regulation for a large industry like microfinance can represent challenges for governments and regulators. In developing countries, because of financial resource and capacity constraints, state banks or central banks face substantial challenges in regulating the commercial banking sector. They cannot, therefore, realistically be expected to regulate and monitor a large microfinance industry, especially since they may have a very limited understanding of the sector (Chiumya, 2006).

[5] The group lending mechanism primarily involves a group of individuals, which becomes the core unit of operations for the MFI concerned (Kodongo and Kendi, 2013). As microfinance loans are collateral free, the group lending method helps in creating social collateral that can effectively substitute for physical collateral (Schurmann and Johnston, 2009). The overall financial activities of MFIs—for instance, giving loans, receiving repayments and savings, and keeping records—are managed at the group level. In this case, the group becomes the basic unit with which MFIs deal (Haldar and Stiglitz, 2016).

According to critics of microfinance regulation, regulation of microfinance can also be welfare reducing because it can raise unnecessary entry barriers, restrict competition, control prices, stifle innovation, and restrict diversification (Chiumya, 2006; Llewellyn, 1999). On the other hand, other scholars claim that there are number of reasons why MFIs should be regulated (Berenbach and Churchill, 1997; Chaves and Gonzalez-Vega, 1994; Chiumya, 2006; Christen and Rosenberg, 2000; Druschel, 2005; Gallardo, 2002; Haq et al., 2008; McNew, 2009; Robinson, 2001; Staschen, 1999). The reasons include improved self-sustainability of MFIs, safeguarding the stability of financial systems, protection of small depositors and their savings, mitigation of risks due to currency mismatches, consumers' welfare, social inclusion, fair market competition, access to funds, and prevention of money laundering and funding terrorism. In terms of accessing funds, Rhyne (2002) found that regulated MFIs have better access to funds and greater ability to serve more clients with more diversified micro products than unregulated MFIs. Regulation can increase access to funding because regulated MFIs can gather the confidence of potential investors that the MFI is sound.

From a legal perspective, microfinance regulation is sometimes required to clarify the institution's legal position, especially in the case of non-governmental organisation (NGO)-MFIs. In many countries, it is illegal for an NGO to offer credit according to the registration rules. Unclear legal status discourages the growth of the industry and diminishes its attractiveness to donors and investors (Druschel, 2005). Many countries like India, China, South Africa, and Mexico have strengthened their prudential standards for monitoring the microfinance industry (Haq, et al., 2008), as is explained in more detail later in this chapter.

As microfinance clients are from vulnerable segments of society, any loss of their savings due to MFI insolvency, incompetence, or failure to judge excessive risks taken by MFIs has disastrous consequences. In this regard, effective regulation can encourage MFIs to avoid excessive risks, and follow standard governance practices by educating and training their employees to avoid this type of disaster (Haq et al., 2008). Chaves and Gonzalez-Vega (1994) claim that regulation can play an important role in preventing vulnerable MFI clients from being exploited through high-interest rates, hidden fees, and charges, misleading information about their loans and savings, etc. Finally, for consumer protection of MFI clients, regulators require a strong and clear enforcement authority (Brix and Mckee, 2010; Kline and Sadhu, 2011; Solli, et al., 2011). This can include forcing providers to refund excess charges or withdraw misleading advertisements, fines and penalties, public notice of violations, restricting orders, and even withdrawal of offending providers' licenses to operate. As microfinance serves the most vulnerable segments of society, it is argued that external regulation is justified on the grounds of protecting poor depositors and should be carried out by government agencies (an external regulatory body or the central bank) responsible for the financial sector of the country (Chaves and Gonzalez-Vega, 1994). Another reason given by researchers and governments is that only effective regulation can ensure the proper use of public resources (Cuttingredtape, 2014). However, this justification is questionable because wholesale lenders or donors, whether public or private, should assume responsibility for monitoring their investments rather than delegating this job to a state bank (Berenbach and Churchill, 1997; Staschen, 1999).

However, external regulation alone cannot protect the interests of the organisation and consumers in regard to enhancing their financial knowledge and awareness and preventing market misconduct (Brix and Mckee, 2010; Beltran 2007). Self-regulatory initiatives and training to improve MFIs' governance practices, consumer awareness, and financial capability programs can play a vital role in strengthening regulation. Solli et al. (2011) claim that the planning process for any new rules should give key attention to good governance practices within organisations, as well as enhance consumer literacy and awareness and rights and knowledge about financial products. The following section highlights different approaches to microfinance regulation and discusses what type of regulation is appropriate in different microfinance contexts.

## 2.4 Approaches to regulating the microfinance industry

For any financial institution, regulation is important for systems to maximise the mobilisation and intermediation of funds, increase efficiency in the allocation of capital, manage risk effectively, and protect depositors (Meagher, 2002). Carrasco (2006) claims that all the arguments that support the regulation of financial institutions (banks) are naturally applicable to non-banks. However, Jansson and Mark (1997) and Stiglitz (2001) argue that the nature and approach of the regulation may differ between banks and non-bank financial institutions. According to Arun (2005) and Jansson and Mark (1997), establishing appropriate and cost-effective regulation for the microfinance industry should be compatible with the objectives of regulation of the financial system as a whole, and the type of regulation should leave room for innovation and flexibility to promote the growth of the industry.

Before the implementation of any new regulatory framework for the microfinance industry, it is important to consider the key factors that will play a significant role in its success. These factors include, for example, a country's readiness, MFIs' liability structure, the existing workload of the financial regulator, engagement of influential public and private advocates for regulatory reform, and organisations pushing for reform (McNew, 2009). Before highlighting the different types of and approaches to microfinance regulation, it is important to focus on these factors.

The first factor is determining a country's readiness, or need, for the financial regulatory reform. The important question is whether the existing regulatory structure inappropriately obstructs access by any particular segment (for instance, the poor) of the society to the financial service (USAID, 2005). For example, in many countries, financial law restricts NGO-MFIs from taking deposits from their clients (Rahman and Luo, 2012). This obstacle not only hinders NGO-MFIs in increasing their outreach and reaching poorer segments of society but also creates challenges for MFIs in achieving organisational sustainability.

Another important factor that needs to be considered is the existing workload and capacity of the financial regulator to implement a new MFI regulatory framework (CGAP, 1998). So, the question is whether the country's financial regulator possesses the capability to undertake new responsibilities (CGAP, 1998). Realistically, financial regulators in many developing countries face challenges in managing their existing commercial banking system (Christen and Rosenberg, 2000). Consequently, it is vital to perform a feasibility analysis before implementing a new regulatory approach.

The third important factor lies in the existence of an influential advocate (public/private) for the regulatory reform. McNew (2009) **s**uggests that this advocate could be either an individual or a group of individuals with knowledge about the complexities of microfinance reform and the ability to initiate the reform process through their political or moral authority (Sengupta and Aubuchon, 2008).

### 2.4.1 Types of microfinance regulation

According to Van Greuning et al. (1998), a regulatory framework for MFIs should depend on the MFIs' liability structure. The framework needs to take into account MFIs' liabilities in order to focus on distinguishing features of different types of MFIs and consider the risk-taking activities that need to be managed and regulated. The literature broadly identifies the different approaches to microfinance regulation (no regulation, self-regulation, existing banking regulation, special window regulation, prudential and non-prudential, and command control versus responsive regulation) and focuses on the advantages and disadvantages of each (Berenbach and Churchill, 1997; Carrasco, 2006; Christen and Rosenberg, 2000; Kirkpatrick and Maimbo, 2002; Staschen, 2003). The following section highlights the different types of microfinance regulation.

### 2.4.1.1 No regulation

Advocates of the 'no regulation' approach argue on the grounds of cost-effectiveness (Arun, 2005; Kirkpatrick and Maimbo, 2002) and the lack of necessity because the total assets of the sector are too small to pose a threat to the overall stability of the financial system (Chiumya, 2006). Kirkpatrick and Maimbo (2002) claim that the cost of designing, developing, and implementing regulation is more than likely to exceed the overall benefit of leaving the sector unregulated. Christen and Rosenberg (2000) support this view and argue that regulation of MFIs is expensive because most have a small asset base but a large number of accounts with a high degree of decentralisation. It is also believed that the level of risk and scale of operations of most MFIs are so low that it is unlikely this sector would generate instability for the overall financial system.; instead, external regulation may generate a risk for their own sustainability (Arun, 2005; Carrasco, 2006).

Limitations in resources and expertise of central banks or government agencies in developing countries also provide a rationale for the 'no regulation' approach. Kirkpatrick and Maimbo (2002) argue that it would be disastrous to divert monitoring and supervisory attention away from banks as a banking failure is more likely to result in a systemic crisis. Due to resource constraints and capacity limits, state banks in most developing countries face challenges in regulating and supervising the commercial banking sector (Berenbach et al., 1998; Kirkpatrick and Maimbo, 2002).

In addition, external regulation may unintentionally cramp competition and stifle innovation, which may hamper the outreach of MFIs (Chiumya, 2006). However, those opposed to this position point to the risk portfolio of MFIs and argue that if the microfinance industry is to develop, it should be under some form of regulation (Kirkpatrick and Maimbo, 2002).

#### 2.4.1.2 Self -regulation

Self-regulation or supervision can be defined as an arrangement under which the key responsibility for supervising, controlling, and enforcing prudential norms lies with a body that is managed by the organisations to be supervised—in this context, usually a member-controlled federation of microfinance institutions (Christen and Rosenberg, 2000). According to Berenbach and Churchill (1997), self-regulation refers to an industry developing its own supervisory and governance bodies and adopting a code of conduct.

The core advantages of self-regulation are that the monitoring agency possesses more technical knowledge of practices and expertise within the industry than a public agency would (Majone, 1996). Also, the rules and regulations are likely to be less formalised than those instituted by a public regulatory agency. As a result, rulemaking costs are likely to be reduced, facilitating fast adaptation of the rules to developments and changing economic conditions, which, in turn, is likely to permit more flexible enforcement (Chiumya, 2006).

The self-regulation approach may take a wide variety of forms, such as a voluntary code of conduct where MFIs agree to adhere to a rigorous licensing system administrated by an apex organisation, backed by the force of law (McGuire, 1999). In this type of regulatory approach, government monitoring and supervision is replaced by the apex organisation or the publication of information by the MFIs whose reliability is vouched for by an institute with maximum autonomy. The feasibility of different types of self-regulation depends on a range of factors, including the extent to which there is a network that can represent MFIs as a whole, the quantum of resources available for supervising and monitoring, and the availability of incentives or sanctions to enforce compliance (Staschen, 1999). Unlike a fully self-regulated approach, under an apex body approach, regulations are not set by the MFIs themselves but by a second-tier institution that makes its lending dependent on certain conditions. Some examples of institutions that use the apex body approach to self-regulation are Fondos-Financieros in Bolivia, and CMAC and EDPYME in Peru (Staschen, 1999). The network called FEPCMAC was established as a public coordinating body for the CMACs; it is housed in the Ministry of Finance and Industry in Peru. The network not only plays a role as an apex body, channeling investment and donor funds to CMACs but is responsible also for the supervisory functions delegated by the Peruvian Banking and Insurance Supervision (SBS) authority (Staschen, 1999).

Self-regulation is considered useful when a microfinance industry is in its infancy due to the fact that microfinance regulators have very little experience with the special features of microfinance or the overall industry (Kirkpatrick and Maimbo, 2002). However, as the microfinance industry enters a 'microfinance service era', as is the case in Bangladesh, self-regulation is thought to be inappropriate because of the scale of operations, and the diversity in size and resources of the various institutions providing microfinance (Carrasco, 2006; Kirkpatrick and Maimbo, 2002). Once the microfinance industry starts growing exponentially, the objectives and interests of different types of MFIs may not be convergent and, as a result, self-regulation is unlikely to succeed (Arun, 2005). Empirical evidence has shown that in many cases, self-regulation is ineffective in enforcing appropriate financial discipline; nonetheless, self-regulation has induced MFIs to pursue sound accounting practices and reporting standards (Christen et al., 2003).

#### 2.4.1.3 Delegated supervision or deregulation

A delegated or auxiliary supervision approach refers to an arrangement where the state bank or regulatory authority of the government maintains legal authority over responsibility for the supervised organisation, but it delegates direct supervision to a body or agency outside the government financial supervisory or regulatory authority (CGAP, 2012; Christen and Rosenberg, 2000). This type of model is referred to also as a 'hybrid approach' (Berenbach and Churchill, 1997), where the third-party agency might be an MFI federation, an independent technical entity, or an apex institution[6] (Christen and Rosenberg, 2000). The government regulatory body maintains legal authority over and responsibility for MFIs but delegates regular monitoring, on-site inspection, and reporting to a third-party agency; it intervenes only in difficult situations (Chiumya, 2006; Christen and Rosenberg, 2000).

An example of a delegated approach can be found in Indonesia, where Bank Rakyat Indonesia has long used its rural branch offices for monitoring and supervising a large number of small municipal banks. Another example can be found in Peru, where the central bank delegates day-to-day oversight to a federation of multiple savings and loan institutions (Christen and Rosenberg, 2000).

In the microfinance industry, a variant of this approach seems to work in South Africa, where the Microfinance Regulatory Council (MFRC) regulates microlenders (Patrick, 2005). This body is a hybrid institution because its board comprises members from different stakeholder groups, such as the microfinance and banking industry, and public institutions (e.g., the central bank, Department of Trade and Industry, and wholesale financial institutions). As a functional regulator, it is involved in a set of activities for the licensing and supervising of MFIs (CGAP, 2012, Patrick, 2005). The MFRC has a clear focus on performance and monitoring, involving data collection and processing, on-site inspections, recommendations for action, corrective enforcement, and, in rare cases, intervention and liquidation (CGAP, 2012). This is different from the prudential regulation framework for other financial institutions in South Africa that

[6] An apex institution typically provides wholesale funding to local microfinance institutions.

lack adequate resources and expertise, operational independence, and remedial powers to fulfill responsibilities (CGAP, 2012; Staschen, 2003).

However, according to CGAP (2012), there are very few successful examples of delegated supervision. This approach is likely to work only when the state regulatory authority closely monitors and has effective control over the quality of the delegated supervisor's duties. The World Bank and International Monetary Fund (2005) in a joint report support this view and claim that there are no or very limited examples of delegated supervision being used for MFIs. As such, it can be claimed that there is insufficient evidence to come to a conclusion about the effectiveness of this approach for the microfinance industry.

**2.4.1.4 Existing banking regulation**

Application of existing banking regulation to the microfinance industry can be defined as an arrangement within the existing legal and regulatory framework for registered MFIs, which requires compliance with key minimum financial ratios and supervisory practices that address the unique risk profile of MFIs (Chiumya, 2006). This arrangement (based on the assumption that MFIs undertake bank-type business) can not only generate additional direct costs for MFIs but may also require organisational changes to MFIs' structures, with additional reporting requirements that can increase operational costs (Haq et al., 2008). Examples of the existing banking regulation approach can be found in many countries, such as Cambodia (unregistered MFIs—Ministry of Interior and Ministry of Foreign Affairs and International Cooperation), Indonesia (Bank Rakyat Indonesia), Nepal (Bank and Financial Ordinance 2004), the Philippines (Security Exchange Commission), Tanzania (Bank of Tanzania), Thailand (Bank of Agriculture and Agricultural Cooperatives), and Vietnam (State Bank of Vietnam) (Haq et al., 2008). These countries have their own existing banking or financial institution Acts, which have been extended to cover microfinance industry regulation.

One of the advantages of this approach is that it saves additional costs for regulators because there is an already existing regulatory body that can enforce the related laws for the microfinance industry (Kirkpatrick and Maimbo, 2002). Staschen (1999) claims that under an existing banking regulation approach, MFI supervision can take place either on-site or off-site by the government or central bank authority, an external body, or a private supervisory institution. As it does with other financial institutions, this authority would supervise MFIs' activities and their proper and efficient utilisation of funds. Staschen (1999) also states that under this arrangement, it might be easier for the government to supervise and assist MFIs in terms of liquidity issues (cash flow issues). Christen et al. (2003) support this view and state that incorporating MFIs into an existing regulatory framework can contribute to better integration of MFIs with the broader financial system of the country. It is easier and more efficient to adjust to an already existing system and to look for adequate harmonisation of regulatory practices so as to facilitate the incorporation of the microfinance industry in the regulated market (Christen et al., 2003).

Rubambey (2005) provides a case study from Tanzania that exemplifies how banking law and the existing legal framework represent a good fit or are suitable for regulation of the microfinance industry. In this case, after reviewing the existing legal framework, the country decided not to implement a special law for microfinance regulation since the existing legal and regulatory framework was suitable for the microfinance sector (Mpango, 2017). Apart from helping integration into the country's broader financial system, incorporating MFI regulation into the existing legal framework for the banking system can encourage and enhance fair competition and innovation, enable effective harmonisation of regulatory changes within the existing regulatory framework, and minimise regulatory arbitrage (Rubambey, 2005). Greuning et al. (1999) show that existing financial regulation can be suitable for MFIs through tiered banking and graduated regulation. They argue that existing bank regulations applied to

MFIs can promote risk management under a statutory framework that drives MFIs to systematically develop and transform into more sustainable and full-service institutions.

### 2.4.1.5 Special window regulation

Some countries, such as Bangladesh, Ethiopia, Pakistan, South Africa, West Africa, and more recently Uganda, have created a distinct legal status for MFIs and their regulation—this is also known as a special window for non-bank MFIs (Chiumya, 2006). In Bangladesh, for example, NGO-MFIs are regulated under the Microcredit Regulatory Authority Act, 2006, whilst the Grameen Bank operates under a special regulatory environment as per the Grameen Bank Ordinance 1983. This current study also examines the role of special window regulation under the Microcredit Regulatory Authority (MRA) Act 2006 of Bangladesh. The MRA Act 2006 is discussed in detail in Chapter three (Section 3.4.3).

In Pakistan, the Microfinance Institutions Ordinance permits MFIs to practice under their own specific MFI guidelines and be supervised and regulated by the central bank of Pakistan. In Tanzania, MFIs are regulated under the Banking and Financial Institutions Act, 1991. In Ethiopia, they are regulated under the Monetary and Banking Proclamation No. 83/1994. In South Africa, microlenders are regulated under the Banks Act (1990, as amended) and Usury Act No. 73 of 168 (Chiumya, 2006; Haq et al., 2008).

According to Haq et al. (2008), the establishment of a special regulatory framework or special window for the microfinance industry is justified by the requirement to develop standards best suited to the microfinance sector. This approach facilitates lower entry barriers, while the government or the central bank can continue to conduct actual supervision and monitoring. This approach, tailored to the risk profile and characteristics of MFIs, is widely accepted by microfinance practitioners (Chiumya, 2006). This is because it permits MFIs to maintain their distinct characteristics and pursue their goals by providing a reduced range of financial services without becoming a commercial bank and in exchange for a lower capital requirement (Kirkpatrick and Maimbo, 2002). According to Gallardo et al. (2005) and Greuning et al. (1999), this approach can contribute to better insertion of MFIs within a regulatory structure, according to the range of financial services to be provided. It has also been suggested that the special window approach could provide a connection between the informal sector and mainstream economy (Chiumya, 2006).

Although experiences around the world show that a special regulatory framework removes barriers to non-bank microlending and is likely to enhance outreach quickly, where the regulatory objective of such a new window is to enable deposit-taking, results have been mixed (CGAP, 2012). The regulator may effectively be captured by the industry, shifting its focus from prudential regulation to model building and MFI development. This, in turn, can result in discouraging the transformation of the commercialisation of microfinance by reducing incentives for merging with other NGOs (Hannig and Mugwanya, 2000). Sometimes the binding constraint may also demotivate entrepreneurs and investors who play an important role in competently handling the risk involved when lending from deposits. In such a case, according to CGAP (2012), opening a special window by itself may add little value to increasing performance or expanding services to the poor. Moreover, as pointed out by Haq et al. (2008), special regulation may lead to increased costs of monitoring and supervising for the government and central bank and can create external and political interference.

As discussed earlier, several countries have adopted a special window approach. CGAP (2012) suggests that countries considering this approach for MFIs should begin by determining whether and how the existing financial system regulation hinders MFIs from providing full financial services (savings) for the poor or accepting external funding to expand outreach. The cost, capabilities, and expertise of the regulator and the complexity of the new window should be considered before embarking on the complex task of creating a new window. If the existing financial sector regulation does not create a barrier, or if the real binding constraint lies elsewhere, then a special window approach will not necessarily improve the situation.

## 2.5 Legal framework for MFIs' regulation

From a legal perspective, there are broadly two categories of regulation and supervision of financial institutions: prudential and non-prudential regulation (Carrasco, 2006). Sometimes the distinction between the two is ambiguous because some standards of regulation can serve the objectives of both (Christen et al., 2003). For the microfinance industry, regulation of MFIs is found in three forms (Gallardo et al., 2005): (a) simple registration as a legal entity; (b) non-prudential regulations that facilitate business operations, standards, and oversight; and (c) full prudential supervision. Because of the innovative nature and distinct characteristics of MFIs regarding their lending methodologies, the composition of loan portfolios, capital structures, and institutional forms (Janson and Mark, 1997), the type of regulation suitable for the industry has been much debated (McNew, 2009). The following section focuses on the suitability of prudential and non-prudential regulation for the microfinance industry.

### 2.5.1 Prudential regulation

Prudential supervision involves monitoring and verification by the external regulatory authorities of compliance by organisations with mandatory standards (e.g., liquidity management ratios, minimum capital levels, and adequacy, asset quality standards) as measures of financial soundness. Such supervision aims to protect the soundness, health, and stability of the overall financial system and depositors by involving the government in overseeing and establishing an appropriate framework of norms and incentives (Arun, 2005; Carrasco, 2006; Christen et al., 2003). In prudential regulation, financial institutions are authorised to carry out financial activities subject to certain restrictions. This type of regulation includes off-site supervision and monitoring, on-site examination of financial documents, internal and external reports, and other actions to verify compliance with prudential guidelines and standards (Gallardo et al., 2005). The authority to regulate includes the power to impose sanctions for non-compliance and, finally, to close or take over and liquidate institutions for flagrant, uncorrected violations (Carrasco, 2006). At the same time, there is wide recognition that compliance with, and enforcement of, prudential regulation is generally more expensive, complex, and difficult to manage compared to non-prudential regulation (CGAP, 2012). This is particularly so for developing countries where the regulatory framework is often already stretched to capacity with the financial and mainstream banking sector.

For the microfinance industry, an effective MFI legal framework can identify the role of the regulatory authority, entry and exit rules for MFIs to encourage fair competition, and the boundaries and benchmarks for sustainable operations (Gallardo, 2002). Like commercial banks, some prudential regulation and legal issues are also crucial for the microfinance industry including capital adequacy, credit classification, and loan-loss provisioning, insider lending and operational restrictions, loan documentation, and government and ownership requirements (Carrasco, 2006; McNew, 2009). At the same time, MFIs are unique entities and face different challenges from banks, so prudential regulation imposed on MFIs needs to look different from that typically imposed on mainstream banks and other financial institutions. The following section focuses on challenges for and issues arising from the prudential regulation of MFIs.

*Systemic consequences*: According to Berenbach and Churchill (1997), in most countries, the total assets of the microfinance industry are too small compared to those of the financial sector to warrant regulation and supervision on the basis of financial system stability. However, in some countries, such as Bangladesh, the growth of MFIs has been so exponential (Akash et al., 2010) that the failure of even one of the larger MFIs would adversely affect confidence in the overall financial system of the country (Chiumya, 2006). In countries such as the Philippines, where MFIs (rural banks) are integrated into the payment system, failure of an MFI may disrupt the overall operation of the payment system (Espenilla, 2007).

*Cost of regulation*: Microfinance practitioners (Ayayi and Peprah, 2018; Smith, 2011; Steel and Andah, 2003) claim that prudential regulation is costly for both the supervisor and the supervised. The experience has been that supervision costs substantially more for MFI assets than an equivalent volume of mainstream bank assets (CGAP, 2012; Steel and Andah, 2003). Unfortunately, MFIs pass these extended costs to clients (Ayayi and Peprah, 2018). However, in the case of depository institutions, prudential regulation costs are likely to be less than the costs of bailing out the financial system (Berenbach et al., 1998).

*Risk management*: MFIs taking external donations have a risk of loss of investors and donor funding if the MFI fails. As a result, MFI clients may lose access to financial services temporarily or permanently. Investors and donors can mitigate this risk by monitoring investee institutions (Hartarska and Mersland, 2012). In this regard, prudential regulation can play a significant role in protecting investors' and donors' money (CGAP, 2012).

*Capacity limitations*: As mentioned earlier, limitations in capacity, resources, and workload for central banks in developing countries represent constraints on implementing prudential regulation of the microfinance industry. According to Berenbach et al. (1998) and CGAP (2012), in many countries, the regulatory agency has no or very little experience with judging or controlling microfinance risks. Further, some prudential norms developed for conventional financial institutions may not fit appropriately with the risks and requirements of microfinance. Additionally, supervisory tools work differently in different geographical locations.

The issues discussed above include the most common challenges, but other rules may need adjustment in some countries (Crabb and Keller, 2008; Bakker et al., 2014). It is interesting to note that many of the adjustments for different geographical locations relate to distinctive characteristics of microlending, highlighting that microfinance differs from conventional financial institutions more on the credit side than on the deposit side (CGAP, 2012).

### 2.5.2 Non-prudential regulation

Non-prudential regulation, also referred to as 'conduct of business' regulation, does not involve supervising or monitoring the financial health of the regulated institution (McNew, 2009). According to CGAP (2012), non-prudential regulation addresses three key objectives: (a) protecting clients of financial services, (b) facilitating a range of organisations that provide a mix of appropriate products and services, and (c) providing governments and agencies with information to carry out economic, financial, and criminal law enforcement policies.

As noted earlier, sometimes a rule serves both prudential and non-prudential objectives. Carrasco (2006) observes that some non-prudential regulation is subject to general enforcement, which may include civil and criminal prosecution and private rights of action. Other non-prudential regulation, such as reporting requirements, permission to lend, and financial consumer protection, can be enforced by specific regulatory agencies (Carrasco, 2006; CGAP, 2012).

As mentioned earlier, for both regulators and providers, non-prudential issues are less complex and less costly to monitor compared with prudential issues. At the same time, non-prudential regulation is not cost-free, and access can be limited when the cost of a given service or clientele becomes unprofitable for providers (CGAP, 2012). Consequently, it is important for policymakers to be as cost-conscious while designing non-prudential measures, as for prudential regulation measures. CGAP (2012) argues that some prudential rules depend on the type of institution: for example, different kinds of financial institutions may require different standards for permitted activities or capital adequacy. On the other hand, most non-prudential rules applicable to microfinance services would generally be similar and appropriate regardless of institutional type.

Non-prudential regulation promotes a healthy environment and good behaviour in the financial system, focusing on the way financial institutions conduct their business (Hardy et al., 2003; Llewellyn, 1999). Carrasco (2006) and McNew (2009) claim that for MFIs, non-prudential regulation is related to pursuing consumer protection, information disclosure (policy, interest rate, etc.), fair business practices, prevention of fraud and financial crimes, implementation of credit bureaus, reporting and institutional transparency, data privacy and security, abusive lending and collection practices, and discrimination, etc.

These non-prudential regulations are similar to those applied in other industries (Arun, 2005; Christen et al., 2003; Hardy et al., 2003). It is argued that non-prudential regulation for the microfinance industry could be self-imposed or supervised by any other authority (Christen et al., 2003). However, it is understandable that efficiencies and effectiveness arise from the same regulatory body or agency that is responsible for the design, oversight, and implementation of prudential and non-prudential standards for MFIs (Carrasco, 2006). It is important to note that defining these standards (discussed above) as non-prudential regulation is not meant to signal them as insignificant or unimportant, but rather to highlight that these standards are not necessarily required to be enforced by an external regulatory agency (as is prudential regulation) responsible for the soundness of the financial system (Christen and Rosenberg, 2000).

From the discussion above, it can be said that an optimal MFI regulatory framework should be designed and implemented to facilitate the objectives of MFIs. It is important to note that the need for regulation also depends on the nature of claims and the intermediary. Each regulatory approach has its advantages and disadvantages. According to Haq et al. (2008), experience in developing countries suggests that an absence of regulation, or self-regulation approaches, may be unsuccessful because of the absence of accountability and problems with transparency. At the same time, engaging an apex institution for monitoring, as a delegated authority, by the state bank or government may give rise to disagreements and conflicts of interest. Consequently, the right choice depends on the country-specific microfinance issues, deficiencies in monitoring capabilities and knowledge, and the time and ability of MFIs to grasp the proposed regulatory environment (Haq et al., 2008). The regulatory framework may vary across different geographical locations, but the regulatory plan should be kept simple enough for clients and authorities to work in harmony (Dewatripont and Tirole, 1994). The following section highlights prior research on microfinance regulation in different geographical locations.

## 2.6 The literature on microfinance regulation

Prior research on microfinance regulation focuses mainly on examining the drawbacks and benefits of different regulatory approaches of the types discussed above through a comparative analysis (Gallardo, 2002; Gallardo et al., 2005; Staschen, 2003). Table 2.1 highlights findings from a number of studies that relate to microfinance regulation in different geographical locations. The findings reveal that most previous studies highlight the impact and requirements of appropriate types of regulation for the microfinance industry and the socio-economic development of MFIs and their clients.

Table 2.1 presents an overview of research studies published from 1999 to 2018 which examine the impact of different types of microfinance regulation using the following classifications: No regulation (NR), Self-regulation (SR), Existing Banking Regulation (EBR), Special Window Regulation (SWR), Prudential Regulation (PR), Non-prudential Regulation (NPR). None focus on differences between regulated and unregulated MFIs' governance practices and their clients, as does this thesis.

Of the 17 studies involving microfinance regulation presented alphabetically by first author in Table 2.1, three were conducted using Bangladesh data (which is the context of this current research). The remaining studies are from different countries, including Bolivia, Colombia, Dominican Republic, India, Kenya, Nigeria, Peru, the Philippines, South Africa, West Africa, and Zambia, while some involve multiple countries, from as few as two to as many as 82 countries.

**Table 2.1: Research on microfinance regulation**

| No. | Study | Coverage | Type | Microfinance Regulation type (NR/ SR/ EBR/ SWR/ PR/ NPR) * | Major Findings |
|---|---|---|---|---|---|
| 1 | (Afonso et al., 2017) | Dominican Republic | Qualitative methodology with semi-structured interview guide. 6 MFIs (45 MFIs' clients and 14 non-clients). Central bank, REDOMIF, FondoMicro, Global Findex Database. (2012–2014) | SR | The study shows that in the Dominican Republic, high-standard microfinance service provision within a regulated (prudential) expanding industry does not necessarily bring about positive social outcomes for clients. However, self-regulation can provide a solution to this crisis. At the same time, the study shows that this mechanism (self-regulation) can also fail to fully fulfill the goals of MFIs in the Dominican market. The author argues this is so because while financial exclusion supports the idea of a sizeable microcredit market, the focus on growth and high competition strongly risks the positive social outcomes of microcredit. |
| 2 | (Arun, 2005) | | Descriptive | NR, SR, SWR, Government/ PR | The paper underlines the necessity for an appropriate regulatory framework to encourage the sustainable delivery of diversified microfinance services. Sector-specific regulations, along with prudential reforms, may open a window that allows MFIs to reduce the issues for enforcing normal banking regulations as well as mobilise savings. A tiered approach can facilitate the development of sustainable microfinance by showing the pathways for MFIs to access resources from commercial markets. The paper also claims that the regulatory framework must incorporate |

| No. | Study | Coverage | Type | Microfinance Regulation type (NR/ SR/ EBR/ SWR/ PR/ NPR) * | Major Findings |
|---|---|---|---|---|---|
| | | | | | sector-specific requirements and diversity among MFIs. When designing a regulatory framework for a country, the specificities of countries within the regulatory approach, the varied macroeconomic environments, and different stages of development need to be considered. |
| 3 | (Ayayi and Peprah, 2018) | Ghana | 25 MFIs. Structured questionnaire. MIX Market database (2000-2013). T-test. | PR | Regulation increases the administrative cost of MFIs. MFIs shift this extra cost to their clients as an interest. Regulation has a negative impact on outreach. |
| 4 | (Barry and Tacneng, 2011) | 34 Sub-Saharan African countries | 281 MFIs. MIX Market database. OLS regression. (1996–2008). | PR | The objective of the paper is to analyse the relationship between different types of MFIs, governance mechanisms, and the presence of regulation in MFIs. Findings show that NGOs are more profitable than other financial institutions (banks, cooperatives, non-banks) but not necessarily self-sufficient. Regulation of MFIs increases the risk for their sustainability. Regulation has a negative impact on the overall performance of MFIs. |
| 5 | (Carrasco, 2006) | Peru | Analytical, descriptive, case study. Causal-chain analysis, cost-benefit analysis. Superintendency of Banking, Insurance and Fund Pension Companies (SBI) database. (1994–2005). | NR, SR, EBR, SWR, PR, NPR | The paper assesses the impacts of the microfinance regulatory framework in Peru through cost-benefit analysis. Findings suggest that the benefits of regulation outweigh costs. The findings also show that Peruvian microfinance regulation has played a significant role in the growth and development of the microfinance industry. |
| 6 | (Chiumya, 2006) | Zambia | Analytical, descriptive, case study. Semi-structured interviews and documentary review. 16 focus group survey data from clients/MFIs. 31 interviews (government and commercial bank officials, consultants, donor representatives, and MFI practitioners), data, 85 survey data. (2004). | EBR | The main finding suggests that regulation of the microfinance industry at the current stage of development would have a negative impact on the development of the industry. Moreover, the cost of regulation would outweigh the benefit to stakeholders. The study recommends that existing banking regulation is maintained for the microfinance sector. |

| No. | Study | Coverage | Type | Microfinance Regulation type (NR/ SR/ EBR/ SWR/ PR/ NPR) * | Major Findings |
|---|---|---|---|---|---|
| 7 | (Christen and Rosenberg, 2000) | | Descriptive | SR, EBR, SWR, PR | Prudential regulation is necessary for the development of the microfinance industry. However, in many developing countries, registration or licensing of MFIs is not the binding constraint to the development of the sector. Rather, continuing availability of subsidies is the key problem for the growth and sustainability of the industry. It should be considered that regulation costs should not outweigh the benefits to clients and MFIs. |
| 8 | (Cull, et al., 2011) | 67 countries (not including Bangladesh) 2003 and 2004 | Empirical, 346 MFIs, MIX Market database, OLS Multiple IV stage instrumental variable regression analysis and treatment effect regression. | PR | Commercially oriented MFIs which are under non-prudential regulation are not less profitable compared to prudential-regulated MFIs, whereas non-commercial oriented MFIs with regular supervision are significantly less profitable than unregulated MFIs. The study found that an institution's orientation is important for determining how it will respond to being regulated. Regulation is negatively associated with financial sustainability and larger average loan size. |
| 9 | (Estape-Dubreuil and Estape-Dubreuil, 2015) | 82 countries (excluding Bangladesh) | 709 MFIs. MIX Market database. OLS regression analysis. (2011). | PR, NPR | The regulation does not have any impact on social performance or overall MFI performance, but it has a significant effect on ROA. However, regulated MFIs exhibit reduced portfolio yield only when such regulation is associated with caps on the interest rate. |
| 10 | (Ghosh, et al., 2014) | India | 9 MFIs, 3 government banks. Qualitative and quantitative approach. MIX Market, MFIN, M-CRIL databases. Survey. (2008–2011). | EBR | The aim is to understand the perspective of MFI clients and executives about the impact of regulatory guidelines. Policies and regulation need to be balanced. Policies, supervision, and regulation need to drive consumer-centric behaviour on the part of MFIs, as well as encourage innovation, growth, and sustainability of MFIs. |
| 11 | (Ghosh, et al., 2018) | India | 57 MFIs. Univariate (t-test, rank sum test) and multivariate (random effect regression model) (2008-2009, 2013-2014) | PR | In terms of legal status, for financial sustainability, NGOs have better performance compare to non-banking financial institutions (NBFC). However, for social performance, there is no significant difference between these two. Also, NGO has better portfolio quality and lesser costs of operation compare to NBFC. So, the |

| No. | Study | Coverage | Type | Microfinance Regulation type (NR/ SR/ EBR/ SWR/ PR/ NPR) * | Major Findings |
|---|---|---|---|---|---|
| | | | | | transformation of NGOs to NBFCs not necessarily will improve the performance of Indian MFIs. |
| 12 | (Haq et al., 2008) | 10 Asian countries (including Bangladesh) | Descriptive | PR, NP, SR, SWR, EBR | In a comparative analysis for 10 countries in Asia, the paper claims that formal MFIs are regulated under EBR, whereas semi-formal MFIs (NGO MFIs) are supervised by the apex or some other government authority; informal MFIs are unregulated. Regulation for the formal MFIs seems effective, but for NGO-MFIs and informal MFIs, governance, internal control, and ownership structure are disappointing. The paper suggests prudential regulation for MFIs with some modification because of the innovative nature of the MFIs. |
| 13 | (Hartarska and Nadolnyak, 2007) | 62 countries (excluding Bangladesh) | 114 MFIs. Empirical. MIX Market database. Multiple regression analysis. | PR | The study analyses the impact of regulation. The regulatory environment does not directly affect the performance of MFIs. MFIs collecting savings have better outreach, which indicates the indirect effect of regulation when regulation is the only way for MFIs to access savings. |
| 14 | (Hubka and Zaidi, 2005) | | Descriptive | PR | Continued reliance on government subsidies and donor funds is unrealistic and detrimental to the industry. The government should exit the sector and ensure transparency and market mechanisms. |
| 15 | (Islam et al., 2013) | Bangladesh | Empirical, data from MRA for 215 MFIs for 2009<br>MRA database. | SWR | The findings indicate a significant relationship between interest rate spread and two measures of sustainability: ROA and OSS. Even after the newly introduced regulatory environment created by the MRA Act 2006 in Bangladesh, the findings show that MFIs that have a lower proportion of administrative costs and a larger interest rate spread are more likely to gain financial sustainability. |
| 16 | (Khalily and Khaleque, 2014) | Bangladesh | 182 MFIs (balanced panel of 96). MRA and PKSF databases. Stochastic Frontier Analysis (SFA) and Data Envelopment Analysis (DEA). (2005–2011). | SWR | Regulatory impact analysis before and after introducing the MRA Act 2006 in Bangladesh. Improvements in the post-regulation period in the area of outstanding loans, savings, and a number of members of MFIs. Substantial improvement is observed in average loan per staff and average loan size. Member savings and institutional borrowing increased, showing increased confidence by both savers and lenders. |

| No. | Study | Coverage | Type | Microfinance Regulation type (NR/ SR/ EBR/ SWR/ PR/ NPR) * | Major Findings |
|---|---|---|---|---|---|
| 17 | (McGuire, 1999) | 9 countries, (including Bangladesh) | Descriptive | PR, EBR | Focuses on the policy and regulatory environment for the microfinance industry in 9 Asian countries. The author claims that overall, the Philippines and Bangladesh have the most effective policy and regulatory environment, while Pakistan appears at the bottom of the list. However, different countries have strengths in different areas. Government and donor agencies play a vital role in the development of the microfinance industry in many countries. In some countries, the overall social and political environment for NGOs is not very friendly. |
| 18 | (McNew, 2009) | | Descriptive | PR, NPR | The author claims that prudential regulation is expensive for the regulator and regulated organisation, so it should be used as minimally as possible. Prudential regulation cannot prevent the failure of a country's financial system from leading to the failure of others. Also, by prudential regulation, it is hard to protect small depositors who are unable to monitor MFIs' financial soundness themselves, whereas non-prudential regulation can support the innovative and flexible nature of MFIs and decrease the overall cost of regulation. |
| 19 | (Nyanzu and Peprah, 2016) | 30 Sub-Saharan African countries. | Multilevel estimation technique. 576 MFIs of 1,237 samples. Sustainability (OSS) = 1229 observation; Outreach Proportion of Female Borrower (PFB) = 968; Average Loan Balance Per Borrower (ALBPB) = 1,122; Number of Active Borrower (NAB) = 1,130. MIX Market database. World Bank Data Indicators and Worldwide Governance Indicators. (2002–2012). | PR, NPR | The findings show that regulated MFIs decrease the depth of outreach but increase the breadth of outreach and offer a larger loan size than non-regulated MFIs. Also, regulated MFIs serve fewer women compared to non-regulated MFIs. Staschen (2010) explains this by pointing out that because regulation increases the costs of MFIs, the regulated MFIs may try to look for means to cover such costs. In the process, some of the MFIs may end up marginalising the poor as a way of overcoming their costs. The findings also show that in terms of sustainability, regulated MFIs are better off than non-regulated MFIs. |
| 20 | (Okoye and Siwale, 2017) | Nigeria and Zambia | 27 interviews (14 Nigeria and 13 Zambia). CEOs of 8 MFIs, directors of two regulatory institutions, 2 | PR | The paper compares and evaluates the effect of regulatory provisions on the attainment of effective corporate governance in Nigerian and Zambian MFIs. The findings show that regulation has a negative impact on board |

| No. | Study | Coverage | Type | Microfinance Regulation type (NR/ SR/ EBR/ SWR/ PR/ NPR) * | Major Findings |
|---|---|---|---|---|---|
| | | | apex microfinance associations, and 2 MFIs in both countries. Secondary data from MIX Market database. | | composition for both countries. The ownership requirement in the regulation has resulted in differing governance implications. A weak regulatory structure in both countries has a negative impact on the risk management of MFIs. |
| 21 | (Pati, 2015) | India | Empirical, panel data, MIX Market database. 40 MFIs (30 regulated). Fixed effects regression model. (2008–2009 and 2012–2013). | PR, NPR | The study makes a comparison between regulated MFIs and unregulated MFIs. It shows that external regulation or maturity of MFIs has no impact on MFIs' performance. Regulation is negatively related to ROA and MFIs' profitability. |
| 22 | (Staschen, 1999) | 7 countries (not including Bangladesh) | Descriptive | SR, SWR, EBR | EBR has not proved to be ineffective for MFIs. SWR may shift institutional variety and innovation in microfinance. Only SWR (without any direct supervision) may suffer from enforcement issues. |

* No regulation = NR, Self-regulation = SR, Existing Banking Regulation = EBR, Special Window Regulation = SWR, Prudential Regulation = PR, Non-prudential Regulation = NPR

Table 2.1 reports that seven of these 22 studies (Arun, 2005; Christen and Rosenberg, 2000; Haq et al., 2008; Hubka and Zaidi, 2005; McGuire, 1999; McNew, 2009; Staschen, 1999) are descriptive. The remaining 15 studies take an empirical approach, with eight (Barry and Tacneng, 2011; Cull et al., 2011; Estape-Dubreuil and Estape-Dubreuil, 2015; Hartarska and Nadolnyak, 2007; Islam et al., 2013; Khalily and Khaleque, 2014; Nyanzu and Peprah, 2016; Pati, 2015) using secondary data from different databases. Afonso et al. (2017) and Carrasco (2006) used a semi-structured interview guide and case study approach respectively. Ghosh et al. (2014) and Okoye and Siwale (2017) both used a secondary database, with survey data and interview data respectively. In his thesis, Chiumya (2006) used a case study, survey and interview data.

A critical observation from Table: 2.1 is that from among the different regulation types, none of the studies support a *no regulation* approach. Bruno and Claessens (2010) claim that strong legal protection is not always helpful for firm performance. Consequently, it is crucial for policymakers to decide whether to regulate and, if so, how to regulate most efficiently to increase MFIs' performance and shareholders' returns (Bruno and Claessens, 2010). Researchers (Chaves and Gonzalez-Vega, 1994; Kirkpatrick and Maimbo, 2002) suggest that for the development and management of the risks of an exponentially growing microfinance sector, there should be some form of (prudential or non-prudential) regulation. Regulation protects depositors from financial loss, helps MFIs develop operational and financial sustainability, protects against moral hazards, and increases the overall confidence of stakeholders of the industry (Christen and Rosenberg, 2000; Druschel, 2005; Gallardo, 2002; Haq et al., 2008; McNew, 2009; Robinson, 2001; Staschen, 1999). This philosophy instigates exploration of new types of regulation in microfinance governance practice.

Afonso et al. (2017) used qualitative data gathered from the administration of a semi-structured interview with six MFIs (45 MFI clients and 14 non-clients) for the analysis and identified that a *self-regulation* mechanism represents the best practice for the industry. At the same time, the study shows how self-regulation can fail to fully fulfill MFIs' goals in the Dominican market. Two important components, clear standards and enforcement, identified as important by Gugerty (2008), are curtailed under self-regulation and that can bring a positive change in the overall success of this mechanism for the microfinance sector (Afonso et al., 2017). Staschen (1999) also supports this view. In his descriptive, normative study, he claims that self-regulation not only protects investors but also is concerned with client protection; however, it requires sanction mechanisms, prescribed by the government.

Arun's (2005) view differs in part from Afonso et al.'s (2017), claiming that self-regulation as a cost-effective mechanism may be appropriate for relatively smaller MFIs or those in the early stages of growth, but for mature MFIs, it may not provide an effective result. Using causal-chain analysis and cost-benefit analysis, Carrasco (2006) shows that self-regulation has not been completely effective in enforcing good financial discipline or good accounting practices and reporting standards for MFIs. Christen and Rosenberg (2000) also support this view in their descriptive study and claim that self-regulation is ineffective for the mature stage of the microfinance industry. In another descriptive study, Haq et al. (2008) claim that self-regulation, which encourages lack of government intervention, can lead to reliability problems, such as lack of depositors' protection, and it can fail to safeguard the financial system. One important observation is, although the study (Afonso et al., 2017) considered self-regulation, it ignored the role of prudential regulation and its impact on MFIs and their clients. Comparison between the influence of different types of regulation on MFIs and their clients could give a clearer picture about the role of regulation in MFIs' governance practice and their performance, as well as their clients' status and this is the key focus of this current study.

Ghosh et al. (2014) conducted qualitative and quantitative research to understand the perspective of MFI clients and executives about the impact of *existing banking regulation* on them. Nine MFIs from five different states of India were selected. The survey was conducted during 2008–2011 and secondary data were collected from the MIX Market database, MFIN (Microfinance Institutions Network)[7], and M-CRIL[8] for the same time period. The study shows that the main problem with existing banking regulation for MFIs is an imbalance in government policies and the requirement for an appropriate regulatory structure that actually benefits consumers of microfinance. It is crucial to make sure that policies and existing bank regulation

[7] Microfinance Institutions Network (MFIN) is an association for the microfinance sector in India. It has setup a database of borrowers who confirm the necessary validation required. The database consists of over 30M micro borrowers and about 60 million loan accounts in India.

[8] A rating agency, to provide effective due diligence, aligned with international standards.

drive consumer-centric behaviour by MFIs, as well as encourage MFI innovation, growth, and sustainability. It is important to note that the study considered organisation level data only and ignored client level observations which could give a more comprehensive picture of regulatory (banking regulation) impact on the microfinance industry in India.

Chiumya's (2006) thesis findings also support existing banking regulation. Chiumya, working in Zambia, chooses a case study approach with documentary review and semi-structured interviews and uses data from 45 focus groups comprising MFI representatives and their clients and 31 interviews with government and commercial bank officials, consultants, donor representatives, and MFI practitioners. The findings provide evidence that the cost of *special window regulation* would be very high, and microfinance-specific regulations would most likely result in regulatory failure. The study thus concludes with the recommendation that the existing banking regulatory framework would be appropriate for the microfinance sector.

Haq et al. (2008) also support this view and state that many commercial banks already provide microfinance under the existing banking regulatory system. Under this approach, the advantage is that these institutions are already regulated, have sound governance structures, cost-effectiveness, and profitability. As a result, they are likely to meet other conditions, such as capital adequacy, fund raising ability, and financial disclosure. Chiumya's (2006) analysis used 45 registered MFIs (by the central bank- Bank of Zambia). Although the study considered both organisation and client perspectives and discussed regulatory and supervisory issues, the observations were from registered MFIs only. Hence, the study does not attempt to examine any differences between regulated and unregulated MFIs and their governance practices as this current study does.

As discussed in section 2.4.1, since without a financial license MFIs are not allowed to leverage their resources by capturing deposits and providing saving services to clients, a separate window for MFIs, with lower barriers to entry and standards, has been introduced in many countries, known as *special window regulation* (Christen and Rosenberg, 2000). Microfinance regulation in Bangladesh is an example of special window regulation. This current study also examines the role of special window regulation in terms of the MRA Act 2006 imposed by the Microfinance Regulatory Authority on the microfinance industry in Bangladesh.

There is a similar study by Khalily and Khaleque (2014) that investigates the before and after situation of the introduction of regulation by the MRA Act 2006 in Bangladesh to examine the impact of special window regulation during 2005–2011 from an organisational perspective. This current study differs in that it examines the relationship between all three key components of MFIs' performance (governance, outreach, and financial sustainability) simultaneously from a regulatory perspective at the organisational or institutional level, as well as at the client level (clients' financial intermediation or their financial awareness and rights in association with MFIs' regulatory status). Khalily and Khaleque's (2014) study not only ignored the client-level perspective, but also did not investigate all three components of microfinance performance simultaneously. Hence, this current study is more comprehensive and gives a more complete picture of the role of regulation in the microfinance industry in Bangladesh.

In the Khalily and Khaleque (2014) study, secondary data was obtained for 182 MFIs from the MRA and PKSF[9] databases. Stochastic frontier analysis (SFA) and data envelopment analysis (DEA) were used to analyse the data. The findings show a substantial improvement in average loans per staff and average loan size after regulation. Also, members' savings and institutional borrowing increased, which is also a positive impact of regulation. However, Carrasco (2006) claims that special-window-regulation alone may not give an optimum result. Instead, a *regulatory-tiered-structure* approach, which defines some thresholds to differentiate the

[9] Palli Karma-Sahayak Foundation (PKSF) was established by the Government of Bangladesh (GoB) in May 1990. It is an apex development organisation for sustainable poverty reduction through employment generation. PKSF provides financial assistance and institutional development support to the ultra-poor, small and marginal farmers, and micro-entrepreneurs.

operations and regularity requirements of each tier, can improve the regulatory structure for MFIs. This regulatory-tiered structure allows MFIs to graduate between different modules after complying with the requirements at each stage (Arun, 2005). Additionally, according to Haq et al. (2008), special window regulation may not only lead to increased costs of monitoring but also the possibility of political interference. As such, further investigation of the role and the different aspects of special window regulation for the microfinance industry is necessary. However, it is important to note that this current study does not examine the impact of regulation but rather focuses on the association of any differences between regulated and unregulated MFIs' with their governance practices, their financial and outreach performance, and the financial literacy and awareness and financial status of their clients.

In a study of direct relevance to the country context of this thesis, Islam et al. (2013) investigated the cost structure of 216 MFIs in Bangladesh in the year 2009, with a view to determining whether the MFIs could achieve financial sustainability given the then newly introduced MRA regulatory environment in the country. The result indicates a significant relationship between interest rate spread and measures of sustainability, such as return on assets (ROA) and operational self-sufficiency (OSS). The findings show that after the newly introduced regulatory environment in Bangladesh, MFIs with a lower proportion of administrative costs and a larger interest rate spread were more likely to gain financial sustainability. The findings give a picture of MFIs' cost structures and their financial sustainability. However, since the study did not use longitudinal data, it is difficult to ascertain the impact of regulation on MFIs' financial sustainability over time. Also, the analysis did not use any comparison group against which the findings could be evaluated. This current study uses comparison (between regulated and unregulated MFIs) to investigate any differences in governance practices and clients' financial literacy and awareness and their financial status.

A cross-country study by Cull et al. (2011) examined the impact of *prudential supervision* for 245 of the world's largest MFIs (organisation level) in 67 developing countries. The study examined the implications of regulation for the institutions' profitability and performance in regard to small-scale borrowers and women. It is important to note that without client level observations, using only organisation level data can give a biased picture of the regulatory impact on the microfinance industry.

Cull et al.'s (2011) findings reveal that prudential supervision is associated with substantially larger average loan sizes, but not significantly associated with profitability. The findings indicate that profit-oriented MFIs absorb the cost of prudential supervision by limiting outreach to market segments that tend to be costlier per dollar lent. The study claims that although the results are intuitive from an economic point of view, it remains an open question as to whether the positive impact of prudential supervision in terms of better protection of small depositors' funds outweighs the reduction in outreach. The authors found an increase in average loan size but a decrease in lending to female clients. Typically, an increase in loan size is consistent with a reduction in lending to poorer borrowers. Furthermore, the study found that MFIs are reluctant to lend to poorer segments of clients because they cost more on a per-borrower basis as a means of absorbing the cost of regulation. Mersland and Strøm (2009), who found no connection between prudential regulation and financial performance, support their findings regarding profitability (ROA, OSS, Portfolio Yield).

Cull et al. (2011) claim that if prudential regulation's costs force borrowers to drop poorer clients to maintain profitability, this could be a significant realisation for a microfinance industry that accepts the belief that lending to all borrowers can be made profitable. As discussed earlier, Hartarska and Nadolnyak (2007) also reached the same conclusion concerning the effects of prudential regulation on profitability and also found no connection between regulation and MFIs' performance. A study of 25 MFIs in Ghana by Ayayi and Peprah

(2018) also found that prudential regulation has an adverse impact on outreach by reducing the percent of female borrowers.

Pati (2012) conducted a longitudinal study of 40 MFIs (organisation level) in India for 2005–2006 and 2009–2010 in order to examine the effect of regulatory status on the operational self-sufficiency and profitability of MFIs. The findings support Cull et al. (2011) and suggest that contrary to expectation, regulation did not have any impact on sustainability or profitability. Cull et al.'s (2011) study provides some explanation for the link between regulation and financial sustainability of MFIs in terms of the impact on outreach. However, a limitation of the study is that the sampling focused only on large, financially sustainable MFIs around the globe. The implications of regulation on the financial sustainability of small- and medium-sized MFIs are ignored.

Another cross-country study, by Barry and Tacneng (2011) of 34 Sub-Saharan African countries investigated the impact of prudential regulation over different types of MFIs and their governance mechanisms. The study examined 281 MFIs (organisational level). The MIX Market database was used for secondary data for the period 1996–2008. The findings show that the regulation did not necessarily enhance portfolio quality, albeit that it might lead to better efficiency and productivity. Additionally, prudential regulation increases the risk to the sustainability of MFIs and has a negative impact on the overall performance of MFIs.

Hartarska and Nadolnyak (2007) looked at the impact of prudential regulation on MFIs (organisational level). The study examined whether regulated MFIs achieve better performance compared to unregulated MFIs using a single year's data for 114 MFIs from 62 countries (including Bangladesh). The findings show that regulatory involvement has a negative effect on MFIs' performance, but better-capitalised MFIs have better financial sustainability. However, the results suggest also that MFIs collecting savings achieve better governance performance, which may be an indirect benefit from regulation. The study demonstrates steps towards understanding the impact of prudential regulation on MFIs' performance worldwide. However, in the absence of longitudinal data, the result could be biased. Additionally, the study examined issues from a cross-country MFI perspective only, ignoring institutional and client-level perspectives. Further analysis with more specific longitudinal data on specific regulatory interventions could have provided more robust results.

A recent study by Okoye and Siwale (2017) compares and evaluates the effect of prudential regulatory provisions on the attainment of effective corporate governance and performance in Nigerian and Zambian MFIs. The authors conducted 27 interviews (organisation level) with eight CEOs of MFIs, two directors of regulatory institutions, and two apex microfinance associations during 2017. Secondary data from the MIX Market database for the year 2015 was used also in the analysis. The findings show that prudential regulation has a negative impact on board composition for both countries; the ownership requirement in the regulation resulted in differing governance implications, and the weak regulatory structure in both countries had a negative impact on risk management and profitability of MFIs.

Prudential regulation plays a significant role in access to external funding. In a report prepared for the World Bank, Hubka and Zaidi (2005) examined the benefits of prudential regulation for MFIs and claim that MFIs providing subsidised loans (such as NGOs) have a negative impact on the long-term sustainability of microfinance in terms of performance. The report argues in favour of prudential regulation and against government subsidies as a more efficient means for MFIs to increase financial performance and provide access to a broader array of funding. Because prudential regulation brings transparency to MFIs, it enhances the confidence of external investors in the overall governance practices of MFIs.

In order to examine the impact of prudential regulation on the social performance of MFIs, Estape-Dubreuil and Estape-Dubreuil (2015) conducted a cross-country (82 countries) study of 709 MFIs drawn from the MIX Market database for the year 2015 (organisational level).

The study found that prudential regulation does not have any impact on the social performance of MFIs but has a significant effect on ROA and caps on interest rates. Nyanzu and Peprah (2016) also found the same result. In their study using World Bank Data Indicators and World Governance Indicators for 30 Sub-Saharan countries and over 576 MFIs (1,237 observations) during the period 2002–2012, they show that the social objectives of MFIs are not satisfactory. In those 30 countries, the main focus of MFIs is to achieve financial sustainability rather than social objectives or the welfare of their poor clients. As such, the regulatory organisation can play a vital role in improving the financial position of MFIs and enabling an environment for enhancing the achievement of MFIs' social objectives.

One important observation from the literature review (Table 2.1) is that of 22 studies on microfinance regulation, only two (Afonso et al., 2017 and Chiumya's, 2006) focused on both organisational and client level perspectives. All other studies focused only on MFI level examination. Although Afonso et al. (2017) and Chiumya (2006) considered both organisational and client level perspectives, they did not take into account the regulatory status of the MFIs in their samples, which gives an incomplete picture of overall governance practices and performance of MFIs from a regulatory perspective. Moreover, no previous study investigated the influence of regulation on poor and vulnerable clients by comparing regulated and unregulated MFIs' clients in terms of their knowledge about their rights, savings with their financial institutions, their financial literacy status, their relationship with financial institutions and their staff and their overall welfare. Also, none of the previous research conducted examines the relationship (if any) between the financial status and the knowledge and awareness status of registered or unregistered MFIs' clients. This current study fills this gap by investigating MFIs' governance and performance as well as client level analysis considering the regulatory and supervisory status of the MFI.

## 2.7 Chapter summary

As microfinance regulation is the scope of this study, this chapter focuses on different types and aspects of microfinance regulation. In the early stage of the microfinance industry, as unregulated financial institutions, MFIs have had considerable freedom to adopt operational mechanisms to serve their target markets efficiently (Chowdhury, 2014; Jackson, 2005). This freedom has led to the development of a small but growing number of robust, specialised financial institutions, innovative delivery mechanisms, and an extension of the financial service market (Berenbach and Churchill, 1997).

With the exponential growth of the microfinance industry, the requirement for some form of prudential regulation has become a critical issue. According to Jackson (2005), the microfinance industry has arrived at a phase where the industry faces many challenges, such as increased competition, entry of commercial providers to the market, and the rapid pace of innovation. In this regard, the industry requires coherent regulation guidelines, which can come from existing banking regulation, special window regulation, or some form of prudential or non-prudential regulation. Appropriate regulation will allow the growth of the microfinance sector while protecting the interests of small savers and supporting the credibility, accountability, and integrity of the financial sector as a whole (Berenbach and Churchill, 1997).

The literature that examines the requirements of different types of microfinance regulation also supports this view and provides direction for efficient and effective regulation of the microfinance industry. However, it is important to note that a comprehensive picture of any differences between regulated and unregulated MFIs' governance practices and their clients' status (e.g., their financial awareness status, their rights, and knowledge about their financial institutions and their relationship with their financial institutions and staff) is absent in this literature. The aim of this current study is to fill this gap and contribute to a better understanding than we presently have of these different aspects of microfinance regulation. This study will provide a clearer picture of how and where regulated and unregulated MFIs' governance practices and their clients' financial awareness and status differs, and how an understanding of any differences can contribute to the development of the sector as well as to the literature on microfinance regulation. Chapter five of this thesis will discuss more extensively the research gap underpinning this literature and develop research questions for this current research. As Bangladesh is the context of this current study, the following chapter focuses on microfinance regulation in Bangladesh, as well as microfinance regulation from a global perspective.

# CHAPTER THREE

# Microfinance Regulation in Bangladesh and from a Global Perspective

## 3.1 Introduction

This chapter examines microfinance regulation from a global perspective: first, in terms of how the microfinance industry in different geographical locations is regulated and supervised using different regulatory structures and, second, through a comparative analysis of countries' regulatory approaches. As Bangladesh is the focus of this current study, this chapter also provides the background to the microfinance industry and regulatory structure in that country.

The chapter commences with a detailed discussion of the global experience of microfinance regulation by comparing different countries (Section 3.2). Section 3.3 introduces the microfinance industry in Bangladesh, discussing different phases of development of the industry in the country. Section 3.4 highlights the legal and regulatory structure of the microfinance industry in Bangladesh by elaborating on different generations of regulation and supervision that have been active over time. Finally, an overall summary of the chapter is presented in Section 3.5.

Figure 3.1 depicts the structure of this chapter.

**3.1 Introduction**

**3.2 The global experience of microfinance regulation**

**3.3 Bangladesh's microfinance industry**

**3.4 Legal and regulatory structure of Bangladesh's microfinance industry**

**3.5 Chapter summary**

## 3.2 The global experience of microfinance regulation

Financial crises in many countries have triggered the need for regulation to be pushed to the forefront of financial sector reforms (Arun, 2005). Protecting depositors and ensuring financial system stability are the key factors behind financial sector reforms. According to Cook et al. (2003), appropriate regulation of financial markets depends very much on country-specific characteristics, such as intutional capacities and the level of development. In other words, regulation can be seen as an agreed set of rules that promote the developmental objectives of a specific country, along with consumer interests and competitiveness of the country (Arun, 2005).

The functioning of the financial sector in virtually all countries around the globe requires licensing and financial regulation of institutions that mobilise deposits from the general public. Given this, it is perhaps not surprising that regulatory reform of the microfinance industry is on the current agenda of many developing and developed countries around the world (Barry and Tacneng, 2011; Hartarska and Nadolnyak, 2007; Nyanzu and Peprah, 2016). As a result, in many countries throughout the world, legal frameworks for the microfinance industry have been amended or, in many cases, completely revised (Staschen, 2003).

As mentioned earlier, the complexity and requirement for regulatory reform of the financial sector are very much country-specific. This is also true for the microfinance industry. An effective regulatory approach is based on an understanding and consideration of the risk profile of the microfinance industry and the legal and institutional framework of the given country (Berenbach and Churchill, 1997). An example provided by Smith (2011) shows that microfinance regulation is highly variable between countries because of country-specific laws and policies, making comparisons across countries difficult. Smith (2011) also claims that this is compounded by the difficulty in cataloging microfinance regulatory practices within a country over a significant time period. The following section demonstrates and compares the diverse regulatory structures and regulation practices in the microfinance industry in different geographical locations around the world.

### 3.2.1 Comparison of microfinance regulations in different countries

The Asian Development Bank (ADB 2008) suggests that the regulatory environment and the design of regulation for the microfinance industry may vary from country to country depending on the nature of claims and the intermediary (ADB, 2008). However, although regulation of the microfinance industry varies from country to country, the goal of MFIs and their regulatory authorities remains the same—to protect depositors’ interests while not hampering poverty alleviation (Haq et al., 2008).

The global scenario of microfinance regulation shows that some countries are forward-thinking and advanced, while others are in a nascent stage (Miah, 2006). For example, the central banks of many countries assume a monitoring and regulatory role within ‘existing banking rules’, whilst others create separate authorities, either newly created or through an existing special window (refer Chapter two, Section 2.4.1.5) empowered or delegated as the regulatory and supervisory authority (Rahman and Luo, 2012).

World microfinance statistics (MIX Market, 2018) show Latin America and the Caribbean (30 percent) and South, East Asia and Asia Pacific (27 percent) cover 57 percent of total microfinance outreach around the globe, whereas Eastern Europe and Central Asia have 15 percent, and the Middle East and North Africa have only 3 percent outreach. Table 3.1 reports a comparative analysis of the regulatory frameworks (including for Bangladesh) of these two biggest regions (Latin America and Caribbean and South, East Asia and the Asia Pacific) of microfinance outreach around the globe. Regulatory features for the microfinance industry in the other parts of the globe (Europe and Africa) are highlighted in Section 3.2.2.

- ***Asia (South, East Asia and the Asia Pacific) and Latin America and the Caribbean***

Since non-governmental organisation (NGO) microfinance institutions (MFIs) are the context of this current study, Table 3.1 highlights some comparative features of regulated microfinance industries from different countries in Asia and America where most of the providers are NGO-type microfinance service providers (except Microfinance Banks in Pakistan and Micro Credit Companies in China). As highlighted, these two regions (Asia- South, East Asia and Asia Pacific and America- Latin America and the Caribbean) cover 57 percent of the total microfinance industry around the globe (MIX Market, 2018). Fifteen aspects of the regulatory features for the NGO-MFIs are shown in the table.

- *Special window approach vs existing banking regulation*

The special window approach and existing banking regulation were discussed in Chapter two (Sections 2.4.1.4 and 2.4.1.5 respectively). From a global perspective, Table 3.1 reports that both approaches are equally accepted and practiced in different geographical locations. Table 3.1 reveals that with the exception of China and Pakistan, all selected institutions are NGO-type microfinance service providers where Bangladesh, Bolivia, India, and Mexico employ a delegated regulatory authority (*special window approach*), while the remaining countries' MFIs are regulated and supervised by the countries' state or central bank (*existing banking regulation*).

Among the nine countries, Bolivia was the first to introduce microfinance regulation by issuing an Act in 1995 (Supreme Decree No. 24000, 1995; amended in 2002) through a special window approach for microfinance regulation, named Authority of Supervision of the Financial System (ASFI) (MEPF, 2014). Cambodia introduced microfinance regulation in 2000 through existing banking regulation by an Act (NBC regulation 2000) of the National Bank of Cambodia (NBC) (Youdy, 2012). Pakistan also introduced microfinance regulation in 2000 through an ordinance (MFB Ordinance 2000 [Ordinance XXXII of 2000]) and delegated regulation to the State Bank of Pakistan (SBP) using existing banking regulation (ADB, 2008). As explained previously, the Bangladesh parliament passed the Microcredit Regulatory Act in 2006 (MRA Act, 2006) and named the authority as the Microcredit Regulatory Authority (MRA). This delegated regulatory authority (special window approach) is responsible for regulating and supervising NGO-MFIs in the country (Khalily and Khaleque, 2014). Indonesia also introduced microfinance regulation in 2006 with a bank ordinance (BI regulation no. 8/26/PBI/2006) and gave the authority to Bank Indonesia (BI) using an existing banking approach (Boston University, 2006).

Microfinance regulation in China also uses an existing banking approach, which was introduced in 2008 with guidelines (MCC guidelines, 2008) from the government of China, and its regulatory authority is the China Banking Regulation Commission (CBRC). As mentioned earlier, microfinance services in China are provided not only by NGO-MFIs but by Micro Credit Companies (MCC) comprising a combination of eleven different types of providers. (Xiaoshan et al., 2010). Mexico introduced microfinance regulation by a law (SCAP law, 2001) that was amended in 2009. The government of Mexico gave the power to a delegated authority (special window approach) named the National Banking and Securities Commission (CNBV) to supervise and regulate the microfinance industry in the country (ACCION, 2017). Vietnam has been monitoring and regulating its microfinance industry through the State Bank of Vietnam (SBV) (existing banking approach) since 2010 by a decree (SBV decree 96/200/ND, CP-2010) (McCarty, 2001). India has regulated its microfinance industry using a special window approach through the National Bank for Agriculture and Rural Development (NABARD) (Pati, 2015).

- *License requirements*

Among the nine countries included in studies reported in Table 3.1, only Vietnam allows MFIs to practice without licensing or registration with the precondition that the MFI does not accept voluntary savings and that the mandatory savings are less than 50 percent of the equity set minimum capital requirement (Rahman and Luo, 2012). MFIs in other countries discussed in Table 3.1 are prohibited from operating without licensing or registration. It is important to note that in spite of legal binding, many countries around the globe do practice microfinance without registration or licensing (Berenbach and Churchill, 1997).

