Effects of Legal and Cultural Attachments on Microfinance Capital Structure

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Abstract

Purpose: The basic intention behind this article is to find that how legal bindings and financial developments sector influence the capital structure of micro finance institutions.

Design/methodology/approach: Panel data of 87 countries is used in the analysis from 2004 to 2013 with annual frequency. Random effect is used after Hausman specification.

Findings: Result shows that good and prudential legal tradition, may pave way for foreign investments by gaining trust and in this way economic development of country move towards progress. But one variable (depth of credit information) shows inverse relationship with leverage. This is because some time when MFIs fully disclose their financial structures and terms and conditions, they fail to get the investors’ confidence because of gap between investors and MFIs interests.

Originality/value: We found limited research work which has been carried out to answer the question that how capital structure respond to the legal traditions and geographical bindings of country.

Keywords: Microfinance; Legal traditions; Strength of creditor’s rights; Financial sector development; Capital structure

Introduction

Poverty is a thoughtful situation of the world which has made the life a constant distress for the most of the human beings. Millions of people living on this planet are in such a state of mind that they do not know what to do and where to go to make both ends meet. So to overcome this problem and to eradicate the curse of poverty, a new concept i.e. microfinance is introduced by Dr. Yunus of Bangladesh that gain importance. Microcredit and microfinance are comparatively fresh terms in the arena of development, which work as a tool for alleviating poverty [1]. Existing literature work by johnson, 2007 shows that distinct micro finance institutions come into existence in decade of 1980’s with the establishment of Grameen bank, which lay down different lending techniques which help and affect the working of microfinance institutions all over the world. But now Microfinance revolved into an industry [2]. According to historical facts describe by Robinson [2] since the decade 1950s to decade of 1970s, the endowment of financial services by donors or governments was primarily in the shape of sponsored rural credit suites [2] and during 1960 these institutions focused on reimbursements and charging high interest rates to cover their cost whereas Robinson indicates that the period of 1980s seems to be the turning point in the antiquity of microfinance whereas in 1990s augmented growth in the number of microfinance institutions was observed [2]. According to Wrenn [3] famous researcher named to be Ditcher declared 1990s as the Microfinance decade in his work of 1999.

Optimal capital structure is important for every firm; same is the case with microfinance institutions. But microfinance institutions are different than conventional firms. They have to face two fold goals of sustainability and social welfare, so the determinants of capital structure of microfinance institutions may be different than that of conventional firms. Microfinance is a movement whose object is “a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers [1]”. Many of those who promote microfinance generally believe that such access will help poor people out of poverty, including participants in the Microcredit Summit Campaign. This study aims to identify the impact of legal traditions, creditor rights and financial sector development on capital structure of MFIs.

Literature Review

There are hardly few articles concerning the financing procedures and capital structure which focuses on the issue of creditors’ rights, depositor protection and legal traditions and terms for microfinance institutions. Microfinance institutions cover an extensive range of funders that differ in terms of legal traditions, objectives, target market and approach style. CGAP research (2011) shows that despite of tensed budgets and worldwide financial crises, the levels of cross-border funding continued to increase, but at a much lower growth rate [4].

Researchers have a grade contribution regarding the relation between finance and law and finance sector development. They found that when the outside investors are not adequately protected with the help of legal framework offered by a country in the result of which entrepreneurs and actual owners are forced to sustain big positions themselves to line up their incentives with other investors [5]. More clearly, countries with weak investor protection should have more intense ownership structures.

Hubert Tchakoute Tchuigoua in his article of 2014 says that

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microfinance financing opportunities rate is low in some countries due to under developed domestic credit markets, coupled with the fact that there is scarcity of short term resources. Furthermore, microfinance institutions that depend on grants are monetarily restraint. To wipe out this restriction to approach outside funds, they start pursuing commercial funds, national or international, to attain the objective of MFIs to relieve poverty.

Decision of the structure of the firm and the legal framework in which it operates depend on the need to raise external finance [6]. MFI capital structure is highly complex which comprises of deposits, debts, and equity mostly. It matters a lot in the sustainability of microfinance institutions. The basic motive of deciding about capital structure is to determine the financial leverage which maximizes the value of the company and on other side minimizes the weighted average cost of capital.

