GOVERNANCE OF MICROFINANCE INSTITUTIONS (MFIS): A CASE STUDY OF BANGLADESH

by

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ABSTRACT

The microfinance programme initiated by the Grameen Bank has become a model of lending to the poor and is now part of the global anti-poverty strategy. The present study examines the corporate governance practices of microfinance institutions (MFIs) in Bangladesh including the Grameen Bank based on a survey of 36 MFIs constituting almost 90 per cent of the borrowers in Bangladesh in 2008.

The corporate governance structure of the Grameen Bank is based on stakeholder value maximization model. Majority of the board members (9 out of 13) are from the borrower groups - the biggest stakeholder of the bank. However, most of the representatives of the borrowers (mostly women) possess very little education so as to function effectively and independently in a board setting. The government which regulates and provides capital to the Grameen Bank (indirectly through Bangladesh Bank) controls the appointment of the CEO and the Chairman of the Board of the Grameen Bank although it is a minority shareholder (10 per cent of the equity). Thus, the board of the Grameen Bank is compliant to the government and lacks the independent character which is crucial to the conduct and performance of the bank. The empirical analysis based on the data for 36 MFIs in Bangladesh show that corporate governance variables are significant in explaining the performance of MFI's in Bangladesh. Among the corporate governance variables, the board composition variable reflecting the independence of the board seems to have a positive and significant impact on the performance of MFI's in Bangladesh. The absence of statistical significance of other corporate governance variables like auditor independence can be explained in terms of lack of quality data and the evolving nature of microfinance industry in Bangladesh.

JEL classification: G30, G32, J23
Key words: Microfinance, Governance, Boards, Audit.

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ABBREVIATIONS

ACLAB – Alliance for Cooperation and Legal Aid Bangladesh
ADESH – Association of Development for Economic & Social Help
ASA – Association of Social Advancement
ASOD – Assistance for Social Organization & Development
BB – Bangladesh Bank
BEES – Bangladesh Extension Education Services
BRAC – Bangladesh Rural Advancement Committee
BRDB – Bangladesh Rural Development Board
CDF – Credit Development Forum
CDS – Centre for Development Services
CEO – Chief Executive Officer
CGAP – Consultative Group to Assist the Poor
CSS – Christian Service Society
DISA – Development Initiative for Social Advancement
DSK – Duhshtha Shasthya Kendra
GB – Grameen Bank
GDS – Generation Development Society
GGS – Grameen Generalized System
GOB – Government of Bangladesh
KSS – Krishak Samabaya Samity
ICAB – Institute of Chartered Accounts Bangladesh
IFDC – International Fertilizer Development Centre
LGRD – Local Government and Rural Development
MD – Managing Director
IRDP – Integrated Rural Development Program
MC – Micro Credit
MDG – Millennium Development Goals
MFI – Microfinance Institution
MRA – Microfinance Regulatory Authority
NGO – Non-Governmental Organization
NHG – Neighborhood Group
PARD – Pakistan Academy for Rural Development
PBK – Palli Bikash Kendra
PKSF – Palli Karma-Sahayak Foundation
PMUK – Padakhep Manabik Unnayan Kendra
PO – Partner Organization
POPI – Peoples Oriented Program Implementation
RASDO - Rural Agricultural Social Development Organization
RD – Rural Development
RDRS – Rangpur Dinajpur Rural Service
RIC – Resource Integration Centre
RHDS - Rural Health & Development Society
ROA – Return on Assets
ROE – Return on Equity

ROSCA – Rotating Savings and Credit Association
RR – Repayment Rate
SATU – Social Advancement Through Unity
SCM – Stakeholder Capitalism Model
SEC – Security Exchange Commission
SJA – Sylhet Jubo Academy
SSS – Society for Social Service
SWM – Shareholder Wealth Maximization
TCCA – Thana Central Cooperative Association
TMSS – Thengamara Mohila Sabuj Sangha
TSUS – Tangail Samaj Unnayan Sangstha
V-AID – Village Agriculture and Industrial Development
UDPS – Uttara Development Program Society
UN – United Nations
VERC – Village Education Resource Centre

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Chapter I :

Introduction

The concept of micro-credit— the extension of small loans without any collateral, based on joint liability— was pioneered by Dr. Muhammad Yunus in 1976 in Bangladesh. The remarkable outreach of this movement in Bangladesh (which presently covers not only credit but also a number of financial and non-financial services) has shown that extending credit and financial services to the poor is feasible and profitable. The access of the poor to credit is recognized as an important strategy in achieving the Millennium Development Goals (MDGs) of promoting gender equality, women's empowerment and poverty reduction. The World Development Report of 2000/2001 widely recommended the microcredit for poverty reduction and as a social safety net for the poor of the developing countries (World Development Report 2001). As of end of December 2006, it had served more than 465 million poorest family members (mostly by providing savings accounts) and extended credit to more than 133 million borrowers (Microcredit Summit Report 2007). Microfinance is high on the public agenda after the UN Year of Microcredit in 2005 and the awarding of the Nobel Peace Prize to Dr. Yunus and the Grameen Bank[1] in 2006.

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[1] Grameen Bank was a project under Bangladesh Bank from 1976 to 1983. A government ordinance in September 1983 transformed the project into an independent bank. In 1983 Government of Bangladesh owned 60% of the equity capital of Grameen Bank and 40%

In Bangladesh, the growth of microfinance has been under, broadly, two institutional structures—as a bank (like Grameen Bank) or as a microfinance institution (MFI). The Grameen Bank is a specialized microfinance bank originated exclusively for providing credit and related services to the poor. It provides credit and other financial services to the poor, encourages them to save so that they can buy a share of the bank, and provides institutional support (training and counseling) for efficient use of loans.

In addition, the microfinance institution (MFI), also like Grameen Bank but under a different institutional framework, provides financial and non-financial services to the poor.[2] Among the MFIs, three institutions identified as very large are the Association for Social Advancement (ASA), Bangladesh Rural Advancement Committee (BRAC), and Proshika. Each has more than one million borrowers. The Association for Social Advancement's (ASA) total borrowers as of June 2006 was 4.6 million and its outstanding loan disbursement was US$293 million; the BRAC's borrowers was US$4.6 million and outstanding loan disbursements were US$350 million; and the Proshika Manbik Unnayan Kendro's borrowers were 1.6 million and its outstanding loan disbursement was US$54 million (Microcredit Regulatory Authority

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were owned by borrowers. Now borrowers/shareholders subscribe to 90% of equity capital and the share of Government of Bangladesh is only 10%, see www.grameen.com.

[2] For an overview of microfinance movement in Bangladesh, see Khandker 1998; Rahman 1993, 1996, 2004; Yunus 1999; Zaman et al. 2007.

Report 2006). At the end of December 2006, in Bangladesh, the overall cumulative borrowers of MFIs were 31 million and their cumulative loan disbursement was US$8,053 million (Credit and Development Forum Report 2006). At the same time, Grameen Bank's members were 6.9 million and cumulative loan disbursement was US$5,751 million (Grameen Bank at www.grameen-info.com).

Although the Grameen Bank and the MFIs were initially dependent on external resources (grants and soft loans), they are now large profit-making institutions. The Grameen Bank made US$20 million profit in 2006 (Grameen Bank at www.grameen-info.com). Moreover, in recent years the MFIs have increasingly accessed commercial sources of finance to scale up their operations and used the poor (at the bottom of the pyramid) to enhance their profits (Zaman et al. 2007; Prahalad 2008).

The main challenge of microfinance is to create social benefits and promote financial inclusion by providing financial services to low-income households. This is often referred to as the "double-bottom line" of MFIs (Tulchin 2003). The increasing emphasis in recent years on financial sustainability rather than on social mission has led to allegations of "mission drift" among MFIs (Armendariz and Szafarz 2009). It is in this context that the issue of governance of MFIs becomes increasingly relevant. The term "governance" has a wide connotation: it broadly refers to the functioning of the legal and social institutions that support economic activity (Williamson 2005; Dixit 2009). However, in the context of Grameen Bank and MFIs, we are more concerned with corporate governance issues than economic governance issues. In the corporate governance literature, under the 'shareholder approach,' the emphasis is on value creation for the shareholder only. Corporate governance theorizing is dominated by the agency theory approach[3]. Under the 'stakeholder approach,' however, the interests of all partners (including borrowers) are given equal importance[4].

In the microfinance industry, the practice has superseded the theoretical developments and the industry has reached a cross-road where one cannot ignore the other. Given these developments, a study of the corporate governance of Grameen Bank and MFIs is important for the following reasons: (1) the microfinance community has experienced some major failures because of inadequacies in its operation, including corporate governance (Labie 2001). (2) Given its tremendous outreach in recent years, its future growth and sustainability depends on how it is governed— the institutional framework (board), legal framework, transparency, etc. (3) To attract further fresh capital into this industry requires a thorough understanding of the corporate governance practices

[3] For a review of literature on the topic, see, Fama and Jensen 1983; Shleifer and Vishny 1997.
[4] The corporate governance models embedded in these two broader approaches include managerial, labour and state-oriented models.

of MFIs. This is especially relevant in the case of the recent trends to attract investment funds by MFIs. The investment funds demand involvement in governance of the MFIs in which they invest equity capital. (4) Microfinance institutions have certain objectives like "double bottom-line" which require considerable trade-offs between profitability and social mission. The main objective of the present study is to understand the governance of microfinance institutions (MFIs) and Grameen Bank of Bangladesh for long-term institutional sustainability from the perspective of best practices in corporate governance. For this study, the primary data of corporate governance indicators of MFIs and Grameen Bank has been collected through a primary survey. The closer examination of governance includes an outline of the roles of the board members, board composition, and an explanation of the important issues of trust and conflicts of interest.

The thesis is organized as follows: chapter 2 reviews the literature on corporate governance structures and formulates the hypothesis for the study, while chapter 3 traces the evolution of the MFI in Bangladesh and its proposed microfinance regulations, and provides a current overview of the sector in Bangladesh. In chapter 4, the data sample for the study is discussed; it also explains the methodology used in the empirical investigation. Chapter 5 analyses the corporate governance structure of Grameen Bank, the composition of its board, and the effectiveness of its governance structure. An analysis of the corporate governance and empirical result of MFI occurs in chapter 6, and in chapter 7 the concluding chapter, concluding observations on the corporate governance of MFIs in Bangladesh are available.

Chapter II:

Corporate Governance and Microfinance Institutions– A Review of the Literature

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The study of corporate governance has assumed greater importance in recent years with issues such as 'transparency,' 'managerial accountability,' 'corporate governance failures,' 'weak board of directors,' 'protection of minority shareholders,' 'investor activism,' 'executive compensation.' These phrases have become household phrases and have attracted considerable attention in the current debate on corporate failures and reforms. In recent times, it has been increasingly recognized that some companies in certain sectors (including microfinance institutions) have violated their social contract with consumers, shareholders, regulators and the community at large. In a March 2009, a McKinsey Quarterly survey of senior executives around the world found that 85 percent of them believed that public trust is the main issue and that the commitment to free markets had deteriorated (Bonini et al. 2009). According to another survey in 2009 by Edelman Trust, 62 percent of respondents across 20 countries feel that they "trust corporations less now than they did a year ago" (Bonini et al. 2009). Similarly, the failure of big corporations like Enron, WorldCom, and Lehman Brothers, among others, has brought into focus the role of corporate governance in company performance.

The question foremost in the minds of practitioners is what constitutes good corporate governance. The dominant view is that corporate governance relates to the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment (Shleifer and Vishny 1997; Becht et al. 2002). This is a narrow view of corporate governance and many commentators believe that stakeholders, such as employees, communities, suppliers or customers also have a significant role in how value (profit) is internalized in a firm.

The classic work by Berle and Means (1932) and Jensen and Meckling (1976) discuss the issue of separation of ownership and control and its consequences. The initial debate occurred with regard to a firm's objective under Shareholder Wealth Maximization (SWM) and the Stakeholder Capitalism Model (SCM) and how the various incentive mechanisms could be used to align the interests of various constituents in a firm (Shleifer and Vishney 1997). The microfinance institutions (MFIs) which have evolved in Bangladesh and various countries face unique challenges because they must achieve a 'double bottom line'– provide financial services to the poor (financial inclusion) as well as create social benefits. This brings into focus how effective governance is critical to the success of MFIs (Champion 1998; Rock et al. 1998; Hartarska 2005). This chapter reviews the literature on corporate governance and in particular its relevance for MFIs. The chapter is organized into seven sections. Section

2.1 briefly summarizes the theoretical debate on Shareholder Wealth Maximization (SWM) vs. Stakeholder Capitalism Model (SCM) and the corporate governance issue in SWM and SCM, with section 2.2 briefly discussing the international codes on corporate governance. Section 2.3 addresses the debate on corporate governance with regard to MFIs, and section 2.4 discusses the corporate governance literature and hypothesis development. A summary of corporate governance in Bangladesh is summarized in section 2.5. Finally section 2.6 summarizes the conclusions of this chapter.

2.1: Goals of Shareholder Wealth Maximization (SWM) Vs. Stakeholder Capitalism Model (SCM).

Creating value or franchise value has always been the goal of corporate policy. The Anglo-American markets have a philosophy that a firm's objective should follow Shareholder Wealth Maximization (SWM) while the non-Anglo-American markets emphasize the Stakeholder Capitalism Model (SCM). This model requires multiple goals and involves a number of trade-offs.

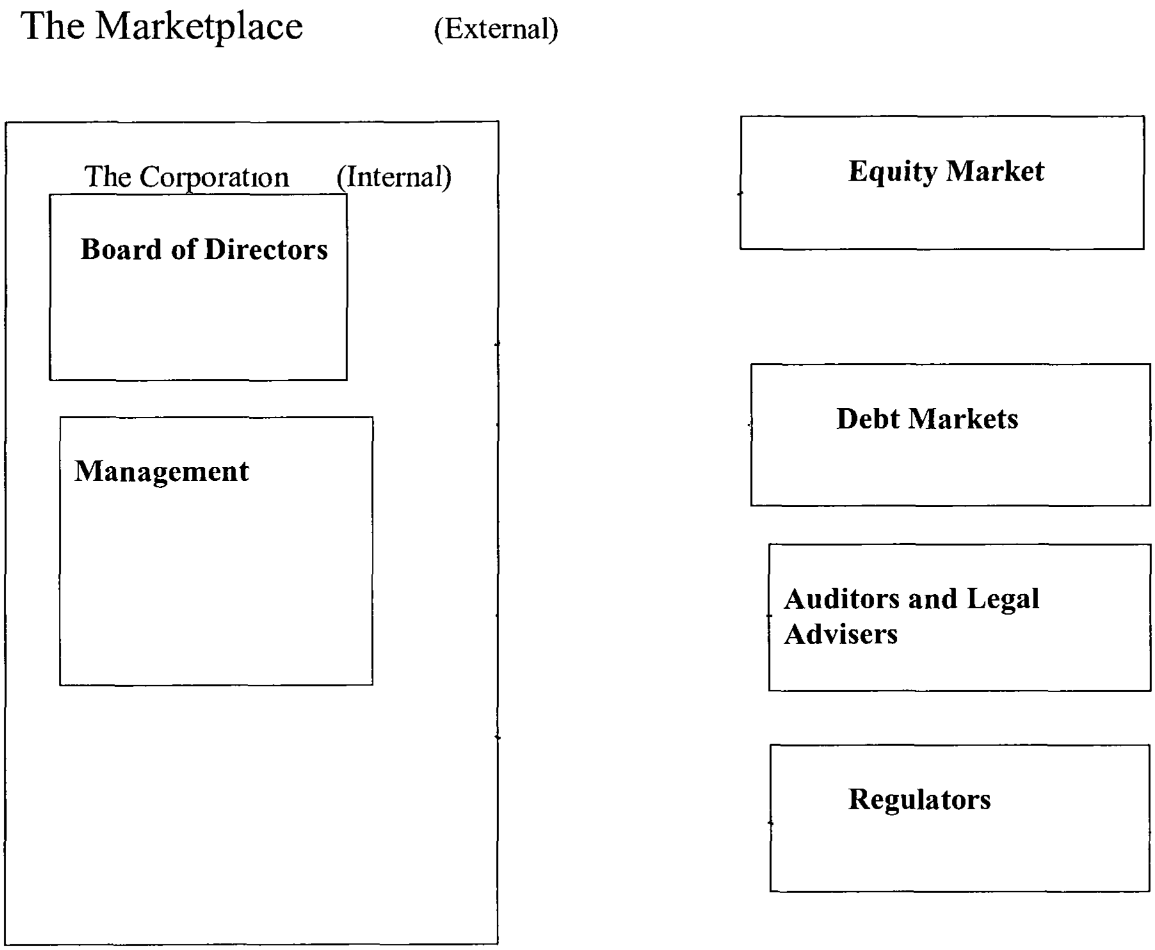
Firms under SWM emphasize maximizing return to shareholders, as measured by the sum of capital gains and dividends for a given level of risk. This model assumes that the stock market is efficient and that stock price reflects the shareholder value. The classical dilemma involved in the

SWM model is the separation of ownership and control and its consequences. The agency theory casts this problem in terms of the principal-agent problem– a principal must delegate a task to an agent whose incentives are not perfectly aligned with those of the principal. The solution of the agency theory makes its case in terms of how shareholders can motivate management through incentive mechanisms like bonus; stock options, etc., to think like shareholders. However, the high-profile scandals involving Enron, WorldCom, Parmalat and so on, and the recent failure of investment banks like Lehman Brothers and Bear Sterns has brought into focus the importance of corporate governance in a well-functioning market economy.