- *Ownership structure*

The ownership structure of MFIs helps us to understand their governance, accountability, and transparency (Beisland et al., 2015). Table 3.1 reports that this feature varies from country to country, with ownership vested in individuals, groups, shareholders, etc. Who or what entity bears the cost of regulation is not clearly defined in many countries, with Bangladesh and Cambodia being exceptions. The regulatory bodies in Bangladesh and Cambodia charge MFIs a fixed amount of license fees and annual registration fees. In Mexico, on the other hand, SCAPs (Popular Savings and Credit Cooperatives) are responsible for microfinance regulation costs and the money goes to the Federation (80 percent) and National Banking and Security Commission (20 percent).

- *Capital adequacy*

Capital requirements, which is an important component of regulation, varies from country to country. For example, Table 3.1 reports that Cambodia and Pakistan have clarified requirements by specifying liquidity, statutory reserve, solvency, and deposit protection funds. The remaining countries in the table, on the other hand, impose restrictions on the registered/paid-up capital amount.

- *MFIs' services*

Table 3.1 reports that services provided by MFIs differ from country to country and even from MFI to MFI within the same country. For example, the Microfinance Regulatory Authority in Bangladesh and Vietnam allow MFIs to provide loans and insurance to their clients. MFIs in Bolivia, China, India, Indonesia, Mexico, and Pakistan can provide loans but not insurance services to their clients.

**Table: 3.1 Comparative regulatory features for MFIs from nine countries that cover 57% of the total microfinance industry (Latin America (30%) and Asia (South, East and Asia Pacific) (27%)) around the globe**

| | Institute type | Regulator | Act/ decree/ rule | Year of inception | License criteria | Ownership structure | Regulation cost | Capital adequacy | MFI's service to clients | Source of fund | Loan size (maximum) | Interest rate | Taxation | Option for transformation | Monitoring and supervisory mechanism |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Bangladesh** | NGO-MFI | Microcredit Regulatory Authority (MRA) | MRA Act 2006 | 2006 | NGO registration and outstanding loans US$ 54,054; one million clients | No ownership | Registration, annual fees | 15% liquidity on deposit; 10% outstanding balance | The loan, deposit and insurance | Commercial sources, deposits, service charges, wholesale loan providers | US$ 1000 | 27% annual | Exempt | NA | On-site and off-site supervision, regular report to MRA |
| **Bolivia** | Private Financial Fund (PFF) | Authority of Supervision of the Financial System (ASFI) | Supreme Decree No. 24000 (1995); amended 2002 | 1995 | Minimum capital US$ 1 million and at least five shareholders | 5 neutral or juridical persons | NA | Registered capital US$ 1 million | The loan, deposits are restricted for the first 3 months | Deposits, service charge, commercial sources | US$ 5,000 | No ceiling | Applicable | Development Financial Institutions (DFI)/ NGOs can transfer to FFP (Private Financial Funds) | On-site and off-site ASFI; clients can complain to ASFI |
| **Cambodia** | MFI | National Bank of Cambodia (NBC) | NBC regulation 2000 | 2000 | Client>1,000; outstanding loan US$ 250,000; registration as NGO | Not defined | US$ 250 | Registered capital 5%; reserve requirement 5%; solvency ratio 15%; liquidity ratio 50% | The loan, deposits are restricted for the first 3 years | Deposits, service charges, commercial sources | US$ 130 | 3% per month (max.) | Applicable | MFI can transfer as deposit-taking institute after 3 years of license | Monthly report to NBC on assets liabilities, loan portfolio, etc., MIS (Management Information System) |
| **China** | Micro Credit Company (MCC) | China Banking Regulation Commission (CBRC) | MCC guidelines 2008 | 2008 | Registered capital > ¥5 million ($759,878) | Maximum 50 shareholders | NA | Registered capital > ¥5 mm ($759,878) and ¥10 mm ($1,519,756) | Loan (no deposit or insurance) | Donations, equity, and debt investment | Max. 5% of to individual | Max. 4 times of statutory rate | 5.3% business tax, enterprise tax 20–25% | | Internal control, on-site and off-site inspection |
| **India** | Microfinance Organisations (MFOs) | National Bank for Agriculture and Rural Development (NABARD) | Microfinance Institutions (Development Regulation) Bill, 2011 | 2011 | Existing MFOs submit an application to NABARD | Defined | NA | 15% reserved fund (minimum) | Loan, deposit | Equity fund; deposits service charge | US$ 260 | 26% Annual | Exempt | NA | On-site and off-site; regular report to NABARD |

| | Institute type | Regulator | Act/ decree/ rule | Year of inception | License criteria | Ownership structure | Regulation cost | Capital adequacy | MFI's service to clients | Source of fund | Loan size (maximum) | Interest rate | Taxation | Option for transformation | Monitoring and supervisory mechanism |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Indonesia** | Lembaga Dana Kredit Pedesaan (LDKP) | Bank Indonesia (BI) | BI regulation no. 8/26/PBI/2006 | 2006 | Registered as rural banks; equity minimum US$ 100,000 | Group or individual | NA | Paid up capital US$ 50,000–200,000; minimum 50% | Loan and Deposit | Deposits, service charges, commercial sources | US$ 500 | 2.5% per month | Applicable | NGO_MFI to Bank Perkreditan Rakyat (BPR) | Like commercial bank (on-site and off-site) |
| **Mexico** | Popular Savings and Credit Cooperatives (SCAPs) | National Banking and Securities Commission (CNBV) | SCAP law 2001; amended 2009 | 2009 | Licence required for assets value> US$ 77,000 | 10 shareholders (minimum) | NA | Minimum US$ 34,000 to US$ 8.5 million | Loan and deposit | Deposits, service charges, commercial sources | NA | 27% annual | Exempt | Transfer NGO-MFIs | On-site inspection; report submitted to CNBV |
| **Pakistan** | Microfinance Banks (MFBs) | State Bank of Pakistan (SBP) | MFB Ordinance 2000 (Ordinance XXXII of 2000) | 2000 | Person/institute having MFI experience; capital US$ 11.75 for national; US$ 5.88 for provincial | Group of people or Individual | Applicable | CAR 15%, liquidity 5%, statutory reserve 20%, deposit protection fund 5% | Credit and deposits | Deposits, service charges, commercial sources | US$ 1,750 | 16% annual | Applicable | MFI to MFB | Report to SBP; disclosure of lending/deposit rates |
| **Vietnam** | MFI | State Bank of Vietnam (SBV) | SBV decree 96/200/ND, CP-2010 | 2010 | Must document OSS 100%: minimum capital US$ 313,000 | Between 1 and 5 members | NA | Registered capital US$ 313,000; Portfolio at risk 5% | The loan, deposit; insurance | National and international commercial sources | US$ 200 | No ceiling | NA | NGO to MFIs | On-site and off-site; report to SBV |

*Source*: Adapted from Rahman and Luo (2012, p. 1022) and the author's summarisation of different countries' Acts/rules.

- *Source of funds*

All countries included in Table 3.1, with the exception of China, allow MFIs to collect deposits from the general public, whereas in the case of Cambodia and Bolivia, MFIs are restricted from deposit collection for three years and three months after registration respectively. Except for MCCs in China, all MFIs are allowed to collect funds from different sources, such as national or international commercial fund deposits, and service charges.

- *Interest rate*

From the beginning of modern microfinance, the interest rate charged by microlenders has been one of the most controversial issues (Rosenberg et al., 2013). The interest rate is usually high, often much higher than commercial banks' rates. The rationale provided by MFIs is that it costs more to lend and collect a given amount through hundreds and thousands of tiny loans as compared with commercial banks' lending and collecting the same amount (Rosenberg et al., 2009). Consequently, MFIs cover the higher administrative costs by higher interest rates.

Different stakeholders (governments, researchers, MFI clients, donors) of the microfinance industry worry that poor clients are being exploited by higher interest rates charged by MFIs, given that those poor borrowers have very little bargaining power. As a result, a large proportion of MFIs are moving into for-profit organisations where higher interest rates could mean higher returns for shareholders (Rosenberg et al., 2013). As a consequence, the regulatory authorities (governments, central banks, or external regulatory body) in different countries often impose interest rate ceilings for MFIs to protect small borrowers. Among the nine countries in Table 3.1, four (Bangladesh, India, Mexico, Pakistan) impose an interest rate ceiling between 16 and 27 percent per year. Cambodia and Indonesia impose it at 3 and 2.5 percent per month respectively, while Vietnam and Bolivia have no ceiling on interest rates for their MFIs. China's MFIs cannot charge more than four times the statutory interest rate of the country's central bank.

- *Taxation, maximum loan size, and transformation option*

Table 3.1 reports that tax exemption rules for MFIs in different countries are not the same. The authorities in Bangladesh, India, and Mexico exempt MFIs from any type of tax, whereas in Bolivia, Cambodia, China, Indonesia, and Pakistan, MFIs are subject to paying tax to their respective governments. Table 3.1 also shows that the maximum loan size an MFI can offer to its clients differs from country to country (the loan amount is as small as $130 to as large as $5,000), depending on the socio-economic standards in the country. Another important regulatory aspect for MFIs is the ability to transform from a microlender to an NGO to an MFI/deposit-taking institution, village bank/microfinance bank/private financial fund, etc. Rahman and Luo (2012) claim that although financial sustainability and experience give microlenders the option of transforming into different types of financial institutions, the government or the regulatory authority in many countries impose restrictions on the transformation in order to maintain control over the overall banking and financial system of the country.

- *Monitoring and supervisory mechanisms*

Table 3.1 reports that supervisory mechanisms are more or less the same for all countries. Most countries' MFIs regularly report to their regulatory authority. On-site and off-site inspection, internal control, and mandatory disclosure of lending/deposit rates are commonly observed in most of the countries' supervisory mechanisms.

### 3.2.2 Microfinance regulation in other parts of the globe

- ***Europe***

The legal framework for microfinance provision in Europe shows significant differences among European Union member countries. These differences vary from dedicated legal Acts (for microfinance) to specific provisions on microlending in Acts that regulate the banking and NGO sectors (European Microfinance Network, 2012). For instance, Romania and France have specific rules relating to microfinance and non-banking institutions—Romania: Microcredit Company Law 240 in 2005 (Boston University, 2016) and Government Ordinance 28/2006, transferred in 2009 by Law 93 of the non-bank financial institutions (NBFIs) (European Microfinance Network, 2012); France has the French Monetary and Financial Code Art. R518-57 to R518-62 (Cozarenco, 2015). Italy and Ireland also have legislation for the microfinance industry (Legislative Decree n. 141/2010 and Microenterprise Loan Fund Act 2012, respectively). Belgium, Germany, Greece, Malta, the Netherlands, Hungary, Serbia, Spain, and the United Kingdom do not have any specific legislation for the microfinance industry (Cozarenco, 2015).

A study by the European Microfinance Network (2012) comparing microfinance law and legislation in Eastern Europe with that in Western Europe shows that the microfinance industry continues to trend towards more commercially oriented and also financially sustainable organisations in Eastern Europe. On the other hand, in Western Europe, social inclusion remains the primary goal of MFIs, which receive financial support from the public to develop their activities.

Due to the lack of specific legislation for MFIs or inadequate provisions in existing legislation, the microfinance industry in different countries in Europe is facing a number of challenges. For instance, even in those countries where specific legislation for microfinance exists, the lack of provisions regarding the social goals of MFIs has led to the formation of 'so-called' MFIs, which unfortunately have solely commercial goals. Their governance practices are often unsupportive of innovative business creation and development of clients, such as very tight reimbursement policies and lack of business development training (European Microfinance Network, 2012). For instance, in Romania and Hungary, while many MFIs were established after the passage of the microfinance law, these are solely commercial financial institutions (Cozarenco, 2015).

In many countries in Europe, access to credit bureau data and similar databases is limited for MFIs. In Spain, for instance, non-bank MFIs do not have access to the database held by the National Risks Information Centre (NRIC) of the Bank of Spain. Only those MFIs in Romania that are registered under the Special Registry of the National Bank of Romania can access credit bureau data and report on their clients to the credit bureau (European Microfinance Network, 2012).

Interest rate caps in most countries limit the ability of small- and medium-scale MFIs to become financially sustainable organisations. For instance, in Macedonia, the microfinance legal framework changed the law on financial companies, and the law on obligations relations includes the introduction of interest rate caps (Vong and Song, 2015). Due to the low rates set by the regulators, these pieces of legislation have a negative impact on MFIs in terms of their financial sustainability and capacity to provide non-financial services (e.g., provision of business support services to their clients) (Cozarenco, 2015).

- ***Africa***

Like Europe, the legal framework for microfinance providers in Africa shows diverse regulation and supervision. However, the standard, direction, and goal of regulation are the same across African countries (Gallardo et al., 2005).

In Egypt, NGOs, banks, and banking service companies provide microfinance services (Moussa, 2007). NGOs are governed by NGO law (Law 84 of 2002) and supervised by the Central Bank of Egypt (CBE). The Ministry of Social Solidarity regulates NGOs. The microfinance industry in Egypt is regulated by CBE and operated under Banking Law No. 88 of 2003 (Mcib and Kehind, 2016). According to NGO law, NGOs are restricted from accessing different commercial sources of funding. Commercial banks do not have sufficient human and institutional capacity to offer microfinance (Moussa, 2007).

Kenyan MFIs are registered under eight different Acts. The Central Bank of Kenya is responsible for the supervision of MFIs using the Microfinance Amendment Act 2013 (Ali, 2015). The objective of the Microfinance Regulation Act 2006 (CBK, 2014) is to establish the legal, regulatory, and supervisory framework for deposit-taking MFIs (DTMs). The Acts make provisions for MFI license issuance, revocation, and restrictions; provide for MFI entry into regulated status, core capital requirements, limits for loans or credit facilities; define ownership and management structure, and overall supervision by the Central Bank of Kenya to which MFIs are expected to report periodically (Ali, 2015). Apart from DTMs and other microfinance providers, some non-deposit taking organisations are delegated for supervision under the Microfinance Unit of the Ministry of Finance. Kenya has three regulatory tiers defined under the DTM Bill and they include both formal and informal MFIs (Ali, 2015; Special Issue: Kenya Gazette, 2013).

In Nigeria, the central bank regulates all microfinance banks, but all microfinance providers must register as a company and NGOs with the Corporate Affairs Commission (CAC) (Mcib and Kehind, 2016). The central bank of Nigeria is responsible for all bank affairs through other financial institutions (Isern et al., 2009). The primary legislation for the regulation of banks and other financial institutions in Nigeria is the Banks and Other Financial Institutions Act (BOFIA) 25 of 1991 that, together with the Central Bank of Nigeria Act 2007 (CBN Act), gives the central bank the authority to regulate and supervise banks and other financial institutions in Nigeria (CBN, 2005).

South Africa provides microfinance services through NGO-MFIs. The Microfinance Regulatory Council (MFRC) was established in 1999 through an Exemption to the Usury Act. The National Credit Regulator (NCR) and MFRC are responsible for supervision of the microfinance industry in the country (Gallardo et al., 2005). The West African country Benin has a relatively small size but a diversified array of MFIs and the largest number in the West

African Economic and Monetary Union (UEMOA) (Steel, 2004). Saving and Credit Cooperative Organisations (SACCOs) law allows NGOs, donor projects, and informal institutions to engage in microfinance after registration with the Ministry of Finance, which is responsible for supervising the microfinance sector in the country (Gallardo et al., 2005).

Ghana's multi-tiered regulatory structure evolved through early efforts in the 1970s by authorising locally owned unit rural banks. In 1993, the Non-Bank Financial Institutions Act was introduced to regulate and monitor the financial sector and the microfinance sector (Steel and Andah, 2003). Central bank supervision proved unworkable and a new credit union law, the Non-Bank Financial Institution Act 2008, and Cooperative Credit Union Regulation 2015, was introduced. Ghana Microfinance Institution Network (GHAMFIN) is responsible for monitoring the institutional performance and benchmarking to develop industry standards for regulated and unregulated MFIs (Gallardo et al., 2005).

Unlike Benin and Ghana, Tanzanian Postal Savings Bank (by the Act No. 11 of 1991 as amended Act No. 1992) and three other commercial banks (National Microfinance Bank, Cooperative Rural Development Bank (CRDB) Bank and Akiba Commercial Bank) are the leading microfinance service providers in Tanzania (Randhawa and Gallardo, 2003). Establishment of National Microfinance Bank helped the formation of a multi-tiered regulatory framework to encourage engagement of formal financial institutions in microfinance and also to encourage the graduation of unregulated MFIs to formal status. Microfinance with non-bank financial services in Tanzania began with NGOs and SACCOs in 1995 (Gallardo et al., 2005). The central bank of Tanzania evaluates the regulatory process to ensure the adequacy of working capital of MFIs, successful experience in microfinance practices, lending limits, and loan loss provisioning, etc. (Chowdhury, 2014).

The regulatory structure of the microfinance industry in Uganda follows a tiered approach. According to Kalyango (2005), the tiered regulatory approach in Uganda classifies MFIs into four categories, and an MFI can graduate from one tier to the next tier only when it meets the requirements of that stage. This approach brings discipline to the microfinance industry of that country.

## 3.3 The Bangladesh microfinance industry

As a pioneering country in microfinance (Sinha, 2011), Bangladesh has lagged behind many countries in introducing a regulatory framework. The global approaches discussed earlier show that in a majority of countries (e.g. Cambodia, Ethiopia, India, Mexico, Nigeria, Vietnam, etc.), the respective state banks are responsible for the supervision and regulation of the microfinance industry, either under the existing laws for bank and non-bank financial institutions, or through the extension of previous laws. Some other countries like Bolivia, Peru, and Nepal have introduced separate legislation for the microfinance industry, implemented by their central banks.

As explained previously, the Bangladesh government has pursued a different approach by establishing an independent regulatory authority (Microcredit Regulatory Authority [MRA]) under the Microcredit Regulatory Act 2006, with a formal link to the state bank. An independent regulatory authority helps the state bank to establish linkages with the formal credit market and thereby ensures effective and efficient monetary policy for the microfinance industry (Khalily and Khaleque, 2014). The following section focuses on the Bangladesh microfinance industry and its regulatory and supervisory environment.

### 3.3.1 Country profile

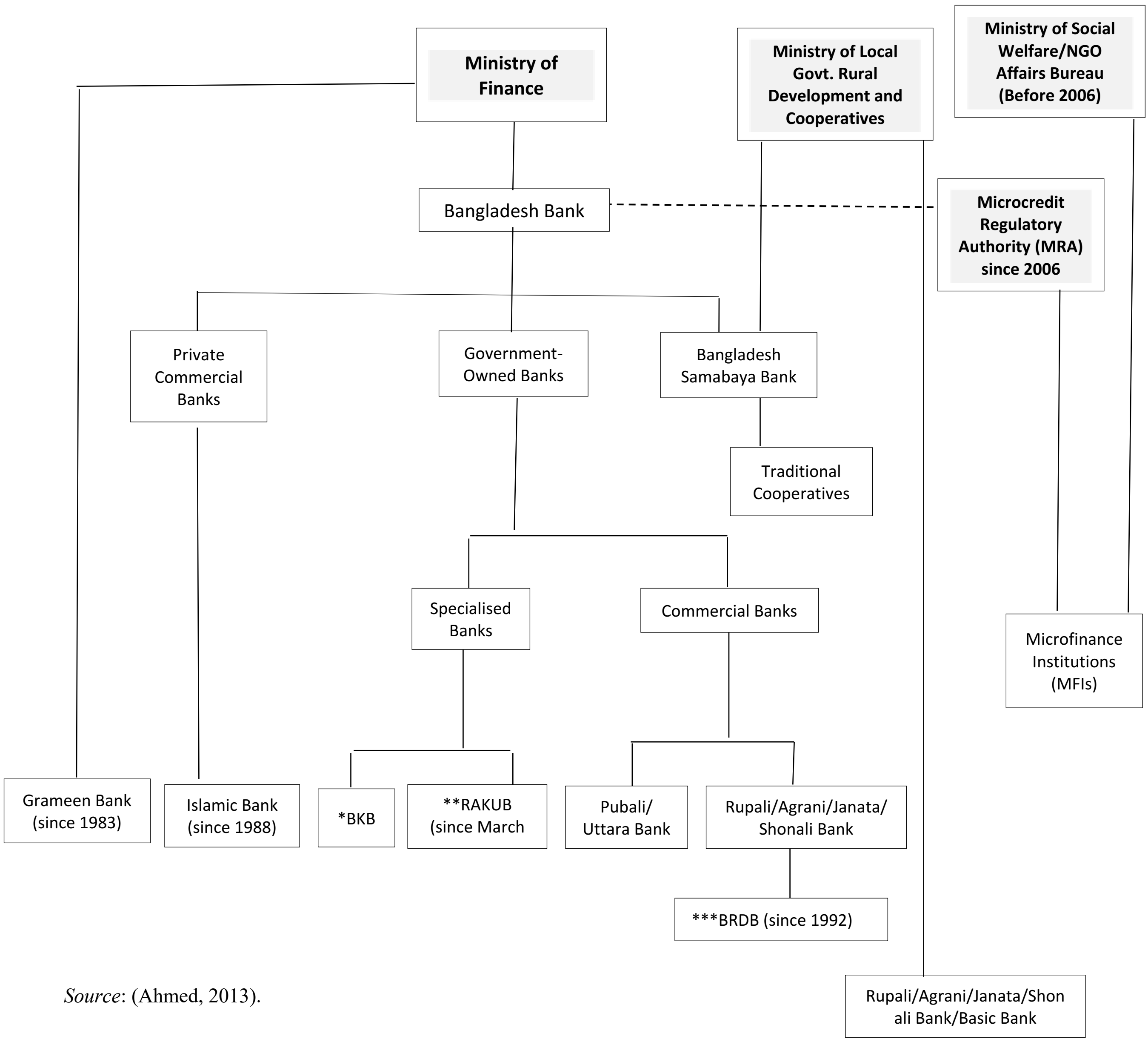
Bangladesh, a South Asian developing country (Begum and Shamsuddin, 1998; Gay, 2017) with a total population of almost 160 million, is one of the world's most densely populated countries (Pine, 2010). According to World Bank data, Bangladesh's poverty headcount ratio (percent) at national poverty lines was 48.9 and 24.3 for years 2006 and 2016 respectively, and its gross national income (GNI) per capita (Atlas method, US$) for 2016 was at 1,330 compared with 1,611 for South Asia. The literacy rate of adults in Bangladesh was 73 percent in 2016, while the country's life expectancy at birth was 72 years in 2015 (World Bank Group, 2018). The poverty of the country has various dimensions that are apparent in terms of inequality in income distribution, an exponential increase in the cost of living, unemployment, and internal migration (Pine, 2010). Bangladesh was ranked 139 out of 177 countries in 2016 in the UNDP (United Nations Human Development Program) Human Development Index (UNDP, 2018).

Right after the Bangladesh war of independence in 1971, the economic, social, and communication infrastructure of the whole country was devastated. State-owned rural banks and cooperative societies came forward to promote rural financing, economic development, and poverty alleviation activities (where some form of microcredit activities was embedded in their services) (Ahmed, 2013). As a part of its pre-independence political commitment towards economic emancipation of the rural poor, the Bangladesh government emphasised increasing banking facilities in rural areas of the country (Bangladesh Bank, 1974). However, the new government was unable to cope with this objective as there was only one government-owned agricultural bank with limited manpower and branches (72 branches for the whole country in 1972) (Bangladesh Bank, 1978). Although the government owned six other commercial banks—Sonali, Rupali, Pubali, Agrani, Janata, and Uttara (Figure 3.2)—these did not have a role in agricultural financing (Ahmed, 2013).

Apart from rural banks, two types of cooperatives (traditional and non-traditional) came forward in rural financing and were engaged in some form of microcredit activities. The traditional cooperatives were supervised and partially financed by an apex organisation called Bangladesh Samabaya Bank (BSB) (BSBL, 2018). The purpose of these traditional cooperative societies (at the union level) was to provide credit to members engaged in activities such as agriculture, fishing, afforestation, and small cottage industries (Bank of Info, 2017). On the other hand, non-traditional cooperatives were established on the Comilla Model[10] that was developed in the 1960s on an experimental basis (Khan, 1979). Two key aspects of the non-traditional model were the establishment of primary cooperatives at the village level, named Krishak Samabaya Samity (KSS), for landless labour and marginal and wealthy farmers, and Thana or Upazila Central Cooperative Associations (TCCA/UCCA) at the *upazila* and union level (Alam, 2006) (Figure 3.2). The purpose of these non-traditional societies was to provide input support, training, credit, and other services to members. The two-tier cooperative system was considered by the government as the most effective way of disbursing modern inputs, credit, and knowledge to poor farmers without changing the structure of their land ownership (Alam, 2006; Khan, 1979).

[10] A two-tier cooperative system, that was developed by Akhter Hamid Khan in the 1960s for the rural development purpose (Khandker, 1998b).

Figure 3.2: Rural financial market in Bangladesh




*Source*: (Ahmed, 2013).

*Bangladesh Krishi Bank, ** Rajshahi Krishi Unnayan Bank, ***Bangladesh Rural Development Board

### 3.3.2 Microfinance development in Bangladesh

Development of the microfinance industry in the country has progressed in four phases: (1) experimentation and innovation (1971 to 1982), (2) birth of modern microfinance and MFIs (1982 to 1989), (3) growth of MFIs (1990 to 2001), and (4) mature stage of MFIs (2002 to present) (Ahmed, 2013). The following section highlights the lifecycle of the microfinance industry in Bangladesh.

#### 3.3.2.1 Phase one: Experimentation and innovation phase (1971 to 1982)

After independence in 1971, a number of NGOs were active, parallel to government and cooperative (traditional and non-traditional) in efforts in rural financing, economic development, and poverty alleviation activities of the new-born country. Although credit was only a minor part of NGOs' overall programs, their main focus was to facilitate for the poor segment of the population awareness building, group solidarity, and a systematic organised relationship with the economic, social, and political systems of the country as a long-term solution to escape poverty (Ahmed, 2013).

In the mid-1970s, which is when the birth of microcredit in Bangladesh is considered to have taken place (Pine, 2010), a group of researchers from the University of Chittagong, led by Muhammad Yunus[11], started an action-research programme that provided loans to poor households in a village called Jobra in the southeast part of Chittagong district (Zaman, 2004). The 'Grameen' model introduced by Yunus involved a delivery system based on group solidarity, which used peer pressure and group guarantees for ensuring regular and timely repayment. The central philosophy of the Grameen model is to provide loans to small businesses run by women (mostly those who did not have any agricultural land) so that these poor women could utilise this money to get out of poverty (Alamgir, 2009). However, microfinance had a much wider appeal than that: borrowers could repay loans with very small weekly installments called *kistey*, irrespective of how the borrowed money was spent. So, borrowers with small businesses could reinvest their loans into their businesses for their growth. Households without a business could use these loans for any other purpose, such as

[11] Muhammad Yunus is a Bangladeshi social entrepreneur, microfinancing pioneer, banker, and economist who was awarded the Nobel Peace Prize in 2006 for founding the Grameen Bank in Bangladesh and pioneering the concepts of microcredit and microfinance.

housing, marriage, health, and education (Pine, 2010). Thus, the Grameen model became very popular and opened a new window for the development sector of the country (Alamgir, 2009).

After some trial and error, the Grameen model showed remarkable success, which eventually paved the way for the establishment of the Grameen Bank in 1983 under a special ordinance of the Bangladesh government (Pine, 2010). The Grameen Bank remains the only bank with a poverty alleviation bank license (Credit and Development Forum, 2009). The Grameen model inspired other NGOs to deliver different types of microcredit schemes, as a result of which microfinance soon became an important part of almost every social development initiative (Ahmed, 2013).

#### 3.3.2.2 Phase two: Birth of modern microfinance and MFIs (1983 to 1989)

The rural financial market (RFM) in Bangladesh experienced notable structural changes in the 1980s (e.g., in terms of legal status and orientation of organisational objectives, bank ownership structure, and an entrance of new types of banks) (Ahmed, 2013).

The structural changes started as a response to the criticism that rural development programs in the country mostly served wealthy farmers at KSS level, and the apex cooperative Integrated Rural Development Program (IRDP) was transformed into Bangladesh Rural Development Board (BRDB) in 1982 to reform the rural development program (Ali, 1990).

As agriculture is the largest employment sector in Bangladesh, the key focus of BRDB and Bangladesh Krishi Bank was in the agricultural sector. But a large section of the rural population also depends on other sectors for its livelihood, for instance, small business, fishing, daily labour, and transportation, with a significant proportion of women's earnings coming from the non-agricultural sector (Kazi and Cate, 2018). A large portion of this segment is very poor and landless and struggles to meet its basic human needs (Ahmed, 2013).

Because the land has been the primary collateral for accessing loans from formal banks, this segment of the population was outside the formal banking sector for a considerable period of time and trapped in a vicious cycle of poverty. To serve this segment of the poor population, a materialistic school of thought emerged in 1983 through the establishment of the Grameen Bank (as discussed earlier) under a special ordinance (Grameen Bank Ordinance 1983) (Pine, 2010). A distinct characteristic of the Grameen Bank is that it is legally mandated to provide credit services and other facilities (microfinance) to the poor and landless population in rural areas.

The success of the Grameen model and the Grameen Bank influenced the development activities of NGOs, encouraging them to become involved in microfinance practices. A number of NGOs started replicating the Grameen model in their development programs, resulting in the birth of modern microfinance and MFI phase in Bangladesh (Ahmed, 2013).

#### 3.3.2.3 Phase three: Growth stage of MFIs (1990 to 2001)

The period 1990–2001 saw a rapid expansion of microfinance activities in the rural economy through NGO-MFIs using the Grameen model (Pine, 2010). Khandker (1998) argues that rural banks' failure to serve the poor segment of the population led to the development of alternative credit programs and institutions in Bangladesh. On the contrary, other researchers (Carpenter, 1997; Conroy and McGuire, 2000) claim that the absence of formal supervision and regulation resulted in the rapid growth of innovative NGO-MFIs in Bangladesh. Although the credit provided by NGO-MFIs to borrowers is in small amounts, these MFIs provide this facility exclusively to landless poor households, which followed the credit policy of the rural formal banking system (Ahmed, 2013). The official eligibility criteria for acquiring loans from MFIs exclude non-poor borrowers. This clear distinction in the lending policy raises the credit flow to the poorer segment of the population of the rural economy (Khandker, 1998a).

During the 1990s, the 'franchising approach' (where new branches replicated the structures and procedures that prevailed in existing branches) by MFIs fuelled the exponential growth of the microfinance sector in Bangladesh (Zaman, 2004). The high population density and relative ethnic, cultural, and social homogeneity of the country aided this approach. During the expansion phase, a notable shift that took place was a greater emphasis on individual borrower loan repayment accountability rather than reliance on peer monitoring. The service/product offered to members was narrow, focusing only on a standard credit package for all members (Zaman, 2004). Using computerised MIS (Management Information System) monitoring and follow-up of loan repayments became more rigorous and professional. Donor funds also played an important role by contributing to expanding the revolving loan funds for MFIs during this growth phase. The emergence of Palli Karma Sahayak Foundation (PKSF) as a wholesale financing institution was yet another notable step in the exponential growth of the industry. The PKSF was established in 1990 (Charitonenko and Rahman, 2002). It is a public-private apex body governed by a board composed of both public and private sector representatives. PKSF channels funds for microfinance to MFIs in Bangladesh and has been critical in the expansion and improved professionalism of the microfinance industry in the country (Zaman, 2004). Table 3.2 highlights the growth of microfinance NGOs during the period 1996–2001.

**Table 3.2: Growth of NGO-MFIs (1996–2001)**

| Year | No. of NGO-MFIs | No. of active members (million) | No. of active borrowers (million) | Outstanding loan portfolio (Tk million) | Cumulative loan recovery rate (Tk million) | Net savings (Tk million) |
|---|---|---|---|---|---|---|
| 1996-end | 351 | 6.0 | 3.12 | 6,952 | – | 2,391 |
| 1997-end | 380 | 6.7 | 4.26 | 9,564 | – | 3,382 |
| 1998-end | 495 | 8.0 | 5.42 | 13,737 | 93.2 | 5,216 |
| 1999-end | 533 | 9.4 | 6.89 | 18,692 | 95.0 | 6,922 |
| 2000-end | 585 | 11.0 | 7.99 | 21,903 | 95.6 | 8,866 |
| 2001-mid | 601 | 11.6 | 8.32 | 23,983 | 95.4 | 9,591 |

*Source*: (CDF, 2001, p.33). ($1 AUD = 62.06 taka)

#### 3.3.2.4 Phase four: Growth and mature stage of MFIs (2002 to present)

The exponential growth (outreach) of MFIs continued after 2001, providing both geographical and demographic access to microfinance throughout the rural economy (Ahmed, 2013). During this stage, MFIs developed a wide range of innovative financial services, including diversification of their services and products, as well as sources of funds. Within a very short span of time, the microfinance industry captured the majority share of the rural financial market, and it made a substantial contribution to the equitable growth path of Bangladesh's economy (Charitonenko and Rahman, 2002). The current status of the microfinance industry and its contribution to pro-poor development are highlighted in the following section.

##### 3.3.2.4.1 Outreach of microfinance services

Table 3.3 reports that Bangladesh's microfinance industry had reached a crucial position in the economy by delivering financial services to 39.21 million clients in 2017, almost 74 percent of the poor population, with 32.44 million being active borrowers. In the same calendar year, the industry provided taka 1,207.54 billion microcredit with savings of taka 349.06 billion ($1 AUD = 62.06 taka). The industry-maintained robustness under the newly established regulatory environment (the Microcredit Regulatory Authority) as a majority of the outreach measures (e.g., loans outstanding and savings per borrower/per client/per branch), showed double-digit growth in 2017. However, a number of reporting MFIs experienced problems, mainly due to the closure of MFIs that could not meet the MRA requirements (CDF, 2017). According to MRA (2018), until July 2018, 100 MFIs lost their license and MRA cancelled their registration due to failure to meet MRA requirements.

**Table 3.3: MFI Growth and outreach during financial years 2015 to 2017**

| No. | Particulars | Number/Amount 2016–17 | 2015–16 | Growth over 2015–16 (%) |
|---|---|---|---|---|
| 1 | Number of reporting NGO-MFIs | 510 | 530 | -3.77 |
| 2 | Number of branches | 19,166 | 18,609 | 2.99 |
| 3 | Number of employees | 239,689 | 230,637 | 3.92 |
| 4 | Number of members/clients | 39,216,816 | 37,657,462 | 4.14 |
| 5 | Number of loan receivers during the year | 33,367,557 | 32,232,244 | 3.52 |
| 6 | Number of outstanding borrowers, June | 32,446,130 | 30,608,042 | 6.01 |
| 7 | Cumulative loan disbursed up to June (BDT in bn) | 7,062.30 | 6,056.12 | 16.61 |
| 8 | Loans disbursed during the year (taka in bn) | 1,207.54 | 955.77 | 26.34 |
| 9 | Loans outstanding, June (BDT in bn) | 770.47 | 611.61 | 25.97 |
| 10 | Members' net savings, June (taka in bn) | 349.06 | 294.11 | 18.68 |
| 11 | Disbursement of micro-enterprise loans during the year (taka in bn) | 361.10 | 277.88 | 29.95 |
| 12 | Disbursement of loans in April. Sub-sector during the year (taka in bn) | 595.96 | 477.66 | 24.77 |
| 13 | Disbursement of loans in remote areas during the year (taka in bn) | 60.49 | 38.98 | 55.18 |
| 14 | Number of NGO-MFIs financed by banks during the year | 450 | 275 | 63.64 |
| 15 | Loans disbursed to NGO-MFIs by banks during the year (taka in bn) | 56.46 | 30.08 | 87.70 |
| 16 | Number of NGO-MFIs financed by PKSF during the year | 169 | 168 | 0.60 |
| 17 | Loans disbursed to NGO-MFIs by PKSF during the year (taka in bn) | 31.14 | 29.85 | 4.32 |
| 18 | Bank-disbursed loans directly to clients during the year (taka in bn) | 65.59 | 63.09 | 3.96 |
| 19 | Public-institution disbursed loans directly to clients during the year (taka in bn) | 29.95 | 11.77 | 154.46 |
| 20 | NGO-MFIs delivered foreign remittance to clients (taka in bn) | 14.92 | 17.07 | -12.60 |
| 21 | Share of agricultural credit in total loans disbursed by NGO-MFIs (in %) | 49% | 50% | -1 |
| 22 | Percentage of NGO-MFI borrowers covered by insurance policies | 82% | 80% | 2 |
| 23 | Number of NGO-MFIs with social development programmes for clients | 379 | 386 | -1.81 |
| 24 | Number of NGO-MFIs with training programmes for clients | 273 | 274 | -0.36 |
| 25 | Share of micro-credit in total loans and advances of all banks (in %) | 17.62% | 15.38% | 14.56 |
| 26 | Share of micro-savings in total deposits of all banks (in %) | 3.87% | 3.47% | 11.53 |
| 27 | Sectoral share in agricultural GDP (in %) | 50% | 43% | 16.28 |
| 28 | Sectoral employment share in national labour force (in %) | 0.40% | 0.37% | 8.11 |

*Source*: (CDF, 2017, p.vi).

#### 3.3.2.4.2 MFIs' Diversified products and services, social development programs (SDP), and training programs (TP)

Since 2002, MFIs in Bangladesh have provided a wide range of financial services, different social development services, and training programs (Table 3.3) along with their regular microfinance operations. MFIs also provide inclusive financial services, such as micro-insurance, mobile-banking, and remittance delivery (Hasan and Malek, 2017). These diversified products and services (Table 3.4) have been created through a demand-driven innovative process in fulfilling the poor's complex livelihood and heterogeneous requirements (CDF, 2017). As the microfinance industry has reached its mature stage (Ahmed, 2013), it now offers various types of savings products aligned with the lifestyle of the poor so that they can save even for a day with a very small amount. Many of the products offered by MFIs are similar to those provided by formal banks; their inherent characteristics such as collateral requirements, loan terms and conditions, instalment size, and repayment period, are in line with the socio-economic pattern and lifestyle of the poor (Hasan and Malek, 2017).

**Table 3.4: MFI Social development programs (SDP) and training programs (TP) during financial years 2014 to 2017**

| **Social development program (SDP)** | **2016–17** | **2015–16** | **2015** | **2014** |
|---|---|---|---|---|
| MFIs providing SDPs | 379 | 386 | 364 | 375 |
| Percentage of total MFIs providing SDPs | 74.31 | 72.83 | 71.94 | 73.39 |
| Number of members who have received social services | 24,482,388 | 24,797,720 | 19,100,604 | 27,919,865 |
| Percentage of total members | 62.43 | 65.85 | 52.72 | 82.02 |
| Number of non-members who have received social services | 30,829,781 | 122,640,811 | 105,944,286 | 107,886,199 |
| **Training programs (TP)** | | | | |
| MFIs that have TPs | 271 | 274 | 266 | 271 |
| Percentage of total MFIs with TPs | 53.53 | 51.70 | 52.57 | 53.23 |
| Number of members who have received training | 1,077,345 | 974,728 | 708,335 | 781,725 |
| Percentage of total members | 2.75 | 2.59 | 1.95 | 2.30 |
| Number of non-members who have received training | 807,601 | 433,703 | 751,573 | 196,466 |

*Source*: (CDF, 2017, p.xv).

A recent review by CDF (CDF, 2017) shows that a large majority of MFIs have been implementing development initiatives under their social services, while a small number are yet to deliver such services. Table 3.4 reports that during 2016–17, 379 MFIs (74.3 per cent) were involved in 16 different social services, while the remaining 131 MFIs (25.7 per cent) did not have any such program during that period.

**Table 3.5: Distribution of MFIs by type of social development program (SDP) during financial year 2016–17**

| No. | Social development programs (SDP) | MFIs providing SDP | | |
|---|---|---|---|---|
| | | No. | (%) of MFIs involved in SDP | (%) of total MFIs |
| 1 | Healthcare & medication | 275 | 72.56 | 53.92 |
| 2 | Family planning & HIV | 100 | 26.39 | 19.61 |
| 3 | Education & academic assistance | 286 | 75.46 | 56.08 |
| 4 | Agriculture & agricultural equipment assistance | 128 | 33.77 | 25.10 |
| 5 | Water & sanitation | 211 | 55.67 | 41.37 |
| 6 | Housing | 139 | 36.68 | 27.25 |
| 7 | Forestation | 150 | 39.58 | 29.41 |
| 8 | Environment & disaster management | 104 | 27.44 | 20.39 |
| 9 | Rehabilitation of disabled | 109 | 28.76 | 21.37 |
| 10 | Rehabilitation of destitute & unemployed | 102 | 26.91 | 20.00 |
| 11 | Prevention of women torture & child trafficking | 97 | 25.59 | 19.02 |
| 12 | Prevention of child marriage | 181 | 47.76 | 35.49 |
| 13 | Relief | 101 | 26.65 | 19.80 |
| 14 | Development of women empowerment | 210 | 55.41 | 41.18 |
| 15 | Good governance & legal assistance | 130 | 34.30 | 25.49 |
| 16 | Others | 75 | 19.79 | 14.71 |
| | **Total (Aggregate)** | **379** | **100** | **74.31** |

*Source*: (CDF, 2017, p.53).

▪ *Micro-insurance*

As most microfinance clients comprise the very poor and are a vulnerable segment of the population, they often experience different types of household-specific and environmental risks, such as natural hazards, harvest failure, urgent medical expenses, theft, and insecure employment status. From 2002 onwards, MFIs have been offering different types of insurance services to deal with such emergencies (Hasan and Malek, 2017). A majority of MFIs provide loan insurance, which is applied for the duration of the loan. However, insurance practice across MFIs is not uniform. A survey of 463 MFIs (90 percent of MFIs reporting to CDF in the year 2016-2017) conducted by CDF (CDF, 2017) shows that 26,729,333 (8 percent of MFI borrowers reporting to CDF in the year 2016-2017) were covered by a micro-insurance policy in 2016–17 (Table 3.6). Of the responding 463 MFIs, a majority of MFIs (436 or 94 per cent) provided loan insurance policies, while 26 MFIs (5.6 per cent) provided livestock insurance, 15 MFIs (3.2 per cent) provided life insurance, 12 MFIs (2.6 per cent) provided welfare funds, eight MFIs (1.7 per cent) provided health insurance, and four MFIs (1 per cent) provided accident insurance. Table 3.6 provides details of micro-insurance programs as of June 2017, along with data for 2015–16 and 2014.

**Table 3.6: MFI Micro-insurance programs during 2016–17, 2015–16, and 2014**

| Insurance | 2016–17 | 2015–16 | 2015 | 2014 |
|---|---|---|---|---|
| Number of MFIs that have insurance programs | 463 | 466 | 405 | 372 |
| Number of borrowers covered by micro-insurance policies | 26,729,333 | 25,957,294 | 24,495,278 | 35,047,809 |
| Balance of insurance funds (Tk in million) | 15,908 | 13,711 | 20,238 | 20,317 |
| Number of unsettled claims of insurers | 794 | 782 | 4,844 | 578,772 |
| Amount of unsettled claims (Tk in million) | 9 | 11 | 109 | 4,347 |

*Source*: (CDF, 2017, p. xiv), ($1 AUD = 62.06 taka (tk))

- *Mobile banking*

Since September 2011, MFIs have introduced mobile financial services as agents/partners of local banks (Ahmed, 2013). These services include disbursement of inward foreign remittances; business payments (utility bill payments, merchant payments); dividend and refund warrant payments; business to person payments such as salary disbursements; vendor payments; government to person payments (elderly allowances, subsidies, freedom-fighter allowances, etc.), and person to government payments (tax, levy payments, etc.). Other payments include microfinance, overdrawn facilities, insurance premia and a Deposit Premium Scheme (DPS). Further, the Bangladesh Central Bank has expanded mobile financial services for MFIs by allowing loan disbursement and repayment activities under agent/partnership agreements with local banks (Hasan and Malik, 2017).

- *Source of funds for MFIs*

In the fourth stage (mature stage) of Bangladesh's microfinance industry, MFIs availed a number of sources for fund generation in providing credit facilities to borrowers. The distribution of sources of funds as at June 2017 is highlighted in Table 3.7, along with data for 2015–16 and 2014. Table 3.7 records that members' savings of 348,576 taka (43.11 percent) was the major contributor, own funds 270,559 taka (33.46 percent), loans from banks 133,108 taka (16.46 percent), PKSF loans 42,083 taka (5.2 percent), local MFIs 1,051 taka (0.13 percent), loans from international NGOs 2,255 taka (0.28 percent), donors' grants 4,099 taka (0.51 percent), and others 6,903 taka (0.85 percent) (CDF, 2017).

**Table 3.7: MFI Sources of funds during financial years 2016–17, 2015–16, and 2014**

| Sources of fund | 2016–17 | 2015–16 | 2015 | 2014 |
|---|---|---|---|---|
| Member savings | 348,576 | 293,272 | 269,951 | 226,587 |
| Own fund of MFIs | 270,559 | 209,521 | 195,494 | 188,437 |
| Bank loan | 133,108 | 92,719 | 77,890 | 55,707 |
| PKSF loan | 42,083 | 41,129 | 38,982 | 34,453 |
| Loan from local MFIs | 1,051 | 772 | 847 | 549 |
| Loan from NGOs | 2,255 | 1,919 | 1,888 | 1,909 |
| Grant from donors | 4,099 | 3,753 | 3,433 | 4,381 |
| Others | 6,903 | 14,387 | 18,058 | 6,740 |
| **Total** | **808,634** | **657,471** | **606,543** | **518,763** |

*Source*: (CDF, 2017, p. xiv)
*Taka in million, ($1 AUD = 62.06 taka).

## 3.4 Legal and regulatory structure of Bangladesh's microfinance industry

Bangladesh, even as a pioneering country in microfinance practices, lagged behind many other countries around the globe in enacting a regulatory framework for the microfinance industry. As discussed earlier (section 3.2.1), the global experience of regulatory frameworks for the microfinance industry gives evidence of several approaches (Table 3.1). The Bangladesh microfinance industry was less interested in a formal regulatory framework until 2006, and the Bangladesh government perceived self-regulation as an effective mechanism for the growth of the industry (Chowdhury, 2014). The philosophy behind the reluctance for formal regulation was that it might hinder MFIs' special innovative characteristics and limit their independence, increase their administrative costs, create a negative impact on their overall sustainability, and affect their ultimate goal of poverty alleviation (Khalily and Khaleque, 2014). The development of a regulatory framework for the microfinance industry in Bangladesh progressed in three phases: (a) first generation (1971–89), (b) second generation (1990–2005), and (c) third generation (2006–present). The following section highlights these stages.

### 3.4.1 First-generation regulation (1971–89): Banking laws and the Grameen Bank Ordinance 1983

As discussed earlier (section 3.3.1), from after independence in 1971 until 1989, other than the Grameen Bank, financial institutions such as government-owned agricultural banks, state-owned commercial banks, and cooperatives, were delivering some microfinance services among the landless poor in rural areas of Bangladesh. Agricultural banks and six other state-owned commercial banks were regulated by the Banking Companies Ordinance 1962 (Ahmed, 2013) (directives and instructions issued by the central bank and government) (Table 3.8).

Grameen Bank, the first microfinance institution, is regulated by the Grameen Bank Ordinance 1983, and it remained beyond the surveillance of the central bank until 1997 as per Clause 4(3) of this ordinance, which restricted the application of the then banking law, Banking Companies Ordinance, 1962 (Ahmed, 2013). The Grameen Bank did not come under the central bank's supervision until the late 1990s (Cracknell, 2012). As mentioned earlier, during the first phase of the development of microfinance, NGOs came forward in rural financing, economic development, and poverty alleviation activities. Since NGOs were not permitted to utilise public deposits, they could use only their own funds and thus their credit program was not sizeable. Given this, the central bank held back from supervising their activities, although they were monitored under respective laws under which they had been registered (Pine, 2010).

**Table 3.8: First-generation regulation (1971–89): Banking laws and the Grameen Bank Ordinance 1983**

| Financial Institutions | Banking Laws/Ordinances/Directives/Instructions |
|---|---|
| **Cooperatives** (IRDP & BSBL) | ▪ Bangladesh Cooperative Societies Act 1940<br>▪ Cooperative Societies Ordinance 1984 |
| **State-owned commercial banks** (Sonali, Rupali, Pubali, Agrani, Janata, and Uttara) and **agricultural banks** (Bangladesh Krishi Bank-BKB & Rajshahi Krishi Unnayan Bank - RAKUB) | ▪ Banking Companies Ordinance 1962<br>▪ Directives/instructions from the government<br>▪ Central bank circulars/instructions/guidance |
| **Grameen Bank** | ▪ Grameen Bank Ordinance 1983<br>▪ Societies Registration Act, 1860<br>▪ Trust Act, 1882<br>▪ Companies Act 1913 |
| **NGOs** | ▪ Charitable and Religious Trust Act (1920)<br>▪ Voluntary Social Welfare Agencies (Registration and Control) Ordinance 1961<br>▪ Foreign Donations (Voluntary Activities) Regulation Ordinance 1978 |

*Source*: (Ahmed, 2013, p.12).

### 3.4.2 Second-generation regulation (1990–2005): Updating banking laws, non-prudential guidelines by PKSF, and background to the formation of the MRA

The immediate positive response from NGOs' initial experiment with microfinance pushed back on governments', policymakers' and donors' pessimistic view of microfinance as a strategy for development intervention (Ahmed, 2013).

The exponential growth of microfinance practices among NGOs demanded higher seed funding (credit). The establishment of PKSF, a wholesale funding agency for MFIs, coincided with the increasing requirement for seed funds. After accessing seed funds from PKSF, microfinance operations changed the landscape by facilitating the rapid growth of the industry. However, PKSF set some conditions and criteria for gaining access to its financial resources, which could be considered as the beginning of quasi-regulation of MFIs in Bangladesh. MFIs that failed to meet those conditions were declined for access to its (PKSFs') financial resources (Pine, 2010). With these conditions and criteria, PKSF introduced a number of non-prudential guidelines and policies for funded organisations (also known as partner organisations), including guidelines for accounting, designing an internal control system, management of savings and service charge earnings, overlapping issues (multiple borrowing by an individual borrower from more than one MFI at a time so that the loan default rate increases), performance standards and categorisation of partner organisations, audit management of partner organisations, internal audit of partner organisations, management information systems, financial ratio analysis, business plan for partner organisations, policies such as loan classification and debt management reserves, utilisation of disaster management funds, and loans for institutional development. (Ahmed, 2013).

During the second-generation regulation of microfinance, there was not any separate law. However, some ordinances such as the Cooperative Societies Ordinance 1984, the Banking Companies Ordinance 1962, and the Companies Act 1913 were upgraded and consolidated in the Bank Company Act 1991, the Company Act 1994, and the Cooperative Societies Act 2001 (Table 3.9) for monitoring and supervising the activities of MFIs in the country (Pine, 2010).

**Table 3.9: Second-generation regulation (1990–2005): Updated banking laws and Grameen Bank Ordinance 1983**

| Financial Institutions | Banking Laws/Ordinances/Directives/Instructions |
|---|---|
| **Cooperatives** | ▪ Cooperative Societies Act 2001 |
| **State-owned commercial banks** (Sonali, Rupali, Pubali, Agrani, Janata, and Uttara) and **agricultural banks** (BKB & RAKUB) and BASIC Bank Ltd. | ▪ Bank Company Act 1991<br>▪ Directives/instructions from the government<br>▪ Circulars/instructions/guidelines issued by the central bank |
| **Grameen Bank** | ▪ Grameen Bank Ordinance 1983 |
| **Private commercial banks** | ▪ Bank Company Act 1991<br>▪ Circulars/instructions/guidelines issued by the central bank |
| **NGO-MFIs** | ▪ Societies Registration Act, 1860<br>▪ Trust Act, 1882<br>▪ Companies Act 1913<br>▪ Charitable and Religious Trust Act (1920)<br>▪ The Voluntary Social Welfare Agencies (Registration and Control) Ordinance 1961<br>▪ Foreign Donations (Voluntary Activities) Regulation Ordinance 1978<br>▪ Non-prudential guideline for microfinance operation developed by PKSF |

*Source*: (Ahmed, 2013, p.14).

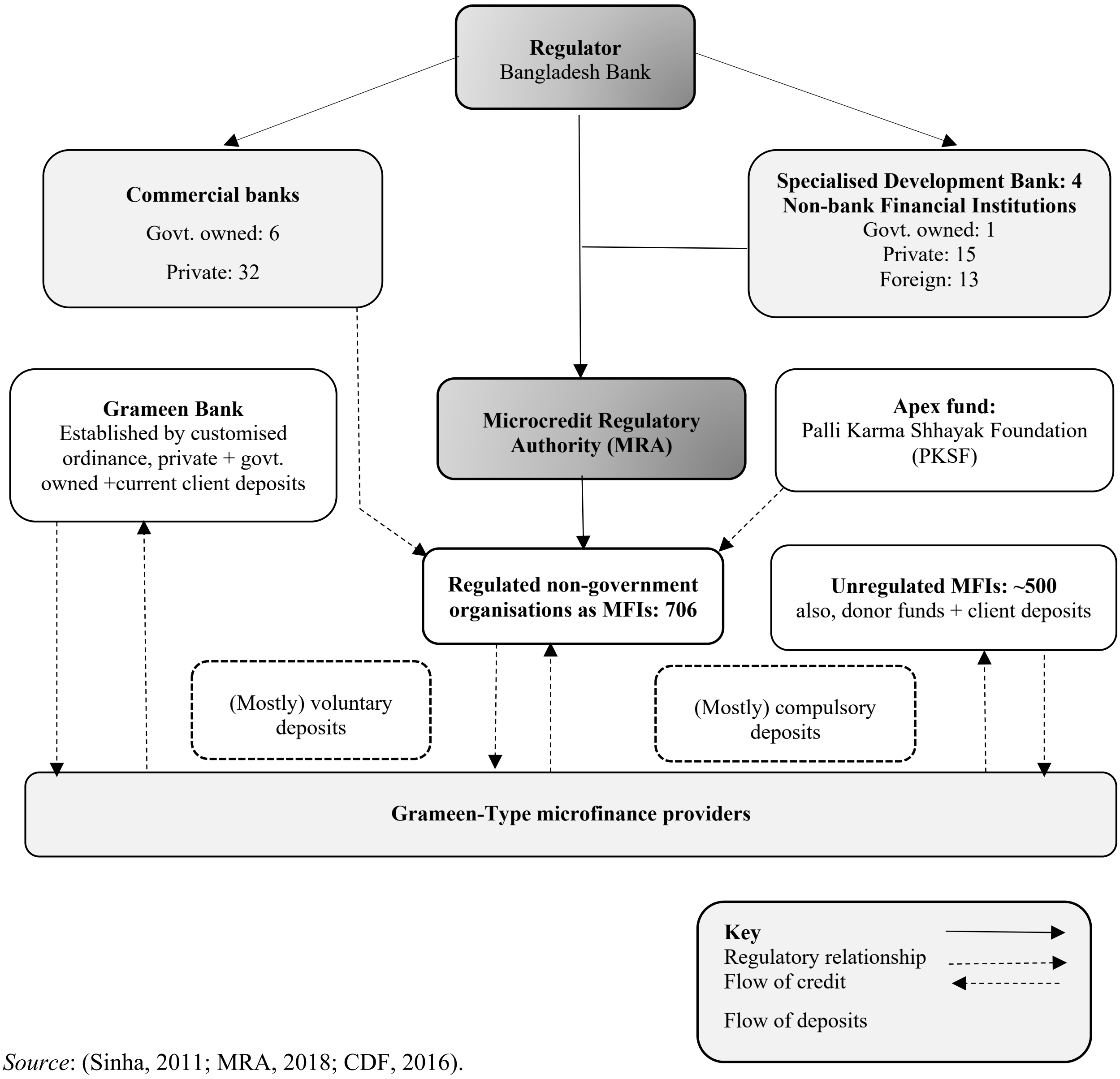
In order to link MFIs with the formal financial sector, in December 1997 the Bangladesh Bank commissioned a study to examine the regulatory aspects of MFIs (Rashid, 2010). After completion in 1998, the study recommended the legal recognition of MFIs through the enactment of a law for accessing formal sources of funds, so that they could operate under an agreed code of conduct, with special licencing arrangements (Ahmed, 2013).

In October 1999, the Bangladesh government formed a committee of seven members under the chairmanship of the governor of Bangladesh Bank. The committee submitted its report in March 2000, recommending an effective credit and saving policy, transparency, and accountability for MFIs' activities, and proposed a regulatory framework and a body to regulate and supervise the microfinance industry (Rashid, 2010). In June 2000, on the basis of the recommendation by the committee, the Microfinance Research and Reference Unit (MRRU) was established in Bangladesh Bank under the supervision of a steering committee to formulate policy guidelines for ensuring the transparency and accountability of the microfinance sector (Rashid, 2010). Recommendations of the national steering committee in 2005 culminated in a separate Microcredit Regulatory Authority Act 2006, which enabled and established a regulatory authority, the Microcredit Regulatory Authority (MRA)—the formal regulatory and supervisory body for the microfinance industry in Bangladesh (Ahmed, 2013).

### 3.4.3 Third-generation regulation (2006–present): MRA Act 2006, MRA Rules 2010, and MRA guidelines/directives

With the third generation of regulation and supervision, microfinance practice in Bangladesh is now governed by four different regulatory authorities: Bangladesh Bank; Ministry of Finance; Ministry of Local Government, Rural Development and Cooperatives; and the MRA (Rashid, 2010). Figures 3.2 and 3.3 show the rural financial market and the key regulators and the delivery mechanisms and regulatory structure of the microfinance industry, respectively (Sinha, 2011).

Figure 3.3: Delivery mechanisms and regulatory structure of the microfinance industry in Bangladesh




*Source*: (Sinha, 2011; MRA, 2018; CDF, 2016).

After enactment of the MRA Act 2006, the MRA became the main regulator for the microfinance industry, particularly MFIs, in Bangladesh. In providing microfinance services, MFIs fulfil the majority of the demand (51 per cent, excluding the Grameen Bank) (MIX Market, 2018), which includes 84 per cent of microfinance branches and 72 per cent of active members. The Grameen Bank constitutes 14 and 24 per cent of the branches and active borrowers respectively, while other financial institutions provide microfinance from 2 per cent of the branches and cover 4 per cent of active borrowers (MIX Market, 2018).

The MRA is entrusted with some key responsibilities, such as licencing, supervision, and policy formulation for MFIs in Bangladesh, along with auditing the accounts of MFIs (Ahmed, 2013). The governor of the central bank of Bangladesh (Bangladesh Bank), is the chairman of the board of directors of MRA by virtue of position (MRA Act, 2006). The following section highlights the basic content of the MRA Act 2006.

- **Basic contents of MRA Act 2006**
  - ✓ *Without licence (registration from MRA), MFIs (including credit only MFIs) are not allowed to provide microfinance services.*
  - ✓ *Collecting deposits from the general public (other than MFIs' members) is not permitted.*
  - ✓ *Development work and financial operation of MFIs and their accounts must be separated.*
  - ✓ *The authority (MRA) holds the power to impose rules related to the operations of microcredit including governance structure of MFIs, reporting requirements and criteria, audit accounts guidelines (internal/external), area of operations, deposit collections, conditions, and spending earned profit.*
  - ✓ *MFIs that apply for registration from MRA must have 1,000 borrowers or a minimum loan outstanding of taka 4,000,000.00.*
  - ✓ *If any MFI fails to comply with these rules, MRA holds the authority to take disciplinary measures against it. Convicted MFIs or the person concerned are punishable with imprisonment of less than one year or a penalty of not more than taka 500,000, or both.*

  *Source*: (MRA Act, 2006).

- **Vision, Mission, and Responsibilities of MRA**

According to the MRA website (www.mra.gov.bd, 2018), the vision of the MRA is to establish a favourable and strong environment for MFIs in Bangladesh for promoting sustainable development of the country. The key mission of the Authority is to ensure accountability and transparency of microfinance operations of MFIs (Baten, 2009). To implement its vision, the MRA provides guidelines to establish good governance and transparency in the financial and operational system of MFIs. Examining priority issues in the microfinance industry for policy advice and distribution of information is one of the key tasks of the MRA. Formulating and providing important suggestions to the Bangladesh government, consistent with the national strategy for poverty reduction, and helping it establish an inclusive financial market for the economic development of Bangladesh, is another important goal of the MRA (MRA, 2011). The authority is responsible for and committed to three primary functions defined by the MRA Act 2006:

- ✓ Registration/licencing of MFIs with explicit legal power
- ✓ Monitoring and supervision of MFIs to ensure they continue to comply with the licencing requirements
- ✓ Enforcement of sanctions for failing to meet licencing and ongoing supervisory requirements

*Source*: (Baten, 2009; MRA, 2011).

- **Important provisions of MRA Rules 2010**

The MRA Act 2006 provides the basic structure of regulatory (prudential/mandatory) requirements, which has scope to expand further through the formulation of guidelines and rules. According to the Act, the MRA has drafted a set of guidelines and rules under the coverage of law (Rahman, 2013) known as MRA Rules 2010, which cover the following areas:

- ✓ Licence issuing procedure (conditions, suspension, withdrawal, and cancelation rules)
- ✓ CEO, general body, the council of directors of MFIs (formation, function, appointment)
- ✓ Accounts maintenance and asset management
- ✓ MFIs' client rights and duties
- ✓ Source of funds and reserve funds (restriction, use, development)
- ✓ Preparation of financial statements
- ✓ Rules of loan disbursements
- ✓ Limit service charges
- ✓ Collection returns of deposit, and fixation of the interest rate on the deposit
- ✓ Maintenance of liquidity and usage of deposit funds

- ✓ Classification of loan provisioning

*Source*: (Badruddoza, 2013; Rahman, 2013).

- **MRA Rules, Guidelines, and Directives**

The MRA regulates the behaviour of licenced MFIs following the MRA Rules 2010 and policy guidelines (Rahman, 2013). It is important to note that not every regulatory announcement (rules and guidelines) affected MFIs' registration status immediately. Nevertheless, these guidelines from the MRA were published long before the date when the MRA recommended full implementation of the guidelines by MFIs (MRA, 2018). According to the MRA, it was practical to allow MFIs sufficient time and to expect significant changes in practice and performance due to MFIs' unfamiliarity with regulatory steps and the responsiveness to regulations by MFIs (Badruddoza, 2013). By August 2012, MRA had declined 3,380 applications, that is, 80 percent of the total applications, as these failed to meet the regulatory requirements. Licences were issued against 706 NGO-MFIs, while the remaining 5 percent have been kept under the potential category (Ahmed, 2013).

Current data from the MRA website www.mra.gov.bd shows that by July 2018 the MRA had issued licenses to 706 MFIs and rejected 4,236 initial applications. Additionally, 100 MFIs have lost their licence due to failing the compliance required by the MRA and 128 MFIs were given time to fulfil the requirements for achieving a licence from the MRA (MRA, 2018). Small and medium size MFIs failing to obtain a licence at their first attempt were advised by the MRA to raise their loans outstanding or increase their borrowers. But these conditions were made more flexible according to demands by small and medium size MFIs. However, after a number of advices and warnings, of 162 temporarily licensed MFIs 34 licences were cancelled by the MRA due to failure to meet the target set by the MRA (MRA, 2018). As explained in Chapter Four, this viewpoint of regulation indicates a 'Responsive regulation' approach by the MRA in Bangladesh.

The guidelines and directives define insurance policies, receipt of deposits, etc. Moreover, from May 2009, the MRA limited the interest rate MFIs charge clients to a flat 15 per cent or an effective rate of 30 per cent (Rahman, 2013). Additionally, MFIs are not permitted to collect deposits of more than 80 per cent of their total outstanding loan portfolio (Pine, 2010). According to MRA rules, only MFIs that have at least five years of microfinance operational experience, have been profitable for at least three years, with an accumulated loan recovery rate of 95 per cent, a current loan recovery rate not less than 90 per cent, and total voluntary deposits not exceeding 25 per cent of total capital, can receive voluntary deposits from clients. The total deposit balance of any MFI cannot exceed 80 per cent of the principal loan outstanding at any given time (Badruddoza, 2013).

The guidelines and directives also suggest that every MFI should have a reserve fund using 10 percent of its total income surplus with a 15 percent liquidity fund for its compulsory, voluntary, and term deposits in the savings account of a bank (Rahman, 2013). The guidelines also suggest the number and characteristics of the general body (chairman and board directors) of MFIs and its functions and responsibilities. The guidelines also focus on issues of female manpower, female quotas for the general body, healthcare and training, equal rights to be loan guarantors of women and men, social development, awareness of money laundering, calculation guidelines for instalments, etc. (Badruddoza, 2013; Pine, 2010).

The MRA is over twelve years old at the time of writing. During these past years, in addition to on-site and off-site monitoring of MFI performance and giving policy directions and guidelines, it has analysed the financial health of registered (licenced) MFIs using audit reports and outreach information (Ahmed, 2013). Additionally, there are various regulatory measures that the MRA has undertaken to enhance the social benefits of microfinance; to establish discipline and homogeneity in practices; and to preserve the interests of MFIs' clients, employees, and donors, by introducing greater accountability and transparency of MFIs. These steps by the MRA support MFIs to maximise their utilisation of resources towards profitability and increasing cost efficiency (Badruddoza, 2013).

## 3.5 Chapter summary

This chapter explains how microfinance activities and their regulation evolved around the world and compares the different regulatory structures in use. The chapter also shows that the central banks in many countries assume a regulatory and supervisory role, while in others, a separate authority (existing or newly created authority/network) has been empowered or delegated with the authority of supervision and regulation. The global scenario shows that some countries are more forward-thinking and innovative with regard to microfinance regulation, while others are at the stage of gathering experience. As Bangladesh is the context for this current study, this chapter focuses on the history of the microfinance industry in that country and presents the development of its regulatory regime through different stages of regulation.

Different regulatory and supervisory structures around the globe have emerged from differences in the socio-political and cultural characteristics and distinct demands of the specific country. The following chapter focuses on different governance and regulation theories that have been applied in the microfinance industry around the globe.

# CHAPTER FOUR
# Theories of Governance and Regulation

## 4.1 Introduction

Governance can be categorised from two perspectives; country-level and firm-level (Koch et al., 2013). Country-level governance reflects a country's legal institutions, securities regulation, and effectiveness of enforcement mechanisms (Bonetti et al., 2016). On the other hand, firm-level governance is defined by mechanisms within a corporation that revolve around the attributes of firms' ownership structure, board composition, and structure, and the roles of the board directors and shareholders (Alchian and Demsetz, 1972; Jensen and Meckling, 1976).

It is true that every firm has its own choice of firm-level governance mechanisms, however, this choice is regulated or restricted by national law, which may be affected by the national legal tradition (Koch et al., 2013). Doidge et al. (2007) claim that a country's institutional framework outlines the governance mechanisms at firm-level through its effect on the cost of implementing governance practices.

It is important to note that the term " corporate governance" has been used in the context of publicly listed and non-listed private for-profit organisations. However, governance practices in for-profit companies differ from those in nonprofit entities. Governance practices of this type of nonprofit organisation (MFIs) may be perceived differently from the for-profit corporate sectors since nonprofit companies explicitly deal with different aims and goals; that is they may have more than one mission ("dual mission goal" in the case of microfinance). Whereas for-profit companies usually focus on profit and value maximisation (shareholders' interests), nonprofit entities such as MFIs need to find a balance between social and financial performance when making decisions (Hermes and Hudon, 2018).

In regard to microfinance, it is true that many MFIs are not corporates in the sense of being public or private companies in legal form, but corporate governance practice is equally applicable to MFIs as it is to other public and private organisations[12]. Because appropriate corporate governance strategies can only encourage the success of any type of organisation (including MFIs) (Lapenu and Pierret, 2006), the governance environment needs to be assessed regularly for the growth and accountability of the organisation (Rock et al., 1998). Bebchuk et al. (2009) and Gompers et al. (2003) claim that there is much recent evidence that supports more stringent corporate governance practices leading to higher valuation and rates of return for financial institutions. The same picture is found at the country-level. That is, stronger legal regimes and external regulations are associated with higher growth and performance of nations (La Porta et al., 1998).

In the microfinance industry, many MFIs operating previously as NGOs have transformed into regulated financial intermediaries, and many more are considering such a transformation (Charitonenko and Rahman, 2002). According to Hartaska and Nadolnyak (2007), access to commercial funds is the main motive for this transformation. Hartarska (2005) argues that external regulation may impact MFI performance by changing the internal governance of MFIs. She also points out that prudential regulation is imposed on organisations that accept deposits because depositors own part of the resources and are thus principals. Furthermore, small and isolated depositors cannot protect their interests, so an external regulatory body is needed that can impose or restore good governance and efficiency by creating governance rules that can guarantee the safety of deposits (Dewatripont and Tirole, 1994).

