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Corporate governance practices and its impact on the financial performance of microfinance institutions in India

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***Abstract*---**The Cadbury report (1992) has defined corporate governance as the "system by which companies are directed and controlled". Explicitly CG is the framework in which stakeholders' interests are to be balanced. Good governance practices have been observed as the key ingredient of microfinance institutions (MFIs) as it ventures to aid social and financial objectives. In this paper, we have examined the corporate governance practices in microfinance institutions (MFIs) and investigated the impact of corporate governance on the financial performance of the microfinance institutions (MFIs). Keyboard features are(board size, independent directors, independent audit committee) that have effects on the financial performance of the microfinance institutions of India. We have used 60 Indian companies as a sample and took 600 observations from selected companies, the time duration of the study is from 2016-2021. The audit committee has a negative impact on the performance, it doesn't help in improving the monitoring and transparency of the firm. We found that the board size and audit committee have a significant impact on the performance, the corporate governance has a moderate impact on the financial performance of the Micro financing institutions.

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Introduction

India is one of the largest countries having the largest number of listed companies, and regulation of the financial market is a crucial part of the economy and as well as for society to protect the interest of the shareholders without precluding the growth of the enterprises. Corporate governance helped in establishing the trust between the companies and their external providers of the capital. Corporate governance builds a strong relationship amongst management, BoD, shareholders, and other stakeholders. These relationships are consisted of various rules and incentives which provide a structure of building objectives and also help in monitoring the performance. Thus, corporate governance is based on responsibility and accountability.

India is ruling since the mid-90s, majority of corporate governance initiatives have been launched in India. Confederation of Indian industry (CII) was the India's first initiative to introduce corporate governance in the field of industry and business association in the year 1998 and SEBI has introduced clause 49 of the listing agreement. Naresh Chandra committee (2002) and Narayan Murthy committee (2002) were third and fourth respectively in the line.

Confederation of Indian Industry (CII):- In 1998 CII has set up the voluntary code of best practices for examining the corporate governance practices in the industries and business associations. CII hosted the national foundation of CG and a partnership with three institutions (Institute of Charted Accountant of India, Institute of Company Secretary of India, and Institute of Cost Accountants of India) initiated by the ministry. CII has been part of the regulatory front in the field of corporate governance, involved in each step of developing the companies bill, decision of finalizing the merger and SEBI code revision, etc. CII was helpful in the voluntary adoption of best corporate governance practices and self-regulations by the companies.

Kumar Mangalam Birla Committee (Clause 49) :-
The CII was a big hit, it was adopted by many industries but it was voluntary code so this time, SEBI initiated the statutory norms for the good corporate governance, it was the second major step for the CG Indian industries taken by SEBI. Early 1999, SEBI had setup the committee under the chairmanship of Shri Kumar Mangalam Birla who was the member of SEBI Board to promote and rising the standards of good corporate governance practices. The committee submitted the report and those recommendations were incorporated in the clause 49 of listing agreement.

Naresh Chandra Report:- On 21 August 2002 the Naresh Chandra committee was appointed to examine the corporate governance on high level which was issued by the department of company affairs. The committee has submitted its report after 4 months. The committee's recommendations were based on financial and non-financial disclosure and talked about the independent directors. Narayan Murthy committee: - The 4th initiative was taken on account of corporate governance was Narayan Murthy committee on CG under the chairmanship of N.R.Narayan Murthy. It was setup by SEBI to review clause 49 of listing agreement and to improve corporate governance standards.

CG helps in identifying the roles and duties of the directors and auditors toward the stakeholders of the company. Good governance practices build the confidence of shareholders in the company for ROI and for other stakeholders' good corporate governance practices ensure the responsible behavior toward the society and the environment. Thus, the good corporate governance practices are not only about the board responsibility and accountability, it also involves the aspects of social and environmental responsibilities.

Micro-financing Institutions in India

In the year 1980, India was introduced with the concept of micro financing to empower the women and to solve the problem of poverty. In spite of its strong potential, this sector faces problems in covering the rural areas. Micro financing provides services to those who have problems in accessing formal financial services from other financial institutions. It targeted low-income group and people who have ideas of start-ups. Micro financing institutions offers services like lending, setting up bank accounts and provides microfinance insurances on products. Developing countries like India, financial services through traditional means cannot fulfill the demands of the rural sectors, so micro financing institutions helps in flourishing small-scale entrepreneurs by providing financial stability.