The dissatisfaction with SWM led to the view that a corporation should serve a larger social purpose and be responsible. In some markets (for example, the developing world), the shareholders also strive to maximize long-term returns to equity and takes into consideration the constraint imposed by other stakeholders like labor unions, local communities, creditors, environment, and so on. This model has been labeled the stakeholder capitalism model (SCM). In other words, it advocates reaching out to other stakeholders and not only to shareholders. It argues that 'stakeholding' makes commercial sense. The SCM does not assume that stock markets are either efficient or inefficient, but assumes that long-term 'loyal' shareholders (typically controlling shareholders) should influence corporate strategy rather than the transient portfolio investor.

The traditional question of corporate governance relates to the question of goal of corporate management. In the SWM, the overriding objective is the maximization over time of the returns to shareholders. In order to achieve this, good governance practices should focus on internal and external forces which affect the functioning of a firm. Chart 2.1 provides an overview of the various parties and their responsibilities associated with the governance of a firm.

Chart 2.1: The Structure of Corporate Governance



Corporate governance represents the relationship among stakeholders that is used to determine and control the strategic direction and performance of the organization

Source Moffett, Stonehill and Eiteman 2009 37

The question of what constitutes a good governance structure is strongly debated One of the widely-accepted statements of good corporate governance practices is that established by the Organization for Economic Cooperation and Development (2004) Table 2 1 lists some of the commonly listed indicators of good corporate governance, and section 2 2 discusses some of the widely used corporate governance codes around the world.

Table 2.1: Indicators of Good Corporate Governance

Accountability - Transparent Ownership - Board Size (5 to 9) - Board Accountability - Ownership Neutrality	**Independence** - Dispersed Ownership - Independent Audits and Oversights - Independent Directors
Disclosure and Transparency - Board, timely, and Accurate Disclosure - Internationally Recognized Accounting Standard	**Shareholder Equality** - One Share, One Vote

Source: Newell and Wilson 2002: 21.

2.2: International Corporate Governance Codes

Although there is no universal model of corporate governance, with the collapse of corporations, changing patterns of ownership, and varying cultural and societal values, the corporate governance codes have varied widely (Reaz and Hossain 2007). Sixty-two countries currently have a corporate governance code (Hunt 2008). Table 2.2 reports some of the recent codes of corporate governance, also showing that independent directors are recommended in almost all of the countries' corporate codes. In addition, separation of chairman-CEO roles occurs and reporting to the board is required semi-annually.

Table 2.2: Some Recent Codes of Governance

Country/Code	Independent Directors	Separation of Chairman-CEO roles	Rotation of External Auditors?	Frequency of Financial Reporting
Brazil(CVM Code-2002)	As many as possible	Clear preference for split	Not covered	Quarterly
France (Bouton Report-2002)	At least one half of board	No recommendation	Regularly, for lead auditors	No recommendation given.
Russia (CG Code-2002)	At least one quarter of the board.	Split required by law	Not covered	Quarterly.
Singapore (CG Committee-2001)	At least one-third of the board.	Recommended.	Periodically for lead auditors	Semi-annually.
United Kingdom (Cadbury Code-1992)	Majority of non-executive directors	Recommended	Periodically, for lead auditors	Semi-annually.
United Kingdom (Combined Code – 2003)	At least one half of the board.	Clear preference for split.	Not covered.	Semi-annually , per listing rules
United States (Conference Board – 2003)	Substantial Majority of Board	Separation is one of the three acceptable options	Recommended for audit firm	Quarterly, as required by law.

Source: Coombes and Wong 2004: 52.

2.3: Corporate Governance and Microfinance Institutions (MFIs)

The term of corporate governance in the context of microfinance first appeared in the literature in 1997 (Lapenu and Pierret 2006) and usually refers to the relationship between the board of directors and the management of MFIs. The main challenge of microfinance is to create social benefits and promote financial inclusion by providing financial services to low-income households. It is in this context that the issue of corporate governance of MFIs becomes increasingly relevant. Under the SWM approach, the emphasis is on value creation for the shareholder only. However, in the SCM approach, the interests of all partners (including borrowers) are given equal importance. In the microfinance industry, it is SCM that has close proximity to the practice. However, in the microfinance industry, the practice has superseded the theoretical developments and the industry has reached the point where one cannot ignore the other. Given these developments, a study of corporate governance of microfinance institutions is important.

Very few studies on the impact of governance mechanisms of MFIs on the dual missions of financial sustainability and social benefits exist (Hartarska 2005; Mersland and Strom 2009). Hartarska (2005) investigates the relationship between governance mechanisms and financial and outreach performance, using three surveys of rated and unrated East European MFIs between 1998 and 2002. Governance mechanism includes board characteristics, CEO compensation and ownership type (shareholder-owned firms, cooperatives, etc.). Hartarska (2005) finds that a more independent board gives a better return on the assets (ROA) of MFI's in Eastern Europe. The study also finds that a board with employee directors results in lower financial performance and outreach.

The study by Mersland and Strom (2009) based on a global dataset of 278 MFIs from 60 countries collected from rating agencies found that financial performance improves with local rather than international directors, an internal board auditor and a female CEO. Given the debate on the impact on corporate governance of MFI's on its performance, the following section broadly sets the hypothesis for empirical investigation.

2.4: Corporate Governance Literature and Hypothesis Development

Considering the agency problem and double bottom line of MFIs, an effective board of directors is an important component of their corporate governance. As well, the microfinance governance literature also recognizes the need of the internal governance (board) mechanism for good governance (Rock et al. 1998; Otero and Chu 2002; Helms 2006;

Labie 2001). The board effectiveness is determined by its monitoring function, independence, size, and composition, gender composition, CEO experience, internal board auditor, external auditor, ownership; external mechanisms such as product market competition and regulation are also important (John and Senbet 1998; Mersland and Storm 2009; Hartarska 2005; Rock et al. 1998; Labie 2001; Kim and Nofsinger 2007). Given that the size of the board does have some bearing on performance, the first hypothesis is stated as follows:

H1: There is a significant relationship between board size and corporate performance.

The literature suggests that a small board would be better for effective monitoring of the management and CEO (Fama and Jensen 1983; Kim and Nofsinger 2007; John and Senbet 1998). Empirical evidence from the study of Monks and Minow (1995) suggests that the size of board does matter (cited in Haniffa and Hudaib 2006) and Lipton and Lorsch (1992) have also argued that a small board is more effective. They recommended a board with eight or nine members (cited in Haniffa and Hudaib 2006). An empirical study of a sample of 792 companies by Yermack (1996), as well, suggests that a smaller board brings better performance than a larger one. Eisenberg et al. (1998) found similar patterns using sample of small and midsize Finnish firms.

In contrast, Holthausen and Larcker's (1993) study did not find any relationship between the board size and performance (cited in Haniffa and Hudaib 2006). Moreover, Bohren and Storm (2005) report that larger boards are associated with lower firm performance. However, Pfeffer (1987), Pearce and Zahra (1992), and Goodstein et al. (1994) reported that a bigger board may be effective because it might be able to provide the board with diverse opinions and resources (cited in Haniffa and Hudaib 2006).

H2: There is a significant relationship between board composition and performance

The board effectiveness in its monitoring function is determined by its independence, size and composition. If a board has more outsiders (other than managers), it is considered to be more independent. Corporate governance in America has increasingly shifted towards independent boards with a majority outside board members (John and Senbet 1998). Bhagat and Black (1997) have reported that 50 percent of the 100 American public corporations surveyed in 1996 had only one or two inside directors (cited in John and Senbet 1998). It has also been suggested that boards dominated by outsider (independent) or non-executive directors may help to reduce the agency problem (Berle and Means 1932; Wiliamson 1985; and Jensen and Meckling 1976). Such boards may help in reducing management consumption and removing non-performing

CEOs and other personnel (Haniffa and Hudaib 2006). Pearce and Zahra (1992) have argued that if the majority of board members are outsiders, then their deliberations and decisions provide better strategic directions which ultimately improve performance (cited in Haniffa and Hudaib 2006).

The empirical evidence of board composition on corporate governance is mixed. Millstein and MacAvoy (1998) study found that corporations in America with a majority of active independent boards perform much better than those of passive, non-independent boards (cited in Haniffa and Hudaib 2006). In contrast, Agrawal and Knoeber (1996) found a significant negative relationship between board outsiders and performance (cited in Haniffa and Hudaib 2006).

An independent board is very important for the governance of MFIs. There is considerable consensus in the literature that when a board has a higher fraction of non-insiders/independent directors it becomes more effective at monitoring management (Kim and Nofsinger 2007). Moreover, in MFIs, if the CEO and the chairman are different person then the board can be more effective (Mersland and Storm 2007). Oxelheim and Randoy (2003) also found that firm performance was improved when the directors were independent.

The gender of CEO and gender composition of the Board (especially with regard to MFI) could have considerable impact on the performance of the firm (Mersland and Storm 2009). Almost 90 percent members of MFIs are women. Having a female CEO or a good number of board members as women can help the MFIs to understand their customers better. This better understanding of customers would influence its performance positively (Mersland and Storm 2009).

H3: There is a significant relationship between auditor's independence and performance

Another important variable crucial to the governance mechanism is the internal board auditor. The internal auditor oversee the firm's financial and operating procedures, checks the accuracy of the financial record keeping, and ensures compliance with accounting regulations (Kim and Nofsinger 2007). The internal board auditor provides an independent, objective assessment of the organization's internal governance structure and the operating effectiveness of the management of MFIs (Mersland and Storm 2009). Policy papers regarding MFIs stress the importance of the internal auditor and its direct reporting to the MFI board (Steinwand 2000). A study by Mersland and Storm (2009) shows that when auditor's report directly to the board, a higher financial performance can be expected.

A number of other hypotheses are embedded in the corporate governance literature. Given the fact that these hypotheses are less relevant at the present time to the performance of MFIs, they are left to future research. The above-mentioned hypotheses will be examined in the empirical chapter in the context of MFI's in Bangladesh.

2.5: Corporate Governance in Bangladesh

Corporate sector development in Bangladesh is still in its rudimentary stage. Most of the companies depend on the banks as financing sources. Bangladesh still follows the hybrid legal system inherited from the British administration. Corporate governance practices in Bangladesh started occupying attention only after its independence in 1972. The legal framework for the conduct of firms in Bangladesh was based on the Companies Act of 1913 and the Securities and Exchange Ordinance of 1969. After independence, the Bangladesh Bank Order of 1972, the Bank Companies Act of 1991, the Financial Institutions Act of 1993, the Securities and Exchange Commission Act of 1993, and the Bankruptcy Act of 1997 were enacted. Currently, the Companies Act of 1994 provides the legal framework for the conduct of the incorporated Domestic Corporation and institutions in Bangladesh.

The Companies Act of 1994 provides framework for the audit, preparation and publication of financial statements and disclosure. This act provides certain supervisory functions of the shareholders, such as attending meetings, appointment and removal of directors, and dissemination of financial information and balance sheet (Bhuiyan and Biswas 2007). The Security and Exchange Commission (SEC) has promulgated different guidelines and notifications to ensure good corporate governance in the listed public companies. However, the compliance with these guidelines and notifications leaves much to be desired (Bhuiyan and Biswas 2007). Most of the regulatory agencies (like SEC) suffer from a shortage of qualified staff/expertise. For example, there is only one full-time corporate accountant working at the agency (Reaz and Arun 2006).

The Bangladesh Bank (central bank of Bangladesh) is the primary regulator for the financial system (including MFIs). The Bangladesh Bank is fully owned by the central government. It lacks trained quality staff in terms of prudent monitoring and supervision of the financial system (Reaz and Arun 2006). In addition, political interventions, lack of quality and corruption undermine the capacity of regulators to play an effective role in corporate governance (Reaz and Arun 2006).

According to the Institute of Chartered Accountants of Bangladesh's (ICAB) mandate, it is the supreme authority for affiliation and regulation of accountants in Bangladesh. It has published a report on Corporate Governance in Bangladesh in 2003, which provides guidelines to improve the corporate governance in Bangladesh. However, ICAB has failed to design effective regulations and train professional accountants to achieve international accounting standards in Bangladesh (Reaz and Arun 2006).

Although there are limited regulatory frameworks, in many cases the current system does not provide sufficient legal, institutional or economic motivation for stakeholders to encourage and enforce good corporate governance practice. A study by the Bangladesh Enterprise Institute (2003) has reported that there is no reward or penalties for practicing good governance or not following good corporate governance practices (Bhuiyan and Biswas 2007). A study by Mazumder (2006) also reported that most of the businesses are owned by family and there are lack a of delegation of power to other officials, a lack of independent internal audit and a lack of professionalism, which may have contributed to the poor corporate governance in Bangladesh (cited in Bhuiyan and Biswas 2007). As the literature suggests, the corporate governance in Bangladesh is in its nascent stage and evolving.

As regards the framework for the conduct of non-government organizations to which most of the MFIs belong, there are virtually no guidelines. The NGOs operating MFIs (NGO-MFIs) in Bangladesh do not have to fulfill any extra terms and conditions or regulations for operating microcredit programs in Bangladesh (Khaled 2001). The MFIs carry out financial intermediation by mobilizing savings and extending microfinance to their members. They are like quasi-banks, but not controlled by banking laws and regulations of the country. In recent years the government's concerns have grown significantly with the increasing size, outreach and savings deposits of MFIs operations. In 1997 active members of MFIs were 6.74 million; this increased to 20.51millions in 2006, in less than a decade. In 1997, whereas outstanding borrowers were only 4.26 million, it increased rapidly and in 2006 it was 16 million. The cumulative disbursement of the MFIs in 1997 was US$968 million which increased to US$7948 million in 2006. These facts indicate the tremendous growth of the sector in Bangladesh, which emphasizes the need for better corporate governance practices among these institutions.

However, in the early stages of the development of MFIs, they depended on low-cost funds from donors. During the 1980s, the donors began to fund on a large scale to the organizations, such as BRAC, the Grameen Bank, RDRS, ASA, and Proshika. Now these are the largest MFIs in Bangladesh. Foreign grants to the MFIs averaged $ 160 million annually in the first half of the 1990s and have grown to US$ 255 million annually since then (Zaman et. al. 2007). These MFIs depended on donors 100 percent. For example, from the beginning, BRAC was 100 percent subsidized by donors and its expenditure from the beginning to 1985 was 100 percent contributed by the donors; even in 2006 it was almost 30 percent (BRAC Annual Report 2006). In the case of Grameen Bank, in 1992 more than 99 percent of its funding came from foreign donors. AT present these low-cost funds have diminished. Therefore, the big MFIs, like BRAC, ASA, and Grameen Bank are increasingly accessing international capital. That is why corporate governance aspects are increasingly relevant today for the conduct and performance of MFIs in Bangladesh.

Table 2.3: Present Reporting System of MFIs in Bangladesh

Law	*Dealing Authority*
Societies Registration Act of 1860, Companies Act 1913/1994 as a non-profit Companies	Joint Stock Companies
Voluntary Social Welfare Ordinance of 1961	Social Welfare Ministry
Foreign Contribution Ordinance of 1962, Foreign Donations Regulation Ordinance of 1978	NGO Affairs Bureau (Under this law no organization can be formed, it gives the permission for foreign fund)
Trust Act of 1882	Ministry of Law
-----	Some are enlisted under Dept. of Family Planning, Youth Development and others

Source: Rashid 2005:11.

Presently, in the NGO-MFIs sectors, there are no specific regulatory or corporate governance guidelines in Bangladesh. Twelve different laws for MFIs registration in Bangladesh exists (discussed in chapter 3). These laws do not require submitting robust reporting, auditing or disclosure. For example, the Societies Registration Act of 1860 requires an annual meeting but does not require submission of annual accounts or audits. The Trust Act of 1882 requires maintenance of accounts but not external audits (Zaman et al. 2007). The Company Acts (1913, 1994) require book keeping, audit and report-filing, but the Registrar of Joint Stock Companies is unable to enforce these requirements (Zaman et al. 2007). In addition, the Bangladesh NGO Affairs Bureau is the primary regulator, because most of the NGO-MFIs who are getting foreign donations or aid must register with the bureau. However, the NGO Affairs Bureau does not actively use its power against non-compliance (Zaman et al. 2007).

Therefore, the financial management practice of MFIs in Bangladesh is shaped by donor requirements and the absence of coherent and uniform accounting standards within regulations. As a result, there is no specific governance structure. It is in this context that the corporate governance of MFIs becomes important as it is vital for their sustainability and poverty alleviation in Bangladesh.

2.6: Conclusion

Considering the importance of the fulfillment of the dual missions of MFIs, there are limited studies on MFIs governance of Bangladesh. This chapter has reviewed the broad contours of theoretical and empirical literature on the various facets of corporate governance and highlighted some important hypotheses for empirical investigation in Bangladesh. The literature on MFI governance suggests that the microfinance governance depends on the interaction between the board, managers and borrowers of the MFIs. From that perspective, three dimensions of governance (horizontal, vertical and external dimensions) are suggested in the literature. The literature suggests that governance is important for the financial performance of microfinance institutions and the hypotheses earmarked for empirical verification are: (i) that there is a significant relationship between board size and corporate performance of MFIs; (ii) that there is a significant relationship between board composition and performance of MFIs; and (iii) that there is a significant relationship between the auditor's independence and the performance of MFIs. These hypotheses will be tested in the empirical chapter.