[12] The term 'corporate governance' in relation to MFIs as used in this current study needs to be considered in its generic sense.

Theories of corporate governance and regulation are closely related and, to some extent, can be considered as two sides of the same coin (Kosonen, 2005). This chapter reviews a number of theories of regulation and governance practices, particularly in the context of MFIs.

This chapter commences with definitions of governance at the firm or internal level and regulation at the country or external level. Then it focuses on theories of regulation comprising normative (*Responsive regulation*), descriptive (*Smart regulation*), post-structuralist (*Nodal regulation*), and *Public and private interest view regulation.* Section 4.4 highlights the regulatory aspects of internal governance theories (*Agency theory, Stewardship theory, Institutional theory, Resource dependency theory,* and *Stakeholder theory*) and the rationale behind the selection of the theory adopted as the theoretical underpinning for this current study. Finally, an overall summary of the chapter is presented in Section 4.5. Figure 4.1 depicts the structure of this chapter.

Figure 4.1: depicts the structure of this chapter.

**4.1 Introduction**

**4.2 Country-level and firm-level governance**

**4.3 Theories of regulation**

**4.4 Regulatory aspects of governance theory**

**4.5 Summary of the chapter**

## 4.2 Country-level and firm-level governance

For effective and efficient performance and appropriate accountability for resources, a comprehensive structure of control between internal (firm-level) and external regulation (country-level) governance mechanisms is vital. External (e.g., ownership structure, external regulatory bodies, external auditors) and internal (e.g., board structure and composition, board independence and diversity, CEO/chairman duality, and transparency) governance mechanisms are discussed in detail in Chapter five, while the following section highlights theory relating to these internal and external regulation governance mechanisms.

- **Country-level governance**

Historically, financial services, financial institutions, and financial markets have been more strongly monitored and heavily regulated in all countries compared to any other industry (Benston, 1998). Llewellyn (1986) argues that it is universally accepted that the risk-taking activities of financial institutions should be constrained. In the majority of cases, the government has stepped in to regulate the financial sector because of market failure (Benston, 1998; Francis, 1993). The principal objectives of this regulation have been maintaining financial system stability by creating systemic stability, maintaining the safety and soundness of financial institutions, and protecting depositors (Goodhart et al., 1998; Llewellyn, 1999).

Regulation is a broad concept. Studies focusing on the role of the state look at it with reference to state-made laws (Laffont, 1994), while society-centred analyses and scholars of globalisation like to point to the proliferation of regularity institutions beyond the state (Faur, 2010). For sociologists and criminologists, it is another form of social control (Braithwaite, 1989), while legal scholars (Ayres and Braithwaite, 1992; Braithwaite, 1989, 2002) often view regulation as a legal instrument. According to Hertog (2003), regulation may be broadly classified into economic regulation and social regulation. Economic regulation refers to the regulation of a specific industry and is concerned with restrictions on price, entry, and exit, and other forms of decision-making by organisations. Social regulation concerns the regulation of common aspects of the behaviour of firms, focusing on the protection of workers, consumers, or the environment (Hertog, 2003).

In the area of financial regulation, a further distinction is made between 'prudential and systematic' regulation and 'conduct of business' regulation. According to Goodhart et al. (1998), prudential and systematic regulation both adopt a similar approach. Prudential regulation is concerned with the safety and soundness of financial organisations as well as consumer protection, in that the consumer loses when an institution fails, even if there are no systematic consequences. Systematic regulation, on the other hand, focuses on the soundness of financial institutions for mostly systematic reasons. Goodhart et al. (1998) observe that consumers do not have the authority to judge the safety and soundness of financial institutions. Moreover, imperfect consumer information and agency problems through information asymmetry also underline the necessity for prudential regulation. The characteristics of prudential regulation and its practice were highlighted in Chapter two (Section 2.5.1).

According to Llewellyn (1999), the other category of 'the conduct of business regulation' concerns how organisations conduct business with their major stakeholder group (customers). Unlike prudential regulation, it is designed to establish rules and guidelines about proper behaviour and governance practice in dealing with customers. It highlights how financial institutions conduct business with their consumers and includes information disclosure, fair business practice, honesty, and the integrity of organisations and their employees (Goodhart et al., 1998).

- **Firm-level governance**

Firm-level governance or internal governance plays a central role in generating accountability and transparency to stakeholders. Corporate governance refers to the principles and rules of managing, controlling, and monitoring an organisation's operations so that the organisation can achieve its mission (Luo, 2005). Governance of an organisation is therefore intrinsically linked to the management and control system of the organisation.

Several theories explain the need for entity governance, including agency theory (Jensen and Meckling, 1976), stakeholder theory (Freeman, 1984), institutional theory (Selznick, 1957), stewardship theory (Donaldson, 1990), and resource dependency theory (Pfeffer and Salancik, 1979). Daily et al. (2003) claim that most researchers focus on agency theory, although Carver (2007), Kiel and Nicholson (2003), Letza et al. (2004), and Pettigrew and McNulty (1995) argue that there is no unified governance theory and that organisations adopt an appropriate governance structure according to what is demanded in different circumstances.

There are various regulation and corporate governance theories. It is important to note that if the theory or the designed regulation does not fit with the reality in all circumstances, the regulation becomes ineffective (Klettner, 2014). The following section focuses on several regulation theories and their applicability for effective corporate governance in the context of this thesis.

## 4.3 Theories of regulation

The public interest view considered one of the key economic theories of regulation (Hertog, 2003) dominated the concept of regulation for most of the twentieth century (Barth et al., 2006). Public interest can be defined as the best possible allocation of resources for individual and collective goods (Hertog, 2003). The theory suggests that under certain circumstances, the allocation of resources by means of the market mechanism is optimal (Arrow, 1985), but this is not always the case, making it necessary sometimes to improve the allocation (Bator, 1958). This approach assumes that significant market failures (for instance, imperfect competition, information problems in deposit-taking businesses, information problems in lending businesses, externalities) occur and the state has both the incentives and capacity to correct these failures (Chiumya, 2006; Staschen, 2010). Table 4.2 provides more detail about some of these market failures in a microfinance context.

In 1971, a start was made towards developing a theory of regulation, called by some theorists 'the economic theory of regulation' or 'the Chicago theory of government' and by other theorists 'the private interest theory of regulation' (Hertog, 2003). Private interest theory states that stakeholders adversely affected by regulation exercise political influence and lobbying for outcomes to their benefit (Chalmers et al., 2012). According to Stigler (1971), the key focus of this view is to explain who will benefit or bear the expense of economic regulation, the impact of resource allocation, and the form that the regulation will take. The following section explains available regulatory forms in more detail.

**Table 4.2: Market failures in microfinance and conventional banking**

*Source*: Adapted from (Staschen, 2010, p.53).

| Market failures | Microfinance | The difference from conventional banking |
|---|---|---|
| Imperfect competition | The entry barrier is the major problem for regulated activity (e.g., deposit taking), whereas regulated MFIs still compete with unregulated MFIs in other activities (e.g., lending). Another problem is the high risk of a local monopoly in remote, rural markets for regulated and unregulated MFIs. | Conventional banking is more an outcome of regulation than a justification of regulation; banking is not regulated as a natural monopoly. |
| Information problems in lending business | This problem is serious because of the small size of loans, lack/limitations of documentation; collateral substitutes quite effective for hidden action problems (monitoring the use of funds, borrowers' repayment capacity, etc.) | Information constraints make it difficult to select the most credit-worthy borrowers *ex-ante* (hidden knowledge) and to prevent hidden actions *ex-post*; incentive effects of the interest rate can lead to credit rationing. |
| Information problems in deposit-taking business | This problem is serious because of the small size of deposits and lower financial literacy of depositors; however, credit-only MFIs and compulsory savings mean MFIs face fewer problems. | Retail depositors lack incentive for monitoring the utilisation of their funds; banks have the incentive to undertake excessively risky investments; information problems can lead to problems of hidden action. |
| Externalities | High risk of runs and high contagion for microfinance, in particular, information-based contagion (mostly among borrowers); systemic risk mostly at the sub-sector level (i.e., among MFIs). | Negative externalities can trigger bank runs (which might even affect big and medium institutions) and cause contagion at a system-wide level; runs and contagion can potentially create high social costs. |

### 4.3.1 Public and Private Interest Theory

According to researchers (Baldwin and Cave, 1999; Stigler, 1971), two opposing strands of regulation theories, are 'public interest view' and 'private interest view'. Both theories originated in the analysis of regulation in the 1960s in the US (Bartle et al., 2012). The following section focuses on these two competing theories.

- ***Public interest view***

The central idea of the public interest view is that those seeking to introduce or develop a regulation focus on public-interest-related objectives rather than group, sector, or individual interests. Those advocating regulation thus act as agents of the public interest (Chiumya, 2006). The theory assumes that the government, acting in the public interest, establishes a legal framework to realise a specific set of regulatory objectives. Regulatory intervention occurs in the interests of the public at large (Joskow and Noll, 1981). Stigler (1971) asserts that public interest theory is a way to ensure competition and impact externalities and it stabilises the economy and introduces social objectives in economic policies.

According to public interest theory, government regulation plays a significant role in achieving efficiency in the allocation of resources in a market. In particular, government regulation may be efficient when private laws fail to address market failure (Hertog, 2003). In other words, public interest theory is considered as an entry point for the explanation of regulation, which is to achieve publicly desirable outcomes when non-interventional processes fail (Baldwin and Cave, 1999).

The theory that regulation and supervision can be explained as a solution to market failure has been criticised from several points of view. An early empirical study by Baldwin and Cave (1999) on the effects of regulation concluded that regulation could not achieve the results that a public interest theory of regulation would have implied, such as correcting market imperfections so as to simulate the welfare-maximising conditions of perfect competition and consumer protection (Chiumya, 2006). Stigler (1971) and Peltzman (1976) argue that public interest theory ignores the degree to which economic and political power influences regulation. Majone (1996) and Posner (1974) support this view and claim that regulatory policies and institutions often are influenced by those who are regulated, politicians or consumers, so the regulation gives more attention to these groups rather than the interests of the general public (Francis, 1993). Posner (1974) states that although regulations were proposed initially to serve public interests, the regulatory process was subsequently misused, with the result that the original goal was not always achieved. Hence, it can be assumed that regulatory policies under the public interest view are not necessarily always a result of a desire to correct market failure. This view is known as regulatory capture theory (Chiumya, 2006).

Regulatory capture theory puts forward two basic propositions. First, the political process of regulation is captured by the industry, where regulation is unable to control monopoly pricing through state intervention. Second, even in the case where under the influence of organised consumer groups, regulators try to promote social welfare, they are incompetent and hardly ever succeed (Peltzman, 1989).

In a microfinance context, too much control with strong regulatory binding and a command and control regulatory nature is considered cumbersome, inflexible, and inefficient (Sinclair, 1997), making it inappropriate given the innovative nature of microfinance. It might hinder MFIs' special innovative characteristics and limit their independence, increase their administrative costs, create a negative impact on their overall sustainability, and affect their ultimate goal of poverty alleviation (Khalily and Khaleque, 2014; Okoye and Siwale, 2017). Also, countries such as Bangladesh, the context of this research, where corruption and political interference is a serious concern may influence the 'public interest view' regulatory system and constrict the actual welfare mission of microfinance by political capture in the form of regulatory capture.

- ***Private interest view***

The central idea of private interest theory demonstrates the importance of knowing who will benefit or bear the costs of economic regulation, what form regulation will take, and what the effect of regulation on the allocation of resources will be (Stigler, 1971). The theory also explains that 'since the state's coercive power can be exercised to benefit particular individuals or groups through economic regulation, the power can be viewed as a product whose allocation is governed by demand and supply' (Posner, 1974, p. 60). However, political leaders are considered to be utility maximisers, and these utility functions are used to secure and maintain political power (the supply side). For achieving these objectives, politicians require money and votes that can be provided by groups positively affected by regulatory decisions (Chiumya, 2006).

Barth et al. (2006) argue that related to the idea of 'regulatory capture' is the notion of 'political capture', which involves the regulatory machinery being used primarily to further the interests of government members. The regulation is modeled in the interests of political leaders, and the regulatory measures may be shaped for improving their financial welfare. There is a possibility that governments with powerful supervisory agencies could misuse this power to benefit favoured constituents, attract donations, and extract bribes (Barth et al., 2006). According to this view, powerful regulators will not concentrate on overcoming market failure and improving social welfare, but rather on their personal interests (Chiumya, 2006). Cook et al. (2003, p. 13) claim that "*A political capture is thus a form of regulatory capture under which regulation is designed and promoted to meet the needs of the political elite and to preserve its power*".

According to Mitnick (1980), Stigler's model (Stigler, 1971) ignores the role played by regulatory agencies, where often representatives have considerable discretion, are often not elected, and are not always subject to a political appointment but may be civil servant employees. Moreover, private interest theory explains that the government regulates the financial sector to help the financing of government expenditure, to funnel credit to politically attractive ends, and more generally to maximise the welfare and influence of bureaucrats and politicians, even when public interest objectives are the apparent goal. Chiumya (2006) states that although there may be substantial market failures in the financial sector, the private interest view explains regulation based on reliance on powerful official regulatory agencies. So, like the public interest view, it can be said that for the microfinance industry, adoption of the private interest view can create an adverse impact of the regulatory objective for countries such as Bangladesh where corruption and political interference remain a serious challenge.

### 4.3.2 Post-structuralist: Nodal governance

The post-structuralist interpretive perspective deals with the flow of regulatory interactions across sector-specific networks and through different 'nodes' for influencing the overall regulatory system (Burris et al., 2005; Wright and Head, 2009). The post-structuralist perspective emphasises regulatory arrangements at the 'governance network' level. In contrast, the descriptive perspective focuses on the cultural and organisational content of regulatory spaces (Wright and Head, 2009). Nodal governance is an example of a post-structuralist perspective. Nodal governance is considered an elaboration of contemporary network theory, which explains how different actors operating within social systems interact along networks to govern the system they inhabit (Burris et al., 2005).

Wright and Head (2009) describe nodal governance as a key model within the post-structuralist perspective, which elaborates on the concepts of Foucault and Castells by reasoning that despite power being transmitted across networks, knowledge and capability are organised and mobilised at the node (Burris et al., 2005; Wood and Shearing, 2007). Wright and Head (2009) claim that nodes can be non-governmental institutions, companies, community groups, government departments, or citizen associations. These nodes can exist both within and across sector-specific networks.

The post-structuralist perspective is often found within polycentric regulatory regimes, where the state is not the core focus of authority (Black, 2008). Black (2002) asserts that the post-structuralist perspective also plays an important role in developing values and processes through which regulation, as the exercise of power and authority, can be legitimated.

Post-structuralists consider legitimacy within regulatory regimes as essentially contested and recognise that legitimacy and accountability are critical problems. The institutional environment, the accountability relationship, and the communicative structure are the three key components of the governance network that can be the solution for this legitimacy and accountability problem (Black, 2008). Wright and Head (2009) suggest that legitimacy claims come from different points in the network and exist as dialectical accountability relationships that are socially and broadly constructed. These relationships can construct the strategic actions of regulators.

According to Wright and Head (2009), the post-structuralist perspective refers to regulatory spaces at the level of public and private agents, organisations, and interest groups located within governance networks. Hence, it can be claimed that models within this perspective (nodal governance) have a capacity to frame useful accounts of the development and operation of regulatory arrangements (Black, 2008; Wright and Head, 2009).

A conventional understanding of the location of power and legitimacy in society is the primary aim of the post-structuralist perspective, which is considered as a potential weakness of the theory (Wright and Head, 2009). Nodal governance discourages privileging state institutions over other nodes within the governance network. Also, the assumption of legitimacy outside the state/ node is a critical issue for nodal governance.

In this regard, since the majority of microfinance clients are from remote areas without any strong monitoring and control system, too much decentralisation of power and authority of microfinance practitioners can cause exploitation, mistreatment by MFI staff of vulnerable MFI clients (discussed in Chapter one, Section 1.3.1) and ultimately can cause mission drift by MFIs from the welfare objective of microfinance. So, it can be said that the adaption of a nodal governance approach may not be appropriate in a microfinance context.

### 4.3.3 Normative perspective: Responsive regulation

The normative perspective highlights formal institutions, rules, and techniques for enforcement. This perspective also deals with strategising and negotiating controls, as well as response frameworks to enhance compliance with public interest goals and frameworks (Braithwaite, 2011; Wright and Head, 2009).

Normative perspective regulation implicitly seeks to provide a basis for improving or reinforcing the efficient operation of a governance practice of a firm (Wright and Head, 2009). Responsive regulation (as an example of normative perspective regulation) emphasises 'negotiation' and 'rational strategising', focusing on actors' motivation and powers (Wright and Head, 2009). The theory highlights elements of the institutional context and is concerned with how regulatory arrangements should be designed. In contrast, in the more traditional directive regulatory (command and control) approach (rules, standard-setting, and enforcement), specific characteristics of individuals, organisations, and industries are not considered in the context of a system based on general rules, but rather in terms of nuanced or tailored requirements (Ayres and Braithwaite, 1992; Wright and Head, 2009).

Command and control regulation is considered as cumbersome, inflexible, costly, and inefficient (Sinclair, 1997). Responsive regulation, in contrast, engages with regulatory spaces in terms of the negotiation 'responsiveness' between regulators, the regulated, and the wider community, and it is enforced by rational strategising and self-regulatory techniques (Ayres and Braithwaite, 1992; Wright and Head, 2009).

Responsive regulation theory suggests a regulatory enforcement pyramid of sanctions (Figure 4.2). The target is to achieve the highest levels of regulatory compliance by persuasion (Gilligan et al., 1999; Welsh, 2009). The pyramid begins with persuasion, and moves through motivation, education, advice, training, and so forth, to the bottom of the pyramid. During the escalation process, if persuasion fails, regulators may consider an escalation in the pyramid and move to a warning letter stage. If a warning letter does not work in securing compliance, the regulator may enforce a civil monetary penalty to prompt compliance. The following stage is that of a criminal penalty. If a civil penalty does not work, then regulators can proceed to shut down or temporarily suspend the licence. If temporary suspension of licence fails, regulators escalate to the last step of the pyramid and revoke the permit/licence of the offender (Ayres and Braithwaite, 1992; Morgan and Karen, 2007; Scott, 2004).

Responsive regulation suggests that it is hard to find any uniform or 'best regulatory solution'. However, some regulations better address the plural configurations of support and opposition that exist at a particular moment in history (Ayres and Braithwaite, 1992). Wright and Head (2009) and Braithwaite (2011) claim that 'responsiveness' involves strategising and negotiation of what action will be effective for a regulatory response and the type of response.

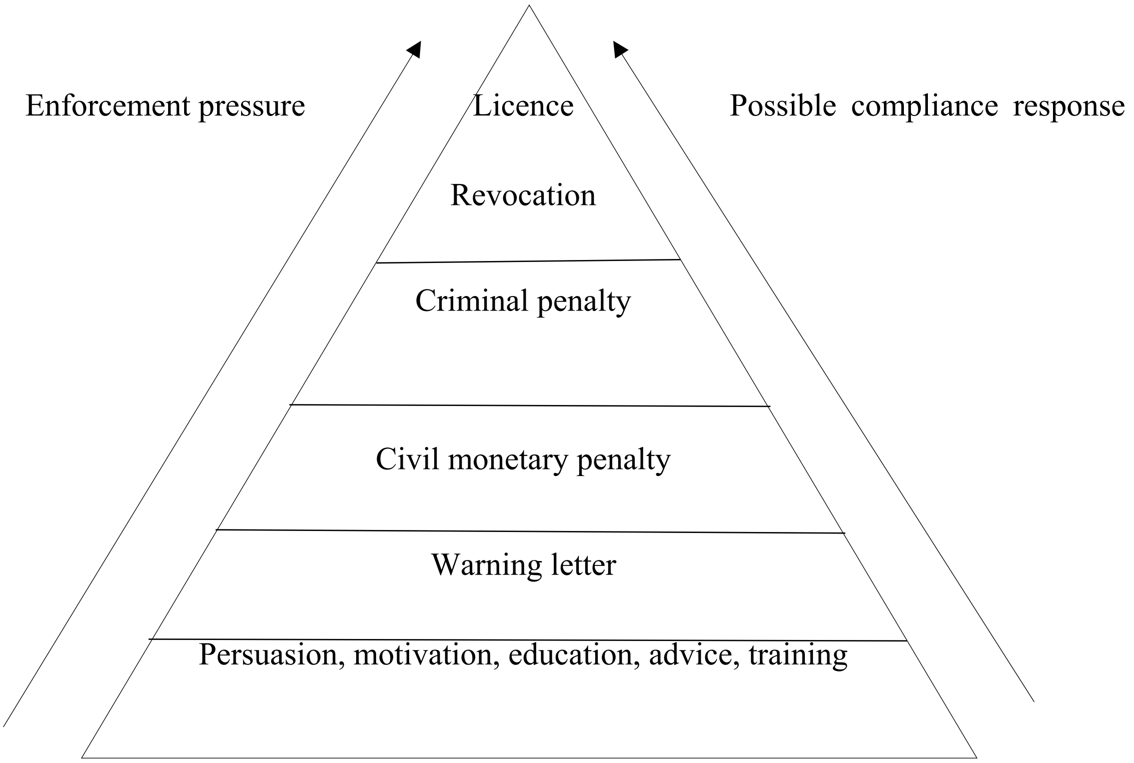



**Figure 4.2: Enforcement pyramid of responsive regulation**

*Source: (Ayres and Braithwaite, 1992, p.52)*

Both responsive and traditional directive regulation represent essentially normative models focusing on advancing public purpose. Traditional directive regulation is best suited to a regulatory space with little or no diversity and where the regulated bodies have relatively uniform characteristics (Wright and Head, 2009). In responsive regulation, regulators, the regulated, and the community sector can build the basis of negotiated "responsiveness" (Ayres and Braithwaite, 1992).

According to Parker (2013), the research-based strategies promulgated under responsive regulation and its dynamic characteristics (e.g., the notion of 'external governance that includes the stakeholders', the 'strengths-based pyramid', and the idea of regulation as freedom from domination) give a direction and structure for protecting the public from the consequences of unfettered capitalism as well as those of a domineering governance. Parker (2013) also claims that this characteristic of responsive regulation eliminates the command control approach of regulation and shrinks it to explain regulation as more of an interpersonal relationship, where cooperation, sharing, and responsiveness are possible and desirable.

The normative perspective (responsive regulation) approach has been adopted explicitly by a wide range of regulators (e.g., Braithwaite, 2002; Braithwaite et al., 2007; Gunningham, 2007; Leviner, 2008; Mascini and Wijk, 2009). For example, the Australian Taxation Office's (ATO)[13] regulatory operations are guided by a 'cooperative compliance model', which is an acknowledged adoption of Braithwaite and Ayres' (1992) 'responsive regulation model' (Wood et al., 2010). According to then ATO Commissioner Michael D'Ascenzo, 'The Compliance Model helps us understand the causes of compliance so that our responses are tailored to the risks' (Wood et al., 2010, p. 13).

Other examples of agencies operating under responsive regulation are the Office for Children, Youth and Family Support, Children's Policy and Regulation Unit (CPRU).[14] The CPRU states that its regulatory approach is 'collaborative, strengths-based and child-centered'. It seeks to 'ensure services feel empowered to meet their minimum requirements and understand the need for the requirements to exist', noting that 'highly developed relationships enable regulators to work proactively to achieve compliance' (Wood et al., 2010, p. 24).

[13] The Australian Taxation Office (ATO) is the principal revenue collection agency of the Australian government. The key role of the ATO is to accurately manage and shape the tax and superannuation systems that support and fund services for Australians.

[14] The Children's Policy and Regulation Unit (CPRU) is the Australian Capital Territory (ACT) government's department that handles assessment and advice to the Early Childhood Education and Care sector in the ACT in accordance with the Australian National Quality Framework.

In his book "Reducing administrative burdens: effective inspection and enforcement", Hampton (2005) focuses on several problem areas, two of which are explicitly relevant to the field of responsive regulation:

- ”*"regulators lack effective tools to punish persistent offenders and reward compliant behavior by business";*
- *"the structure of regulations, particularly at [a] local level, is complex, prevents joining up, and discourages business-responsive behavior"* (Wood et al., 2010, p. 30).

Some other examples of agencies operating under responsive regulation include the Australian Quarantine and Inspection Service[15] (AQIS, 2007), and the Ontario Securities Commission (OSC),[16] the biggest securities regulator in Canada. The latter's vision statement reflects its regulatory approach: 'To be an effective and responsive securities regulator—fostering a culture of integrity and compliance and instilling investor confidence in the capital markets' (OSC, 2016, p. 1).

### 4.3.4 Descriptive perspective: smart regulation

In contrast to the traditional command-control approach to regulation, the descriptive perspective on regulation does not emphasise law and governmental institutions solely but also examines the distinctive features of regulated entities and the context of their operations (Wright and Head, 2009). The descriptive perspective focuses on the historical, organisational, and cultural content of regulatory challenges and matches these with appropriate mixes of regulatory mechanisms (Wright and Head, 2009). A descriptive, analytical model, such as the

[15] The Australian Quarantine and Inspection Service (AQIS) was the Australian government agency responsible for enforcing Australian quarantine laws, as part of the Department of Agriculture. Following a period operating under the name DAFF Biosecurity, it has since been absorbed into divisions in the Department of Agriculture and Water Resources.

[16] The Ontario Securities Commission (OSC) is a regulatory agency that administers and enforces securities legislation in the Canadian province of Ontario. The OSC is an Ontario Crown corporation that reports to the Ontario legislature through the Minister of Finance.

smart regulation developed by Gunningham and Grabosky (1998), emphasises the active role that specific contexts (organisational, political, economic, and cultural) can play in crucial regulatory regimes and outcomes. The smart regulatory approach claims to have built on Ayres and Braithwaite's (1992) enforcement pyramid model (see Figure 4.2 in the previous section) (Weers, 2012). The difference between responsive and smart regulation is explained next.

Gunningham and Grabosky (1998) argue that law does not have to be enforced by national regulatory authorities, but rather self-regulatory initiatives or third parties can play a vital role in enforcement. Their model consists of a three-sided smart regulatory pyramid. Three different forces of controls can be imposed under this model: by national regulatory authorities, by surrogate regulators, or by organisations (Baldwin and Black, 2007).

May (2005) asserts that the key concept of the descriptive perspective is that the regulated body does not respond in a natural manner 'to signals of regulatory agencies', nor does it operate 'in a vacuum when thinking about their actions'. Regulated bodies are always rooted in contexts that strongly influence their needs and compliance motivations.

Structural features of regulatory arrangements in the descriptive model can work at different levels. For instance, first at the macro level, where cultural and attitudinal norms play a significant role in shaping the motivations for different issues of regulatory design, and second at the micro level, for specific issues such as policy problems and different organisational factors. Opschoor and Tunner (1994), Gunningham and Grabosky (1998), and May (2005) claim that for models using smart regulation, emphasis should be given to these contextual features (issues of regulatory design, policy problems, industry sectors, organisational factors, etc.) for regulatory solutions. In this regard, *a priori* perceptions and general theories of regulation are highly hazardous and inferior to case-by-case analyses.

The smart regulation pyramid also involves a responsive escalation process. Weers (2012) argues that smart regulation encounters the same difficulties as responsive regulation. Where there is a serious risk or catastrophic damage involved, responsive escalation is not appropriate. There is always a risk of accommodating existing arrangements rather than helping decision-makers to take much more effective means to achieve social goals. Thus, the descriptive perspective can operate securely only in regulatory spaces where legitimacy is already assured.

The descriptive perspective (smart regulation) approach has been adopted explicitly by a wide range of regulators. For instance, the European Commission's 2010 communication on smart regulation introduced a 'fitness check' as comprehensive policy evaluation access for European Union (EU) consumer laws (European Commission, 2015a), as part of a regulatory fitness and performance programme (European Commission, 2015b).

The preceding discussion shows how responsive regulation and smart regulation involve regulatory spaces by negotiation 'responsiveness' between regulators, the regulated, and the wider community. It also suggests that the three-sided smart regulatory pyramid (by the national regulatory authority, by surrogate regulators, and by organisations) can give an effective result.  This philosophy can be applied to the regulation of microfinance practice. Hence, this research adopts responsive and smart regulation theories in order to explain and predict behaviour and achieve a better understanding of the microfinance context examined.

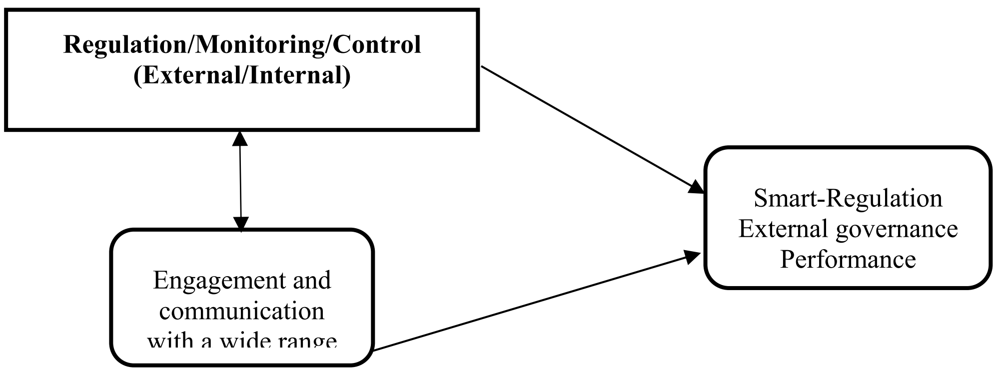



**Figure 4.3: Responsive regulation or smart regulation**

## 4.4 Regulatory aspects of governance theories

Critics of regulation and governance theories (internal, firm-level governance) argue that no one theory can give the best explanation of good governance, because it depends on the context, types, and characteristics of the organisation (Barth et al., 2006; Bartle et al., 2012; Chiumya, 2006; Hertog, 2003; Seal, 2006; Staschen, 2010; Wright and Head, 2009). Kosonen (2005) and Seal (2006) assert that all governance theories have overlapping aspects regarding principals' (owners/shareholders) and agents' (management/employees) rights. However, since as mentioned earlier this thesis examines the regulatory aspects of microfinance governance practice from an organisational perspective as well as MFI key stakeholder (clients') perspective, stakeholder theory is applied to explain firm-level governance practices and their regulatory aspects. Thus other major theories often used in governance studies are not deemed appropriate for this study as is explained for each prior to elaborating more on stakeholder theory and its relevance for this study.

**Agency theory:** Agency theory[17] is based on the assumption that the board acts on behalf of shareholders rather than any other corporate stakeholders (Klettner, 2014). Hence, the

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[17] In the last decades of the twentieth century, agency theory has become a dominant force in the understanding of governance and organisation and is considered the 'Bible' of corporate governance academic literature (Gabrielsson and Huse, 2004). Regulators in different countries have been influenced by agency theory in reforming their governance structure and activities (Cornforth and Edwards, 1999). The theory is based on the economic man model (Brennan, 1994; Perrow, 1986; Shapiro, 2005). Jensen and Meckling (1976) established agency theory as the dominant theoretical framework in the governance literature and positioned shareholders as the key stakeholder group (Daily et al., 2003; Mftransparency, 2010). The theory suggests that the management of an organisation is undertaken on behalf of the owners (shareholders) (Crowther and Jatana, 2005). According to agency theory, to protect shareholders' interests and effectively monitor and supervise the CEO, the positions of board chairman and CEO need to be kept separate (Peng 2007)to keep managerial opportunism under control (Donaldson and Davis, 1991). Fama and Jensen (1983) found that chairman and CEO duality is negatively associated with organisational performance, a finding Peng (2007) supports. In the context of the governance of an institution, agency theory suggests that adequate monitoring mechanisms are vital for protecting shareholders from management's self-interest. In this regard, outside directors can play a guardianship role (Fama and Jensen, 1983; Shleifer and Vishny, 1997). Consistent with agency theory, researchers have suggested an alternative explanation of board composition with external and internal board members (Harris and Raviv, 2008; Hermalin and Weisbach, 1998). Agency theory also implies that these external and internal board members can function as an exceptionally relevant information system for stakeholders to monitor executive behaviour and organisation performance (Gabrielsson and Winlund, 2000). Key recommendations arising from application of agency theory include a formal control system, budget controls and limitations, external and internal audits, and incentive systems aligning the interest of managers with those of principals (Houng and Ryan, 2005). With respect to the board of directors, agency theory suggests that a diversified and expert board (executive and non-executive directors) limits the discretion of top managers. Damaging information asymmetry may exist between the knowledge held by management and the knowledge held by the representatives of the owners/non-executive directors of the board. The key role of the board is to gather adequate

regulatory approach focuses on shareholder value as the measure of managerial performance (Lazonick and O'Sullivan, 2000). That is, the theory explains and predicts managerial behaviour regarding shareholder issues rather than issues pertinent to other stakeholders. Therefore, agency theory is deemed to be limited use for this current study.

**Stewardship theory:** Although stewardship theory[18] does not emphasise regulating or controlling the organisation, in terms of board governance it does suggest that managers and owner representatives (external and directors on the board) work together to develop strategy and monitor performance (Chambers et al., 2013). As a theory of management behaviour, stewardship theory does not explore the meaning of 'the interests of the company' other than to define that a steward's behaviour can be considered 'organisationally centred', where the main focus is to improve organisational performance rather than the interests of any particular

information for monitoring the performance of the firm and to hold managers to account (Chambers et al., 2013). According to Mitnick (1982), adoption of an agency theory approach implies a number of important areas in external (country-level) and internal (firm-level) regulation. For example, designing an efficient regulatory system depends on how regulatory controls can solve the principal-agent problem. Mitnick (1982) argues that it is important to have an integrating framework that applies to the explanation of regulatory behaviour and the design of regulatory institutions. The concept of agency theory can provide such a framework. Mftransparency (2010) argues that regulation for governance practice of an organisation is designed to mitigate the agency problem. Agency theory suggests that internal and external regulation enhances board independence and monitoring capacity. Managers require careful control and monitoring because self-interested managers may not always act in the best interests of the organisation (Klettner, 2014). However, because managers have more information and hence more power than most members of the board, there is an asymmetry of information problem accompanying the principal-agent problem.

[18] Stewardship theory has its roots in the disciplines of psychology and sociology and was developed as a model whereby CEOs are motivated to act in the best interests of the principals (Donaldson and Davis, 1989). According to Donaldson and Davis (1991), the key difference between agency and stewardship theories relates to psychological factors associated with the 'model of man'. Under agency theory, man is rooted in economic rationality, whereas Donaldson and Davis (1991) argue that unlike agency theory, stewardship theory empowers managers and CEOs with information, equipment, and power, and offers maximum autonomy to build trust. The theory posits that the decisions made by managers and CEOs will be in the best interests of the organisation and for the principals. Unlike agency theory, stewardship theory empowers managers and executives with power, information, and equipment. This empowerment helps make an effective decision in the best interests of the firm and for the principals. Stewardship theory argues that any control or monitoring structure may discourage decision-makers, and that can cause a negative impact on firm performance (Argryis, 1964). In terms of corporate governance structure, a difference between agency and stewardship theories arises from the relationship between the CEO and executive directors. Abdullah and Valentine (2009) argue from a stewardship theory perspective that unifying the CEO and chairman roles is more efficient than leaving them separate in reducing agency costs and helps to safeguard the interests of principals. From this evidence, it can be said that stewardship theory focuses on the creation of empowering structures that enhance effectiveness, efficiency, and productiveness by combining the roles of chairman and CEO (Chen, 2014). Stewardship theory assumes that executives' and managers' main goal is maximising organisational performance. Stewards and managers maximise firm performance with the objective of getting benefits from the firm. They maximise shareholders' wealth by achieving good performance so that they are able to maximise their utility functions (Donaldson and Davis, 1991). McConvill (2005) suggests that stewardship theory is largely the product of management scholarship rather than legal scholarship. As a legal scholar, McConvill found only one passing reference to stewardship theory in his research of governance theory.

group or stakeholder by monitoring or controlling the organisation (Davies, 2011). The key emphasis of the theory is at an institutional level (management, performance, and shareholder level) rather than stakeholder level. However, this current research focuses on the role of regulation at an institutional level as well as stakeholder (client) level. In this regard the adoption of stewardship, theory is not appropriate for the microfinance context and this current research.

**Institutional theory:** Institutional theory[19] emphasises the external (political, social, and economic systems surrounding the organisation) and the internal (organisation's governance structure and actions) environment of the organisation, rather than the stakeholder level of the organisation. Given that MFI clients are one of the key focuses of this current study, the institutional theory is not appropriate for adopting for this current research.

**Resource dependency theory:** Resource dependency theory[20] has a significant consequence for corporate governance practices and regulation of organisations. It argues that an

[19] In organisational analysis, institutional theory is considered one of the most prominent theories (Walsh et al., 2006). The theory emphasises that organisations do not exist just for providing goods or services, but are part of social and cultural systems (Mamun et al., 2013). In recent years, institutional theory has developed as a major theory for explaining an organisation's governance structure and its actions, as it argues that organisations, organisational fields, and nations are important components of society (Judge et al., 2008). Institutional theory helps people to understand and examine the normative environment in which an organisation exists (Martinez and Dacin, 1999). Organisations can vary by function, size, structure, culture, and capacity for change (Judge et al., 2008). These components play a vital role in organisational fields and institutional environments. The literature on institutional theory addresses two main scenarios. First, when effective corporate governance is present, the primary concern for an organisation is to gain legitimacy (Hall and Taylor, 1996; Scott and Meyer, 1994; Selznick, 1957) (this is also known as legitimacy theory which is a subset of institutional theory). Second, when effective governance is absent, the main focus of an organisation is to fill or work around institutional voids (Chakrabarty, 2009; Khanna et al., 2005; Mair and Martí, 2009). Under this theory, organisations are influenced by normative pressures, which can be raised internally or externally (Zucker, 1987). In his book *Institutions and Organizations*, Scott (2001) asserts that the key philosophy behind this theory is that organisational activities and behaviour are affected and encircled by the external environment, such as by political, social, and economic systems surrounding the organisation. Institutional theory focuses on how the organisation adapts to the regulatory environment of rules and sanctions, and the symbolic environment of cognitions and expectations (Argote and Greve, 2007). In regard to internal or corporate governance activity, institutional theory conceptualises board structures and functions as a response to external regulation/pressure, environmental norms, and firm history (Clarke, 2004).

[20] Pfeffer and Salancik (1979) developed the idea of resource dependency theory in the late 1970s. The basic proposition of the theory is the requirement for environmental linkages between organisation and external resources (Pfeffer and Salancik, 1979) in order to achieve organisation success. Moreover, these linkages could serve to reduce transaction costs associated with environmental interdependency (Pfeffer and Salancik, 1978). Resource dependency theory focuses on how uncertainty caused by external factors and dependence on outside organisations can be minimised. Yusoff et al. (2012) assert that directors serve to connect the organisation with external factors by co-opting the resources required to survive. In this regard, the board of directors is a critical mechanism for absorbing essential components of environmental uncertainty into the organisation. Directors bring resources, such as information, skills, key constituents (public policy decision-makers, suppliers, buyers, social groups), and legitimacy to reduce uncertainty (Gales and Kesner, 1994). In this theoretical context, the role of the corporate

independent board is not vital for better governance performance (Klettner, 2014), rather the independence of board members may reduce boards' ability to recruit others with important qualities and skills. However, the theory supports environmental linkages between the organisation and external stakeholders. This linkage could serve to reduce transaction costs associated with environmental interdependency (Pfeffer and Salancik, 1978). However, according to Verbruggen et al. (2011), the theory plays a vital role in transparency and disclosure, particularly in the quality of financial reporting by an organisation. The key focus of the theory is at an institutional level, encompassing board structure and composition, external directors, the requirement for environmental linkages between the organisation and external resources, reduction of transaction costs, corporate governance practices, and regulation of the organisation, although the theory also emphasises transparency, which can benefit stakeholders' interests indirectly. However, this current research aims to investigate the role of regulation at an institutional level as well as stakeholder (client) level. Stakeholders (clients) of MFIs are a key focal point of this current research. In this regard adoption of resource dependency theory may not be appropriate for a microfinance context and this current research.

board is boundary spanning, because the board is a critical part of the organisation and its environment. The theory suggests that boards decrease uncertainty by generating strong linkages between firms and trying to co-opt external influences (Provan, 1980). With regard to board governance, resource dependency theory suggests that board members add value to the organisation through their experience, skills, and networking in the industry (Chambers et al., 2013). The theory also implies that the key responsibility of the board is leveraging and managing external relationships. This relation may come from belonging to a powerful network of people who exercise control over the direction of public life in a series of board interlocks (Chambers et al., 2013). According to Hillman (2005), Huse and Rindova (2001), and Provan (1980), the theory suggests that different stakeholders and influential community parties can be included on the board and can bring legitimacy and prestige with their knowledge, skills, and valuable external links, which can create environmental dependencies. The theory claims that firms need larger boards with bigger external linkages to resources and higher quality advice for improving their performance (Dalton et al., 1999; Provan, 1980). In this view, boards are driven by external directors, with some executive directors required for organisation-specific information, and the role of boards is to advise management on reducing external uncertainty and aid organisational survival by dealing with external threats (Dalton et al., 1999).

### 4.4.1 Stakeholder theory

Stakeholder theory was developed by Freeman in 1984 in his seminal book *Strategic Management: A Stakeholder Approach*. Stanford Research Institute (SRI) defined the concept of stakeholders in 1963 as 'those groups without whose support the organisation would cease to exist' (Mamun et al., 2013, p. 41). Freeman (2004) modified the definition and defined stakeholders as those groups that are vital to the survival and success of the organisation. Friedman (1962) argues that Freeman's definition is more balanced than that of SRI because it broadens the concept of 'stakeholders'. It does this by including individuals outside the firm and also individuals or groups who may consider themselves to be stakeholders of an organisation without the firm considering them to be such.

Rampling (2012) and Shankman (1999) claim that until Freeman's stakeholder theory, management theories were struggling to establish the role and duties of the organisation to groups other than shareholders, including employees, suppliers, and customers. Shankman (1999) states that Freeman's general theory of firms, for the first time, included the concept of stakeholders, providing an explanation of the kinds of responsibilities that organisations have to stakeholders and setting forth a suitable justification for such duties. This concept was and continues to be accepted widely in managerial circles, as well as by management scholars and researchers.

Another theory known as shareholder theory defines the core responsibility of an organisation's CEO or manager as the maximisation of shareholder wealth (Berle and Means, 1932; Friedman, 1962). However, this theory is criticised for focusing on short-term managerial thinking and overlooking unethical behaviour by an organisation (Friedman, 1962). Danielson et al. (2008) recommend that under stakeholder theory, the interests of future stakeholders need to be considered explicitly otherwise its use will lead to the same type of short-term goals that represent one of the problems of shareholder theory. Danielson et al. (2008) also claim that for protecting the interests of current and future stakeholders, the shareholder model can provide a better framework than the stakeholder model if it encourages organisational goals from a long-term perspective.

The identification of stakeholders and shareholders can represent a major challenge for the application of both theories. In stakeholder theory, the identity of individual stakeholders can change continuously, so customers or employees who are currently extracting excess benefit are not the same people who will lose future benefits. Likewise, the identity of shareholders can also change over time. So, it can be argued that stakeholder theory cannot claim to be superior to shareholder theory from an ethical perspective (Danielson et al., 2008).

In terms of board governance, stakeholder theory suggests that the key role of the board is to ensure the long-term survival of and value creation by the firm, and it depends on the commitment of stakeholders, not just shareholders (Chambers et al., 2013). The theory also suggests that another important role of board members is to represent and understand the concerns of all stakeholders. Moreover, the board may need to manage the complex tradeoffs between stakeholders' and shareholders' interests (Chambers et al., 2013).

Concerning good governance, stakeholder theory provides an alternative approach to the conventional shareholder wealth maximising the view of the firm (Ayuso and Argandona, 2007). In the shareholder model, the governance process focuses on controlling managers and other organisational participants to ensure that they act in the owners' interests (Ayuso and Argandona, 2007). Governance practice under stakeholder theory, on the other hand, proposes multiple objectives related to the diverse stakeholders. Since multiple firm shareholders risk their investments to achieve their goals, it is arguably their legitimate or moral right to claim a share of the value created or firms' residual resources (Blair 1995).

Taking this into consideration, stakeholder theory suggests a shift in the governance structure from a principal-agent approach to a team production problem, where the core governance activities are aimed at ensuring effective negotiations, coordination, cooperation, and conflict resolution to maximise and distribute the mutual gains among multiple stakeholders (Ayuso and Argandona, 2007). A stakeholder theory approach has been adopted explicitly in a wide range of areas, for example, information systems (Mishra and Mishra, 2013; Lacity and Hirschheim, 1995), corporate governance (Cheng and Wang, 2009), e-governance (Kamal et al., 2011), health education (Lapointe et al., 2011), business ethics (Yuthas and Dillard, 1999), and strategies for stakeholder management (Lim and Lee, 2005).

*Regulatory aspects of Stakeholder theory*

The key distinguishing corporate governance features under stakeholder theory compared with other conventional shareholder wealth maximising theories are governance structure, governance process (monitoring rather than control), and governance performance. For governance performance metrics, stakeholder theory deals with fair distribution of value created to maintain the commitment of multiple stakeholders in contrast to investor commitment.

Stakeholder theory argues that the monitoring/controlling and overall governance practices of the board must address the importance of engaging and communicating with a wide range of stakeholder groups and take into account the interests of these groups in terms of setting strategy or advising management groups. Indeed, critics of this approach argue that it adds an additional role for the board in terms of monitoring and controlling—that is, of managing stakeholders and increasing corporate responsibility (Wang and Dewhirst, 1992).

Stakeholder theory supports the importance of non-executive directors who can represent and protect external stakeholders. Klettner (2014) and Walker (2009) suggest that regulatory aspects of stakeholder theory posit a coordination role for the board, which is expected to mediate between stakeholder groups to find the best outcome for the corporation. The theory also suggests that communication channels must be in place for engaging with wider stakeholder groups as well as demonstrating accountability to stakeholder groups.

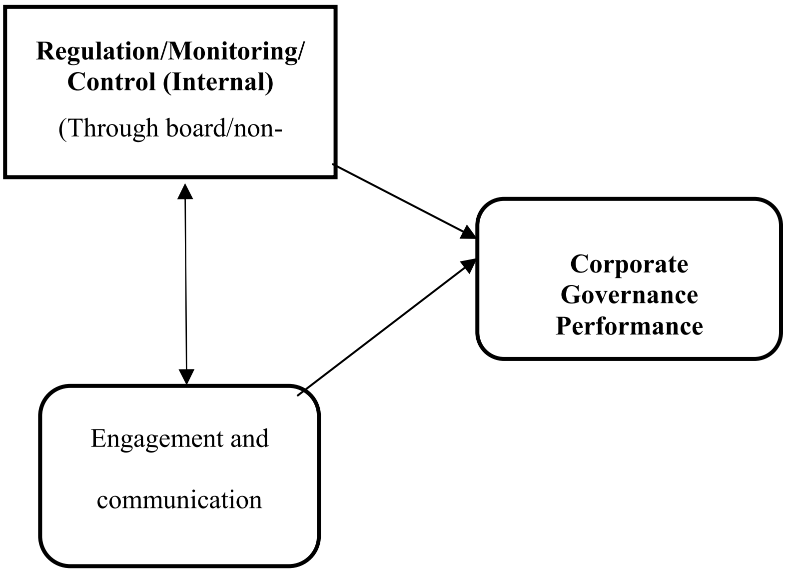



**Figure 4.4: Regulatory aspects of Stakeholder theory**

As discussed earlier, stakeholder theory looks at the interests, needs, and protection of stakeholders by underlining the importance of engaging and communicating with a wide range of stakeholder groups and taking the interests of these groups into account. The theory also suggests that regulating, monitoring, controlling, and overall governance practices of the board must address the interests, needs, and protection of stakeholders, which is the key focal point of this current research. Consequently, this study adopts the stakeholder theory in the microfinance context.

## 4.5 Chapter summary

Because of the great diversity in institutional frameworks, policy issues, industry sectors, and national contexts, empirically grounded researchers have argued that an 'optimal combination' of regulatory and governance arrangements is not possible. Wright and Head (2009) support this view and suggest that no single perspective or governance and regulation combination model is capable of providing either a sufficient explanatory framework for existing arrangements or a reliable guide for future improvements.

However, as microfinance is the context of this study, this chapter suggests that responsive regulation is an appropriate theory for application to analyse regulatory regimes at the level of formal institutions, and it gives a normative frame based on public interest considerations. It provides a tripartite system for the negotiation of responsiveness (regulator, regulated, and third parties). Hence, collective decisions can address the concerns of all stakeholders and encompass the key idea of microfinance practice.

In the same way, stakeholder theory addresses the interests, needs, and protection of stakeholders to organisations. It suggests effective negotiation, coordination, cooperation, and conflict resolution among stakeholders. The theory addresses the importance of engaging and communicating with a wide range of stakeholder groups and hence is useful for the microfinance context. The current study examines the microfinance industry in Bangladesh using responsive regulation and stakeholder theories to explain the behaviour of regulated and unregulated MFIs. The following chapter (Chapter five) focuses on the role of corporate or internal governance in microfinance practice.

# CHAPTER FIVE

# The Role of Governance (country-level and firm-level) in Microfinance Institution Performance

‘*Good governance is a journey and not a destination*’ (King, 2006, p. 68)

## 5.1 Introduction

The Global Financial Crisis in 2007 and the East Asian Financial Crisis of 1997, in part, demonstrate the effect of non-compliance with best practice corporate governance mechanisms and failures in investor protection (Brunnermeier, 2009; Radelet et al., 1998; Rerkens et al., 2012). There have been many corporate failures and scandals, such as Toshiba in Japan, Madoff, and Enron in the USA, HIH Insurance and Harris Scarfe in Australia, that make a case for better protection of investors by appropriate regulation and good corporate governance (France et al., 2002).

Similarly, evidence relating to the microfinance sector (Afonso et al., 2017; Banerjee and Jackson, 2017; Ghosh et al., 2014) indicates that poor firm-level governance practices can create problems for MFIs’ sustainability, client confidence, client/stakeholder rights, as well as client financial loss. Without a good governance (firm-level) practice and external regulation (country-level), it is difficult for MFIs to compete effectively, for regulators to implement effective policies (country-level), and for donors to select and manage partnerships with MFIs. Both country and firm-level governance policies play a central role in generating transparency and accountability to stakeholders as well as to society. This chapter focuses on two broad conceptual areas relevant to this study based on the potential implications of regulation and good governance practices for MFIs.

Regulation and governance of MFIs are two key issues that have received significant attention from various agencies due to issues surrounding the welfare of MFI clients and the sustainability of the microfinance industry (Fung, 2014). The objective of this chapter is to provide the relevant background literature to what constitutes sound governance practices in the context of MFIs, whether regulated or not, so as to contribute to the development of a theoretical model in Chapter six.

This chapter is structured as follows. Section 5.2 introduces governance practices for MFIs from two perspectives, external (country-level) and internal (firm-level) governance. Section 5.3 provides a detailed discussion of external governance mechanisms, particularly governance practices in relation to external investors and donors to MFIs, and the ownership structure of MFIs. Section 5.4 highlights internal governance practices of MFIs. Here the discussion focuses on MFIs' board structure and composition, board independence and self-regulation, board diversification, and chief executive officer (CEO)/board chair duality. Section 5.5 highlights the role of MFIs' governance practices in corporate social responsibility (CSR), transparency, and disclosure. Sections 5.6 and 5.7 focus on the role of governance in relation to MFIs' outreach and financial sustainability, and the welfare of their clients. An overall summary is presented in Section 5.8.

Figure 5.1: depicts the structure of this chapter.

**5.1 Introduction**

**5.2 Governance and the microfinance industry**

**5.3 External governance of MFIs**

**5.4 Internal governance of MFIs**

**5.5 MFIs' governance and transparency**

**5.6 Role of regulation and governance in MFI performance: MFIs' outreach and financial sustainability**

**5.7 Role of regulation and governance in MFI performance: MFI clients' perspective**

**5.8 Gap in the literature and hypotheses**

**5.9 Chapter summary**

## 5.2 Governance and the microfinance industry

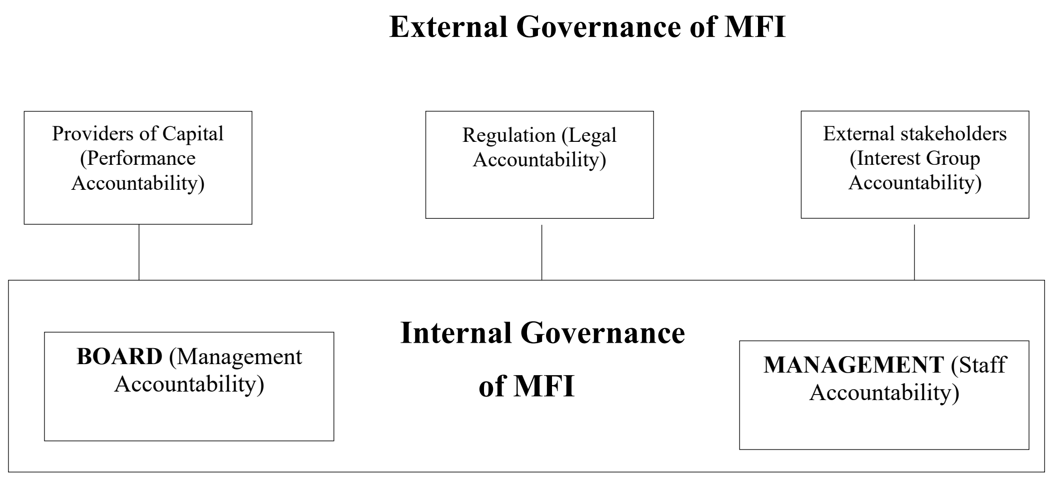
In 2001, 'good governance' was set as an essential element of the Millennium Development Goals (MDGs) of the United Nations (UN) (United Nations, 2018). According to the UN, good governance (both firm and country-level) establishes the structure for combating poverty, inequality, and many of humanity's other shortcomings for both governments and non-governmental organisations. However, the Sustainable Development Goals (SDGs)[21] introduced by the UN in 2015 to replace the MDGs are based on the growing consensus that sustainable development and effective governance are inseparable (United Nations, 2018). In response to the needs of society, good governance, at both country and firm-level, assist to ensure efficient and effective management of public resources (Kefela, 2011). Good governance entails transparency, accountability, and plural participation in the protection of public resources. Biermann et al., (2014) shows that enhancing the capacity of country-level and firm-level governance can significantly contribute to the achievement of the objectives of the SDGs.

According to Huse (2007), the governance context for the microfinance sector is complex. This complexity makes the achievement of effective governance even more difficult and challenging than in traditional non-governmental, financial, or corporate sectors. In the microfinance literature, the term 'governance' first appeared in 1997 (CGAP, 1997). In the beginning, the term was used mostly in the context of governments (country-level), but now firm-level governance is also considered one of the key factors in the microfinance sector (Lapenu and Pierret, 2006).

[21] The UN member countries agreed upon 17 Sustainable Development Goals (SDGs) and their associated 169 targets in September 2015, and these constitute a shared global framework of development priorities until 2030. They aim to bring an end to extreme poverty, promote prosperity and well-being for all, protect the environment and address climate change, encourage good governance, and promote peace and security (Sustainable Development Solutions Network, 2017).

In terms of firm-level governance, according to Lapenu and Pierret (2006), a lack of appropriate corporate governance strategies is one of the major obstacles to the microfinance sector's growth. They also suggest that the proper functioning of the board of directors is not enough to guarantee the mission and assets of an MFI. It is important to broaden the scope and include the concerns of all stakeholders (employees, managers, elected officials, clients, donors, bank partners, shareholders, the government, etc.) for achieving the dual mission of microfinance.

According to Rock et al. (1998), every MFI should assess its governance environment. Researchers (e.g. CMEF, 2012; Dharmastuti and Wahyudi, 2013; Gillan, 2006; Healy, 2011; Rezaee, 2007) analyse the role of MFI governance from two perspectives, external (country-level) and internal (firm-level) governance. External governance consists of entities that oversee MFIs' financial health (e.g., regulators and auditors), providers of financing (e.g., shareholders, lenders, and depositors), and communities served by the MFI (e.g., employees and MFIs' clients). External players include providers of capital (donor institutions and individuals, commercial banks, line of credit providers), providers of guarantees, regulatory bodies (e.g., central banks, relevant ministries, external regulatory organisations), and other stakeholders (clients, employees, suppliers of expertise, e.g., legal counsel) (Rock et al., 1998). Internal players consist of the board of directors, senior management, and internal auditors if they interact with the board (CMEF, 2012; Dharmastuti and Wahyudi, 2013). Figure 5.2 depicts the context of MFIs' environment.




*Source*: Adapted from (Rock et al., 1998, p. 15).

**Figure 5.2: The context that frames governance**

For MFIs, the players involved with external and internal governance share a dynamic relationship. The expectations and relationships with external actors serve as a framework for boards' work (Rock et al., 1998). Sections 5.3 and 5.4 focus on this partitioning into MFI external and internal governance mechanisms respectively. The following section discusses the external and internal governance of MFIs. It is important to note that many of the studies discussed in the following section involve not only MFIs but also publicly listed companies. As discussed in Chapter four (Section 4.1), although MFIs are not corporates in the sense of being public or private companies in their legal form, corporate governance practices are equally as applicable to MFIs as other public and private organisations.

## 5.3 External governance of MFIs

- *External investors and donors to MFIs*

External investors and donors to the microfinance industry (Table 5.1) include a broad range of institutions and individuals with diversified financial and social goals (Ledgerwood and White, 2006). Ledgerwood and White (2006) argue that MFIs' governance practices should be designed and implemented with consideration and understanding of the characteristics of each investor and donor in mind so that MFIs can choose a cohesive group of investors.

Donors' and other types of investors' interest in the microfinance sector has increased significantly over the past few years (Ledgerwood and White, 2006). El-Zoghbi and Gahwiler (2013) point out that all donors, including local, bilateral, and multilateral government donors and local branches of international NGOs, support the microfinance sector in its institutional capacity building, to cover operating shortfalls, and for loan capital or equity and lines of credit or guarantees for commercial funds.

**Table 5.1: External investors in the microfinance industry**

| Name | | Definition | Examples |
|---|---|---|---|
| Development Finance Institution (DFI) | None | Financial institutions owned by a government or governments and that raise private capital to finance projects with development objectives | SIDBI (Small Industries Development Bank of India) |
| Government | Multilateral and Bilateral Development Agency | Bilateral or multilateral aid agencies owned by governments | JICA *(Japan International Cooperation Agency),* UNCDF (*United Nations Capital Development Fund)* |
| Government | Development Programme | Government or another public programme with development objectives | USAID-Tijara ( USAID Tijara Provincial Economic Growth Program**)**, IDES Nacional (Instituto de Desarrollo Económico y Social), CAMFA (Central Asia Micro Finance Alliance) |
| Government | Government Agency/Programme | The administration, departments, or agencies of any sovereign entity | Ministry of Finance, Luxembourg, BmZ Deutsch |
| Government | Regulator | A domestic central bank | Central Bank of BiH, IAS (Innovative Assessment System) |
| Financial Institution | Commercial Bank/Public Bank | Bank or other regulated financial institution where private entities are majority shareholders | Citibank Nicaragua, Banplus/United Bank of India |
| Financial Institution | Cooperative Society | Financial institution owned by its members, not external shareholders | Alterfin, Consorzio Etimos |
| Fund | None | Professionally managed collective investment scheme that pools money from many investors | Dexia Microcredit Fund, Minlam Microfinance Fund, Oikocredit |
| Other | Private Corporation/ NGO/Foundation | Registered legal entities; the category does not include governments, non-profits, funds or financial institutions/non-governmental organisations/ non-profit corporations or other non-profit entities | Genesis Steel/ CORDAID (Catholic Organisation for Relief and Development Aid), CARE ( Cooperative for Assistance and Relief Everywhere) |

*Source*: Adapted from (MIX Market, 2012).

There exists a clear interrelationship and overlap between internal and external governance practices in microfinance. Governance, transparency, and accountability are the three most critical issues that concern external investors (Pouliot, 2005). According to Pouliot (2005), in order to gain the trust and confidence of external investors, MFIs' governance fiduciary practices should focus on the fund structure, the risk control system, compliance, the investment process, price setting, quality of reporting, integrity, and comparability of data.

According to agency theory, microfinance governance practices should take into consideration the ways in which donors, investors, and suppliers receive assurance and confidence that they will receive a return on investment and that MFIs will achieve their social mission (Galema at al., 2012b). From an investor point of view, Hudon (2007) argues that the entry of different types of external investors and donors in the microfinance sector has created changes in MFIs' governance practices and brought significant challenges to the industry, for example, the need to include donors and investors on MFI boards, and the separation of ownership and control. These changes can improve the confidence in and the relationship between external and internal governance practices (Hudon, 2007).

As mentioned earlier, external and internal governance practices in the microfinance industry overlap in many contexts. According to Galema et al. (2012b), in almost all NGO-MFIs, fund suppliers and managers are separated because each has a different set of interests and there is information asymmetry between the two, which can create agency problems.

Mersland (2009) claims that regulation and control mechanisms for public banking have a stronger impact on banks' governance practices than those for MFIs. However, external donations shield NGO-MFIs from unfair competition for funds with public banks and other financial institutions that also offer microfinance. Collection of donations, achieving the required level of confidence, and fulfilling the expectations of donors can be considered as other external governance mechanisms for MFIs (Galema et al., 2012b).

The United Nations Capital Development Fund (UNCDF 2005) reports that regulated, specialised institutions (excluding banks), often the largest ones, in transition economies have benefited from a majority share of donor investments (nearly 90 per cent). However, unregulated institutions are largely ignored and are not beneficiaries of this type of capital. Hudon (2007) argues that donors' and external investors' support is focused mostly on some of the already self-sufficient, sustainable MFIs because of the failure of some previously sponsored unstable MFIs and the lack of sustainability of the sector. Unfortunately, these unplanned funding/donations only to self-sufficient sustainable MFIs can end up funding inefficient and lax management practices that result in negative outreach and high loan default for some MFIs (Bhutt and Tang, 2001).

Bhutt and Tang (2001) assert that very few MFIs have gained independence from donors' and investors' funds. Furthermore, an exit strategy from dependence on donor and investor support has not been considered adequately by many MFIs (Bhutt and Tang, 2001). This would require MFIs to undertake an evaluation of their governance practices surrounding an exit from such a support strategy. Hendricks (2003) asserts that MFIs' governance structures should focus on financial self-sufficiency rather than external support. Moreover, this self-sufficiency should come from low operational costs and good governance (Hudon, 2007).

- *External regulation*

External regulation of MFIs (external regulatory body, government, and central bank regulation), governance practice and different regulation theories were discussed in Chapter two (Section 2.4.1) and Chapter four (Section 4.2) respectively.

- *External audit*[22]

The audit function is a governance mechanism, and auditors are gatekeepers who attest to the information provided by companies (Coffee, 2002). Prior research suggests that procurement of high-quality auditing services improves the trust of investors in financial reporting and increases fundraising possibilities (Lin and Liu, 2009). High-quality auditing is important for organisations that are involved in raising funds frequently (Broye and Weill, 2008; Knechel et al., 2008). Also, external audit and its quality are highly related to both corporate governance (Hay et al., 2006; Lin and Liu, 2009) and firm complexity (Hay et al., 2006; Knechel et al., 2008).

Beisland et al. (2015) argue that MFIs are not different in nature from other financial institutions involved in raising funds, so like other financial institutions, MFIs demand an external audit. From a donor's perspective, Tate (2007) asserts that, typically, donors get no direct benefit from the charitable contributions they provide to non-profit organisations. They cannot directly monitor the use of the funds, so they rely more heavily on auditing to ensure their funds are used in a way consistent with their intent. This requires both internal and external auditing for MFIs.

Beisland et al. (2015) claim that differences in ownership structure are an interesting aspect of MFIs and may influence both governance structure and audit quality. Like other financial intermediaries, MFIs are inherently complex because it is hard for outsiders to judge the quality of projects that are financed by them or the soundness of an MFI's funding (Rochet, 2008). Hence governance mechanisms, including audit and its quality, are especially important in this sector. Moreover, one of the main advantages of high-quality auditing for MFIs is the increased

[22] All registered MFIs in Bangladesh are encouraged to procure an external audit by a MRA-suggested public accounting (CA) firm (MRA, 2018), and so this requirement is considered external regulation in the context of this thesis.

potential to raise funds as a consequence of the auditing-related reduction in information asymmetries (Dechow et al., 2010; Hartarska, 2009). Hence, it can be argued that for the microfinance industry, external auditing and its quality are crucial for good governance, transparency, and the overall financial sustainability of MFIs.

The preceding discussion highlights various components of external governance in the environment of MFIs. The following section focuses on the internal governance structure of MFIs.

## 5.4 Internal governance of MFIs

- *Board structure, size, and composition*

Board structure, composition, and size play a significant role in the internal governance performance of any financial institution (Campion and Frankiewicz, 1999; Hartarska and Mersland, 2012). Adam and Mehran (2003) and Pathan et al. (2007) observe that empirical evidence shows both a positive and negative relation between board size and performance. According to Hattel et al. (2010), a smaller board is often easier to assemble, and it can make decisions more efficiently and in a more timely way through a high level of participation and involvement of each member of the board. On the other hand, with a larger board, organising meetings and making decisions efficiently can be a big challenge (Hartarska and Mersland, 2012). Financial institutions often have larger boards compared to non-financial firms (Oster and O'Reagan, 2004). Moreover, studies of non-profit boards have supported having larger boards because of the additional duties that board members take on in supervising fundraising (Oster and O'Reagan, 2004).

In the microfinance industry, board structure, size, and composition are key control mechanisms for the internal governance of MFIs (Hartarska and Mersland, 2012). Hattel et al. (2010) claim that to determine the optimal size, structure, and composition of a board, the key factors to consider are the requirements of the institution, in addition to the board's life cycle, its mission, its fundraising role, and the geographical distribution of the institution (CMEF, 2012; Hattel et al., 2010).

The size of the board is often noted in MFIs' bylaws and may be set by legal requirements in specific countries (Campion and Frankiewicz, 1999; Hattel et al., 2010). Eisenberg et al. (1998), Hartarska and Mersland (2012), and Yermack (1996) argue that there is evidence that larger boards are less efficient in comparison to smaller boards. Cheng's (2008) findings show that larger boards take longer to reach a consensus and, as a result, they are less effective. Boards with a large number of members sometimes struggle to come to a conclusion because of diverse opinions (Eisenberg et al., 1998; Hartarska and Mersland, 2012; Yermack, 1996).

Campion and Frankiewicz (1999) observe that the composition of the board shows the complex and unique characteristics of an MFI. Selecting appropriate board members is critical. It is unlikely that any individual director possesses all the qualities and skill sets required for an effective microfinance board. In addition, it is not feasible for anyone to understand all issues that an organisation might confront (Campion and Frankiewicz, 1999).

Studies of MFI board composition classify directors as insiders and outsiders. Insiders are directors and managers at the same time, while outsiders are non-manager directors (Arosa et al., 2013). These insider and outsider directors can have different characteristics, behaviours, and incentives (De et al., 2005). Raheja (2005) observes that insiders are a valuable source of firm-specific information for the board. Although insiders' experience can improve firm performance, there is a possibility that they have distorted objectives because of personal interests and lack of independence from the CEO. Outsiders, on the other hand, can oversee better firm performance as a result of their more independent monitoring, but there is a possibility that outsiders are less informed about the firm's constraints and opportunities (Raheja, 2005).

- *Board independence*

The theoretical literature suggests that board independence and ownership structures are the two key corporate governance mechanisms that influence firm performance (Adams et al., 2010; Bozec, 2005; Denis and McConnell, 2003; Gillan, 2006). Board independence and the existence of independent board committees and members can positively affect MFIs' performance under any legal regime (Bruno and Claessens, 2010).

