



Good Governance and Sustainability in Islamic Microfinance Institutions

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Abstract

In the context of microfinance institutions (MFIs), good governance is highly critical in ensuring that the interests of the diverse stakeholders are being protected, while simultaneously safeguarding the viability and financial sustainability of the institution. As the microfinance industry scales up and expands globally, the decision making, and operational processes of the MFIs are becoming increasingly complex, hence the need for stronger governance. This paper explores the relationship between good governance and sustainability particularly in the context of the Islamic MFIs. It also examines the mechanisms of governance in Islamic MFIs by critically evaluating the best practices of governance in the microfinance industry.

Keywords: Governance, microfinance, Islamic finance

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1. Introduction

Being defined as a process through which an institution is directed and managed to accomplish its goals, governance has been widely recognized as a contributing factor to ensure the smooth running of companies. It essentially highlights the issues of incentive and control mechanisms that allow organizations to grow, while simultaneously striking a balance between the interests of all stakeholders. In the current highly competitive business environment, there are increasing interests on the measures of governance, as these measures are believed to be able to greatly influence the managements' efficiency in utilizing available resources in companies.

The need for good corporate governance is also closely related to sustainability of the companies or institutions. The main objective of corporate governance is to ensure that the direction of the company is in line with its objectives and there is an element of control in the organization. Interests on corporate governance gained momentum after the Enron scandal in the USA in 2001. Following Enron, many other scandals in the USA and other countries, for example, Parmalat in Italy and Transmile Bhd. in Malaysia in 2007 with the main reasons for the corporate collapse being identified as mismanagement and frauds committed by the managers, directors and even the external auditors. Indeed, the global financial crisis which resulted from the USA's banking woes in 2007 has called for more ethical conduct and good corporate governance to avoid mismanagement and fraud and less government control (Mohd Hanefah, Shafii, Salleh, & Zakaria, 2012). The purpose of corporate governance is to help build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies (Chapra & Ahmed, 2002).

In the context of microfinance institutions (MFIs), good governance is highly critical in ensuring that the interests of the stakeholders are being protected, while simultaneously safeguarding the viability and financial sustainability of the institution. In pursuing its main objective of providing financial assistance to the poor and small and micro enterprises which are excluded from the mainstream banking institution, the MFIs face a distinctive set of challenges as it manages a double bottom line – to fulfil the social objective of poverty

alleviation and the financial objective of continuous sustainability. As for the Islamic microfinance where the Islamic finance industry merges with the microfinance industry, it has a distinctive feature as compared to the conventional microfinance industry is the compliancy towards *Shari'ah*. Thus, it is able to provide for financial inclusion to the large number of Muslim population stricken with poverty. As such, the Islamic microfinance industry is subjected to the same mechanism of governance as its counterpart with an added element that is *Shari'ah* governance.

Much attention has been given on governance arrangements as to whether they are adequate to ensure the efficiency and accountability of the institutions. In the past, the inadequacy of governance practices was among the reasons associated with major failures in MFIs (Lapie, 2001). Several studies have highlighted the importance of governance whereby they proposed that each employed measures of governance have the ability to substantially influence the ability of investors to pressure the management to use resources efficiently in MFIs. Good governance structure of a MFI arbitrates the interest of its diverse stakeholders and safeguards its viability and financial sustainability. The need for proper governance to ensure sound management of MFIs rises in importance as the microfinance industry continues to expand and become commercially attractive. As risk taking is an inherent component in the microfinance industry, effective governance assists MFIs to be well-prepared in dealing with those risks.

Governance has persistently been a major issue in the microfinance industry since 2008 following Organisation for Economic Co-operation and Development (OECD) comes out with recommendations for Corporate Governance due to the report on financial crisis that found that one of the main reason for financial crisis was governance failure. According to the Microfinance Banana Skins Report (2012), governance ranked second in the list of risks facing MFIs. Some issues relating to governance as highlighted in the report are standard of leadership, role of independent directors, Board of Director's professionalism, governance performance measurement, as well as inadequate internal checks. In 2014, the same report showed an improvement in governance of MFIs as it moves down the list to number five. However, the competency of boards is still an issue as they are considered to be inadequate in providing sound leadership required by MFIs. This paper examines the various mechanisms of governance, both internal and external and its impact on MFIs, to further understand and distinguish the best practice of governance in the industry.