Chapter III:

Evolution of Microfinance in Bangladesh: 1971 – 2008.

Bangladesh has had a colorful political history. Part of the undivided Bengal province during the colonial period, during the partition (1947) it became the part of Pakistan called East Pakistan. It attained political independence in 1971 after a prolonged and disruptive liberation struggle. After independence in 1971, the country had to confront a massive displacement of population and faced the challenges of providing relief and rehabilitation to the vast majority of the population. Along with governmental efforts, there were efforts by a number of non-government agencies (like Bangladesh Rural Advancement Committee) to provide relief and rehabilitation of the displaced and improve their livelihood.

The Grameen Bank, which won the Nobel peace prize in 2006 and was the model of lending to the poor and, as an anti-poverty strategy, emulated in many parts of the world, was created and nurtured in Bangladesh. The chapter traces the evolution of the microfinance industry in Bangladesh since its independence in 1971. The chapter is divided into five sections: section 3.1 provides an overview of the rural credit delivery mechanism in Bangladesh; section 3.2 traces the evolution of microfinance in Bangladesh; section 3.3 offers an analysis of the program of microfinance in Bangladesh; section 3.4 discusses the current legal and regulatory framework of microfinance institutions (MFIs); and section 3.5 provides the conclusion.

3.1: An Overview of Rural Credit Delivery Mechanisms in Bangladesh (Before and After the Independence in 1971)

3.1.1: The Role of Moneylender in the Rural Credit

The undivided Bengal province was dominated by informal credit, especially by the money lenders. The people of ancient Bengal had experienced exploitation from moneylenders even before 400 BC; reference to this phenomenon is found in Koutilya's *Artha Shastra.* The credit system in the Indian sub-continent (undivided Bengal province) gained substantial strength during the Mughal period (1526-1858) when gold coins were in use which facilitated money-lending activities (Azad 1993).

The rural credit system in Bengal is closely linked with agriculture. In the early eighteenth century, mahajans (moneylenders) advanced money to the rural peasants before the season for grains production. They accepted grain as repayment and stored it until a profitable market period. The interest rate was embedded in the grain and repayment was very high. In the middle of the nineteenth century, the peasants were provided loans by merchants and landlords (Azad 1993). Thus, the credit market, especially the informal credit market, was interwoven with the agriculture tenure system.

The then British government, considering the repression of peasants by local lenders (money lenders) established the Indian Central Banking Enquiry Committee to investigate, among other things, the agrarian lending practices in agriculture. The committee found malpractice in money lending. Money lenders took unfair advantage of the rural peasants who were illiterate, ignorant and helpless (Amaravati District Gazetteers; Borooah 1980). On the basis of the Committee's report, the finance department of the government made some suggestions to prevent the practice throughout India. The Bengal Money-Lenders Act of 1940 was adopted to regulate the activities of the moneylenders. This was an important addition to other laws such as the Usurious Loans Act of 1918 or the Bengal Moneylenders Act of 1933. According to the latter, interest in excess of 15 percent on secured loans and in excess of 20 percent on unsecured loans was declared illegal.

Following independence from the British in 1947, Pakistan inherited a banking and credit structure from the British regime consisting of a host of formal and informal institutions. The formal-informal system constituted of 631 local and foreign bank offices. However, the presence of informal sources of credit was also noticeable in both provinces of

Pakistan (East & West). The share of the formal and informal credit markets in rural areas was 4.53 percent and 95.47 percent respectively in 1956; 13.89 percent and 86.11 percent in 1966; 14 percent and 86 percent in 1974; and 25 percent and 75 percent in 1989. The average rate of interest on informal credit during the periods varied from 60 percent to 110 percent per annum (Azad 1993)

Table 3.1: Informal Credit in Bangladesh (Before and after the Independence)

	1956	*1966*	*1974*
Informal credit of total market share (%)	95.5	86.1	86.0
Formal credit of total market share (%)	4.5	13.9	14.0

Source: Azad 1993.

After independence in 1971, Bangladesh inherited a very weak credit and banking system. The informal segment was comprised of local moneylenders and merchants, shopkeepers, and other types of lenders, who were almost non-functional during the early years of independence due to the scarcity of loanable funds. Despite the increases in institutional components of the rural credit market in Bangladesh, non-institutional sources continued to remain as the major sources of rural credit (see Table 3.2).

Table 3.2: Distribution Pattern of Rural Credit, by Landownership Group- 1982

Landownership Group (in acres)	*Households receiving loans from Institutional Sources (%)*	*Households receiving loans from Informal Sources (%)*	*Loans obtained (households) from Institutional Sources ($US)*	*Loans obtained (households) from Institutional Sources ($US)*	*Share of total loans obtained from institutional sources (%)*
Functionally landless (upto0.49)	6.8	91.6	4.05	46.8	8.0
Small Owner (0.50-1.99)	15.0	55.9	11.30	42.05	21.2
Medium owner (2.00-4.99)	20.0	46.9	25.2	48.15	34.4
Large Owner (5.00 or more)	21.0	29.0	46.45	74.65	38.4
All Households	14.3	61.7	16.15	48.2	25.0

Note: Exchange rate $US 1= 20 (BDTK.)
Source: Hossain 1988: 22

As is evident from Table 3.2, 62 percent of the rural households obtained loan in 1982 from moneylenders or the informal credit market. Nearly 92 percent of the functionally landless households were dependent on the informal market/moneylenders. In addition, in many cases the average rate of interest charged was estimated at 125 percent a year (Hossain 1988: 22).

3.1.2: The Role of Co-operatives in the Rural Credit

In the middle of the nineteenth century, the dadan (advance) loans to weavers, local farmers, and industrial producers were provided by merchants (foreign and domestic), landlords and companies for supplying a particular amount of goods within a particular period. The interest rate embedded in production-system agreements such as share-cropping was extraordinarily high (more than 100 percent). This was a source of concern to public authority. The Nobel laureate Rabidranath Tagore (1861-1941) came up with the idea of collateral free credit to rural peasants and established the Kalligram Krishi Bank in 1905 in the village of Patishar in the district of Naogaon in north-eastern Bengal province (now in Bangladesh). It was modeled on the basis of co-operative societies of England and other European countries. His rural co-operatives were started in 1914 and were community based and; they functioned until the 1920s (Mondal 2002). Before that there was the Agricultural Loans Act of 1885 set up by the British Government for 'Taccavi' loans in Bengal—loans for peasants affected by natural disasters. This system lasted until the 1970s. The loan was considered as a debt relief and repayment was not enforced by the government (Rutherford 1995).

In 1904, undivided India's first Cooperative Societies Act was passed to provide a legal framework for the establishment of village-level, self-help, user-managed co-operative societies which mobilized the society's personal savings. Moreover, the Agricultural Debtor's Act of 1935 and the Money Lenders Act of 1939 were enacted to restrict the money lenders activity in the most credit system. The British government also amended the Cooperative Societies Act of 1940 and increased the number of loan mortgage banks to facilitate the availability of credit to the rural peasant (Nath 2004). Nevertheless, in the1930s, the cooperatives did not work well for a number of reasons. The illiteracy of the rural poor and peasant made it difficult to manage their schemes. The official character of the cooperative movement distanced it from the rural users. These users were controlled by wealthy and influential people in society and many members were engaged only for personal profit. The Money-Lenders Act of 1939 also gave a jolt to the societies because it defined co-operatives as money-lending agencies and imposed restrictions on them.

Although the professional money lenders could evade the restrictions, the societies as an institution could not do that. In addition, the great depression of the 1930s put the agricultural sector in a position that resulted in the closure of many co-operatives (Rutherford 1995). Furthermore, the Second World War, the great famine in 1943 and the political and social upheaval of partition of the country in 1947 were further blows for the co-operatives. At the time of partition, there were 26,664 agricultural credit societies in East Pakistan and many of them were on the brink of liquidation because of large overdue. By 1956-57 over 24,000 of these societies were under liquidation (Rutherford 1995).

As the co-operative movement declined, the government tried to revive the co-operative movement from the Union (smallest elected administrative unit in the rural area) level in the early 1960s. The Pakistan government introduced the "Multipurpose Societies" at the Union level. Again, the members of these co-operatives were close to centers of influence and they became the influential's source of outside money in favorable conditions. The Annual Reports of the Co-operative Directorate stated that in the year 1962-63, only one percent of the societies were closed or 'thoroughly good' and 86 percent were classified 'unsatisfactory' (Rutherford 1995).

The Village Agriculture and Industrial Development (V-AID) programme was introduced to facilitate the self-help group in the rural areas in the 1960s. It was followed by the "Comilla Model" developed by the Pakistan Academy for Rural Development (PARD) in 1960. The Comilla Model had four components: the establishment of the Thana (sub-district) training and development centre; a rural works program for construction of road and drainage; a Thana-based irrigation program; and a two-tier cooperative system under the Thana Central Co-operative

Association. Although these initiatives institutionalized the rural cooperative system, they also had a number of problems:

(a) the cooperatives have been taken over by large farmers;
(b) discipline of the cooperative never occurred and the recovery rate was very low;
(c) the two–tier co-operatives lacked inner strength and have become totally dependent on the government for survival;
(d) the system ignored the poor and women;
(e) the co-operatives were not large enough to respond to individual needs and aspirations; and
(f) too-fast expansion of the model made it vulnerable (Rahman 1996).

The Comilla Model was expanded throughout the country in 1970 as the Integrated Rural Development Programmes (IRDP). This model was based on a group approach and provided credit to the co-operators. Under IRDP, farmers were organized into two-tier cooperative groups: credit and agricultural output were mobilized through these cooperatives (Nath 2004). In 1982, the IRDP was reconstituted as the Bangladesh Rural Development Board (BRDB) which is working to strengthen the credit programme to the rural poor in Bangladesh.

3.1.3: The Role of Banks in Rural Credit

The banking system in the territory of Bangladesh grew slowly during the British and Pakistan periods. There were only 25 bank branches in 1901, but the number had grown to 668 in 1946. The creation of Pakistan was a deterrent in the sector, as was evidenced by the closure of bank branches, which was only 148 in 1950 (Azad 1993). After independence from the British, the then-Pakistan government tried a 'new' approach to rural credit and established the Agricultural Development Finance Corporation in 1952 and the Agricultural Bank of Pakistan in 1956. These two banks had similar loan conditions, but each had only a few branches in East Pakistan (now Bangladesh) cities. The loans were given to the wealthier farmers and the recovery rates were low. A commission in 1959 concluded that the banks had failed to make any significant contribution to the rural credit (Rutherford 1995).

In 1961, the Agricultural Development Bank of Pakistan was established. In addition, the State Bank of Pakistan created a program for jute retailers, named, Farias and Beparis, a financing scheme for small loans. The loans were collateral free, but trading licenses were deposited as collateral (Khaled 2001; Islam 2005). Moreover, as advised by the Central Bank, the scheduled banks developed their own small-loan schemes for small-scale economic activities: the National Bank of Pakistan opened the People's Credit Scheme; Habib Bank Ltd. opened the Shop-keepers Loan Scheme; and the United Bank Ltd. opened the Small Loan Scheme. These loans were given to the big dealers; banking institutions and the legal environment were not suitable for rural credit programs. In addition, mass discontent grew up and the political leaders' imagination of mass banking made the people confused. As a result, the

Faria-Bepari scheme and the small loan schemes imposed by the central bank failed to fill the gap in the rural credit system (Khaled 2001).

After independence in 1971, the new government of Bangladesh nationalized all the scheduled banks to fulfill its social commitment to introduce people-oriented 'mass banking' to meet people's aspirations. Branches were opened in rural areas and started micro-lending to small farmers. Rural institutional credit was dispensed mainly through (i) the agricultural development bank (Bangladesh Krishi Bank: BKB); (ii) the nationalized commercial banks- Sonali, Janata, Agrani, Rupali and all private commercial banks; and (iii) the Bangladesh Samabaya Bank Ltd., the apex bank for co-operatives. The number of rural branches increased rapidly, from 854 in 1975-76 to 3225 in 1983 - 84; and in 1986 there were 5114 bank branches operating in Bangladesh; of these, 67.4 percent branches were serving rural areas (Hossain 1988; Chowdhury and Garcia 1993).

Unfortunately, most of the opportunities for the loans were received by a few medium and large landowners and influential person. A survey conducted by the International Fertilizer Development Centre (IFDC) in 1982 showed that in a paddy-growing season only 4.6 percent farmers received credit from institutional sources (Hossain 1988). In addition, the World Bank calculated that 50 percent of urban and 75 percent of rural borrowers did not have access to institutional credit (Chowdhury and Garcia 1993).

The reasons for this lack of adequate institutional credit to the rural small borrowers are as follows: complicated and lengthy loan procedures, delay and higher transaction cost; restrictive features which also narrowed coverage of the traditional credit scope, and the security requirements unaffordable to most rural borrowers, who have neither the assets nor income to support their loan liability; and the lack of banking and facilities in the remote rural areas (Chowdhury and Garcia 1993). Furthermore, the credit that is available goes to the rich, who basically do not require it (Khandker and Chowdhury 1996).

In short, it is evident that the formal credit delivery mechanisms were not only inadequate in the rural areas but also carried high transaction costs, low efficiency, low coverage, and control and manipulation by the rich farmers and local influential people (Khandker and Chowdhury 1996).

3.2: Evolution of Microfinance in Bangladesh

In response to the failure of the formal rural credit delivery system to reach the rural poor, alternative credit dealing mechanisms were contemplated in the early 1970s and mid-1980s. The setting up of Grameen Bank, the Bangladesh Rural Advancement Committee (BRAC), Proshika and other government and non-government microfinance institution programs were attempts to increase flow of credit/assistance to rural areas especially the poor. These targeted credit programs were directed towards the rural poor who did not have access to the formal credit system and especially to the poor women who were discriminated in the labour and credit markets. Moreover, these targeted credit programs were group-based (based on joint-liability), peer monitored/mentored in contrast to the directed credit delivery system in Bangladesh (Khandker and Chowdhury 1996). These non-governmental organization (NGOs) credit programs emerged as microfinance institutions (MFIs) in Bangladesh.

3.2:1: The Role of Grameen Bank in the Evolution of Microfinance in Bangladesh

The origin of the microfinance industry can be traced to the pioneering effort of Professor Muhammad Yunus's Grameen Bank (GB). Microcredit was invented as a strategy for survival of the poor. Professor Muhammad Yunus gave collateral-free microcredit to the rural poor females of Bangladesh with nearly 100 percent repayment rates. The success of Grameen Bank in lending to the poor on a group basis has become a livelihood and development strategy not only in Bangladesh but also in other parts of the world. Professor Yunus began his experiment by distributing small loans to the poor of the village of Jobra from his own pocket and then with the help of Bangladesh Bank, he later expanded the project in 1976 as the Grameen Bank Prakalpa (project). Professor Yunus's aim was to test the hypothesis that if credit is provided to the poor without collateral and at reasonable terms, it could provide self-employment for them (Wahid 1993). Professor Yunus, with the help of Bangladesh Bank (the Central Bank), started to provide small credit to the poorest of the poor as a project and later, in 1983, a government ordinance transformed the project into Grameen Bank, an independent specialized microfinance financial institution for the rural poor. Collateral-free financial services were brought to the doorstep of the targeted rural poor and exclusively to rural women. From the mid 1980s and the early 1990s, there was rapid expansion of Grameen-style microfinance programs all over the country and abroad as well.

The decisive factor in the rapid growth of the sector has undoubtedly been the availability of foreign aid. In the beginning, donor agencies provided funding on a large scale to organizations such as the Grameen Bank. In the 1990s, the Grameen Bank began rapid expansion with the help of subsidized donor funds. For example, between 1985 and 1996 Grameen Bank's membership expanded 12 times and at the same time the bank got US$175 million subsidized funds from donors (Morduch

1999). In 1992, more than 99 percent funding came from foreign donors, although by 1994, the figure had fallen to just 4 percent (Khandker 1998). In the mid 1990s, the Grameen Bank received most of its funding from Bangladesh Bank. The remaining funds came from the International Fund for Agricultural Development (IFAD), Norway, Sweden, the Netherlands, and the Ford Foundation (Morduch 1999)

In the 1990s, the Grameen Bank became able to present itself as a second generation microcredit institution and it appeared to be much better equipped than it was in its earlier version. This new Grameen Bank II is now a real and functioning institution. There was a call for change and it got better equipped after the crisis of 1995, namely the withdrawal of "Group Fund". In addition, in the flood of 1998, the borrowers lost their houses and businesses; they felt the burden of accumulated loans and started to stay away from weekly centre meetings. As a result, the repayment rate declined. These external factors reinforced the internal weaknesses in the system. To overcome this situation, the Grameen Bank introduced the new system, "the Grameen Generalized System (GSS)," by the beginning of 2001. By April 2002, the Grameen Bank II had emerged. In GGS, the "Group Fund" was eliminated and the bank introduced three obligatory savings accounts: personal saving account, special saving account, and pension deposit account.