Literature shows positive correlation between leverage and profit efficiency in MFIs and it is also found that decreasing leverage pave way for decline in cost efficiency [7]. Microfinance institutes differ according to source of financing. Some institutes rely on subsidies and some take public deposits as a source of capital. Present study relates the growth of microfinance capital sources with theory of institutional life cycle of MFI development [8]. This perspective of analysis shows that maximum microfinance institutions initially operate as NGOs, and fund their operations through concessional loans, grants from supporters and some cross-border financial institutions that significantly serve in terms of prime sources of funds used by microfinance industry.

Research examine a determining factor of international funding and provide evidence that better outreach and profitability perhaps to upsurge the likelihood of microfinance institutions to fascinate the cross-border commercial debts [9]. In initial phase, many MFIs depended on borrowings from governments and donors. Presently, however, deposits are their key source of funds, easily surpassing other funding options [10].

A distinctive characteristic of MFI capital is a portion its external finance comprises of subsidies. Which is correspondingly termed as soft loans or concessionary borrowings, subsidized external funds are retrieved at positive circumstances [11]. However according to CGAP, between 2009 and 2011, Debt funding did not experience any progress for decline in cost efficiency [7]. Microfinance institutes differ according to source of financing. Some institutes rely on subsidies and some take public deposits as a source of capital. Present study relates the growth of microfinance capital sources with theory of institutional life cycle of MFI development [8]. This perspective of analysis shows that maximum microfinance institutions initially operate as NGOs, and fund their operations through concessional loans, grants from supporters and some cross-border financial institutions that significantly serve in terms of prime sources of funds used by microfinance industry.

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Microfinance institutes can only gain access to commercial funding if the rules and regulations are sound plus strong and only if the micros finance industry has the proper legitimate standing and strong economic grounds [12]. Such type of judicial structure and legal system that allow or avoid resources for bear the heap of obligation [12].

Under a World Bank program, PKSF levies slightly extra rigorous enactment benchmarks, in addition enormous microfinance institutions retain least possible capital of $240,000, loan recovery rates of 95% or higher and maximum ratio of debt equity 2.5 to 1 at any cost [13]. Low cost of capital is of vital importance for microfinance institutions because on one side MFIs have to attain sustainability by acquiring low cost finance and on the other side it has to achieve the objective of social productivity.

The regulation of financial institutions is very important to increase the utilization of funds, improve efficacy in the apportionment of funds, enforce contracts, and protect depositors [13].

Usually profit-oriented micro finance institutions do not face cash problems. Microfinance Servicers can assist their clients continuously without necessitating constant infusions of subsidies, and fund exponential advancement of facilities for new customers through shifting themselves towards marketable sources. Indeed, they can ensure the independence of NGOs from donor financing, if they add deposits and borrowings to their strategic arrangements and that would be practicable in states where microfinance institutions come to be regulated.

The ability to extend microcredit is shown by NGOs but then again they want the legal framework for accumulation of deposits in order to avoid trouble of finding donors to endure their operational activities. According to Dr yunus “If person want to borrow money for lending purpose, he will be at mercy of third person. But when he is allowed to accept public payments, he has numerous choices. Dr. Yunus says that I can still borrow but being legal entity, increase the ability of borrowing”.

In order to provide adequate service to clients and to reach significant scale, MFIs have to look for some other source of sustenance other than donor and government sources if they want to mesmerize private capital. But to accomplish this objective, they want a proper suitable and supporting legal and supervisory surroundings. The core precedence for financial ruling is to look after the system’s protection and accuracy. Regulation and supervision have to be targeted in such a way that their results in terms of depositor protection and the security of the financial system generally balance the costs and risks involved [13].

External financing is the main source of MFI capital, external donors and investors only feel comfortable and satisfied in investing when they feel less risky and see sound and strong financial structure which is only possible through legal regulations and supervision.

To attract the funders, there is a need of direct prudential supervision by the public sector supervisory authority. This encompasses all measures by which regulators execute compliance by licensed financial institutions with a specified legal and regulatory framework, because licensing implies that the financial authority is assuring for or is prepared to assume responsibility for the soundness of the regulated financial institution which the public may be dealing with. This attitude is the most desirable because the safety of the small but numerous depositors is primarily a Function appropriate for the public sector. Moreover, the tactic evades the conflict-of interest Problem [12].