2. Governance in Islamic MFIs

The most pivotal mechanisms of an effective and sound governance framework for MFIs are ownership structure, role and structure of board in terms of size and composition, CEO and director remuneration, information disclosure, auditing and market for corporate control. As propounded by several researchers such as Hartarska, (2004) Mersland and Strom (2008) and Bassem (2009), there is a distinct category of governance mechanisms namely internal and external mechanisms. The former, which consist of the functions of the board, ownership types and internal control and audit are dubbed "internal mechanisms" because any implementations of the decision-making processes are subjected to the board's approval. The latter, however, are beyond the board's control and often times determined by the market force as well as the regulatory environment. Both of the aforementioned governance mechanisms are very important as accentuated by microfinance practitioners because the institutions' administration will be molded by these mechanisms and thus, impacting the performance and sustainability of MFIs.

In the context of Islamic MFIs, governance in Islamic financial institutions involve upholding and promoting the guidance enshrined by the *Shari'ah*, which states that Islamic businesses must be conducted and founded on ethical norms and social obligations, and also must be grounded on the moral framework of the *Shari'ah*. The holy Quran and Hadith and the teachings of the Prophet Mohammed (PBUH) have extensively stated and supported all the fundamentals behind corporate governance, by stressing the importance of values, ethics, and morals. Hence, in order to ensure that the operations and activities of IFIs are in compliance with *Shari'ah* rules and principles, a *Shari'ah* Supervisory Board (SSB) must be in existence in all IFIs. This Board has the task of reviewing and evaluating newly introduced products and services in order to ensure compliance with *Shari'ah* (Magalhães & Al-Saad, 2013).

The Organisation for Economic Co-operation and Development (OECD) defines corporate governance as the set of relationships between a company's management, its board, its shareholders and other stakeholders. The corporate governance framework designed to protect the interests of all stakeholders, ensure compliance with regulatory requirements, and enhance organisational efficiency. The robust organisational

structure clearly segregated functions and responsibilities and reflects a division of roles and responsibilities of the Board of Directors and Management. Improving corporate governance in IFIs is an indispensable measure that must be taken for the industry to continue to grow and remain competitive (Samra, 2016). One of the most important elements for success of Islamic financial institutions is authenticity of *Shari'ah* compliance in all their dealings. The executives of Islamic financial institutions, stakeholders, board members and *Shari'ah* advisors have a strong responsibility to adopt Islamic finance principles in a completely transparent manner, in particular accountability for ensuring the confidence of their clients to conduct their transactions in accordance with certain principles.

A central feature of IFIs is the *Shari'ah* Supervisory Board (SSB). The SSB is separate from the Board of Directors for the IFI but works with the Board to ensure the IFI is complying with Islamic law. The SSB plays several major roles such as ensuring compliance with overall Islamic banking fundamentals, certifying permissible financial instruments through fatwas, verifying that transactions comply with issued fatwas, calculating and paying zakat, disposing of non-*Shari'ah* compliant earnings, and advising on the distribution of income or expenses among shareholders and investment account holders. Islamic contracts, specifically partnership contracts or participation in profit and loss are built on the rule of ownership of assets, such as participation and speculation, require a lot of confidence in the beneficiary of the financing, and these contracts need an environment with a high degree of institutional control (governance, oversight mechanisms) (Ellaythy, 2013).

A very limited number of the variables influence MFIs' sustainability and outreach. Only insiders in the board are a predictor for sustainability and several aspects of outreach. The governance of MFIs is often studied from perspectives such as ownership control, board management, regulation and supervision. Only a very limited number of predictors influence sustainability and outreach of an MFI. The limitation of the investment fund lies in the fact that it invests in expanding and mature MFI. Measurement of outreach with respect to MFI is difficult, and only in recent years has any research been initiated. An important question in this respect is the impact of microfinance on economic poverty. Another important matter is the relationship between microfinance and empowerment. These relationships have not yet been mentioned by the literature. More academic research is needed to cover these aspects. To determine the relationship between governance mechanisms on the one hand and sustainability and outreach on the other, longitudinal research should be done. This type of study provides data about the same MFI at different points in time, allowing researchers to track changes at the level of MFI. Longitudinal studies can also be used to study change in the lives of MFIs. Regular corporate governance mechanisms may not be suitable for MFIs, and reference to a nascent framework drafted by Labie and Mersland (2010). To further develop this framework, additional research is needed, including an historic analysis of the governance mechanisms that have been proven effective and that have so far helped MFIs to survive and achieve their goals (Bakker, Schaveling, & Nijhof, 2014).