To make the loan system more flexible, the bank also introduced one prime-loan product; called "basic loan." In addition, there are two other loan products: housing loans, and higher education loans. In the case of failure to pay the basic loan, GGS introduced "Flexible Loan" as an alternative way to repay a basic loan. In these ways, the GGS removed the tensions from microcredit permanently for both sides, both lenders and borrowers. The Grameen II introduced flexible and sustainable microfinance institution.

3.2.2: The Role of BRAC and Other MFIs

Following independence in 1971, external donor agencies supported the government and other private initiatives for relief/rehabilitation of displaced population due to war. The NGOs were also working for relief and rehabilitation with the support of foreign aid/donors support. However, the main focus of the NGOs was basically to mobilize masses for empowerment. They believed that without credit or access to the credit any development or mobilization of these poor would not be effective. For example, the Bangladesh Rural Advancement Committee (BRAC), started as an NGO in 1972, was in the forefront of settlement of displaced families/households due to the liberation war in 1971. The BRAC believed that the poor need skills development and other organizational inputs such as skills promotion and consciousness-raising

(Khandker 1998). The NGOs like BRAC identified three problems of development: lack of resources including finance; unemployment; and lack of social cohesion (Rutherford 1995). The NGOs responded quickly to these development failures with credit programs.

Over time, NGOs like the BRAC and the Grameen Bank have learned from each another. The BRAC learned that credit must be provided along with skills development training and awareness building. The Grameen Bank also realized that credit alone would not be able to solve the problems, because their borrowers needed social development and organizational inputs for their discipline and poverty reduction (Khandker 1998). Moreover, the Grameen Bank model has taken note of the major limitations of the Comilla Model of rural development, which has been struggling to provide credit to the poor through cooperatives (Rahman 1996).

3.2.3: The Role of Government Credit Program

Following the examples of BRAC and the Grameen Bank, the government of Bangladesh introduced a group-based, targeted-credit approach based on the Comilla Model of two-tier cooperatives. Under Integrated Rural Development Programs (IRDP), farmers were organized into two-tier cooperative groups: credit and agricultural output were mobilized through these cooperatives (Nath 2004). In 1982, the IRDP was reconstituted as the Bangladesh Rural Development Board (BRDB) which is working to strengthen the credit programme to the rural poor. In 1988, with the funds from the Canadian International Development Agency, the progammes of BRDB was strengthened and renamed the Rural Development Project-12 (RD-12). It was based on the two-tier cooperative structure with the group-lending model of the Grameen-style delivery model (Khandker 1998). In addition to these, the government's various ministries and divisions are also providing credit to the poor.

3.2.4: Current Position of MFIs

The history of microfinance in Bangladesh spans more than 35 years. Among the pioneers, the BRAC and the Grameen Bank launched their operations in1974 and 1976 respectively. One third of the MFIs were established between 1995 and 2000 (Credit and Development Forum 2006). About 47 percent of the MFIs are relatively late entrants (Graph 3.1). They joined the industry from 2001 onwards. As of February 2007, 4236 MFIs have applied to Microfinance Regulatory Authority (MRA) for license (MRA Report 2006). Although the number is very big, the industry is dominated by Grameen Bank and three other MFIs (BRAC, ASA, and Proshika). Table 3.3 illustrates the scale of these institutions. These four institutions combined have over $1189 million in outstanding loans and around US$594 million in savings. The differences between the borrowers and members reflect a variety of services provided by these MFIs.

Table 3.3: Microcredit Portfolios of the Big three MFIs and the Grameen Bank in Bangladesh (As of end- December 2006)

Organization	*Active Members Million*	*Outstanding Borrowers Million*	*Savings Million US$*	*Cumulative Disbursement Million US$*	*Outstanding Loan Million US$*
Grameen Bank	6.9	6.9	390.48	5750.57	471.19
BRAC	5.3	4.6	151.55	2981.10	345.53
ASA	6.5	5.2	48.75	2521.44	300.42
Proshika	2.8	1.7	2.64	501.13	71.50
Total	**21.5**	**18.4**	**593.42**	**11754.24**	**1188.64**

Source: Credit and Development Forum 2006.

After the big four, there are only twelve MFIs who have more than 100,000 borrowers. Around 30 MFIs are categorized as medium, large and very large and can be considered as the major players of the sector (Credit and Development Forum 2006; Microcredit Regulatory Authority 2006).

3.2.5: Why in Bangladesh

After the fierce liberation struggle of 1971, Bangladesh was facing multiple challenges to rebuild the nation, with the challenges of the reconstruction and rehabilitation of the displaced. In addition, the nation frequently faced natural disasters. A survey found that over 80 percent of the population was living in poverty in 1973-1974 (cited in Aghion and

Morduch 2005). After independence in 1971, the donors supported the government and private initiatives for relief and rehabilitation of the displaced during the war. The NGOs were also working for relief and rehabilitation with the support of foreign aid/donors. However, the main focuses of the NGOs were mobilizing mass people and building awareness, neither of which worked well (Rutherford 1995).

The new government tried to develop programs for the rural poor; one program was a credit program for the rural poor through mass banking. This had a limited impact on the livelihood of the rural poor. As a result of the grave situation in the rural area, some visionary leaders came forward with their long-term vision to rebuild the country. During the liberation war volunteer groups were helping freedom fighters and refugees. The driving forces behind these self-motivated volunteer groups were moral, ethical, humanitarian and patriotic. Some of them were also ideologically motivated.

After independence, these volunteer groups continued to work with the people to rehabilitate them in a new country. In a short time, they founded organizations for social welfare and development and NGOs for development. Some of these organizations became today's BRAC, Gono Sasthya and Rangpur Dinajpur Rural Service (RDRS) (Khaled 2001). Moreover, some of them were revolutionary such as the ASA's founder who wanted to set off a process of rural change which would eventually become a big driving force of the nation and come into state power within a decade (Rutherford 1995). The visionary leaders were born out of necessity and gradually expanded their activities from community development to income generation activities for the rural poor. These non-governmental organizations started to provide credit to the rural poor gradually and established themselves as microfinance institutions. A number of NGOs also replicated their credit program and transformed themselves as microfinance institutions (MFIs). These MFIs in 2004 accounted for 5.3 percent of the total private sector credit in Bangladesh (Table 3.4).

Table 3.4: Share of Microfinance Credit as a Proportion of Total Private Sector Credit (in million- US$)

	2002	*2003*	*2004*
Banks	1167.0	1328.7	1495.9
Non-banks	42.5	54.1	66.6
Microfinance institutions	62.7	73.7	87.9
Total	1272.2	1456.5	1650.4
Microfinance as % of private sector credit	4.9%	5.1%	5.3%

Source: Zaman et al. 2007.
Note: [a] Includes PKSF, Grameen Bank, BRAC, ASA, and Proshika

The main source of funding of MFIs came from donors and government which were instrumental in the homogeneity of the growth and development of the MFI sector (Table 3.5). One decisive factor in the rapid growth of the sector has undoubtedly been the availability of foreign aid. During the 1980s, the donors began funding on a large scale to organization such as BRAC, the Grameen Bank, RDRS, ASA, and Proshika, now the largest MFIs in Bangladesh. Foreign grants to the MFIs averaged US$160 million annually in first half of the 1990s and have grown US$255 million annually since then (Zaman et. al. 2007). For example, from the beginning BRAC was 100 percent subsidized and its expenditure from the beginning to 1985 was 100 percent covered by the donors; even in 2006 it was almost 30 percent (BRAC Annual Report 2006). In the case of Grameen Bank, in 1992 more than 99 percent of its funding came from foreign donors, although by 1994 the figure had fallen to just 4 percent (Khandker 1998).

Table 3.5: Sources of Funds for Microfinance Lending (%)

Sources	*1996*	*1998*	*2000*	*2002*	*2004*	*2006*
A. External Sources: Donors	**48.5**	**28.0**	**18.6**	**15.3**	**10.6**	**6.0**
B. Internal Sources			**81.4**	**84.7**	**89.3**	**94.0**
B1. MFIs own sources	**39.6**	**36.0**	**45**	**50.6**	**56.6**	**59.8**
i) Members savings	20.4	22.6	25.5	26.9	28.5	28.8
ii) Service charge	19.2	13.4	16	17.8	23.7	26.5
iii) Own fund			3.6	5.9	4.4	4.5
B2: Other sources	**11.8**	**36.0**	**36.4**	**34.1**	**32.7**	**34.2**
i) PKSF	2.4	23.2	23.0	21.9	17.0	13.9
ii) Local Banks	9.5	12.8	9.8	9.1	12.7	17.6
iii) Others			3.7	3.1	3.0	2.7
Total (A + B)	**100**	**100**	**100**	**100**	**100**	**100**

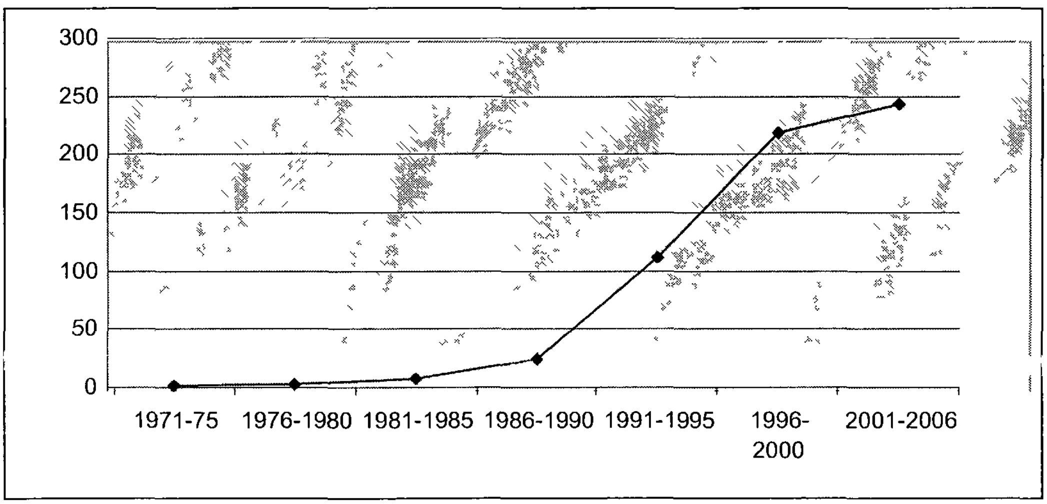
Source: Credit and Development Forum 1996, 2003, 2006.

At the same time, public policy directed at the MFIs played an important role in the growth of the sector, giving the MFIs the necessary functional autonomy to operate and innovate. In addition, the successive government's favorable policies to the MFIs were instrumental to the sector's growth (Zaman et al. 2007).

3.3: Analysis of the Microfinance Programs in Bangladesh

Both BRAC and the Grameen Bank started microcredit programs in the mid 1970s. However, until the1990s, only a few organizations were delivering credit to the poor. The early 1990s was a period of rapid expansion of the Grameen-style microcredit program (Zaman 2004).

Graph 3.1: Rate of Growth of MFIs in Bangladesh- 1971-2006

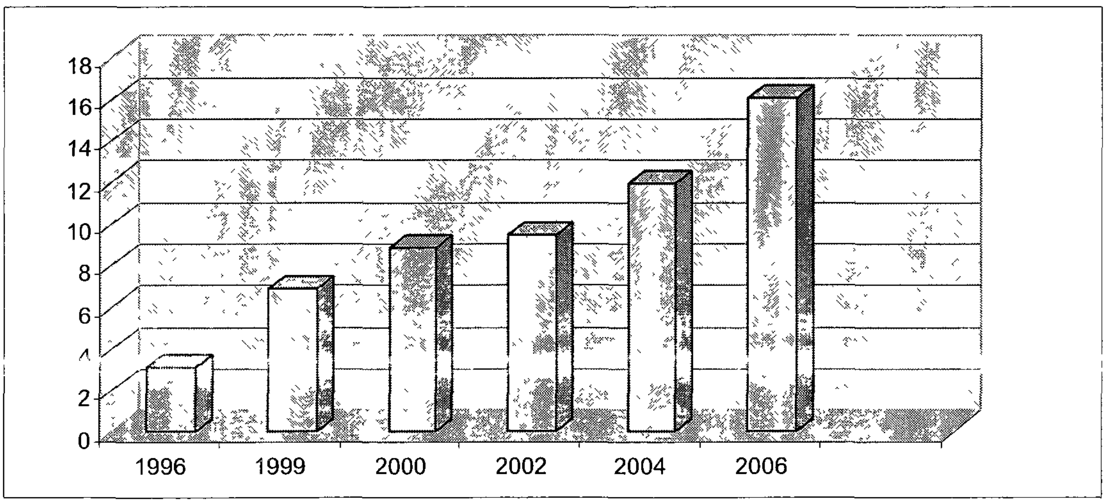


Source: Credit and Development Forum 2006.

A shift from group lending to individual lending also occurred and more professionalism came to the sector. At this time, the Palli Karma - Sahayak Foundation (PKSF—the rural employment generating foundation) emerged as the wholesale financing institution to the MFIs.

By the 1990s, trial-and-error experimentation in the fields led to a big push that spearheaded a massive expansion of microfinance activities during the 1990s. The PKSF contributed significantly to the expansion of microcredit programs in Bangladesh as an apex body of financing and helped to organize them with proper procedures and regulations. Furthermore, microfinance service was now covering almost the entire country. Graph 3.1 shows that one third of the MFIs were established between 1995 and 2000. About 47 percent of the MFIs are relatively late entrants, joining the industry only from 2001 onwards.

Graph 3.2: Growth of Borrowers of MFIs— 1996 - 2006 (in millions)



Source: Credit and Development Forum 1996, 2006.

The principal microfinance service providers in Bangladesh are usually divided into four major categories: microfinance institutions (MFIs); specialized institutions (Grameen Bank and PKSF); banks (nationalized and private commercial bank); and government ministries

/divisions. However, three MFIs (BRAC, ASA and Proshika) and the Grameen Bank share almost eighty percent of the microfinance sector. After the big four, there are only twelve MFIs who have more than 100,000 borrowers. Around 30 MFIs, categorized as medium, large and very large, can be considered as the major players of the sector.

Table 3.6 shows the major indicators of MFIs outreach in Bangladesh. In 1997, although total outstanding borrowers were only 4.26 million, this increased rapidly in 2006 to 16 million; and cumulative disbursement of the MFIs in 1997 was US$968 million, increasing to US$7948 million in 2006. These figures indicate the tremendous growth of the sector in Bangladesh (see Table 3.6).

Table 3.6: MFIs in Bangladesh— Key Indicators

Indicators	*1997 (N= 380)*	*1999 (N= 533)*	*2002 (N=656)*	*2004 (N=721)*	*2006 (N=611)*
Active Members (million)	6.74	7.99	12.86	16.62	20.51
Cumulative Borrowers (million)	-	-	15.84	16.24	30.76
Cumulative Savings deposit (in US$ million)	-	-	553	883	1,165
Net Savings (in US$ million)	74	136	224	295	352
Cumulative Loan Disbursement (in US$ million)	968	1,812	3,603	5,615	7,948
Total credit staff	25,060	32,233	42,918	59,215	79,464

Source: Credit and Development Forum 1998, 1999, 2006.

3.3.1: Scaling–up of MFIs in Bangladesh

In Bangladesh, the outreach of MFIs has increased substantially; the number of active members increased three fold during 1997-2006 (from 6.7 million in 1996 to 20.5 million in 2006) (Table 3.6). The cumulative loan disbursement increased nearly nine-fold— from US$ 968 million in 1997 to US$ 7,948 million in 2006 (Table 3.6).

Table 3.7: Indicators of Financial Self-Sufficiency and Profitability of MFIs in Bangladesh— 2001- 2004

Category	*Indicators*	*2001 (%)*	*2002 (%)*	*2003 (%)*	*2004 (%)*
Very	Financial Self-Sufficiency (FSS)	168	122	119	121
Small	Return on Equity (ROE)	n.a	3.8	3.4	4.0
Small	Financial Self-Sufficiency (FSS)	128	113	122	127
	Return on Equity (ROE)	n.a	1.7	3.4	4.8
Medium	Financial Self-Sufficiency (FSS)	144	122	122	119
	Return on Equity (ROE)	n.a	3.5	3.6	3.2
ASA	Financial Self-Sufficiency (FSS)	113	169	173	269
	Return on Equity (ROE)	10.9	10	10.5	15.0
BRAC	Financial Self-Sufficiency (FSS)	107	111	118	117
	Return on Equity (ROE)	n.a	2.3	3.4	3.3

Source: Zaman 2004; Mix Market (web http://www.mixmarket.org).
Notes: n.a—not available

The increasing outreach of MFIs in Bangladesh has enabled them to enhanced profitability. The return on equity (ROE) of all categories of MFIs (Very small, small, medium, large and very large MFIs like BRAC and ASA)[5] has recorded rapid growths during 2001- 2004 (Table 3.7).

[5] MFI's borrowers less than 10,000 is classified as very small, borrowers from 10,000 to less than 50,000 is classified as small, borrowers from 50,000 to less than 100,000 is medium, borrowers from 100,000 to less than 1,000,000 is large and borrowers 1,000,000 to above is called the very large MFIs, such as BRAC, ASA, GB, etc.