Hartarska and Mersland (2012) claim that the collapse of the MFI Corposol/Finansol in Colombia in 2002 was due to a lack of board independence and a weak monitoring system. As a result, excessive power was concentrated in the hands of one executive. Hartarska (2005) found that MFIs with a larger proportion of independent directors achieve relatively better outreach, but found no significant difference in financial sustainability between those with larger or smaller proportions.

- *Board diversification*

Board diversification is another aspect that reflects a board's quality and its efficiency in monitoring/controlling and advising management (Boone et al., 2007). Board diversity helps achieve a better understanding of the marketplace, enhances creativity and innovation, produces more practical and effective problem solving, increases the effectiveness of corporate leadership, and promotes efficient global relationships (Robinson and Dechant 1997). Cherono (2013) argues that the skills, qualifications, and diversification of board members should be aligned with the requirements of the organisation. The board should have members with the required technical, financial, and management knowledge and a range of skills to accomplish the organisation's strategic priorities (Hartarska and Mersland, 2012). The main challenge is to balance these characteristics amongst board members and not concentrate representation at one extreme or the other.

Hartarska and Mersland (2012) argue that representatives of different stakeholders need to be included on the board to balance varying interests. The inclusion of social investors (funds from the external market), donors, and clients on the board can be beneficial (Hartarska and Mersland, 2012). Lapenu and Pierret (2006) support this view and propose the involvement of all stakeholder groups, such as clients, donors, shareholders, employees, managers, elected officials, and bank partners, on the boards of MFIs. Diversification among board sub-committee (e.g., audit, executive, risk) members also plays an important role in improving the efficiency and quality of board decisions. Klein (1998) argues that different board committees help directors to engage deeply in oversight activities, increase interaction between board members and employees, and facilitate informed and effective decision-making by the board.

*Gender diversification*

Advancing gender equality and female representation in corporate governance, particularly amongst management staff and board members, has increasingly become the focus of societal and political debates in different parts of the corporate world (Pande and Ford, 2011). Carter et al. (2010) suggest that heterogeneous boards are more capable of taking a decision by evaluating more alternatives compared to homogenous boards. Also, it is important to note that MFIs serve women clients to a large extent, so female directors are likely to have a better understanding of the industry and are likely to take more effective decisions than males (Bassem, 2009). In their study, Mersland and Strøm (2009) found that financial performance improves with female managers and directors and they conjecture that this is because in these positions females better understand the opportunities and challenges of the markets they serve. That is, having a higher fraction of women on the board benefits MFIs in understanding clients better in terms of separating good risks from the bad (Mersland and Strøm, 2009).

A number of studies explore the relationship between board gender diversity and board performance (e.g., Dalton et al., 2007; Farrel and Hersch, 2005; Sheridan and Milgate, 2003). In his investigation, Galbreath (2011) found that firms with more women on their boards can perform efficiently and show better economic performance. Studies such as Østergaard et al. (2011), Robinson and Dechant (1997), and Dezsö and Ross (2012) also found a positive relationship between gender diversity and firm board performance. Fondas and Sassalos (2000) found that woman can add value by bringing different perspectives, experiences, and opinions to the table. Galbreath (2011) argue that women have higher expectations than men regarding their responsibilities as directors which can lead the board to become more effective.

In a microfinance context, Kyereboah-Coleman (2006) found that female CEOs on MFI boards increase financial performance, and also, the more women there are on the board, the better the financial performance of the organisation. Augustine et al. (2016), and Østergaard et al. (2011) also found that MFIs in the microfinance industry benefit from higher inclusion of women, specifically at higher levels (CEO/board of directors) of organisational function.

- *CEO and chair duality*

CEO and chair duality refers to the situation when the position of CEO and board chair are served by the same individual (Peng, 2007). During the last decade, many organisations have converted from dual CEO leadership to a non-dual structure, while some have turned in the opposite direction (Moscu, 2013). The argument in favour of CEO duality emphasises the unparalleled firm-specific knowledge of CEOs and the benefit of active stewardship (Jensen and Meckling, 1995). A CEO/ chair can implement strategies and manage and coordinate board actions more efficiently and swiftly than one who is not. Dual leadership also enables considerable savings in processing and information sharing costs (Yang and Zhao, 2011). In their study, Brickley et al. (1997) found that dual CEO firms perform (financial performance) no worse than those that separate these functions. Moreover, a single leader will have more extensive knowledge about the organisation, can give clear directions, and be more responsive to changes. Some researchers also claim that the cost of separating the CEO and chair overshadows the benefits (Moscu, 2013; Yang and Zhao, 2011).

In contrast, another school of thought (Goyal and Park, 2002; Rechner and Dalton, 1991; Mersland and Strøm, 2009; Vo, 2010) claims a positive impact from separating CEO and chair roles. It argues that the separation provides a governance framework better suited to the fulfillment of directors' management and monitoring responsibilities (Vo, 2010). According to Adams et al. (2010) and Galema et al. (2012a), combining the roles implies a weak governance structure because the board is less independent. Goyal and Park (2002) found that organisation performance (financial sustainability) is significantly lower in the case of CEO/chair duality. CEO/chair duality has an adverse effect on financial performance and increases costs (Mersland and Strøm, 2009). Moreover, making a change in or removing the top management represents a major challenge for the board if the CEO and chair are the same individuals (Jensen 1993b). Jensen (1993a) argues that hiring, firing, and compensation for the CEO is the responsibility of the chair. If both are the same individual, it will be difficult for him or her to take an action against his/her personal interest. Thus, separating the CEO and chair roles will be more efficient when there is likely to be a conflict of interest between the two.

Rechner and Dalton (1991) used an accounting-based performance measure and found that organisations with separation of CEO and chair positions show better performance in terms of sustainability. Aside from financial accounting and performance perspectives, Williamson (1985) argues that the interests of shareholders are better protected when the CEO and chair roles are separated. In addition, since the responsibility of the board is to monitor the performance of top management, the separation may be desirable to maintain checks and balances between CEO and chair (Rechner and Dalton, 1991).

In contrast, Brickley et al. (1997) found no association between the performance of the organisation and CEO duality. Also, Rechner and Dalton (1991) show that a sample of 141 companies in the USA having CEO duality performed better compared to other companies. Peng et al. (2007) found that CEO duality is not only likely to be positively associated with firm performance, but that such a positive impact is likely to be profound for organisations confronting problems associated with resource scarcity and environmental dynamics.

Like other financial institutions, in the microfinance industry, MFIs' internal governance structure comprises of the board and management (Rock et al., 1998), where the CEO and the chair hold the highest authority in these two sections of the internal structure. The relationship between the CEO and board chair in this industry has been debated and addressed theoretically (Burton, 2000), as well as through empirical studies (e.g, Ng and Cock, 2002). Daily and Dalton (1992) found no association between the performance of the organisation and CEO duality.

However, many studies in microfinance research claim a negative impact of CEO–chairman duality. For instance, Gohar and Batool (2015) found that CEO–chair duality has a negative impact on firm performance and productivity. Other studies (e.g., Beisland et al., 2014; Hartarska and Mersland, 2012; Mersland, 2011; Tchuigoua, 2015) show a negative relationship with performance (outreach and financial sustainability). However, Mersland and Strøm (2009) and Kyereboah-Coleman and Biekpe (2005) find a positive relationship between MFI financial performance and CEO duality. Mersland and Strøm (2009) found that CEO duality increases the number of credit borrowers and enhances MFI financial performance. Kyereboah-Coleman and Biekpe (2005) also found the same result. Both studies conclude that the separation of CEO and chair roles does not improve the performance or outreach of MFIs.

- *Internal control and internal audit*

Internal control can be defined as 'the process designed, implemented and maintained by those charged with governance, management, and other personnel, to provide reasonable assurance about the achievement of an entity's objectives with regard to the reliability of financial reporting, effectiveness, and efficiency of operations and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control' (Collins, 2014, p. 142).

For any organisation, the control environment is responsible for setting the tone of the organisation, and it is the foundation of all other components of internal control (Whittington and Pany 2001). The control environment and activities include firm culture, integrity, and ethical values, assignment of authority and responsibility, the board of directors or audit committee participation, human resource policies and practices, and management philosophy and operating style (Collins, 2014).

Independence from the board and management influence and the efficiency of the audit committee are crucial for the effectiveness of internal control (Coram et al., 2006). An internal audit function offers the assurance of the effectiveness of internal control, risk management, and the overall governance process. For sound accountability and transparency, an internal auditor should report directly to the board and be free from any type of influence or pressure from management (Mersland and Strøm, 2009). The internal auditor can check and verify the accounts randomly to ensure correct information in the financial statements provided by management.

- *Audit committee*

For executing its monitoring responsibility, an active audit committee can use the internal audit function as a necessary source of information (Sarens and Beelde, 2006). The audit committee ensures that internal audit performs independently and objectively in accordance with appropriate professional standards. Amongst other things, the audit committee can advocate for a better-staffed internal audit function. In an MFI, an audit committee as a board sub-committee plays a pivotal role in protecting the MFI's interests by monitoring management's activities in regard to financial reporting, risk management, and internal control (Spira, 2002).

Coram et al. (2006) show the importance of the control environment for the audit committee and the internal audit function. The study provided evidence that the internal audit is related to the level of commitment to risk management. Sarens and Beelde, (2006) also found that certain control environment characteristics are highly related to the presence of an internal audit function within an organisation.

## 5.5 MFIs' governance, transparency, and corporate social responsibility (CSR)

- *Governance and transparency*

Transparency is widely recognised as an essential element and core principle of good governance (Parigi et al., 2004). Effective application of transparency enables inward observability—the ability of external stakeholders to monitor the activities and decisions made within organisations (Grimmelikhuijsen and Meijer, 2014). Higher transparency and better disclosure decrease the information asymmetry between a firm's management and financial stakeholders (Patel et al., 2002). Wehmeier and Raaz (2012) assert that organisations should be open and accountable to the public because they are expected by various stakeholders to disclose information about their product, their decisions, decision-making processes, and financial information, etc.

From a stakeholder decision-making point of view, transparency plays a vital role. A transparent organisation discloses accurate, timely, and relevant information so that stakeholders can make informed decisions regarding their relationships with the organisation and its trustworthiness (Rawlins 2009).

A transparent organisation not only shares accurate information but also offers accountability to stakeholders (Rawlins, 2008). The literature on new public management (Dunleavy et al., 2006; Ferlie et al., 2011; Grimmelikhuijsen et al., 2013) and corporate governance (Brennan and Solomon, 2008; Mallin, 2006) finds that organisations practising principles of accountability, transparency, and disclosure enjoy increased confidence and trust compared to others. Beekes and Brown (2006) also argue that organisations practising good governance disclose more information while organisations with weak governance tend to lack financial disclosure and transparency (Brennan and Solomon, 2008; Mallin, 2006).

Transparency is related to continuous dissemination through accessibility to media, consistent communication with stakeholders, and periodic disclosure of firm-specific information on a voluntary or mandatory basis (Bushman et al., 2004; Luo, 2005; Patel et al., 2002; Pope, 2003).

In his conceptual model of transparency, Schnackenberg (2002) proposes that transparency consists of three interrelated principles: *disclosure*, *clarity*, and *accuracy*. He argues that all three principles are necessary but not sufficient for information to be considered transparent. In his model, disclosure consists of the quantity and quality of information in the representation, as well as the availability of the representation to interested parties. Accuracy is considered to be the degree to which information is accurate as perceived by the sender. Clarity is a critical principle that is based mainly on the perceived interpretive capabilities of the receiver, along with the perceived conditions about the receiver at the time he or she is involved in the representation. It is the principle of clarity that infuses representations with the capability to guide understanding (Schnackenberg, 2002). Researchers (Ackoff et al., 1963; Chalmers, 1999; Daft and Lengel, 1986) claim that clarity is difficult to measure, so it is seldom investigated directly even if it is recognised as a critical component for transparency.

In the microfinance industry, transparent, open communication about the true cost of different products is a critical element for free markets. According to Mftransparency[23] (Mftransparency, 2012), transparent and open communication regarding the true cost of micro-loan products is necessary for the free market. Sharing accurate and standardised pricing information among all stakeholders can ensure fair competition, a sustainable market, and improved quality of product and service. Unfortunately, open communication and transparency are virtually absent in the microfinance industry (CGAP, 2002).

CGAP is an international consultative group for assisting the poor, with a global partnership of 34 leading organisations worldwide. In its donor report, CGAP (2002) states three benefits of transparency in the microfinance industry. First is *MFI performance*—accurate and timely information helps MFI administration to identify areas for improvement and take better and more timely decisions (Beisland and Mersland, 2014). Freely available information helps managers compare their institution with industry benchmarks and peers. Second is the *attraction of funders*—accurate and standardised information helps donors and other investors by giving a clear picture of the performance of MFIs as input to funding decisions (Augustine, 2012; Beisland and Mersland, 2014). The report also shows that the transparency of MFIs helps their clients receive clear, straightforward disclosure of product terms. It also informs clients about the quality of management and the safety of their deposits so that they can make informed decisions about their institution (CGAP, 2002).

- *Corporate Social Responsibility (CSR) in MFI governance*

[23] MicroFinance Transparency is an international NGO (launched in July 2008, with 912 industry leaders, including MFIs and apex banks serving 60 million clients worldwide) that promotes transparency by facilitating microfinance pricing disclosure, offering policy advisory services, and developing training and education materials for all market stakeholders. MFTransparency enables transparent communication among market players on the prices of microcredit products (Mftransparency, 2012). See http://www.mftransparency.org/what-we-do/

The need to identify and anticipate stakeholders' needs is crucial for the success of corporate social responsibility (CSR) activities of an organisation (Freeman, 1984). Microfinance itself is considered 'one of the fastest growing CSR tools in the finance sector' (Cull et al., 2011). In the last decade, CSR issues within the microfinance industry have received considerable attention from researchers, scholars, donors, and governments of both developed and developing countries (Battilana and Dorado, 2010; Cull et al., 2011).

According to Pohl and Tolhurst (2010), the microfinance industry is often characterised as being made up of hybrid institutions with a dual mission: one, to do good by increasing their social outreach and credit, and two, to do well by achieving financial sustainability (Battilana and Dorado, 2010; Cull et al., 2011). According to Hudon and Sandberg (2013), CSR investments have a positive impact on MFIs by not only creating opportunities to raise savings deposits but also reducing default rates among debtors.

In recent years, however, the microfinance industry has been the target of much moral criticism, referred to as an 'ethical crisis' for the industry (Hudon, 2011). According to Harper (2007) and Humle and Arun (2011), the debate started in 2007 when MFIs were accused of high-interest rates, relying on exploitative lending techniques, using forceful loan recovery practices, and pushing borrowers into debt traps. A number of scholars and researchers started raising their concerns about the assertion that 'microfinance is an effective tool for alleviating poverty', or at least demanding further empirical evidence for supporting this claim (Ellerman, 2007; Meyer, 2007). Chapter one (Section 1.3.1) highlights the debate about mission drift and exploitation and mistreatment by loan collectors of the clients of MFIs.

## 5.6 Role of regulation and governance in MFI performance from MFIs' perspective

According to Pedrini and Ferri (2016) and Otero (1998), MFI-NGOs give significant attention to the 'dual mission' in their governance practices. The dual mission of MFIs generates a balance between the social and profit objectives (Campion and Frankiewicz, 1999). The social objectives seek benefits for clients by providing financial and social (education, health, awareness of rights) services and the financial objective drives the organisation to achieve institutional sustainability and maximise outreach (Rock et al., 1998). In this regard, regulation and governance practices play a significant role. Both objectives (benefit of clients and the institution) require that MFI-NGOs have some form of internal regulation (Otero, 1998).

- *Outreach and financial sustainability*

The scope of outreach in an MFI context refers to the number of active borrowers that an organisation reaches with its loan portfolio (Bakker et al., 2014). Governance guides an institution in fulfilling its corporate mission and protects the institution's assets over time (Bassem, 2009). According to Bakker et al. (2014), governance in MFIs has double bottom-line (outreach and sustainability) goals. However, Hartarska (2005) argues that there is no evidence that these two dimensions of performance in every MFI function as substitutes or complements. Estimation of the impact of governance mechanisms on both dimensions may provide insights into possible trade-offs between outreach and sustainability (Hartarska, 2005). It is important to note that investigating the link between good governance and the performance of MFIs in regard to both financial sustainability and outreach are critical.

Evidence relating to the microfinance industry shows that lack of good governance can create problems for outreach and financial sustainability (Galema et al., 2012a; Brown and Gladwell, 2009; Hartarska, 2005). Empirical studies show that unethical intentions and malpractice by some MFIs in India (Andhra Pradesh and Karnataka) increased the debt liability of low-income clients, pushing some of them to commit suicide (Galema et al., 2012a). Instances like this raise questions such as: Why did the corporate governance fail so massively, and how and why did boards and management let these scandals happen?

Brown and Gladwell (2009, p. 8) claim that for MFIs, ineffective board composition, deficient risk management practices, and failure of non-executive directors and shareholders to efficiently govern and scrutinise the decisions of boards are the main areas in need of reform for avoiding performance failure.

In her study of central European and newly independent states, Hartarska (2005) found that different corporate governance mechanisms affect the performance of MFIs differently. For example, external mechanisms of control (e.g., external regulation and auditing) have different effects on outreach and sustainability. Her study shows that monitoring and supervision by an external regulator do not impact sustainability but have a positive effect on outreach. However, board diversity and composition have a major impact on both sustainability and outreach. Hartarska (2005) shows that organisations with local boards have better outreach but negative sustainability. In the same study, she found that organisations with larger boards have poorer performance than those with smaller boards, and boards comprising a higher proportion of insiders rather than outsiders are linked with poorer financial results (Hartarska, 2005). In addition, she found that underpaid managers have a negative impact on outreach.

A study of 25 MFIs conducted by Gohar and Batool (2015) in Pakistan over five years (2005–09) found that outreach and financial sustainability improved with female representation on the board. The authors also found that outreach is better when there is a local businessman on the board, but this does not help achieve better sustainability. However, board members with diverse skills and knowledge enhance MFI sustainability. Moreover, donor representatives on the board have a negative effect on both outreach and financial sustainability (Gohar and Batool, 2015).

For creating a balance between financial sustainability and outreach, Sinha (2012) suggests that a good governance framework and proper incentives at the MFI level can play a crucial role. Evidence shows improved governance practices bring improvement not only in MFI performance (outreach and financial sustainability) but also help decision-makers, such as donors and government authorities, to make effective decisions (El-Zoghbi and Gahwiler, 2013).

## 5.7 Role of regulation and governance in MFI performance from MFI clients' perspective

Although MFI clients are considered a key stakeholder group, even in the last decade, the microfinance industry has viewed its clients as a given (Cohen, 2002). Cohen claims that the general attitude of the industry towards clients has been, 'We have the products, demand is unlimited, and the clients will come' (Cohen, 2002, p. 9). Clients were considered as a statistic, measured in terms of repayment and repeat borrowing rates, but today much of this picture is different.

McIntosh and Wydick (2005) claim that in the last decade, competition between MFIs in developing countries has increased exponentially and this competition creates another problem for the industry. Heterogeneous objectives of non-profit lenders and client maximising objectives cause unhealthy competition that exacerbates the asymmetric information problem over borrower indebtedness (McIntosh and Wydick, 2005). This yields a new equilibrium in which poorer borrowers are worse off (Kar, 2010). In this regard, monitoring and regulation of MFIs, and educating MFI clients about their rights to information and knowledge of their lending organisation (hereafter clients' awareness) have become crucial.

"*We have rights, but we don't know them. Nobody knows them. We know that with the loan we have the right to have life insurance. We should have some rights to paying on time.*"

"*I have the right to be treated well. They (MFI) should explain (the products) to us better.*"

—Focus Group Montero (Perdomo, 2008, p. 32)

It is important to note that the lack of access to financial services is not the key cause of poverty (Baten, 2009). Other factors play a significant role, such as lack of financial literacy, lack of access to proper education, lack of proper training, lack of good health services, and inadequate resources for breaking out of the poverty cycle (Zulfiqar, 2013). Proper monitoring and regulation and good governance by MFIs can play a significant role in being responsible to all stakeholders.

The role of governance in enhancing consumers' awareness of their rights, knowledge about their financial institution and their overall financial status, are critical issues within the microfinance industry. In January 2008, the Global Financial Education Program (GFEP) conducted market research, which identified the knowledge and skills that financial service clients require to exercise their rights and responsibilities. The research showed that most clients of financial institutions, particularly of MFIs, are unaware of their rights as consumers of financial services. These clients are often confused about their institutional rights, interest rate, debt collection, privacy, and terms and conditions of their loans and savings. Most importantly, many clients do not even expect transparency and accountability to be the fundamental components of their financial rights (Perdomo, 2008). Market research conducted by Perdomo (2008) among 64 clients from regulated and unregulated MFIs in Bolivia found that many consumers do not even expect truth and honesty from their MFI as a fundamental component of their financial rights, even from MFIs that have explicitly integrated consumer protection into their operations.

Although microfinance is a socially motivated poverty alleviation tool, its goals may vary from MFI to MFI. Financial service providers have power and information advantages over vulnerable, low-income clients that can create an opportunity or even temptation for abuse (Brix and Mckee, 2010; Rozas et al., 2011). As a result, strong consumer protections and client awareness are necessary to safeguard the interests of MFI clients from adverse effects created by the undesirable practices of financial providers (Rozas et al., 2011). Table 5.2 provides typical product-specific and protection concerns (e.g., requirements for product transparency; clients' knowledge about their rights to know how and where to complain about their products; ethical sales practices by financial institutions; deposit and credit products; clients' privacy, security, and permission to share information with other parties).

Brix and Mckee (2010) argue that in the microfinance industry, minimum client protection standards should apply to all retail financial institutions and in relation to all products (e.g., microenterprise loans, personal loans, savings, microinsurance, and payment products). Studies (e.g., Baten, 2009; Bradley et al., 2001) show that MFI clients need to have a clear understanding of their loans, the MFIs with which they deal, and the overall financial status of their institution.

Brix and Mckee (2010) argue that as competition increases, MFIs and their clients face a variety of challenges. These include pricing transparency, appropriate sales and collection practices, and over-indebtedness. In countries in which the industry is growing rapidly and remains unregulated, microfinance has come under critical scrutiny in the press and recent publications because of MFI client over-indebtedness and overlapping or multiple borrowing (Yuge, 2011).

Overlapping or multiple borrowing by an individual borrower is considered a critical issue for loan repayment by MFI clients (Johnson, 2004; Krishnaswamy, 2007). Multiple borrowing makes governance of loans more difficult. Several studies (e.g., Chaudhury et al., 2002; Rhyne, 2001; Wisniwski, 2010) have found that multiple borrowers have increasingly high debt levels and repayment obligations, which they frequently cannot fulfill. According to Wisniwski (2010), overlapping by MFI clients has become a very common practice in areas where there is a concentration of MFIs. The key reasons behind multiple borrowing are client poaching and loan pushing by MFIs, and loan recycling by clients (Krishnaswamy, 2007, Wisniwski, 2010).

Tiwari et al. (2008) studied 299 Indian microfinance clients to examine their understanding of their loans in the context of rising concerns over consumer protection and financial literacy. They found that consumers have limited knowledge and understanding of their loans. Consumers understand and are concerned with only how much they have borrowed, for how long, and their weekly liability. They are even apathetic about the interest rate charged; they focus on how much they need to pay weekly. According to Tiwari et al. (2008), the reason behind this apathy is a lack of awareness and extremely limited client-level arithmetic knowledge. Interestingly, in spite of their confusion about loan terms, consumers expressed a high degree of satisfaction that MFI staff explained the loans to them.

From a regulatory perspective, the literature (refer Chapter two, Section 2.6) shows that there is very limited research (e.g, Ghosh et al., 2014) that highlights MFIs' governance performance with regard to their clients. Effective regulation and good governance practice by MFIs not only ensure effective monitoring and accountability for the organisation but also help ensure the interests of all stakeholders (Ghosh et al., 2014). Specifically, it helps ensure MFI clients' financial literacy, and most importantly, knowledge and skills that financial service clients require to exercise their rights and responsibilities. Addressing this research gap can give a clearer picture than we have currently about the role and importance of regulation for MFIs and its consequences.

**Table 5.2: Client awareness and some product-specific concerns**

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**Typical cross-cutting client awareness and product-specific concerns and protection concerns**

- ***Product transparency.*** Consumers do not understand the service's total cost; this can be exacerbated by deceptive advertisements, excessive small print, complicated terms, inadequately trained staff, etc.

- ***Recourse.*** Consumers do not know that they have the right to complain or get errors resolved; they may know they have this right, but they do not know how and where to complain; often even if they know how and where to complain, they fail to receive appropriate redress.

- ***Sales practices.*** Consumers face aggressive sales techniques as part of door-to-door solicitations or limited-time offers.

- ***Inadequate documentation.*** Consumers do not receive copies of contracts, receipts, etc.

- ***Privacy, security, permission to share with third parties.*** Consumers cannot be sure that personal data will be treated appropriately.

- ***Deposit products.*** Consumers' savings are eroded by hidden fees.

- ***Credit products.*** Consumers do not understand the terms and conditions of their loan agreement, e.g., what happens in the case of delinquency or default; they pay a high price; they take on too much debt; they are exposed to loan officers who ask for a 'gift' to complete the loan process, to recommend a larger loan, or to expedite loan approval; they are subject to intimidation, abuse, or humiliation by collection staff/agents.

- ***Payments services***. Consumers transfer money to the wrong person or mobile phone and do not know how to correct the error; they lose their personal identification number or have it intercepted electronically by a fraudster.

- ***Insurance.*** Consumers do not understand or fail to receive policy benefits (e.g., they do not receive the full benefit when a family member dies); they do not realize that the loan price includes credit life insurance, so they end up paying more than expected and fail to benefit from the insurance.

- ***Overcharging.*** Consumers are charged extra fees and commissions that are not authorized or proper.

*Source*: Adapted from (Brix and Mckee, 2010, p. 4).

## 5.9 Chapter summary

Governance and regulation are the two key components of this current study. This chapter describes the evolution of governance in the microfinance industry from both MFI and MFI client perspectives. It presents the different components of external (country-level) and internal (firm-level) governance mechanisms important for MFI performance (outreach and financial sustainability) and for their clients' welfare. The chapter also highlights the role of regulation in MFIs from both organisation and client perspectives. Different regulatory aspects of MFI performance and client welfare (discussed in this chapter) show that regulation plays an important role in MFIs and the microfinance industry. To investigate the role of regulation and governance practices of MFIs requires in-depth analysis. The following chapter highlights the development of a conceptual model and hypotheses to be tested on the basis of the research questions developed in Chapter one (Section 1.4).

# CHAPTER SIX

# Conceptual Model and Development of Hypotheses

## 6.1 Introduction

The main purpose of this research is to investigate differences in performance between regulated and unregulated microfinance institutions (MFIs) in Bangladesh. From an organisational perspective, the investigation is focused on governance, and performance measured as MFI outreach and financial sustainability, while from a client perspective, the investigation is focused on clients' awareness, knowledge, financial literacy, and financial intermediation through their MFI.

This chapter develops a theoretical model that links these concepts on the basis of underpinning theories discussed in Chapter four (Section 4.3). This model proposes that responsive regulation as applied to regulated MFIs in Bangladesh plays a significant role in their discretionary governance practices and performance, but this is not the case for unregulated MFIs, and it depicts multiple, complex relationships between these factors.

From an MFI client perspective, the model proposes that responsive regulation plays a significant role in MFIs' key stakeholder (client) welfare, particularly in terms of their clients' financial literacy, financial status, and their financial intermediation (hereafter clients' awareness). The proposed model also shows an expected relationship between MFI clients' financial literacy and awareness and their financial status. It is this model and subsets of it that are tested in the latter half of this thesis.

This chapter commences with a comprehensive review of prior studies that have examined MFIs and their performance outcomes (Section 6.2) that are of significance for the current study. Based on the theoretical discussion in Chapter four and this literature review, theoretical and conceptual models are proposed in Sections 6.3 and 6.4 respectively in order to develop hypotheses that can be tested. Section 6.5 articulates the hypotheses related to expected differences between regulated and unregulated MFIs in terms of their discretionary governance practices, outreach, and financial sustainability. Hypotheses related to the expected nature of the relationship between MFI governance, and performance are proposed in Section 6.6. Finally, hypotheses related to MFI client financial literacy, awareness and status are proposed in Section 6.7, followed by a summary of the chapter in Section 6.8.

Figure 6.1: depicts the structure of this chapter.

**6.1 Introduction**

**6.2 Prior research**

**6.3 Theoretical model for the study**

**6.4 Conceptual model for the study**

**6.5 Hypothesis development: Expected differences between regulated and unregulated MFIs' governance practices, outreach, and financial sustainability**

**6.6 Hypothesis development: Nature of relationship between regulated and unregulated MFIs' governance, and performance (outreach, and financial sustainability)**

**6.7 Hypothesis development: Expected differences in and nature of relationship between regulated and unregulated MFI clients' awareness and their financial status**

**6.8 Chapter summary**

## 6.2 Prior research

The supervision and regulation of the microfinance industry and their association with MFI performance are the key focus of this research. Aspects of governance and regulation theories were discussed in detail in Chapter four (Sections 4.3 and 4.4). This section highlights findings related to the role of regulation in microfinance performance based on existing research, particularly in the four key areas of interest to this study—governance, and performance (MFI outreach and financial sustainability) and client financial literacy, awareness and financial status.

A number of studies (e.g., Ahmed, 2013; Akash et al., 2010; Bakker et al., 2014; Baten, 2009; Charitonenko and Rahman, 2002; Jackson and Islam, 2005; Miah, 2006; Rahman and Luo, 2012; Rashid, 2010; Yuge, 2011) examine the role of regulation in the microfinance industry across different countries. Most studies focus on the normative requirements of appropriate types of a regulatory system from an MFI performance perspective in terms of the supervision and socio-economic development of MFIs and their clients. These studies address, for instance, registration requirements, reserve requirements, consistency with prudential accounting norms, supervision (on- and off-site), and reporting systems. Research has addressed also MFI performance in relation to aspects such as governance, outreach, financial sustainability, ownership, and depositors' protection.

There is, however, very limited research that examines these key components of MFI performance to determine whether any differences are associated with MFIs' regulatory status. In particular, none of the studies examine the relationship between all three key components of governance and performance simultaneously from a regulatory perspective at the organisational or institutional level, as well as at the client level. No published study has examined the associations between clients' financial literacy and awareness or status and MFI regulatory status. Also, no published prior study examines the difference (if any) between regulated and unregulated MFI client financial awareness and financial status. This study fills this research gap and so makes an important contribution to the literature, and potentially to policymaking with respect to the benefits and costs of regulation in the microfinance industry.

The majority of research articles regarding supervision in the microfinance industry and MFI performance have been published post-2000. Table 6.1 presents an overview of these studies, spanning the period 2000–2018.

**Table 6.1: Research on microfinance regulation (R) and MFI performance (G: governance; O: outreach; F: financial sustainability; CP: client protection; CA: client awareness)**

| | No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|---|
| | **Organisation perspective** | | | | | |
| Organisation perspective | 1 | (Ahmed, 2013) | Bangladesh | Descriptive history and analysis of the impact of MRA Act on MFIs | ROF | For the Bangladesh microfinance industry, a soft touch supervisory approach (by bringing the head office of MFIs with their selected high-default branches under on-site supervision) can provide a sound footing for the regulation and supervision of the industry. Also, an off-site supervision system, accompanied with mobile monitoring, can be adopted. As commercial banks are unwilling to give loans to MFIs; a credit guarantee scheme under PKSF (Palli Karma-Sahayak Foundation) or under the central bank may be initiated. Two-way linkages between MFIs and banks can be initiated for MFIs to get funds on a sustainable basis. Dhaka Inter-MFI Borrowing Market (DIMBOM) can be developed for addressing the short-term liquidity problem of MFIs. Establishing a central database of MFIs and customising the financial literacy campaign can not only enhance the financial sustainability of MFIs but also have a positive impact on the regulation and supervision of the industry. |
| | 2 | (Akash et al., 2010) | Bangladesh | Normative | ROFG | Ownership and governance, financial sustainability, and broader outreach. Microcredit operators must seek out different sources of primary funds or seed capital. Microfinance regulators should allow MFIs to take public deposits as well as savings of their own borrowers. Regulators must create an environment for NGOs to transform themselves into microcredit banks. |
| | 3 | (Alamgir, 2009) | Bangladesh | Descriptive | ROFG | The author reports on the state of the microfinance sector in Bangladesh. The major areas covered are evolution and outreach of microfinance, governance, financial sustainability of the sector, the impact of the regulatory regime on the sector. |
| | 4 | (Annim, 2012) | Ghana 2004 | Interviews with 1,589 client households from 16 MFIs | FO | Unlike **financial self-sufficiency**, MFIs that are only **operationally self-sufficient** reach poorer clients. Formal institutions with financial self-sufficiency target non-poor clients for funds, operational costs, and overall financial self-sufficiency. |
| | 5 | (Bakker et al., 2014) | 97 MFIs across 35 countries (not including Bangladesh) 2012 | Empirical World Bank Database | ROFG | Regulation (a dummy indicating an MFI is regulated/supervised by a government regulatory agency valued 1 and 0 otherwise) significantly predict sustainability in a negative way. Boards of MFIs with internal stakeholders are a significant predictor of sustainability. Ownership does not significantly influence either sustainability or outreach. Moreover, the proportion of women on the board does not significantly predict sustainability and outreach. The study was conducted on expanding and large-scale MFIs only. |

| | No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|---|
| | 6 | (Barry and Tacneng, 2014) | 30 Countries (not including Bangladesh) 2001–07 | Empirical, 200 MFIs, MIX Database | OFG | NGOs are more profitable and have better outreach than banks and cooperatives. Shareholder-owned MFIs do not have better outreach than NGOs. |
| | 7 | (Bassem, 2009) | 42 MFIs in 21 Mediterranean countries (not including Bangladesh) in 2006 | Empirical data from the survey questionnaire of 40 MFIs (Bassem 2008) and MIX Database | ROFG | Regulation (a dummy that takes the value of 1 if the MFI was supervised by the central bank or another bank supervisory agency) is positively associated with the MFI's financial sustainability. Larger board size and a higher proportion of unaffiliated directors are negatively associated with outreach and financial sustainability. A female board member is positively associated with effective governance and performance. Also, external governance mechanisms (auditing, external regulation, an audit of financial statements, and supervision) help MFIs to achieve better financial performance. |
| | 8 | (Baten, 2009) | Bangladesh | Descriptive | RO | Social service (human development). This thesis compiles legal, regulatory, and institutional policy on microfinance consumer protection, particularly for MFIs, microfinance clients, community leaders, practitioners, and regulators. |
| | 9 | (Beisland, Mersland, and Randøy, 2014) | 73 countries (including Bangladesh) 2000–09 | Empirical database of microlender rating agencies | RG | CEO/chairman duality has a negative relation with performance rating scores for MFIs (American MicroRate agency, Italian Microfinanza agency, French Planet Rating agency, CRISIL, M-CRIL). The study used regulation (binary variable taking the value of 1 if MFI regulated by a local bank authority) as a control variable. The study shows that the number of external directors, the presence of internal audit, and the level of competitive intensity are positively associated with rating scores. |
| | 10 | (Beisland, Mersland, and Strøm, 2015) | 70 countries (including Bangladesh) 200109 | Hand collected a sample of 379 for-profit and non-profit MFIs | RG | Examined two measures of MFI audit quality (presence of Big 4 [Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers]—and of internal auditor). The result shows that these two-quality metrics are highly related. The presence of an internal auditor is highly related to governance indicators (board size, CEO/Chair duality, MFI age, number of branch offices), whereas that of Big 4 is highly related with other governance mechanisms, such as ownership type, bank regulation (external governance indicator taking value of 1 if MFI regulated by a local bank authority), competition, number of branch offices, and MFI age. |
| Organisation Perspective | 11 | (CDF, 2006) | Bangladesh | The historical, descriptive, survey report | OF | Challenges of MFI programmes: Enhancing financial resources (funds) vs reaching poor clients: To extend the size of operations, MFIs may require interest rates to rise, which can discourage poorer clients.<br>Financial sustainability: Small vs large size: To increase financial sustainability, MFIs prefer larger loan sizes, which can worsen repayment performance and exclusion of poorest.<br>Increased client base vs sustainability of MFIs: For financial sustainability, MFIs require increased client numbers, implying investment in less profitable activities that reduce demand for loans and reduces the impact on poverty alleviation (outreach and financial sustainability). |

| | No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|---|
| | | | | | | |
| | 12 | (Charitonenko and Rahman, 2002) | Bangladesh, Indonesia, the Philippines, and Sri Lanka 2002 | Descriptive, case Study | RG | Positive and negative aspects of the commercialisation of microfinance. Few positive implications mentioned: overall, focuses on ownership, governance and transparency, and legal and regulatory framework. The study found that commercialisation of microfinance improves outreach and financial self-sufficiency. Unfortunately, the industry is far from reaching the potential benefits of the commercialisation of microfinance. |
| | 13 | (Chowdhury, 2014) | Bangladesh | Analytical, descriptive, case Study | RG | MRA should introduce a tiered regulatory approach in its law, particularly in the area that depends on the institutional capacity for both large and small MFIs. Also, MRA should enhance its own institutional capacity and staff development for monitoring and supervision of MFIs. A credit information bureau (CIB) should be established to reduce MFI clients' over-indebtedness and overlapping. Incorporating social performance and disaster management law in MRA's regulation law can enhance MFIs' efficiency in regulation as well as their social commitments. |
| | 14 | (Crabb and Keller, 2006) | 37 Developing countries (not including Bangladesh) 2001–03 | Empirical, 37 MFIs, 935 observations | GO | Loan portfolio risk of MFIs is strongly associated with their lending methodology. Group lending is positively associated with women's empowerment and outreach of the firm. A group lending method reduces portfolio risk significantly as compared to individual loans. |
| | 15 | (Cull, Demirguc-Kunt, and Morduch, 2007) | 49 countries (not including Bangladesh) 1999–2002 | Empirical, 124 MFIs, Mix Database | F | MFIs can be profitable while they serve poor customers, but a trade-off emerges between profitability and serving the poorest. Raising fees does not ensure greater profitability. |
| | 16 | (Cull, Demirguc-Kunt, and Morduch, 2011) | 67 countries (not including Bangladesh) 2003 and 2004 | Empirical, 346 MFIs, MIX Database | RFO | Regulation is measured as three dummy variables indicating whether: (1) an MFI faces a regular reporting requirement to a regulatory authority; (2) the MFI faces on-site supervision; or (3) on-site supervision occurs at regular intervals. Profit-oriented MFIs respond to regulation by maintaining profit rates but limit outreach to women and clients who are costly to reach. MFIs with a less commercial focus, on the other hand, tend to reduce profitability but maintain outreach. |
| | 17 | (Dubreuil and Mirada, 2015) | 82 developing countries (not including Bangladesh) 2013 | Empirical, 562 MFIs, MIX Database | GF | Comparison between for-profit and NGO-MFIs in terms of governance mechanisms, social performance, and financial performance. NGO-MFIs have more diversity in their boards, more social training programmes, and better fair practices in human resources as compared to for-profit MFIs. NGO-MFIs perform better at a social level, such as reaching poorer clients, achieving better outreach, and more female clients. The study also reveals that external governance mechanisms have little or no |

| | No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|---|
| | | | | | | effect on social performance, but board characteristics, such as board size, diversity, structure, and composition, are significantly associated with social performance. |
| | 18 | (Ghosh, et al., 2018) | India 2008-09, 2013-14 | 57 MFIs. Univariate (t-test, rank sum test) and random effect regression) | F | In terms of legal status, for financial sustainability, NGOs have better performance compare to non-banking financial institutions (NBFC). However, for social performance, there is no significant difference between these two. Also, NGO has better portfolio quality and lesser costs of operation compare to NBFC. So, the transformation of NGOs to NBFCs not necessarily will improve the performance of Indian MFIs. |
| | 19 | (Gohar and Batool, 2015) | 25 MFIs in Pakistan 2005–09 | Empirical, Pakistan Microfinance Review and MIX Databases | ROFG | Regulation (a dummy taking the value 1 if the MFI is regulated by banking authorities, otherwise 0) is positively associated with outreach and financial sustainability. Governance variables are not associated with MFI performance or productivity. Larger boards are inversely associated with the economic performance but positively associated with outreach and productivity. Female directors are positively associated with outreach but not with financial sustainability. |
| | 20 | (Halouani and Boujelbene, 2015) | 67 African MFIs 2002–09 | Empirical, MIX Database of level 4 and 5 diamonds of MFIs (diamond a measure of MFI's transparency and quality of information in MIX market database), rating agency (rating fund) database | RGF | The study analyses the relation between external governance measured by external regulation, rating on the efficiency of MFIs, and the external audit. The study also investigates the relation between competition and social performance, and financial performance of MFIs and the impact of external governance mechanisms on the dual mission of MFIs. The impact of regulation on the dual mission of MFIs represented with binary variable, which detects if MFI subject to regular surveillance; takes the value of 1 if MFI regulated and 0 otherwise. The result shows that external control is negatively associated with MFIs' financial performance but positively with their social performance. Competition encourages the financial performance of MFIs. Regulation is not associated with financial performance. |
| | 21 | (Hartarska, 2005) | 3 countries (not including Bangladesh) 1998, 2001, 2002 | 3 Surveys (1998, 2001, 2002) Microfinance Centre (MFC) for central Europe and | GOF | The greater experience of managers improves MFIs' performance. Lower wages for managers for mission-driven organisations worsen outreach. The result shows that MFI outreach and sustainability depend on stakeholders' representation on the board and as well as board independency. However, external governance mechanisms play a limited role in MFIs' performance. |

| | No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|---|
| | | | | the newly independent states | | |
| | 22 | (Hartarska and Mersland, 2012) | 155 MFIs from 45 countries (1 from Bangladesh) 2000–07 | Empirical, database, microlender rating agencies | RGO | Larger board size (more than 9), CEO/Chair duality, and larger proportion of insiders (employees) on the board, or presence of donors on the board decrease governance performance as well as efficiency. No consistent evidence that competition improves efficiency. However, regulation of MFIs by an independent banking authority improves their governance performance. The impact of banking regulation is measured by an index of regulation that takes values from 1 to 7. Higher levels in the index indicate a more mature regulatory environment (judged by the rating agency provided in rating agencies' rating report). The analysis used a dummy variable, which takes on the value of 1 for regulated MFIs by an independent banking authority, and 0 otherwise. |
| | 23 | (Hartarska and Nadolnyak, 2007) | 114 MFIs from 62 countries (not including Bangladesh) 2002 | Empirical, database MIX Market | ROF | Examines the impact of regulation on MFIs' performance. A dummy variable is used taking the value of 1 if the MFI is regulated (external regulation/banking regulation), 0 otherwise. Regulatory environment does not directly affect MFIs' performance (operational self-sufficiency/financial sustainability or outreach). Less leveraged MFIs have better financial sustainability. MFIs collecting savings comparatively have better outreach, which indicates the indirect effect of regulation. |
| | 24 | (Islam, Porporato, and Waweru, 2013) | Bangladesh 2009 | Empirical, data from MRA database for 215 MFIs 2009 | RF | Examines the cost structure of MFIs to determine the financial sustainability of MFIs after MRA introduced an interest rate cap. The findings show that two key factors are significantly associated with financial sustainability: the interest rate and general administrative costs. MFIs with a lower proportion of administrative costs and higher interest rates are positively associated with financial sustainability, even with a newly introduced interest cap (regulation). |
| Organisation Perspective | 25 | (Jackson and Islam, 2005) | Bangladesh | Normative, Bangladesh as a case study | RF | The paper was published before the MRA Act, 2006, and prior to microfinance regulation in Bangladesh. It looked at the growing calls for regulation of MFIs in the country. The paper proposes the possibility of placing microfinance regulation under PKSF, an autonomous financial institution. As a second-tier MFI or apex financial institution, PKSF appears to have reasonable support for ensuring the transparency of the management of MFIs, as well as promoting MFIs to have a significant impact on their goals of poverty alleviation and financial sustainability. |
| | 26 | (Mersland, 2011) | | Normative, historical review of literature (Mersland and Strøm, 2009; | RG | Comparison between historic savings banks and today's non-profit MFIs. Findings show that external monitoring (external regulation, bank regulation, depositors, donors, and local community) is important in securing the survival of savings banks. Serving wealthier customers indirectly helps organisations to serve poorer clients. Stakeholder-based understanding of corporate governance is crucial for MFIs. |

| No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|
| | | | Hartarska, 2005) | | |
| 27 | (Mersland and Strøm, 2009) | 278 MFIs across 60 countries (not disclosed) 2000–07 | Empirical database; microlender rating agencies; MicroRate, Microfinanza, Planet Rating, CRISIL, and M-CRIL | ROFG | Examines the relationship between MFIs' performance and corporate governance. The result shows that financial sustainability improves with internal auditing, local directors, and a female CEO. CEO/chairman duality increases outreach. Outreach is lower in the case of individual lending compared to group lending. Regulation (dummy taking value 1 if the MFI is regulated by banking authorities) has no effect. |
| 28 | (Mia and Chandran, 2016) | Bangladesh | Empirical, data obtained from MRA for 2007 to 2012 for 162 MFIs | FO | Overall productivity progress, attributed mainly to better managerial efficiency. |
| 29 | (Miah, 2006) | Bangladesh Japan, Lao PDR, Malaysia, Nepal, Pakistan, the Philippines, Sri Lanka, and Vietnam, 2003 | Historical and descriptive work of legal and regulatory framework as per the 2003 report | RF | Asian Productivity Organisation (APO) conducted a survey in nine Asian countries to study the legal and regulatory framework for microfinance. The paper discusses the emerging structures for microfinance in Asia to assist policymakers in developing appropriate regulatory regimes. It shows that the legal and regulatory frameworks (e.g., ownership structure of MFIs, special laws for MFIs, interest rate policy, self-regulation and responsibility of regulatory authority, banking regulations for MFIs to mobilise savings, requirement for capital adequacy, loan loss provision and the collateral/risk of microfinance, microinsurance and training needs of MFI clients and staff) impact the financial sustainability of MFIs and the safety of deposits mobilised from poor people and the public. Although the paper was published before the MRA Act, 2006 in Bangladesh, it focuses on some important features (like in the case of other countries in Asia mentioned earlier) of the requirements of regulation in Bangladesh. It also highlights the importance of second-tiered wholesale lending to MFIs in Bangladesh (e.g., PKSF). |
| 30 | (Mori, Golesorkhi, Randøy, and Hermes, 2015) | 3 countries (Kenya, Tanzania, and Uganda) 2004–09 | Empirical, survey questionnaire about governance sent to 103 MFIs (50% response rate) | GO | Outreach performance is improved when an MFI has better governance in terms of boards having a higher share of independent, international, and/or female members. |

| No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|
| | | | MFI websites and financial reports for 63 MFIs | | |
| 31 | (Okumu, 2007) | Uganda. 53 MFIs (31 regulated non-banks, 12 commercial banks and National Bank of Uganda) 2000–05 | Empirical, database MIX Market and Bank of Uganda Annual reports, structured questionnaire | ROF | Financial sustainability is positively associated with MFI age and lending rates but negatively with outstanding loan portfolio to total assets and average loan size to national per capita income. Outreach is positively associated with governance efficiency, MFI age, and gross outstanding loan ratio to total assets, but negatively linked with the unit cost of loan distributed. Financial regulation is measured using CAMEL (Capital adequacy/Asset quality/Management/Earnings/Liquidity management), which was originally designed to enable US bank regulators to examine the financial soundness of US commercial lending institutions. The study shows that financial regulation is negatively associated with outreach, but positively with sustainability. In the long term, financial regulation positively impacts both MFI sustainability and outreach. The empirical analysis could not establish a positive impact of regulation; this finding arises from responses to the questionnaire. |
| 32 | (Pati, 2012) | India, 40 MFIs 2005–06 and 2009–10 | Empirical, database MIX Market | ROF | Regulation (dummy variable valued 1 for MFI regulated by the Reserve Bank of India, 0 for unregulated) does not have an impact on MFI financial performance. Instead, operational expenditure is positively associated with MFI financial sustainability and profitability. External regulation is important for the proper functioning of MFI governance, but it needs to be handled very efficiently. |
| 33 | (Pati, 2015) | India, 40 MFIs (30 regulated and 10 unregulated) 2008–09 and 2012–13 | Empirical, panel data MIX Market Database | ROF | External regulation (dummy variable valued 1 for regulated MFI by the Reserve Bank of India, 0 for unregulated) or maturity of MFIs has no impact on outreach and financial sustainability. The capital structure of MFIs, operation costs, and quality of assets are associated with MFI outreach and sustainability. |
| 34 | Piot-Lepetit and Nzongang, 2014) | Cameroon, 52 MFIs 2009 | Empirical, database, ADF (Appropriate Development for Africa Foundation) database | OF | The author developed a performance indicator and DEA (Data Envelopment Analysis) technique to improve the financial and social efficiency of MFIs in Cameroon. DEA is used for identifying best practices and setting benchmarking goals. Performance indicators are used for characterising areas that need improving. |
| 35 | (Purkayastha, Tripathy, and Das, 2015) | | Normative | RG | Regulatory impact on the microfinance industry from a strategic management perspective. The author discusses the importance of regulatory governance for the microfinance industry. |

| | No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|---|
| | 36 | (Quayes and Khalily, 2014) | 71 MFIs Bangladesh 2004–07 | Empirical, database compiled from MFI annual reports | RFO | The member MFIs of PKSF in Bangladesh are also licenced and regulated by MRA. Comparing member and non-members of PKSF in the country, the study shows that external oversight and regulation (by PKSF and MRA) can enhance efficiency. Larger MFIs are more efficient than smaller ones. Moreover, as smaller MFIs survive and grow, they undergo a process of learning efficiency. |
| | 37 | (Rahman and Mazlan, 2014) | 5 largest MFIs Bangladesh 2005–11 | Empirical, 5 largest MFIs, data from Mix Market (MIX, 2013) from 2005 to 2011 database | F | Examines MFI financial self-sustainability and compares positions of the five largest MFIs in Bangladesh. The result shows that there is a positive relationship between financial self-sufficiency and yield on the gross loan portfolio, personal productivity ratio, average loan balance per borrower, the age of MFI, and active borrowers. However, there is a negative relationship between financial self-sufficiency and MFI debt to equity ratio, cost per borrower and operating expense ratio. |
| Organisation Perspective | 38 | (Rahman and Luo, 2012) | Bangladesh and 9 other countries | Normative/ descriptive | RF | After comparing the regulatory framework in Bangladesh and nine other countries, the study concludes that a separate regulatory framework for NGO-MFIs is necessary for the financial sustainability and development of the industry in China. |
| | 39 | (Rashid, 2010) | Bangladesh | Normative/ Descriptive | ROF | Savings of beneficiaries and the outreach of regulated/licenced MFIs (under MRA regulation in Bangladesh) increase at a higher rate than those of unregulated/ unlicensed MFIs. Also, the annual income of licensed MFIs has become significantly higher than that of unlicensed MFIs. During 2005–09, the average capital growth of licenced MFIs became 5 to 10 times higher than that of non-licenced MFIs. |
| | 40 | (Servin, Lensink, and Berg, 2012) | 315 MFIs across 18 Latin America countries 2003–09 | Empirical, MIX Market Database | G | Examines the technical efficiency of different types of MFIs in Latin America. The ownership structure of MFIs has a significant influence on their technical efficiency. The findings show that NGOs and cooperatives have much lower technical efficiencies compared to banks and non-bank financial intermediaries, which shows the importance of ownership type for technical efficiency. |
| Organisation perspective | 41 | (Ssekiziyivu, et al., 2018) | Uganda | 179 MFIs. Cross-sectional. Survey (Primary data). Univariate and multivariate (random | G | Boards of MFIs are non-functional. Most of the time shareholders' rights are not respected. Accountability failures are common. No financial and accounting knowledge by board members. |

| | No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|---|
| | | | | effect regression model). (2017-2018) | | |
| | 42 | (Strøm, D'Espallier, and Mersland, 2014) | 329 MFIs from 73 developing countries (not including Bangladesh) 1998–2008 | Empirical, database rating reports from five rating agencies: MicroRate, Microfinanza, Planet Rating, CRISIL, and M-CRIL | G | Examines the relationships between female leadership, firm performance, and corporate governance. The results show that female leadership is significantly associated with larger boards, younger firms, non-commercial legal status, and more female clients. Female CEO or female chairman is positively associated with MFI performance. |
| Organisation perspective | 43 | (Tchuigoua, 2012) | 135 MFIs across 23 countries (not including Bangladesh) 2003–08 | Empirical database | GO | There is a trade-off between outreach and average loan size per borrower when MFIs decentralise credit decisions or establish joint liability contracts. |
| | 44 | (Tchuigoua, 2015) | 53 countries (not including Bangladesh) 2001–11 | Empirical, 250 Planet Rating reports for 178 MFIs, World Bank Development Indicators, and Governance Indicators | GO | Board expertise, board activity, and ownership type are the main board characteristics that significantly determine the quality of MFI governance. MFIs with better governance also have better outreach. |
| | 45 | (Yuge, 2011) | Bangladesh 2009 | Interviews with 27 clients in two branches of ASA (Association for Social Advancement) | O | Competition has increased among major MFIs in Bangladesh, which creates overlapping loan problems among major MFIs and borrowers (outreach). |

| | No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|---|
| | **Client Perspective** | | | | | |
| Client's Perspective | 46 | (Beltran, 2007) | The Philippines | Normative | RCP | This is a thesis that compiles in a single source the legal, regulatory, and institutional policy on microfinance consumer protection, particularly for MFIs, microfinance clients, community leaders, practitioners, and regulators. |
| | 47 | (Ghosh, Valechha, and Chopra, 2014) | India 2008–11 | 9 MFIs and 3 government banks; qualitative and quantitative; database: MIX Market, MFIN, M-CRIL survey | RCA | Aims to understand the perspective of MFI clients and executives in relation to the impact of regulatory guidelines on them. It argues that policies and regulation need to be balanced. Policies, supervision, and regulation need to drive consumer-centric behaviour on the part of MFIs, as well as encourage the innovation, growth, and sustainability of MFIs. |
| | 48 | (Kalra, Mathur, and Rajeev, 2015) | India June–Sep. 2011 | 320 clients with outstanding loans from 4 MFIs, questionnaire survey, and interviews with MFI officers | CA | Develops a composite indicator index (Microfinance Client Awareness Index, MCAI) to measure the level of financial awareness of MFI clients in the context of raised concerns over financial literacy, consumer protection, and reckless lending. Application of the index revealed that clients of one MFI had a moderate level of financial awareness and the other three MFIs' clients had low levels of financial awareness. The index categorises four types of MFI clients (MFI1, MFI2, MFI3, and MFI4) from a financial awareness and skills perspective, where MFI4 are the top-ranked in terms of financial awareness, skills, and literacy. Findings from MCAI show that at the time of data collection, MFI4 clients were more aware of their loan product compared to MFI1–3. So, they are categorised as having a moderate level of financial awareness, whereas the other three categories are considered to have low levels of financial awareness. The index also shows which particular area of knowledge and skills MFIs should pay attention to in their future training programmes. |
| | 49 | (Mazumder and Lu, 2015) | Bangladesh 2010, 2012 | Structured interviews in June 2010 and 2012 with 500 MFI members from both non-government and government organisations, | CA | Microfinance appears to increase the awareness of basic rights of clients and help improve their quality of life. The positive changes are consistently higher for NGO-MFIs compared to government-run MFIs. |

| | No. | Study | Coverage | Type | Microfinance regulation (R) and performance (G/O/F/CP/CA)* | Major findings |
|---|---|---|---|---|---|---|
| | | | | 300 loan recipients and 200 non-recipients | | |
| | 50 | (Rozas, Barrès, Connors, and Rhyne, 2011) | 130 Countries 2008–11 | 479 independent third-party ratings of client protection practices covering approximately 300 MFIs' survey report | CAP | The report articulates a smart campaign and consumer protection principles. The findings show that a basic level of client protection performance is widespread in the practice of many MFIs, but transparency and over-indebtedness practice is a big challenge for the microfinance industry. |
| | 51 | (Tiwari, Khandelwal, and Ramji, 2008) | India 2008 | Phase 1: 290 respondents, phase 2: 40 respondents; survey report | RCA | Highlights how MFI clients understand their loan contract and implications of this understanding for policy. The authors claim that small borrowers can identify the size and duration of the loan and the weekly installment on their loans, but they know very little about the interest rate and the total interest expense on the loan. Clients think about their loans in terms of how much they owe on a weekly basis. |

*R: regulation; G: governance; O: outreach; F: financial sustainability; CP: client protection; CA: client awareness.

Of the 51 studies presented in Table 6.1, 12 were conducted using Bangladesh data. The remaining studies were conducted using data from various countries, including India, Kenya, Nairobi, Pakistan, the Philippines, Uganda, while some used multiple countries numbering from as few as three to as many as 130.

The table documents studies that have researched the internal and external governance mechanism of MFIs. Some of these studies also highlight the significance and requirements of appropriate types of regulatory system or the impact of regulation on the socio-economic development of MFIs or their clients. The regulatory perspectives of these studies are discussed in detail in Chapter two (Section 2.6). This chapter focuses on MFIs' performance and their internal and external governance mechanisms.

Table 6.1 categorises MFI-related issues into four main aspects: regulation (R), governance (G), outreach (O), financial sustainability (F), and client awareness and client protection (CP/CA), consistent with the themes of this thesis. The following section reviews the studies covered in Table 6.1, whilst also highlighting the key components of this current study from an organisational perspective (governance/outreach/financial sustainability) and client perspective (clients' financial literacy and awareness/rights/protection).

***Organisational perspective***

Table 6.1 reports that most studies that focus on governance, outreach, or financial sustainability concurrently examine two or more aspects (e.g., G, O, or F). However, none of the studies cover the multifaceted and comprehensive aspects of all the four categories (G, O, F, and CA), as examined in this current study. None of the studies examine all four categories or subcategories contemporaneously, despite the expected multifaceted relationships between them.

A critical analysis of the studies demonstrates that 30 of the 51 studies examine these factors (G, O, F, CP/CA) by MFIs' regulatory status (registered/unregistered) from an institutional or client perspective. Although, many studies (Akash et al., 2010; Bassem, 2009; Beisland, Mersland, and Strøm, 2015; Charitonenko and Rahman, 2002; Chowdhury, 2014; Cull, Demirguc-Kunt, and Morduch, 2011; Gohar and Batool, 2015; Halouani and Boujelbene, 2015; Hartarska and Mersland, 2012; Hartarska and Nadolnyak, 2007; Islam, Porporato, and Waweru, 2013; Jackson and Islam, 2005; Mersland, 2011; Miah, 2006; Okumu, 2007; Pati, 2012; Quayes and Khalily, 2014; Beltran, 2007) consider regulatory status, their key focus often is on proposing an appropriate regulatory system or examining the impact of regulation by considering the outreach and financial sustainability of the organisation.

Eleven of these 51 studies use survey data, while the remaining 24 use secondary data from different databases (explained in Table 6.1), all at the organisational level. Only one study (Ghosh et al., 2014) uses both survey data and a secondary database. Five studies (Annim, 2012; Hartarska, 2005; Hartarska and Nadolnyak, 2007; Mazumder and Lu, 2015; Pati, 2012; Tiwari et al., 2008) of these 51 used a control group, where performance was specified as a function of MFI-specific regulatory, microeconomics, and institutional variables. No client-level observation study includes a control group that takes regulation into account as does this current study. For understanding the microfinance industry, it is crucial to have a comprehensive picture of all key stakeholders. A research design that includes the role of regulation at an institutional level and MFIs' governance practices and responsibilities for the welfare of the major stakeholder group (client level) is argued here to be important to the better understanding of the role of regulation.

This current study examines MFIs in Bangladesh considering their regulatory status (regulated/unregulated) at both institutional and client levels. Rather than analysing the impact of regulation[24], it examines differences in performance between regulated and unregulated MFIs from an organisational perspective and from an MFI client financial literacy and awareness, rights, and knowledge perspective.

Another important observation from Table 6.1 is that very few studies focus on the client level, (Beltran, 2007; Ghosh, Valechha, and Chopra, 2014; Kalra, Mathur, and Rajeev, 2015; Mazumder and Lu, 2015; Rozas, Barrès, Connors, and Rhyne, 2011; Tiwari, Khandelwal, and Ramji, 2008) being important exceptions. Most studies adopt an institutional point of view, ignoring the client-level perspective. In particular, clients' financial intermediation and awareness about their rights and knowledge about their loans and savings are absent from most studies. The following section provides a review of relevant studies from Table 6.1 that focus on MFI performance and provides the rationale for the expected relationships and differences between prior studies and this current study.

One of the key challenges for microfinance practitioners has been balancing the dual mission of outreach and financial sustainability. In terms of better understanding, the external and internal governance performance of MFIs, outreach and financial sustainability are the two key components examined in this current study. For measuring outreach and financial sustainability, different measures, such as (financial sustainability) - *return on assets* (*ROA)*, *return on equity (ROE)*, *operating self-sufficiency (OSS)*, *yield on gross loan portfolio*, and *interest rate spreads* and (outreach) – *number of branches, average loan balance, credit borrowers* are commonly used by prior researchers.

[24] This would require data from before and after introduction of the MRA regulation in 2006. While this data exists for some financial items in historical annual reports, it does not exist consistently for governance mechanisms, and it is not realistic to request an accurate recall of these mechanisms by the executives of any MFI, regulated or not.

A cross-country study by Bassem (2009) examines the relationship between governance mechanisms and performance of MFIs regarding outreach and financial sustainability. The major part of the data was obtained from a survey conducted in 2006 of 42 MFIs working in 21 countries with a view to testing the efficiency of MFIs in the Euro-Mediterranean region. Data for the performance variables and some governance variables were collected from MFIs' annual financial reports by Microfinance Information Exchange (MIX), the organisational founder of a large microfinance database (www.https://www.themix.org/).

The study examined how financial sustainability is impacted by management remuneration, board independence and diversity, having an internal auditor who reported directly to the board, external governance mechanisms of control, and MFI and country indicators. One of the major findings is that external monitoring and external auditing are positively associated with financial sustainability. Having financial statements audited externally and being rated by international agencies (external governance mechanisms) are associated with better financial performance. The findings indicate that not all governance mechanisms impact MFIs' performance equally.

Another major finding of Bassem (2009) is that larger boards are better for MFI performance. The rationale for larger boards is that members are more likely to have a range of expertise to help make effective decisions and greater numbers will minimise domination by powerful CEOs. Additionally, board gender diversity (e.g., a higher proportion of women) enhances MFI performance. The study also notes the importance of independence for MFI board members. The result shows that MFIs with a larger proportion of unaffiliated rather than affiliated directors achieve better MFI results. The study brings some clarification to the connection between governance mechanisms and performance in MFIs. However, several governance mechanisms, such as transparency and accountability, and loan recovery rate, remain unexplored.

Another study (Bakker et al., 2014) also examined the influence of governance mechanisms on the sustainability and outreach of MFIs. Data were based on statistics obtained from a Dutch independent investment manager that focused on responsible investment in developing countries. Data were collected in 2012 for 97 countries. The findings demonstrate that the type of ownership of MFIs does not directly influence their outreach or sustainability. Findings from Cull et al. (2007) and Hartarska (2005) also support this view. For the internal mechanism of board composition, Bakker et al. (2014) found that a larger proportion of employees on the board positively impacts board efficiency and outreach. Hartarska and Mersland (2012), however, find the opposite result—the inclusion of a larger proportion of employees on the board having a negative association with MFI performance in that study. Bakker et al. (2014) also found that insiders have a positive influence on the proportion of female clients.

A potentially important variable in investigating MFI governance is female leadership. Strøm et al. (2014) investigated the conditions under which female leadership emerges, and the relationships between female leadership, firm performance, and corporate governance for a global panel of 329 MFIs from 73 countries. Unlike other studies, this investigation specifies female leadership as the presence of a female CEO, chair, or director. The study used longitudinal data (1998–2008) hand-collected from third-party rating agencies' reports. Each MFI rating report gives information for up to six years. There are three major findings from the study. First, increased female leadership is positively associated with MFIs' mission to supply credit specifically to women. However, the study found that female leadership is associated with weaker corporate governance since board meetings are fewer, internal audits are less common, and CEO duality more common. Findings from Bakker et al. (2014) support this view since they reveal that a higher proportion of women on the board is significantly associated with weaker governance. However, this result is inconsistent with Bassem (2009) who finds that a higher proportion of females on the board positively influences MFI performance and governance. Interestingly, Strøm et al. (2014) also found that female CEOs are positively associated with MFI financial performance, a result consistent with Mersland and Strøm (2008). Although beyond the scope of this current study, further investigation would benefit from exploring the attributes of female leaders, such as experience and education, which seem beneficial for financial performance. Moreover, a comparison between female and male leadership in meeting MFIs' outreach goals is needed.

This study includes a broader array of internal governance (Section 7.9.1.1.1) mechanisms than prior studies. Hartarska and Mersland (2012) conducted a cross-country study to investigate the effectiveness of internal governance mechanisms in association with the performance of 278 MFIs from 60 countries for the period 2000–2007. The findings suggest that CEO/chair duality and a larger proportion of insiders on the board are negatively associated with MFI efficiency. Moreover, efficiency increases with board size up to nine members and decreases thereafter. The presence of donors on the board is not beneficial, whereas creditors' presence improves efficiency. While external governance mechanisms do not improve efficiency, the study shows that MFIs in countries with a mature regulatory environment reach more clients, mainly by operating as regulated financial institutions. It is important to note that the study ignores the poverty level of clients in measuring MFI outreach. Also, external governance mechanism data is not sufficient to reflect external regulation and competition amongst MFIs. While the study contributes to an understanding of the relationship between MFI efficiency and external governance mechanisms, it does not cover some important aspects of internal and external governance mechanisms (e.g., external audit, voting rights of directors, loan classifications).

Some other important internal governance mechanisms for MFIs include board effectiveness, CEO characteristics, and MFI–client relationships. Mersland and Strøm (2009) analysed the relationship between performance and MFI corporate governance using a self-constructed global dataset from five third-party rating agencies. The data covers 278 MFIs from 60 countries gathered for 2000 to 2007. The study examined the association of board and CEO characteristics, firm ownership type, firm–customer relationships, and competition and regulation with MFI financial performance and outreach to poor clients. The findings show that financial performance improves with local rather than international directors, an internal auditor, and a female CEO. The study also demonstrates that the number of credit clients increases with CEO/ chairman duality, in contrast to Hartarska and Mersland (2012), who found that CEO/ chair duality and a larger proportion of insiders on the board are negatively associated with firm efficiency. Mersland and Strøm (2009) also found that outreach is lower in the case of lending to individuals compared with group lending. The study found no effect of bank regulation on MFIs. This current research not only examines all three major components of MFI performance (governance, outreach, and financial sustainability) simultaneously but also examines the interrelationship between them.

Beisland et al. (2014) investigate the association between governance structure and MFI performance. The dataset was hand-collected from assessment reports by five leading rating agencies in the microfinance industry. The data covers 405 MFIs from 73 countries and was gathered for 2000 to 2009. The findings show that CEO/chair duality has a negative relationship with rating scores, but the number of international board directors, internal audit, and the level of competition were positively associated with rating scores. The findings provide useful information about governance mechanisms, highlighting the relative importance of different governance structures. However, the regulatory status of sample MFIs is not included and nor is a client-level perspective.

In a study of direct relevance to the context of this thesis, Rahman and Mazlan (2014) investigate and compare the financial sustainability performance of MFIs in Bangladesh. The study was conducted on five different-sized MFIs in Bangladesh during the period 2005–2011.

The results reveal that size, cost per borrower, personal (employees') productivity ratio, and the yield on gross loan portfolio positively explain the financial self-sufficiency of MFIs. Also, the age of the MFI, its operating expense ratio, and its number of active borrowers are negatively associated with financial sustainability. This result is consistent with that of Gohar and Batool (2015) who found MFI age to be negatively associated with outreach and financial sustainability. Beisland et al. (2014) and Tchuigoua (2015) also found the same result—MFI age has a negative association with MFIs' rating score for sustainability. Another study in Bangladesh by Quayes and Khalily (2014) examined the cost efficiency of a sample of MFIs. Using data for 2004–2007 from PKSF, the study shows empirical evidence of a trade-off between depth of outreach and cost efficiency. The study also indicates that external supervision and regulation (in this case PKSF monitoring and supervision) can enhance MFI efficiency. The result reveals that larger rather than smaller MFIs are more efficient. Gonzalez (2007) and Tchuigoua (2010) also support this result.