2.1 Ownership Structure

Ownership structures of providers in the microfinance sector are normally categorized into non-governmental organisations (NGOs), cooperatives (COOPs) and shareholder-owned firms (SHFs) (Mersland, 2009). NGOs usually refer to the institutions enlisted as non-profit, normally unregulated, lack real owners, offer limited financial services and are unlicensed to take deposits. NGO was the pioneer in the microfinance sector and majority of MFIs globally are run based on this type of structure (Galema, Plantinga & Scholtens, 2008). COOPs on the other hand are organisations that are governed and owned by members where the regulations of such organisations are different globally. As a way of mobilising funds, some NGOs have converted into cooperatives. Although they are able to mobilise client's deposit savings, there is little to no regulation of COOPs, which is an issue of concern and when combined with ineffective governance, causes insolvency issues. Shareholder-owned firms (SHFs) refer to commercialised institutions like banks or non-bank financial institutions (NBFIs). Banks providing microfinance services, which are also inclusive of rural banks, fall under the SHF category and can be either privately or publicly owned.

A number of studies have been carried out to determine the impact of ownership types towards the performance of MFIs. Mersland and Strom (2008) found that ownership type has no effect on the performance of MFIs. Several other researches indicated that ownership type does not significantly impact the performance of MFIs (Hartarska, 2005; Cull, Demirgüç-Kunt & Morduch 2011 & Bakker et al., 2014). In contrast to

Mersland and Strom (2008), Thrikawala, Locke and Reddy (2013) noted that MFIs that transformed their ownership structure from NGOs to SHFs generally rises in performance but in terms of outreach to the poor, NGOs fared better. Although the NGO structure is considered weak in comparison to other structures due to lack of ownership as propounded by Mersland and Strom (2009), this does not necessarily render it riskier or less successful as many MFIs have gained success operating as an NGO. In terms of external governance mechanisms such as competition and banking regulation, MFIs, which are NGOs are less impacted (Galema, Lensink & Mersland, 2012). For example, due to its reliance on donor funding, NGOs are not affected by competition. Although the NGO structures are more restricted in terms of acquiring funding, they easily gain donations, which could not be expropriated because of the restriction on distribution (Mersland, 2009).

Numerous authors advocate that SHF is the most suitable structure and MFIs should transform into SHFs (Mersland, 2009). The argument is based on the features inherent in SHFs which are proper regulation, deposit-taking organisation, broad range of high quality services offered, non-reliance on donors, ability to draw in equity capital and also much superior corporate governance. This notion is rebutted by a study conducted by Mersland and Strom (2008) comparing between MFIs with NGO and SHF structure based on few characteristics of performance measurements. Regardless of the different outcomes of the studies, it is however observed that ownership structure does influence the performance and efficiency of MFIs in whatever structure it adopts.

2.2 Role and Composition of Board

The standard of board members is crucial in ensuring proper management and response to matters of external accountability. Donors and investors consider the disposition and involvement of the board as a reflection of the proper use of funds invested. Board composition needs to be observed in several aspects such as skills and characteristics of board members; their commitment to the institutional mission and their capability to perform their responsibilities among other factors. A survey conducted by MIX Market indicated that both NGOs and commercial MFIs have boards that are properly structured and gathered regularly. The survey involving 162 MFIs found that some MFIs have positively exercised independence of board by separating the role of CEO from board and effective mechanism to ensure board's oversight of the MFI's social performance.