Lending from the formal banking institutions were creating a hurdle for borrowing because of its documentation and proof of employment and collateral that can be offered by the small-scale businesses while applying for loans. Transaction cost and high risk is involved in this procedure which creates difficulty for banks too. This lead small scale entrepreneur with no alternative to borrow money for business except from moneylenders at high interests.

Corporate Governance in Micro-financing Institutions

International financial corporation is working on MFIs to strengthening their structure, system and relationship to achieve the objective. MFIs is providing financial services to the small enterprises, also to micro level and retailers. IFC is guiding them to perform good governance practices. MFIs have reached at that growth and professionalism where the need of CG is increased. Corporate governance practices have become necessary for the MFIs due to increased risk and challenges in the changing market situation, increased competition, and modernization in the technology. As new opportunity is coming with such changes, needs a proactive and structured board of directors with sound risk management and a good governance. A good governance structure can help the MFIs to tackle the current changing challenges and also manage to minimize the tension which was generated by MFIs double bottom line of social impact and profitability.

Micro financing institutions helps small lender to access loan safely, and in an ethical consistent manner. Although micro financing institutions are around the world but it is widely popular in developing countries like India. MFIs support large number of activities relating to bank checking and saving accounts. It provides easy loans to start-up and small business enterprises. Unlike other financing institution which primly focused borrowers' collateral for covering the loan, MFIs support rising entrepreneur.

Objectives

Objective of the study are as follows:

- To study the conceptual framework of corporate governance.
- To study the impact of corporate governance on financial performance of MFIs.
- To achieve these objectives, we identify the specific governance mechanism such as board size, independent director and auditors committee, which helps in improving the financial performance of the company

Literature Review

Bassem(2008) examines the relationship between the CG mechanism and the impact on the performance in the MFIs in the Mediterranean countries, in terms of sustainability. The impact of remuneration, board independence and diversity were examined. The result indicates that not only the corporate governance mechanism effects the outreach and sustainability but it was also affected by different external factors (regulation and individual lending methodology). However, being active as NGOs, the micro financing institutes work with more consistency in respect to achieve their social mission then financial performance. Marsland(2010) found that the micro financing is the weakest of all in the industry and in very serious need to work in systematic way, which can be achieve by good corporate governance practices. The paper aims to give information about, why the good corporate governance is important in respect to micro financing institutions, and also review the existing academic researchers in the field which leads to highlight the ideas to tackle the problems faced by MFIs in governance. Marulanda,B., Faujury, L.,&Paredes,M.(2010) studied about the failure of micro financing institutions in the Latin America region. In the study they work on the six causes of failure of micro financing institutions in Latin American region namely, systematic fraud, uncontrolled growth, loss of focus, design flaws and intervention of government. They highlighted the needs of improving the micro financing institutions. Durgavanshi(2014) studies the corporate governance practices and key board features like audit committee, independent directors, international directors, CEO-Board chairman duality, board size and skilled directors, that have effects on the financial performance of the micro financing institutions in Indian context. The study shows that increase in the board size doesn't increases the profitability as well as international directors has also negative impact but directors' financial skill have significant impact on the financial performance of the MFIs. CEO-chairman duality and audit committee has no effect on the profitability. Rupa(2014)studied about the financial performance of the MFIs of India, collected data from the microfinance information exchange from 2007-2011, used descriptive statistics and growth rate to know the profitability. Found that the return on equity(ROE) and operational self-sufficiency(OSS) has better position in the MFIs.Uchenna,Lawrence,Okoye.,Adedayo,Olayika,Erin.,Ahmad,Ado.,Isibor,Areghan(2017) investigated the impact of corporate governance and financial sustainability on the microfinance institution in Nigeria with the 5 year data from 2011-2015, by using regression model through ROA and OSS. Key boards feature such as board independence, board size and gender diversity were adopted as CG proxy. The result shows that the board size have significance impact but the board independence and gender diversity show the negative impact on the financial sustainability. Saraswathy, K.P., Kannan, Gopalakrishnan& Parthasarathy, Lakshmi(2019) explores the relationship between the corporate governance and the financial performance of the micro financing institutions in Indian context. They studied the effect of AP ordinance, Boardroom conflicts and recent governance policy on the MFIs. AP ordinance used for regulation and boardroom conflicts were used as governance equality. They found that the AP ordinance and the Boardroom conflicts have no significance impact on the performance of the Microfinance institutions. Board conflicts were increases due to the diversity and experience of the board members which leads to the delay in the decision making. Gupta.N, Mirchandani.A (2019) have studied on the corporate governance and performance of microfinance institutions using a global data set of 456 micro financing institutions. They investigated that the ownership structure and CG of micro financing institutions influences its social performance or not. They found that the socially oriented micro financing institutions like NGOs and Cooperatives showed their sturdy focus on the social goals with high percentage of female borrowers and low average loan size than commercial oriented like banks and non-banking financial institutions, which indicated that the ownership structure and corporate governance have a positive impact on the micro financing institutions structure. Hussain and Ahmad (2020)have studied on corporate governance in microfinance organizations for past 20 years and elaborated an agenda for the future scholars. They have collected data from different online sources such as EBSCO Host, Science direct and Scopus over the period of 2000-2019. They found that there are three major factor which affects the microfinance organization the most in the field of corporate governance are BOD, Top level management and external governance. Ahmad, Ibrahim, Bhuiyan (2021)investigated the effect of regulatory status of the MFIs performance. They found that the study doesn't show any significant evidence that the regulatory status affects the profitability of MFIs. The study additionally shows that the interest rate helps in accelerating the profitability, but it doesn't harm the outreach. They found that the ethical regulation practices and fair pricing in micro financing institution helps in saving the poor from exploitation.

