# Improving Governance for sustainability of microfinance institutions (MFIs)

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## Executive Summary

Poverty reduction is the core target of many national and global policy initiatives, including the Sustainable Development Goals (SDGs). Microfinance institutions (MFIs) have the dual goal of simultaneously reaching out to the poorest and ensuring financial sustainability. SDG 1 explicitly places poverty reduction at the core of global policy initiatives (UN 2015). World Bank (2022) reported that about 54% lacked access to formal banking services. MFIs are devised to eliminate poverty by helping marginal entrepreneurs Aslam, et al., (2018). Although Welfarists believe that MFIs have to fulfil their social mission regardless of who bears the cost of financial service, institutional frameworks that encourage financial inclusion and confirm stable governance support the financial sustainability of financial intermediaries and contribute to poverty reduction process (Beck &Demirgüç-Kunt, 2020). Despite those competing views, the growing body of literature on financial sustainability witnesses the widely accepted belief that financially self-sufficient MFIs are needed for sustainable poverty reduction.

**Keywords**: Financial sustainability; Governance; Microfinance institutions; Sub-Sahara Africa


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## 1. Introduction

Microfinance institutions face a problem of dual objective. They need to help people with financial services that are affordable and at the same time they have to make sure they have sustainability to keep going. They also need to be governed in a smooth way.

When microfinance institutions are governed well they can handle problems. They can also build trust, with the people they help and the people who give them money. This way they can keep giving services to the people who need them the most. This policy brief says that making governance stronger and making microfinance institutions more financially sustainable are two things that go together. They can help more people get services and really reduce poverty. Microfinance institutions need to do these two things to really help people.

Key policy implications regarding institutional and governance over finance sustainability

- Political stability and absence of violence has a significant effect on financial sustainability due to reduced donor dependence, increased competition from formal financial institutions, and higher regulatory compliance costs in stable environments.
- Government effectiveness i.e. road infrastructure, rule of law and control of corruption positively affect financial sustainability.
- When the public abide by the rules of society, and particularly when there is strong contract enforcement, MFIs would become financially sustainable.
- Policies targeted at reducing corruption could be vital in enhancing MFI financial sustainability. Corruption could be detrimental to financial sustainability because it might increase default risk when loans are granted to ineligible clients.

### 1.1. Policy Motivation

Microfinance institutions (MFIs) could reduce poverty by providing financial services such as microcredit to marginalized people to start micro and small business and improve their livelihood. Institutional theory suggests that institutions are vital in determining firm performance as they shape political, social and economic interactions, (North, 1991). Previous studies have investigated the role of institutional quality mainly in lending behaviour.

Some studies also shown effect of institutional environment on microfinance performance has also concentrated on the moderating effect of institutional quality and do not consider institutional environment as a main predictor of performance (Barry &Tacneng, 2014).

The study adds to the literature on the effects of institutions by providing empirical evidence on the role of the institutional environment in the attainment of financial sustainability as a main determinant.

### 1.3. Policy Impact

Even though MFIs are faced with challenge of balancing between two main goals; reaching marginalized group and sustaining financially, it's inevitable that sustainability is essential in order to serve clients continuously. This issue will have a direct impact on identifying the governance related factors affecting sustainability of MFIs. Additionally, specified suggestions to target audience to make proper policy which improve sustainability of MFIs in SSA.

## 2. Target Audience

This policy targets audiencesincludingNational bank of Ethiopia/NBE, regulatory oversight bodies, MFIs boards & shareholders and local administrations.

### 2.1. Methods and major findings

This policy brief is prepared by comprehensive studies of various articles published in different journals.The evidences were analysed thematically and translated into practical policy brief from Tehulu et al. (2024). The research of Tehulu et al. (2024) relies on unbalanced panel dataset of MFIs in Sub-Saharan Africa (SSA) spanning obtained from World Bank catalogue. Data for institutional factors are accessed from the World Bank database for World Governance Indicators. The study applies the two-step system Generalized Method of Moments (GMM) to analyse the data.