Bakker et al., (2014) observes that board comprising of a sizable portion of internal board members or insiders (managers and employees) has a positive impact towards MFIs, which is contrary to the findings of Hartarska and Mersland (2012). Hartarska (2005) reveals that certain MFIs have clients as part of the board. It is argued that having representation of employees and customer on the board would improve the MFI's understanding of the market and thus accommodates stakeholders' alignment towards the institutional mission. With regards to board members, Mersland (2009) proved that performance is enhanced when the board consists of local instead of international members. The proportion of women in the board plays an important role to the MFIs as well. The representation of women on the board positively influences the performance of MFIs (Bassem, 2009). In their study, Mersland and Strom (2009) noted that MFIs with a female CEO performs better than those with male CEOs. Possible explanation of this finding is that since most MFI customers are women, female CEOs are more able to lessen the information asymmetry through better knowledge of products that best suit female customers.

2.3 Internal Control and Audit

The aim and function of an organisation's internal control system, according to Robert and Charles (2006) are to boost operational efficiency, ensure sound financial reporting, protect the assets of the organization as well as encourage observance towards the policies of the management. Some small and growing MFIs do not establish a proper internal control, lacking in procedures and systems due to limitations and constraints on funding and human capital. However, inadequate internal control would cause more damage and weaken operations. Ultimately, improper setting of internal controls would result in the occurrence of incremental expenses in the long run. Internal control and audit of MFIs covers financial transactions, operations and upholding the mission of the institution.

According to Hoitash, Hoitash and Bedard (2009), audit board quality is linked to internal control quality whereby the internal audit process is identified as one of the shortcomings of MFIs as it lags in growth of a

satisfactory audit process. This is supported by the findings of Thrikawala, Locke and Reddy (2016) where they observed that internal audit practices in selected MFIs inflicted additional cost, thus, offsetting returns. In contrary, Mersland and Strom (2010) found that the function of internal auditors in an MFI improves performance as through them, the board is well-informed. Similarly, as a way of enhancing financial and social performance, MFIs should have internal auditors reporting directly to the board.

Most small and growing MFIs tend to not have their own internal audit department resulting to the need to appoint external auditors for financial reporting task. Fan and Wong (2003) advocated that function of external auditors hold a vital role in the effectiveness of governance. In terms of monitoring task, external auditors ensure quality oversight of financial reporting standards. External auditors also play important role in retaining sound internal controls essential to a transparent financial reporting practice.

2.4 Regulation

According to Hartarska (2009), external governance is the influence of stakeholders and the market over the MFIs' decision-making and execution as well as accountability mechanism to ensure managements' compliance with the companies' operational policies and procedures.

There have been some recent developments in microfinance industry which would call for the supervisory role of external governance to enable MFIs to withstand a variety of economic shocks without major distress. Such examples include the reduction of funding received from governments due to budget cuts and the MFIs' growing dependency on other financiers to achieve sustainability and outreach. It is noteworthy that there are mixed opinions among researchers on the effectiveness of regulation on MFIs performance. For instance, Hartarska and Nadolnyak (2007) mention that some practitioners are concerned about mission drift in MFIs induced by regulation as MFIs may depart from their genuine motivation to combat poverty in pursuit of commercial purposes by focusing more on regulatory requirements like meeting up a satisfactory level of capital requirements. Additionally, a study conducted by Hartarska (2004) to study the impact of regulation on MFIs' performance shows that despite gaining investors' and donors' confidence by having their financial statements audited and verified by external auditors, the regulated MFIs still have a lower ROA. In a similar vein, a research by Bassem (2009) asserts that regulated MFIs do not have a wider outreach of borrowers relatively to the unregulated MFIs.

On the contrary, Wiesner and Quien (2010) report in their findings that regulated MFIs are in favor of microfinance investment vehicles (MIVs) that are looking for fundable MFIs to channel their funds. In a comparison made by Barry and Tacneng (2011) between regulated and unregulated MFIs, they find that the unregulated MFIs are more profitable, but lack self-efficiency as compared to regulated MFIs.