Hypothesis

In this section, following hypothesis has been propounded on the basis of the above literature review and theoretical arguments.

1st Hypothesis: -
$H_0 1$: The governance of the company has no significant impact on the performance of the MFIs.

$H_1$1: The governance of the company has significant impact on the performance of the MFIs.

2nd Hypothesis: -
$H_0$2: Board size has no significant impact on the financial performance.
$H_1$2: Board size has significant impact on the financial performance.

3rd Hypothesis: -
$H_0$3: Higher proportion of independent director has no impact on performance
$H_1$3: Higher proportion of independent director has impact on performance

4th Hypothesis: -
$H_0$4: Independent audit committee has not improved the monitoring and transparency
$H_1$4: Independent audit committee has improved the monitoring and transparency

Methodology

The study is based on longitudinal study, it involves the observation based on same subjects or variables (corporate governance and financial performance) over a 5-year period (2016-2021). It is totally based on the secondary data using panel data set where many cases were observed at different time periods (say two or more). Cross sectional time series gives two information's first, the cross-sectional data reflects the difference between selected subjects and second, the time series reflects the change within selected subjects over time.

In the study we use Descriptive research as well as correlation and ex-post facto design. Ex-post facto helps in examining the causal information and the result will show us the effects on the performance of the micro financing institutions in Indian context. Independent and dependent variables were adopted to see the effects, where independent variables are board size, independent directors, audit committee and dependent variables are return on asset and operational self-sufficiency. To achieve the purpose of the study we limit our sample to 60 microfinance institutions. There are 223 NFIs in India including NGO- run units and societies. The data was collected from mixmarket.org. The study used descriptive method, correlation and generalized least square (GLS) regression method to analyse the data.

Variable Definition

Independent variables

Financial performance is the dependent variable in this study. Proxies for performance are board size, independent director and audit committee. Board size (BRDSIZE) represents the total number of board members. Board independence (BRDIND) is represented by the number of outside board members and international directors of the firm of firm i in year t divided by total number of board members of firm i in year t.
Audit committee (AUDCOM): represents the audit committee has improvement in the monitoring and transparency in the firm

Dependent Variable

ROA shows how an organization is profitable in comparison to its total assets. In this study, ROA is measured by dividing NOI/ATA (where NOI represents Net Operating Income, and ATA represents Average Total Assets). OSS signifies the efficiency of an organization in relation to its operating expenses. Operational self-sufficiency determines the extent to which operating income covers operating expenses. OSS is calculated as: Financial Revenue – (Financial Expense + Net Impairment Loss + Operating Expense) Both ROA (profitability estimate) and OSS (efficiency estimate) are measures of financial performance in the MFIs. A high value of this factor implies a strong impact of corporate governance on the financial performance of MFIs.

Model Specification

The objective of the study was achieved by examined the effects of corporate governance on financial performance of microfinance institutions, panel regression model was used to examined model specification. Therefore, we developed the following regression model:

FINPERit = αit +βit GOV+ μ it ………………………………………………… (1)

FINPER is the proxy for MFIs financial performance (dependent variable) which represents the Return on Assets (ROA) and Operational Self Sufficiency (OSS) of the MFIs. α is the intercept (y intercept), βit is slope coefficients of explanatory variables. Where subscript i denote the individual institutions characteristics across time dimension t. GOV represents the vector of corporate governance (independent) variables which include board size, board independence and audit committee.