However, Pati (2015) found that external regulation is negatively associated with the outreach and financial sustainability of MFIs. Okumu (2007) also supports this view and found that financial regulation is negatively associated with MFI outreach, but positively associated with the sustainability of MFIs. However, in the long term, financial regulation positively impacts both the sustainability and outreach of MFIs.

From an organisational perspective, prior research shows that governance, outreach, and financial sustainability play an important role in MFIs. One important observation from these prior studies reveals that although some focus on regulatory aspects of MFIs, these studies are mostly related to examining the importance of regulatory systems rather than focusing on a comparison of differences between regulated and unregulated MFIs in the areas of governance, outreach, and financial sustainability. Such a comparison between regulated and unregulated

MFIs could assist policymakers, governments, and donors to better understand microfinance regulation, thereby encouraging more efficient and effective decisions.

***Clients' perspective***

In addition to the MFI organisational perspective, Table 6.1 provides a summary of the research literature on MFIs from a client perspective (clients' financial *awareness and rights* and their *financial status).* Much of the prior research regarding MFI clients are related to client protection and training and empowerment of women. These studies focus on MFI client awareness and rights and knowledge about their financial institutions' services or their own financial status. Most importantly, these studies ignore the regulatory status of clients' financial institutions, which is the key focus of this current study.

Table 6.1 reveals seven articles that focus on client financial awareness and protection. Of these, five are quantitative. The single country studies are in the context of Bangladesh, India, Kenya, and Nairobi, while the multi-country studies cover 97–130 countries around the world. None of the studies focus on clients' financial status. Further, the studies ignore the regulatory status of sample MFIs to which clients are attached and only normatively propose the importance and requirements of client protection and training for MFIs, without testing the impact of differences in these practices. Mazumder and Lu (2015) come closest to the aim of the current study in that quality of life measure is created, which includes some expense items to compare before and after loan receipt for clients of NGO-MFIs and government organisations, but it does not measure client financial status account for MFI regulatory status.

In qualitative field survey research, Tiwari et al. (2008) examined clients of two MFIs in two phases for 299 and 40 clients respectively to reveal their understanding of their loan contracts and assess the implications of this understanding for policy. The findings show that small borrowers could identify their loan size, loan duration, and their weekly installments. Unfortunately, these clients had very little understanding of the interest rate and total interest expense on their loans. Also, most clients considered what is commonly viewed as coercive collection practices to be acceptable. For example, questions like *"If you cannot repay their loan in your group, do you think it's appropriate to extend the meeting for three hours to enforce repayment?"* or *"Let's say that you are not able to repay her loan. Would it be okay for the MFI to take any of her assets such as for instance, any cows she owns, her house, her land or the machinery she uses for work?"*. Responses of up to 53 per cent of participants indicated: "*Yes it is alright to extend our meeting for three hours or take any of our assets if we can not pay our repayment on time.*" (Tiwari et al., 2008, p.16). The results indicate that clients think about their loans primarily in terms of how much they owe on a weekly basis. According to Tiwari et al. (2008), a top-down regulatory approach makes the incorrect assumption that borrowers can calculate and understand their loan and interest rate, which is not always the case.

With MFI clients being one of the key stakeholder groups, their basic rights, knowledge, and awareness of financial matters associated with their loans are another major component of this current research. Mazumder and Lu (2015) analysed the impact of different microfinance providers on clients' basic rights, awareness, and quality of life. Empirical data were collected in two phases in 2014 from 300 microfinance members and 200 control respondents. The findings show a positive impact of microfinance in increasing awareness about credit clients' basic rights and eventually improving the quality of life of microfinance beneficiaries. The results also show that positive changes are consistently higher for NGO-MFI recipients. The research focuses on MFI clients' awareness and their rights and quality of life under different categories of microfinance providers (NGOs, formal financial institutions, government welfare departments). However, the study does not reveal or distinguish between the differential regulatory status of sample NGOs. Also, the data could be biased because only external monitoring and supervision can assist to ensure the standard of all these important characteristics (clients' basic rights, knowledge, and awareness) for MFI clients.

Kalra et al. (2015) developed an index for measuring the awareness and skills of MFIs' clients. The index scores clients' financial awareness education, and knowledge of loans and insurance. It also evaluates clients' financial, product analysis, and computing skills. The study was conducted during 2011 with four different MFIs operating in India. The findings show that clients of one MFI were more aware of their rights and products offered compared to clients of the other three MFIs. Kalra et al. (2015) claim that the index not only allows comparison of different MFIs on the basis of their clients' awareness scores but also indicates which particular area of knowledge and skills MFIs should give attention to in their training programmes to educate their clients and protect them from being over-indebted. However, the study did not focus on the regulatory status of the MFIs clients are members of, nor did it take into account the financial status of clients. Doing so could have helped policymakers, governments, and donors to understand the industry and make decisions more effectively. This current study, on the other hand, examines the non-mandated or discretionary governance mechanisms of different MFIs, together with the financial status of clients of regulated and unregulated MFIs in Bangladesh.

Another important observation from reviewing the prior research is that the majority of studies focus on the development of the microfinance sector, with most studies ignoring the regulatory status of MFIs in regard to differences in governance practices and client awareness and financial status. From this perspective, the current study is more comprehensive than published studies listed in Table 6.1.

What distinguishes this study is its attention to the regulatory status of MFIs investigated and any differences in a broad array of discretionary practices regarding their governance in their association with MFI outreach and financial sustainability. This study also investigates the difference between regulated and unregulated MFI clients' financial status and awareness about their rights.

It is important to note that although the investigations at an organisational level and client level were conducted separately, both organisation and client level investigations were conducted within the same time period (November 2014 to February 2015) and both executives and clients from the same institution were interviewed. Given this, one strength of this study is that it provides an informed picture of the role of regulation in organisational level governance practices and how these practices are associated simultaneously with MFI outreach and financial sustainability, and also with clients' financial literacy and their financial status.

No published prior study examines these relationships in a holistic way and it is this research gap that this study fills. Addressing this gap likely can give a clearer picture than we have currently about the role and importance of regulation for MFIs and its consequences. Moreover, this study is likely to provide significant insights and contribute towards assisting policymakers, governments, and donors in better understanding the microfinance industry and taking decisions more effectively. It also may help governments to design efficient regulation that addresses MFIs' client interests and optimises social welfare.

The aspect of MFI clients' financial status and knowledge and awareness about their rights assumes an important place in this current study. Thus this study does not deal exclusively with membership of an MFI as a tool to measure clients' financial status and awareness about their rights. Rather, it examines empirically whether the regulated status of clients' financial institutions is associated with enhanced client awareness and whether this awareness is associated with their financial status. The proposed model used to test the hypotheses is presented next.

## 6.3 Theoretical model

As discussed in Chapter four (Section 4.3.3), the philosophy behind *responsive regulation* relates to the engagement of regulatory spaces by negotiation (responsiveness) among regulators, the regulated, and the wider community, and by enforcing rational strategising and self-regulatory techniques (Ayres and Braithwaite, 1992; Wright and Head, 2009). The philosophy of the proposed model supports this view and proposes that monitoring, controlling, and regulating MFIs by persuasion, motivation, advising and training, and most importantly, by engaging different stakeholders (MFI clients) can provide positive outcomes compared to leaving MFIs unregulated, with no accountability to any external authority or regulatory body.

*Stakeholder theory*, also discussed in Chapter four (Section 4.4.5) proposes that monitoring/controlling and overall governance practices need to address the importance of engagement and communication with a wide range of stakeholder groups and take the interests of these groups into account in terms of decision-making strategies (Freeman, 1984). The theoretical model (Figure 6.2) is designed to support this view and suggests that engagement with different stakeholders can bring fruitful results for MFIs.

It is hypothesised that good governance practices of MFIs can only come from an appropriate monitoring, controlling, and regulatory environment for MFIs compared to unregulated MFIs. Figure 6.2 presents the theoretical model for this study.

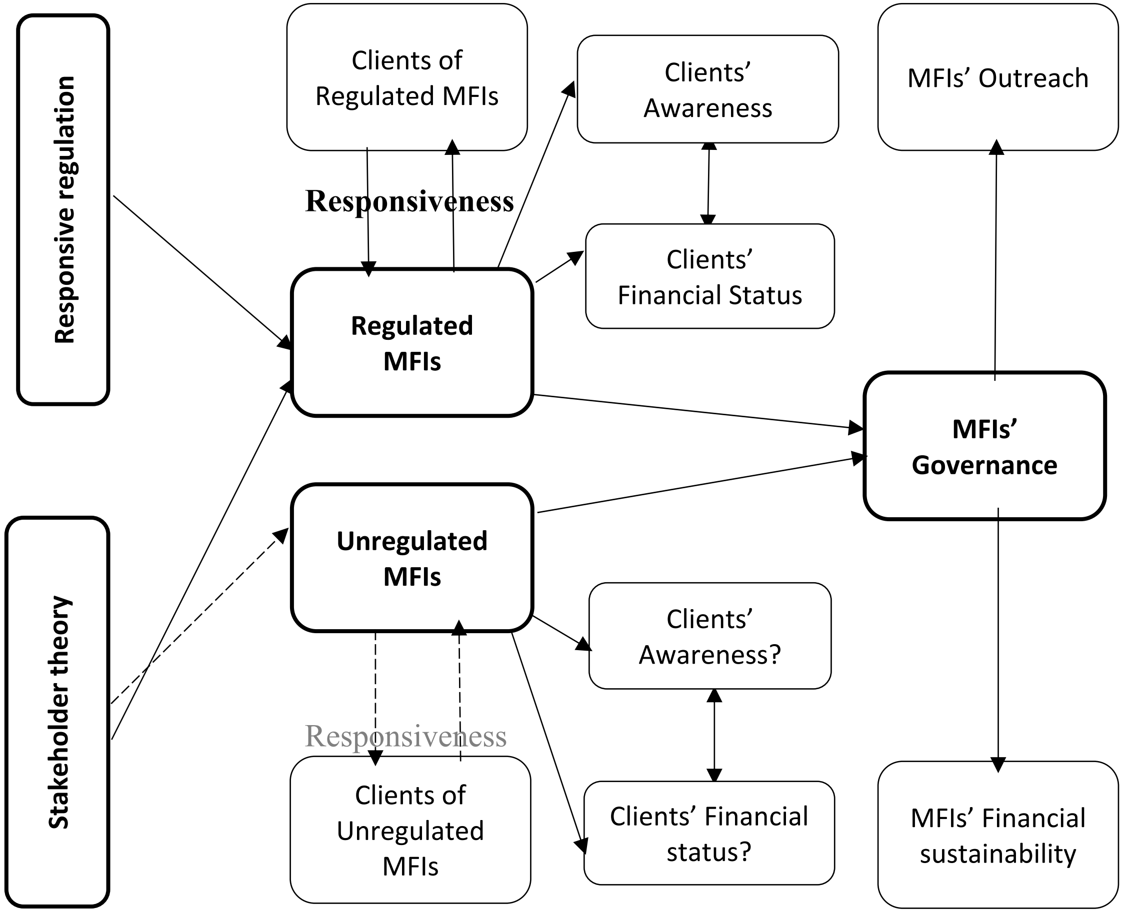


**Figure: 6.2 Theoretical model**

## 6.4 Conceptual model

Based on the Bangladesh context and the introduction of regulation for eligible MFIs through the MRA Act 2006, with the remainder left unregulated, as well as the theories presented in Chapter three and the review of prior literature in this chapter, Figure 6.3 depicts the proposed research model for this study.

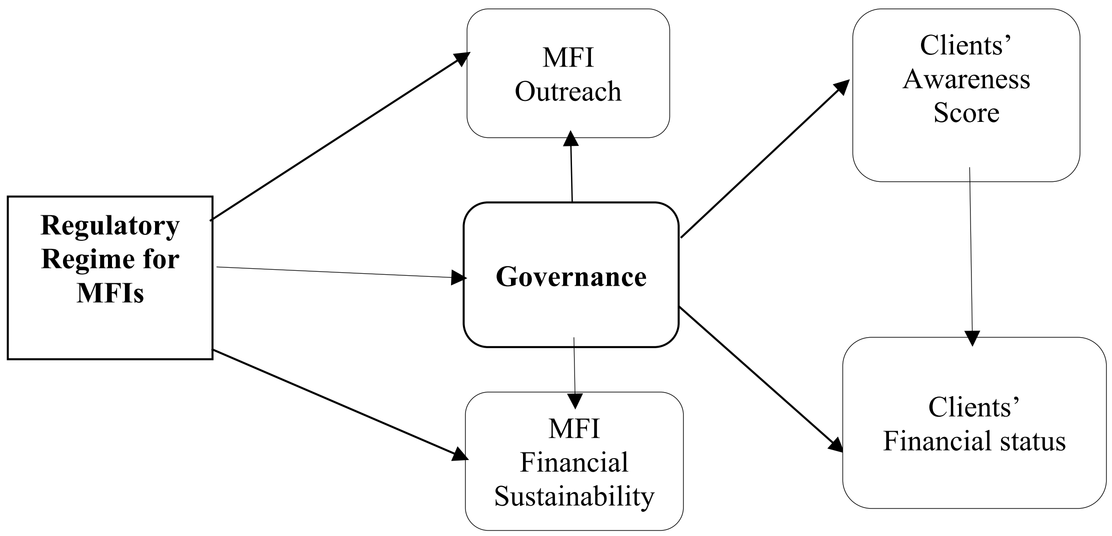


**Figure 6.3: Proposed Research Model**

Responsive regulation theory and stakeholder theory discussed in Chapter four underpin the theoretical and conceptual models for this research.

From an organisational perspective, this conceptual model depicts the existence of a regulatory regime for MFIs and its expected relationship with their discretionary governance practices above and beyond those necessary for registration with the MRA, which in turn are expected to influence both MFI outreach and financial sustainability. The model also shows the expected complex and multidimensional relationships between discretionary governance practices, and performance (outreach, and financial sustainability) for regulated and unregulated MFIs. The model depicts a relationship between outreach and financial sustainability of regulated and unregulated MFIs. From a client perspective, this model shows the expected relationship from regulation to discretionary governance practices to the client's awareness and their financial status. Also, the model depicts the expected interrelationship between clients' awareness and their financial status.

It is hypothesised that this model, when tested using data collected for this study, will provide empirical evidence that regulation plays an important role not only for MFIs' governance practices, outreach, and financial sustainability but also for clients' awareness, rights, and financial intermediation. The conceptual model proposed here is unique in that it links both MFI and client perspectives and sets a framework from which to create hypotheses that can be tested empirically.

### 6.5 Hypothesis development: Differences between regulated and unregulated MFIs' discretionary governance practices, outreach, and financial sustainability

Pati (2012) conducted a longitudinal study of 40 MFIs for years 2005–06 and 2009–10 in order to examine the effect of regulatory status on MFI operational self-sufficiency and profitability. The findings suggest that, contrary to expectations, regulation did not have any impact on sustainability or profitability. Another study (Cull et al., 2011) examined the relationship between MFI supervision and regulation, on one hand, and outreach and financial sustainability, on the other, for 245 of the world's largest microfinance institutions in 67 developing countries. The result showed no direct relationship between regulation and financial sustainability. Bakker et al. (2014) found that regulation is negatively associated with financial sustainability and external control negatively impacts financial performance (Halouani and Boujelbene, 2015).

In contrast, other findings (e.g., Bassem, 2009; Gohar and Batool 2015) suggest that regulation is positively associated with MFI outreach and financial sustainability, although Okumu (2007) shows that regulation is positively associated with outreach but negatively with financial sustainability.

Another school of thought claims that financial regulation of the microfinance industry may generate mission drift (Cull et al., 2011; Hartarska and Nadolnyak, 2007), providing evidence that rigorous financial regulation may shift MFIs' goal from outreach to meeting the required financial criteria.

With regard to MFIs' outreach, Hartarska and Nadolnyak (2007) and Pati (2015) claim that there is no evidence that the regulatory environment directly impacts outreach or financial sustainability. Hartarska and Nadolnyak (2007) also indicate that regulated MFIs with a higher proportion of savings as a financial requirement have better outreach. However, the evidence presented by Cull et al. (2011) is against this view and suggests that profit-oriented MFIs, which are meeting regulatory requirements, have a tendency to limit the number of female clients and clients that are costly to reach, so financial regulation is negatively associated with outreach (Okumu, 2007).

Traditional command-control regulation has long been subject to scholarly critique because of its ineffective results and frequent failures (Lobel, 2012). In terms of MFIs' regulation and governance practices, as predicted by responsive regulation theory (Ayres and Braithwaite, 1992) and stakeholder theory (Freeman, 1984), this study also makes a case for the importance of engagement and communication with a wide range of stakeholder groups (particularly MFI clients) by taking the interests of this group into account in decision-making strategies, as well as internal and external monitoring, control, and regulation. This study argues that close monitoring and supervision for MFI clients and other stakeholders can bring good governance in terms of discretionary practices not required by regulation, better outreach, and sound financial sustainability for MFIs.

In this regard, to examine differences between regulated and unregulated MFIs' discretionary governance practices, the first three hypotheses of this study are presented. These hypotheses address issues arising from the first research question posed in Chapter one (Section 1.4). The regulatory status of MFIs is the key focus of the first research question and these first three hypotheses. Hypotheses H1a, H1b, and H1c examine registered (regulated) and unregistered (unregulated) MFIs in the context of Bangladesh in terms of their non-mandated governance practices, outreach, and financial sustainability respectively. Registered MFIs are expected to have better governance practices over and above those required under for registration, better outreach, and sounder financial sustainability compared to unregistered MFIs.

***Hypotheses: MFIs' regulation***

*Governance*

> ***H1a:*** *Regulated MFIs exhibit superior non-mandatory governance practices compared with those of unregulated MFIs.*

*Outreach*

> ***H1b:*** *Regulated MFIs exhibit superior outreach compared with that of unregulated MFIs.*

*Financial sustainability*

> ***H1c:*** *Regulated MFIs exhibit superior financial sustainability compared with that of unregulated MFIs.*

## 6.6 Hypothesis development: Nature of relationship between regulated and unregulated MFI governance, and performance (outreach and financial sustainability)

The relationship between outreach and financial sustainability of MFIs has been the subject of much-heated debate (Bakker et al., 2014; Beltran, 2007; Baten, 2009; Charitonenko and Rahman, 2002; Gohar and Batool, 2015; Hartarska and Mersland, 2012; Herman, 2012; Mersland and Strøm, 2009; Nurmakhanova et al., 2015; Rozas et al., 2011; Tiwari et al., 2008; Yuge, 2011). However, there is a lack of systematic, empirical analyses on the nature and determinants of this relationship.

Studies conducted by Conning (1999), Hulme and Mosley (1996), Olivares-Polanco (2005), and Zeller et al. (2003) provide arguments supporting the existence of a trade-off between outreach and financial sustainability and the role of governance of MFIs. Evidence suggests that in order to become financially sustainable, MFIs end up reaching out to poor (i.e., better-off clients) rather than the poorest clients, which indicates a mission drift for MFIs. Navajas et al. (2000) suggest that high transaction costs come from poor and inefficient governance practices. Additionally, high transaction costs play a catalyst role in the trade-off between financial sustainability and MFIs' outreach. The authors claim that giving smaller loans targeted to the poorest is expensive, creating high transaction costs. Consequently, MFIs prefer to issue larger loans targeted to relatively well-off clients so that the MFIs become or remain financially sustainable.

In contrast, other findings provide evidence against this view and suggest that with good governance practices, outreach to the poorest and financial sustainability of the organisation can be achieved concurrently (Mersland and Strøm, 2010; Rhyne, 1998; World Bank, 2007). These studies claim that sustainability and outreach depth are complementary objectives; that is, there may not necessarily be a trade-off between these two goals for MFIs. Arguments presented in these studies suggest that as the number of clients increases, MFIs' transaction costs are reduced, which helps attain sustainability since transaction costs are a major determinant of financial sustainability. However, relatively few studies provide evidence to support these arguments (Fernando, 2004; Hishigsuren, 2007; Makame, 2008).

It is important to note that several studies (refer to Table 6.1) have examined the relationship between MFI governance, outreach, and financial sustainability. Of the 51 studies, 30 show that regulation plays an important role in the performance of MFIs. However, none of these studies investigate the difference between regulated and unregulated MFIs in terms of their discretionary governance practices, outreach, and financial sustainability.

Based on the competing arguments and evidence provided by empirical studies, it is important to explore the relationship between MFI governance and performance (outreach, and financial sustainability) for regulated and unregulated MFIs. The relationship between governance, outreach, and financial sustainability of MFIs in regard to their regulatory status is the key focal point of the second research question and the next two hypotheses (H2a, H2b). Voluntary or discretionary governance practices (i.e., practices not required explicitly by the MRA Act of 2006) of registered MFIs are expected to bring better outreach and better financial sustainability compared with those of unregistered MFIs.

***Hypotheses: Relationships between governance, outreach and financial sustainability***

*Governance and outreach*

> ***H2a.*** *Voluntary governance practices of regulated MFIs are positively associated with their outreach, but this is not the case for unregulated MFIs.*

*Governance and financial sustainability*

> ***H2b.*** *Voluntary governance practices of regulated MFIs are positively associated with their financial sustainability status, but this is not the case for unregulated MFIs.*

## 6.7 Hypothesis development: Difference in and nature of the relationship between regulated and unregulated MFI clients' awareness and their financial status

Prior research (refer Table 6.1) shows two important observations about MFI clients. First, few studies focus on MFI clients' awareness; knowledge about their rights, loans, interest rate, savings; or overall knowledge about their financial institutions and their financial status. Second, the only relevant study (Mazumder and Lu, 2015) did not take into account the regulatory status of the included MFIs and only proposed the importance of client protection and training. No study has focused on *consumer protection*, *client awareness*, and *rights* or clients' financial intermediation in association with the regulatory status of their financial institutions.

Studies by Baten (2009), Beltran (2007), and Tiwari et al. (2008) focus on the financial awareness and knowledge of MFI clients and argue that MFI clients need to understand their loans, be aware of their rights to information about their financial institutions, and have knowledge of their responsibility to their financial institutions. These studies, as well as the only relevant quantitative study (Mazumder and Lu, 2015), claim that most clients are unaware of their fundamental rights as consumers of financial services. Many consumers do not even expect truth and honesty from their MFIs as a fundamental component of their financial rights, even from MFIs that have integrated consumer protection into their operations explicitly (Mazumder and Lu, 2015).

As mentioned earlier, the philosophy behind responsive regulation theory (Ayres and Braithwaite, 1992) and stakeholder theory (Freeman, 1984) proposes engagement with a wide range of stakeholder groups for decision-making strategies for the interests of the organisation, as well as the for the interests of stakeholders.

This study also argues that there is a need for engagement and communication with a wide range of stakeholder groups, including MFI clients. It proposes that this engagement, training, involvement, and addressing the needs and concerns of MFI clients and taking the interest of MFI clients into account can bring fruitful outcomes. An outcome can be to increase MFI clients' awareness about their rights, their responsibility, and knowledge about their loans and savings, and their financial institutions. Further, this awareness can also play a significant role for MFI clients' overall financial intermediation.

This study argues that close monitoring, supervision, and internal-external regulation, including effective responsiveness towards MFI clients, can encourage good discretionary governance practices for MFIs. This type of responsive regulation and governance practice can assist to ensure characteristics such as engagement, training, the involvement of MFI clients and addressing the needs and concerns of MFI clients, and taking the interests of MFI clients into account in MFIs' decision-making and strategy setting for governance practices. This type of governance practice is, however, expected to be minimal or absent in unregulated MFIs, which do not have any type of internal or external regulation or accountability to their stakeholders (MFI clients), or any authority or external regulatory body.

To measure the difference between regulated and unregulated MFIs from a client perspective, Hypothesis H3a examines the relationship between clients' awareness of consumer protection issues and MFIs' regulatory status (regulated or unregulated), and it predicts that regulated MFIs will provide better information and training to inform their clients compared with unregulated MFIs.

Hypotheses H3b and H3c examine, respectively, the relationship between client awareness of consumer protection issues and MFI membership status and financial status. The proposition for these two hypotheses focuses on any difference in financial status and awareness exhibited by clients of these two groups of MFIs. Clients of registered MFIs are expected to be more financially literate and aware of their rights, loan details, savings, and knowledge about their MFIs compared to clients of unregistered MFIs, and they are, therefore, expected to be more in control of their financial status than clients of unregistered MFIs.

***Hypotheses: MFI regulation and MFI clients***

*Regulation and clients' awareness*

***H3a:*** *Clients of regulated MFIs are associated with higher awareness of information about loans and savings compared with clients of unregulated MFIs.*

*Regulation and clients' financial sustainability*

***H3b:*** *Clients of regulated MFIs are associated with higher financial status than clients of unregulated MFIs.*

*Clients' awareness and financial sustainability*

***H3c:*** *Clients with higher awareness of information about loans and savings are associated with higher financial status than clients with lower awareness.*

Based on the hypothesised relationships, Figure 6.4 depicts the same research model as Figure 6.3 but links the relationships to be tested with the respective hypotheses.

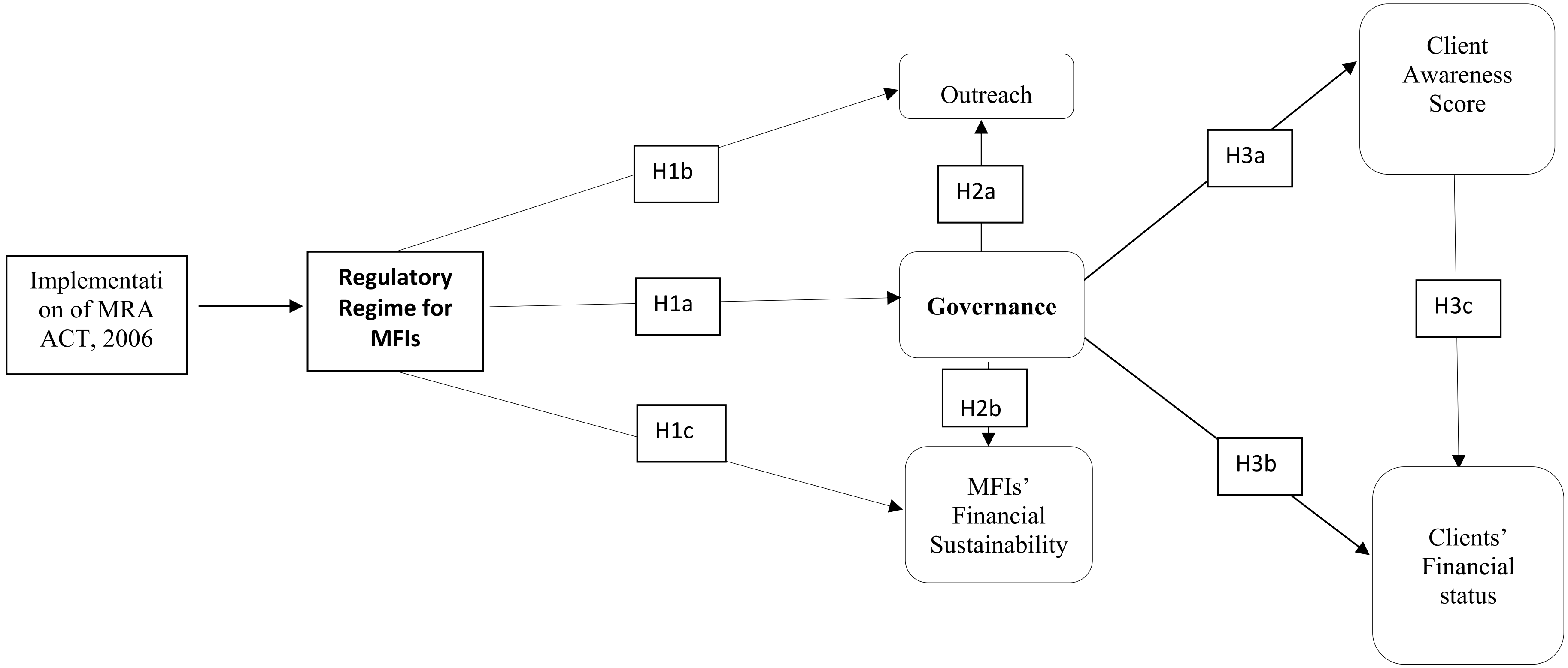


**Figure 6.4: Proposed research model with hypothesised relationships**

## 6.8 Chapter summary

Based on a review (Section 6.2) of studies on regulation, governance, and MFI performance (outreach and financial sustainability) and theories of regulation and governance (Chapter four, Section 4.3), this chapter develops the conceptual model used and hypotheses to be tested in this research.

Based on the literature review Chapter two (Section 2.6) and this chapter, an integrated conceptual model is proposed in order to examine differences between regulated and unregulated MFIs on the basis of their discretionary governance practices, and performance (outreach, and financial sustainability), and the awareness and financial status of MFI their clients.

This chapter reviews prior research on MFI governance, and performance (outreach, and financial sustainability), and the financial awareness and status of MFI clients and develops nine hypotheses to be tested. Testing these hypotheses will facilitate a better understanding of the role of regulation for MFIs and focus on differences between regulated and unregulated MFIs' discretionary governance practices, outreach, and financial sustainability, as well as the awareness and financial status of their clients. The next chapter presents the research method and data collection methods to be used in testing the hypotheses.

# CHAPTER SEVEN

# Research Design and Methods

## 7.1 Introduction

This chapter focuses on the research design and method adopted for this study. Having elucidated the research questions and hypotheses in Chapters one and six respectively, this chapter elaborates on the population and sampling design. It explains the data-gathering techniques and the models used for examining the relationship between the three key governance and performance outcome measures (outreach, and financial sustainability) for microfinance institutions (MFIs).

Section 7.2 of this chapter introduces alternative research paradigms and rationalises the reasons for adopting the paradigm used in this study. The next Section (7.3) highlights various methodologies and analysis utilised in prior studies in a summarised Table format. The discussion then goes on to further elaborate the types of data gathering techniques utilised in prior microfinance research. Building on this discussion, the following section (7.4) rationalises the reasons for using a structured interview guide and unstructured interviews as a principal data-gathering tool for this study. The structured interview guide developed for this study is provided in Section 7.6, with Tables 7.3 and 7.4 providing the structured interview guides and variable lists used with MFI executives and clients respectively. Section 7.7 discusses the content and criterion validity of the structured interview guides.

Section 7.8 highlights the population, sampling frame, and data sampling, followed by the development of ten regression models (Section 7.9) used to investigate the relationships between governance, and performance (outreach, and financial sustainability) of MFIs and their clients' awareness and financial status, with the main hypothesis variable being MFI regulatory status. An overall summary of the chapter is presented in Section 7.10.

Figure 7.1: depicts the structure of this chapter

**7.1 Introduction**

**7.2 Research paradigm**

**7.3 Methodology and analysis techniques adopted in prior studies**

**7.4 Types of prior studies**

**7.5 Rationale for a highly structured interview guide and unstructured interview data approach**

**7.6 Development of interview instrument**

**7.7 Validity of the interview instrument**

**7.8 Population and data sampling**

**7.9 Research design**

**7.10 Chapter summary**

## 7.2 Research paradigm

A paradigm includes the research philosophy and research method, where the former is a comprehensive belief system and worldview, and the latter refers to a framework that gives direction to the researcher to develop an understanding and knowledge of the topic of research (Wills, 2007). In the social sciences, there are several predominant paradigms, each with its own unique ontological and epistemological perspectives. The four most common paradigms adopted by researchers in the social sciences are positivism, constructivism/interpretivism, critical postmodernism, and pragmatism (Bryman, 2012; Creswell and Clark, 2011; Lincoln et al., 2011; Wills, 2007). A brief comparison between these four paradigms is made in Table 7.1.

### Table 7.1: Research paradigms

| Principles | Positivism | Constructivism/ Interpretivism | Critical Postmodernism | Pragmatism |
|---|---|---|---|---|
| | *Discovery of the laws that govern behaviour* | *Understanding from an insider perspective* | *Investigates and exposes power relationships* | *Interventions, interactions, and their effect in multiple contexts* |
| **Ontology** Nature of reality/ways of constructing reality | Objective, independent of social actors, reality, apprehensible, driven by universal laws by which behaviour is governed. | World and knowledge created by social and contextual understanding. Subjective and constructed by human beings. | Reality exists and has been created by direct social bias. | External and multiple views chosen to facilitate the best answers to research questions. The reality is the practical effect of ideas. |
| **Epistemology** What constitutes acceptable knowledge/nature of the relationship | Employs scientific disclosure derived from the epistemologies of positivism and realism. | Understanding of a unique person's worldview. A researcher not separated from the subject of enquiry. | Understand the oppressor's view by revealing the contradictory conditions of action, which are hidden or destroyed by everyday understanding and work to help social conditions. | Combining both inductive and deductive thinking, subjective meaning and observable phenomena can provide acceptable knowledge depending on the research questions. |
| **Methodology** How the researcher reveals reality/tools for revealing the reality | Experimental and quasi-experimental design, survey questionnaires, and testing of hypotheses using statistical methods. | Qualitative methods—narrative, interviews, observations, ethnography, case studies, phenomenology, etc. | Critical analysis, historical review, participation in programmes of action. | Mixed methods, design-based research, action research depending on research problems being investigated. |

*Source*: Adapted from (Bryman, 2012; Creswell and Clark, 2011; Lincoln et al., 2011; Robson, 2011; Wills, 2007).

- ***The paradigm for this research***

The purpose of this study is to better understand any differences between regulated and unregulated MFIs in aspects of their performance from an organisational (governance practices, outreach, financial sustainability) and client perspective (clients' financial status and financial literacy or awareness). For this research, a mixed method approach has been chosen for data collection and its analysis, using both structured interviews and archival data. The research employs an objective approach, whereby the expected research findings are observable and quantifiable, both of which are the main characteristics of a positivist paradigm.

Positivist principles depend on quantifiable observations that lead the researcher to statistical analysis (Collins, 2010). As a philosophy, positivism is in accordance with the empirical view, where knowledge stems from human experience (Collins, 2010) and a deductive approach is adopted. Positivist studies usually adopt an experimental or quasi-experimental design, structured interview guides, and statistical methods for testing hypotheses (Bryman, 2012; Creswell and Clark, 2011; Crowther and Lancaster, 2008; Saunders et al., 2009). The positivist paradigm is considered a scientific approach, based on the assumption that X causes Y under certain circumstances and the difference between X and Y can occur under certain circumstances (Crowther and Lancaster, 2008; Collins, 2010). This philosophy is reflected in the characteristics of the current study.

The literature review in Chapters two, three, and six demonstrates that microfinance regulation in different parts of the world has been investigated inadequately. Some important aspects surrounding regulation in the area of its association with governance practices, outreach, and financial sustainability of MFIs and their clients' financial literacy need further investigation. Also, the literature review suggests that extant theories need testing, which has often been ignored in prior studies. From the extant theoretical foundations, hypotheses were developed in Chapter six (Section 6.5). From the outcomes of hypothesis testing, conclusions can be drawn and generalised, albeit with caveats, for microfinance regulation in other contexts.

The literature review in Chapter six (Table 6.1) shows that of 52 relevant studies, 40 adopt a positivist paradigm in that they use a quantitative method. Positivism is considered to be appropriate for the purpose of this research given that the intended analyses are mostly quantitative, that is, a deductive, quantitative approach based on prior logical reasoning is adopted for this research (Crowther and Lancaster 2008).

## 7.3 Methodology and analysis techniques adopted in prior studies

After selecting the research paradigm, the next step is the development of the research design (refer to Section 6.7 for the research design of this study). The following discussion focuses on the research design and analysis techniques used in relevant prior studies in different geographical contexts. On the basis of prior studies, the rationale for the method adopted in this current study is developed.

Saunders et al. (2009) and Bryman (2012) claim that in social science research there are two types of research design: explanatory and exploratory. Explanatory studies are supported by extant theories using quantitative methods (e.g., surveys) (Bryman, 2012) with the involvement of a new group of respondents and/or another context (Neuman, 2011; Saunders et al., 2009). Exploratory research, on the other hand, identifies patterns, themes, ideas, and hypotheses that can be tested (Hair et al., 2011; Saunders et al., 2009; Neuman, 2011). An exploratory design often relies on qualitative techniques, such as case studies, in-depth interviews, or focus groups (Neuman, 2011).

Extant theoretical models and empirical studies underpin the current research. Relevant theories are applied to the context of governance practices for regulated and unregulated MFIs in Bangladesh and the financial and awareness status of clients of these MFIs in order to examine the predicted relationships between these characteristics and measures of MFI performance. In this regard, this is an explanatory study involving quantitative methods, which is best suited to address the objectives, research questions, and hypotheses of the current study. The following discussion focuses on research design, methodology, and analysis techniques used by prior studies (a majority of which [40] choose a positivist paradigm approach) and provides the rationale for the research design chosen.

## Table 7.2: Research design adopted by prior studies

| | No. | Study | Regulation (R) and Performance (G/O/F/CP/A) * | Analysis Technique | Type | Sample MFI/clients=N | Methodology | Longitudinal | Comparison with control group |
|---|---|---|---|---|---|---|---|---|---|
| Organisation Perspective | | **Secondary Data** | | | | | | | |
| | 1 | (Afonso et al., 2017) | G | Qualitative | Central bank, REDOMIF, FondoMicro, Global Findex Database | 6 MFIs, 45 MFIs' clients and 14 non-clients | Qualitative methodology with a semi-structured interview guide | (2012–2014) | No |
| | 2 | (Ayayi and Peprah, 2018) | GO | Quantitative | Structured questionnaire. MIX Market database | 25 MFIs | T-test | (2000-2013). | No |
| | 3 | (Bakker, Schaveling, and Nijhof, 2014) | ROFG | Quantitative | Dutch independent investment manager database | 97 MFIs | Stepwise regression analysis with backward elimination and hierarchical multiple regression analysis | (2012, 2013) | No |
| | 4 | (Barry and Tacneng, 2014) | OFG | Quantitative | Database MIX Market | 200 MFIs | Multiple regression analysis | (2001–07) | No |
| | 5 | (Beisland, Mersland, and Randøy, 2014) | RG | Quantitative | Database rating agencies (American MicroRate agency, Italian Microfinanza agency, French Planet Rating agency, CRISIL, M-CRIL) | 405 MFIs | Hierarchical multiple regression analysis | (2000–09) | No |
| | 6 | (Beisland, Mersland, and Strom, 2015) | RG | Quantitative | Database Ratingfund | 379 MFIs | Multiple regression analysis | (2001–09) | No |

| | | No. | Study | Regulation (R) and Performance (G/O/F/CP/A) * | Analysis Technique | Type | Sample MFI/clients=N | Methodology | Longitudinal | Comparison with control group |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 7 | (CDF, 2006) | OF | Qualitative | Database Bangladesh Economic Review 2003, 2004, 2005, and World bank 2005 database | N/A | Not applicable | | |
| | | 8 | (Crabb and Keller, 2006) | GO | Quantitative | Database Opportunity International (OI), International Monitory Fund, World Economic Outlook database | 37 MFIs | Multiple regression analysis | (2001–03) | No |
| | | 9 | (Cull, Demirguc-Kunt, and Morduch, 2007) | F | Quantitative | Database MIX Market | 124 MFIs | Multiple regression analysis | (1999–2002) | No |
| | | 10 | (Cull, Demirguc-Kunt, and Morduch, 2011) | RFO | Quantitative | Database MIX Market | 346 MFIs | Ordinary least squares (OLS) multiple IV stage instrumental variable regression analysis | (2003, 2004) | No |
| | | 11 | (Dubreuil and Mirada, 2015) | GF | Quantitative | Database MIX Market | 563 MFIs | OLS regression analysis | 2013 | No |
| | | 12 | (Ghosh, et al., 2018) | S | Quantitative | Structured questionnaire | 57 MFIs | Uni variate (t test, rank sum test) and multi variate (random effect regression model) | (2008-2009, 2013-2014) | No |
| | | 13 | (Gohar and Batool, 2015) | ROFG | Quantitative | Database, MIX Market | 25 MFIs | Multiple regression, panel data estimation technique, common effects model, fixed effects model, random effects model | (2005–09) | No |
| | | 14 | (Halouani and Boujelbene, 2015) | RGF | Quantitative | Database MIX Market and rating agency (Ratingfund database) | 67 MFIs | STATA with panel data for taking account of the time dimension (2002–09) and the extent (67 MFIs). Regression using a random effects estimation model to account for individual effects. | (2002–09) | No |
| | | 15 | (Hartarska and Nadolnyak, 2007) | ROF | Quantitative | Database MIX Market | 114 MFIs | Multiple regression analysis | 2004 | Yes |

| | | No. | Study | Regulation (R) and Performance (G/O/F/CP/A) * | Analysis Technique | Type | Sample MFI/clients=N | Methodology | Longitudinal | Comparison with control group |
|---|---|---|---|---|---|---|---|---|---|---|
| | | 16 | (Hartarska and Mersland, 2012) | RGO | Quantitative | Database rating agencies ((MicroRate, Microfinanza, Planet Rating, CRISIL, and M-CRIL)) | 155 MFIs | Multiple regression analysis | (2000–07) | No |
| | | 17 | (Islam, Porporato, and Waweru, 2013) | RF | Quantitative | Database Microcredit Regulatory Authority (MRA) | 216 MFIs | OLS regression | (2009) | No |
| | | 18 | (Mersland and Strøm, 2008) | RGOF | Quantitative | Database (Ratingfund) | 132 NGOs, 68 shareholders owned firms (SHFs), 13 banks, and 55 non-bank financial institutions (NBFIs) | Generalised least squares (GLS) and three-stage least squares (3SLS) regression analysis | (2000–06) | No |
| | | 19 | (Mersland and Strøm, 2009) | ROFG | Quantitative | MicroRate, Microfinanza, Planet Rating, CRISIL, and M-CRIL | 278 MFIs | GLS regression and 3SLS | (1998–2007) | No |
| | | 20 | (Mia and Chandran, 2016) | FO | Quantitative | Database MRA | 162 MFIs | Data Envelopment Analysis (DEA) and Malmquist total factor productivity index (TFP) | (2007–12) | No |
| | | 21 | (Pati, 2012) | ROF | Quantitative | Database MIX Market | 40 MFIs | Multiple regression analysis | (2005–06) and (2009–10) | No |
| | | 22 | (Pati, 2015) | ROF | Quantitative | Database MIX Market | 40 MFIs (30 regulated 10 unregulated) | Multiple regression analysis | (2008–09) and (2012–13) | Yes |
| | | 23 | (Quayes and Khalily, 2014) | RFO | Quantitative | Database Institute of Microfinance Bangladesh (InM), | 659 MFIs | Stochastic Frontier Model (SFA) | (2004, 2005, 2006, 2007) | No |

| | No. | Study | Regulation (R) and Performance (G/O/F/CP/A) * | Analysis Technique | Type | Sample MFI/clients=N | Methodology | Longitudinal | Comparison with control group |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | PKSF (Palli Karma Shahayak Foundation) | | | | |
| | 24 | (Rahman and Mazlan, 2014) | F | Quantitative | Database MIX Market | 5 MFIs | Descriptive, statistical, and financial ratio analysis | (2005–11) | No |
| | 25 | (Rashid, 2010) | ROF | Qualitative | Database, CDF (Credit Development Forum), InM report | N/A | Analysis of implications of before and after the establishment of MRA, as well as for licensed and unlicensed MFIs | | No |
| | 26 | (Servin, Lensink, and Berg, 2012) | G | Quantitative | Database Microfinance Information Exchange Network | 315 MFIs | Stochastic Frontier Analysis (SFA) | (2003–09) | No |
| | 27 | (Tchuigoua, 2012) | GO | Quantitative | Database MIX Market and Ratingfund | 135 MFIs | Multiple regression analysis. | (2003–08) | No |
| | 28 | (Tchuigoua, 2015) | GO | Quantitative | Database rating agency (Planet Rating, CRISIL, Microfinanza Rating, Microrate, M-CRIL) | 178 MFIs | Ordinal logistic regression | (2001–11) | No |
| | | | | | | | | | |
| | **Survey Reports** | | | | | | | | |
| | 29 | (Alamgir, 2009) | ROFG | Quantitative | Survey report (interviews and in-depth discussion) | 7,041 clients, 297 groups, from 20 MFIs. | Survey report based on published and unpublished research reports and papers and a limited number of interviews | 2009 | No |
| | 30 | (Annim, 2012) | FO | Quantitative | Survey report (field survey) | 16 MFIs, 1,589 clients 1,102 non-clients | Cross-sectional regression | (2004) | Yes |

| | No. | Study | Regulation (R) and Performance (G/O/F/CP/A) * | Analysis Technique | Type | Sample MFI/clients=N | Methodology | Longitudinal | Comparison with control group |
|---|---|---|---|---|---|---|---|---|---|
| | 31 | (Hartarska, 2005) | GOF | Quantitative | 3 surveys by Microfinance Centre for Central Europe and the Newly Independent States (MFC) (online survey) | 105 MFIs | Multiple regression analysis and random effects estimation | (1998, 2001, 2002) | No |
| | 32 | (Miah, 2006) | RF | Quantitative | Survey report an online survey by Asian Productivity Organisation (APO) | N/A | MFI survey report | (2003–04) | No |
| | 33 | (Ssekiziyivu et al., 2018) | S | Quantitative | Survey report (field survey) | 179 MFIs | Cross-sectional. Univariate and multivariate (random effect regression model) | (2017-2018) | Yes |
| | | | | | | | | | |
| | **Survey Reports & Database** | | | | | | | | |
| | 34 | (Bassem, 2009) | ROFG | Quantitative | Online survey & database MIX Market | 40 MFIs | Multiple regression analysis | (2006) | No |
| | 35 | (Mori, Golesorkhi, Randøy, and Hermes, 2015) | GO | Quantitative | Field survey & database (from MFI websites and online resources) | 63 MFIs | Seemingly unrelated regression and Breusch-Pagan test | (2004–09) | No |
| | 36 | (Okumu, 2007) | ROF | Quantitative | Online survey and database MIX Market | 53 MFIs | Random effects model and fixed effects model regression | (2000–05) | No |
| | 37 | (Strøm, D'Espallier, and Mersland, 2014) | G | Quantitative | Field survey & database from rating report (MicroRate, Microfinanza, Planet Rating, | 329 MFIs | Two-step least squares regression analysis | (1998–2008) | No |

| | No. | Study | Regulation (R) and Performance (G/O/F/CP/A) * | Analysis Technique | Type | Sample MFI/clients=N | Methodology | Longitudinal | Comparison with control group |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | CRISIL, and M-CRIL) | | | | |
| **Case Studies** | | | | | | | | | |
| | 38 | (Ahmed, 2013) | ROF | Quantitative | Case study (Bangladesh Microfinance industry) | 651 MFIs | Univariate analysis (e.g., percentages) | (2006–11) | Yes |
| | 39 | (Akash, Ahmed, and Bidisha, 2010) | ROFG | Qualitative | Case study (Bangladesh microfinance industry) | N/A | Univariate analysis (e.g., percentages), face-to-face interviews with top executives of a small, medium, and large MFIs | | No |
| | 40 | (Baten, 2009) | RO | Qualitative | Case study (Bangladesh microfinance industry) | N/A | Normative comparative discussion between different MFI models | | No |
| | 41 | (Charitonenko and Rahman, 2002) | RG | Qualitative | Case study (Bangladesh microfinance industry) | N/A | Survey report | (2002) | No |
| | 42 | (Chowdhury, 2014) | RG | Qualitative | Case study (Bangladesh microfinance industry) | N/A | N/A | No | No |
| | 43 | (Jackson and Islam, 2005) | RF | Qualitative | Case study (Bangladesh microfinance industry) | N/A | Comparative analysis of commercial bank regulation vs apex financial institutions and microfinance bank regulation | | No |
| | 44 | (Rahman and Luo, 2012) | RF | Qualitative | Case study (MFIs in China and Bangladesh) | N/A | Comparative analysis of two regulatory frameworks | | No |
| | 45 | (Yuge, 2011) | O | Quantitative | Case study (ASA Bangladesh) | 27 MFIs | Univariate analysis (e.g., percentages) | (2009) | No |

| | | No. | Study | Regulation (R) and Performance (G/O/F/CP/A) * | Analysis Technique | Type | Sample MFI/clients=N | Methodology | Longitudinal | Comparison with control group |
|---|---|---|---|---|---|---|---|---|---|---|
| | **Clients' Perspective** | | | | | | | | | |
| Client's perspective | | 46 | (Beltran, 2007) | CP | Thesis | Normative | N/A | Not applicable | | No |
| | | 47 | (Ghosh, Valechha, and Chopra, 2014) Consultants with MicroSave, which provides market-led solutions for financial services | RCA | Qualitative and quantitative | MFIN, M-CRIL survey; database MIX Market | | | (2008–11) | No |
| | | 48 | (Herman, 2012) | CP | Guidebook | Project report | N/A | N/A | | No |
| | | 49 | (Kalra, Mathur, and Rajeev, 2015) | CA | Quantitative | Field survey report | 4 MFIs | Multivariate analysis and principal components analysis (PCA) | (2011) | No |
| | | 50 | (Mazumder and Lu, 2015) | CA | Quantitative | Field survey report | 300 clients, 200 control group (non-client) | Multiple regression, propensity score matching, treatment effect models | 2010, 2012 | Yes |
| | | 51 | (Rozas, Barrès, Connors, and Rhyne, 2011) | CAP | Quantitative | Survey report | 300 MFIs | Survey report | (2008-2011) | No |
| | | 52 | (Tiwari, Khandelwal, and Ramji, 2008) | RCA | Qualitative | Field survey and interviews in 2 phases | 2 MFIs<br>299 surveyed and 40 clients interviewed | Survey report—comparative analysis between two different MFIs' clients | 2008 | Yes |

***Note*: *R: Regulation, G: Governance, O: Outreach, F: Financial Sustainability, CP: Client Protection, CA: Client Awareness.**

## 7.4 Types of data gathering techniques utilised in prior studies

Aside from the various aspects and of the research undertaken, the methodology (research design, sample size, time, data gathering technique, analysis technique) chosen is important for achieving the objectives of a study. Table 7.2 reports briefly on the methodologies and statistical techniques used in relevant microfinance research conducted in the last one and half decades.

### 7.4.1 Secondary data

The majority of studies (Afonso et al., 2017; Ayayi and Peprah, 2018; Bakker, Schaveling, and Nijhof, 2014; Mersland and Strom, 2009; Hartarska and Mersland, 2012; Beisland, Mersland, and Randøy, 2014; Gohar and Batool, 2015; Tchuigoua, 2012; Servin, Lensink, and Berg, 2012; Hartarska and Nadolnyak, 2007; Cull, Kunt, and Morduch, 2007; Cull, Kunt, and Morduch, 2011; Barry and Tacneng, 2014; Tchuigoua, 2015; Rahman and Mazlan, 2014; Islam, Porporato, and Waweru, 2013; Mia and Chandran, 2016; Quayes and Khalily, 2014) reported in Table 7.2 used secondary data gathered from various databases or from financial and other reports for analysis. The table shows that hierarchical stepwise multiple regression, general least squares regression (GLS), ordinary least squares regression (OLS), three-stage least squares regression (3SLS), and frontier analysis techniques are the most common, involving both cross-sectional and panel data.

### 7.4.2 Survey

Table 7.2 reports that some studies (Alamgir, 2009; Annim, 2012; Hartaska, 2005; Kalra, Mathur, and Rajeev, 2015; Mazumder and Lu, 2015; Miah, 2006; Rozas, Barrès, Connors, and Rhyne, 2011; Ssekiziyivu et al, 2018; Tiwari, Khandelwal, and Ramji, 2008) use surveys to gather data. Survey data can come from single or multiple sources as explained in Table 7.2. Fixed and random effects estimation and multiple regression models, principal component analysis (PCA), and comparative analysis techniques have been applied to the cross-sectional or panel.

### 7.4.3 Survey data and database

Some researchers (e.g., Bassem, 2009; Mori et al., 2015; Strøm et al., 2014) use data combined from both surveys and databases for their studies. They use two-stage least squares regression (2SLS) for testing endogeneity in their analyses.

### 7.4.4 Case Study

Table 7.2 reports that several researchers (Yuge, 2011; Rahman, and Luo, 2012; Ahmed, 2013; Akash et al., 2010; Charitonenko, 2002; Jackson, 2005; Chowdhury, 2014) use case study analysis for their research. They use both qualitative and quantitative techniques. The studies use univariate (percentage) analysis, comparative analysis between multiple regulatory frameworks, and comparative analysis of commercial bank regulations and microfinance bank regulations.

### 7.4.5 Cross-sectional versus longitudinal surveys

Table 7.2 reports that nine studies (Rashid, 2010; Alamgir, 2009; Ahmed, 2013; Gohar and Batool, 2015; Mersland and Strom, 2009; Hartarska and Mersland, 2012; Beisland et al., 2014; Tchuigoua, 2012; Strøm et al., 2014) use a longitudinal approach, where respondents participated in a microfinance programme for a specified duration.

The spread of longitudinal research demonstrates its perceived importance by both researchers and major funding agencies (Menard, 2002). According to Menard (2002), longitudinal research serves two primary purposes: to define patterns of change and to establish the direction (positive or negative and from Y to X or from X to Y) and magnitude of a causal relationship. Change is typically measured with reference to one of two continua: chronological time or age (Menard, 2002). On the other hand, in a cross-sectional study, data is from one point in time and is used to predict and examine relationships between constructs. As such, the change or development in the subjects or sample cannot be investigated over a period of time (Hair et al., 2011).

The current study carries out a longitudinal examination at the MFI organisational level. From a client perspective, as this study aims to examine any differences between regulated and unregulated MFI clients' financial awareness and status at a point in time, this represents a cross-sectional examination.

### 7.4.6 Comparison group

In classical experimental design, two groups are targeted, which form the basis of experimental manipulation of independent variables, where one group receives treatment and the consequences are evaluated against a comparison group (Bryman and Bell, 2011). The comparison group method is used widely in exploratory quantitative research.

It is important to note that very few of the 52 studies (Ahmed, 2013; Annim, 2012; Hartarska and Nadolnyak, 2007; Mazumder and Lu, 2015; Pati, 2015; Ssekiziyivu et al, 2018; Tiwari et al., 2008) reported in Table 7.2 include a comparison group in their research design in order to examine the influence of external regulation in MFIs, thereby being important exceptions. Ahmed (2013) compared the regulation and guideline standards for microfinance services between NGO-MFIs and commercial banks, particularly in the area of agriculture and microcredit loans. The comparison shows that the size of microcredit loans, its duration, collateral requirements, and terms and conditions of repayments often differs substantially with that of traditional agricultural credit. Annim's (2012) comparison was between clients and non-clients of MFIs. The comparison components included education, assets of the household, quality of the house, occupation, and expenditure. Mazumder and Lu (2015) also made a comparison between the study group and a control group, where male and female microfinance recipients were considered as the study group and microfinance non-recipients as a control group of MFIs. Hartarska and Nadolnyak (2007) investigated the outreach and financial sustainability (organisation-level) of regulated and unregulated MFIs. Pati (2015) also compared the social (outreach related) and financial sustainability (cost and profit related) between regulated and unregulated MFIs, while Tiwari et al.'s (2008) comparison was between two MFIs' performance and their clients' education level and knowledge about their financial institution.

In this study, the treatment group comprises MFIs that are monitored, observed, and regulated by external regulatory authority and the clients of those regulated MFIs and a comparison group comprising MFIs that are not regulated by any external regulatory authority and their clients.

Among the 52 studies documented in Table 7.2, only Hartarska and Nadolnyak (2007) and Pati (2015) used a comparison group to compare the differences between MFI members and non-members after imposition of external regulation. The current study uses both a longitudinal (MFI level) approach and cross-sectional (client level) approach and a comparison group approach for each. The primary data has been collected from respondents who are executives of MFIs (registered/ unregistered) and their clients who have been members for a specified duration. For the MFIs, archival secondary data was collected from historical records, such as annual reports and the Microfinance Regulatory Authority (MRA) and MIX Market databases. This study does not compare outcomes for MFIs and non-MFIs, or members and non-members of MFIs, but rather compares performance between regulated and unregulated MFIs and the financial literacy and status of the members of each.

## 7.5 Rationale for a highly structured interview guide and unstructured interview data approach

In the social sciences, structured interview guides or survey techniques are used to gather large amounts of data about the perceptions, awareness, beliefs, attitudes, and behaviours of a sizeable sample of people (Creswell, 2009; Robson, 2011; Saunders et al., 2009). Kraemer (1991) identified three distinguishing characteristics of structured interview guides or survey research. First, they describe specific aspects of a given population quantitatively, which can involve examining the relationships among variables. Second, because the data is collected from people, it is subjective. Finally, research using a structured interview guide or survey aims to use a representative sample, results from which can, in turn, be generalised for the population. A structured interview guide with closed-ended questions enables researchers to gather quantifiable data that can be analysed statistically to examine causal relationships between constructs (Bryman, 2012).

However, highly structured interview guides comprising closed-ended questions have been criticised for forcing respondents to the alternatives given (Reja et al., 2003). On the other hand, in the case of open-ended questions arising from unstructured or less structured interview guides, respondents provide a more diverse set of data, providing more information compared to closed-ended questions (Bailey, 2008). Additionally, an unstructured interview guide allows respondents to express opinions without being influenced or biased by the researcher (Foddy, 1993). It provides an opportunity for discovering responses that individuals give spontaneously and avoids the bias that may come from suggesting responses to individuals through closed-ended questions (Blalock, 1972).

For the current study, a structure was required to develop data for quantitative analysis in a setting where clients may not be highly literate, with the interviewer administering a survey-like instrument rather than being self-administered. Additionally, especially for MFI executives, a less structured interview guide with open-ended questions was used to elicit detailed and spontaneous unbiased perceptions.

Table 7.2 reports that of the 52 studies, five consist of surveys and four use a combination of surveys and secondary data sources. Data in the current study has been gathered using a highly structured interview approach for both MFI executives and MFI clients. However, some open-ended questions were included for MFI executives' responses. Where appropriate, responses from both types of stakeholders have been combined with secondary data.

Structured and unstructured (open-ended) interview instruments were developed for the current study as the principal data-gathering instrument because it was anticipated that a high level of structure would be needed to help interviewees understand the purpose of the research and the questions. Another consideration was that many potential respondents, particularly MFI clients and even some MFI executives in remote areas, were thought unlikely to exhibit the level of strong literacy required to read and understand a self-administered questionnaire and write responses. Given this, a structured interview instrument was considered most suitable for primary data collection. Detailed sample size and data-gathering techniques are discussed in Section 7.8.2.

The interview questions were developed to gather data for analysing and testing the hypotheses posited in Chapter six (Section 5.6), particularly with respect to measuring regulated and unregulated MFIs' discretionary *governance practices*, *outreach*, and *financial sustainability* (organisation perspective) and MFI clients' financial literacy, *awareness* and *financial status* (client perspective). Two different sets of interview questions were developed: one for MFI executives and the other for MFI clients. Hence, the comparison groups are regulated and unregulated MFI executives' responses and similarly for clients.

Since the data is both cross-sectional and longitudinal, depending on whether the analysis is of MFI clients or MFIs, both cross-sectional and panel data analysis techniques are used. Various quantitative techniques (chi-square, t-tests, multiple regression, and logistic regression) are used for testing the proposed models and hypotheses. The detailed analysis and results are reported in Chapter eight.

## 7.6 Development of the interview instrument

### 7.6.1 Operationalising the constructs in the conceptual model

The development of the conceptual model was discussed in Chapter six (Section 6.4). Each construct in the conceptual model is operationalised using multiple items/variables. Adapting items from theories and prior research for operationalising a construct is a common practice for researchers (Fink, 2003; Nunnally, 1967). Using items based on theories and previous studies increases the reliability and validity of constructs by minimising potential errors (Nunnally, 1967). Additionally, using items from previous research can better justify generalising for a wider population (Fink, 2003). Thus, the items measuring the five constructs included in the conceptual model (governance, outreach, financial sustainability, client awareness, client financial status) are obtained from previously validated scales.

The structured interview guides, one for use with MFI executives (from both regulated and unregulated MFIs) and the other to be administered to MFI clients (from both regulated and unregulated MFIs) are presented in Tables 7.3 and 7.4 respectively. The structured interview guide (options with open-ended questions) for executives representing regulated and unregulated MFIs is divided into three parts composed of questions directed to interviewees regarding (1) MFIs' governance, (2) MFIs' outreach, and (3) MFIs' financial sustainability. For clients, the structured interview guide as members of regulated or unregulated MFIs is divided into two parts composed of questions directed to interviewees regarding: (1) their awareness and (2) their financial status.

### 7.6.2 Interview questionnaire and variables

Two structured interview guides (Tables 7.3 and 7.4) were presented in the language used by participants in Bangladesh. The interview guide for executives included open-ended options. For MFI clients, questions were mostly structured and very specific to their personal information, their source of household income, their financial and enterprise development, knowledge about their loan portfolio, and their awareness of their rights to access services provided by MFIs in the areas of insurance, health, education, training, etc. The questions are informed by the literature, and detailed justification for each group of questions appears in the discussion of the models developed to test the hypotheses in Section 6.7.

**Table 7.3: Structured interview guide and variables for MFI executives**

(Regulated and Unregulated MFIs)

| | Structured interview guide for MFI executives (2014–15) | | Variable name |
|---|---|---|---|
| | ***Organisation Profile*** | | |
| 1E | MFI code | | MFI_code |
| 2E | Registration status | | Registered_MFI |
| 3E | Year of credit program | | Year_Credit_Program |
| 4E | Licence year (if applicable) | | Licence_Year |
| | ***Governance*** | | |
| | | | |
| 5E | Is the council of directors elected? | (Y/N) | Director_Selected |
| 6E | Is it mandatory for the directors to attend board meetings? | (Y/N) | Director_Attendence |
| 7E | Does the council of directors have voting rights to the executive committee? | (Y/N) | Director_Voting_Right |
| | | | |
| 8E | Is a yearly internal audit conducted for the organisation? | (Y/N) | Internal_Audit |
| 9E | Do you publish your annual report along with the financial report (every year)? | (Y/N) | Publish_Annual_Report |
| 10E | Do you inform your members about their rights and responsibilities at the beginning of the loan disbursement? | (Y/N) | Inform_Clients |
| | | | |
| 11E | Does your organisation have a council of directors? | (Y/N) | Council_Directors |
| 12E | Is there any familial relationship (parents/children/spouses/siblings) between the CEO and chairman of the organisation? | (Y/N) | CEO_Chair |
| 13E | Do you have independent board members? (at least 50%) | (Y/N) | Independent_Board_mem |
| 14E | Do your board members have qualifications or experience in banking/business/ finance/law/management? (for at least one of the board members) | (Y/N) | Board_Qualification |
| | | | |
| 15E | Do you carry any type of emergency or safety fund other than a depositor's safety fund? | (Y/N) | Emergency_Safety_Fund |
| 16E | Do you practise loan classification? | (Y/N) | Loan_Classification |
| 17E | Do you calculate monthly interest on average balance determined on the basis of the balance of deposits at the beginning and end of every month (declining balance method)? | (Y/N) | Decline_Balance_Method |
| 18E | Presence of committees (executive/risk/audit/HR/corporate governance) (at least three) | (Y/N) | Committee |
| 19E | In the past year, did the board change/upgrade policies concerning product range/product distribution network/source of capital/client protection/internal control/regulatory compliance? (any two) | (Y/N) | Policy_Change_Upgread |
| | | | |

| | | | |
|---|---|---|---|
| 20E | Is the organisation member of PKSF, CDF, or any other external authority for guidance, monitoring, supervision, or accountability | (Y/N) | Member_External_Authority |
| 21E | Is there a yearly external audit carried out by MRA or any other authority? | (Y/N) | External_Audit |
| | | | |
| 22E | Does a yearly evaluation of board members occur? | (Y/N) | Board_Member_Evaluation |
| 23E | Is there training for board members? | (Y/N) | Board_Member_Training |
| | ***Secondary Data (sources explained in Section 7.8.3)*** | | |
| 24E | Registration status (Registered = 1) | | Registered_MFI |
| 25E | Recovery rate | | Recovery_Rate |
| 26E | Total net savings | | Total_Net_savings |
| 27E | Female CEO | (Y/N) | Female_CEO |
| | ***Outreach*** | | |
| | ***Secondary Data (sources explained in Section 7.8.3)*** | | |
| 28E | Year (age) of credit program as of 2014 | | CreditProgramAge |
| 29E | Registration status | (Y/N) | Registered_MFI |
| 30E | Number of branches | | No_Of_Branch |
| 31E | Average loan balance | | Avrg_Loan_Balance |
| 32E | No. of credit borrowers | | Credit_Borrower |
| | ***Financial Sustainability*** | | |
| | ***Secondary Data (sources explained in Section 7.8.3)*** | | |
| 33E | Operational self-sufficiency | | OSS |
| 34E | Return on assets | | ROA |
| 35E | Portfolio yield | | Portfolio_Yield |
| 36E | Interest rate spread | | Interest_Rate_Spread |
| 37E | Registration status | (Y/N) | Registered_MFI |
| 38E | Total outstanding loans | | Total_Outstanding_Loans |

## Table 7.4: Structured interview guide and variables for MFI clients

(Regulated and Unregulated MFIs)

| | Structured interview guide for MFI clients (2014–15) | | Variable name |
|---|---|---|---|
| | ***Organisation Profile*** | | |
| 1C | MFI code | | MFI_code |
| 2C | Registration status | | Registered |
| 3C | Year of credit program | | Year_Credit_Program |
| 4C | Licence year (if applicable) | | Licence_Year |
| | ***Personalised Information about Savings/Loans Basic*** | | |
| 5C | Do you know the interest rate (per month) on your loan and savings charged by and paid by your MFI? | (Y/N) | Knowledge interest rate |
| 6C | Do you maintain any loan or savings passbook given by your MFI? | (Y/N) | Maintain loan passbook |
| 7C | Do you have a copy of the promissory note for your records? | (Y/N) | Receive promissory note |
| 8C | If you require, can you get 'loan and savings information' from your branch office on any working day? | (Y/N) | Loan Info from branch |
| 9C | Do you have savings with your MFI? | (Y/N) | Knowledge about saving |
| 10C | Do you know what your service charge is? | (Y/N) | Knowledge service charge |
| 11C | Do you earn any interest on your savings? | (Y/N) | Knowledge savings interest |
| | ***General Information about Products and Loans*** | | |
| 12C | Do you know the types of loans and other facilities available from your MFI? | (Y/N) | Knowledge loan type |
| 13C | Do you know the terms and conditions of the loan? | (Y/N) | Knowledge terms of loans |
| 14C | Do you know about the fees, premium, and settlement of the claim of your insurance service? | (Y/N) | Knowledge insurance Services |
| | ***Knowledge about Access to Savings*** | | |
| 15C | Can you withdraw your savings (partially or fully) from your MFI (if your loan is cleared)? | (Y/N) | Knowledge withdrawing savings |
| 16C | Do you have any other voluntary savings in your MFI? | (Y/N) | Knowledge voluntary savings |

| | | | |
|---|---|---|---|
| | | | |
| | ***Control Variables*** | | |
| 17C | Registration status | (Y/N) | Registered |
| 18C | What is your highest education degree? | | Education |
| 19C | Do you have a business? | (Y/N) | Client_Business |
| 20C | What is your age? | | Client_Age |
| 21C | What is your marital status? | Yes = married No = single/ widow/ separated | Married |
| 22C | How many children do you have? | | Children |

## 7.7 Validity of the interview instrument

Aaker (2011) and Zikmud and Babin (2012) state that validity refers to the accuracy of a scale or measuring instrument for measuring what it aims to measure. To ensure an accurate reflection of the occurrence of a phenomenon or fact, the validity of a structured interview guide or survey instrument is crucial (Saunders et al., 2009). Among various methods for testing validity, this research uses two different methods: content validity and criterion validity.