The problem of investor protection could also have more dimensions. For example, the interest of junior and senior creditors are not compatible; it might not be necessary that laws that protect one group may also safeguard the interest of the other. According to Thadden [6] the corporate law is shaped by legal origin, specifically the degree to which it protects external investors and that developments in legal structure can, therefore be attained only by improving the contract enforcement which is important to gain the trust of investors.

Research also reflects positive correlation between capital structure of MFIs and FDI, however according to researcher It is also found that FDI is also effected by numerous formal institutions: foreign exchange, trade liberalization, banking sector reform, private ownership of business and lawful improvement. Contrariwise, liberalization in local prices, non-bank financial sector development and rivalry strategy may not boost FDI [14].

The countries where the legal environment is not so strong and
weak enforcement of laws and regulations exist, in that countries moral hazards issues arises which include information asymmetries and lack of financial expertise. This is necessary to make rational decision and to judge MFI riskiness. To avail superior exterior financing opportunities on favorable terms and conditions is possible for MFIs in those countries where high legal tradition and strong enforcement of laws prevails and this strong and prudent environment encourage MFIs to avoid excessive risks.

The sagacious parameter for any MFIs depends on the requirement to safeguard the creditors against the loss of their funds that they give and strengthen the financial system and to preserve their confidence. But according to some researchers, regulation become unproductive in developing nations because of data collection, information asymmetry problems, political interference, and lack of professionalism [15].

A main reason for supervising the traditional MFIs is to safeguard the interest of investors and to preserve their confidence because gap between interests of funders and MFIs, arise moral hazard issues. It might be difficult for Investors and Individual depositors to evaluate the reliability of a MFIS (information asymmetry problem). Thus, an unbiased third party is needed to govern plus supervise the functioning of a state’s MFIs through strong and sound supervision because it help to attract investors by building their confidence over MFIs capital structure.

Many microfinance institutions have such type of capital structure which comprises of debt and equity both Capital structure literature suggest two different theories. Tradeoff theory states that, distress costs, taxes, and agency costs cartel to generate an ideal capital structure on the other side pecking order theory states that capital structure is an outcome of investment opportunities and capital retaining strategies in the absence of symmetrical information.

Microfinance that largely finances their operation by using debts is highly leveraged microfinance institutions. And organizations which are highly leveraged mostly they decide their ideal ratio of leverage via computing the costs of financial distress, tax advantages plus other related costs. According to researcher abundant investment opportunities upturn the ratio of Leverage, expand tax shield of debt, minimize the cost of financial distress and increase the call for investment capital Whereas, situation is vice versa in case of limited investment opportunities [16].

The expected cost of financial distress rises as the relative use of debt financing rises. The observed literature tells that organizations took their capital structure, as this theory forecast, by projecting firm leverage as a function of firm characteristics. It is generally assumed that leverage of a firm is entirely depends on company’s claim for funds. Microfinance institutions must shrink reliance on donations and resort to mount up share capital for survival in long run [17]. Besides all some of finding shows low leverage can be result of rigorous implementation of creditor rights [18].

Research of kimando states that reliability of microfinance institutions is vastly affected by number of customers assisted, financial ruling and capacity of credit executed [19]. Existing researches on the association b/w regulatory environment and capital structure touches the idea that firm functioning in good legal settings can take advantage of exterior financing opportunities with eye-catching circumstance [20]. However, microfinance practitioners underscore the proposition through their experience in many different settings throughout the developing world that the future for sustainable microfinance lies in a regulated [21]. Booth, latest works shows that till now many MFI programs depend on subsidies till now to cover their cost on the other side [22]. Niels Hermes, report that 8% of MFI are running at profit and 70% still functioning on subsidies from government and donors the 2010 MFI bench marks (the mix 2011) reports operational self-sufficiency ratio of 1.03 of 305 MFIs out of 1300.

In the nonprofit sectors the study specifies that individual donors are much interested to donate when they have full access to required accounting information [23,24] discover that only 235 of worlds MFI’s subsist without subsidies specified that donors are geologically far away from microfinance operational activities due to which there is a large drift between MFI’s information and creditors information. The fortifications particular creditor rights rest on the reason for which the debt is owed, and the level of financial sector development is considerably associated with level of external finance of micro finance institutions [11].