### 2.2. Policy recommendations

Based on our findings, governance and institutional environment significantly affect financial sustainability of Microfinance Institutions (MFIs) in Sub-Saharan Africa. Therefore, the following policy recommendations are proposed (Tehulu et al., 2024):

- Given the positive impact of rule of law and government effectiveness on financial sustainability, Enhancing Governance and Rule of Law will reduce operational risks for MFIs- Governments should advance legal enforcement, bond security, and strict anticorruption actions. Such plans can be executed via developing proportionate MFI regulations, digital governance reforms and simplifies legal procedures for loan recovery.

- In line with findings that regulatory quality enhances institutional performance, policy makers should improve regulatory quality by strengthening supervision and reporting systems- through on-site and off-site inspections frameworks, develop digital regulatory platforms for supervision and reporting, standardize financial reporting formats and setting consumer protection regulations with regular regulatory impact assessments.

- Considering the evidence that political stability supports sustainable funding and investor confidence, government should Promote Political Stabilityto increase investor confidence and funding flows- This can be achieved through inclusive governance, promoting peaceful transfer of power and promote peaceful dialogue among stakeholders.

- Given the overall positive relationship between institutional quality and financial sustainability,MFIs should integrate into financial sector development strategiesto support financial inclusion- MFIs should be recognized as key actors in national financial inclusion strategies and supported through coordinated policy reforms by developing targeted policy frameworks for MFIs.

- Based on the finding that institutional effectiveness contributes to sustainability, MFIs should enhance institutional capacity building through training and proper governance structures- enhance capacity especially through creating specialized board committees (merit based than political attachment), invest in capacity-building and continuous staff training, setting structured human resource policies and manuals and establish compliance units.

## 3. Summary of Research

In recent years, researchers have shown an increased interest in studying the institutional environment–financial institutions' performance interconnection. However, little attention has been paid to inspecting the role of institutional quality in the financial sustainability of MFIs. Thus, this study explores whether investments in strengthening the institutional environment enhance MFIs' financial sustainability.

The research reveals that institutional environment matters in the financial sustainability of MFIs. Among factors, institutional quality is, in the aggregate, positively associated with financial sustainability. Different institutional factors also have distinct impacts on financial sustainability. While simultaneous relationships are discovered between government effectiveness, rule of law and sustainability, the relationship between control of corruption and sustainability is an inter-temporal one. Nevertheless, the effects of the aforementioned institutional factors on financial sustainability are all positive, consistent with the result for the aggregate measure.

For policy makers, our findings underscore the significance of policy documents that assist developing economies in improving their institutional environment as strong institutions are vital for MFIs in the attainment of financial sustainability, which is crucial for sustainable poverty reduction.

## 4. Policy Implications

The research results demonstrate that Microfinance Institutions (MFIs) in Sub-Saharan Africa need both effective internal management and external governance. The financial success of microfinance institutions depends on their management capabilities and the institutional framework that governs their operations.

The first point demonstrates that strong governance and rule of law create a safer and more predictable environment for microfinance institutions. When contracts are enforced and corruption is controlled through legal procedures, MFIs experience lower operational risks. The system helps organizations achieve better loan default rate which leads to decreased operational expenses and improved organizational security.

The importance of regulatory quality emerges as the second point. The regulations provide MFIs with operational guidelines which they can follow without facing excessive compliance requirements. The microfinance sector gain consumer trust through effective supervision and standardized reporting which establishes consumer protection frameworks.

The third point establishes that political stability serves as a main factor for economic development. Businesses function normally when political conditions are stable because their operations proceed without interruptions and borrowers fulfil their financial obligations while investors show greater interest in funding. MFIs can better organize their future activities according to predictable policy frameworks which eliminate operational uncertainties.

The national financial development strategies through which MFIs operate receive both recognition and active policy support from national financial development strategies. Financial inclusion improves through better coordination between governments and MFIs because governments treat MFIs as main partners in financial inclusion.

Finallythe process of building internal institutional capacity needs equal attention with all other operational needs. The human resource plans and compliance frameworks of MFIs together with their ability to lead and develop staff create better risk management capabilities for organizations.

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