Table 3.8: Microfinance Outreach Indicators of MFIs in Bangladesh—2001-2004

	2001	*2002*	*2003*	*2004*
Very Small MFIs	148	161	167	207
Borrowers per credit officer				
Portfolio per credit office	570,000	573,000	630,000	811,000
Cost ratio	7.6%	9.9%	9.9%	9.2%
Small MFIs	190	200	209	207
Borrowers per credit officer				
Portfolio per credit office	506,000	576,000	622,000	677,000
Cost ratio	10.5%	10.3%	9.9%	9.1%
Medium MFIs	345	448	461	461
Borrowers per credit officer				
Portfolio per credit office	686,000	733,000	740,000	898,000
Cost ratio	8.8%	11.4%	10.1%	9.6%
ASA	345	4408	461	461
Borrowers per credit officer				
Portfolio per credit office	1,310,000	1,700,000	1,970,000	2,110,000
Cost ratio	4.1%	3.4%	3.3%	3.1%
BRAC		298	364	
Borrowers per credit officer				
Portfolio per credit office	n.a	881,000	1,160,000	n.a
Cost ratio	n.a	12.6%	11.5%	n.a

Source: Zaman et al. 2007.
Notes: n.a—not available

The ROE of very small MFIs in Bangladesh were relatively high (amount 3.8 to 4.0%) as compared with small and medium MFIs in Bangladesh. The financial sustainability indicator reflecting the ratio of financial revenue to financial expenses was relatively high (larger than 100) for all categories of MFI's in Bangladesh (Table 3.7)

3.4: The Current Legal and Regulatory Framework of MFIs in Bangladesh

The legal framework for MFIs has not undergone any substantial change in recent times. The NGOs in general derive their legal rights from the constitutional guarantee of freedom of association with the country. Although most of the NGO-MFIs are registered with one agency or the other, there are some NGO-MFIs which are not registered with any agency in Bangladesh. One of the most important laws for the registration of MFIs dates back to 1860 and the newest one is in 1982. There are 12 different statutes for MFIs registration in Bangladesh. The most important laws and regulations for the registration and operation of the development NGOs-MFIs the Societies Registration Act of 1860; Trust Act of 1882; Voluntary Social Welfare Agencies (Regulation & Control) Ordinance of 1961; Charitable & Religious Trust Act of 1920; Company Act of 1913; and Foreign Donations (Voluntary Activities) Regulation Ordinance of 1978 (Zaman et al. 2007; Khaled 2001). These laws and regulations are implemented by four government agencies: the Social Welfare Ministry, the NGO Affairs Bureau, the Ministry of Commerce, and the Ministry of Women and Children Affairs (Zaman et al. 2007).

Table 3.9: Present Reporting System of MFIs

Law	*Regulatory Authority*
Societies Registration Act of 1860, Companies Act 1913/1994 as a non-profit Companies	Joint Stock Companies (Commerce Ministry)
Voluntary Social Welfare Ordinance of 1961	Social Welfare Ministry
Foreign Contribution Ordinance of 1962, Foreign Donations Regulation Ordinance of 1978	NGO Affairs Bureau (Under this law no organization can be formed, it gives the permission for foreign fund)
Trust Act of 1882	Ministry of Law
Other relevant laws	Some are enlisted under Dept. of Family Planning, Youth Development and others

Source: Rashid 2005:11.

Most of the NGO-MFIs in Bangladesh are registered with the Societies Registration Act of 1860. Over 16,000 NGOs/MFIs are registered under this act (Khaled 2001). Registering with this law is very simple and no provision is made for whether or not the society is maintaining any audit or accounts. The Trust Act of 1882 is another law providing the legal basis for MFIs. The Companies Act of 1913, which was amended in 1994, provides a legal basis for not-for-profit companies (Zaman et al. 2007). In addition, a large number of MFIs are registered under the Voluntary Social Welfare Agencies (Regulation and Control) Ordinance of 1961. Other than these, NGOs whose are receiving foreign donations must be registered under the Foreign Donations (Voluntary Activities) Ordinance of 1978 with the NGO Affairs Bureau. About 1200 MFIs are currently receiving foreign funds and almost 1900 MFIs are registered with the NGO Affairs Bureau (Zaman et al. 2007).

Table 3.10: Regulatory Environment of Microfinance Operation in Bangladesh

Legal statute	*Regulatory Authority*
Banks- Bank- Companies Act of 1991	Bangladesh Bank
Grameen Bank- Grameen Bank Ordinance of 1983	Government
NGOs— Under different Laws /Acts	Different Ministries/Division of Government of GOB
Government Programs	Different Ministries
Co-operatives—Co-operative Societies Ordinance of 1984	LGRD and Cooperatives Ministry

Source: Rashid 2005:10.

The NGOs operating in microfinance do not have to fulfill any extra terms and conditions or regulations for operating credit programs for the poor in Bangladesh (Khaled 2001). They carry out financial intermediation by mobilizing savings and extending microfinance to their members. They are like quasi-banks, but not governed by the banking laws and regulations of the country. In recent years, the government's concerns (from the financial stability point of view) have grown significantly with the increase in size, outreach and savings deposit of MFI operations. Considering the need for a regulatory system, the Government of Bangladesh passed a law in 2006, which led to the creation of the Microcredit Regulatory Authority (MRA), which is endowed with the powers to license, monitor and regulate MFI's in Bangladesh.

3.4.1: The Role of the Microfinance Regulatory Authority (MRA)

The main objectives of the MRA are the efficient regulation of microcredit programs and institutions and the ensuring of transparency and accountability in the activities of microcredit organizations operating in Bangladesh. By February 2007, 4,236 MFIs had applied to MRA for license. The MRA has specified that license will issued only to the MIFs with a minimum of 1000 or more borrowers or equal to or more than $58,000 loans outstanding. Accordingly, only applications from 705 MFI's were approved. Up to May 20, 2008, the MRA has issued 250 licenses to different MFIs and the licensing procedure for other selected MFIs is under process (Microcredit Regulatory Authority 2008). The MRA is also working to prepare detailed rules and policies to monitor and supervise licensed MFIs that will cover governance issues, financial transparency, mode of operations and other related issues to ensure transparency and accountability in operation.

3.4.2: The Role of the Palli Karma-Sahayak Foundation (PKSF)

The Palli Karma-Sahayak Foundation (PKSF) was established in 1990 by the Government of Bangldesh as an apex body of MFIs, the only apex wholesale financing body in Bangladesh. Its main objective is to build organizations like MFIs for eradicating poverty in the rural areas and subsequently in urban areas as well. The basic operational strategies of PKSF (Rural Employment Support Foundation) are the following: lend money through its Partner Organizations (POs) especially to the NGO-MFIs; provide greater thrust to institutional development, both in its own capacity as an apex organization as well as the capacities of partner organizations (MFIs). The PKSF does not support any particular model or approach of microfinance; it advocates for appropriate policies and regulations useful for the microcredit sector in Bangladesh. Therefore, PKSF, as an apex body of microfinance program is helping to develop an appropriate regulatory framework, as well as helping the MFIs in funding their microfinance program for the poor.

3.5: Conclusion

In Bangladesh, microfinance developed out of necessity and the environment helped its tremendous growth. In this development, Professor Dr. Yunus' Grameen Bank stands out as a model for all over the world for lending to the poor without collateral. Apart from the Grameen Bank a number of MFIs under various legal statuses exist in Bangladesh and their outreach has grown over the years. The growth of Grameen Bank and MFIs in the earlier years has been facilitated by cheap donor funds. This was supplemented by funds and support from central bank (Bangladesh Bank) and rural development regulator (PKSF). Lately attempt is made under the umbrella of Microfinance Regulatory Authority (MRA) an arm of the Bangladesh Bank to license, monitor and regulate MFIs in

Bangladesh. Overall, the most of the MFIs has attained financial self-sufficiency and has recorded good returns on their equity.

Chapter IV:

Database and Research Methodology

This chapter provides a brief description of the database and research methodology used in this study. The chapter is divided into three sections: section 4.1 provides an overview of the secondary data used in the study; section 4.2 explains the sampling methodology and the description of primary data; and section 4.3 provides a brief overview of the analytical framework used in empirical investigation.

4.1: Data

In Bangladesh, there are two primary sources of data on MFIs; one is provided by a self-regulatory body called Credit and Development Forum (CDF), which provides statistics on microfinance industry in Bangladesh on a regular basis from 1995. The other source is the official statistics provided by the report of the newly established Microfinance Regulatory Authority of Bangladesh Bank (the central bank of the country). The CDF is a microfinance apex organization that compiles data from its members only. The CDF has been publishing microfinance data from 1995 and its latest issue 2006 (published only in 2008) contains self-reported information of 611 MFIs in Bangladesh. To understand the long-term trend and dynamics of MFI, the CDF data is most appropriate and valuable, although it has coverage limitations.

The Microfinance Regulatory Authority was established recently (in 2006) to replace the Microfinance Research and Reference Unit (MRRU) which existed under the Bangladesh Bank- the central bank of the country. The MRRU was in existence from 2000 to bring microfinance industry under a single regulatory framework and started publishing data from 2004. The MRA report summarizes the information provided by the MFIs in their application form for a license. The latest data compiled by MRA, relating to 641 MFIs, are more comprehensive than that of Credit and Development Forum (CDF) database.

The data from the CDF and MRA provide information about the MFIs basic characteristics of MFIs in Bangladesh: inception date, branches, number of groups, numbers of members, numbers of borrowers, total savings, total debt, recovery rate, and so on. These data formed the initial database for our primary survey.

4.2: Methodology and Description of Primary Data

The primary data of corporate governance indicators of MFIs in Bangladesh are collected through a primary survey (a structured questionnaire). The variables included in the survey relate to board size, board independence, board composition, tenure, gender composition, and other areas and have been selected by scanning the existing literature on corporate governance, in particular literature that relates to MFIs.

Sample Size

In the selection of the sample, we stratified the population of MFIs according to size and used the random sampling method within the stratified population to generate a sample cohort. The purpose of the sampling method was to attain a high usage (in terms of borrowers).

As of June 2006, these 36 MFIs in our sample cover 34 percent of total members (all members are not borrowers), 40 percent of the total borrowers, 46 percent of outstanding loan, and 54 percent of the total saving of MFIs services sector in the country. This study also includes the Grameen Bank, which covers almost 27 percent of the borrowers of microfinance sector in Bangladesh (Credit and Development Forum 2006: 2). Thus, our study covers nearly 67 per cent of the total borrowers in Bangladesh based on information for the year 2008. Table 4.2 reports the basic characteristics of the sample. Since the focus of the study was on corporate governance aspects (especially relating to board characteristics, composition, size and auditor independence), this additional information was collected through a structured questionnaire based on visits to their head office.

Table: 4.1: Organizational Profiles: Basic Information of Studied MFIs

Name of MFIs	*Date of Inception*	*Total Members*	*Total Borrowers*	*Total Savings*	*Outstanding Loan*
Alliance for Cooperation and Legal Aid Bangladesh (ACLAB)	1994	570	493	658838	1843852
Antar Society for Development	2004	1516	1479	1957783	6595037
Annesha Foundation	1991	32648	25839	49768695	119741173
Assistance For Social Organization & Development (ASOD)	1986	77006	66962	70995827	230885712
Association of Development for Economic & Social Help (ADESH)	1995	5168	3368	8535901	18107933
Association for Social Advancement & Rural Rehabilitation	2001	2700	2158	1530700	9423850
Bangladesh Extension Education Services (BEES)	1988	96328	79551	107687974	341095953
BRAC	1974	5310317	4550855	10595070000	24156690000
Buro Bangladesh	1990	313350	243948	550560564	1359068888
Centre for Development Services (CDS)	1989	4340	3465	5432484	151571515
Chirontoni	2002	1525	458	4935923	6845170
Christian Service Society (CSS)	1972	33046	29488	36560460	134014808
Development Initiative for Social Advancement (DISA)	1994	6316	4844	9786120	22580209
Duhshtha Shasthya Kendra (DSK)	1985	94310	68736	165517601	315717366
Generation Development Society (GDS)	1998	9042	4620	2624294	6525072
Gharoni	2002	6604	5803	3396041	10075144
Grameen Bank	1976	6908704	6908704	43274470000	33235460000
HEED Bangladesh	1990	89593	60884	167530956	277855491
Muslim Aid-UK	1993	24203	20575	27317566	69624146
Padakhep Manabik Unnayan Kendra (PMUK)	1993	116708	103087	190727703	679102668
Palli Bikash Kendra (PBK)	1993	34938	30090	46908391	122008893
Peoples Oriented Program Implementation (POPI)	1986	126610	105689	128212402	374208314
RDRS	1991	348536	338079	255425407	705835167
Resource Integration Centre (RIC)	1989	48116	34992	81033109	230020666

Rural Agricultural Social Development Organization (RASDO)	2000	696	628	1062767	3419755
Rural Health & Development Society (RHDS)	1997	3214	2829	6903526	10486235
Sajida Foundation	1993	42163	40374	91369727	261773491
SATU	1994	26317	20502	31408020	79431454
Shakti Foundation For Disadvantaged Women	1992	172741	119139	638425800	971540004
Society for Social Service (SSS)	1990	232218	184902	371517009	1045118573
Swanirvar Bangladesh	1978	19657	17835	16071490	65179646
Sylhet Jubo Academy (SJA)	1991	1456	1018	737765	2048360
Tangail Samaj Unnayan Sangstha (TSUS)	1994	2350	1846	4020932	9585930
Thengamara Mohila Sabuj Sangha (TMSS)	1987	499035	437715	962545383	2148307115
UDDIPAN	1991	96249	74274	195466324	412665949
Uttara Development Program Society (UDPS)	1988	47658	38181	68071283	187630643
Village Education Resource Centre (VERC)	1982	27110	20899	60777735	144164534
Total borrowers		14863058	13654309	58235022500	67926248716

Source: Microfinance Regulatory Authority 2006; Credit and Development Forum 2006.

4.3: Analytical Framework

For this study, primary data collected from the MFIs in Bangladesh were analyzed using descriptive statistics. We also employed cross-section regression (based on ordinary least squares) to analyze the impact of corporate governance variables on the financial performance of MFIs as given below:

$$ROA = \alpha_0 + \alpha_1 \log (TA)_{it} + \alpha_2 \text{ (Auditor Independence Dummy)}_{it} + \alpha_3 \text{ Board Composition Dummy}_{it} + \text{Board Size Dummy}_{it} + \varepsilon_{it}$$

Chapter V:

Governance of Grameen Bank of Bangladesh: A Brief Analysis

The concept of microfinance owes its origin to the Grameen Bank in Bangladesh, which was established as a specialized bank for microfinance (similar to an industrial or agricultural bank) in 1983 under a separate charter. Its successful lending model to the poor, based on group joint-liability (association of poor borrowers), is widely emulated worldwide as a model of providing credit to the poor and as an anti-poverty strategy. Of its 7 million active borrowers, nearly 97 per cent of them are women. The average loan size is around US$100 and the bank boasts of a repayment record of about 98 per cent which far exceeds the record of other formal financial intermediaries like banks throughout the world.

In 2006, the Grameen Bank, along with its founder Dr. Mohammed Yunus, won the Nobel Peace Prize for their efforts "...to create economic and social development from below".[6] The Nobel selection committee said that the peace prize was for developing what "...had appeared to be an impossible idea", namely loans to people who lack collateral. In the initial phases of its development, Grameen bank had

[6]http://nobelprize.org/nobel_prizes/peace/laureates/2006/press.html, Accessed on November 29, 2009.

to depend on the savings of its members and funds from philanthropic funds. Lately, however, it has become self-sufficient and has expanded beyond its borders. This chapter is devoted to an analysis of corporate governance of Grameen Bank. The chapter is organized as follows: Section 5.1 provides a brief history of Grameen Bank and its roles in rural credit infrastructure in Bangladesh. Section 5.2 the credit delivery model of Grameen Bank is discussed and section 5.3 discusses the growth and economic performance of the bank. Section 5.4 discusses the bank's governance; and section 5.5 provides the conclusion of the chapter.

5.1: A Brief History of Grameen Bank

After gaining independence in 1971 from Pakistan, Bangladesh inherited a very weak and fragile economic (including credit and banking) system. The loan or credit market, especially in rural areas, was still dominated by informal lenders - moneylenders who performed these tasks independently or in conjunction with other tasks like petty trading, commission agents, share-cropping, etc. The formal financial institutions like banks had an urban bias and were almost nonexistent in rural areas. The non-institutional sources dominated the rural loan market: in 1992, 62 percent of the rural households obtained loans from the moneylenders or the informal credit market (Hossain 1988). Nearly 92 percent of the functionally landless households were dependent on the informal market/

moneylenders. Moreover, in many cases the average rate of interest charged was estimated at 125 percent a year (Hossain 1988).

The new government of Bangladesh sought a solution to the elitist behavior of the formal banking system and came up with a solution of social control of financial intermediaries; in 1972 all scheduled banks in Bangladesh were nationalized and an era of social banking or mass banking was initiated. Through government control, bank branches were opened in the rural areas and started lending to small farmers. Rural institutional credit was dispensed mainly through the nationalized banking system. Consequently, the number of rural branches increased rapidly, from 854 in 1975-76 to 3,225 in 1983- 84. In 1986 there were 5,114 bank branches operating in Bangladesh; of these, 67.4 percent branches were serving the rural areas (Hossain 1988; Chowdhury and Garcia 1993).