In credit markets information symmetry is main issue that exists between parties which in result influence the financing strategies of micro finance organizations. Asymmetric information is the situation in which different parties have different information. The degree of asymmetric information varies among companies and industries, depending on the Density of business, Unambiguousness of finance and Ideal capital structure.

Researcher observed that scarcity of consistent information and inadequate revelation in the MFI region can pave way for the information asymmetry problem so in order to tackle with that type of situation creditors right protection and better law enforcement plays a vital role. Similarly deposits can be seen as a source capital to fund their projects, used by MFIs. These savings play role of a prerequisite to be qualified for as loan and work as a collateral to secure loan. Due to which person who does not retain savings and deposits face difficulties to access the financial services provided by the micro finance institutions so in countries with better law enforcement and strong legal tradition, these savings are less important because there is no need of security and collateral before obtaining a loan [25].

According existing research, common-law prevailing countries safeguard the rights of investors in better way which increases the access to credit opportunities and ensure easy availability of external finance.

Empirical study shows that, disclosing facts about pay back of loans and the future interest cost did not moderate the undesirable effects of presenting minimum information [26]. Evidence suggesting that better disclosure and reporting can be beneficial to capital markets, for instance, by reducing information asymmetries, increasing liquidity, and lowering the cost of capital [27].

The study, recommend that agency and asymmetric information cost, effects the level of both the long and short term debt. Michaelas research says that the existence of higher agency and asymmetric information costs mean that smaller firms with lower ratios of collateral sable assets, which is risky for financial institutions as they seem to be sensitive to imperfect economic recessions [28].

In territories where regulations and supervision arrangements are not sound and strong, rules and policies are only glory of papers which are not enforced and followed by inhabitants and may not be recognized or valued by the community or imposed formally by state, dishonest law lords are major obstacle in the way of private sector growth (World Bank, 1997).

More commonly institutional reforms work as a prerequisite for
positive pecuniary revolution. According to existing literature the appeal for judicial improvements and institutional restructuring that ascends in result of economic liberalization is as considerate as the supply of moral laws and working legitimate bodies to legal reform [29].

Due to that weak enforcement it is general perception of researcher that general public fear that financial expansion only assists only alien and dominant class particularly when institutions are not credible. For this assumption of peoples, George Clarke identifies reasons that this is because of condition of collateral. Financially well off peoples can fulfill this condition and have potential to pay back loan earlier but poor people are not [30].

He concludes that it is very difficult for poor’s to get loans, if they do not have enough property to use as collateral whereas. On other side, the rich who possess assets that can work as security might be beneficial as the economic sector grows. If financial development improves access for the rich, but not the poor, it might worsen inequality [30].

Literature shows that microfinance governance safeguards the sector from wrong applications with the help of sacriﬁcious control.

Regulation also promotes MFIs supervision and lessen problem of unreliable information and ethical hazard. Its impact on MFIs competition and innovation, ﬁnancing costs and social welfare, however, remains to be seen. Main Objective of this is to defend the interest of minor depositors, enrich liquidity control, and improve functional and financial reliability plus safeguard from ethical perils [15].

The lack of good governance, strong supervision and regulatory measures make virtually impossible for investors to make comparison between their risks and rewards. Study displays that funds structure, risk control system, comparability of data, investment processes and quality reporting are variables which are most critical components of the three key concerns (governance, transparency, accountability) of any serious investors [31].

DiMaggio and Powell article determines that there are commonly three types of pressure that are forced b organizations named to be coercive which is also called regulatory, mimetic, and normative. His work mainly focuses on coercive pressure, which covers the legal restraints that organizations mostly face.

Researcher works shows that in particular countries Environmental and social outcomes are not only be linked with governing requirements and the degree of execution, but also with some common traits of the organization environment [32,33].

A growing body of literature suggests that four elements are very vital: financial enclosure, customer safety, ﬁnancial reliability, and ﬁnancial solidity. These elements are interconnected and under the accurate surroundings, positively correlated.

Observation indicates that little risk of credit is a straight result of rigorous execution of prudential control and trustworthy economic performance with the support of worthy qualitative and measurable tools of risk control [34].

Strahan research concludes that debt have longer maturities and have minimum interest charges under sound protection of creditors Moreover, he says that our multidimensional empirical model reﬂects clear image than other existing studies that how legal and institutional environment effect the ﬁnancial contracts [35].

