Research Paper

Muluneh Hideto Dato, a PhD student at SBS-EM, received the best PhD Paper Award at the 5th European Research Conference on Microfinance!

The association between microfinance social ratings and governance structure: a global survey.

BY **MULUNEH HIDETO DATO**

What is the corporate governance structure of socially responsible microfinance institutions (MFIs)? Interest in robust governance and corporate social performance is growing in both academic and non-academic literature considering today's corporate indignities. Likewise, financiers and other MFI stakeholders are increasingly considering more than financials, but the MFI's commitment to its social mission. However, little research has focused on the corporate governance drivers of MFI social ratings. This paper responds to this research gap.

MFIs: social ratings and corporate governance?

Microfinance aims to solve social problems not tackled effectively by mainstream banking institutions by providing banking services to poor families and their income generating activities (Hudon & Sandberg, 2013). MFIs are social enterprises, that is, like banks they should at least be financially sustainable; and as nongovernmental organizations (NGOs) they should serve the poor people and most importantly improve clients' lives (Battilana & Dorado, 2010).

Recently questions endure as to the effectiveness of the link between corporate governance and MFI performance. The public and media have frequently criticized MFIs. Some MFIs appear to overindulge in profitability even at the cost of their social performance (Armendariz &

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Szafarz, 2011). These concerns have predominately blamed on the lack of effective governance structures in MFIs (CSFI, 2015)

Many microfinance practitioners and funders are now seeking more transparent ways to measure social performance. MFIs are also gradually evaluating their social performance by specialized third-party rating agencies. The growing interest for more research on corporate governance and social performance seeks to shed light on how financial services affect the lives of poor people.

This study is the first to use a composite social performance scores to evaluate the corporate governance drivers of MFI social ratings. By addressing this link, we are focusing on an issue that concerns the ability of microfinance to contribute to social progress.

Data

We use third-party social rating assessments to addresses our research question. The rating assessments summarize the overall MFI social performance into one collective rating score. Our dataset is hand-collected from rating reports that contain 10 to more than 40 pages of narratives, social and accounting information from 3 leading microfinance rating agencies—MicroRate, Microfinanza, and Planet Rating. In total, our dataset contains information from 199 MFIs in 58 countries for 2007–2012.

"The Award experience is a great inspiration to any PhD students especially to myself. The prize has been a great support to my work. It is so precious that makes my study so worthwhile. This success has been utterly a team effort; I have had much support that is far beyond what a doctoral student supervisor expected to provide. This Award is thus a recognition and kind gesture that witnesses the devotion of my promoters to my work. So I am greatly indebted to Professor Marek Hudon and Professor Roy Mersland to my work."

- Muluneh Hideto Dato

Results: how governance boosts MFI performance

Our results lend support to the theoretical baseline predictions for the MFI's governance association to corporate social ratings. The results show that MFIs with higher social performance ratings have significantly larger board size, international directors, and internal auditors reporting to the board. We also find that these MFIs are initiated by some international organizations.

Our result also shows that NGOs appear to receive better social ratings. Institutional arguments suggest that NGOs with wider stakeholder-base are more likely being concerned with their reputation and promote positive social performance (Linck *et al.*, 2009). Yet, shareholder-firms (SHFs) may choose to signal their commitment to financial performance through socially risky activities.

We find that top management team size is negatively associated with social ratings. From a team production perspective, the relative costs of big management team may overweigh the benefits.

We can also see similar results for tightly controlled MFIs—regulation and competition. So, strong outside scrutiny and market restrictions may put pressures on MFIs to engage in more aggressive, socially risky strategies (McGuire *et al.*, 2012).

Conclusions and implications

Overall, our work has important academic and policy implications that emerge from a better understanding of the corporate governance drivers of social performance. First, we demonstrate that governance mechanisms strongly associate with good social scores. The essential takeaway is that if the MFI is better rewarded by rating scores, it seems reasonable to hypothesize that these MFIs should have strong governance structures in place (Webb, 2004).

Second, corporate governance is a multidimensional construct. For example, we have some evidence that the board of directors plays a particularly important role in shaping the MFI's social agenda (McGuire *et al.*, 2012). Third, social performance is manifested along several dimensions which may not be fully captured by the third-party social rating assessments. MFIs could particularly focus their social activities on certain stakeholder groups, for example the clients, community, or employee who may represent important sources of support.

Furthermore, we find a positive, yet not significant, association between social score and MFI profitability, ROA, suggesting that the two goals are not necessarily at odds with one another. This could indicate that MFIs tend to be profit satisfiers and not profit maximizers as hinted by Mersland and Strøm (2013) – a topic that deserves more attention by researchers.

More Information

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