However, most of the loans were given to medium and large landowners and to people with good social and political connections. A survey conducted by the International Fertilizer Development Centre (IFDC) in 1982 showed that in a paddy growing season only 4.6 percent farmers received credit from institutional sources (Hossain 1988). The World Bank estimated that 50 percent of urban and 75 percent of rural borrowers did not have access to institutional credit (Chowdhury and Garcia 1993).

The cooperative system based on the Comilla Model (discussed in chapter III) was expanded throughout the country in 1970 as part of the Integrated Rural Development Programmes (IRDP). This model was based on group an approach and provided credit to the membership of co-operatives. Under IRDP, farmers were organized into two-tier cooperative groups. The two-tier cooperative is a co-operative system comprising village-based primary cooperative societies called Krishak Samabaya Samity (KSS) (Farmers cooperative association) at the local level. Members of KSS accumulate capital through weekly savings. Every KSS formulates joint production of plans, and creates a block of 50 to 100 acres of land in the village in order to facilitate the economic adoption of irrigation, institutional credit and improved farming. The KSS receives credit from the Thana Central Cooperative Association (TCCA), which is a larger administrative unit (Momin 1987). The credit and agricultural outputs are mobilized through these cooperatives. The co-operative movement was controlled by large farmers and the system ignored the poor and women (Rahman 1996).

In response to the failure of the formal rural credit delivery system, the informal moneylenders patron-client relations, and their high interest rate (sometimes more than 125 percent), targeted credit programs were developed in the late 1970s into the mid-1980s. The Grameen Bank is one of the pioneer microfinance banks that was created to make credit directly available to the rural poor who do not have access to a formal credit system and to focus exclusively on women. Moreover, this targeted credit program used group-based peer monitoring, a closely supervised credit approach which is different from the formal credit institutions; this makes a significant difference in the rural credit market in Bangladesh (Khandker and Chowdhury 1996).

The origin of the microfinance industry can be traced to the pioneering efforts of Professor Muhammad Yunus' Grameen Bank. The bank's origin goes back to a chance meeting of the founder, Mohammad Yunus, with a bamboo stool maker, Sufia Khatoon, in the village of Jobra in the southern part of rural Bangladesh. Sufia was making bamboo stools with raw materials supplied on credit by a moneylender, who then bought the finished product. The money lender set both the price of raw materials and the price of the finished product. After paying for the raw materials, Sufia had hardly enough left to feed her family of five. Sufia made two cents from each stool which meant that she had to return to the money lender for credit.

Seeing this exploitative situation, Professor Yunus tried to find out how many other people were in the same situation as Sufia in the village. With the help of his students and through a survey, he found that there were 42 such people. Professor Yunus gave collateral-free microcredit (US$27) to these exploited people out of his own pocket. The initial loan that Professor Yunus made was repaid in full. This strengthened his belief in the poor's ability and willingness to repay and provided the foundation for the creation of Grameen Bank, which was turned into a development philosophy.

Subsequently, with the help of the Bangladesh Bank (the central bank in Bangladesh); he later expanded the project in 1976 as Grameen Bank Prakalpa. Later, in 1983, a government ordinance transformed the project into the Grameen Bank—a village bank, an independent specialized microfinance financial institution for the rural poor. The announcement of the Norwegian Nobel Committee to award the Nobel Peace Prize to Professor Yunus and Grameen Bank points out that the Grameen Bank has been a source of ideas and a model for the many institutions in the field of micro-credit that have sprung up around the world (The Nobel Peace Committee 2006).

The Grameen Bank was established as a challenge to the existing collateral-based banking system and the exploitative moneylenders (Khandker et al. 1995). Professor Yunus argues, "....the money-lending business has served as an expensive alternative to official institutions, but it often undermines individual efforts to alleviate situations of poverty.

Money lenders can charge exorbitant interest rates that initiate an endless cycle of poverty and debt..." (Yunus 2007b: 21). Collateral-free financial services were brought to the doorstep of the rural poor, especially to the rural women. Professor Yunus also notes that "...the new system should target the detrimental effects of money lending by freeing borrowers from high interest rates and any pressures or legal requirements to repay loans....." (Yunus 2007b: 21). Therefore, Grameen Bank wants to save the poor from the clutches of the exploitative moneylender whose role impoverishes the poor. The moneylenders charge exorbitant interest rates (in the range of 60 to 300 per cent) an action that creates indebtedness and perpetuates the vicious circle of poverty.

On the other hand, the traditional banking system neglected the poor because of the lack of collateral and high transaction costs. The Grameen Bank differs from traditional banks in the "....value of the principal amounts and types of the loans it offers, the terms of its loans, the repayment conditions of its loans, its lending procedures and in the overall social consciousness and guidance that it incorporates in its loan policies.." (Hassan 2002: 240). The Grameen Bank focuses not on profit but on the needs of its borrowers. Professor Yunus notes, "...the objective is to bring financial services to the impoverished, particularly women and the poorest of the poor, to aid them in their fight against poverty and ensure that their business endeavors remain financially sound. It is a composite objective with both social and economic visions…." (Yunus 2007b:21). For this, it provides organizational support to the poor to make effective use of their credit and income. In Yunus words, "…micro-credit is a well trained and well funded method that can bring financial services to the poor. Micro-credit promotes entrepreneurship, and put each individual poor person, especially women in the driving seat, in their own lives..." (cited in Mjos 2006).

Lamia Karim (2008) summarizes the declared objectives from Grameen Bank's document as follows: according to Professor Yunus, the GB model of micro credit (MC) is not solely a matter of the extension of credit; it has a unique set of social objectives that it aims to implement through MC policies. These are:

- It promotes credit as human right.
- It is aimed towards the poor, particularly poor women.
- It is based on "trust", not on legal procedures and system.
- It is offered to create self-employment, income-generating activities and housing for the poor, as opposed to consumption.
- It was initiated as a challenge to conventional banking which rejected the poor by classifying them as "not creditworthy."
- It provides service on the doorstep of the poor based on the principle that the people should not go to the bank, the bank should go to the people.
- It gives high priority to building social capital (cited in Muhammad 2009: 38-39).

Now Grameen Bank is the world's largest bank for the poorest of the poor, and is based on a different philosophy from traditional banking.

It is more about people than about money. Professor Yunus says, "...lend the poor money in amounts which suit them, teach them a few sound financial principles, they manage on their own..." (cited by the Chairman of Nobel Peace Prize Committee). Since its formal opening in 1983 it has lent almost eight billion US dollar. Today the bank has almost eight million borrowers; Grameen Bank lends US$800 million dollars per year. The bank is presently self-sufficient and has also generated a return on assets in the range of 0.11 to 2.5 per cent per annum in recent years (2001-2007) (www.grameen.com).

5.2: The Credit Delivery Model of the Grameen Bank

The Grameen Bank has integrated group activity with credit delivery to assist the rural poor in income-generating activities. In the process of the Grameen Bank credit program, households first take the initiative to organizing themselves into a group of five. The Grameen bank officials most often help the households in the formation of the group. Men and women form separate groups, considering the religious and societal values of Bangladesh society. Membership in a group is strictly limited to people who own less than half an acre of land or whose assets do not exceed the value of one acre of land, live in a village and are not members of the same households. Therefore, the members of the group belong to the same socio-economic characteristics. This facilitates bonding, mutual trust and confidence that give them a sense of strong feelings of working together.

Each group elects a chairperson, who performs the leadership role in the group, and a secretary, who assists the group in many organizational activities like book-keeping. Members gather once in a week for group meetings where they share their experience and learn and discuss the rules of Grameen Bank's group lending programme. In a village five to eight groups are collated as a centre. A centre is led by an elected chairperson and secretary. Each centre is also assisted by a Grameen Bank employee, who visits several groups on a weekly basis. All transactions are openly conducted at the centre meeting. These peer monitoring and peer mentoring mechanisms work at the level of the group and at the centre levels. The Grameen Bank credit delivery system has the following features:

- There is an exclusive focus on the poorest of the poor
- Borrowers are organized into small homogenous groups
- Special loan conditionalities which are particularly suitable for the poor
- Simultaneous undertaking of a social development agenda addressing basic needs of the clientele
- Design and development of organization and management systems capable of delivering programme resources to target clientele
- Expansion of loan portfolio to meet diverse development needs of the poor

The Grameen Bank considers savings mobilization to be an integral part of lending. Each member is required to save at least one taka every week, which is deposited in the weekly meeting. In addition, each borrower is required to contribute 5 percent of their borrowed amount to the group fund. The group fund is self-managed and can be used for mutually agreed purposes. In addition to mandatory savings, each member can purchase a Grameen equity share worth Taka 100 ($US1.50).

By the beginning of 2001, the new system, "The Grameen Generalized System" or GGS was launched and by April 2002, the Grameen Bank II emerged on a full-fledged operational basis. The transition was completed on August 7, 2002. The new Grameen Bank II is now a real and functioning institution. This second- generation microcredit institution appears to be much better equipped than it was in its earlier version. In the Grameen Bank II, gone are the general loans, seasonal loans, family loans, and more than a dozen other types of loans; gone is the group fund; gone is the branch and zone loan ceiling; gone is the fixed-size weekly installment; gone is the rule to borrow every time for one whole year, even when the borrower needed the loan only for three months; gone is the high-level tension among the staff and the borrowers trying to steer away from the dreadful event of a borrower turning into a "defaulter," even when she is still repaying; and gone are many other familiar features of the Grameen Classic System.

Moreover, the GGS has been built around one prime loan product— the Basic Loan. In addition, there are two other loan products: 1) the housing loan, and 2) the higher education loan which runs parallel to the basic loan. All borrowers start with a basic loan.

One most visible change everybody notices in GGS is the disappearance of the Group Fund. The Grameen Bank had had to keep defending the Group Fund ever since it was created twenty-five years earlier. There are no more joint accounts. Each borrower will have three obligatory savings accounts— a) Personal savings account, b) Special savings account, and c) Pension deposit account (obligatory only for borrowers borrowing above Taka 8,000 (US$ 118).

The Grameen Bank's microfinance programmes target women with the explicit goal of empowering women. The Grameen Bank believes that money that goes to women brings more benefits to the family. When women borrow, children become immediate beneficiaries. Moreover, women have a longer vision and they want to bring changes to their lives step by step. The women use money more cautiously and they are excellent managers of scares resources. The majority of women receive loans for activities that are considered traditionally female activities— milch cow, cow fattening, poultry rising, paddy husking, vegetable cultivation and trading, clothing shop, plantation, village phone and so on. Therefore, microcredit is working as a liberating force for the poor women in the rural area. Nobel Prize Committee notes that "micro-credit proved to be an important liberating force in societies where women in particular have to struggle against repressive social and economic conditions" (Announcement of Nobel Committee 2006).

The Grameen Bank as the pioneering microfinance institution has established the trust in the poor's ability to repay the credit on time, use it for self-development and become an agent of socio-economic development. The Grameen Bank helped to create a norm of credit discipline in the rural poor of Bangladesh. The 98 percent repayment rate of the credit has become the gold seal of approval (Dowla 2006). The Grameen credit gives high priority to building social capital; this promoted through formation of groups and centers, developing leadership quality through annual election of group and centre leaders, and electing board members when the institution is owned by the borrowers.

To develop a social agenda owned by the borrowers, something similar to the "sixteen decisions," it undertakes a process of intensive discussion among the borrowers, and encourages them to take these decisions seriously and implement them. Grameen Bank's sixteen decisions have established set of norms. The credit delivery model of the bank- group formation, weekly group discussion, group disbursement, collection, and centre meetings are the basis of accountability and performance (Dowla 2006).

The Bank also puts special emphasis on the formation of human capital and concern for protecting the environment. It monitors children's education, and provides scholarships and student loans for higher education. For the formation of human capital it makes efforts to bring technology such as like mobile phones, and solar power, and promotes mechanical power to replace manual power. The microfinance program has provided the message to the people of various walks of life that the poor have every right to get credit and those poor have proved their credit worthiness. The Grameen Bank also established the norm that credit is not charity (Dowla 2006).

Basher (2007) suggests that the Grameen Bank credit program helps, (1) to reduce the fertility rate of women in Bangladesh; (2) the Grameen Bank helps its borrowers as an agent of economic and social development; (3) the Grameen credit program helps to empower the women in the rural area of Bangladesh (Basher 2007). The Grameen Bank also provides housing loans, education loan to its members. The bank encourages members to build homes, plant vegetable gardens, and plant trees and install sanitary latrines for a healthy life. In addition, it also train its members in maternal health care, nutrition and child care, family planning and public health as well (Hassan 2002).

Moreover, participation in the credit program increases the mobility of the rural women from purchasing power to household decisions and their ownership of property. Grameen Bank microfinance is empowering the rural poor of Bangladesh (Hashemi et al. 1996). Therefore, in addition to economic self-sufficiency, the microfinance encourages control over resources, changes in attitudes and decision making, changing parental preference for male children, self-confidence, decision regarding the child's education; women are in the process of empowering themselves.

5.3: Growth and Performance of the Grameen Bank

The growth of the Grameen Bank in Bangladesh has been tremendous; it has now around 7 million borrowers, and the proportion of female clients increased from 20 per cent in 1976 to 98 per cent in 2007. Grameen Bank over the years has made a number of operational changes (Hassan 2002; Zaman 2004). Initially it included both male and females in a group and then separated the male and female groups. The classical Grameen bank model was based on group formation— promotion of thrift and after a certain incubation period, extension of credit to the group.

The classical Grameen bank model consisted of a bank unit being set up with a Field Manager and a number of bank workers, covering an area of about 15 to 22 villages. The manager and workers would start by visiting villages to familiarize themselves with the local culture in which they would be operating and identify prospective clients. They also explained the purpose, functions and operations of the bank to the local population. Groups of five members are eligible to receive a loan. In the first stage, only two out of the five group members are eligible for, and receive, a loan. The group is observed for a month to see if the members are conforming to the rules of the bank. Only if the first two borrowers repay the principal plus interest over a period of fifty weeks do other members of the group become eligible for their loan. These restrictions provide for substantial peer monitoring and group pressure.

The collective responsibility of the group serves as collateral for the loan. Those borrowers with good repayment records are eligible for higher loan amounts and graduate to seasoned borrower status in which case they become eligible for individual loans. The Grameen Bank's pioneering use of group-lending contracts with joint-liability potentially reduces the problems of moral hazard and adverse selection in the credit market for the poor (Morduch 1999).

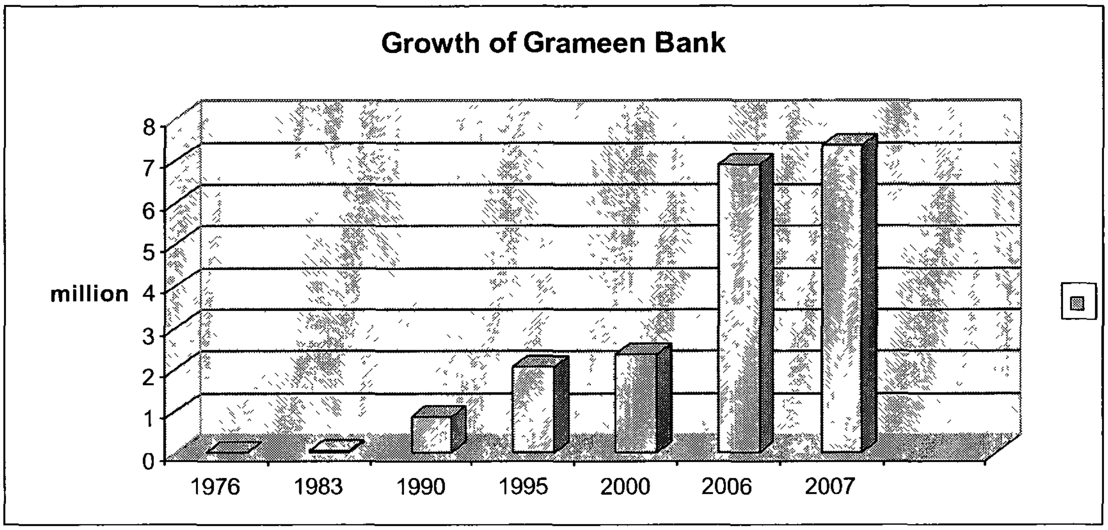
From the 1980s and the early 1990s, Grameen Bank started to expand its credit all over the country (Table 5.1). Loans were made to individuals but through small groups under joint-liability. The loans were meant for income-generating activity. The collection of the loans was frequent— usually weekly. The interest rates charged did not include any sort of subsidy and the rates were relatively low (around 20 per cent). The fundamental tenet of the Grameen Bank is that the poor are credit worthy and the poor always pay back (Dowla and Barua 2006).

Table 5.1: The Progress of the Grameen Bank (Amount in Million US$)

Performance indictors	1976	1983	1990	1995	2000	2006	2007
Cumulative Disbursement	.001	194.9	248.0	1405.9	3060.4	5954.0	6685.5
Disbursement during the year	.001	99.3	68.7	333.2	268.4	724.9	731.5
Total Deposit	-	18.5	25.9	117.6	126.8	633.3	758.9
Total Members (in millions)	-	.06	0.9	2.1	2.4	6.9	7.4
Percentage of Female Members	20	46	91	94	95	97	97
Profit/ Loss (for the year)	-	-0.0059	0.0027	0.4	0.21	20.00	1.56

Source: Grameen Bank (www.Grameen-info.org)

Chart 5.1: Number of Borrowers of Grameen Bank (1976- 2007)



Source: Same as in Table 5.1.