As it is often assumed that high cost may decrease leverage in this regard Amir Barnea argues that we can minimize these costs between the parties in conflict through complex contractual arrangement. Thus, cost problems may explain the progression of complexities in capital structure [36].

Existing literature support the results with strong evidence that contract of loan and decision of ﬁrm ﬁnance depends on strength of creditor and investor rights. Aghion and Bolton developed a theory of capital structure constructed on costs related to transactions and incompleteness of loan contracts [37].

Richard Rosenberg works indicates that to ensure survival and to cover the cost microfinance organizations need to charge rates which are higher as contrasted with rates charged by ordinary banks. Yet at the same time these charges are far beneath than the rates charge to poor’s by normal cash banks and casual wellsprings of their topographical zone. MFIs need to charge rates that are higher than ordinary keeping money rates to take care of their expenses and keep the administration accessible. Anyway even these rates are far beneath what destitute routinely pay to town cash loan specialists and other casual sources, whose rate premium rates routinely climb into the hundreds and even the thousands [38]. A strong and prudential supervision may play a vital role in these unfair practices and pave way for economic growth.

This does not justify the high interest rates imposed by microfinance institutions. To achieve sustainability, increasing interest charges is not the only way. It can also be attained by reducing costs to most possible level.

According to report published by CGAP, in 2006 the average of interest charges is about 28% which is found to be decreasing with the ratio of 2.3% annually since 2003.

A well-known researcher “Harvey” conduct a persuasive test in his article to check that can debt moderate the consequence of uneven info and agency issues his ﬁndings support re contracting theory that equity owners value acquiescence with scrutinized conventions, especially when the ﬁrms are interested to invest more [39]. According to Meggison “when to safeguard their rights and claims, money lenders relies on regulation and prosecution of legal mechanism they build more focused syndicates to expedite monitoring and low cost contracting. But when countries have weak enforcement systems of regulation and investor’s rights the situation is different, mean they start constructing diffuse consortiums in order to prevent strategic elusion. According to some estimated ﬁgures approximately 100 million people avail the services of microfinance institution all over the world with estimated loan size of 170S, whereas the total projected size of market is 178 billion. However still the feasible demand is 15 times more than recent market. Therefore microfinance symbolizes a total commercial market of $250 billion or above.

Presently ¼ or above of the 178 billion funds are collected from local markets. Whereas, nearly about $8 billion are covered by deposits coming from states where microfinance institutions are allowed to take deposits from public it is also observed that almost 10000 current microfinance institutions still not permitted to accept deposits. Thus it is true up to some extent that still the capital structure of MFIs is not likely to be sourced primarily by deposits [40].

Microfinance institutions can achieve proﬁciency beneﬁt through enforcement of legal and logical expectations of creditor and by ﬁlling the loophole between contractual relationships with the help of negotiation without indulging themselves in high transaction costs.
There are a several causes for failure of creditors to protect their selves adequately. Increasing Rivalry in the microfinance industry unseals the market to suppliers who are not much concerned by socially-responsible ideologies of microfinance.

1. Those investors who have inadequate access to information and not fully aware about the functioning of MFIs mostly fails to take rational financial decisions.

2. Inconsistency between the interest of investors and microfinance institutions also pave way for unfavorable results and outcomes [41].

According to famous researcher, it is believed that to reduce the information asymmetry problem among MFIs creditors, directors are responsible to ponder the interest of creditor [42].

Countries offering better protection of investors rights have proficient stock markets studies of different researcher specifies that high safety of creditor’s rights may diminish the information drift. Furthermore, Robin and Hwang, works pinpoint that states where common law prevails have is more appropriate and timely access to accounting information. Consequently, equity-based reimbursement should be more effective and extensively used in stats where solid fortification exists [43].

Credible information regarding social and operational performance of MFIs is required to allocate finance rationally effectively. This efficiency in capital market drives the wheel of microfinance industry on the road of progress in order to attain the objective of reliable and supportable financial assistance [44]. Empirical evidence finds that subsidization of microfinance leads to cost-inefficiencies and decrease in the staff productivity [45,46].