### 7.7.1 Content validity

The terms 'face validity' and 'content validity' are used interchangeably in social science research (Brennan et al., 2007). Malhotra (2010) and Zikmund and Babin (2012) claim that for items or questions to represent the conceptual definition of the constructs, a structured interview guide or survey instrument requires content or face validity. Generally, content validity is established through the acceptance of measures by experts and scholars in the related field. Previous studies and literature can also support content validity (Malhotra, 2010; Zikmund and Babin, 2012).

Consistent with this approach, a thorough literature review was conducted before developing the interview guides. Measures obtained from previously validated scales were adapted to the context of regulatory aspects of microfinance in terms of MFIs' governance, and performance (outreach, and financial sustainability) and MFI clients' awareness and financial status.

Once developed, the two structured interview guides were reviewed and evaluated by several experts. These included a former UNDP team leader on microfinance, who is also a microfinance expert and practitioner in the Philippines, and a microfinance and MRA expert who works as a senior director in one of the world's largest financially sustainable MFIs, ASA, in Bangladesh. Copies of the interview guides were evaluated and commented upon by non-government organisation (NGO) executives and an MRA expert from Bangladesh. None of the evaluators was a partaker in this study. After receiving comments and recommendations (e.g., suggestions about the number of clients to interview per MFI, sensitive questions about client marital status) and making the suggested amendments (in the area of MFIs' governance, outreach, and financial sustainability, particularly MFI clients' awareness and financial literacy), both the structured interview guides were adopted and administered.

After the expert review and finalisation of the structured interview guides, these were translated into Bengali to ensure better understanding by both interviewer and interviewees. This ensured that quality data would be collected from respondents who had no or inadequate literacy training.

### 7.7.2 Criterion validity

Cooper and Schindler (2003) claim that criterion-related validity reflects the success of measures for prediction or estimation. Criterion validity measures whether a construct reflects as expected in relation to other variables identified as relevant to the phenomena (Hair et al., 2011).

Focus group discussion helps provide a better understanding of the population (Churdy et al., 2011; Kidwell and Turrisi, 2004; Schmidt, 2010). For testing criterion validity, the identified measures were substantiated through focus group discussions conducted with MFI executives and clients during pre-testing of the structured interview guide.

Four separate focus groups were organised utilising four different MFIs in Bangladesh, two regulated MFIs from urban areas and two unregulated MFIs from villages, each comprising one MFI executive and five MFI clients. The aim of these focus group discussions was to reveal insights into participants' beliefs about microfinance, their primary expectations, and their concerns in relation to microfinance practices. Generally, the measures and indicators, taken from relevant theories and the literature review relating to microfinance regulation, were determined as appropriate to the context. Then the interview guides were again sent for expert review (mentioned earlier) and updated accordingly. On the basis of acceptable content validity, pre-testing feedback of the questionnaire, and the expert review, it was considered appropriate to administer the instruments in the field.

## 7.8 Population and data sampling

Bangladesh was chosen as the country context for this research due to it being well known for pioneering microfinance and for hosting the largest microfinance industry in the world (CDF, 2006). It represents an ideal site to investigate regulation in the industry due to the passage of the Microcredit Regulatory Authority Act, 2006, which created a regulatory and supervisory body (MRA) for the microfinance industry in the country.

Having a licence from the MRA is mandatory for NGOs that want to practise microfinance in Bangladesh. However, a large number of MFIs remain unregulated and are practising microfinance without an MRA licence and hence without any monitoring or supervision from the government or any other authority in Bangladesh. Furthermore, these unregulated MFIs are not accountable to any authority and are not required to submit financial or other information to any authority or regulatory body. This research aims to examine the differences between these regulated and unregulated MFIs and associated outcomes in terms of governance, and performance (outreach, and financial sustainability) for the organisations themselves and in terms of the financial literacy and awareness and financial status for their clients.

As explained earlier, structured interview guides were developed to collect cross-sectional data from regulated and unregulated MFI executives and MFI clients. The following section explains the primary and secondary data-gathering techniques and the process undertaken to choose the participating MFIs in the study.

### 7.8.1 MFIs advocating microfinance

The main purpose of all quantitative sampling techniques is to draw a representative sample from the population (Marshall 1996) so that the results of studying the sample can be generalised for the population. For this study, stratified random sampling was used to select 86 MFIs from 706 registered (12 per cent) MFIs reported in the MRA database (MRA, 2018), which had operated for at least the last 10 years. Additionally, the Mix Market (2018) and CDF (2010, 2012 and 2014), databases and individual MFI websites were used to randomly select 63[25] unregistered MFIs from the 107 (59 per cent) listed as operating for a similar duration. The random sampling technique

[25] There were 107 unregistered MFIs that reported to CDF in 2012, but there are more than 500 unregistered MFIs working in Bangladesh without any formal recognition from the government, CDF, or the Institute of Microfinance (InM) (according to the CDF president). Ahmed (2013: 26) gives details of the number of MFIs that applied for registration. After its establishment in 2006, MRA received 4,241 applications for the licencing permit for microcredit operation. However, by August 2012, MRA had declined 3,380 applications, that is, 80 per cent of the total applications, as they failed to meet the regulatory requirements. Licences have been issued against 651 NGO-MFIs, while the remaining 5 per cent have been kept under the potential category (Ahmed, 2013).

involved numbering each MFI in existence between 2001 and 2015 within each of the regulated and unregulated categories and using Excel to generate random numbers to select MFIs. This 10-year timeline is important in order to examine the role of regulation in MFIs and their clients (Chowdhury, 2000). The researcher contacted the randomly selected MFIs by email and telephone with detailed information about the project. The contacts with MFI representatives continued until the predetermined number in each stratified sample agreed to participate.

### 7.8.2 Primary/cross-sectional data collection (MFI executives and clients)

Once cooperation from the 149 randomly selected registered (86) and unregistered (63) MFIs had been achieved, at the second stage, meetings were arranged with their CEOs/managing directors. Prior to these meetings, the structured interview guide (refer to Table 7.3) was forwarded for information. After signing formal consent forms (Appendices B and F), the MFI executives were interviewed for 25–30 minutes each and their responses recorded.

At the third stage, consistent with the university's ethics approval, the researcher sought approval from selected MFIs to visit branch offices during times of client meetings. These branch office names and locations are publicly available from MFI websites, MRA reports, and published MFI reports. A formal letter of approval that introduced the researcher to branch offices was sought from each participating MFI head office. On receipt of this letter, randomly selected (as described previously for MFI selection) branch managers were approached until three accepted a request that the researcher be introduced before a branch meeting to recruit clients for interviews. Hence, the MFI head office representative had no knowledge of which branch managers participated.

The task requested of MFI clients was to engage in a completely anonymous, 10–15-minute structured interview that requested demographic information and information about loans received, etc. Here it is important to note that, over 90 per cent of the MFI clients in Bangladesh are female (Hossain, 2015). So, the MFI clients selected and interviewed were only female clients. Participants were advised of the time commitment involved and also that participation in the interview was entirely voluntary and would not affect clients' dealings with the MFI in any way. When each branch group meeting finished, the researcher randomly approached MFI clients until five clients expressed a willingness to be interviewed. Hence, MFI branch managers had no influence over the participation of branch members other than to introduce the researcher.

Using this approach, the researcher visited 149 branch offices (86 registered and 63 unregistered MFIs) from all over Bangladesh for client interviews during a five-month period towards the end of 2014 and into 2015. A total of 342 clients were interviewed (200 from registered and 142 from unregistered MFIs) from 147 of the 149 (99 per cent) selected MFIs, although not all questions were answered by all clients. These highly structured interviews (refer to Table 7.4) solicited information such as how many loans had been granted, and demographic information. There were checkboxes for the interviewer to tick according to responses. The response sheets needed to be completed by the interviewer since many of the interviewees were expected not to be capable of completing them due to literacy issues. The response sheets were completely anonymous.

### 7.8.3 Secondary/longitudinal data (institutional data)

It is suggested that secondary data not only offer advantages in terms of cost and effort, as conventionally described in research methods books, but also that in certain cases their use may overcome some of the difficulties that particularly afflict business ethics researchers in the gathering of primary data' (Cowton, 1998, p. 423).

Availability of data for a longitudinal study and inaccessibility of primary data may be a good reason for the recent increase in empirical research in social science (Sorensen et al., 1996). However, according to Stewart (1984), the two types of data do not simply substitute for one another but can often function as complements, such as in this study, with each serving to make up for inadequacies of the other or providing confirmation or 'data triangulation' (Jick, 1979).

In social science research, the quality and reliability of the data source is a major concern for secondary data (Cowton, 1998; Stewart, 1984; Sorensen et al., 1996). The MIX Market[26] database is considered the most reliable publicly available financial data for individual MFIs around the globe (Gonzalez and Rosenberg, 2006; Hartarska and Nadolnyak, 2007). MIX Market provides a transparent information market to connect MFIs worldwide with investors and donors and promote better information flows and bigger investments (Alamgir, 2009).

Table 7.2 reports several recent studies (Ayayi and Peprah, 2018; Cull et al., 2011; Hartarska, 2007; Rahman and Mazlan, 2014; Quayes, 2012) in highly ranked journals that use data from the MIX Market database. Lafourcade et al. (2006) claim that the MIX Market data is collected mainly through contracted consultants and country-level networks. The database consists of financial and social information for MFIs around the globe, with 81 per cent of the sample audited externally and 28 per cent rated independently (Gonzalez and Rosenberg, 2006). According to Lafourcade et al. (2006), the MIX Market data is self-reported and reclassified on the basis of international accounting standards.

Additionally, for this current research, annual reports and financial portfolio data for sample MFIs were collected individually in the course of meetings with CEOs/managing directors during each head office visit, and the data documents contained were cross-checked with the MIX Market data where applicable (www.mixmarket.org), and Credit Development Forum (CDF) reports (2006–

[26] Information on MIX Market is available at www.themix.org. MIX Market, also known as the 'virtual market of microfinance', was established jointly by UNCTAD (United Nations Conference on Trade and Development) and the Government of Luxembourg (Bassem, 2009).

2014). Other sources include MRA reports from the MRA head office in Dhaka (for registered MFIs), the InM[27] database, and individual websites and different communication channels used by MFIs.

## 7.9 Research design

As discussed in Chapters five and six, this study investigates regulated and unregulated MFIs from two perspectives: organisational (governance, and performance- [outreach, and financial sustainability]) and client (client awareness and financial status). Eight hypotheses were developed in Chapter six (Section 6.5) to investigate MFIs and their clients. The following section explains the regression models used for testing and the variables in the models.

### 7.9.1 Organisational perspective

*Through the lens of governance and regulation theory*

In regard to governance and performance, *Agency theory* (in Chapter four) suggests that organisations with the 'right' board composition, including directors who can give diverse viewpoints, have improved board administration and organisation performance (Cherono, 2013). Relying on Agency theory and *Resource dependency theory*, the current study argues that an increase in MFIs' board diversity and appropriate board composition, sufficient transparency and disclosure, and accountability in internal and external governance practices can increase linkages to additional resources (Keasey et al., 1997). Additonally it can increase connections to organisations' external environment (Pfeffer, 1973), and improve organisations' external and internal governance and performance (Huse and Solberg, 2006).

[27] Institute of Microfinance (lnM) is an independent non-profit organisation. It was established to meet the research and training needs of national as well as of global microcredit programmes. It was initiated and promoted by Palli Karma-Sahayak Foundation (PKSF) on 1 November 2006. InM conducts surveys annually for the financial reports of MFIs in Bangladesh and is considered one of the main data sources for the financial portfolio of MFIs in Bangladesh.

In this regard, effective regulation and good governance play an important role (refer Chapter five) in an organisation's good governance and performance. *Responsive regulation theory* (refer Chapter four) suggests that engagement among the regulatory spaces by negotiation 'responsiveness' between the regulators, the regulated, and the wider community (Ayres and Braithwaite, 1992; Wright and Head, 2009) can help ensure good performance and governance compared with *unregulated* organisations without internal or external regulation or accountability to any external authority or regulatory body. Adapting this responsive regulation perspective in a microfinance context, the following section explains three regression models developed to examine differences, if any, between regulated and unregulated MFIs' Governance, and performance (outreach, and financial sustainability)

#### 7.9.1.1 Governance: Regression model (H1a)

A logistic regression model extended from Tchuigoua (2015) and Beisland et al. (2014) is used to test the relationship between MFIs' regulatory status and governance mechanisms. The dependent variable is the regulated or unregulated status of the MFI, and the independent variables are measures of governance that are factor analysed to reduce the number of variables to the themes on which they load. Included also are measures of size and the presence or absence of a female CEO, given the emerging importance of this variable in recent research (e.g., Gohar and Batool 2015). The year control variable (Yr_Indicators) is not used in the regression model because it is cross-sectional analysis (like Annim, 2012 and Tchuigoua, 2015), and governance measures are chosen from the structured interview guide for MFI executives.

$$\textit{Registered\_MFI}_{it} = \beta_0 + \beta_1 \textit{Governance performance}_{it} + \beta_2\, \textit{Recovery\_Rate}_{it} + \beta_3 \textit{Female\_CEO}_{it} + \beta_4 \textit{Total\_net\_savings (sqrt)}_{it} + \varepsilon_{it} \ldots\ldots \textit{(Model 1)}$$

Where for MFI *i* at time *t*:

| | | | |
|---|---|---|---|
| **Dependent variable** | | | |
| Registered_MFI | = | | Regulatory status of the MFI (regulated under the MRA Act 2006) (coded yes = 1, 0 otherwise) |
| **Independent variables** | | | |
| *Hypothesis variable* | | | |
| Governance performance | = | | Performance indicators (discussed below) |
| **Control variables** | | | |
| Recovery_Rate | = | + | Loan repayment rate by credit borrowers |
| Female_CEO | = | + | Female CEO (coded female = 1, 0 otherwise) |
| Total_net_savings (sqrt) | = | + | Square root of total net savings |

##### 7.9.1.1.1 Variables

**Dependent variable (Governance performance)**

***Registered_MFI*** (refer to Table 7.3 Question 29E)

MFIs can operate as regulated or unregulated (Jackson and Islam, 2005; McNew, 2009; Staschen, 1999). Chapter two and the prior studies discussed in Table 7.2 show that the regulatory status of MFIs is an important variable for MFI governance studies (Bakker et al., 2014; Bassem, 2009; Cull et al., 2011; Gohar and Batool, 2015; Hartarska and Nadolnyak, 2007; Hartarska and Mersland, 2012; Quayes and Khalily, 2014; Strøm et al., 2014). Adam and Mehran (2003) and Hartarska and Nadolnyak (2007) claim that the regulatory status can impact MFI performance because a sound regulatory environment can change organisations' internal governance mechanisms as well as their design.

Gohar and Batool (2015) and Bassem (2009) find that regulation is positively associated with MFI governance. Hartarska and Mersland (2012) find that MFIs regulated by an independent banking authority (external) have more efficient governance compared to unregulated MFIs. In terms of MFI performance, Bakker et al. (2014) and Cull et al. (2011) find that regulation has a negative impact on financial sustainability. Gohar and Batool (2015) and Bassem (2009) find that MFI outreach increases with better financial sustainability and external regulation. Hartarska and Nadolnyak (2007) find that the regulatory environment does not directly affect operational self-sufficiency or financial sustainability but may have an indirect effect on MFI governance.

Given that one aim of this study is to examine differences in governance between regulated and unregulated MFIs, *Registered_MFI*, the dependent variable, takes the value of one where the MFI is registered with the MRA (external regulatory body) and is otherwise zero.

**Hypothesis variable (Governance performance)**

To answer the first research question and to test the first hypothesis, Model 1 represents governance performance as a function of *board characteristics*, *external and internal governance*, and *transparency and disclosure by the organisation*. The approach used to achieve this objective follows that of previous studies on effective governance (Bassem, 2009; Beisland et al., 2014; Gohar and Batool, 2015; Hartarska and Mersland, 2012; Hartarska, 2005; Strøm et al., 2014; Tchuigoua, 2015).

Tchuigoua (2015) examined whether MFIs that implement good governance practices at the board level will be perceived by rating agencies as effective in their missions. Tchuigoua (2015) used individual governance mechanisms perceived as determinants by Planet Rating[28] in the attribution of its governance score. The Planet Rating score for good governance includes board size, activity, expertise, CEO–chairman duality, the number of board committees, and the presence of an audit committee.

[28] Planet Rating is considered one of the major rating agencies specialising in microfinance (Tchuigoua, 2015). Planet Rating uses the so-called GIRAFE (governance, information, risk management, activity, funding and liquidity, efficiency) assessment methodology and puts great emphasis on governance issues in MFIs. According to Tchuigoua (2015), Planet Rating is considered to be the only rating agency that assigns a rating score of governance at the end of the evaluation process. The choice of MFIs rated by Planet Rating is justified by the availability and accessibility of the governance score as per the website of Planet Rating (www.planetrating.com/FR/rating-girafe.html).

From prior studies, effective governance performance can be considered as a function of the following individual elements. Data for these items are gathered through the questionnaire (refer Table 7.3), with several questions addressing each item. For this reason, the response to these questions is factor analysed to create common themes.

***Board committee composition*** *(refer to Table 7.3, Questions 5E, 11E, 13E, 14E)*

It is difficult to recruit individual directors with all the qualities and skillsets required to create an effective microfinance board. Additionally, it is not practical for anyone to understand all the issues that an organisation might confront (Campion and Frankiewicz, 1999). Bruno and Claessens (2010) investigated internal governance mechanisms, particularly board composition (i.e., the presence of former CEOs on the board, the presence of independent members) and independent board committees. They found a positive impact of these factors on board performance. Diversified board composition is represented by an indicator variable taking the value one if the board consists of members with diversified knowledge, experience, skills, and education, and is otherwise zero.

***Board evaluation*** *(refer to Table 7.3, Questions 22E, 23E)*

'Governance is a leadership process, and to function effectively, individual board members and boards as a whole should have a clear understanding not only of their governance roles and responsibilities but also how to practically and correctly apply them within a leadership framework or context. Thus, regular governance training is essential for non-profit boards' (Better Boards, 2011, p. 1). The existence of yearly evaluation of board members' leadership quality, the performance of board members, and training of members are considered a best practice for increasing the effectiveness of board performance. It is also recognised that board member training increases the efficiency and productivity of the board (Inglis and Cleave, 2006). In the CGAP report (CGAP, 1997), board evaluation and training requirements for board members are considered crucial for effective MFI board performance (Jacobs, Mbeba, and Bill, 2007). Board evaluation is represented by an indicator variable taking the value one if there exists a yearly evaluation of board members and is otherwise zero.

***Board meeting frequency and attendance*** *(refer to Table 7.3, Question 6E)*

Tchuigoua (2015) asserts that frequent board meetings and attendance by board members reinforce control over managerial direction. De Andres and Vallelado (2008) support this view and claim that board members' attendance and regular board meetings have a positive impact on board performance since board members become active stakeholders in the strategic planning process. De Andres and Vallelado (2008), Mersland and Strøm (2008) and Vafeas (1999) find a positive relationship between attendance at board meetings and the number of board meetings, on one hand, and effective bank performance, on the other.

*CEO/chair duality (refer to Table 7.3 Question 12E)*

Adams et al. (2010) and Galema et al. (2012a) claim that combining the role of the CEO and the chairman implies a weak governance structure because the board is less independent than if the roles are separate. Gohar and Batool (2015) found that CEO/chair duality decreases the return on assets (ROA) and productivity. Hermalin and Weisbach (1991) claim that CEO/chair duality can impact negatively on MFI governance as the CEO may pressure/change policies for his or her own interest. Many studies (Beisland et al., 2014; Gohar and Batool, 2015; Hartarska and Mersland, 2012; Mersland, 2011; Mersland and Strøm, 2009; Tchuigoua, 2015) include a CEO/chair duality indicator variable. CEO/chair duality is represented by an indicator variable taking the value one if there exists CEO/chair duality and is otherwise zero.

***Credit risk management through loan classification and declining balance method*** *(refer to Table 7.3, Question 17E)*

Another important component of internal governance is loan classification and the use of the declining balance method[29] (Cao et al., 2012; Schreiner, 2000). Credit risk assessment has become a key issue for financial institutions (Cao et al., 2012). Tchuigoua (2015), as discussed earlier, used Planet Rating governance measures, which include the existence of board committees, loan classification, and policy changes as key items for measuring the effectiveness of internal governance. Many prior studies have considered credit risk management, particularly loan classification, as an important component for the good governance of MFIs (Cao et al., 2012; Ibtissem and Bouri, 2013; Schreiner, 2004; Schreiner, 2000). Loan classification and the declining balance method are represented by two indicator variables, taking the value one if there is an existence of loan classification and the declining balance method respectively, and is otherwise zero.

***External governance*** *(refer to Table 7.3, Questions 20E–21E)*

Regulation is a key component of external governance (Dubreuil and Mirada, 2015). The performance of an audit by an MRA selected accounting firm, or any other appropriate firm, is one of the key characteristics of the MRA's regulatory approach. The external audit is represented by an indicator variable taking the value one if an external audit is conducted and is otherwise zero.

***Internal Governance*** *(refer to Table 7.3, Questions 8E, 15E, 16E, 18E, 19E)*

In their studies, Beisland et al. (2014), Mersland and Strøm (2009), Tchuigoua (2015), and Bassem (2009) used the presence of an internal audit function as an important variable in measuring MFI

[29] The declining balance method is used for calculating the interest rate based on the outstanding loan balance, the balance of money that remains in the MFIs' clients' borrower's hand as the loan is repaid during the loan term. As the borrower repays the weekly instalments, the remaining loan balance declines over time. Then the interest of the loan is charged only on the loan amount that the borrower still holds (Ledgerwood et al., 2013).

governance performance. Mersland and Strøm (2009) found a positive relationship between internal audit and MFIs' financial and board performance. Their study shows that financial and board performance improves when an internal auditor informs the board. Steinwand (2000) supports this view and claims that an internal auditor helps the board with independent, objective assessments of MFI operations. Internal audit is represented by an indicator variable taking the value one if the function exists and is otherwise zero.

***Transparency*** *(refer to Table 7.3, Questions 9E–10E)*

Transparency is widely recognised as a core principle of effective governance (Parigi et al., 2004). Fung (2014) claims that a key element for effective governance is transparency and disclosure of information in a timely and accurate way to stakeholders. This practice incorporates a system of checks and balances among the board of directors, management, auditors, and other stakeholders. Information disclosure is represented by an indicator variable taking the value one if the information is disclosed regarding loan balance, interest rate, and other necessary information about the MFI to stakeholders, and is otherwise zero.

***Voting rights*** *(refer to Table 7.3, Question 7E)*

Pistelli et al. (2012) state that the voting rights of board members and the founder of the MFI reflect the democratic characteristics of an organisation. Information about voting rights helps stakeholders assess the extent of power concentration at the board level. Gompers et al. (2003) observed that more democratic firms enjoy higher valuation, higher profits, higher sales growth, and lower capital expenditure. The current study includes board administration representing voting rights as an element of MFI governance performance. Voting rights are represented by an indicator variable taking the value one if board members have voting rights and are otherwise zero.

**Control variables (Governance performance)**

The literature review in Chapter six (Section 6.2) and the prior studies discussed in Table 7.2 show that other variables impact MFIs' governance performance and so it is important to include these as control variables.

***Recovery_Rate*** (*refer to Table 7.3, Question 25E*)

The recovery rate or repayment rate of an MFI is a crucial indicator for measuring the governance performance of MFIs (Godquin, 2004; D'espallier et al., 2011; Khandkker et al., 1995). Recovery rate is calculated as the ratio of the actual principal amount collected and the principal amount that has fallen due.

Khandkker et al. (1995) found that the strategy used by the MFI governing body plays a significant role in the recovery rate of that MFI. Khandkker et al. (1995), Sharma and Zeller (1997), Zeller (1998), Besley and Coates (1995), and Ghatak (1999) also point to some good governance characteristics, such as membership training, transparency and accountability to clients, and risk management, which have a positive influence on the recovery/repayment rate of MFIs. Therefore, this study uses the *recovery rate* as a control variable in examining the governance performance of MFIs.

***Female_CEO*** (*refer to Table 7.3, Question 27E*)

Female leadership is considered a potential key variable in microfinance governance studies (Strøm et al., 2014). Previous studies show that a large proportion of CEOs in MFIs are female (Bassem, 2009; Mersland, 2011). Microfinance is to a large extent a women's business (Strøm et al., 2014) because female borrowers are the main target market and lending to women plays a key role in the success of MFIs (Armendariz and Morduch, 2010). Strøm et al. (2014) investigated 329 MFIs in 73 countries and found that about 27 per cent of CEOs are females. Further, the presence of a female CEO is positively associated with MFI performance (Bassem, 2009; Mori et al., 2015; Strøm et al., 2014) in terms of outreach (Bassem, 2009; Gohar and Batool, 2015; Mori et al., 2015). Many researchers include female CEO as an important variable for measuring MFIs' governance/ performance (Bassem, 2009; Gohar and Batool, 2015; Mori et al., 2015; Strøm et al., 2014). Female CEOs are represented by an indicator variable taking the value one if the CEO of an MFI is a woman and is otherwise zero.

***Total_net_savings (sqrt)*** *(refer to Table 7.3, Question 26E)*

The variable *Total_net_savings (sqrt)* implicitly contains information on the use of savings deposits as a source of capital, which reflects MFIs' governance performance and their financial sustainability (Ahmed, 2013; Cull et al., 2011; Hartarska and Nadolnyak, 2007; Islam et al., 2013). This study uses the square root value of the total net savings due to the high volume of disruption between the maximum and minimum number.

Hartarska and Nadolnyak (2007) found that MFIs with a higher proportion of savings tend to ignore poorer borrowers by serving richer borrowers, which represents inefficient performance in an MFI context. However, the study also reveals that MFIs collecting savings have better outreach, which indicates better performance. Richardson (2003) claims that higher savings indicate better governance because MFIs receiving higher savings from their richer clients make possible the provision of saving facilities to poorer borrowers. Fiebig et al. (1999) found that better savings may lead to improved governance efficiency and profitability for sustainability and expansion. Other prior research also claims that savings have a positive impact on governance (Campion and White, 1999; Schreiner, 2000; Hulme and Mosley, 1996; Kurgat, 2009). Savings mobilisation provides relatively less costly information during the loan appraisal process. Therefore, the log of total net savings is used as a control variable to examine the governance performance of MFIs.

### 7.9.1.2 Outreach: Regression models (H1b), (H2a)

The robust regression model, adapted from Crabb and Keller (2006), Hartarska (2005), Pati (2015), and Tchuigoua (2012), tests the relationship between MFIs' outreach and governance performance where three (separate) dependent variables ***LN_No_Of_Branch*** (*Number of branches-log*), ***LN_Avrg_Loan_Balance*** (*Average loan balance-log*), and ***LN_Credit_Borrower*** (*Number of credit borrower-log*) are used to test the relationship. Models 2–4 have been created as follows:

$$\boldsymbol{LN\_No\_Of\_Branch_{it}, (LN\_Avrg\_Loan\_Balance_{it}, LN\_Credit\_Borrower_{it}) = \beta_0 + \beta_1 Registered\_MFI_{it} + \beta_2 CreditProgramAge_{it} + \beta_3 Recovery\_Rate_{it} + \beta_4 Total\_net\_savings\ (sqrt)_{it} + \beta_5 Female\_CEO_{it} + \beta_6 Yr2010_{it} + \beta_7 Yr2012_{it} + \varepsilon_{it} \ldots\ldots (Models\ 2\text{-}4)}$$

Where for MFI *i* at time *t*:

| | | | |
|---|---|---|---|
| **Dependent variable (separately)** | | | |
| LN_No_Of_Branch | = | | The natural logarithm of the number of branches for the MFI |
| LN_Avrg_Loan_Balance | = | | The natural logarithm of the average loan balance of the MFI |
| LN_Credit_Borrower | = | | The natural logarithm of the number of credit borrowers of the MFI |
| **Hypothesis variable** | | | |
| Registered_MFI | = | + | Regulatory status of the MFI (regulated under the MRA Act 2006) (coded yes = 1, 0 otherwise) |
| **Control Variables** | | | |
| Recovery_Rate | = | + | Loan repayment rate by MFI credit borrowers |
| Total_net_savings (sqrt) | = | + | The square root of total net savings of the MFI |
| Female_CEO | = | + | Female CEO of the MFI (coded female = 1, 0 otherwise) |
| CreditProgramAge | = | + | Age of the credit program as of 2012 |
| Yr_Indicators | = | + | Dummy taking value 1 for each year (2010, 2012, 2014), 0 otherwise |

#### 7.9.1.2.1 Variables

**Dependent variables (separately): Outreach**

To understand the relationship between outreach and MFIs' regulatory status, it is important to identify the key components of MFIs that contribute to outreach.

***(LN_No_Of_Branch, LN_Avrg_Loan_Balance, LN_Credit_Borrower)*** (*refer to Table 7.3, Questions 30E–32E*)

The microfinance governance and performance literature employs MFI size, average loan balance, and number of credit borrowers as dependent variables that proxy for outreach (Bakker et al., 2014; Barry and Tacneng, 2014; Gohar and Batool, 2015; Hartarska and Nadolnyak, 2007; Mersland and Strøm, 2008; Strøm et al., 2014), and these variables have been noted as important in the relationship between outreach and MFI governance. Prior researchers (Gohar and Batool, 2015; Mersland and Strøm, 2008; Strøm et al., 2014) have used different proxies as a dependent variable to examine outreach, such as average loan balance, total assets, annual sales, fixed assets, credit borrowers, paid-up capital, shareholder equity, market value of the firm, and the number of branches, to examine the relationship with MFIs' performance.

Consistent with prior studies, the natural logarithm of the number of branches (Gohar and Batool, 2015; Mersland and Strøm, 2008; Servin et al., 2012), the average loan balance (Gohar and Batool, 2015; Mersland and Strøm, 2008), and the number of credit borrowers (Barry and Tacneng, 2014; Gohar and Batool, 2015; Hartarska and Mersland, 2012; Hartarska and Nadolnyak, 2007; Mersland and Strøm, 2008, 2009; Tchuigoua, 2015) are considered as measures of MFI outreach and used separately as dependent variables when examining the relationship between MFIs' outreach and regulatory status. This study uses the natural logarithm of *No_Of_Branch, Avrg_Loan_Balance, Credit_Borrower* due to the non-normality of the data.

**Hypothesis variable: Outreach**

***Registered_MFI*** (*refer to Table 7.3, Question 29E*)

As discussed in Chapter six, it is expected that regulation will have an impact on MFIs' governance practices, which will influence both MFI outreach and financial sustainability. External regulation (*Registered_MFI*) is as defined previously.

**Control variables: Outreach**

Apart from the regulatory status of MFIs, there are a number of variables that may affect outreach, and these are discussed next.

***Recovery_Rate, Total_net_savings (sqrt), Female_CEO*** (*refer to Table 7.3, Questions 25E–27E*)

Loan *recovery rate,* the square root of *total net savings*, and the presence of a *female CEO* are considered as important control variables in prior studies, as explained previously. These variables are measured as discussed earlier.

***CreditProgramAge*** (*refer to Table 7.3, Question 28E*)

In prior studies (Bakker et al., 2014; Barry and Tacneng, 2014; Bassem, 2009; Beisland et al., 2014; Gohar and Batool, 2015; Hartarska and Nadolnyak, 2007; Mersland and Strøm, 2009; Tchuigoua, 2015), MFI age is considered an important variable in analysing the relationship between MFI governance and outreach. Prior studies show that older MFIs may perform better because of their institutional experience and knowledge compared to newly established MFIs. An alternative hypothesis, however, is that older MFIs have had to learn by trial and error, whereas comparatively new MFIs may profit from knowledge built in the past years, and hence they may be better performers compared to their counterparts. This current study uses *CreditProgramAge* as a control variable for age, measured as the number of years that the MFI has been operating a credit program. As the secondary data used for the analysis has been collected for 2008, 2010, and 2012 (subject to the availability of complete sets of data of the

MFIs selected for the analysis), the commencement year of the credit program is subtracted from 2012 to calculate age.

***Year indicators (2008, 2010, 2012)***

As discussed in Chapter three (Section 3.4.3), regulation in Bangladesh took place under the MRA Act in 2006. Archival data at two-year intervals after the passage of that act, comprising data collected for 2008, 2010, and 2012, was chosen (subject to the availability of complete sets of data of the MFIs selected for the analysis) to investigate the role of regulation for registered and unregistered MFIs. Assessing the impact of regulation by comparing the same MFIs before and after the regulation is not within the scope of this current study, rather regulated and unregulated MFIs are compared to determine differences in their performance post-regulation.

#### 7.9.1.3 Financial sustainability: Regression models (H1c), (H2b)

Financial performance is examined mostly through efficiency ratios, sustainability ratios, quality of portfolio, and profitability (Hartarska and Nadolnyak, 2007; Mersland and Strøm 2009; Quayes, 2012; Pati 2015). A robust regression model (adapted from Bakker et al., 2014; Beisland et al., 2015; Cull et al., 2007; Gohar and Batool, 2015; Hartarska and Nadolnyak, 2007; Pati, 2012) is used to test the relationship between MFIs' financial sustainability and regulatory status. Four separate dependent variables are used to measure financial sustainability: *return on assets (ROA)*, *operational self-sufficiency (OSS)*, *portfolio yield (Portfolio_Yield)*, and *interest rate spread (IntrstRtSpread)*. The following section explains the variables and their measures used in Models 5–8 to estimate the financial sustainability of MFIs.

$$ROA_{it}, (OSS_{it}, Portfolio\_Yield_{it}, Interest\_Rate\_Spread_{it}) = \beta_0 + \beta_1 Registered\_MFI_{it} + \beta_2 Female\_CEO_{it} + \beta_3 Recovery\_Rate_{it} + \beta_4 CreditProgramAge_{it} + \beta_5 Sqrt\_Total\_Outstanding\_Loans_{it} + \beta_6 Yr2010_{it} + \beta_7 Yr2012_{it} + \varepsilon_{it} \ldots \text{(Models 5-8)}$$

Where for MFI *i* at time *t*:

| | | | |
|---|---|---|---|
| **Dependent variable (separately)** | | | |
| ROA | = | | Return on assets = After tax profits/Starting (or period average) assets |
| OSS | = | | Operational self-sufficiency = Operating revenue/(Financial expense + Loan loss provision expense + Operating expense) |
| Portfolio_Yield | = | | Portfolio yield = Cash financial revenue from loan portfolio/Average gross loan |
| Interest_Rate_Spread | = | | Interest rate spread = Portfolio yield – Financial cost ratio |
| **Hypothesis variable** | | | |
| Registered_MFI | = | + | Regulatory status of the MFI (regulated under the MRA Act 2006) (coded yes = 1, 0 otherwise) |
| **Control variables)** | | | |
| Female_CEO | = | + | Female CEO of MFI (coded female = 1, 0 otherwise). |
| Recovery_Rate | = | + | Loan repayment rate by credit borrowers. |
| CreditProgramAge | = | + | Age of the credit program |
| Sqrt_Total_Outstanding_Loans | = | + | Square root of total outstanding loans |
| Year Indicators | = | + | Dummy taking value 1 for years (2008, 2010, 2012), 0 otherwise |

#### 7.9.1.3.1 Variables

**Dependent variables (separately): Financial sustainability**

***ROA*** (*refer to Table 7.3, Question 34E*)

ROA measures the capability or efficiency of the MFI to use its total assets to generate returns or earnings (Bakker et al., 2014). It is calculated by comparing *after-tax profit* with *starting (or period average) assets* (Hartarska and Nadolnyak, 2007; Mersland and Strøm, 2009; Servin et al., 2012). Several researchers use ROA for measuring the financial sustainability of MFIs when analysing the relationship with other variables (Bakker et al., 2014; Barry and Tacneng, 2014; Hartarska, 2005; Hartarska and Nadolnyak, 2007; Mersland and Strøm, 2009; Servin et al., 2012).

***OSS*** (*refer to Table 7.3, Question 33E*)

OSS explains how well an MFI can cover its costs through operational revenues. According to Bassem (2009) and Mersland and Strøm (2009), OSS is the most frequently observed performance measure for quantifying MFIs' financial sustainability. To cover operational costs such as employees' wages, loan losses, and other establishment and administrative costs, MFIs need a sufficient operating income. OSS is calculated by comparing operating revenue with financial expense, loan loss provision expense, and operating expense (Bassem, 2009; Mersland and Strøm, 2009; Hartarska and Nadolnyak, 2007). Several prior studies (Bakker et al., 2014; Barry and Tacneng, 2014; Gohar and Batool, 2015; Hartarska and Nadolnyak, 2007; Mersland and Strøm, 2009; Pati, 2015; Tchuigoua, 2015) use OSS for measuring the financial sustainability of MFIs.

***Portfolio_Yield*** (*refer to Table 7.,3 Question 35E*)

The yield on gross loan portfolio (*Portfolio_Yield*), also known as portfolio yield, measures the loan portfolio ability by indicating the amount of interest and other payments from clients received by an MFI during a certain period of time (Microfinance Systems, 2015). Portfolio yield is commonly used in microfinance studies, where the actual cost of loans is often much higher than the nominal interest charged (Gutierrez-Nieto et al., 2007). Yield on gross loan portfolio is considered a reliable measure of true costs because it not only considers all fees, discounts, and special charges but also understates the true cost to the extent that loans are in arrears (Microfinance Systems, 2015). Portfolio yield is calculated by comparing the cash revenue from loan profit with the average gross loan. Portfolio yield is widely used by researchers (Dubreuil and Mirada, 2015; Gohar and Batool, 2015; Mersland and Strøm, 2008, 2009; Piot-Lepetit and Nzongang, 2014; Rahman and Mazlan, 2014) for measuring financial sustainability.

***Interest_Rate_Spread*** (*refer to Table 7.3, Question 36E*)

MFIs' financial sustainability and development are constrained by high-interest rate spreads (Aboagye et al., 2008). Many factors that explain the interest rate spread have been discussed and used in the literature (Addo, 2013; Aboagye et al., 2008; Groppet al., 2007; Maudos and Fernandez, 2004; Mensah, 2005), for example, composition of deposits, loan portfolios, ownership structure, MFI size, operational cost, provisioning for bad loans, and profit margin. For this study, the interest rate spread is calculated by subtracting the financial expense ratio from the portfolio yield.

**Hypothesis variable: Financial sustainability**

***Registered_****MFI* (*refer to Table 7.3, Question 37E*): The regulatory status of the MFI (as discussed previously).

**Control variables: Financial sustainability**

Apart from the regulatory status of MFIs, there are a number of variables that may also affect the financial sustainability of MFIs, and these are justified and explained next.

***Sqrt_Total_Outstanding_Loans*** *(refer to Table 7.3, Question 38E)*

In previous studies (Mersland and Strøm, 2009; Okumu, 2007; Schreiner, 2002; Tchuigoua, 2015), *total outstanding loans* have been used for measuring the outreach and sustainability of MFIs. Although the total outstanding loan portfolio reflects the outreach of an MFI (Okumu, 2007), it is important to note that an increase in the total loan portfolio could also create a negative impact on the operational revenue and affect the sustainability of the firm since less revenue is generated if loans are disbursed and left uncollected due to poor governance. Thus, an increased total loan portfolio could be negatively linked with sustainability but positively linked with outreach (Okumu, 2007).

Other control variables including ***Female_CEO, Recovery_Rate, CreditProgramAge****,* and ***Year Indicators (2008, 2010, 2012)*** *(refer to Table 7.3, Questions 25E, 27E, 28E)* are measured as discussed previously.

### 7.9.2 Client perspective

*Through the lens of governance and regulation theory*

As discussed in Chapter four (Section 4.4.5), proponents of the stakeholder theory argue that maximising only shareholder interest cannot be the core objective of a firm because rights of different stakeholder groups need to be considered for the success of the MFI (Blair, 1995). Also, researchers (e.g., Deegan, 2006; Mason et al., 2007) using the legitimacy theory propose that firms are bound by the social contracts that they have with the societies in which they operate. As such, it can be said that the continued existence of an organisation depends on society's approval of its existence (Deegan, 2006).

The core focus of the stakeholder theory is the relationship between an organisation and its stakeholders. For the current study, clients are a key stakeholder group of MFIs. Proponents of the stakeholder theory argue that the success of an organisation depends on addressing stakeholders' needs and attending to stakeholders' social purposes (Letza et al., 2004). This study argues that the stakeholder theory is applicable not only because of the importance of the relationship between MFIs and their clients but also due to MFIs' responsibility to their stakeholders (clients).

The role of regulation of MFIs in engaging their client stakeholders, addressing their concerns and voice, and protecting their rights in governance practices is explicable from a *responsive regulation* perspective. As highlighted in Chapter four (Section 4.3), responsive regulation can engage regulatory spaces by negotiation 'responsiveness' between the regulators, the regulated, and the wider community. In terms of microfinance regulation, responsive regulation can bring a fruitful result for motivating and informing MFIs' processes and staff through the engagement of clients as key stakeholders in their governance practices.

It is argued here that MFIs that operate under responsive regulation by an external regulatory body can ensure good performance and good governance in terms of accountability to their client stakeholders by effective information disclosure. Hence, clients of regulated MFIs are expected to be more aware of their rights, loan details, savings, and knowledge about their MFIs (hereafter awareness). They are also expected to be more in control of their financial status than clients of unregulated MFIs*,* which neither have any type of internal or external regulation or accountability to their client stakeholders, nor to any external authority or regulatory body. From a client perspective, the following section develops two regression models to examine the difference between regulated and unregulated MFI clients' awareness and their financial status.

### 7.9.2.1 Client awareness: Regression model (H3a)

$$\textbf{\textit{Client Awareness}}_{it} = \beta_0 + \beta_1 \textbf{\textit{Regulated}}_{it} + \beta_2 \textbf{\textit{Client\_Business\_C21}}_{it} + \beta_3 \textbf{\textit{Education\_C7}}_{it} + \varepsilon_{it} \ldots\ldots \textbf{\textit{(Model 9)}}$$

Where for MFI *i* at time *t*:

| | | | |
|---|---|---|---|
| Client Awareness | = | + | Awareness indicators (discussed below) |
| Registered | = | | Regulatory status of the microfinance institution (regulated under the MRA Act 2006) (coded yes = 1, 0 otherwise). |
| Client_Business_C21 | = | + | Self-declared client microenterprise exists (coded yes = 1, otherwise 0) |
| Education_C7 | = | + | Client has some schooling (coded yes = 1, otherwise 0) |

#### 7.9.2.1.1 Variables

**Dependent variable**

**Client Awareness:** Awareness variables are represented by clients' awareness indicators, e.g., knowledge about their personal loan basics, gathered through the administration of a structured questionnaire (*refer to Table 7.4, Questions 5C, 9C, 10C, 11C)*. This model is applied on a cross-sectional basis (questions posed to MFI clients). The questions include knowledge about the interest rate, service charge, and interest on savings. Awareness about clients' financial institutions includes knowledge relating to their loans and savings (*refer to Table 7.4, Questions 6C, 7C, 8C),* e.g., whether their financial institutions provide a passbook, a copy of promissory notes, etc. Clients' understanding about different products offered by their financial institutions (*refer to Table 7.4, Questions 12C, 13C, 14C*), their rights, and knowledge about accessing information and withdrawing their savings (*Questions 15C, 16C*) were also gathered. This information is a factor analysed to derive a reduced number of factors for analysis in the regression model.

**Hypothesis Variable**

***Registered_MFI:*** Registration status of the microfinance institution to which the member (client) belongs. The regulatory status of the MFI has been discussed previously.

**Control Variables**

***Education_C7*** (*refer to Table 7.4, Question 18C*)

Education and training have positive impacts on clients' financial knowledge and awareness (Kalra et al., 2015; Tiwari et al., 2008). In their studies, Kalra et al. (2015) and Mazumder and Lu (2015) used financial literacy for measuring the awareness of MFI clients. Findings from both studies show that the financial literacy of MFI clients is positively associated with their awareness and financial sustainability.

***Client_Business_C21 (****refer to Table 7.4, Question 19C)*

Client-owned microenterprises help clients gather knowledge about business and increase their financial awareness (Horan, 2011; Mazumder and Lu, 2015; Sebstad and Cohen, 2000; Tiwari et al., 2008).

Since clients' awareness is expected to be positively associated with their level of education and the presence of a client-owned microenterprise, responses to relevant questions (mentioned earlier) about these characteristics are included as control variables.

#### 7.9.2.2 Client financial status: Regression model (H3b), (H3c)

$$\textit{Client Financial Status}_{it} = \beta_0 + \beta_1(\textit{Client Awareness}_{it}) + \beta_2 \textit{Regulated}_{it} + \beta_3 \textit{Client\_Age\_C3}_{it} + \beta_4 \textit{Married\_C4}_{it} + \beta_5 \textit{Children\_C6}_{it} + \beta_6 \textit{Client\_Business\_C21}_{it} + \beta_7 \textit{Education\_C7}_{it} + \varepsilon_{it} \quad \textit{(Model 10)}$$

Where for MFI *i* at time *t*:

| | | | |
|---|---|---|---|
| Financial Status | = | + | The natural logarithm of self-declared client annual income (Taka) |
| Client Awareness | = | + | Awareness indicators |
| Registered | = | | Regulatory status of the microfinance institution (regulated under the MRA Act 2006) (coded yes = 1, 0 otherwise) |
| Client_Age_C3 | = | | Self-declared client age in years |
| Married_C4 | = | | Client marital status (married = 1, 0 otherwise [widow, separated, single]) |
| Children_C6 | = | | Self-declared number of client's children |
| Client_Business_C21 | = | + | Self-declared client microenterprise exists (coded yes = 1, otherwise 0) |
| Education_C7 | = | + | Client has some schooling (coded yes = 1, otherwise 0) |

##### 7.9.2.2.1 Variables

**Dependent variable**

MFI client's *financial status* represents a self-declared annual income in Bangladesh's currency (Taka). Many prior studies (Khan, 2014; Mazumder and Lu, 2015) used the annual household income for measuring clients' financial status. This study uses the natural logarithm value of financial status due to the high volume of disruption between the maximum and minimum number.

**Hypothesis variables**

***Client Awareness*** (*refer to Table 7.4, Questions 5–16C*): Clients' awareness variables have been discussed previously.

***Registered_MFI:*** The regulatory status of the MFI (as discussed previously).

**Control variables**

Along with the dependent and hypothesis variables, other client characteristics (*Client_Age_C3, Married_C4, Children_C6, Client_Business_C21, Education_C7*) are also used as control variables to examine the financial intermediation of regulated and unregulated MFIs.

***Married_C4*** (*refer to Table 7.4, Question 21_C*): Client's financial status is expected to be positively associated with being *married* (here, married is considered as a client living with her husband = 1, otherwise 0 if the client is a widow, unmarried, or separated) rather than being single. Several prior studies (Khan, 2014); Mazumder and Lu, 2015) control for marital status and the number of family members in measuring a client's financial status.

***Client_Business_C21*** (*refer to Table 7.4, Question 19C*): The presence of a client-owned *microenterprise* is another control variable used for determining the financial status of clients. Clients with microenterprises indicate that their families are likely to be more financially solvent compared to those serving as housewives and unable to contribute financially to the family. The existence of a client-owned microenterprise has been commonly used in explaining clients' financial status in prior studies (Gomez and Santor, 2001; Khan, 2014).

***Education_C7*** (*refer to Table 7.4, Question 18C*): Clients' level of *education* is another control variable used for determining the financial status of the client. Clients with greater education and financial literacy are likely to be more capable of doing business or adding value to the family income compared to clients who do not have any education. Several studies (Ghosh et al., 2014; Kalra et al., 2015; Mazumder and Lu, 2015) control for clients' education when estimating client financial status.

***Children_C6*** (*refer to Table 7.4, Question 22_C*): The number of *children* is another important variable in explaining a client's financial status. However, it is not clear in which direction this variable is likely to affect the dependent variable. While on the one hand, more rather than fewer children may strain a family's financial status, on the other hand, children often work and contribute to the family income. Client responses to questions about these important demographic characteristics are included as control variables in the model.

### 7.10 Chapter summary

Table 7.2 reports that different analysis techniques have been used in the prior studies to analyse the relationship between Governance, and performance (outreach, and financial sustainability) of MFIs. It is important to note that none of the prior studies examines the relationship between all three accepted components of MFIs' performance (governance, outreach, and financial sustainability) and the clients' perspective simultaneously, taking into account the regulatory status of the organisation. To address this research gap (also discussed in Chapter one, Section 1.4), 10 regression models have been developed in this chapter to investigate the relationship between Governance, and performance (outreach, and financial sustainability) of MFIs and their clients' awareness and financial status in terms of MFIs' regulatory status. The next chapter focuses on results arising from the application of the models presented in this chapter.

# CHAPTER EIGHT

# Analysis and Discussion of Results

## 8.1 Introduction

This chapter reports the findings from testing the hypotheses regarding the difference between regulated and unregulated MFIs in terms of their Governance, and performance (outreach, and financial sustainability) and their clients' financial awareness and financial status The analyses and results are presented in two sections: Organisation Perspective (Section 8.2.1), and Client Perspective (Section 8.2.2).

The section on the Organisation Perspective reports results from testing six hypotheses using eight regression models developed in Chapters six and seven respectively for 149 registered (86 or 58 per cent) and unregistered (63 or 42 per cent) MFIs in Bangladesh.

The section on the Client Perspective reports results from testing three hypotheses using two regression models again developed in Chapters six and seven respectively for 342 clients of the same sample 149 registered and unregistered MFIs in terms of their financial awareness, knowledge, and financial status. A discussion of the results is provided and a conclusion is presented in the chapter summary section (Section 8.3).

Figure 8.1: depicts the structure of this chapter

**8.1 Introduction**

**8.2 Analysis and results**

**8.2.1 Organisation perspective**

**8.2.2 Client perspective**

**8.3 Chapter summary**

## 8.2 Analysis and results

As discussed earlier (Section 6.4), this study investigates regulated and unregulated MFIs in Bangladesh from two perspectives: organisational and client level. Two sets of data (primary and secondary) are used to examine MFIs and their clients. In order to collect the cross-sectional data (primary data) from the stratified randomly selected 149 MFIs (86 registered and 63 unregistered) and their clients, face-to-face interviews were conducted with MFI executives and clients. Some open-ended supplementary questions were posed to MFI executives.

Most of these open-ended questions were exploratory in nature and elicited interviewees' perceptions of challenges in complying with the microfinance regulatory regime in Bangladesh and the implications of these challenges for the achievement of both MFI and regulatory objectives. Responses to the open-ended questions were expected to provide rich information to explain and supplement the findings from estimating the regressions. As the interviews were conducted by appointment with MFI executives and clients, the interview response rate was 100 per cent. Saunders et al. (2009) suggest that a response rate of 50 per cent or above is acceptable for face-to-face interviews.

Statistical tools—SPSS version 24 and Stata 14—were used to analyse data. After collecting and entering the two sets of data into SPSS, the data were screened for errors to ensure appropriateness for multivariate analysis. The following section presents analyses and results from estimation of regression models from both organisation and client perspectives.

### 8.2.1 <u>Organisation Perspective</u>

Performance of MFIs is examined using eight regression models in the areas of MFIs' discretionary governance practices (*H1a*), outreach (*H1b* and *H2a*), and financial sustainability (*H1c* and *H2b*), underpinned by application of *responsive regulation theory* and *stakeholder theory* (Sections 4.3.3 and 4.4.5) in a microfinance context.

#### 8.2.1.1 Governance practices

The following section examines the testing of Hypothesis *H1a* (the relationship between MFI status [Registered/Unregistered] and MFIs' discretionary governance practices). As discussed in Section 6.5, Hypothesis H1a is as follows:

> ***H1a:*** *Regulated MFIs exhibit superior non-mandatory governance practices compared with those of Unregulated MFIs.*

Model 1 (Section 7.9.1.1) used to test H1a is also re-stated here for convenience:

$$Registered\_MFI_{it} = \beta_0 + \beta_1 Governance\ performance_{it} + \beta_2\ Recovery\_Rate_{it} + \beta_3 Female\_CEO_{it} + \beta_4 Total\_net\_savings\ (sqrt)_{it} + \varepsilon_{it} \ldots \quad .(Model\ 1)$$

Where Regulatory status is measured at a nominal level (Registered = 1, Unregistered = 0), Governance performance indicators as determined using factor analysis, and control variables, including the loan repayment rate by credit borrowers (Recovery_Rate), the presence of a female CEO (Female_CEO) (coded female = 1, 0 otherwise), and total net savings (Total_net_savings (sqrt)).

##### 8.2.1.1.1 Factor analysis of MFIs' governance practice variables

Table 8.1 presents the rotated (oblimin) principal components' factor analysis loadings derived from responses to questions (refer to Table 7.3) put to 149 MFI executives about MFIs' governance practices. Data in respect of only the year in which MFI executives were questioned is included since it was considered inappropriate to have interviewees try to recall aspects of governance in prior years. Only observations for which all data is present to meet the requirements of Model 1 are included in the factor analysis. The scree plot and loadings suggest six factors (Table 8.1), to represent Board Administration (Factor 1), Transparency and Disclosure (Factor 2), Board Composition (Factor 3), Internal Governance (Factor 4), External Governance (Factor 5), and Board Evaluation (Factor 6). Together these six factors explain over 67 per cent of the variance, with 30 per cent for Factor 1, 10 per cent for Factor 2, eight per cent for Factor 3, seven per cent for Factor 4, six per cent for Factor 5, and five per cent for Factor 6. Each component of these six factors was discussed in detail in Section 7.9.1.1.1). It is important to note that only discretionary governance practices are included in the factor analysis, with mandatory threshold registration requirements excluded.

For the first theme, 'Board Administration', the items relate to the characteristics of MFIs' boards and their administration in terms of key processes and functions. The key area under this heading includes the election of council members, attendance levels of members at board meetings, and the voting rights of board members (MicroSave, 2015). MFI executives' responses to questions relevant to this factor include the provision of information about the election of the council of directors, attendance of board directors at board meetings, and voting rights of the council of directors.

In the second theme, 'Transparency and Disclosure', items related to MFI policies that allow stakeholders to access information that is reliable. Different types of products and their repayment rates, interest rates, and fees and other associated costs need to be explained to clients. In addition, financial contracts with clients or other institutions must be worded clearly and carefully to ensure transparency (BBVA, 2011). MFI executives' responses to questions relevant to this factor relate to informing clients about loans, interest rates, fees, and their rights and responsibilities; publishing annual reports along with financial reports that are reliable and easily accessible to stakeholders, and the presence of an internal audit function.

The third theme, 'Board Composition', relates to parameters of the structure of the governance model adopted by MFIs. The key components under this heading include board members' diversification in terms of their skills and expertise to lead, independence of board members enabling them to give freely of their opinions and act accordingly, and the presence of a general body (chairman, and board members) (MicroSave, 2015). MFI executives' responses to questions relevant to this factor are in relation to the presence of independent board members, board member diversification, CEO/chairman duality, and presence of a general body (chairman and board members) of the MFI.

The theme 'Internal Governance' relates to control mechanisms and practices within MFIs, such as MFI boards and their activities, presence of different committees, and ability to make changes to policy structures according to demands by clients or changing circumstances (Hartarska and Mersland, 2012). MFI executives' responses to questions relevant to this factor include use of an emergency safety fund; managing the loan portfolio using loan classifications (regular, watchful, sub-standard, doubtful and bad); use of the declining balance method where interest is charged only on the loan amount that borrowers hold; and the presence or absence of committees, such as for audit, risk, human relations (HR) or corporate governance.

The fifth theme, 'External Governance', relates to external regulation and supervision, and external audit of MFIs. Regulation and supervision by a government agency, external audit, and ratings are important external governance mechanisms for MFIs (Hartarska, 2005). MFI executives' responses to questions relevant to this factor relate to whether annual external audits are carried out by chartered accounting firms and whether the MFI is a registered with an organisation such as PKSF, CDF, or the MRA, or any other authority for their guidance, supervision or external regulation and accountability.

**Table 8.1: Factor analysis (N = 149), rotated component matrix (governance)**

| | Questions asked of MFI executives | Component* | | | | | |
|---|---|---|---|---|---|---|---|
| | | 1 | 2 | 3 | 4 | 5 | 6 |
| Fac 1 | An elected council of directors | .836 | | | | | |
| | Attendance of directors at board meetings | .823 | | | | | |
| | Voting rights of the founder of MFI to the board committee | .820 | | | | | |
| Fac 2 | An internal audit of MFI | | .827 | | | | |
| | Publishing annual reports and financial reports of MFI | | .827 | | | | |
| | Information disclosure to borrowers and clients about loans interest, fees, charges, products, and borrowers' rights and responsibilities at the beginning of loan disbursement | | .739 | | | | |
| Fac 3 | Presence of board | | | .737 | | | |
| | Relation (parents/children/spouse/siblings) with CEO or chairman of the MFI | | | .711 | | | |
| | Independent board members | | | .691 | | | |
| | Board member diversification | | | .515 | | | |
| Fac 4 | Emergency or safety fund (other than depositor's safety fund) | | | | .732 | | |
| | Loan classification | | | | .583 | | |
| | Calculation of monthly interest by declining balance method | | | | .433 | | |
| | Presence of committees (executive/risk/audit/HR/corporate governance) (any three) | | | | .638 | | |
| | Changed policies by the board in the past year concerning product range/product distribution network/source of capital/client protection/internal control/regulatory compliance (any three) | | | | .581 | | |
| Fac5 | External audit | | | | | .850 | |
| | Member of PKSF, CDF, or any other external authority for guidance, monitoring, supervision, or accountability | | | | | .755 | |
| Fac 6 | Board members' training | | | | | | .795 |
| | Yearly evaluation of board members | | | | | | .801 |

***Legend***: Fac 1—Board Administration, Fac 2—Transparency and Disclosure, Fac 3—Board Composition, Fac 4—Internal Governance, Fac 5—External governance, Fac 6—Board Evaluation.

For the sixth theme, ‘Board Evaluation’, the items relate to parameters dealing with the evaluation and training of board members to increase their efficiency in effective guidance and management of MFIs. Governance is considered a leadership process where board members should have a clear understanding of their roles and responsibilities and of how to practically and accurately apply them within a leadership framework (Better Boards, 2011). Given this, regular training and evaluation are essential for an effective and efficient MFI board (CGAP, 1997). MFI executives’ responses to questions relevant to this factor include the provision of information about the training of board members and yearly evaluation of board members.

#### 8.2.1.1.2 MFI governance practices: Descriptive Statistics

Table 8.2 provides descriptive statistics for variables included in Model 1 for 2012, the closest reporting period to when the data were gathered through both highly structured and open-ended questions of MFI executives and archival evidence drawn from annual reports, websites and other secondary sources. The table reveals significant differences between Registered and Unregistered MFI discretionary governance practices.

The mean for all factor scores (Factor 1–Factor 6) for the full sample (149 MFIs) is zero, by design. What is of interest is whether there is a significant difference between the factor means for Registered compared with Unregistered MFIs. For Factor 1 Board Administration there is a significant difference ($t = 5.000$, $p < .000$) between mean factor scores for the 86 (58 per cent) Registered MFIs (0.367) and that for the 63 (42 per cent) Unregistered MFIs (-0.514). For Factor 2 Transparency and Disclosure there again is a significant difference ($t = 3.218$, $p < .002$) between mean factor scores for Registered (0.367) and Unregistered MFIs (-0.501). For Factor 3 Board Composition there is a significant difference ($t = 6.739$, $p < .000$) between mean factor scores for Registered (0.251) and Unregistered MFIs (-0.343). For Factor 4 Internal Governance there is a significant difference ($t = 3.072$, $p < .003$) between mean factor scores for Registered (0.268) and Unregistered MFIs (-0.366). For Factor 5 External Governance there is a significant difference ($t = 3.145$, $p < .002$) between mean factor scores for Registered (0.086) and Unregistered MFIs (-0.118). Factor 6 Board Evaluation provides the only insignificant difference ($t = 0.656$, $p = .513$) between mean factor scores for Registered (0.248) and Unregistered MFIs (-0.338).

**Table 8.2: Descriptive statistics (discretionary governance practices and control variables)**

| | All MFIs N = 149 | Registered MFIs N = 86 (58%) | | | | Unregistered MFIs N = 63 (42%) | | | | Test of Difference | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Continuous variables** | **Mean** | **Mean** | **Std. Dev.** | **Min.** | **Max.** | **Mean** | **Std. Dev.** | **Min.** | **Max.** | **t-statistic** | **p value** |
| **Fac 1: Board Administration** | 0.000 | 0.376 | 0.861 | -1.800 | 1.479 | -0.514 | .952 | -1.938 | 2.429 | 5.000 | **0.000** |
| **Fac 2: Transparency and Disclosure** | 0.000 | 0.367 | 1.011 | -1.862 | 1.933 | -0.501 | .739 | -1.759 | 2.219 | 3.218 | **0.002** |
| **Fac 3: Board Composition** | 0.000 | 0.251 | 0.894 | -1.808 | 1.708 | -0.343 | 1.042 | -1.723 | 2.995 | 6.739 | **0.000** |
| **Fac 4: Internal Governance** | 0.000 | 0.268 | 0.558 | -.535 | 1.353 | -0.366 | 1.314 | -4.286 | 1.718 | 3.072 | **0.003** |
| **Fac 5: External Governance** | 0.000 | 0.086 | 1.000 | -1.502 | 2.012 | -0.118 | .996 | -2.403 | 2.096 | 3.145 | **0.002** |
| **Fac 6: Board Evaluation** | 0.000 | 0.248 | 0.896 | -1.906 | 1.556 | -0.338 | 1.042 | -1.829 | 2.206 | 0.656 | **0.513** |
| **Recovery_Rate (%)** | 93.250 | 96.620 | 7.740 | 41.000 | 100.000 | 88.640 | 15.932 | 15.000 | 100.000 | 115.846 | **0.000** |
| **Tot_net_savings (Taka in '000)** | 283,499,170 | 488,601,228 | 2,697,421,833 | 141,662 | 24,907,280,000 | 3,518,584 | 7,837,669 | 12,000 | 43,690,000 | 71.669 | **0.000** |
| **Dichotomous variable** | | | | | | | | | | $Chi^2$ | |
| **Female_CEO** | | 21.5% | | | | 78.5% | | | | 12.588 | **0.000** |

***Legend***: Fac 1–Fac 6 = factor analysis scores (Board Administration, Transparency and Disclosure, Board Composition, Internal Governance, External Governance, Board Evaluation); Recovery_Rate = loan repayment rate (%) by credit borrowers; Tot_net_savings is the total net savings; Female_CEO (coded yes = 1, otherwise 0).

In terms of control variables, the mean loan repayment rate by credit borrowers (Recovery_Rate) from all sources for the full sample is 93.25 per cent, with a significant difference ($t = 115.846$, $p < .000$) between the mean for Registered (96.62%) and Unregistered MFIs (88.64%). The mean total net savings from all sources (Total_net_savings) for the full sample is 283,499,170 taka ('000), with a significant difference ($t = 71.669$, $p < .000$) between the mean for Registered (488,601,228 taka '000) and Unregistered MFIs (3,518,584 taka '000).

The chi-square test for the dichotomous variable 'Female_CEO' shows that there is a significant difference between MFIs' regulatory status and female CEO presence ($chi^2 = 12.588$, $p < .000$). However, for this variable, it is the Unregistered MFIs that have a higher mean (78.5%) and thus are more likely to have female CEOs than Registered MFIs (21.5%).

#### 8.2.1.1.3 Pearson's correlations of MFI governance practice (independent) variables

Pearson's correlations measure the degree of the linear relationship between two variables. Table 8.3 reports the Pearson's correlations between the dependent (Registered/Unregistered) and independent variables.

Table 8.3 reports significant positive correlations between the six discretionary governance factor scores ($r = 0.441$, $r = 0.430$, $r = 0.295$, $r = 0.314$, $r = 0.101$, and $r = 0.291$ respectively) and regulatory status. The total net savings (Tot_net_savings (sqrt)) are significantly correlated with Factors 1 (Board Administration), 2 (Transparency and Disclosure), 3 (Board Composition), and 4 (Internal Governance) ($r = 0.228$, $r = 0.266$, $r = 0.343$, and $r = 0.214$ respectively).

**Table 8.3: Pearson's correlations (governance practice) (N = 149)**

| Governance variables correlation matrix | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Independent variables** | Fac 1 | Fac 2 | Fac 3 | Fac 4 | Fac 5 | Fac 6 | Recovery_Rate | Tot_net_savings (sqrt) | Female_CEO |
| Fac 1: Board Administration | | | | | | | | | |
| Fac 2: Transparency and Disclosure | 0.000 | | | | | | | | |
| Fac 3: Board Composition | 0.000 | 0.000 | | | | | | | |
| Fac 4: Internal Governance | 0.000 | 0.000 | 0.000 | | | | | | |
| Fac 5: External Governance | 0.000 | 0.000 | 0.000 | 0.000 | | | | | |
| Fac 6: Board Evaluation | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | | | | |
| Recovery_Rate | 0.031 | 0.144 | 0.185* | -0.048 | 0.051 | 0.084 | | | |
| Tot_net_savings (sqrt) | 0.228** | 0.266** | 0.343** | 0.214** | 0.103 | 0.122 | 0.254** | | |
| Female_CEO | -0.047 | -0.034 | 0.074 | 0.050 | -0.129 | -0.175* | -0.045 | -0.049 | |
| Registered_MFI | 0.441** | 0.430** | 0.295** | 0.314** | 0.101 | 0.291** | 0.316** | 0.645** | -0.182* |

***Legend***: Fac 1–Fac 6 = factor analysis scores (Board Administration, Transparency and Disclosure, Board Composition, Internal Governance, External Governance, Board Evaluation); Recovery_Rate = loan repayment rate (%) by credit borrowers; Tot_net_savings is the squire root of total net savings; Female_CEO (coded yes = 1, otherwise 0); Registered_MFI = *indicator for whether MFI is registered (yes = 1, otherwise 0)* ** correlation is significant at the 0.01 level (2-tailed); * correlation is significant at the 0.05 level (2-tailed).

MFIs' regulatory status (Registered_MFI) is strongly and positively correlated with Recovery_Rate (r = 0.316) and Tot_net_savings (sqrt) (r = 0.645) and negatively so with Female_CEO (r = -0.182). Recovery_Rate is strongly correlated with Tot_net_savings (sqrt) (r = 0.245) and Factor 3 (Board Composition) (r = 0.185). It is important to note that the factor scores are not correlated with each other by design since orthogonal rotation was conducted.

#### 8.2.1.1.4 Logistic Regression: MFIs' discretionary governance practices

The dependent variable (Registered_MFI) for Model 1 is a categorical variable, which does not have a normal distribution and is best addressed using logistic regression. The logistic regression model was first used by Dyke and Patterson (1952) and then widely introduced by Cox (1958). The logistic regression model inherits a number of advantages from regression analysis by facilitating additional information on the directionality and size of an effect compared to standard ANOVA output. The logistic model deals with imbalanced data and allows flexible research designs that affect the naturalness of the object of the study (Jaeger, 2006). The inclusion of continuous predictors in the model is another important characteristic that the logistic model inherits from regression. Also, the logistic regression model can examine linearity assumptions from continuous predictors (Harrell, 2016).

$$y = \beta_0 + \beta_1 x_1 + \cdots + \beta_n x_n + \varepsilon$$

Logistic regression seeks to **model** the probability of an event occurring, depending on the values of the independent variables, which can be categorical or numerical (for Model 1, Governance Performance, Recovery_Rate, Tot_net_savings (sqrt), and Female_CEO); **estimate** the probability that an event occurs for a randomly selected observation versus the probability that the event does not occur (for Model 1, Registered or Unregistered MFI); **predict** the effect of a series of variables on a binary response variable; and **classify** observations by estimating the probability that an observation is in a particular category. Several studies involving microfinance similarly use logistic regression when the dependent variable is measured dichotomously (for example, Aveh (2011), Tchuigoua (2015), Agbemava, et al. (2016), Baklouti (2013), Gruszczynski (2006), Nawaz and Iqbal (2015), and Nwachukwu (2014)).

#### 8.2.1.1.5 Multivariate analysis of MFIs' Discretionary Governance Practices

The logistic regression results for testing of *H1a* (the relationship between MFI regulatory status [Registered/Unregistered] and MFI discretionary governance practices) are discussed in the following section. Table 8.1 reports that the -2-log likelihood statistic (37.3298) for the model is significant ($p<0.000$). The Pseudo R square is 82 per cent, showing how much of the variance in the dependent variable is explained by the predictor variables. The overall classification accuracy is 98 per cent.[30], with 98 per cent of Unregistered and 97 per cent of Registered MFIs classified correctly.