Data Analysis and Discussion of Findings

This section presents and interprets the regression result obtained from the GLS estimations. It starts with preliminary test of the data using descriptive statistics and correlation followed by a regression result

Table 1: Descriptive Analysis

Variables	N	Min	Max	Mean	Std. Dev.
BRDSIZE	600	4	20	0.1453	0.0743
BRDIND	600	0.00	9.46	0.1799	0.0578
AUDCOM	600	0.00	4	0.1468	2.246
ROA	600	19	23.5	0.1532	0.0539
OSS	600	37	40	10.97	0.496

The table 1 shows the presentation of descriptive statistics of the explanatory and dependent variables. It shows that there are 600 observations (5 years annual computation of 60 sampled companies) in India. The average improvement of audit committee (AUDCOM) is 14.68% which needs to be improved in MFIs. As regards other corporate governance variables, the average board size e is 14.53% and independent directors' percentage is 17.99%. it shows that companies need to increase the number of directors in the organisation.

Table 2: Correlation Matrix

	ROA	OSS	BRDIND	BRDSIZE	AUDCOM
ROA	0.978				
OSS	0.253	0.984			
BRDIND	-0.169**	-0.236**	0.991		
BRDSIZE	0.117	0.453**	0.982	0.98	
AUDCOM	-0.268	-0.149**	0.477**	-0.371**	0.97

In Table 2, a correlation matrix of the variables is provided. The correlation matrix shows that the corporate governance has some impact on the financial performance of selected companies. The explanatory variables such as BRDIND (-0.169), AUDCOM (-0.268) show a negative relationship with financial performance; only BRDSIZE (0.117) shows a positive relationship. The analysis shows that the corporate governance has moderate impact on the financial performance of the MFIs.

Table 3: Summary of Regression Result

Variables	ROA			OSS			Collinearity Value (VIF)
	β	T-value	P-value	β	T-value	P-value	
BRDIND	-0.107	0.069	0.387	-7.189	2	0.14**	1.396
BRDSIZE	0.239	1.989	0.02**	0.293	3.772	0.002**	1.559
AUDCOM	-0.028	0.5	0.422	-0.111	1.334	0.14**	2.00
INTERCEPT	-0.992	0.021	0.869	-8.987	1.72	0.2035	
F-VALUE		0.00			0.00		
R^2	0.2836			0.4689			
Durbin Watson	1.6498			1.9654			
	** significant at 5% level						

In table 3, the results show the regression analysis of the MFIs. Multi-collinearity diagnostic statistics (variance inflation factor) were used. We found that the VIF ranging from 1.396 to 2.00 which is lower than the upper limit i.e.,10. This is the indicator of weak correlation of the explanatory variables. Also, it shows that Durbin Watson test which helps in measuring the presence of the autocorrelation, is d=1.6498 and 1.9654(which lies between the 2 critical of 1.5 and 2.5)

The results are moreover discussed in the form of following hypothesis statements:-

H_02: Board size has no impact on the performance. The result on both models is (0.239 and 0.293), which represents that board size has positive impact on the financial performance of MFIs therefore null hypothesis has been rejected.

H_03: Higher proportion of independent director has no significance impact on the performance of the MFIs. Both model in the regression coefficient shows negative results and non-significant at 5%, therefore there is no significance impact of higher number of independent directors on the performance of the MFIs, so we accepted the null hypothesis.

H_04: audit committee has not improved the monitoring and transparency of the firm it was expected to improve but it shows negative results in both the model, which represents that is has not played the role in improvement of firm's monitoring and transparency, therefore, we rejected the null hypothesis.

H_01: the governance of the company has no significance impact on the financial performance of the MFI. From all the above results it can rightly be said that corporate governance does affect the working of MFIs, however, the effect is not moderate. Therefore, we rejected the null hypothesis.

Conclusion and Recommendation

This study investigates the impact of corporate governance on the financial performance of MFIs in India during the period of 2015-2020. Results indicate that the MFIs of India is lacking in performance due to independent directors, low performance of audit committee and the board size. Findings has showed that corporate governance does not contribute meaningfully in the performance of the MFIs, but still have some positive impact on the performance of the MFIs. On the basis of the findings the study concluded that practices of corporate governance in microfinance institutions in India still quite shallow and needs to be enhanced.
In the above findings, it is recommended to improve the corporate governance practices in the micro financing institutions of India. More women directors should participate to enhance the performance. Corporate governance codes should be strictly followed to properly managing and directing the firm. For the future studies, the researchers can use larger data set and use aggregated Global MFI data or cross-country dataset, which can enhance the understandability on this particular topic of improving the performance of micro financing institutions.

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