It is proposed to take care of a becoming demand for obviously identifiable standards and rules on how microfinance can be properly managed and administered. The becoming consciousness of the capability of microfinance, coupled with the rise of a few profoundly fruitful and quickly developing foundations, has viable put the issue on the political motivation in most creating nations. Whereas when we talk about financial sector development we observed that the sound financial system makes transactions quicker, cheaper and safer, because it eradicates the tension of cash or barter payments. In addition, we observed the positive change in acquiring finance facilities in developing states which assist individuals to shape their future according to their desire greater access to financial services enables poor people to plan for the future. The main hurdle witnessed in the accessibility of loan is the inadequate outreach of several microfinance institutions. Without an established financial sector, for example, local depositors and overseas investors would be more uncertain to part with their money to otherwise sound investments, resulting in lower economic output. As such, the financial sector is an engine of economic growth and household welfare.

The benefits of financial sector development extend beyond financing investment, and essentially habitually twitch by offering economical payments and attractive savings services. These services allow firms and households to avoid the costs of cash transactions, reduce the costs of remitting funds, and bring the chance to mount up resources and uniform revenue, thus mitigating the threat of falling into poverty.

Apparently, better financial sector development may expedite further financing at least possible costs. Moreover, it is seemed that well administrated firms show more consent towards environmental considerations. Concluded that through better-quality supremacy, financial sector development may outgrowth superior ecological performance.

A well-known researcher concludes that prudential environment safeguards the financiers from expropriation by entrepreneurs. And it also raises their consent to submit their funds in replacement for sanctuaries and therefore expend the space of capital markets [47,48]. So that’s why according to “kessy” it is I is therefore suspected that legitimate and supervisory backgrounds have a great influence over the existence of microfinance industry [49].

It is assumed that a microfinance institute serves the region of East Asia deeply whereas. The numeral individuals served and the high delivery of loans plus deployment of savings in terms of GNP is observed in Bangladesh, Thailand and Indonesia. However on the other side of picture, in Asia the two densely populated countries, the China and India, face poor outreach, and Republics such as, Afghanistan and Pakistan also have low outreach because of multiple reasons According to research conducted by Meyer in 2002. But regardless of these Geographical inconsistencies within the region, generally it is believed that microfinance institutions prospered in Asia and they show better outreach and high reimbursement rates as compare to other geographical areas. This sweeping statement shields up various catholic inequalities within the region.

Growth is being funded due to legitimate access to public deposits through commercial loans, from domestic banks and financial development institutions [50]. There are various factors that determine the financing structure of individual’s optimal funding mix. Loan portfolio, savings deployment, regulatory structure, the accessibility to donors as well as costs and maturity of distinct finance sources are vital factors it is believed that equity issuing is most expensive source of microfinance. (Excluding of grant equity and other donations) which is followed by unsecured and subordinated debt, whereas retail deposits are stated to be the inexpensive and economical financing source. For overseas funding, forthcoming currency risks must also be pondered [51].

Another researcher noticed that there is a difference in the speed of adjustment of leverages between numerous legal groups under the vibrant setting. According to “song” the speed of congregating leverage to a target level in Civil-law prevailing states is relativity slow as compared to common-law countries [52].

Louvain in his article states that corporate financial structure is dependent on legal bindings and structures. He says that valuable to observe that few countries accomplish the presence of lawful reserve requirements. This limitation prepared organizations to keep a desired level of capital in order to evade an unconscious liquidation and shields investors when they possess limited power. The excellence of legal implementation might also affect the financial structure of organizations [53]. He also claims that intensely protected investors are less risk averse and feel secure to lend without any hesitation. Creditor protections would thus lead to higher leverage aptitudes for MFIs. Moreover, the higher the legal reserves, the more secured the creditors and the higher the incentives to lend [53].

The utmost conspicuous resistance is among French and the German regions he observe that. In French origin, week protection of creditors appears to decrease the access to credit as compare to the smaller firms.

According to research, in examination with prior years, microfinance institutions now discover it generally simpler to raise
funds from banks. After 2000 this change has been seen, when the reserve bank of India (RBI) permitted banks to provide loan to microfinance institutions and treat such give financing as a major aspect of their need area subsidizing commitments. Banks need to chip away at discovering the right frameworks to survey the danger of subsidizing to microfinance institutions. They would likewise do well to enhance their capacity of assessing such institutions and surveying their credit needs [54].