The odds ratio related to each of the governance factors indicates how likely MFIs are to be Registered or Unregistered. The table reports that among the governance performance factors (Fac1–Fac6), except for the External Governance factor (Fac 5), the other five factors - Board Administration ($p < 0.000$), Transparency and Disclosure ($p < 0.000$), Board Composition ($p < 0.046$), Internal Governance ($p < 0.002$), and Board Performance ($p < 0.009$) - are statistically significant in predicting MFI regulatory status (Registered_MFI).

[30] Multicollinearity issues are deemed to be a major concern when the correlation coefficients are above 0.7 (Alin, 2010). The correlation matrix shows whether multicollinearity is likely to be resilient to invalidating the simultaneous inclusion of certain independent variables in a linear regression model. The highest value in Table 8.3 is 0.645. Further testing through examination of variance inflation factors (VIF) after estimation of each OLS regression. When a VIF is 10 and the tolerance (1/VIF) is 0.10 or less, there is problematic multicollinearity among the variables (Daoud, 2017). All VIF and tolerance values are less than 2.6 and greater than 0.39 respectively when Model 1 is estimated using OLS regression.

**Table 8.4: Relationship between MFI regulatory status and governance performance (N=149)**

| | **Dependent variable: Registered_MFI=1** | **B** | **S.E.** | **z** | **Exp(B)** | **Sig. (2-tail)** | **Remarks on Hypothesis *H1a*** |
|---|---|---|---|---|---|---|---|
| **Independent variables** | Board Administration_Fac 1 | 2.332 | 0.636 | 3.670 | 10.299 | 0.000 | **Accepted** |
| | Transparency and Disclosure_Fac 2 | 1.974 | 0.562 | 3.510 | 7.196 | 0.000 | **Accepted** |
| | Board Composition_Fac 3 | 1.051 | 0.526 | 2.000 | 2.859 | 0.046 | **Accepted** |
| | Internal Governance_Fac 4 | 3.185 | 1.036 | 3.070 | 24.164 | 0.002 | **Accepted** |
| | External Governance_Fac 5 | 0.276 | 0.491 | 0.560 | 1.317 | 0.574 | **Rejected** |
| | Board Performance_Fac 6 | 1.347 | 0.513 | 2.630 | 3.848 | 0.009 | **Accepted** |
| | Recovery_Rate | 0.074 | 0.038 | 1.920 | 1.077 | 0.055 | **Accepted (weak)** |
| | Female_CEO | -2.424 | 1.261 | -1.920 | 0.089 | -0.055 | **Accepted (weak)** |
| | Tot_net_savings (sqrt) | 0.001 | 0.000 | 2.030 | 1.001 | 0.043 | **Accepted** |
| | Constant | -8.160 | 3.564 | -2.290 | 0.000 | -0.022 | |
| | -2 Log Likelihood | | 37.328 | | | | |
| | p-value | | **0.000** | | | | |
| | Pseudo $R^2$ | | 0.816 | | | | |
| | Percentage correctly classified | | 97.32% | | | | |

***Legend**: Registered_MFI = indicator for whether MFI is registered (yes = 1, otherwise 0), Fac 1–Fac 6 = factor analysis scores; Recovery_ Rate = loan repayment rate (%) by credit borrowers; Tot_net_savings is the square root of total net savings; Female_CEO (coded yes = 1, otherwise 0).*

Among the governance performance variables, Internal Governance factor (Fac 4) has the highest odds ratio of 24.162 ($p < 0.002$), or in other words, MFIs with a high score for Internal Governance have the highest chance (24.162 times higher than other indicators) of being Registered. This indicates that MFIs with sound Internal Governance, particularly MFIs with different sub-committees to monitor and supervise management; that maintain loan classification for improving accountability and loan management; that maintain an emergency safety fund for crisis periods; and that update board policies in terms of product diversification, distribution network, source of capital, client protection, internal control, and regulatory compliance—have the highest chance of being Registered. Note that these are not requirements for registration, but optional or discretionary aspects of governance performance that both registered and unregistered MFIs can choose to adopt. This result is consistent with previous studies as discussed in Section 8.2.1.1.6.

The second highest governance factor is Board Administration (Fac 1). The odds ratio for this governance performance variable is 10.298 ($p < 0.000$). This indicates that MFIs with a higher score for Board Administration, which includes the election of members of the council of directors, directors required attendance at board meetings, and board members having voting rights in board meetings, have a higher chance (10.298 times higher than other indicators) of being Registered.

In the same way, the Transparency and Disclosure factor (Fac 2) has an odds ratio of 7.196 ($p < 0.000$), indicating that MFIs whose regular conduct includes internal audit; publishing annual and financial reports for clients and other stakeholders, informing borrowers about loan interest rates, fees, charges, and their rights and responsibilities at the beginning of the loan disbursement, have a higher chance (7.20 times higher than other indicators) of being Registered.

The Board Evaluation factor has an odds ratio of 3.847 ($p < 0.009$), indicating that MFIs that provide regular training for their board members and conduct a yearly evaluation of members have a 3.85 per cent higher chance than other indicators of being Registered.

The Board Composition factor (Fac 3) has an odds ratio of 2.859 ($p < 0.046$), indicating that MFIs with a board, with diversified and independent board members, and where there is no relationship between the CEO and chairman of the board, have a 2.86 times higher chance than other indicators of being Registered.

The only insignificant governance performance factor is External Governance (Fac 5) indicating no difference between Registered and Unregistered MFIs in terms of the conduct of external audits only by chartered accounting firms suggested by the MRA, or membership of peak authoritative bodies such as CDF, PKSF, InM, etc.

With regard to control variables, Female_CEO has an odds ratio of negative 0.089 ($p < 0.055$), which indicates that there is an 8.9 per cent chance that MFIs having a female CEO are Unregistered compared to other governance indicators in the model. Total net savings (Tot_net_savings (sqrt)) has an odds ratio of 1.001 ($p < 0.043$), indicating that MFIs with higher net savings have a 1.00 per cent higher chance of being Registered compared to other indicators of the model. The loan recovery rate (Recovery_Rate) has an odds ratio of 1.077 ($p < 0.055$), indicating that MFIs with higher recovery rates have a 1.08 higher chance of being Registered compared to other governance indicators. Of the control variables, Recovery Rate and Female CEO are weakly significant, with the others significant at conventional levels.

The above discussion and results reported in Table 8.4 show that except for External Governance (Fac 5), governance factors support Hypothesis *H1a*. That is, Registered MFIs exhibit better discretionary governance practices.

#### 8.2.1.1.6 Discussion of empirical results for MFIs' governance practice

Hypothesis *H1a* focuses on the role of regulation in MFIs' governance practices. It is important to note that although the governance factors and control variables used in Model 1 are not mandatory for awarding of a licence from the MRA (Section 3.4.3), except for External Governance, superior governance practice indicators are significant for Regulated MFIs. That is, the results support the hypothesis and reveal that regulation plays a significant and positive role in the exercise of superior governance practices among MFIs in Bangladesh. The findings are consistent with stakeholder theory and previous studies (Section 4.4.5 and Section 2.6) as discussed later in this section.

Although the theoretical model put forward for this study suggests stakeholder theory, critics of regulation and governance theories argue that no one theory can provide the best explanation of good governance, which depends on the context, type, and characteristics of the organisation (Barth et al., 2006; Bartle et al., 2012; Chiumya, 2006; Hertog, 2003; Seal, 2006; Staschen, 2010; Wright and Head, 2009). Kosonen (2005) and (Seal, 2006) assert that all governance theories have overlapping aspects of principals' (owner/shareholders) and agents' (management/employees) rights.

According to Verbruggen et al. (2011), resource dependency theory plays a vital role in transparency and disclosure, particularly for quality financial reporting by an organisation. The theory suggests that it is necessary to safeguard (through monitoring and supervising) the quality of financial reports, and it supports the usefulness of these reports to stakeholders of the organisation who have the right to accountability and improved transparency (Benjamin, 2008). This supports the finding of the significance of Fac 2: Transparency and Disclosure ($p < 0.000$).

The result is also consistent with interview evidence from responses to the open-ended supplementary questions asked of MFI executives. For instance, in response to the open-ended question: 'Do you see any difference in terms of accountability of your organisation to the stakeholders (clients, shareholders, donors, etc.) before and after registration with MRA?', MFI executives highlighted some of the board accountability, transparency, and disclosure issues that had improved after registration with the MRA. One MFI executive made the following statement:

> *"Before registration (with MRA), there were no*(t) *any internal audits within the organisation. Also, the annual report was published very irregularly (not every year). There was no accountability to the borrowers. Clients were rarely getting information*

*about their loan portfolio or information about the fees and interest rate (as the practice of maintaining a passbook or register book was absent during that period)"* (MFI No. 37).

For the Board Composition factor, the key attention of resource dependency theory is at an institutional level, encompassing board structure and composition, external directors, the requirement for environmental linkages between the organisation and external resources, governance practices, and regulation of the organisation (Verbruggen et al., 2011). With regard to board governance, resource dependency theory also suggests that board members add value to the organisation through their experience, skills, and networking in the industry (Chambers et al., 2013). The theory is consistent with findings from this current study, with Fac 3: Board Composition significant ($p < 0.046$).

From an agency theory perspective, corporate governance regulation is necessary and is aimed at improving shareholders' control of executive management. This regulation and control can come directly through the voting power of members of the board of directors (Lan and Heracleous, 2010), and internal and external regulation enhances board independence and monitoring capacity (Mftransparency, 2010), which is consistent with the finding of significance for Fac 2: Board Administration ($p < 0.000$). Another study (Okoye and Siwale, 2017), which compares and evaluates the effect of regulatory provisions on the attainment of effective corporate governance in Nigerian and Zambian MFIs, also found that external regulation has a positive impact on MFIs' board administration and the effectiveness of the board to the extent that they improved discipline within the board. The response from a management executive of an MFI interviewed by Okoye and Siwale (2017) stated that:

"*To some extent, the [regulatory] provisions could be viewed as "positively limiting". In the area of corporate governance, the provisions help by instilling discipline within the system. The rules have enabled more effective governance regimes; we have boards that work. The rules have given us limited activities and help us to stay within our allowed remit. The CBN (external regulator) oversees our board appointments and removals etc. and also checks our sources of funds. When you know someone is checking on you, you will check yourself"* (Okoye and Siwale, 2017, p. 111).

Quayes and Khalily (2014) point out that external supervision and regulation (in this case PKSF monitoring and supervision) can enhance firm efficiency and good governance. Findings by Bassem (2009) also show that external governance mechanisms (auditing, external regulation, and supervision) help MFIs to achieve better governance and financial performance. Hartarska and Mersland (2012) found that MFIs regulated by an independent banking authority had improved governance performance.

However, Haq et al. (2008) report mixed results in that while regulation for formal MFIs seems effective, it is not the case for NGO-MFIs and informal MFIs, particularly in the areas of internal governance, internal control, and ownership structure. However, the result reported in Table 8.4 reveal that board composition has a positive association with Regulated MFIs (Fac 3: Board Composition, $p < 0.043$), which is consistent with responses to open-ended supplementary questions asked of MFI executives. For instance, in response to the question: 'What difference do you see in terms of board structure, composition, and discipline within the board activities before and after registration with MRA?', MFI executives highlighted some aspects of board discipline as well as board diversification and composition issues that have improved after registration with the MRA, with one MFI executive stating:

*"(Before registration with MRA) [t]here was severe internal governance abuses and corruption, like members of the board were taking loans and defaulting. Board members' experience, knowledge, and capacity about microfinance practice were also very poor. After registration with the MRA, there is regular training for board members (every three months). The attendance in the board meeting also increased as the board constitutions included the minimum requirements of attendance for every board meeting"* (MFI No. 12).

In investigating internal governance, Okoye and Siwale (2017) found that external regulation had a positive impact on internal governance to the extent that it required the establishment of boards and board committees by MFIs. In interview data, a management executive from an MFI stated that:

"*The BOZ (external regulator) guidelines as it relates to governance are just guidelines, but issues such as board self-assessment and the need to have committees, (like risk committee) has helped improving good governance within the organisation. The governance aspects of the regulations have been positive; we now have better quality boards and committees"* (Okoye and Siwale, 2017, p. 111).

The findings from this study (Fac 4: Internal Governance, $p<0.003$) are also consistent with the findings by Okoye and Siwale (2017).

However, as discussed earlier (Section 2.2) in spite of all the positive steps and initiatives taken by the MRA and the positive outcomes (discussed above) of microfinance regulation, a number of MFIs in Bangladesh choose to remain unregulated. Responses to some open-ended questions posed to executives of regulated and unregulated MFIs revealed different perspectives and the rationale for some MFIs choosing to remain unregulated. For example, an important observation from this current study is that the MRA has some mandatory criteria for awarding a licence and some discretionary guidelines to follow, e.g., all registered MFIs should have minimum capital adequacy, a general body with elected directors and an executive director, and a separate chairman and CEO. According to one executive of a regulated MFI:

> *"Sometimes it is hard to meet the minimum capital adequacy for us (small- and medium-scale MFIs) because our MFI is small, and we are new compared to large- and medium-size MFIs who are running their business for more than 20 years. Also, for the formation of a general body, we prefer the same chairman and CEO because they know the business better and know the local environment and the clients, which is difficult for the general body where it is changing every three-four years. As I have invested in my business, I prefer to be the chairman of the organisation. I do not want to take a risk of changing the chairman and putting the business in another person's hands. Also, it is hard to get a knowledgeable person for running the organisation; we change the board every two–four years"* (MFI No. 07).

Not all MFIs are the same size or age, so, it is impractical to expect the same capital adequacy or structure of the general body (minimum number of directors) from all types of MFIs (small, medium, large). Also, MFI executives' concerns about the unavailability of experienced people who can fill positions of directors and chairs comprise a serious challenge for small-scale MFIs. Concerns such as these and the feasibility of requirements need to be addressed at the time of designing the regulatory structure for the microfinance industry.

#### 8.2.1.2 Outreach

The following section examines two hypotheses developed in Chapter six, *H1b* (the relationship between MFI status [Registered/Unregistered] and MFIs' outreach) and *H2a* **(**the relationship between MFI outreach and governance practices). Hypotheses H1b and H2a (Sections 6.5 and 6.6) are re-stated here for convenience:

***H1b:*** *Regulated MFIs exhibit superior outreach compared with that of unregulated MFIs.*

***H2a:*** *Voluntary governance practices of regulated MFIs are positively associated with their outreach, but this is not the case for unregulated MFIs.*

Many prior studies (Cull et al., 2011; Dubreuil and Mirada, 2015; Islam et al., 2013; Hartarska, 2005) adopt OLS regression models for examining the outreach of MFIs. Outreach is measured using client-facing measures, such as the number of branches or borrowers. Models 2-4 dealing with outreach (refer Section 7.9.1.2), are repeated here for convenience, each with a different measure of outreach as the dependent variable:

$LN\_No\_Of\_Branch_{it,}$ $(LN\_\ Avrg\_Loan\_Balance_{it,}$ $LN\_Credit\_Borrower_{it})$ $= \beta_0 + \beta_1 Registered\_MFI_{it} + \beta_2 CreditProgramAge_{it} + \beta_3\ Recovery\_Rate_{it} + \beta_4 Tot\_net\_savings\ (sqrt)_{it} + \beta_5 Female\_CEO_{it} + \beta_6 Yr2010_{it} + \beta_7 Yr2012_{it} + \varepsilon_{it}$ ...... *(Models 2-4)*

Where LN_No_Of_Branch = Natural logarithm of the total number of MFI branches, LN_Avrg_Loan_Balance = Natural logarithm of (Gross outstanding loan/Active borrower), LN_Credit_Borrower = Natural logarithm of the number of credit borrowers of MFIs, Registered_MFI = indicator for whether MFI is registered (yes = 1, otherwise 0), CreditProgrammeAge = Age of credit programme of MFI, Recovery_Rate = Loan repayment rate (%) by credit borrowers, Tot_net_savings = Square root of total net savings of the MFI, Female_CEO (coded yes = 1, otherwise 0), Yr2010,Yr2012 = Dummy taking value 1 for each year (2008, 2010, 2012), 0 otherwise.

**8.2.1.2.1 Descriptive statistics for MFI outreach variables**

Table 8.5 provides descriptive statistics for variables included in Models 2–4, including the mean, median, standard deviation, and minimum and maximum value for each variable and tests of difference between Registered and Unregistered MFIs. The table reveals that there is a significant difference between Registered and Unregistered MFIs in terms of outreach. Since the data for variables included in Models 2–4 are gathered from archival sources and do not rely on the memories of MFI executives, these models are estimated using longitudinal data. Years 2008, 2010 and 2012 are included with respective sample sizes of 230 Registered MFI-years (51 per cent), and 217 Unregistered MFI-years (49 per cent), totalling 447 MFI-years). The mean average loan balance (Avrg_Loan_Balance) for the full sample is 7867.120 (‘000 taka) with a significant difference ($t = 15.662$, $p < .000$) between the mean for Registered (10,719.460 ‘000 taka) and Unregistered MFIs (4,843.910 ‘000 taka). The mean number of credit borrowers (Credit_ Borrower) for the full sample is 74,173.940, with a significant difference ($t = 3.395$, $p < .001$) between the mean for Registered (129,711.000) and Unregistered MFIs (15,309.770). The mean number of branches (No Of Branch) for the full sample is 51.84, with a significant difference ($t = 4.604$, $p < .000$) between the mean for Registered (81.27) and unregistered MFIs (20.64). The mean recovery rate (Recovery_Rate) for the full sample is 94.7 per cent, with a significant difference ($t = 197.173$, $p < .000$) between the mean for Registered (97.55 per cent) and Unregistered MFIs (91.67 per cent). The mean CreditProgramAge for the full sample is 14 years, with a significant difference ($t = 43.56$, $p < .000$) between the mean for Registered (17.55 years) and Unregistered MFIs (10.43 years). The mean Tot_net_savings (in ‘000 taka) for the full sample is 585,618,948, with a significant difference ($t = 2.985$, $p < .003$) between the mean for Registered (1,101,589,117) and Unregistered MFIs (307,612,895). The chi-square test for the dichotomous variable ‘Female_CEO’ shows that there is a significant relationship between MFI regulatory status and female CEOs ($chi^2 = 12.588$, $p < .000$). Unregistered MFIs (78.5%) are more likely to have female CEOs than registered MFIs (21.5%). The year variables (Yr2008, Yr2010, and Yr2012) show that the number of registered MFIs increases gradually (Yr2008 = 29.1%, Yr2010 = 33.5%, and Yr2012 = 37.4%) and unregistered MFIs decreases gradually (Yr2008 = 35.8%, Yr2010 = 33.2%, and Yr2012 = 31%).

## Table 8.5: Descriptive statistics (outreach variables)

| | All MFIs | Registered MFIs | | | | Unregistered MFIs | | | | Tests of Difference | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | N = 447 MFI-years | N = 230 MFI-years (51%) | | | | N = 217 MFI-years (49%) | | | | | |
| **Continuous variables** | **Mean** | **Mean** | **Std. Dev.** | **Min.** | **Max.** | **Mean** | **Std. Dev.** | **Min** | **Max.** | **t-statc** | **p value** |
| **Avrg_Loan_Balance (Taka in '000)** | 7,867.120 | 10,719.460 | 13,277.465 | 67 | 91,281 | 4,843.91 | 5,304.502 | 5 | 62,866 | 15.662 | **0.000** |
| **Credit Borrower** | 74,173.940 | 129,711.000 | 624,823.100 | 338 | 6,367,250 | 15,309.77 | 140,863.002 | 105 | 170,6540 | 3.395 | **0.001** |
| **Number of Branches** | 51.840 | 81.270 | 292.344 | 1 | 2,649 | 20.64 | 156.558 | 1 | 1705 | 4.604 | **0.000** |
| **Recovery_Rate** | 94.700 | 97.550 | 5.247 | 41 | 100 | 91.67 | 12.878 | 0 | 100 | 197.173 | **0.000** |
| **CreditProgramAge** | 14.090 | 17.550 | 5.995 | 5 | 40 | 10.43 | 5.688 | 0 | 34 | 43.563 | **0.000** |
| **Tot_net_savings (Taka in '000)** | 585,618,948 | 1,101,589,117 | 5,732,327,901 | 429,730 | 60,067,480,000 | 38,738,124 | 307,612,895 | 244 | 3,747,810,000 | 2.985 | **0.003** |
| **Dichotomous variables** | | | | | | | | | | **Chi²** | **p-value** |
| **Female_CEO** | | | 21.5% | | | | 78.5% | | | 12.588 | **0.000** |
| **Yr2008** | | | 29.1% | | | | 35.8% | | | | |
| **Yr2010** | | | 33.5% | | | | 33.2% | | | | |
| **Yr2012** | | | 37.4% | | | | 31% | | | | |

***Legend:*** *AvrgLoanBalance =Gross outstanding loan/ Active borrower, Credit Borrowers = Number of Credit borrowers of the MFI, Number of Branches = Total number of MFI's branches, Recovery_ Rate= Loan repayment rate (%) by credit borrowers, CreditProgramAge= Age of credit program of MFI, Tot_net_savings= Total net savings of the MFI, FemaleCEO (coded yes = 1, otherwise 0), Yr2010, Yr2012= Dummy taking value 1 for each year (2008, 2010, 2012), 0 otherwise.*

#### 8.2.1.2.1 Pearson's correlations for MFI outreach (independent) variables

Table 8.6 reports the Pearson's correlation matrix for the 447 MFI observations across years 2008, 2010 and 2012 for the independent variables (Registered_MFI, CreditProgramAge, Recovery_Rate, Tot_net_savings (sqrt), Female_CEO, and Year indicators. Table 8.6 reports significant positive correlations between CreditProgramAge (r = 0.520), Recovery_Rate (r = 0.290), Tot_net_savings (r = 0.311), Female_CEO (r = -0.168), Yr2008 (r = -0.092), and Yr2010 (r = 0.003), and MFIs' regulatory status (Registered_MFI). CreditProgramAge is significantly correlated with Recovery_Rate (r = 0.204), Tot_net_savings (r = 0.540), Female_CEO (r = -0.003), Yr2010 (r = -0.207), and Yr2012 (r = 0.000). Recovery_Rate is significantly correlated with Tot_net_savings (r = 0.121), Female_CEO (r = -0.016), and Yr2010 (r = -0.024), and Yr2012 (r = 0.077). Tot_net_savings is significantly correlated with Female_CEO (r = -0.055), Yr2010 (r = -0.047), and Yr2012 (r = -0.002). Female_CEO is negatively and significantly correlated with Yr2010 (r = -0.012) and Yr2012 (r = -0.012). Yr2010 and Yr2012 are negatively and significantly correlated with each other (r = -0.500). The highest value in Table 8.6 is 0.540 so multicollinearity is not likely to be an issue, but VIFs are examined after each regression to be sure.

**Table 8.6: Pearson's correlations (outreach variables) (N = 447)**

| Independent variables | Registered_MFI | CreditProgramAge | Recovery _Rate | Tot_net_savings | Female_CEO | Year 2010 |
|---|---|---|---|---|---|---|
| **CreditProgramAge** | 0.520** | | | | | |
| **Recovery_Rate** | 0.290** | 0.204** | | | | |
| **Tot_net_savings (sqrt)** | 0.311** | 0.540** | 0.121* | | | |
| **Female_CEO** | -0.168** | -0.003 | 0.016 | -0.055 | | |
| **Year 2010** | -0.092 | -0.207** | 0.024 | -0.047 | -0.012 | |
| **Year 2012** | 0.003 | 0.000 | 0.077 | -0.002 | -0.012 | -0.500** |

*Legend: Registered_MFI = indicator for whether MFI is registered (yes = 1, otherwise 0), CreditProgramAge = age of credit program of MFI, Recovery_Rate = loan repayment rate (%) by credit borrowers, Tot_net_savings = square root of total net savings of the MFI, Female_CEO (coded yes = 1, otherwise 0), Yr2010, Yr2012 = dummy taking value 1 for each year (2008, 2010, 2012), 0 otherwise.*

#### 8.2.1.2.2 Selection of analysis technique for MFI Outreach and Financial Sustainability

For Models 2–4, and Models 5-8 that model financial sustainability (discussed subsequently), dependent variables are continuous so OLS regression is appropriate. OLS models examine the relationship between a collection of predictor variables and a scalar response (dependent variable). The value of the dependent variable is defined as a linear combination of the predictor variables and an error term.

$$\boldsymbol{Y} = \boldsymbol{\beta_0} + \boldsymbol{\Sigma_{j=1..p}}\ \boldsymbol{\beta_n x_n} + \boldsymbol{\varepsilon}$$

For p explanatory variables, $\boldsymbol{Y}$ is the dependent variable, $\boldsymbol{\beta_0}$ is intercept of the model, and $\mathbf{x_n}$ corresponds to the n[th] explanatory variable of the model (n = 1 to p), where $\boldsymbol{\varepsilon}$ is the random error. The regression coefficients are interpreted as the change in the expected value of Y associated with an increase per unit in a predictor variable, while other predictor variables are held constant. Since the data are panel data, robust regression is used, clustering on MFI identity to control for heteroscedasticity.

#### 8.2.1.2.3 Multivariate analysis for MFI outreach

Robust multiple OLS regression clustering on MFI identity is used to test Hypotheses *H1b* (the relationship between MFI regulator status [Registered/Unregistered] and MFI Outreach) and *H2a* (the relationship between MFI outreach and governance practices) with results reported in Table 8.7.

Table 8.7 shows that the $R^2$ for the three dependent variables - Number of Branches, AvrgLoanBalance, Credit Borrowers (each log transformed) is 60.5 per cent, 8.1 per cent, and 70.9 per cent respectively. The F statistics for each of the three Models are significant. Since all VIF and tolerance values are less than 2.6 and greater than 0.39 respectively, there is no multicollinearity issue with the independent variables included in Models 2–4.

Table 8.7 reports that the regulatory status of MFIs (Registered_MFI) is significantly associated with MFI outreach measured as the Number of Branches, AvrgLoanBalance, and Credit Borrowers ($p = 0.002$, $p < 0.000$ and $p < 0.000$) respectively. This finding is similar to findings by Hartarska and Nadolnyak (2007), Gohar and Batool (2015), and Nyanzu and Peprah (2016). Another study (Okumu, 2007) found that regulation positively impacts both sustainability and outreach of MFIs. However, Cull et al.'s (2011) study show the opposite result, that is, an outreach of regulated MFIs is not better than that of unregulated MFIs. In that study, it is explained that in order to maintain profit rates, MFIs limit outreach to women and clients who are costly to reach. However, MFIs with a less commercial focus tend to reduce profitability but maintain outreach.

The Age of the Credit Program is significantly associated with all three dependent outreach variables (Number of Branches, $p < 0.001$; AvgLoanBalance, $p < 0.019$; and Credit Borrowers, $p < 0.000$), which is also consistent with prior studies. Awaworyi and Marr (2014) found that for South Asia, new MFIs perform poorly compared to more mature MFIs in terms of their outreach, but for Latin America, no association was found. However, Wijesiri et al. (2017) found that although older MFIs perform better than younger MFIs in terms of financial objectives, their outreach achievement is not better than that of younger MFIs. The study by Kyereboah-Coleman and Osei (2008) also found that the age of the credit program has a negative impact on the outreach of MFIs. Findings by Narawal and Yadav (2014) also indicate that the age of MFIs' credit programs has a negative impact on outreach. The authors claim that this may be due to the fact that the poor do not necessarily look to an MFI's reputation to enjoy access to low credit amounts.

## Table 8.7: OLS robust regression (outreach) results (N=447)

| | Model 2 | | | | Model 3 | | | | Model 4 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Dependent variable** | **Number of Branches (Ln)** | | | | **AvrgLoanBalance (Ln)** | | | | **Credit Borrowers (Ln)** | | | |
| | Coef. | Robust Std. Err | t | P>\|t\| | Coef. | Robust Std. Err | t | P>\|t\| | Coef. | Robust Std. Err | t | P>\|t\| |
| Registered_MFI | 0.662 | 0.208 | 3.170 | **0.002** | 0.480 | 0.130 | 3.680 | **0.000** | 1.366 | 0.233 | 5.860 | **0.000** |
| CreditProgramAge | 0.065 | 0.018 | 3.490 | **0.001** | 0.022 | 0.009 | 2.380 | **0.019** | 0.115 | 0.021 | 5.310 | **0.000** |
| Recovery_Rate | 0.006 | 0.004 | 1.420 | 0.157 | 0.006 | 0.005 | 1.050 | 0.293 | -0.005 | 0.005 | -0.880 | 0.381 |
| Tot_net_savings (sqrt) | 0.000 | 0.000 | 2.580 | **0.011** | -0.000 | 0.000 | -0.480 | 0.634 | 0.000 | 0.000 | 2.430 | **0.016** |
| Female_CEO | -0.608 | 0.195 | -3.120 | **0.002** | 0.208 | 0.125 | 1.660 | 0.100 | -0.305 | 0.222 | -1.370 | 0.172 |
| Yr2010 | 0.525 | 0.076 | 6.920 | **0.000** | 0.134 | 0.095 | 1.410 | 0.162 | 0.662 | 0.087 | 7.610 | **0.000** |
| Yr2012 | 0.274 | 0.052 | 5.270 | **0.000** | 0.304 | 0.088 | 3.440 | **0.001** | 0.315 | 0.057 | 5.530 | **0.000** |
| Constant | -0.290 | 0.373 | -0.780 | 0.438 | 7.006 | 0.524 | 13.370 | 0.000 | 5.713 | 0.569 | 10.04 | 0.000 |

| | **Number of Branches (Ln)** | **AvgLoanBalance (Ln)** | **Credit Borrowers (Ln)** |
|---|---|---|---|
| F(7, 148) | 29.95 | 8.22 | 53.56 |
| p-value | 0.000 | 0.000 | 0.000 |
| $R^2$ | 0.605 | 0.081 | 0.709 |
| No. of clusters | 149 | 149 | 149 |
| Mean VIF | 1.40 | 1.40 | 1.40 |
| Highest VIF | 1.88 | 1.88 | 1.88 |

***Legend:*** *AvrgLoanBalance =LnGross outstanding loan/ Active borrower, Credit Borrowers = LnNumber of Credit borrowers of the MFI, Number of Branches = Ln Total number of MFI's branches, Recovery_ Rate= Loan repayment rate (%) by credit borrowers, CreditProgramAge= Age of credit program of MFI, Tot_net_savings= square root of total net savings of the MFI, Female_CEO (coded yes = 1, otherwise 0), Yr2010, Yr2012= Dummy taking value 1 for each year (2008, 2010, 2012), 0 otherwise.*

However, the picture is different for Bangladesh MFIs. The reason may be because 70 per cent of the total microfinance portfolio in Bangladesh is captured by three large MFIs (Grameen 37 percent, BRAC 29 percent, and ASA 21 percent) (Sinha, 2011). These three MFIs are also the oldest in the microfinance industry in Bangladesh. Hence, it is understandable that the age of MFIs (mature MFIs) will have a positive impact on MFIs' outreach compared to younger, small and medium MFIs.

Table 8.7 reports that for measuring the breadth of Outreach, Tot_net_savings (sqrt) is significantly associated with Number of Branches and Credit Borrowers (at $p < 0.011$ and $p < 0.016$ respectively), which is similar to the findings of Hartarska and Nadolnyak (2007). The authors found that better outreach is associated with a higher level of total net savings, suggesting an indirect impact of external regulation if the regulator's guidelines suggest deposit-taking activities. Kurgat (2009) also found a strong relationship between total net savings and MFI outreach with MFIs offering savings services and having higher total net savings tending to have higher outreach and higher loans compared to MFIs that do not offer savings services. However, it was also found that MFIs with higher net savings offer higher loans to medium- and higher-income groups and tend not to reach out to the poorer among socially excluded clients.

The presence of a female CEO is significantly and negatively associated with outreach measured as the Number of Branches (Ln) ($p < -0.002$), again consistent with prior studies. Strøm et al. (2016) found that MFIs with a female CEO reach poorer segments of clients and female clients to a greater extent than MFIs with a male CEO, whereas male CEOs tend to reach more clients (both male and female) than female CEOs. Likewise, Hartaska (2005) found a positive relationship between the presence of a female CEO and MFIs' ability to reach poorer clients (depth of outreach) but not in terms of breadth of outreach (number of clients), whereas male CEOs were found to reach more clients than female CEOs. Even though Mersland and Strøm (2009) claimed that female CEOs are better informed, they did not find any significant relationship between the presence of a female CEO and outreach. This current study also fails to find a significant relationship between Female_CEO and AvrgLoanBalance (Ln) or Credit Borrowers (Ln), but finds a negative relationship with the Number of Branches (Ln) ($p<0.002$), that is, the breadth of outreach. Interestingly, although both Credit Borrowers and the Number of Branches indicate the breadth of outreach, according to the results, it can be said that a female CEO is not only associated with a decrease in the breadth of outreach (Number of Branches) but also does not have any impact on the number of credit borrowers (Credit Borrowers).

Table 8.8 summarises the overall results of OLS regression analyses for testing hypotheses *H1b* and *H2a* using Models 2-4.

### Table 8.8: OLS robust regression (outreach) results

| | **Model 2** | | **Model 3** | | **Model 4** | |
|---|---|---|---|---|---|---|
| **Dependent variable** | **(Number of Branches)(Ln)** | | **(AvrgLoanBalance) (Ln)** | | **(Credit Borrowers)(Ln)** | |
| | P>\|t\| | Remarks on Hypotheses H1b & H2a | P>\|t\| | Remarks on Hypotheses H1b & H2a | P>\|t\| | Remarks on Hypotheses H1b & H2a |
| Registered_MFI **(H1b)** | 0.002 | **Accepted** | 0.000 | **Accepted** | 0.000 | **Accepted** |
| CreditProgramAge **(H2a)** | 0.001 | **Accepted** | 0.019 | **Accepted** | 0.000 | **Accepted** |
| Recovery Rate **(H2a)** | 0.157 | **Rejected** | 0.293 | **Rejected** | 0.381 | **Rejected** |
| Tot_net_savings (sqrt) **(H2a)** | 0.011 | **Accepted** | 0.634 | **Rejected** | 0.016 | **Accepted** |
| Female_CEO **(H2a)** | -0.002 | **Accepted** | 0.100 | **Rejected** | 0.172 | **Rejected** |
| Yr2010 | 0.000 | **Accepted** | 0.162 | **Rejected** | 0.000 | **Accepted** |
| Yr2012 | 0.000 | **Accepted** | 0.001 | **Accepted** | 0.000 | **Accepted** |

***Legend:*** *AvrgLoanBalance =LnGross outstanding loan/ Active borrower, Credit Borrowers = LnNumber of Credit borrowers of the MFI, Number of Branches = Ln Total number of MFI's branches, Recovery_ Rate= Loan repayment rate (%) by credit borrowers, CreditProgramAge= Age of credit program of MFI, Tot_net_savings= square root of total net savings of the MFI, Female_CEO (coded yes = 1, otherwise 0), Yr2010, Yr2012= Dummy taking value 1 for each year (2008, 2010, 2012), 0 otherwise.*

However, open-ended questions posed to executives of unregistered MFIs eliciting the reasons behind poor outreach revealed an interesting picture. One such MFI executive gave the rationale for the low outreach of his MFI, stating that:

> "*Many big MFIs have a better outreach than ours, but we serve the poorest of the poor. You will find that many of our clients were declined or rejected by big MFIs (registered) because of their (borrowers') previous bad record (loan repayment default). Some clients have overlapping issues as well. But still, we serve them because we believe that we are helping the poorest segments that are rejected by formal banks as well as MFIs (registered/commercial MFIs), which only look for their outreach and not the welfare of the poor clients. Also, there is ample evidence that large MFIs sometimes cause physical and mental harassment to their clients in collecting repayments. In many cases, clients of large MFIs committed suicide because they could not bear the pressure (for repayment) and insults from their MFIs. But you will not find a single instance from my MFI or any other small-scale MFI like this. This is because registered MFIs think that they have the licence for running their business to show MRA that they are sustainable with good capital and outreach. We believe this is a wrong ideology and against the spirit of microfinance*" (MFI No. 111).

It is, therefore, important to note that numbers (better outreach) do not always indicate good governance practices. Many scholars and researchers (Ahmmed 2003; Banerjee and Jackson, 2017; Maˆıtrot, 2018) have highlighted the gap between the double bottom line goals of microfinance and the systematically abusive and exploitative practices of MFIs. Also noted has been the unlawful and inappropriate pressure, violence, and abuse suffered by borrowers at the hands of loan collectors and members of their borrowing groups (Duggan, 2016), known as practice drift (by field level employees) or mission drift (by MFI head offices). Evidence from India and Bangladesh shows that a significant number of debt-ridden borrowers who killed themselves were members of market-leading microfinance companies with the highest outreach, e.g., SKS Microfinance Limited from Andhra Pradesh, India (Duggan, 2016) and Grameen Bank from Bangladesh (Hulme and Maitrot, 2014). Certainly, these market leaders have better outreach compared to medium- and small-scale MFIs, but the interview evidence presented above shows that good governance practices and concern for stakeholders need to be ensured at all levels (head office and branch level) of MFIs. The double bottom-line goal of microfinance can be achieved only by ensuring inclusion at all levels, including the poor, vulnerable population and not neglecting clients on the basis of prior negative financial records or other criteria. Microfinance practitioners should find a mechanism to include the poorest of the poor segment who are rejected by most financial institutions as well as commercial large-scale MFIs. At the field level, there should be strong monitoring and guidelines by MFIs to ensure no malpractice (e.g. push selling of loans, forceful loan renewals, no or little follow-up on use of loan funds, no standards for client section, abuse and violent client-retention and collection strategies) by MFI staff in dealings with clients.

#### 8.2.1.3 Financial Sustainability

The following section reports on testing of Hypotheses *H1c* (a relationship between MFI regulatory status [Registered/Unregistered] and MFI financial Sustainability) and *H2b* (the relationship between MFI financial Sustainability and MFI governance practices), which were developed in Chapter six. Hypotheses H1c and H2b, as discussed in Sections 6.5 and 6.6), are re-stated here for convenience as follows:

> ***H1c:*** *Regulated MFIs exhibit superior financial sustainability compared with unregulated MFIs.*
>
> ***H2b:*** *Voluntary governance practices of regulated MFIs are positively associated with their financial sustainability status, but this is not the case for unregulated MFIs.*

**Financial Sustainability**

Many prior studies (Cull et al., 2011; Dubreuil and Mirada, 2015; Islam et al., 2013; Hartarska, 2005) adopt OLS regression models to examine the financial sustainability of MFIs. In examining Financial Sustainability, Models 5–8 use Return on Assets (ROA), Operating Self-sufficiency (OSS), Portfolio Yield and Interest Rate Spread as separate dependent variables and Registered_MFI, Female_CEO, Recovery_Rate, CreditProgramAge, TotOutstanding_Loan (square root) and indicator controls for years as predictor variables. The Models are re-stated below for convenience.

$ROA_{it,}$ $(OSS_{it},$ $Portfolio\_Yield_{it},$ $Interest\_Rate\_Spread_{it}) = \beta_0 + \beta_1 Registered\_MFI_{it} + \beta_2 FemaleCEO_{it} + \beta_3\ Recovery\_Rate_{it} + \beta_4\ CreditProgramAge_{it} + \beta_5 TotOutstanding\_Loans_{it} + \beta_6\ Yr2010_{it} + \beta_7 Yr2012_{it} + \varepsilon_{it}$ .... *(Models 5–8)*

### 8.2.1.3.1 Descriptive statistics for MFI Financial Sustainability variables

Table 8.9 provides descriptive statistics for variables included in Models 5–8, including the mean, median, standard deviation, and minimum and maximum value for each variable and tests of difference between Regulated and Unregulated MFI observations. The table reveals that there is a significant difference between Registered and Unregistered MFIs' financial Sustainability.

Since the data for variables included in Models 5–8 are gathered from archival sources and do not rely on the memories of MFI executives, these models are estimated using longitudinal data. Observations for years 2008, 2010, and 2012 are included with respective sample sizes of 230 registered MFI-years (51 per cent), and 217 unregistered MFI-years (49 per cent), totalling 447 MFI-years). This sample is identical to that used to examine Outreach in the previous section.

The mean ROA from all sources for the full sample is 2.354, with a significant difference ($t = 14.448$, $p < 0.000$) between the means for Registered (3.582) and Unregistered MFIs (1.054). The mean OSS from all sources for the full sample is 77.925, with a significant difference ($t = 40.587$, $p < .000$) between the means for Registered (103.478) and Unregistered MFIs (50.842). The mean Portfolio_Yield from all sources for the full sample is 18.820, with a significant difference ($t = 55.864$, $p <0 .000$) between the means for Registered (22.059) and Unregistered MFIs (15.388). The mean Interest_Rate_Spread from all sources for the full sample is 15.700, with a significant difference ($t = 53.334$, $p < 0.000$) between the means for Registered (17.799) and Unregistered MFIs (13.475). The mean TotOutstanding_Loans from all sources for the full sample is 224,566,096, with a significant difference ($t = 2.798$, $p <0 .005$) between the means for Registered (412,756,905.02) and Unregistered MFIs (25,101,183). Descriptive statistics for the independent variables (Recovery_Rrate, CreditProgramAge, Female_CEO, Yr2008, Yr2010, and Yr2012) are identical to those for the Outreach analysis and were discussed in Section 8.2.1.2.1.

## Table 8.9: Descriptive statistics (Financial Sustainability)

| Sustainability multiple measures | All MFIs, N = 447 MFI-years | Registered MFIs, N = 230 MFI-years (51%) | | | | Unregistered MFIs, N = 217 MFI-years (49%) | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Mean | Mean | Std. Dev. | Min. | Max. | Mean | Std. Dev. | Min. | Max. | t-test | p-value |
| ROA | 2.354 | 3.582 | 4.166 | -24.95 | 24.670 | 1.054 | 1.674 | -5.09 | 11.56 | 14.448 | 0.000 |
| OSS | 77.925 | 103.478 | 26.807 | 14.33 | 192.990 | 50.842 | 34.759 | 5.87 | 139.59 | 40.587 | 0.000 |
| Portfolio_Yield | 18.820 | 22.059 | 6.220 | 3.60 | 38.470 | 15.388 | 6.382 | 5.78 | 31.72 | 55.864 | 0.000 |
| Interest_Rrate_Spread | 15.700 | 17.799 | 5.595 | 3.56 | 32.230 | 13.475 | 6.093 | 4.11 | 29.29 | 53.334 | 0.000 |
| **Continuous variables** | | | | | | | | | | | |
| Recovery_Rate | 94.700 | 97.55 | 5.247 | 41 | 100 | 91.67 | 12.878 | 0 | 100 | 197.173 | 0.000 |
| CreditProgramAge | 14.090 | 17.55 | 5.995 | 5 | 40 | 10.43 | 5.688 | 0 | 34 | 43.563 | 0.000 |
| TotOutstanding_Loans | 224,566,096 | 412,756,905.02 | 2,342,450,010.120 | 101,717 | 24,907,280,000 | 25,101,183 | 219,924,418 | 11,568 | 2,735,730,000 | 2.798 | 0.005 |
| **Dichotomous variables** | | | | | | | | | | **Chi²** | **p-value** |
| Female_CEO | | | 21.5% | | | | 78.5% | | | 12.588 | 0.000 |
| Yr2008 | | | 29.1% | | | | 35.8% | | | | |
| Yr2010 | | | 33.5% | | | | 33.2% | | | | |
| Yr2012 | | | 37.4% | | | | 31% | | | | |

**Legend:** ROA=Return On Assets (After tax profits/ Starting (or period average) assets), OSS=Operational Self Sufficiency (Operating Revenue/(Financial Expense + loan-loss provision expense + operating expense)), Portfolio_Yield = Cash financial revenue from loan portfolio/ Average gross loan, Interest rate spread= Portfolio Yield – Financial cost ratio Recovery_Rate= Loan repayment rate (%) by credit borrowers, CreditProgramAge= Age of credit program of MFI, TotOutstanding_Loans= Total outstanding loan of MFI, FemaleCEO (coded yes = 1, otherwise 0), Yr2008,Yr2010= Dummy taking value 1 for each year (2008, 2010, 2012), 0 otherwise.

#### 8.2.1.3.2 Pearson's correlations for MFI Financial Sustainability variables

Table 8.10 reports the Pearson's correlation matrix for the 447 MFI-year observations across years 2008, 2010 and 2012 for the independent variables. Significant positive correlations are reported between CreditProgramAge (r = 0.520), Recovery _Rate (r = 0.290), TotOutstanding_Loans (r = 0.342), Female_CEO (r = -0.168), Yr2010 (r = -0.092), and Yr2012 (r = 0.003), and MFIs' regulatory status (Registered_MFI). TotOutstanding_Loans is significantly and negatively correlated with Female_CEO (r = --0.072), Yr2010 (r = -0.052), and Yr2012 (r = -0.010) and positively correlated with Recovery_Rate (r = 0.121), CreditProgramAge (r = 0.550). Other variables (Female_CEO, Recovery_Rate, CreditProgramAge, Yr2010, and Yr2012) are discussed in Section 8.2.1.2.1. The highest value is 0.550, so multicollinearity is not likely to be an issue, but VIFs are examined after each regression to be sure.

**Table 8.10: Pearson's correlations (Financial Sustainability) (N = 447)**

| Financial Sustainability independent variables correlation matrix | | | | | | |
|---|---|---|---|---|---|---|
| **Independent variables** | **Registered/unregistered** | **Female_CEO** | **Recovery _Rate** | **CreditProgramAge** | **TotOutstanding_Loans** | **Yr2010** |
| Female_CEO | -0.168** | | | | | |
| Recovery_Rate | 0.290** | 0.016 | | | | |
| CreditProgramAge | 0.520** | -0.003 | 0.204** | | | |
| TotOutstanding_Loans | 0.342** | -0.072 | 0.121* | 0.550** | | |
| Yr2010 | -0.092 | -0.012 | 0.024 | -0.207** | -0.052 | |
| Yr2012 | 0.003 | -0.012 | 0.077* | 0.000 | -0.010 | -0.500** |
| ** Correlation is significant at the 0.01 level (2-tailed). * Correlation is significant at the 0.05 level (2-tailed). | | | | | | |

Legend: ROA=Return On Assets (After tax profits/ Starting (or period average) assets), OSS=Operational Self Sufficiency (Operating Revenue/(Financial Expense + loan-loss provision expense + operating expense)), Portfolio_Yield = Cash financial revenue from loan portfolio/ Average gross loan, Interest rate spread= Portfolio Yield – Financial cost ratio Recovery_Rate= Loan repayment rate (%) by credit borrowers, CreditProgramAge= Age of credit program of MFI, TotOutstanding_Loans= Total outstanding loan of MFI, FemaleCEO (coded yes = 1, otherwise 0), Yr2008,Yr2010= Dummy taking value 1 for each year (2008, 2010, 2012), 0 otherwise.

#### 8.2.1.3.3 Multivariate analysis for MFIs' Financial Sustainability

Multiple OLS regression for testing Hypotheses *H1c* (a relationship between MFI regulatory status [Registered/Unregistered] and MFI financial Sustainability) and *H2b* (the relationship between MFI financial Sustainability and governance practices) are highlighted in the following section.

Table 8.11 shows that $R^2$s for the four dependent variables (ROA/ OSS/ Portfolio_Yield/ Interest_Rate_Spread) is 17.9 per cent, 45.2 per cent, 23.1 per cent, and 13.3 per cent respectively. F statistics for each of the four Models are significant. Since all VIF and tolerance values are less than 2.6 and greater than 0.39 respectively, there is no multicollinearity issue with the independent variables included in Models 5–8.

Table 8.11 reports that except for ROA ($p < 0.097$), the regulatory status of MFIs (Registered_MFI) is significantly associated with all three financial sustainability measures, OSS, Portfolio_Yield, and Interest_Rate_Spread ($p < 0.000$; $p < 0.000$; $p < 0.000$) respectively. Previous studies (discussed subsequently) also support these results.

Several researchers use ROA for measuring the financial sustainability of MFIs when analysing the relationship with other variables (Bakker et al., 2014; Barry and Tacneng, 2014; Hartarska, 2005; Hartarska and Nadolnyak, 2007; Mersland and Strøm, 2009; Servin et al., 2012). Consistent with the findings, Cull et al. (2011) found no significant relationship between supervisory variables (regulation) and the adjusted ROA of MFIs. Regulation is negative and significant for commercial MFIs (for-profit organisations such as commercial banks), but it has no association with non-profit organisations. Chikalipah (2017) also found the same result using a 'deposit-taking status' variable. If we consider deposit-taking status as the regulatory status of MFIs (as only MFIs registered with the MRA are permitted to take deposits from clients), this current study finds no significant relationship between ROA and regulation of MFIs. However, Pati (2015) found that regulation is negatively associated with ROA and MFIs' profitability, which is consistent with Estape-Dubreuil and Estape-Dubreuil's (2015) findings; that is, regulation has no impact on the social performance of MFIs but has a significant effect on ROA and caps on interest rates.

For the dependent variable OSS, consistent with the current findings, Nyanzu and Peprah (2016) also found that regulation is positively associated with MFIs' OSS. Staschen (2010) explains this by pointing out that because regulation increases the costs of MFIs, regulated MFIs may end up marginalising the poor as a way of overcoming their costs. Ndambu's (2011) findings also support the current results and show that regulatory status (external regulation) of MFIs is positively associated with OSS. However, a higher official supervisory power (internal regulation) also has a positive effect on MFIs' financial sustainability. Hartarska and Nadolnyak (2007) found that although the regulatory environment does not directly impact OSS, it has an indirect effect on MFIs' performance. Barry and Tacneng (2011) also found that regulation enhances MFIs' efficiency and profitability (OSS). However, Muwamba (2012) found that only the Asia Pacific and East Asia region showed a statistically significant relationship between regulation and OSS, but this was not the case in other parts of the globe (Africa, Eastern Europe, and Central Asia, Latin America and the Caribbean, Middle East, North Africa, and South Asia).

## Table 8.11: Robust regression (Financial Sustainability) (ROA, OSS, Portfolio_Yield, Interest_Rate_Spread)

| | Model 5 | | | | Model 6 | | | | Model 7 | | | | Model 8 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Dependent Variable** | **ROA** | | | | **OSS** | | | | **Portfolio_Yield** | | | | **Interest_Rate_Spread** | | | |
| | **Coef.** | **Robust Std. Err** | **t** | **P>\|t\|** | **Coef.** | **Robust Std. Err** | **t** | **P>\|t\|** | **Coef.** | **Robust Std. Err** | **t** | **P>\|t\|** | **Coef.** | **Robust Std. Err** | **t** | **P>\|t\|** |
| **Registered_MFI** | 1.486 | 0.890 | 1.670 | 0.097 | 43.257 | 5.874 | 7.360 | 0.000 | 6.016 | 1.032 | 5.830 | 0.000 | 3.996 | 0.994 | 4.020 | 0.000 |
| **Female_CEO** | -1.401 | 0.930 | -1.510 | 0.134 | 3.993 | 5.995 | 0.670 | 0.506 | 0.384 | 1.136 | 0.340 | 0.736 | -0.494 | 1.139 | -0.430 | 0.665 |
| **Recovery Rate** | 0.027 | 0.010 | 2.540 | 0.012 | 0.214 | 0.178 | 1.200 | 0.233 | 0.024 | 0.050 | 0.480 | 0.630 | 0.024 | 0.037 | 0.650 | 0.518 |
| **CreditProgramAge** | 1.221 | 0.679 | 1.800 | 0.074 | 13.340 | 5.556 | 2.400 | 0.018 | 0.377 | 1.004 | 0.380 | 0.707 | 0.013 | 0.981 | 0.010 | 0.989 |
| **TotOutstanding_Loans** | 0.000 | 0.000 | 0.340 | 0.737 | 0.000 | 0.000 | 1.560 | 0.122 | 0.000 | 0.000 | 2.670 | 0.008 | 0.000 | 0.000 | 1.230 | 0.220 |
| **Yr2010** | -0.116 | 0.236 | -0.490 | 0.623 | 1.628 | 2.150 | 0.760 | 0.450 | 0.539 | 0.452 | 1.190 | 0.235 | 0.639 | 0.410 | 1.560 | 0.122 |
| **Yr2012** | -0.183 | 0.225 | -0.810 | 0.418 | -2.158 | 1.835 | -1.180 | 0.241 | 0.881 | 0.429 | 2.050 | 0.042 | 1.410 | 0.411 | 3.420 | 0.001 |
| **Constant** | -1.391 | 0.950 | -1.460 | 0.145 | 25.052 | 16.935 | 1.480 | 0.141 | 12.349 | 4.622 | 2.670 | 0.008 | 10.647 | 3.482 | 3.060 | 0.003 |
| **F(7, 148)** | 20.32 | | | | 24.04 | | | | 11.94 | | | | 7.52 | | | |
| **p-value** | 0.000 | | | | 0.000 | | | | 0.000 | | | | 0.000 | | | |
| **R square** | 0.179 | | | | 0.452 | | | | 0.231 | | | | 0.133 | | | |
| **N** | 447 | | | | 447 | | | | 447 | | | | 447 | | | |
| **No. of clusters** | 149 | | | | 149 | | | | 149 | | | | 149 | | | |
| **Mean VIF** | 1.34 | | | | 1.34 | | | | 1.34 | | | | 1.34 | | | |
| **Highest VIF** | 1.68 | | | | 1.68 | | | | 1.68 | | | | 1.68 | | | |

Legend: ROA=Return On Assets (After tax profits/ Starting (or period average) assets), OSS=Operational Self Sufficiency (Operating Revenue/(Financial Expense + loan-loss provision expense + operating expense)), Portfolio_Yield = Cash financial revenue from loan portfolio/ Average gross loan, Interest rate spread= Portfolio Yield – Financial cost ratio Recovery_Rate= Loan repayment rate (%) by credit borrowers, CreditProgramAge= Age of credit program of MFI, TotOutstanding_Loans= Total outstanding loan of MFI, FemaleCEO (coded yes = 1, otherwise 0), Yr2008,Yr2010= Dummy taking value 1 for each year (2008, 2010, 2012), 0 otherwise.

There is little research that investigates the relationship between MFIs' regulatory status (Registered_MFI) and portfolio yield (Portfolio_Yield) or interest rate spread (Interest_Rate_Spread). Most studies focus on ROA and OSS. Only one study, that by Estape-Dubreuil and Estape-Dubreuil (2015) found that regulated MFIs exhibit reduced portfolio yield only when regulation is associated with caps on the interest rate, but the study did not consider other aspects of regulation, such as capital adequacy or age of the credit program.

A summary of results from the OLS regression analyses for testing Hypotheses H1c and H2b is presented in Table 8.12.

**Table 8.12: OLS robust regression (Financial Sustainability) results**

| | Model 5 | | Model 6 | | Model 7 | | Model 8 | |
|---|---|---|---|---|---|---|---|---|
| **Dependent variable** | **ROA** | | **OSS** | | **Portfolio_Yield** | | **Interest_Rate_Spread** | |
| | P>\|t\| | Remarks on hypotheses H1c & H2b | P>\|t\| | Remarks on hypotheses H1c & H2ba | P>\|t\| | Remarks on hypotheses H1c & H2b | P>\|t\| | Remarks on hypotheses H1c & H2b |
| **Registered_MFI (H1c)** | 0.097 | Rejected | 0.000 | Accepted | 0.000 | Accepted | 0.000 | Accepted |
| **Female_CEO (H2b)** | 0.134 | Rejected | 0.506 | Rejected | 0.736 | Rejected | 0.665 | Rejected |
| **Recovery Rate (H2b)** | 0.012 | Accepted | 0.233 | Rejected | 0.630 | Rejected | 0.518 | Rejected |
| **CreditProgramAge (H2b)** | 0.074 | Rejected | 0.018 | Accepted | 0.707 | Rejected | 0.989 | Rejected |
| **TotOutstanding_Loans (H2b)** | 0.737 | Rejected | 0.122 | Rejected | 0.008 | Accepted | 0.220 | Rejected |
| **Yr2010** | 0.623 | Rejected | 0.450 | Rejected | 0.235 | Rejected | 0.122 | Rejected |
| **Yr2012** | 0.418 | Rejected | 0.241 | Rejected | 0.042 | Accepted | 0.001 | Accepted |

Legend: ROA=Return On Assets (After tax profits/ Starting (or period average) assets), OSS=Operational Self Sufficiency (Operating Revenue/(Financial Expense + loan-loss provision expense + operating expense)), Portfolio_Yield = Cash financial revenue from loan portfolio/ Average gross loan, Interest rate spread= Portfolio Yield – Financial cost ratio Recovery_Rate= Loan repayment rate (%) by credit borrowers, CreditProgramAge= Age of credit program of MFI, TotOutstanding_Loans= Total outstanding loan of MFI, FemaleCEO (coded yes = 1, otherwise 0), Yr2008,Yr2010= Dummy taking value 1 for each year (2008, 2010, 2012), 0 otherwise.

However, in his response to open-ended questions regarding microfinance regulation and MFIs' financial sustainability, an executive of an unregistered MFI revealed some interesting insights about sustainability issues and the rationale for not being registered with the MRA. According to this executive of an unregulated MFI,

> "*Regulation is good for large- or medium-scale MFIs but not for small MFIs like us because it increases administrative costs; also, we need to pay for external audits by CA firms suggested by MRA, which is expensive. The only benefit of being regulated is to get loans from the bank and access the savings of clients for our business, which is not necessary for a small-scale organisation like us because we have small customers and we don't need a large amount to run our business. Even, sometimes small villages like us, have limited customers where it is hard to maintain the capital adequacy required for getting registration from MRA"* (MFI No. 106).

This interview evidence reveals how regulation impacts the performance (sustainability) of small, medium, and large organisations, because the costs of enforcing regulatory policies and of designing mechanisms for meeting the specific challenges of MFIs are substantial. A study conducted by Steel and Andah (2003) on Ghana's microfinance industry found that regulation of the microfinance industry was costly compared to the potential benefits it might have had on the financial system. Theodore and Loubiere (2002) also argued that in some Latin American countries, benefits may exceed the cost of microfinance regulation. In a study of 25 MFIs in Ghana, Ayayi and Peprah (2018) found that microfinance regulation increases administrative and business costs for MFIs. As a result, MFIs tend to pass this cost to their clients by increasing the interest rate.

While it is true that there are examples of successful microfinance regulation (e.g., ASFI-Authority of Supervision of the Financial System in Bolivia, Finansol in Colombia) (Hartarska and Nadolnyak, 2007), policy recommendations based on these examples may not be appropriate universally. A successful transformation from unregulated to regulated MFIs and the implementation of rules, policies, and regulatory norms is likely to depend upon the socio-economic environment and circumstances of the individual country or even individual location within the same country. Another executive of an unregulated MFI gave his rationale for cancelling registration with the MRA, stating that:

> "*We stopped sending our report to MRA and getting an external audit by an MRA-recommended CA firm, also we lost our licence because the requirement for minimum capital adequacy drifted our mission from serving poorer clients to wealthier borrowers. If we serve wealthier borrowers with bigger loans, we can meet the target, but poorer borrowers cannot repay bigger loans and do not have large-scale businesses. So, dealing with small loans and poorer customers is more important than having registration with MRA and helping the wealthier segment of borrowers"* (MFI No. 23).

Mission drift is a crucial issue for MFIs. According to MRA guidelines, minimum capital adequacy is a mandatory precondition for receipt of a licence. But there is a possibility that maintaining a minimum capital and securing sustainability by focusing on maximising profit can cause mission drift for MFIs. Another reason for mission drift could be excessive dependence on wealthier borrowers, which is sometimes motivated by profit-oriented donors and the desire to attract more capital from these donors (Ghosh and Tassel, 2008). Cull et al. (2009) found that mission drift comes from the recent trend towards commercialisation in microfinance. Given this, it is crucial for donors and regulators to understand the risk of an adverse relationship between mission drift and the profit-maximizing goal of MFIs.

### 8.2.2 Client perspective

Performance of MFIs (in regard to their clients) is tested using two regression models to address three hypotheses in the area of MFI regulatory status and clients' awareness (*H3a*), regulatory status and clients' financial sustainability (*H3b*), and clients' awareness and financial sustainability (*H3c*). These hypotheses are underpinned theoretically by *responsive regulation theory* and *stakeholder theory* (refer Sections 4.3.3 and 4.4.5) in a microfinance context. Hypotheses H3a, H3b, and H3c and regression models developed in Chapters six and seven respectively can be recalled as follows:

***H3a:*** *Clients of regulated MFIs are associated with higher awareness of information about loans and savings compared with clients of unregulated MFIs.*

***H3b:*** *Clients of regulated MFIs are associated with higher financial status than clients of unregulated MFIs.*

***H3c:*** *Clients with higher awareness of information about loans and savings are associated with higher financial status than clients with lower awareness.*

Models 9-10 are used to test H3a-H3c

$$Client\ Awareness_{it} = \beta_0 + \beta_1 Regulated_{it} + \beta_2 Client\_Business\_C21_{it} + \beta_3 Education\_C7_{it} + \varepsilon_{it} \qquad (Model\ 9)$$

$$Client\ Financial\ Status_{it} = \beta_0 + \beta_1 (Client\ Awareness_{it}) + \beta_2 Regulated_{it} + \beta_3 Client\_Age\_C3_{it} + \beta_4 Married\_C4_{it} + \beta_5 Children\_C6_{it} + \beta_6 Client\_Business\_C21_{it} + \beta_7 Education\_C7_{it} + \varepsilon_{it} \qquad (Model\ 10)$$

#### 8.2.2.1 Factor analysis for MFI Client variables

Table 8.13 presents the rotated (Oblimin) principal components' factor analysis loadings for responses to several questions (Table 7.4) responded to by MFI clients related to knowledge about their savings and loan(s) and awareness of consumer protection issues associated with a financial institution. Only observations for which all data is present to meet the requirements of Models 9 and 10 are included in the factor analysis (N = 342). The aim of gathering client data was to interview at least two clients per MFI included in the analysis at the organisational level earlier in this chapter.  Of the 342 clients from whom data are gathered, 200 or 58.5 per cent are from Registered MFIs and 142 (41.5 per cent) are from Unregistered MFIs.

The scree plot and loadings suggested three factors that were deemed to represent Personalised Information about Savings/Loan basics, General Information about Products and Loans, and

Knowledge of Access to Savings. Together these three factors explain over 73 per cent of the variance, with 47 per cent for Factor 1, 14 per cent for Factor 2, and 11 per cent for Factor 3.

For the first theme, 'Personalised information about savings/loan basics', the items relate to the clients' knowledge about personal financial information, such as their loans/savings. This reflects on the thematic areas of knowledge and awareness about their personal financial information and their rights and responsibilities to seek information from their financial service provider. Client responses to questions relevant to this factor consisted of 'interest charged on their loans and savings account by respective MFIs', 'access to information from MFIs during business hours', 'having passbooks linked with their accounts', and providing receipts to clients for financial transactions by respective MFIs.

**Table 8.13: Factor analysis (N = 342) rotated component matrix (Client)**

| | **Component** | | |
|---|---|---|---|
| | **Personalised info. about savings/loan basics** | **General info. about products and loans** | **Knowledge of access to savings** |
| Knowledge about the service charge | .969 | | |
| Knowledge about interest rate | .969 | | |
| Knowledge about savings interest | .969 | | |
| Loan information from branch | .898 | | |
| Receive promissory note | .825 | | |
| Knowledge about saving | .766 | | |
| Maintain loan passbook | .572 | | |
| Knowledge terms of loans | | 0.887 | |
| Knowledge loan type | | 0.876 | |
| Knowledge insurance services | | 0.698 | |
| Knowledge withdrawing savings | | | 0.850 |
| Knowledge voluntary savings | | | 0.798 |
| Extraction method: Principal component analysis. Rotation method: Oblimin with Kaiser normalization. | | | |

In the second theme, 'General Information about Products and Loans', the items relate to client knowledge about their financial service provider. The better they know their financial service provider, the more likely clients are aware of their rights and their own financial status. The questions mostly focused on general information about their MFIs, e.g., the types of loan available, fee premium, settlements of claims of their insurance (if any), and whether the loan officer explained the terms and conditions of their loans. For the third theme, 'Knowledge of access to savings', the items relate to the clients' knowledge about their rights to access their savings and their knowledge of the voluntary nature of savings.

#### 8.2.2.2 Descriptive statistics MFI Clients

Table 8.14a–c report the descriptive statistics for responses by clients to questions (refer Table 7.4) about consumer awareness categorised by the three factors revealed by the principal components analysis and reported in Table 8.13. Table 8.14a reports the descriptive statistics for the client's knowledge about personalised information on their savings/loan portfolio. It reveals that there is a significant difference between clients of Registered MFIs and those of Unregistered MFIs in terms of their knowledge of their savings/loan portfolios. None of the clients of Unregistered MFIs had any knowledge of the interest rate on their outstanding loan or the interest earned on their savings compared with the 100 per cent of members of Registered MFIs who were aware of interest rates on their accounts. Overall, this difference is significant ($chi^2 = 386.00$, $p < 0.001$).

The difference for responses to the question about maintaining a passbook provided by the MFI is also significant. For clients of Registered MFIs, 89.6 percent responded positively, but this percentage was only 42.3 for clients of Unregistered MFIs ($chi^2 = 97.741$, $p < 0.001$). The difference for responses to a question about receipt of a copy of promissory notes is also significant, with 71.2 per cent of clients of Registered MFIs and none of the clients of Unregistered MFIs clients responding positively ($chi^2 = 203.568$, $p < 0.001$). Table 8.14a also reports that there is a significant difference between clients of Registered and Unregistered MFIs in terms of provision of information about their loan and savings any working day, with 95.8 per cent of the former group and only 6.9 per cent of the latter group responding positively ($chi^2 = 306.83$, $p < 0.001$).

**Table 8.14a: Personalised information about savings/loan basic**

| Variables | Question (client) | Combined | Registered MFIs | Unregistered MFIs | Chi² | p-value |
|---|---|---|---|---|---|---|
| Knowledge interest rate | Do you know the interest rate (per month) on your loan and savings charged by and paid by your MFI? | 212 (54.9%) | 212 (100%) | 0 (0.0%) | 386.00 | <0.001 |
| Maintain loan passbook | Do you maintain any loan or savings passbook given by your MFI? | 261 (68.7%) | 190 (89.6%) | 71 (42.3%) | 97.741 | <0.001 |
| Receive promissory note | Do loan officers/lenders give you a copy of the promissory note for your records? | 151 (39.1%) | 151 (71.2%) | 0 (0.0%) | 203.568 | <0.001 |
| Loan info. from branch | Loan and savings information from your branch office any working day? | 215 (55.6%) | 203 (95.8%) | 12 (6.9%) | 306.830 | <0.001 |
| Knowledge about saving | Do you have savings with your MFI? | 267 (69.2%) | 210 (99.5%) | 57 (32.6%) | 201.009 | <0.001 |
| Knowledge service charge | Do you know what your service charge is? | 212 (58.1%) | 212 (100%) | 0 (0.0%) | 365.000 | <0.001 |
| Knowledge savings interest | Do you earn any interest on your savings? | 212 (54.8%) | 212 (100%) | 0 (0.0%) | 387.000 | <0.001 |

Responses to questions in relation to knowledge about their (i) savings, (ii) service charges, and (iii) earning interest on their savings also display significant differences between clients of Registered and Unregistered MFIs. For savings, 99.5 per cent of clients of Registered MFIs and 32.6 per cent of clients of Unregistered MFIs responded positively ($chi^2 = 201.009$, $p < 0.001$); for service charges, 100 per cent of clients of Registered MFIs and no clients of Unregistered MFIs responded positively ($chi^2 = 365$, $p < 0.001$), and for interest on savings, 100 per cent of clients of Registered MFIs and no clients of Unregistered MFIs responded positively ($chi^2 = 387$, $p < 0.001$), respectively.