From the mid 1990s, it significantly expanded its outreach and activities throughout the county (Table 5.1, 5.2 and also discussed in chapter III). The Grameen bank faced significant challenges in the late 1990s when in 1998, the nation faced a devastating flood, putting two-thirds of the country under water for eleven weeks. The Grameen bank faced repayment problems during this period; 20 per cent of the loans became irregular (Dowla and Barua 2006). This forced the bank to rethink their business model. Prof. Yunus changed the model in September 2001 (called Grameen II)- switching from group lending and savings to individual lending and savings, merging various loan products into one product called the basic loan, and providing temporary reprieve in the form of a flexible loan for borrowers having repayment problems. The first pronouncement of the change in Grameen II came with the publication of a monograph by Prof. Yunus in April 2002 titled Grameen Bank II: Designed to Open New Possibilities.

Table 5.2: The Grameen Bank— Indicators of Outreach— 2002 - 2007

Year	Number of Active Borrowers (in Millions)	Rate of Growth (%)	Total Women Borrowers	Rate of Growth (%)	Share of women in total borrowers	Number of Depositors (in millions)	Rate of Growth (%)
2002	2.08		1.98		95.20	1.48	
2003	2.87	37.98	2.73	37.88	95.44	3.12	110.8
2004	3.70	28.92	3.54	29.67	95.66	4.06	30.13
2005	5.05	36.49	4.86	37.29	96.27	5.58	37.44
2006	5.96	18.02	5.76	18.52	96.70	6.91	23.84
2007	6.16	3.36	5.97	3.65	96.85	7.41	7.24

Source: Same as in Table 5.1.

At the present level of disbursement and loans outstanding, the GB is operating without a financial subsidy. In addition, the present level of disbursement and outstanding loan has increased its growth in assets and loan portfolio significantly (Table 5.3)

Table 5.3: The Grameen Bank—Growth in Assets and Loan Portfolio— 2002-2007

Year	**US$ Assets In million dollars**	**Rate of Growth (%)**	**US$ Gross Loan Portfolio**	**Rate of Growth (%)**
2002	315.70		213.34	
2003	394.03	28.81	268.03	25.64
2004	514.71	30.63	337.70	25.99
2005	633.02	22.99	424.47	25.69
2006	819.79	29.50	482.08	13.57
2007	941.27	14.82	532.04	10.36

Source: Same as in Table 5.1.

The bank diversified its program from credit to insurance and other types of loans such as educational loans. Moreover, from the mid 1990s, it established eleven sister organizations that range from profit organizations to not-for-profit organizations (discussed in this chapter in 5.3.1). These sister organizations provided support in Grameen's mission of poverty alleviation of the rural poor.

The growth of the Grameen Bank started in the 1990s and applies to both borrowers and assets. The Grameen Bank is not taking any subsidy or aid from the donors. This discussion reveals that the Grameen Bank's growth of borrowers, outstanding loan, assets and profitability has confirmed it as a profitable microfinance institution. Given its operational costs and financial performance, the Grameen Bank is a financially viable microfinance institution.

5.3.1: Grameen Bank's Family Organizations

The Grameen Bank has twelve family organizations (subsidiaries) which are equally responsible for helping the rural poor of Bangladesh in various ways. The Grameen Bank family organizations are Grameen Communications, Grameen Trust, Grameen Fund, Grameen Telecom, Grameen Cybernet Limited, Grameen Shakti/Energy, Grameen Phone, Grameen Shikkha/Education, Grameen Knitwear Limited, Grameen Solutions, and Grameen Byabosa Bikash (business promotion services).

Grameen Communications: Grameen Communication is a not-for-profit Grameen Telecom Company, established in 1997. Its main goal is developing software, hardware, networking, IT services and IT education.
Grameen Trust: Grameen Trust was introduced in 1989 to support and promote a GB type program that works for poverty alleviation. It builds networks, publishes materials, and provides technical support to national and international organizations for GB replication initiatives.
Grameen Fund: Not-for-profit sister organization of GB was founded in 1994. It provides finance to ventures that are risky, technology-oriented and otherwise deprived of finances from existing formal lending institutions.
Grameen Telecom: Grameen Telecom was established in 1995 as a sister organization of GB to provide easy access to telephone services all over rural Bangladesh.
Grameen Cybernets Ltd.: Grameen cybernet was established in 1996 to provide internet services in Bangladesh.
Grameen Shakti/Energy: Not-for-profit sister organization of GB established in 1996. It is a rural power company to empower the rural people with access to green energy and income. It supplies renewable energy to unelectrified villages in Bangladesh.
Grameen Phone: A profit based sister organization of Gameen Bank established in 1997 to provide cellular phone services.
Grameen Shikkha/Education: Grameen Education was established in 1997 to promote mass education in rural areas, provide financial support in the form of loans and grants for the purpose of education.
Grameen Knitwear Limited: Established in 1997, it is an export oriented knitwear company.
Grameen Solutions: A software development company. Moreover, it provides solution services for the businesses, technology fields
Grameen Byabosa Bikas (business promotion services): A not-for-profit business promotion services organization established in 2001 as sister organization of GB. Its strategy is to make resources and scope available to the poor (farmers/producers) entrepreneurs through technical, financial, and marketing support.

The wide variety of subsidiaries that Grameen set up has provided for a diversified asset base and provided revenue from multiple sources (assets) which then formed as a corpus for many of its charitable activities.

Grameen Bank not only expanded its credit programs but also a wide variety of services to the poor. As a result, the poor receive products and services at an affordable price that leads the opportunity to scaling up services as well.

5. 4: Corporate Governance of the Grameen Bank

Governance is about achieving corporate goals. In the case of Grameen Bank it has dual missions— called the "double bottom line" (Tulchin 2003). It has to serve the poor through financial inclusion (social benefits) and at the same time be financially sustainable. The social impacts can be assessed in terms of outreach variables such as (a) number of borrowers covered, (b) share of women in total outreach, (c) magnitude of assets and (d) magnitude of loan extended. Similarly, financial sustainability can be assessed in terms of overall profitability through measures such as (a) return on equity (ROE), (b) return on assets (ROA), (c) gross portfolio yield and (d) operational cost (Christen 2001). We present such an analysis in the following paragraphs.

As discussed in the preceding paragraphs, the number of borrowers covered by Grameen bank is around 7 million in 2007 of on nearly 97 percent are women (Table 5.2).The rate of increase in outreach (borrowers) averaged between 3 to 38 per cent between 2002 and 2007. There were more than 7 million depositors by 2007. The assets of the

Grameen Bank stood at US $ 941 million at the end of 2007; nearly 56 per cent of the assets were in the form of a loan portfolio (Table 5.3).

The Grameen Bank has been financially successful. With a repayment record as high as 98 per cent, the return on equity varied between 1 per cent and 22 per cent between 2002 and 2007 (Table 5.4). The return on assets (ROA) has been positive and in some years (2005 and 2006) was as high as 2.5 per cent, which is impressive given the average return of banks internationally of one per cent. The yield on return on its gross portfolio was as high as 20 per cent (Table 5.5). The proportion of default (impaired) assets is very low— around 2 per cent. The operating expenses to loan portfolio has been low (around 9 to 13 per cent).

Table 5.4: The Grameen Bank— Financial Performance—2002- 07

Year	Capital/Asset	Debt to Equity	Return on Assets	Return on Equity
2002	10.81%	8.25		
2003	9.12%	9.96	0.11%	1.07%
2004	15.37%	5.51	0.19%	1.07%
2005	11.25%	7.89	2.41%	18.40%
2006	10.81%	8.25	2.46%	22.37%
2007	9.12%	9.96	0.11%	1.07%

Source: Same as in Table 5.1.

Table 5.5: The Grameen Bank— Operating Performance— 2002-07

Year	Yield on Gross Portfolio	Provision for Loan Impairment/ Assets	Operating Expense/ Assets	Operating Expense/Loan Portfolio
2002				
2003	20.31%	2.23%	7.33%	12.72%
2004	-	1.81%	6.19%	9.29%
2005	22.43%	0.44%	8.35%	12.57%
2006	22.94%	1.50%	6.97%	11.17%
2007	20.31%	2.23%	7.33%	12.72%

Source: Same as in Table 5.1.

Considering the good economic performance and outreach, it would be interesting to examine its links with other elements of corporate governance.

5.4.1: Corporate Governance Literature and Governance of the Grameen Bank

In terms of analytical framework, we use the stakeholder model of corporate governance as the basis for analytical and empirical analysis (as discussed in chapter II). As outlined in chapter II, the evaluation of corporate governance of Grameen Bank is conducted on (a) board characteristics, size, etc., and (b) Auditor independence.

From 1976, the Grameen Bank was a project directed by Prof. Mohammed Yunus and the central bank of Bangladesh (Bangladesh Bank) along with international donors. There was no board or council to oversee its functioning. In 1983, a board was constituted by the government with only government nominees. In 1996, through an amendment, the board size was expended to 13, of which nine were to be elected from borrowers/shareholders and other four members (two general members, Chairman of the Board and Managing Director-CEO) were appointed by the government.

The board of directors is the body that oversees the management of the Grameen Bank (from 1983). As elected representatives of the stakeholders, the directors are obligated to ensure that managers protect the interests of the stakeholders— in the case of the Grameen Bank they could be identified as borrowers (who own 90 per cent of the equity), government (who own the remaining 10 per cent), donors, and regulators (like PKSF and central bank). The independence of the board and its effectiveness are important attributes crucial to the functioning of the Grameen Bank. If a board has more outsiders (other than managers), it is considered to be more independent. Bhagat and Black (1997) reported that 50 percent of the 100 American public corporations surveyed in 1996 had only one or two inside directors (cited in John and Senbet 1998).

It has also been suggested that boards dominated by outsider (independent) or non-executive directors may help to reduce agency problems (Berle and Means 1932; Wiliamson 1985; and Jensen & Meckling 1976). Such boards may help in reducing management consumption and removing non-performing CEOs and other personnel (Haniffa and Hudaib 2006). Pearce and Zahra (1992) argue that if the majority of board members are outsiders, then their deliberations and decisions provide better strategic directions which ultimately improve performance (cited in Haniffa and Hudaib 2006).

The Grameen Bank is a specialized village bank for lending to the poor. Borrowers of the bank own 90 percent of its share capital and 10 percent of its share capital is owned by the government of Bangladesh. The government, which owns 10 per cent of the share capital of Grameen Bank, appoints the CEO and Chairman of the Board of the Grameen Bank and has a greater voice in the day-to-day functioning of the bank. Thus, a minority shareholder (government) is able to control the appointment of CEO, Chairman of the Board of Grameen Bank and thereby the functioning of the bank.

Even though a majority of board members are outsiders (stakeholders), the government in terms of its control over supply of capital (through BB) and regulatory power (through Bangladesh bank) is able to vest itself in control of the Grameen Bank. Hence the board of the Grameen bank is subservient to the government. As long as Dr. Mohammed Yunus is the moving spirit behind the organization, Grameen Bank may be able to minimize the intrusive behavior of the government.

The Grameen Bank board is composed of outside board members. Out of 13 board members, the managing director of the bank is the only insider in the board. In the Grameen Bank, 9 out of 13 board members are the borrowers/shareholders on the board. Most of them are hardly literate and have little formal education; they could be overwhelmed by government nominees or managers. On the contrary, most of the government representatives are graduates of from universities and professional institutions and management schools.

Almost all the outside board members are women borrowers. Thus in theory, outsiders dominate the board of Grameen Bank; in reality they may not have a 'real voice' as these outside board members (women borrowers) may not have the knowledge, expertise in board conduct. They could easily be influenced or cajoled into submission by powerful insiders. Therefore, they may not be able to follow the proceedings of the board and contribute to a good and effective board. A high fraction of women borrowers on the board could help the Grameen bank to understand their customers better and that could prevent the mission drift. However, most of the office bearers (including the CEO) are men. It is paradoxical that a bank with an almost exclusive focus on women clientele allows them very little influence at the operational level.

The second issue related to board performance is the *size of the board* of the Grameen bank. A board with fewer members could improve the decision-making process and efficiency of the board. Literature suggests that a small board would be better for effective monitoring of the management and CEO (Fama and Jensen 1983; Kim and Nofsinger 2007; John and Senbet 1998). The empirical evidence from the study of Monks and Minow (1995) suggest that the size of board does matter (cited in Haniffa and Hudaib 2006). Lipton and Lorsch (1992) argue that small board may be more effective, recommending a board of eight or nine members (cited in Haniffa and Hudaib 2006). An empirical study of a sample of 792 companies by Yermack (1996) suggests that a smaller board brings better performance.

The Grameen Bank has a board size of 13 which is relatively large by corporate board standards. The 1983 Grameen Bank ordinance stipulates a board of governors composed of the chairman, the managing director, and nine other members— five appointed by the government of Bangladesh and four appointed by the borrower-shareholders. The 1983 board was essentially dominated by the government nominees. However, the 1986 amendment of the ordinance provides for 13 members of the board, of which nine are to be elected members from the borrowers/ shareholders and the other four members (two general members, chairman and managing director) are selected by the Bangladesh government. The Grameen Bank board members are elected every year and the board members are eligible for re-election to the board.

For electing the board members form the borrowers, the Grameen Bank has divided the whole coverage area into nine electoral areas. From each of the electoral area one board member is elected by the borrowers of the Grameen Bank. The election process starts from the group level and then goes up to the electoral areas through centre, branch, area, and zone. The Grameen Bank board meetings are held four times per year. However, in case of emergency or need, meetings can be held more than four times in a given year. The Board is assisted by various committees of the Board for various aspects of decision making (like human resources, overseas operation, etc.).

On the other hand, Pfeffer (1987), Pearce and Zahra (1992), and Goodstein et al. (1994) argue that a bigger board may be effective because members will bring diverse opinion and resources which may eventually reduce environmental uncertainties (cited in Haniffa and Hudaib 2006). It may be appropriate to have a larger board for the Grameen Bank, because almost all of the outside board members are the borrowers/members of Grameen Bank. Therefore, a larger board composed of various experts will bring critical resources for the bank, which will be helpful for good and effective governance.

Another important variable crucial to the governance mechanism is the independence of the auditor. The internal auditor oversees the firm's financial and operating procedures, checks the accuracy of the financial record keeping, and ensures compliance with accounting regulations (Kim and Nofsinger 2007). The internal board auditor provides independent, objective assessment of the organization's internal governance structure and the operating effectiveness of management of MFIs (Mersland and Storm 2009). Policy papers regarding the MFIs stress the internal auditor's independence and to report directly to the MFI board (Steinwand, 2000). A study by Mersland and Storm (2009) show that MFIs are reporting directly to the board shows higher financial performance.

The Grameen Bank board has several sub-committees that are chaired by members of board; an audit committee, finance committee, budget committee, and planning and evaluation committee. At the same time, the Grameen Bank has an internal auditor who report directly to the board. Corporate governance stresses the importance of internal audit and recommends that the internal auditor reports directly to the board. Thus, an MFI allowing its internal auditors to report directly to the board should show higher financial performance. The present study found that Grameen Bank sent the audit report directly to the board. Moreover, it has external independent auditor and its report is published regularly and posted on its website regularly. In addition, it publishes its financial report regularly.

5.5: Conclusion

The corporate governance structure along with its business model of the Grameen Bank is widely emulated worldwide and is often cited as a model code for other MFIs. Essentially, the corporate governance structure of the Grameen Bank is based on the stakeholder value maximization model. The majority of the board members (9 out of 13) are from the borrower groups— the biggest stakeholder of the bank. However, most of the representatives of the borrowers (mostly women) possess very little education so as to function effectively and independently in a board setting. The government, which regulates and provides capital to the Grameen Bank (indirectly through nationalized bank and Bangladesh Bank), controls the appointment of the CEO and the Chairman of the Board of the Grameen Bank although it is a minority shareholder (10 per cent of the equity). Thus, the board of the Grameen Bank is compliant with the government and lacks the independent character which is crucial to the conduct and performance of the bank.

At present, the Grameen Bank is dependent on the tremendous clout and goodwill of Professor Mohammed Yunus (founder of the bank) in preventing potential abuses by the government and also in attracting capital worldwide (from various governments and NGOs). The question of how the bank will be able to function in the absence of its founder is a serious one. On the positive side, the Grameen Bank possesses independent auditors (internal and external) who report to the board directly. This positive aspect is overshadowed the dominance of the government in the vital decision-making of the bank.

Chapter VI:
Corporate Governance and Microfinance Institutions (MFIs) Performance in Bangladesh— Empirical Results

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This chapter presents the results of the empirical investigation and is organized as follows. Section 1 presents basic statistics of the data used in the empirical investigation, while Section 2 presents the results of the empirical investigation. Section 3 summarizes the main conclusions.

Section 6.1
Summary Statistics

The average asset size of MFIs in Bangladesh used in the study is US$24 million. However, the median size is only US$2.8 million, which indicates that there is considerable variation in the firm size among the MFIs in Bangladesh used in the study (Table 6.1). The lowest size of asset size in the study is US$0.03 million while the largest firm has a total asset size of US$619 million. The standard deviation of total assets of MFI's in Bangladesh is high (US$102 million). In general, the total asset size variable is positively skewed (skewness= 5.63). Similarly, the number of borrowers of MFIs, which is an alternative measure of size, is also highly skewed. The lowest number of borrowers among the MFIs was 458 and the largest one has 4.5 million borrowers; the median number of borrowers was 1.9 million.