Therefore Microfinance institutions of those countries where financial sector is highly developed have greater and easy access to capitals and funds at attractive terms and conditions. And positive legal environment of country also result in stress-free loan availability and favorable loan contract terms.

**Development of Hypothesis**

**Hypothesis**

- **a** = enforcement of contracts has positive correlation with leverage
- **b** = economic development has positive correlation with leverage
- **c** = depth of credit information is negatively correlated

**Sample and Methodology**

Data related to capital structure of microfinance institutions is collected from MIX database. MIX database contains data of microfinance institutions all over the world. Leverage is taken as proxy for capital structure of MFIs. Through this source we take data about individuals MFIs. We filter it in term of variable we used. That is legal origin, regulation, creditor rights, enforcement of contracts etc. and for financial sector development we take data from World Bank website. We scrutinize the data of eighty seven countries for time period of 2004 to 2013. We exclude countries with missing MFI level data

**Variables**

To test our hypothesis, we take four variables one is leverage which is taken as a independent variable and economic development, enforcement of contacts and depth of credit information are taken as dependent variables. And by applying panel regression we test our hypothesis for the following model.

**Economic model**

In the present study, panel data approach is used in order to measure the effect of legal attachments on the capital structure of microfinance institutions.

\[ \text{Lev}_t = \alpha + \beta_1 \text{ED}_t + \beta_2 \text{LT}_t + \beta_3 \text{DCI}_t + \epsilon_t \]

We test above specification in which i indexes countries, and t indexes time period (year). \( \text{Lev} \) (leverage) is used as variable for measure the effect of legal attachments on the capital structure of hypothesis for the following model. And by applying panel regression we test our hypothesis but with more significant percentage. So for more clarity we apply Hausman–Taylor model. Result of this model supports the result of random effect test. We conclude that due to strong and prudential enforcement of laws and positive legal traditions, MFIs of countries can attract foreign funders to invest on favorable conditions. Progress in financial sector development also drive the economy and financial structure of MFIs on smooth road. However our findings support our hypothesis but one variable which show inverse relationship is just because of gap between interest of investors and MFIs. According to Jenkins findings, wide revelation and reportage also generated inefficiencies in the setups of microfinance institutions, mainly those which were credit and investments associations [56].

**Conclusion**

The basic intention behind this article is to find out that how the legal tradition of a country and financial sector development influence the capital structure of micro finance institutions. We test our hypothesis in term of fixed effect as well as in terms of random effect also. Fixed effect result shows that economic development and enforcement of contract are positively correlated with leverage [55]. Whereas, depth of credit information has inverse relationship with leverage.

Similarly random effect table also show the same results but with more significant percentage. So for more clarity we apply Hausman–Taylor model. Result of this model supports the result of random effect test. We conclude that due to strong and prudential enforcement of laws and positive legal traditions, MFIs of countries can attract foreign funders to invest on favorable conditions. Progress in financial sector development also drive the economy and financial structure of MFIs on smooth road. However our findings support our hypothesis but one variable which show inverse relationship is just because of gap between interest of investors and MFIs. According to Jenkins findings, wide revelation and reportage also generated inefficiencies in the setups of microfinance institutions, mainly those which were credit and investments associations [56].

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| Variables         | Standard deviation | Mean | Min | Max |
|-------------------|--------------------|------|-----|-----|
| leverage          | 0.364              | 0.270| 0   | 5.944|
| Enforcement of contacts | 5.369          | 37.668| 23  | 55  |
| Information depth | 2.040              | 2.136| 0   | 5   |
| Economic development | 22.925            | 31.022| 1.068| 140.009|

**Table 1: Descriptive statistics.**

**Table 2: Results of the random effect estimation.**

It means that countries with more developed credit sector have more access to credit and use more debt in their capital structure. Similarly in countries with strong enforcements of contracts more access to credit is observed by microfinance institutions. The reason may be that the lenders in the countries where there are good legal traditions may face lesser risk and more people may qualify for dept MFIs. Depth of credit information is negatively related to leverage because when more scrutiny is maintained in lending a loan then less people will be able to qualify for the loan. That is the reason that lesser debt ratio is observed in the capital structure of microfinance institutions where information is scrutinized in greater depth.
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