2.5 Rating System

Rating system is an important external governance mechanism impacting MFIs' accomplishment. There are less studies conducted on the role of credit rating agencies in literature. According to De Young, Flannery, Lang and Sorescu (2001), credit rating provides insightful information as studies have shown that investors would incorporate rating information in stock prices. Credit ratings are vitally important as changes in them reflect substantial changes in the credit worthiness of the firms over a long period of time and greatly affect companies' policies. For instance, it can lead to security prices' adjustments (Hand, Holthausen, and Leftwich, 1992; Klinger and Sarig, 2000) or influence the firms' entry to the external debt market (Kisgen, 2006). Kuhner (2001) opines rating agencies as important intermediaries because they help to reduce information asymmetries. Mukhopadhyay (2003) raises concern over moral hazard problem induced by rating agencies arguing that managers in firms may not have any motivations to put in their best efforts to deliver the best services to the clients once the firms are rated and funds are secured. In a more recent study Hung, Banerjee and Qingrui (2017) argue that rating agencies may not make appropriate revisions to their ratings, therefore increasing the already existing information asymmetry between firms and the market.

2.6 Shari'ah Governance

The increasing importance of MFIs and their future prospects have attracted an increased supervision and

better governance practice. The resurgence of Islamic MFIs could be achieved through the implementation of *Shari'ah* governance founded upon Islamic law. The significance of *Shari'ah* compliance in any Islamic entities has added a new dimension of governance and thus a call for a new code of governance that complies with *Shari'ah* principles (Muneeza & Hassan, 2014).

Malaysia's *Shari'ah* Governance Framework (SGF) for Islamic financial institutions is considered to be one of the most all-encompassing in the world. It is meant specifically for Islamic banks and takaful companies, SGF can be effectively applied to other Islamic based financial institutions such Islamic MFIs and Islamic Cooperatives (Ismail, Hassan & Alhabshi, 2016). One of the SGF's fundamental purposes is to provide comprehensive guidelines on the board, *Shari'ah* committee and audit committee. It highly stresses on the importance of sense of responsibility and accountability, as these virtues are vital for any institutions. Of more importance, the management should encourage all members including employees and stakeholders to abide by *Shari'ah* governance to promote fairer and systematic MFIs (Samad & Shafii, 2010).

3. Conclusion

Islamic MFIs are in dire need of enhanced governance to help them in the strategic decisions-making process as the market grows more competitive each day. It also plays a pivotal role to guard them against additional risks posed by increasing number of loan portfolios hence resulting in more complex internal operations. Improvement in the effectiveness of MFIs' governance can help them manage some of the challenges they are currently facing in order to increase outreach and sustainability. Furthermore, it would aid MFIs to realize their dual bottom line of balancing social objectives with financial objectives, which is a feature distinctive to them.

In implementing good governance in Islamic MFIs, two main issues are pertinent and requires full attention from the MFIs. First, sustainability of the Islamic MFIs due to the lack of fund mobilization and high admin costs which cannot be solved with voluntary contributions. Apart from the initial start-up capital, generally provided by way of volunteers, NGOs or governments, most funds for IMFIs come from external sources. The need for investment is greatest throughout the preliminary stages of operation. There are greater issues in acquiring funds for IMFIs, and the lack of good governance practices sometimes deters the external sources of funding. Also, some of the money available may be illegal in *Shari'ah* perspective, and invalidate its use, for example, loan with interest. IMFIs are still struggling to clarify sources of funds and benefited from Islamic institutions of *zakah*, charity and *waqf* (Abdul Rahman & Dean, 2013). A study conducted by Ehsan (2012) state that Akhuwwat in Pakistan that emphasize on various dimensions of sustainability has proven to be highly sustainable. Consequently, emphasizing on good governance is highly important to ensure financial sustainability of Islamic MFIs. Further scale and performance efficiency may be achieved by joining hands with the Islamic banking in the country.

Secondly, the Islamic MFIs are also facing high transaction costs due to the nature of Islamic microfinance products that are based on the profit and loss sharing models. These costs relate to the costs of monitoring, research and enforcement costs, all of which are directly related to information problems in rural financial markets. Small loans are expensive because of high overhead costs, which usually have a large fixed cost attached. IMFIs must innovate to reduce transaction costs, so that incremental costs are often transferred to customers. The physical constraints of negative infrastructure such as the lack of markets, roads, power and communications have made it difficult for IMFIs to gather information about their clients. The absence of appropriate market information may be costly (Abdul Rahman & Dean, 2013). Ensuring good governance would help to attract funders who are willing to provide funding to ensure the sustainability and effectiveness of the Islamic MFIs.

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