**Table 8.14b: General Information about Products and Loan**

| Variables | Question (client) | Combined | Registered MFIs | Unregistered MFIs | Chi² | p-value |
|---|---|---|---|---|---|---|
| Knowledge loan type | Do you know the types of loans and other facilities available from your MFI? | 147 (38.2%) | 105 (49.5%) | 42 (24.3%) | 25.734 | <0.001 |
| Knowledge terms of loans | Did loan officers/lenders explain to you the terms and conditions of the loan? | 121 (31.3%) | 106 (50%) | 15 (8.6%) | 76.563 | <0.001 |
| Knowledge insurance services | Do you know about the fees, premium, and settlement of the claim of your insurance service? | 66 (17.1%) | 58 (27.4%) | 8 (4.6%) | 35.189 | <0.001 |

Table 8.14b reports descriptive statistics for responses indicating clients' grasp of general information about products and loans and insurance services. With respect to loans, the table shows a significant difference between clients of Registered MFIs and Unregistered MFIs for two aspects: one, knowledge about the types of loans and other facilities available from their MFI (49.5 per cent for Registered and 24.3 per cent for Unregistered, $chi^2 = 25.734$, $p < 0.001$) and, two, information about the terms and conditions (50 per cent for Registered and 8.6 per cent for Unregistered, $chi^2 = 76.536$, $p < 0.001$). In terms of knowledge about the fees, premium, and settlement of claims under insurance services, 27.4 per cent of clients of Registered MFIs and 4.6 per cent of clients of Unregistered MFIs responded positively, a difference that, although disturbingly low for both, is significantly different ($chi^2 = 35.189$, $p < 0.001$).

**Table 8.14c: Knowledge of access to savings**

| Variables | Question (Client) | Combin-ed | Regist-ered MFIs | Unregist-ered MFIs | Chi² | p-value |
|---|---|---|---|---|---|---|
| Knowledge withdrawing savings | Can you withdraw your savings (partially or fully) from your MFI (if your loan is cleared)? | 377 (97.4%) | 212 (100%) | 165 (94.3%) | 12.436 | <0.001 |
| Knowledge voluntary savings | Do you have any other voluntary savings in your MFI? | 347 (89.9%) | 191 (90.5%) | 156 (89.1%) | 0.2 | <0.735 |

Table 8.14c reports descriptive statistics for responses to questions related to clients' knowledge about access to their savings with their MFI. The table shows a significant difference between clients of Registered and Unregistered MFIs for this question. For knowledge about withdrawing savings from their MFI, 100 per cent clients of Registered MFIs and 94.3 per cent of clients of Unregistered MFIs responded positively ($chi^2 = 12.436$, $p < 0.001$). However, there is no significant difference between clients of Registered and Unregistered MFIs in relation to their knowledge of having any other voluntary savings with their MFIs (90.5 per cent for registered MFIs and 89.1 per cent for unregistered MFIs [$chi^2 = 0.2$, $p = 0.735$]).

Table 8.15 reports descriptive statistics about the factors reported above and other MFI client characteristics and tests of difference based on the regulatory status of their MFI for each independent variable. The mean annual income from all sources for the sample of 342 clients is 42,611 taka, with a significant difference ($t = 14.958$, $p < 0.000$) between the mean for the 200 clients of Registered MFIs (53 724 taka) and the mean for 142 clients of unregistered MFIs (27,592 taka). In terms of the factors, the factor scores for Factor 1 'Personal info. About savings/ loan basics for the full sample is -0.018, with a significant difference ($t = 72.152$, $p < 0.000$) between the mean for clients of Registered MFIs (0.801) and that for clients of Unregistered MFIs (-1.171). For Factor 2 'General information about products and loans', the mean for the full sample is -0.037, with a significant difference ($t = 7.473$, $p < 0.000$) between the mean for the clients of Registered MFIs (0.275) and that for clients of Unregistered MFIs (-0.475). For Factor 3 'Knowledge of access to savings for the full sample, the mean is -0.004, with an insignificant difference between the means for clients of Registered and Unregistered MFIs.

The mean age of clients is 39.9 years, with no significant difference between clients of Registered versus Unregistered MFIs. Clients' mean number of children is 4.5 overall, with a mean of 3.7 for clients of registered MFIs and 5.7 for unregistered MFIs, a difference which is significant ($t = 7.814$, $p < 0.000$).

For the dichotomous variables, overall 59 per cent of clients are married, with a significant difference in this number for clients of Registered (50 per cent) and Unregistered (70 per cent) MFIs ($chi^2 = 11.399$, $p < 0.01$). In terms of microenterprise ownership, 66 per cent of the full sample owns a microenterprise, with 83 per cent owned by clients of Registered MFIs and 42 per cent by clients of Unregistered MFIs, a difference that is significant ($chi^2 = 61.622$, $p < 0.000$). In terms of education, there is a significant difference ($chi^2 = 66.052$, $p < 0.000$) between the clients of the two types of MFIs, with 77 per cent of clients of Registered MFIs and only 33 per cent of clients of Unregistered MFIs having some schooling.

## Table 8.15: Descriptive statistics MFI Clients

| | All MFIs | Registered MFIs | | | | Unregistered MFIs | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | N = 342 | N = 200 (58.5%) | | | | N = 142 (41.5%) | | | | | |
| **Continuous variables** | Mean | Mean | Std. Dev. | Min. | Max. | Mean | Std. Dev. | Min. | Max. | t-test | p-value |
| Annual income (Taka) | 42611 | 53,724 | 18,611 | 5,400 | 114,000 | 27,592 | 11,441 | 6,000 | 78,000 | -14.598 | .000 |
| Fac 1: Personalised info. about savings/loan basics | -0.018 | 0.801 | 0.271 | 0.170 | 1.010 | -1.171 | 0.210 | -1.482 | -0.477 | -72.152 | .000 |
| Fac2: General info. about products and loans | -0.037 | 0.275 | 1.152 | -0.910 | 2.058 | -0.475 | 0.380 | -0.834 | 0.170 | -7.473 | .000 |
| Fac3: Knowledge of access to savings | -0.004 | 0.055 | 0.557 | -1.665 | 0.673 | -0.087 | 1.423 | -5.967 | 0.685 | -1.283 | .201 |
| C3_Age | 39.892 | 38.955 | 13.967 | 16.000 | 86.000 | 41.211 | 11.966 | 21.000 | 79.000 | 1.561 | .120 |
| C6_No. Children | 4.538 | 3.715 | 2.405 | 0.000 | 13.000 | 5.697 | 2.173 | 0.000 | 10.000 | 7.814 | .000 |
| | | | | | | | | | | | |
| **Dichotomous variables** | | | | | | | | | | **Chi²** | **p-value** |
| C4_Married | 0.591 | 0.515 | 0.501 | 0.000 | 1.000 | 0.697 | 0.461 | 0.000 | 1.000 | 11.399 | .001 |
| C21_Microenterprise | 0.655 | 0.825 | 0.381 | 0.000 | 1.000 | 0.415 | 0.495 | 0.000 | 1.000 | 61.622 | .000 |
| C7_Education | 0.588 | 0.770 | 0.422 | 0.000 | 1.000 | 0.331 | 0.472 | 0.000 | 1.000 | 66.052 | .000 |

**Legend:** Fac1=Factor 1 score from factor analysis- Personalised info about savings/loan basics, Fac2-=Factor 2 score from factor analysis- General Info. about products and loans, Fac3-=Factor 3 score from factor analysis- Knowledge of access to savings, Regulated =Client membership of Registered or Unregistered MFI (coded yes =1, otherwise 0), Age=Client age, Children=-Self-declared number of clients' children, Married=married =1, otherwise 0, Microenterprise=Self-declared client microenterprise exists (coded yes =1, otherwise 0), Education=Client has some education (coded yes =1, otherwise 0).

#### 8.2.2.3 Pearson's correlations (MFI Clients)

Table 8.16 reports the Pearson's correlations for the 342 client observations for registered and unregistered MFI members' client awareness, knowledge about their rights, loans, interest rate, savings, and overall knowledge about their MFIs, as well as income, age, number of children, and education level. There are significant positive correlations between clients' awareness measured as the scores for the three factors ($r = 0.969$, $r = .376$, $r = .069$ respectively) and the regulatory status (Registered/Unregistered) of their MFIs. It is important to note that Factor 1, 'Personalised information about savings/ loan basics', is almost perfectly correlated ($r=0.969$) with Registered MFI status, and it is likely that this lack of variability will cause problems with the running of the regressions. None of the correlations between the three factors themselves is higher than 0.232.

Client income is significantly correlated with the three factors ($r = .619$, $r = .294$, and $r = .177$) respectively and also with MFI status ($r = .638$). Strong positive correlations are noted between MFI status and client children number, education level, and ownership of a microenterprise, but all are below 0.500 and should not present a multicollinearity concern. Client age, as is to be expected, is highly correlated ($r = .660$) with the number of children. None of the other correlations between the independent variables are higher than 0.400 and so should not present multicollinearity concerns.

**Table 8.16: Pearson's correlations (N = 342) MFI Clients**

| Variables | LnIncome | Fac 1 | Fac 2 | Fac 3 | Registered | Age | Married | Children | Education |
|---|---|---|---|---|---|---|---|---|---|
| Fac 1 | 0.619*** | | | | | | | | |
| Fac 2 | 0.294*** | 0.232*** | | | | | | | |
| Fac 3 | 0.177** | 0.089 | -0.006 | | | | | | |
| Regulated | 0.638*** | 0.969*** | 0.376*** | 0.069*** | | | | | |
| Age | -0.057 | -0.010 | -0.251*** | 0.084 | -0.084 | | | | |
| Married | -0.036 | -0.217*** | 0.062 | 0.050 | -0.183** | -0.237*** | | | |
| Children | -0.179** | -0.345*** | -0.292*** | 0.091 | -0.390*** | 0.660*** | -0.061 | | |
| Education | 0.342*** | 0.430*** | 0.323*** | 0.013 | 0.440*** | -0.425*** | 0.148** | -0.390*** | |
| Microent | 0.314*** | 0.483*** | 0.065 | 0.182** | 0.425*** | -0.018 | -0.141** | -0.173** | 0.267*** |

**Legend:** Fac1=Factor 1 score from factor analysis- Personalised info about savings/loan basics, Fac2-=Factor 2 score from factor analysis- General Info. about products and loans, Fac3-=Factor 3 score from factor analysis- Knowledge of access to savings, Regulated =Client membership of Registered or Unregistered MFI (coded yes =1, otherwise 0), Age=Client age, Children=-Self-declared number of clients' children, Married=married =1, otherwise 0, Microenterprise=Self-declared client microenterprise exists (coded yes =1, otherwise 0), Education=Client has some education (coded yes =1, otherwise 0).

#### 8.2.2.4 Multivariate results for MFI Clients

OLS regression results for the test of H3a are reported in Table 8.17. This test regresses the hypothesis and control variables on each of the factor scores, representing the three client awareness factors, together with the total factor score. The F statistics for all three models are significant and the $R^2$ ranges from 95 per cent for Factor 1 to 19 per cent for Factor 2 and only 3 per cent for Factor 3. For the total factor score as the dependent variable, the $R^2$ is 56 per cent. The regressions are robust, controlling for the fact that some clients belong to the same MFI, with 147 MFIs represented in the sample of 342 clients. Importantly, the regulatory status of MFI, (Registered/Unregistered) is highly significant ($p < 0.001$) and positive for all three factors and the total of the factors. That is, consumer awareness is higher for Registered MFIs compared with Unregistered MFIs. Hence H3a is supported. Having some schooling (education) is significant ($p < 0.001$) only for Factor 2 'awareness of General Information about Products and Loans'. Ownership of microenterprise is significant ($p < 0.01$) in explaining all three client awareness factors and their total ($p < 0.05$).

## Table 8.17: OLS regression with dependent variables Client awareness factors (H3a)

| | Panel A—Factor 1 score | | | | Panel B—Factor 2 score | | | | Panel C—Factor 3 score | | | | Total factor score | | | | Remarks on Hypothesis H3a |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Dependent variables** | **Personalised information about savings/ loan basics** | | | | **General information about products and loans** | | | | **Knowledge of access to savings** | | | | **Client awareness** | | | | |
| | Coef. | Std. Err. | t | P>t | Coef. | Std. Err. | t | P>t | Coef. | Std. Err. | t | P>t | Coef. | Std. Err. | t | P>t | |
| Regulated | 1.899 | 0.034 | 56.370 | 0.000 | 0.681 | 0.104 | 6.530 | 0.000 | 0.014 | 0.126 | 0.110 | 0.913 | 2.594 | 0.157 | 16.510 | 0.000 | **Accepted** |
| Education | -0.008 | 0.030 | -0.250 | 0.802 | 0.418 | 0.111 | 3.770 | 0.000 | -0.084 | 0.142 | -0.590 | 0.557 | 0.327 | 0.189 | 1.730 | 0.086 | **Rejected** |
| Microenterprise | 0.186 | 0.036 | 5.220 | 0.000 | -0.280 | 0.093 | -3.020 | 0.003 | 0.403 | 0.118 | 3.410 | 0.001 | 0.309 | 0.147 | 2.100 | 0.037 | **Accepted** |
| Constant | -1.246 | 0.027 | -45.460 | 0.000 | -0.497 | 0.061 | -8.210 | 0.000 | -0.227 | 0.147 | -1.550 | 0.124 | -1.970 | 0.163 | -12.050 | 0.000 | **Accepted** |
| F Stat | 1623.38 | | | | 23.840 | | | | 8.270 | | | | 175.320 | | | | |
| p value | .000 | | | | .000 | | | | .000 | | | | .000 | | | | |
| R2 | .946 | | | | .187 | | | | .034 | | | | .562 | | | | |
| Root MSE | .235 | | | | .893 | | | | .998 | | | | 1.267 | | | | |
| N | 342 | | | | 342 | | | | 342 | | | | 342 | | | | |
| Clusters | 147 | | | | 147 | | | | 147 | | | | 147 | | | | |

**Legend:** Fac1=Factor 1 score from factor analysis- Personalised info about savings/loan basics, Fac2-=Factor 2 score from factor analysis- General Info. about products and loans, Fac3-=Factor 3 score from factor analysis- Knowledge of access to savings, Regulated =Client membership of Registered or Unregistered MFI (coded yes =1, otherwise 0), Age=Client age, Children=-Self-declared number of clients' children, Married=married =1, otherwise 0, Microenterprise=Self-declared client microenterprise exists (coded yes =1, otherwise 0), Education=Client has some education (coded yes =1, otherwise 0).

For the tests of H3b and H3c, robust OLS regression is used, with results are reported in Table 8.18. Total factor score is used to represent Client awareness because of the high correlation between Registered MFI and Factor 1 score at 0.969 precludes including both as independent variables[31]. Instead, Total factor score for each client is used, consisting of the sum of each of the three-factor scores representing knowledge of 'Personalised information about savings/loan', 'General Information about products and loans', and 'Access to savings' respectively. Again, the robust regressions fit well, with significant F statistics and an $R^2$ of 45 per cent. Total factor score is significant ($p < 0.01$) supporting H3b, as is Registered MFI ($p < 0.001$), supporting H3c. Amongst the control variables, only Children is significant ($p < 0.05$) and positive, indicating that children add to family income on average, rather than detracting from it. Age is negative but not significant.

**Table 8.18: OLS regression, dependent variable Client financial status (H3b & H3c) (N = 342)**

| Dependent Variable: LnIncome | Coef. | Robust Std. Err | t | P>\|t\| | Remarks on H3b & H3c |
|---|---|---|---|---|---|
| Total factor score | 0.052 | 0.019 | 2.780 | 0.006 | **Accepted** |
| Regulated | 0.549 | 0.083 | 6.580 | 0.000 | **Accepted** |
| Age | -0.002 | 0.003 | -0.800 | -0.424 | **Rejected** |
| Married | 0.067 | 0.043 | 1.580 | 0.116 | **Rejected** |
| Children | 0.030 | 0.012 | 2.400 | 0.017 | **Accepted** |
| Microenterprise | 0.042 | 0.047 | 0.910 | 0.364 | **Rejected** |
| Education | 0.054 | 0.054 | 1.000 | 0.320 | **Rejected** |
| Constant | 10.068 | 0.098 | 102.750 | 0.000 | |
| F(9, 146) | 38.97 | | | | |
| p-value | 0.000 | | | | |
| R2 | 0.446 | | | | |
| No. of clusters | 147 | | | | |
| Highest VIF | 2.91 | | | | |

Legend: Fac1=Factor 1 score from factor analysis- Personalised info about savings/loan basics, Fac2-=Factor 2 score from factor analysis- General Info. about products and loans, Fac3-=Factor 3 score from factor analysis- Knowledge of access to savings, Regulated =Client membership of Registered or Unregistered MFI (coded yes =1, otherwise 0), Age=Client age, Children=-Self-declared number of clients' children, Married=married =1, otherwise 0, Microenterprise=Self-declared client microenterprise exists (coded yes =1, otherwise 0), Education=Client has some education (coded yes =1, otherwise 0).

[31] When the three factor scores are included as variables in their own right rather than as a total in the regression, the highest variance inflation factor is over 30.

#### 8.2.2.5 Discussion of empirical results for MFI Clients

Examination of MFI clients focuses on the importance of MFI regulation for client awareness and rights and knowledge about their loan and savings and its impact on their financial intermediation. From the results, we can conclude that regulation and guidelines for MFIs can play a very significant role in increasing clients' awareness, knowledge about their rights, loans, interest rate, savings, etc., and overall knowledge about their MFIs. Further, this awareness has a positive impact on clients' financial status.

However, in spite of the evidence of many positive outcomes from MFI regulation, there is a number of clients who prefer Unregistered MFIs over Registered MFIs as their financial institutions. For example, an important observation from interview evidence gathered for this study revealed that the most vulnerable and poor borrowers are served by Unregulated MFIs. An executive of an Unregulated MFI provided the rationale behind this:

> "*Loan defaulters from other large MFIs and overlapping customers who are disqualified from all registered MFIs are the poorest segment of clients. They do not have any source for accessing credit. As a result, many of them engage themselves with destructive activities like social crimes and domestic violence and become a burden on society. We support these types of clients by providing them training and education and giving them loans so that they can regain their confidence and become valuable citizens of the country"* (MFI No. 133).

Recently, the MRA has set an interest rate ceiling for all registered MFIs in Bangladesh (MRA, 2018). This may be not practical for many types (small and medium) of MFIs. One executive of a Regulated MFI stated that:

> "*Sometimes local clients have specific demands (e.g., agriculture or special types of risky business, which requires a higher interest and can aid our sustainability), but these are not possible to be met because of the interest rate ceilings enforced by MRA"* (MFI No. 90).

It is, therefore, crucial to recognise the actual needs of borrowers (key stakeholders) before setting rules for MFIs. Sometimes, standard rules for all types of MFIs can be impractical with regard to stakeholders' needs.

One of the key elements for the double bottom line goals of microfinance is facilitating poor borrowers' access to credit and helping them become independent and emerge from the loan cycle trap by crossing the poverty line. Too much focus on outreach and on profit-oriented donors (by commercial MFIs) sometimes drifts MFIs from their original goal. One executive of an unregulated MFI stated the following:

> *"As outreach is not our primary goal, our organisation focusses on the future of our clients so that they can become independent and come out of the loan cycle. You will see many of our clients have become independent and paid off their loans, and we encourage them for that. Not like other large MFIs (registered) where clients are encouraged and pushed illegally to take larger loans again and again and continue their (clients') loan cycle. We provide our clients with training for the current job market. We have an information centre in our office from where our clients can get information about opportunities to invest their money. We also help them in finding the right types of business and finding appropriate business partners (from this organisation or from outside) to start a business, which also helps them come out of the loan cycle"* (MFI No. 139).

It is, therefore, important to note that the outreach of MFIs does not necessarily bring the welfare of MFI clients to the fore, which is the primary goal of microfinance. Previous research has also found a gap between the goals of MFIs and their unlawful and inappropriate pressure, violence, and abuse of clients by loan collectors and members of MFIs' borrowing groups (Duggan, 2016). There is evidence of abuse, mistreatment, and exploitation of loan collection from poor vulnerable clients, as well as of their (MFIs') own employees found in the Bangladesh microfinance industry (Banerjee and Jackson, 2017; Maˆıtrot, 2018). The double bottom-line goal of microfinance can be achieved by ensuring strong monitoring of MFIs and discouraging any type of malpractice (e.g. push selling of loans, forceful loan renewals, abuse, and violent client-retention and repayment collection strategies) by MFI staff in their dealings with clients.

It is also well known that rules, principles, and regulations alone cannot prevent market transgressions and corruption or protect consumer interests. As a result, we see in many countries that responsibility for financial consumer protection is shared among multiple financial and non-financial regulators and enforcement bodies (Brix and Mckee, 2010). From the results of this study, it can be claimed that the welfare of MFI clients and other stakeholders (MFI employees) can be achieved not only by proper monitoring and guidance but also by focusing on increasing consumer awareness and financial capability rather than only enforcement and monitoring of the MFIs themselves.

## 8.3 Chapter summary

In this study, various univariate and multivariate analysis techniques have been used to examine the data and test eight hypotheses developed in Section 6.5. These eight hypotheses were the basis of the proposed research model (Figure 6.4), which are operationalised and tested in this chapter. The complex relationships between Governance, and performance - (outreach, and financial sustainability) (organisational perspective) and clients' knowledge, awareness, and financial status (client perspective) are examined in these analyses using logistic regression and robust multiple OLS regression.

From the organisation perspective, for MFI discretionary governance practices, this study finds that regulatory status is associated with most governance key indicators, consistent with responsive regulation and stakeholder theories and prior studies. MFIs' regulatory status (Registered_MFI) is found to positively influence Board Administration, Transparency and Disclosure of the organisation, Board Composition, Internal Governance, Board Performance, and Tot_net_savings of the MFI, but negatively influence the likelihood of a female CEO. This is perhaps concerning given prior findings that female leadership brings benefits in dealing with clients of MFIs.

For MFIs' outreach, this study finds that regulatory status (Registered_MFI) is associated with some key outreach indicators. For the examination of outreach, the analysis used three different dependent variables (Number of Branches, AvrgLoanBalance, Credit Borrowers). The result shows that for the Number of Branches, except for one, all variables and their coefficients are statistically and positively significant, which is consistent with the theory and prior studies. Registered_MFI, CreditProgramAge, Recovery_Rate, Tot_net_savings, and Female_CEO are found to positively influence the Number of Branches. For the dependent variable AvrgLoanBalance, although most of the signs of the coefficients generated from the regression analysis are consistent with the theory, very few (three out of seven) are statistically significant. Except for Tot_net_savings, coefficients for other variables are positive and Registered_ MFI and CreditProgramAge are found to positively influence AvrgLoanBalance. For the dependent variable Credit Borrowers, except for Recovery_Rate and Female_CEO, other variables (Registered_ MFIs, CreditProgramAge, and Tot_net_savings) are found to positively influence the number of Credit Borrowers.

For MFIs' financial sustainability, this study finds that the regulatory status of MFIs is associated with few key financial sustainability indicators. For the examination (financial sustainability), the analysis used four different dependent variables (ROA, OSS, Portfolio_Yield, and Interest_Rate_Spread). The result shows that for dependent variable ROA, only Recovery_Rate has a positive influence. For the dependent variable OSS, only Registered_MFI and CreditProgramAge were found to have a positive influence. For the dependent variable Portfolio_Yield, other than Registered_ MFI and TotOutstanding_Loans, no other variable was found to have any influence. For the dependent variable Interest_Rate_Spread, only Registered_MFI had an influence.

From the clients' perspective, this study found that Regulated MFIs are positively associated with most of the key financial awareness indicators. Most of these relationships are statistically significant with directions consistent with theory. MFIs' regulatory status is found to positively influence clients' awareness status, particularly their knowledge about their savings and loan basics, and overall knowledge about the loan products and types, fees, charges, and interest rate for their MFI. However, there is no significant difference between clients of Regulated and Unregulated MFIs in terms of their knowledge of accessing their savings account. All types of MFIs should pay attention to educating their clients about their savings accounts and accessing facilities.

For the financial status of clients, this study found that MFI regulatory status is positively associated with only a few (three out of seven) of the key indicators of client financial status. Even though most of the signs of the coefficients generated from the regression analysis are consistent with theory, very few are statistically significant. The findings also reveal that the financial awareness status of the client is positively associated with their financial status. That is, MFI clients who have a clear awareness about their loan status and their financial institution have better financial status.

Although not all measures included in the models are statistically significant, the results do strongly suggest that the regulatory status of MFIs in Bangladesh has a strong positive association with the discretionary governance practices, outreach, and financial sustainability of MFIs as well as with their clients' awareness and financial status. It can be claimed that the evidence presented in this chapter should encourage external regulatory bodies to monitor and supervise MFIs so that they can better fulfil their dual mission and thereby improve the overall sustainability of the industry.

# CHAPTER NINE

# Conclusion, limitations and future research

## 9.1 Introduction

This chapter summarises the findings of this current study by discussing its underpinning theoretical and conceptual models and drawing conclusions regarding the relationship between the governance and performance (outreach and financial sustainability) of regulated and unregulated microfinance institutions (MFIs) in Bangladesh and their clients' awareness and financial status. The following section revisits the background of the study in terms of the theoretical and conceptual models used. Sections 9.3 and 9.4 discuss the key findings in relation to the hypotheses (organisation and client level) by providing the rationale for this study from different perspectives. Section 9.5 looks at the study's contributions to the knowledge of the microfinance industry and how this study contributes to the existing body of literature and theory. Policy implications arising from the findings for both academics and development practitioners are discussed in Section 9.6. Limitations and possible directions for future research are noted in Section 9.7. Finally, Section 9.8 provides concluding remarks.

Figure 9.1 depicts the structure of this chapter

**9.1 Introduction**

**9.2 Revisiting the background and theoretical and conceptual models**

**9.3 Key findings in relation to the hypotheses (organisation level)**

**9.4 Key findings in relation to the hypotheses (client level)**

**9.5 Contribution**

**9.6 Policy implications**

**9.7 Limitations and directions for future research**

**9.8 Concluding remarks**

## 9.2 Revisiting the background and theoretical and conceptual models

This study investigates the differences between unregulated and regulated MFIs in Bangladesh in terms of several phenomena. The promulgation of the Microcredit Regulatory Authority Act by the Bangladesh government in 2006, the establishment of the Authority (MRA) itself, and the policies and guidelines (refer Section 3.4.3) provided for registered MFIs by the MRA reflect flexible and *responsive regulation* practiced by the MRA, and can be explained by the application of *stakeholder theory* (refer Sections 4.3 and 4.5).

After its establishment in 2006, the MRA received 4,241 applications seeking licencing permission for microfinance operations in Bangladesh. However, 80 percent (3,380) of the applications were declined (Ahmed, 2013) because they did not meet the minimum regulatory requirements (Section 3.4.3) set by the Authority. It is important to note that MFIs that failed to meet the licencing requirements were not shut down immediately, but were given time (three years) to fulfil the requirements. Even after that grace period, 5–10 per cent of MFIs that failed to meet requirements were kept under a 'potential' category. In 2018, more than 500 MFIs continue to be involved in microfinance operations without registration with the MRA.

The MRA considers MFI clients to be the most important stakeholder group in the microfinance industry, which is reflected in its operations (MRA, 2018). It pushes and encourages registered MFIs to adapt to the needs of their clients in terms of policy formulation, and by offering diversified products, and financial and social training (Badruddoza, 2013). This behaviour of the MRA to guide and encourage regulated MFIs can be explained by stakeholder theory, which argues that organisations need to pay attention to important stakeholder groups. It is interesting to note that a number of MFIs choose to remain unregulated.

This study investigates differences in performance between regulated and unregulated MFIs using the theoretical lens of responsive regulation and stakeholder theory in order to explain the behaviour of the MRA and of MFIs under its control. The next section focuses on the findings in relation to the hypotheses (refer Sections 6.5, 6.6, and 6.7) tested.

### 9.3 Key findings in relation to organisation level hypotheses

For convenience, hypotheses directed to the organisational level are repeated here.

***Hypotheses:***

Governance

> ***H1a:*** *Regulated MFIs exhibit superior non-mandatory governance practices compared with those of unregulated MFIs.*

Outreach

> ***H1b:*** *Regulated MFIs exhibit superior outreach compared with that of unregulated MFIs.*

Financial sustainability

> ***H1c:*** *Regulated MFIs exhibit superior financial sustainability compared with that of unregulated MFIs.*

To test H1a-H1c, formulated on the basis of the theoretical underpinning of responsive regulation and stakeholder theory, six constructs determined using factor analysis were incorporated into an empirical model (Model 1) (Section 8.2.1.1) with the status of the MFI (Regulated/Unregulated) as the dependent variable and determinants of discretionary governance mechanisms used by MFIs as the independent variables. Governance requirements needing to be met for registration with the MRA were not included in the model. The rationale for selecting governance indicators consistent with prior studies is discussed in Sections 5.2 and 6.2.

Using the data from a sample of both regulated and unregulated MFIs, the results revealed that MFIs' discretionary governance practices are associated with regulated rather than unregulated MFIs. Except for External governance (external audit by MRA and external audit by any CA firm enlisted by MRA), all the governance indicators (Board Administration, Transparency and Disclosure, Board Composition, Internal Governance, and Board Performance) are positively and significantly associated with Regulated MFIs.

With regard to MFIs' outreach, the results revealed that all three measures used (Number of Branches, Average Loan Balance, and Number of Credit Borrowers) are positively and significantly associated with regulated MFIs.

In terms of the four financial sustainability measures used separately as dependent variables, three measures, Operational Self-sufficiency (OSS), Portfolio_Yield and Interest Rate Spread, are positively associated with Regulated MFIs, however, Return on Assets is not.

These findings reveal that there is a positive association between microfinance regulation and MFIs' governance practices, outreach, and financial sustainability. For the welfare of MFIs and their clients and the overall sustainability of the microfinance industry, external regulation appears to play a crucial role. However, in spite of the evidence of these positive outcomes arising from the regulation of MFIs, a significant number of MFIs (approximately 500) continue to remain unregulated. This circumstance is consistent with Gallardo et al.'s (2005) claim that an important aspect of regulatory reform in developing countries is that many MFIs choose to remain unregulated because of high regulation cost, lack of skilled manpower, unavailability of experienced member for the formation of the different committee and the board of directors.

In further interview data evidence, the responses to some open-ended questions posed to executives of both regulated and unregulated MFIs (refer Section 8.2.1.1.6) reveal some important aspects of this choice. One important concern is that meeting the minimum criteria for the award of a licence from MRA sometimes is not very practical. For example, not all MFIs are the same size or have the same capital adequacy, or access to the skilled and experienced human resources necessary to meet the 'minimum number of directors' requirement for the governing body. Concerns such as this need to be addressed carefully at the time of designing the regulatory structure for MFIs.

***Hypothesis:*** *<u>Relationships between MFIs' governance and outreach</u>*

***H2a:*** *Voluntary governance practices of regulated MFIs are positively associated with their outreach, but this is not the case for unregulated MFIs.*

To test H2a, Models 2–4 (Section 8.2.1.2) use the Registered MFI dummy variable as a substitute for the governance variable since the former fully explains the latter in Model 1 (refer Section 8.2.1.1.5). The results from estimating Models 2–4 reveal that MFIs with better outreach (Number of Branches, Average Loan Balance, and Number of Credit Borrowers) are likely to be registered MFIs. In other words, registered MFIs practising good governance have a higher chance of better outreach compared to unregistered MFIs. These findings suggest that the good governance of MFIs is positively associated with their outreach.

At the same time, open-ended questions posed to executives of regulated and unregulated MFIs (refer Section 8.2.1.2.3) revealed that better outreach does not always indicate good governance practices. So, it can be claimed that large scale MFIs which have better outreach compared to small and medium-size MFIs sometimes ignore the welfare of poor and vulnerable clients and engage in malpractice and abasement of clients in order to meet targets. Prior studies (Banerjee and Jackson, 2017; Maˆıtrot, 2018; Hammill et al., 2012; Jackson and Islam, 2005) support this finding.

Certainly, large scale MFIs have better outreach compared to medium- and small-scale MFIs, but one important observation from the open-ended question to an MFI executive (refer Section 8.2.1.2.3) and prior studies (discussed in Section 1.3.1) reveal that good governance practices need to be ensured at all levels (head office and branch level) of MFIs to achieve the objective and the dual mission (welfare of the clients and the sustainability of the organisation) of microfinance programs.

***Hypothesis:*** *Relationships between MFIs' governance and financial sustainability*
***H2b:*** *Voluntary governance practices of regulated MFIs are positively associated with their financial sustainability status, but this is not the case for unregulated microfinance institutions.*

To test H2b, Models 5–8 (Section 8.2.1.3) use the Registered MFI dummy variable as a substitute for the governance variable since the former fully explains the latter in Model 1 (refer Section 8.2.1.1.5). The results from estimating Models 5–8 reveal that regulated MFIs have better financial sustainability for three measures, OSS, Portfolio Yield, and Interest Rate Spread, but ROA is not significant. In other words, MFIs practising good governance have a higher chance of having better financial sustainability compared to unregistered MFIs. These findings suggest that good discretionary governance practices by MFIs are positively associated with MFIs' financial sustainability.

From interview data gathered through open-ended questions posed to executives of regulated and unregulated MFIs (refer Section 8.2.1.2.3), it became clear that MFI sustainability and good governance indicators cannot necessarily ensure every aspect of the welfare of poor and vulnerable clients. MFI executives stated that their rationale for choosing to remain unregulated was to continue to help the poorest of the poor who are rejected by regulated MFIs due to previous negative repayment records, debt overlapping issues, etc. These unregulated MFI executives wanted to help these vulnerable clients who had nowhere else to go for access to credit. Their interview evidence confirmed that these unregulated MFIs could have increased their outreach and ensured their sustainability by serving wealthier clients, but they chose to facilitate the poorest of the poor borrowers' access to credit and help them become independent and emerge from poverty.

This evidence suggests that all microfinance practitioners should find a mechanism for inclusion of this poorest of the poor segment of the population in microfinance programs so that this population segment can access credit, prove themselves as reliable borrowers, and come out of poverty, which is the key objective of microfinance.

## 9.4 Key findings in relation to client level hypotheses

***Hypothesis:*** *MFIs' regulation and clients' awareness*

***H3a:*** *Clients of regulated MFIs are associated with higher awareness of information about loans and savings compared with clients of unregulated MFIs.*

The conceptual model for this study is based on responsive regulation and stakeholder theory. To test the hypotheses related to MFI clients, three constructs were incorporated into the conceptual model as potential determinants of clients' awareness about their loan and rights and knowledge of their institution (Model 9) (refer Section 8.2.2.). These three constructs, determined from factor analysis, are (i) clients' personalised information about savings/loan basics, (ii) clients' general information about MFIs' products and loans, and (iii) clients' knowledge of access to their savings.

The results revealed that there is a positive association between regulated MFIs and clients' awareness. All three awareness indicators (Personalised information about savings/loan basics, General information about products and loans, and Knowledge of access to savings) are positively and significantly associated with the Regulated dummy variable.

It is important to note that mere knowledge about weekly repayments for loans cannot be considered as sound awareness by the client. Access to more complex products, such as insurance, and understanding of interest, require higher levels of awareness. With the knowledge of loans, interest rates, savings, insurance, etc., clients would have the capability to plan budgets in order to repay in instalments. According to Tiwari et al. (2008), financial literacy training not only involves changes in levels of knowledge about financial products but also behavioural changes. During financial literacy training, clients should be given information by their MFIs that they are able to understand and use.

***Hypothesis:*** *<u>MFIs' regulation and clients' financial sustainability</u>*

***H3b:*** *Clients of regulated MFIs are associated with higher financial status than clients of unregulated MFIs.*

***Hypothesis:*** *<u>Relationship between clients' awareness and financial sustainability</u>*

***H3c:*** *Clients with higher awareness of information about loans and savings are associated with higher financial status than clients with lower awareness.*

To test H3b and H3c, Model 10 (Section 8.2.2) uses the client's financial status as the dependent variable and the regulatory status of the MFI as the independent variable of interest and other client awareness indicators.

The result reveals that clients of regulated MFIs exhibit higher financial status (LnIncome, $p < 0.000$) than clients of unregulated MFIs. The result also shows that there is a positive association between financial awareness by MFI clients in terms of information about their loans and savings and clients' financial status (total factor score, $p < 0.006$). These findings reveal that regulation plays a positive role in MFI clients' awareness and financial status. The result also shows that better financial awareness by clients has a positive impact on clients' financial status.

The preceding discussion of results shows a strong positive association between microfinance regulation and MFI governance, outreach, and financial sustainability, and client awareness and financial status. As such, there are many areas that policymakers, researchers, and governments can focus on in order to improve the expectations and welfare of clients and the sustainability of the industry in fulfilling its double bottom line goal.

The following section highlights the contributions of this study to the knowledge of the microfinance industry and the existing literature on microfinance regulation.

## 9.5 Contribution

This study makes a number of significant contributions to the literature in the area of regulated and unregulated MFIs' governance and performance and their clients' awareness and financial status.

In investigating the regulation of the microfinance industry, the key stakeholders are MFIs, their clients, and external regulators. The literature review and the research gap discussed in Section 2.6 show that prior studies do not provide a comprehensive picture of microfinance regulation because they do not take into consideration each of these key stakeholders. No previous study has examined microfinance regulation or MFI governance practices from both an organisational perspective (MFIs) and clients' perspective at the same point in time so that inferences can be drawn about the role of these factors in client welfare. Given this, policy recommendations based on prior studies may not be appropriate because they give a one-dimensional picture of microfinance regulation. This current study fills this gap by investigating the role of regulation and MFI governance practices from both perspectives (executive and client level), and this is one of the key contributions of this research.

Another significant contribution to the literature is the providing of an understanding of the differences between regulated and unregulated MFIs' mandated and discretionary governance practices, level of outreach, and financial sustainability and client outcomes. The inclusion of these three key components simultaneously in order to better understand any differences between regulated and unregulated MFIs is also a valuable contribution to the extant literature. A better understanding of whether, and if so how, regulation and governance practices influence MFIs in achieving their dual mission of reaching clients as well as achieving sustainability is important.

Prior literature (refer Table 2.1) shows that understanding the difference between regulated and unregulated MFIs from clients' perspective is an under-researched area that is not well-developed. Analysis of client-level observations in terms of the welfare of MFI clients provides a deep and comprehensive understanding of the impact of microfinance regulation on clients' financial literacy and financial status, which is another significant contribution of the current study.

Further, this study has examined the governance, outreach, and financial sustainability of MFIs using longitudinal data with clustering of MFI observations and a wide range of hypothesis and control variables compared to prior studies, which assists in providing robust results regarding MFI performance. For measuring MFIs' discretionary governance practices, six constructs (Board Administration, Transparency and Discloser, Board Composition, Internal Governance, External Governance, and Board Performance) extracted using factor analysis were taken into consideration. For measuring the outreach of MFIs, the study investigated three different measures (Number of branches, Number of credit borrowers and Average loan balance), and for financial sustainability, the study used four different measures (ROA, OSS, Portfolio yield, and Interest rate spread). This range of measures not only adds value to the current research but also contributes to the literature on microfinance.

Finally, the adaptation of two theories (responsive regulation theory and stakeholder theory) in a microfinance context (Sections 4.3.2 and 4.4.2 and Section 6.3) represents a significant contribution of this research. The results are consistent with these two theories, that is, regulated MFIs (flexible and responsive regulation by the MRA and addressing the needs of stakeholders (stakeholder theory) by MFIs in their governance practices) have better discretionary governance practices, better financial sustainability, and better outreach compared to unregulated MFIs. Also, clients of regulated MFIs have better awareness and better financial status compared to clients of unregulated MFIs.

### 9.6 Policy implications

In light of the empirical findings, a number of important policy implications for theory and practice can be extracted. The following sections highlight the theory and policy implications arising from the findings of this study.

#### 9.6.1 Implications for theory

This research, by proposing an integrated conceptual model, is the first of its kind to examine the role of regulation in the microfinance industry from both organisational and clients' perspectives at the same point in time. This conceptual model could be applied to examine the role of regulation in the microfinance industry globally. This model could potentially contribute to researchers' and practitioners' interest in examining the role of regulation in the microfinance industry from different stakeholder (MFIs, clients, government, regulators, policymakers, donors) perspectives.

Many prior studies (Afonso et al. 2017; Berenbach and Churchill, 1997; Chiumya, 2006; Kirkpatrick and Maimbo, 2002; Staschen, 1999) discussed in the literature review (Chapter two, Section 2.6), consider different regulation theories (prudential and non-prudential, public and private interest view, self-regulation, deregulation, etc.) in investigating the role of regulation in the microfinance industry from an organisational perspective. As was discussed in Chapter six (Section 6.3), because of the specialised, innovative nature and distinct characteristics of MFIs, responsive regulation is arguably the most appropriate for regulating the microfinance industry. This study examined regulation under the Bangladesh MRA Act 2006 using a responsive regulation context and found that this Act is associated with positive outcomes for all MFI governance and performance indicators tested.

In addition to the organisation perspective, this study also uses stakeholder theory in investigating at an MFI client-level to provide a comprehensive picture of outcomes associated with this regulation. The study shows that MFIs regulated and guided by the MRA through its responsive regulation approach not only better address their clients' needs by facilitating the provision of appropriate information, guidelines, and services, but also acknowledge their clients' financial and social economic concerns through policy formulation and governance practices, compared with unregulated MFIs. However, one important observation is that adoption of responsive regulation and concern for stakeholders by the regulator and MFIs themselves can bring fruitful outcomes only if appropriate attention is paid to the awareness creation and financial literacy of MFI clients.

Thus, this model can be seen as an amalgamation of responsive regulation theory and stakeholder theory that can be applied to investigate the role of regulation in the microfinance industry from a broader perspective that has been the case previously.

### 9.6.2 Implications for practice

Besides its contribution to theory, this study demonstrates the importance of responsive regulation by acknowledging the needs of MFI stakeholders (clients). The study also demonstrates the difference between regulated and unregulated MFIs governance practice and their (MFIs) clients' awareness and financial status. The findings can assist policymakers, governments, regulators, and donors to better understand the role of regulation and to design effective policies for the welfare and overall sustainability of the microfinance industry. Hence, the findings of this study can be of use in understanding microfinance regulation as a precursor to enhancing the design of an effective regulatory structure for the microfinance industry in a developing or developed country.

The insights provided reveal that in designing regulatory structure, it is crucial to understand the needs of the stakeholders (MFI clients). As discussed earlier, standard rules and regulation (e.g., repayment cycle, product types, and group liability) are not practical for all types of MFIs (in terms of age and size). Also, services and product requirements of clients can vary in different geographical areas (even within the same country).

For microfinance regulators, it is also vital to understand the different types of MFIs because the size and age (experience) of MFIs varies as does their strength and financial and administrative capacity to fulfil minimum requirements (e.g., minimum capital adequacy, the minimum number of clients, and availability of experienced board of directors). The findings also reveal that the existence of a general body of experienced and skilled board members is positively associated with good governance for MFIs. However, the availability of skilled and experienced board members and the existence of a minimum number of board members is not practical in many cases because small- and medium-sized MFIs do not have adequate administrative or financial strength and capacity to appoint skilled and experienced board members. Also, for MFIs in remote areas, it is difficult to find experienced board members willing to serve.

The findings also suggest that the CEO/chairman duality has a negative impact on MFIs' governance. However, for many small- and medium-scale MFIs, separation of the CEO and chair of the board is not feasible. After gathering good networking and adequate knowledge about a particular microfinance market, it is difficult for the board to find another knowledgeable and experienced candidate to appoint as a CEO every three to four years. Small and medium MFIs prefer to keep the same CEO, chairman, and board members every year. This may not represent good practice for any financial institution. However, as comparatively new types of financial institutions and because of their specialised, innovative nature and distinct characteristics, practitioners and policymakers need to encourage the gradual transformation of MFIs and rely on responsive regulation in the meantime.

While the findings suggest that responsive regulation is positively associated with MFIs' outreach, it should be noted by policymakers that 70 percent of the total regulated and unregulated microfinance portfolio in Bangladesh is captured by three large MFIs (Grameen 37 percent, BRAC (Building Resources Across Communities) 29 percent, and ASA

(Association for Social Advancement) 21 percent) in terms of outreach (Sinha, 2011). On the other hand, the remaining 30 per cent of the microfinance market is served by the small and medium-sized regulated and unregulated MFIs. The findings of this study show that regulated MFIs' clients exhibit higher financial status compare to unregulated MFIs' clients. So, the poorest segment of clients of the microfinance industry in Bangladesh is served by the unregulated MFIs. Thus, policymakers and the government should focus on this unregulated MFIs for winning their confidence and encouraging them to register with the MRA and thus be provided with appropriate supervision over the welfare of the poorest segment of microfinance clients.

The cost of microfinance regulation sometimes hinders unregulated MFIs from registering. Additional administrative expenses discourage even registered MFIs that are struggling in their financial and administrative capacities. Requirements for an external audit by chartered accounting firms as suggested by the MRA are another regulatory expense for MFIs that discourage them from being licenced. Regulators and policymakers should focus on these additional expenses that become a burden for MFIs. These expenses increase administrative costs, which poor borrowers then have to bear in the form of interest on loans. Government and policymakers might consider subsidising small and medium sized MFIs to procure an external audit by chartered accounting firms suggested by the MRA.

This research identifies the knowledge and skills that financial services clients require in order to exercise their rights and responsibilities. This research reviews literature that suggests most clients of financial institutions, particularly of MFIs, are unaware of their rights as consumers of financial services. These clients are often confused about their institutional rights, interest rates, debt collection, privacy, and terms and conditions for their loans and savings. Most importantly, many clients do not even expect transparency and accountability to be fundamental components of their financial rights. This study will help microfinance practitioners, policymakers, and governments understand and address the needs of MFI clients so that the necessary action can be taken to safeguard client welfare and that of the overall microfinance industry.

Finally, this study can guide policymaking and regulatory design by assisting policymakers, governments, practitioners, and donors in assessing the efficacy of responsive regulation. From a client perspective, this study provides evidence-based findings that can help governments design an effective regulatory system that addresses MFI clients' interests and optimises social welfare, as well as design an effective regulatory structure for the microfinance industry.

### 9.7 Limitations and direction for future research

Despite the potential contributions of this research, this study has some limitations. These limitations do not detract from the robustness of the analysis but rather bring forth some issues that are relevant for possible future research. The primary limitation of this study relates to the scope of the research. The research was conducted in a single country (Bangladesh), hence the study needs to be replicated in other regions and countries in order to examine the role of regulation in the microfinance industry, which can, in turn, provide a clearer picture and contribute to the generalisation of the findings.

Another limitation of this study is the availability of data in the public domain concerning the governance, sustainability, and outreach of regulated and particularly of unregulated MFIs in Bangladesh. Like many prior studies of microfinance regulation, to measure governance and performance (outreach and financial sustainability), MIX market, CDF (Credit and Development Forum), and MRA databases are the best sources of secondary data, but the information provided is often very limited. Three years of data (2010, 2012, and 2014) were used for analysing the performance of MFIs in this study. Because of non-availability of data for the number of MFIs, investigating the period before 2010 was not possible. For the analysis, ten years of data could give more robust results in investigating the role of regulation in the microfinance industry. For client-level data, it is very difficult to gather information, particularly about clients' financial and socio-economic status.

For primary data analysis, cross-sectional data was used for MFI executives and their clients. Non-reliability issues surrounding longitudinal data for MFI clients were a big issue. Longitudinal data from MFI executives and clients could give a more comprehensive picture of executives' governance practices and clients' understanding of their financial institutions as well as their financial status. Sometimes MFI executives were reluctant to provide financial information that could help cross-check financial data with MIX market, CDF, and MRA databases. Accessing more comprehensive longitudinal data covering additional characteristics of MFI clients, such as their financial data (ten years), overlapping memberships, reasons for becoming loan defaulters, reasons for choosing a specific MFI, adverse relationships with financial institutions (if any), feedback from clients about changes (if any) in accountability, information disclosure, overall good governance practices by financial institutions before and after registration, and clients' rationale for choosing regulated/unregulated MFIs, could give a more detailed picture of the differences in outcomes between regulated and unregulated MFIs and their clients.

In the case of MFI executives, access to more comprehensive data covering additional characteristics of MFI boards and their governance practices (e.g., ethical and moral issues, directors' leadership qualities, how to integrate different stakeholders, particularly MFI clients, in boards in ways that will add value to MFIs) and inclusion of additional governance indicators (e.g. efficiency: operating expense ratio—OER, cost per client— CPC; portfolio quality: portfolio at risk—PAR, write-off-ratio, annual loan-loss ratio—ALR), could enrich understanding of governance practices of regulated and unregulated MFIs.

This study used three outreach criteria for measuring the breadth of outreach—number of Credit Borrowers, Number of Branches and Average loan balance—as it was possible to access the data. Further future research may formulate other metrics, such as depth of outreach[32] (e.g., average outstanding balance per client or account/gross national income [GNI] per capita) by obtaining necessary data to enrich understanding of outreach performance by MFIs.

Finally, in the regulatory environment of the microfinance industry, the key stakeholders include regulators (regulating authorities), regulated organisations, governments, and donors. For investigating microfinance regulation, the conceptual model used in this study considered only the regulator and regulated organisations (MFIs) and their clients. Other key stakeholders (governments and donors) also play a very important role in the regulatory environment. This implies that future research needs to consider a comprehensive conceptual model including all key stakeholders to provide a clear and comprehensive picture of microfinance regulation.

## 9.8 Concluding remarks

A wider understanding of microfinance regulation is still needed among governments, policymakers, and regulators in order to improve policies and implement an effective regulatory environment. Inappropriate regulation is more dangerous than no regulation (Chaves and Gonzalez-Vega, 1994). However, there is no universally applicable standard approach to regulating and supervising the microfinance industry. Hannig and Mugwanya (2000, p.164), in their review of the African experience, state that: "*The debate is still guided by contemporary experimentation, and is complicated by the span of institutional types, country contexts and the variety of interests of the key actors involved*". It is, therefore, important to identify, much less replicate, an appropriate regulatory framework by considering

[32] Depth of outreach evaluates how efficiently an MFI reaches the poorest segment of the population. It also focuses on poverty lending within a specific context, which compares the size of the loan to GNI per capita of a country (Bassem, 2009; Hartarska, 2005).

the diversity of its environment. At the end of the day, what actually matters is the impact of regulation and not its objectives.

Hence, a holistic focus is necessary for researchers to understand and further investigate the complex relationships between the key players involved in microfinance regulation. This study represents a response to that role and its findings further support the importance of regulation by incorporating the voice of other key stakeholders (MFI clients). The findings of this study can be regarded as universal because the study investigates the relationship between regulated and unregulated MFIs in terms of their governance practices and performance, thus covering the common key components and players irrespective of institutional type and country context. The findings lead to the conclusion that economists, social scientists, policymakers, governments, and development agencies should make pragmatic efforts to motivate and encourage MFIs (particularly unregulated MFIs) to comply with regulation for effective governance practices and performance. From a client perspective, encouragement to increase awareness of rights and access to information about their financial dealings with MFIs is crucial. This should be one of the key focus points for the overall planning process for any new guidelines.

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**Appendix**

## Appendix 1: Ethics approval letter

To: Dr M Habib, Mr Z Morshed FBE

Dear Mohshin and Zakir,

**SUHREC 2013/277 Regulatory impact on the microfinance industry: a Bangladesh study**

Dr M Habib Mr Z Morshed et al FBE

Approved duration from 12/05/2014 To 12/08/2015

I refer to the ethical review of the above project protocol by a Subcommittee (SHESC2) of Swinburne's Human Research Ethics Committee (SUHREC). Your responses to the review, as per the email sent on 21 January 2014 and subsequent revisions sent on 12 May 2014, were put to the Subcommittee delegate for consideration.

I am pleased to advise that, as submitted to date, the project may proceed in line with standard on-going ethics clearance conditions here outlined.

- All human research activity undertaken under Swinburne auspices must conform to Swinburne and external regulatory standards, including the current *National Statement on Ethical Conduct in Human Research* and with respect to secure data use, retention and disposal.
- The named Swinburne Chief Investigator/Supervisor remains responsible for any personnel appointed to or associated with the project being made aware of ethics clearance conditions, including research and consent procedures or instruments approved. Any change in chief investigator/supervisor requires timely notification and SUHREC endorsement.
- The above project has been approved as submitted for ethical review by or on behalf of SUHREC. Amendments to approved procedures or instruments ordinarily require prior ethical appraisal/clearance. SUHREC must be notified immediately or as soon as possible thereafter of (a) any serious or unexpected adverse effects on participants any redress measures; (b) proposed changes in protocols; and (c) unforeseen events which might affect continued ethical acceptability of the project.
- At a minimum, an annual report on the progress of the project is required as well as at the conclusion (or abandonment) of the project. Information on project monitoring, self-audits and progress reports can be found at: http://www.research.swinburne.edu.au/ethics/human/monitoringReportingChanges/
- A duly authorised external or internal audit of the project may be undertaken at any time.

Please contact the Research Ethics Office if you have any queries about on-going ethics clearance. The SHR project number should be quoted in communication. Researchers should retain a copy of this email as part of project recordkeeping.

Best wishes for the project.

Yours sincerely,

Astrid Nordmann

SHESC2 Secretary

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Dr Astrid Nordmann
**Research Ethics Executive Officer**
Swinburne Research (H68)
Swinburne University of Technology
PO Box 218, Hawthorn, VIC 3122
Tel: +613 9214 3845
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SWINBURNE UNIVERSITY OF TECHNOLOGY

## Appendix 2: Structured interview guide for MFI executives

(Regulated and Unregulated MFIs)

| | Structured interview guide for MFI executives (2014–15) | Variable name |
|---|---|---|
| | ***Organisation Profile*** | |
| 1E | MFI code | MFI_code |
| 2E | Registration status | Registered_MFI |
| 3E | Year of credit program | Year_Credit_Program |
| 4E | Licence year (if applicable) | Licence_Year |
| | ***Governance*** | |
| | | |
| 5E | Is the council of directors elected? | (Y/N) |
| 6E | Is it mandatory for the directors to attend board meetings? | (Y/N) |
| 7E | Does the council of directors have voting rights to the executive committee? | (Y/N) |
| | | |
| 8E | Is a yearly internal audit conducted for the organisation? | (Y/N) |
| 9E | Do you publish your annual report along with the financial report (every year)? | (Y/N) |
| 10E | Do you inform your members about their rights and responsibilities at the beginning of the loan disbursement? | (Y/N) |
| | | |
| 11E | Does your organisation have a council of directors? | (Y/N) |
| 12E | Is there any familial relationship (parents/children/spouses/siblings) between the CEO and chairman of the organisation? | (Y/N) |
| 13E | Do you have independent board members? (at least 50%) | (Y/N) |
| 14E | Do your board members have qualifications or experience in banking/business/ finance/law/management? (for at least one of the board members) | (Y/N) |
| | | |
| 15E | Do you carry any type of emergency or safety fund other than a depositor's safety fund? | (Y/N) |
| 16E | Do you practise loan classification? | (Y/N) |
| 17E | Do you calculate monthly interest on average balance determined on the basis of the balance of deposits at the beginning and end of every month (declining balance method)? | (Y/N) |
| 18E | Presence of committees (executive/risk/audit/HR/corporate governance) (at least three) | (Y/N) |
| 19E | In the past year, did the board change/upgrade policies concerning product range/product distribution network/source of capital/client protection/internal control/regulatory compliance? (any two) | (Y/N) |
| | | |

| | | |
|---|---|---|
| 20E | Is the organisation member of PKSF, CDF, or any other external authority for guidance, monitoring, supervision, or accountability | (Y/N) |
| 21E | Is there an yearly external audit carried out by MRA or any other authority? | (Y/N) |
| | | |
| 22E | Does a yearly evaluation of board members occur? | (Y/N) |
| 23E | Is there training for board members? | (Y/N) |
| | | |
| 24E | Registration status (Registered = 1) | (Y/N) |
| 25E | Recovery rate | |
| 26E | Total net savings | |
| 27E | Female CEO | (Y/N) |
| | ***Outreach*** | |
| | | |
| 28E | Year (age) of credit program as at 2014 | |
| 29E | Registration status | (Y/N) |
| 30E | Number of branches | |
| 31E | Average loan balance | |
| 32E | No. of credit borrowers | |
| | ***Financial Sustainability*** | |
| | | |
| 33E | Operational self-sufficiency (OSS) | |
| 34E | Return on assets (ROA) | |
| 35E | Portfolio yield | |
| 36E | Interest rate spread | |
| 37E | Registration status | (Y/N) |
| 38E | Total outstanding loans | |

## Appendix 3: Structured interview guide for MFI clients

(Regulated and Unregulated MFIs)

| | Structured interview guide for MFI clients (2014–15) | Variable name |
|---|---|---|
| | ***Organisation Profile*** | |
| 1C | MFI code | MFI_code |
| 2C | Registration status | Registered |
| 3C | Year of credit program | Year_Credit_Program |
| 4C | Licence year (if applicable) | Licence_Year |
| | | |
| 5C | Do you know the interest rate (per month) on your loan and savings charged by and paid by your MFI? | (Y/N) |
| 6C | Do you maintain any loan or savings passbook given by your MFI? | (Y/N) |
| 7C | Do you have a copy of the promissory note for your records? | (Y/N) |
| 8C | If you require, can you get 'loan and savings information' from your branch office on any working day? | (Y/N) |
| 9C | Do you have savings with your MFI? | (Y/N) |
| 10C | Do you know what your service charge is? | (Y/N) |
| 11C | Do you earn any interest on your savings? | (Y/N) |
| 12C | Do you know the types of loans and other facilities available from your MFI? | (Y/N) |
| 13C | Do you know the terms and conditions of the loan? | (Y/N) |
| 14C | Do you know about the fees, premium, and settlement of the claim of your insurance service? | (Y/N) |
| 15C | Can you withdraw your savings (partially or fully) from your MFI (if your loan is cleared)? | (Y/N) |
| 16C | Do you have any other voluntary savings in your MFI? | (Y/N) |
| | | |
| 17C | Registration status | (Y/N) |
| 18C | What is your highest education degree? | |
| 19C | Do you have a business? | (Y/N) |

| | | |
|---|---|---|
| 20C | What is your age? | |
| 21C | What is your marital status? | Yes = married No = single/ widow/ separated |
| 22C | How many children do you have? | |

**Appendix 4**

**Consent Information Statement (Microfinance Institute)**

**Faculty of Business and Enterprise**

**Swinburne University of Technology**

**Project title:** Regulation and Performance of the Microfinance Industry

**Name of the investigators:** Mr. Zakir Morshed, Dr. Mohshin Habib, Professor Christine Jubb, Swinburne University of Technology, Melbourne Australia.

**What the project is about and the background of the project:**

Since the introduction of the concept of modern microfinance, the regulation of microfinance has engaged the attention of economists, social scientists, policy makers and Governments. Numerous studies and research projects have taken place to analyse and examine the need for regulations on microfinance. Many researchers claim that the need for regulation and supervision of microfinance institutions (MFIs) arises from several considerations, like protecting the interests of small depositors, ensuring proper terms of credit and financial discipline, and institutionalising a proper reporting system for orderly development. Other institutional regulations include, a requirement for registration to act as MFIs, reserve requirements, agreement with prudential accounting norms and guidelines and supervision (on-site and off-site) for operational and reporting systems.

Bangladesh is best known for pioneering microfinance programs and well known for having the largest microfinance industry in the world. The growth of the microfinance industry in Bangladesh has raised issues regarding the service quality, outreach, governance, transparency and sustainability of the microfinance industry. In 2006, the Bangladesh Parliament passed the Microcredit Regulatory Authority Act, 2006 (MRA 2006) to create a regulatory and supervisory body for the microfinance industry in the country and enact regulations. This research, which is for my PhD, focuses on assessing the role of regulation in MFIs and their clients in Bangladesh. Thus, the research intends to investigate the role of regulation in the Bangladesh microfinance industry in respect of key issues including, but not limited to, governance and performance (outreach and financial sustainability). This research is cross-sectional in nature in that interviews are intended to be held over a short period of time; however it intends to investigate the role of regulation imposed by MRA (Microcredit Regulatory Authority) on the microfinance industry in Bangladesh. The study also investigates the role of regulation in clients' entitlements and MFIs' service attributes to their clients, especially in the areas of financial intermediation, awareness and enterprise development etc.

**What does the study involve?**

**Participants:** Microfinance Institutions and their clients

Participation in the study involves responding to a set of interview questions about your MFI and its operational aspects that are related to the MRA Act 2006. The interview will be conducted in two stages. In the first stage, an executive of the MFI will be interviewed using a structured interview guide and open ended questions and, with your permission, will be audio recorded. In the second stage, with the MFI's permission, 3 clients will be randomly resected for interviewing from three randomly selected branch offices that the researcher will visit at an agreed time. Once the researcher receives formal approval from your MFI with a letter of introduction and endorsement, the researcher will randomly sample to select three branches, whereupon he will approach the branch managers to introduce him before a branch meeting to recruit MFI clients. as well as to provide a brief rationale for the research and mention that participation in the interview is absolutely voluntary and will not affect clients' dealings with the MFI or the branch manager in any way and that participants can opt out of the interview at any time during the interview.. The branch manager will be asked to read the information statement (attached) to the clients, seeking their cooperation to participate in structured interviews with the researcher. Neither the MFI clients' names nor any other identification will be recorded during these interviews. It will also be mentioned to the branch manager that the researcher will not remain in the branch meeting. Rather he will wait outside the branch premises. As soon as any group of MFI clients finishes its meeting and comes out of the branch premises, the researcher will approach the client and request participation in structured, anonymous interviews of 10-15 minutes duration.

**The time commitment:**

This face to face interview may require about 30 minutes for MFI executives and 15 minutes for each client. A time that suits you will be arranged for the interview.

**Confidentiality of the information:**

The primary data will be collected in the form of face to face interviews. Data collected from the interview will not be revealed or given to any other individual or organisation. Data will be de-identified at the point of data entry. Data will be kept locked securely and will be accessible only by researcher. All the data will be stored on a password protected computer hard drive and hard copies of all data in super locked filling cabinets in the researcher's home and principal supervisor's office.

**Use of Collected Information:**

The interview will be anonymous and will not request any information that can potentially identify the organisation, its executives or its clients. Access to and the use of all the information and collected data regarding MFIs and their clients will be limited to only the candidate and the supervisors. This information and data will not be used for any purpose other than for this project as describe in the protocol. Part of or the complete thesis will be published in a form of a book or aspects of it will be published as academic journal articles or presented at conferences.

*If you have any questions about the project at any stage, please contact: Zakir Morshed: zmorshed@swin.edu.au or his supervisors,* Dr. Mohshin Habib: mhabib@swin.edu.au; or Professor Christine Jubb: cjubb@swin.edu.au;

This research is also been approved by the Swinburne University Human Research Ethics Committee. If you have any question about the project at any stage, you may also contact:

Faculty of Business & Enterprise
Research office
Swinburne University of Technology
PO Box 218
Mailbox H25
Hawthorn, Victoria 3122
Australia

Email: fbe_phdenquiries@swin.edu.au

**Appendix 5**
**Consent signature form MFI executive interview**
**Faculty of Business and Enterprise**
**Swinburne University of Technology**

I, ________________________________________________ of

__________________________________________

**Hereby consent** to be a participant in the microfinance institution research study to be undertaken by Mr Zakir Morshed of the Swinburne University of Technology in his PhD research project entitled "Regulation and Performance of the Microfinance Industry"

I understand that the purpose of the research is academic and for his PhD research. The information and data will not be used for any purpose other than for this project as describe in the protocol. No participating MFI, MFI executive or MFI client will be named in any of the publications from this research.

**I acknowledge**

1) That the aims, methods, and anticipated benefits, and possible risks/hazards of the research study, have been explained to me.
2) That I voluntarily and freely give my consent to my participation in such research study.
3) That I voluntarily shared the name of MFI branch offices for the researcher to randomly select three Branches for interviewing the clients.
4) I understand that aggregated results will be used for research purposes and may be reported in scientific and academic journals.
5) Individual results **will not** be released to any person except at my request and on my authorisation.
6) That I am free to withdraw my consent at any time during the study, in which event my participation in the research study will immediately cease and any information obtained from me will not be used.
7) Some sections of the interview will be digitally audio recorded (delete if you don't agree to recording).

Signature: Date:

**Appendix 6**

**Information Statement for client interviews**

**Faculty of Business and Enterprise**

**Swinburne University of Technology**

**Project title**: Regulation and Performance of the Microfinance Industry

**Name of the investigators:** Mr. Zakir Morshed, Dr. Mohshin Habib, Professor Christine Jubb, Swinburne University of Technology, Melbourne Australia.

Dear members, I would like to introduce you to Mr Zakir Morshed who is a PhD candidate at the Swinburne University of Technology, Australia. He is currently visiting us to conduct research as part of his PhD studies at Swinburne University of Technology. As part of his research, Mr Zakir would like to interview some of you and ask a few questions about the services you receive from our Microfinance Institutions. This interview will held outside the branch premises and will take between 10-15 minutes to complete. Your participation in this research is absolutely voluntary and you may decline to be interviewed or withdraw from the interview at any time. Your name will not be recorded at any time during the interview and participation in this interview will have no implications for your membership entitlements or any other services you receive from this microfinance institution. You may raise any questions about this interview or the process any time with the Branch Manager or other officials at the Branch office.

Thank you for your cooperation.

**Appendix 7**

**MFI Organisation Consent Form**

**Faculty of Business and Enterprise**

**Swinburne University of Technology**

On behalf of (name of organisation)___________________________________________________________________

**I Hereby consent** for this organisation to be a participant microfinance institution in the research undertaken by Mr Zakir Morshed of the Swinburne University of Technology for his PhD research project entitled "Regulation and Performance of the Microfinance Industry".

We understand that the purpose of the research is academic and for his PhD research. The information and data will not be used for any purpose other than for this project as describe in the protocol. No participating MFI, MFI executive or MFI client will be named in any of the publications from this research.

**I acknowledge**

- I have read the information statement listed above and I understand its contents.
- I believe I understand the aims, methods, and anticipated benefits, and possible risks/hazards of the project.
- I voluntarily and freely give my consent to my participation in such research study.
- I understand that aggregated results will be used for research purposes and may be reported in scientific and academic journals.
- I understand that the individual results **will not** be released to any person except at my request and on my authorisation.
- I understand that some sections of the interview will be digitally audio recorded (cross/delete if you do not agree to recording).

**Please tick one of the following:**

- I consent to our (the) Organisation MFI taking part in this project.
  MFI Staff☐ MFI Clients☐

OR

- I do not want our (the) Organisation take part in this phase of the project interviewing the MFI staff/clients, but I am happy to be contacted about future research follow-up.

OR

- I do not want our (the) organisation to take part in this project, and I don’t want to be contacted by researcher again.

Name: ______________________________ Position: ___________________

Organisation

Signature: ___________________________ Date: ______________________

## Appendix 8

### Draft Letter of Endorsement of the participating MFI

### Organisation's (MFI's) Letterhead

Dated:

The Branch Manager

______________________________ *(name of the MFI)*

_______________________________ *(address of the MFI)*

Dear Branch Manager,

This is to certify that Mr Zakir Morshed is a PhD candidate at the Swinburne University of Technology, Australia. He is currently undertaking his research work for his PhD thesis entitled "Regulation and Performance of the Microfinance Industry"". We _____________________________________________ *(name of MFI)* are glad to participate in his research endeavour. As part of his research, Mr. Morshed has conducted an executive interview in our organisation. Now, Mr Morshed needs to interview 5 members/ clients from each branch. Each interview will take between 10 to 15 minutes to complete. The participation of our clients is absolutely voluntary. The name of our MFI or the branch manager or the interviewee will not be recorded at any time during the interview. Mr Morshed will attend weekly meetings only to be introduced. He will conduct these 3 short individual interviews with our clients outside of the branch premises. As branch manager, you have nothing more to do other than introducing Mr. Morshed and his research to our clients.

_________________________ *(name of the MFI)* is supporting this research and I would like to endorse Mr. Morshed's research activities at the branch level. Thus, at your discretion, the organisation is happy for you to cooperate with Mr Morshed and provide support as necessary. You may contact the head office or directly contact ___________________________________ *(assigned contact person at the head office)*

Sincerely yours

_____________________________ *(Signature)*

_____________________________ *(Name)*

_____________________________ *(Designation)*

_____________________________ *(Contact details)*