The average return on assets (ROA) is 2.25 per cent with the median value lower at 2.13. The lowest ROA was -13.84 while for MFIs with the highest ROA it was 11.13. Unlike total assets ROA is negatively skewed (-1.07 per cent).

Table 6.1: Basic Descriptive Statistics

Basic Statistics	ROA	Total Assets	No. of Borrowers	Duml	Dum2	Dum3
Mean	2.25	24,558,834	187,378	0.88	0.44	0.19
Median	2.13	2,852,311	27,663	1.00	0.00	0.00
Std. Deviation	4.48	102,644,049	754,323	0.32	0.50	0.40
Skewness	-1.07	5.63	32.90	-2.47	0.22	1.54
Range	24.97	619,365,159		1.00	1.00	1.00
Minimum	-13.84	34,379	458	0.00	0.00	0.00
Maximum	11.13	619,399,538	4,550,855	1.00	1.00	1.00
Observations	36	36	36	36	36	36

Chart 6.1 and 6.2 reports the box plot (which presents graphical plot of variations in data like quartile 1, quartile 2, quartile 3 and range) of the MFI data used in the empirical investigation. As is evident, the size of the firms (total assets and number of borrowers) show significant variation (Chart 6.2)

Chart 6.1: Box Plot of Return on Assets of MFIs in Bangladesh— 2008

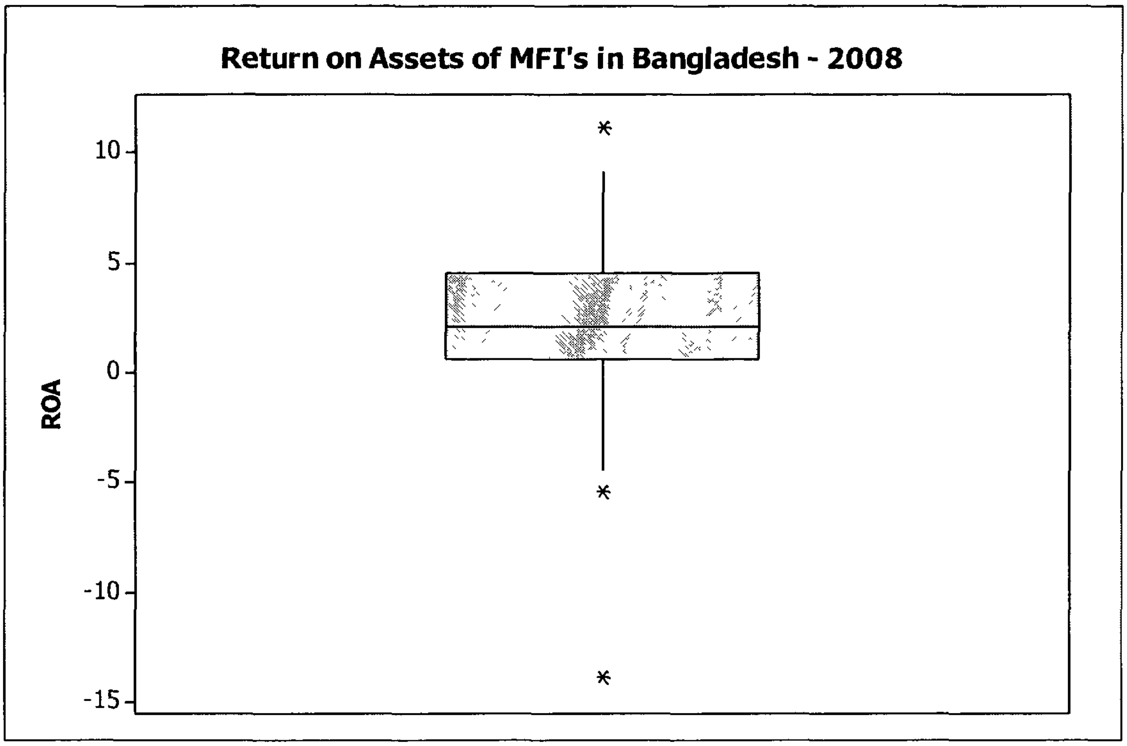
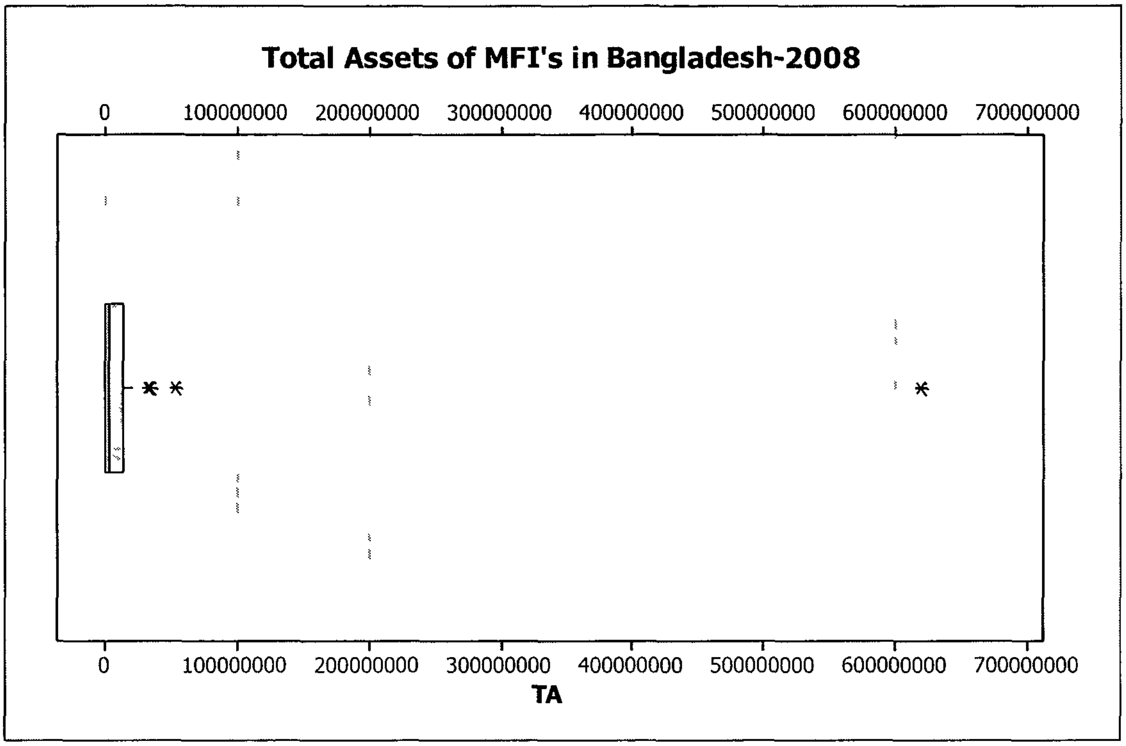
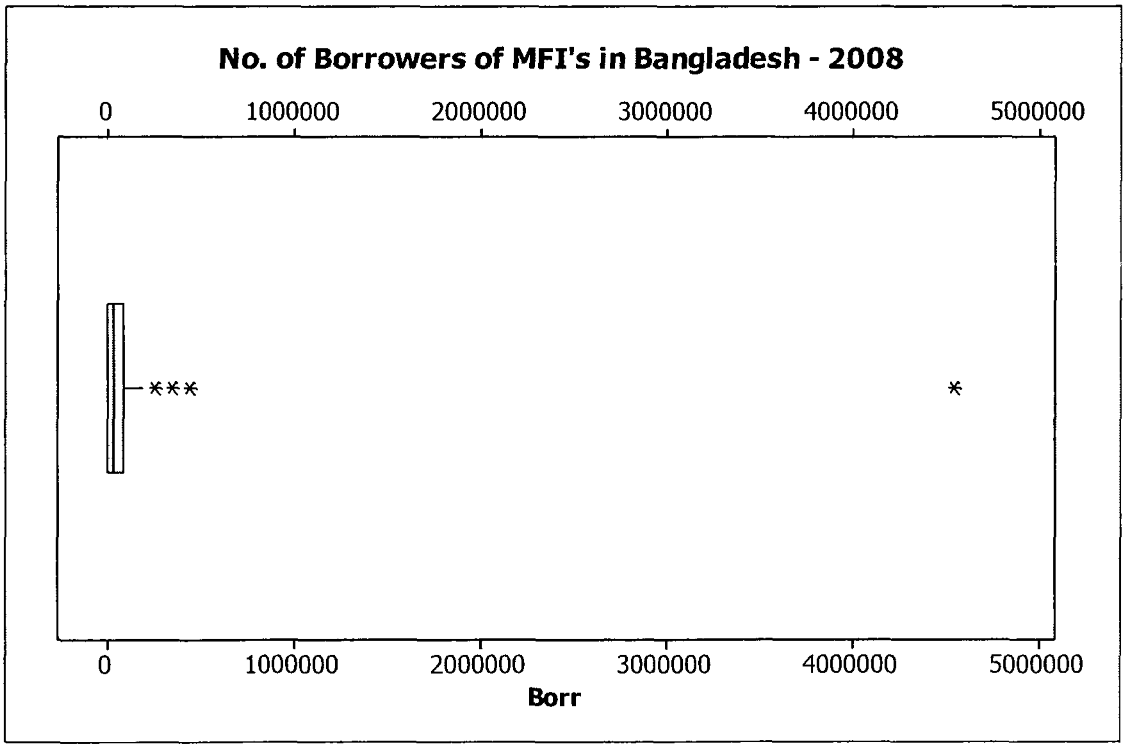


Chart 6.2: Box Plot of Total Assets and Borrowers of MFI's in Bangladesh—2008





Section 6.2:

Cross-Sectional Results

Table 6.2 summarizes the results of the cross-section regression results based on ordinary least squares based on the following equation

ROA = α_0 + $\alpha_1$log (TA) $_{it}$ + α_2 (Auditor Independence Dummy) $_{it}$ + α_3 Board Composition Dummy $_{it}$ + Board Size Dummy $_{it}$ + ε_{it}

(6.1)

Table 6.2: Determinants of Performance of MFI's in Bangladesh— Dependent Variables— ROA – 2008

	ROA	ROA
Constant	7.01	5.12
	(1.61)	(1.53)
Log (Total Assets)	-0.50	
	(-1.77)*	
Log(Borrowers)		-0.53
		(-1.82)***
Auditor independence (Dummy1)	-0.71	-0.66
	(-0.39)	(-0.36)
Board Composition (Dummy2)	6.62	6.45
	(5.16)*	(5.21)*
Board Size (Dummy3)	0.55	0.56
	(0.38)	(0.38)
Number of Observations	36	
Diagnostics		
R Square	0.48	0.48
Durbin-Watson Statistic	2.1	2.2
F- Value	7.14	7.2

Note: 1. Figures in brackets are 't'-values.
2. *, **, *** indicates statistical significance at 1%, 5% and 10% respectively.

The ROA equation (equation 6.1) shows that the corporate governance variable– board composition (dummy2) has a positive and statistically significant impact on MFI performance in Bangladesh. The board composition variable captures the impact of the number of independent directors (outsiders) relative to insiders (managers); MFIs with independent board (number of independent directors > insiders) have a positive impact on MFI performance. These results are corroborated with the regression results where the size variable is the number of borrowers as well. Other corporate governance variables like board size and auditor independence are not statistically significant. The overall explanatory power of the equation is relatively good ($R^2 = 0.48$).

Section 6.3

Conclusion

The empirical results reported in this chapter show that corporate governance variables are important in explaining the performance of MFI's in Bangladesh. Among the corporate governance variables, the board composition variable reflecting the independence of the board seems to have a positive and significant impact on the performance of MFI's in Bangladesh. The absence of statistical significance for the other corporate governance variables like auditor independence can be attributed to lack of clarity regarding these. For example, almost all of the MFIs report that the auditors are independent. However, a careful scan of these data and checking into other information shows that the auditors may be related to the CEO in one way or another.

Chapter VII:

Concluding Observations

The microfinance programme initiated by the Grameen Bank has become a model of lending to the poor world-wide and is now part of the global anti-poverty strategy. Bangladesh has the highest MFI density and has now become a model of outreach to the poor worldwide. Given the fact that MFIs have to tread a fine path between profits and social outcomes, the future expansion of the microfinance sector hinges on among other things, the integrity and credibility of the industry. In this regard a study of the corporate governance of microfinance institutions (MFIs) in Bangladesh is appropriate. This study is the first step in this direction.

The microfinance institutions (MFIs) operate under different institutional frameworks, providing financial and non-financial services to the poor. However, three MFIs (BRAC, ASA and Proshika) and Grameen Bank share almost eighty percent of the micro-credit in this sector. Most of the NGOs-MFIs in Bangladesh are registered with the Societies Registration Act of 1860. Registering with this law is very simple and no distinction is made on whether or not the society is maintaining any audit or accounts. In addition, there are a few other NGO-MFIs reporting laws, not sufficient to provide supervisory and regulatory environment for MFIs in Bangladesh. For this, the Government of Bangladesh passed a law in 2006 that created the Microcredit Regulatory Authority (MRA), which will recommend relevant laws and regulations and provide licenses to all the MFIs. Without the MRA license, MFIs are not allowed to deliver microcredit in Bangladesh.

For its part, the Grameen Bank has been financially successful. With a repayment record as high as 98 per cent, the return on equity varied between 1 and 22 per cent between 2002 and 2007 which far exceeds the return of the formal banking system worldwide. The return on assets (ROA) has also been positive and in some years (2005 and 2006) was as high as 2.5 per cent which is impressive given the average return of banks internationally of one per cent. The yield on return on its gross portfolio was as high as 20 per cent. The proportion of default (impaired) assets is very low— around 2 per cent. The operating expenses of the loan portfolio have been low (around 9 to 13 per cent). Considering the good economic performance and outreach, this bank's elements of corporate governance have been studied on the basis of the analytical framework provided in chapter 4.

The MFIs in Bangladesh expanded in the 1990s and one-third of MFIs joined the industry from 2000 onward. However, the MFI's product market in Bangladesh is very competitive. At the same time the overlapping of customers is increasing rapidly and there are increasing concerns about borrowers having multiple memberships which could lead to over-indebtedness of borrowers. This situation is aggravated by the fact that the MFIs are not regulated yet, but the process is ongoing. Moreover, the MFIs are following the rules of financial transparency as a process of regulation.

Although the NGO-MFIs are broadly following the corporate governance structure, however, the chief executives are said to overpower the boards. Because of the chief executive selects the members of general body, it is possible that like-minded people and friends will become members of the general body of MFIs. If this is the situation, good governance will not occur by just inducting good people in the governing body. Moreover, the essence of governance is to ensure an overall system of structuring accountability and transparency in an organization. The governance problems of NGO-MFIs are mostly due to the inadequacy of the existing laws and regulations, and the lack of reporting, supervision and monitoring in Bangladesh.

One of the innovations in microfinance has been the targeting of female customers. In case of the sample of 36 MFIs, more than 90 percent of the members/borrowers are women. Presumably, having a female CEO or a high representation of women in the board could help the MFIs to understand their customers better, and that would eliminate the risks. Our empirical investigation found results to the contrary: most of the board members and CEOs of MFIs are male and men dominate the boards of MFIs where almost all of their clients are women.

The Grameen Bank's governance is based on the stakeholder value maximization model. The majority of the board members (9 out of 13) are from the borrower groups - the biggest stakeholder of the bank. The board of Grameen Bank is independent. However, most of the representatives of the borrowers (usually women) possess very little education needed to function effectively and independently in a board setting. The government that regulates and provides capital to the Grameen Bank (indirectly through Bangladesh Bank) controls the appointment of the CEO and the Chairman of the Board of the Grameen Bank although it is a minority shareholder (10 per cent of the equity). Thus, the board of the Grameen Bank may lack the independent character which is crucial to the conduct and performance of the bank. At present, the Grameen Bank is dependent on the tremendous clout and goodwill of Professor Mohammed Yunus (founder of the bank) to prevent potential abuses by the government and also to attracting capital worldwide (from various governments and NGOs). The question of how the bank will be able to function in the absence of its founder is a serious one. On the positive side, the Grameen

Bank possesses independent auditors (internal and external) who report to the board directly.

The empirical results reported in Chapter 6 clearly show that corporate governance variables are significant in explaining the performance of MFI's in Bangladesh. Among the corporate governance variables, the board composition variable, reflecting the independence of the board, seems to have a positive and significant impact on the performance of MFI's in Bangladesh.

The microfinance industry in Bangladesh is in the consolidation phase: big MFIs and the Grameen Bank account for more than two-thirds of the clientele. In recent years, with the entry of commercially-oriented MFIs, there is a need to strengthen the governance and supervision of MFIs in Bangladesh. Although the Grameen Bank is under the direct supervision of the Bangladesh Bank, other MFIs have only recently been brought under the umbrella of supervision. Secondly, with MFIs offering not only savings services but other elements like insurance, pension products, mobile phones, etc., a co-ordinated and consolidated supervision is called for to prevent regulatory arbitrage.

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