AN INVESTIGATION OF FINANCIAL CONSTRAINTS AND THEIR IMPACT ON PERFORMANCE OF MICRO FINANCE INSTITUTIONS IN KENYA

By

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DECLARATION

This Research Project is my original work and has not been presented in any other University

Signed…………………………………………Date………………………………………….

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This Research Proposal has been submitted for examination with my approval as a University Supervisor.

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DEDICATION

This research project is dedicated to my family for their inspiration, encouragement, understanding and prayers towards the successful completion of this course. I pay glowing tribute and gratitude to the Almighty God who has given me the wisdom to undertake this course.

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ABSTRACT

The development of small firms is considered a key ingredient in poverty reduction. These small businesses face specific constraints in raising external finance and as a result, worldwide, microfinance institutions (MFIs) have come in to expand the frontier of finance by providing loans and other financial services to under-served small firms and populations. However, by the nature of clients that the MFI deal with and their size of capital structures, these organizations face financial constraints that impact on their performance level.

The purpose of the study was to investigate the impact that financial constraints affect the level of loan disbursement level of micro finance institutions in Kenya and towards the realization of the research objective both a descriptive analysis and correlation and regression analysis was undertaken. Data was collected through the use of a questionnaire that was distributed to all the sampled MFIs and also secondary data was collected from the organizations financial statements.

The study found out that the dependence on donor funds by the local MFIs affected their capacity to advance loans to potential customer and there is need to reduce this present level of dependence. The study also found out that most MFIs had a low capital base and that is way they tend to depend mostly in donors and the low capital base is further compounded by the risk aversion of lenders on the performance of MFIs that discourages them to lend to these small institutions. The study found that the regulation of the operation of the MFIs will help in increasing the confidence of these organizations and at

the same time streamline the operation of the organization which will give it the necessary confidence to can result in their capital base being shored up.

LIST OF ABBREVIATIONS

KIPPRA   -   Kenya Institute of Policy and Research Analysis

MFI   -   Micro Finance Institutions

MSE   -   Micro and Small Enterprises

ROA   -   Return on Assets

ROE   -   Return on Equity

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

In recent years, governments in developing countries as well as least developed countries, have come to embrace microcredit/microfinance has a favored poverty intervention mechanism. This has come about due to the realization that microfinance, the provisions of financial services to the low-income households and micro and small enterprises (MSEs) (Satta, 2008), provide an enormous potential to support the economic activities of the poor and thus contribute to poverty alleviation. Widespread experiences, such as in Bangladesh, and research have shown the importance of savings and credit facilities for the poor and MSEs. Thus he points out that governments have put emphasis on the sound development of microfinance institutions as vital ingredients for investment, employment and economic growth. At present, Sach (2010) point out that there is scarcely a poor country and development oriented donor agency (multilateral, bilateral and private) not involved in the promotion (in one form or other) of a microfinance program.

The development of small firms is considered a key ingredient in poverty reduction (World Bank, 2010). However, these firms suffer from a range of problems in their establishment and development and key among them, is difficulties on accessing finance. According to Berger et al., (2008) small business as opposed to large firms face specific constraints in raising external finance and as a result, worldwide, microfinance institutions (MFIs) have come in to expand the frontier of finance by providing loans and other financial services to under-served small firms and populations. A number of

reasons have been put forward to explain the difficulties small firms face in accessing credit from formal financial institutions. Among them small firms access to the formal financial sector is constrained by high risk and transaction costs brought about by difficulties in enforcing contracts, information asymmetry, and lack of appropriate instruments to manage the risk involved. In some cases the problem is aggravated by supervisory and capital adequacy requirements that restrict banks from extending uncollateralized loans to small firms (Wright, 2009).

Micro finance institutions have been shifting their "modus operandi". Hamada (2010, pp. 2 – 8) argues that there has been a paradigm shift in MFIs from a social movement to the integration of microfinance into the banking sector. In the second half of the 1980s, the first occurred as MFIs focused on product-centered lending in which there was generally a single standard product. The second paradigm occurred in the middle of the first decade of the 2000s with a shift to client-centered lending in which there was a greater variety of products, and a definite commercialization of MFIs in an attempt at gaining sustainability. However, the same MFI's have been experiencing challenges in their operations and as an elusive economic condition, sustainability has not been achieved by most MFIs, and consequently subsidies are still needed. As a result, Morduch (2005) argues that only MFIs that pursue best practices or "principles of good banking" can both alleviate poverty and attain sustainability. On the issue of sustainability of the MFI's, Ayayi and Sene (2010) observe that a number key issues should be monitored which they believe will affect the sustainability of the firms. Some of the steps which they propose is that interest rates need to be high to cover costs- but needlessly high rates would drive away clients, classification of loan repayment arrears that will allow managers to make

fully enlightened decisions, use of information technology that will facilitate the control of operating and personnel costs and also that efficient banking practices need to be adopted, including a corporate structure, marketing department, internal control system, and audit and risk committees.

The growth rate of microfinance initiative has been high in many countries, but funding levels in the industry have not matched this growth. This is particularly of concern when the traditional sources of finance are considered and the uncertain capacity of MFIs to access alternative funds (KIPPRA, 2007). For MFIs identifying factors that enhance successful attraction of leveraged funds could potentially reduce their funding constraints and the growing scarcity of donor funds and increasing MFI competition for funding has sparked increased interest from the financial markets. The report further points out those MFI managers do not understand the most important factors that drive successful attraction of commercial funding and in some cases; the method of financing microfinance poses a threat to sustainability of programs. According to Jeng and Wells (2008), the approach to solving financing constraint in microfinance has always been inward looking. They observe that while donations represent an important source of funding for microfinance, their scope is limited. It has been established that as a company consolidates its products and delivery processes in the marketplace, it becomes a candidate for external funding.

1.1.1 Financial Constraints facing Micro-Finance Institution

Microcredit for enterprise development attracts much of its funding from donors and subsidized state run credit schemes. This method of financing microfinance poses a threat

to sustainability of programs due to the limited funds available with these institutions. However, according to KIPPRA (2007) the approach to solving financing constraint in microfinance has always been inward looking and this underscores the need for an exit strategy; away from "captive" donor funding that has characterized the industry. While donations represent an important source of funding for microfinance, their scope is limited. It has been established that as a company consolidates its products and delivery processes in the marketplace, it becomes a candidate for external funding (Jeng and Wells, 2000). Consequently, as MFIs grow and expand their need for external funding increases continuously.

Several reasons have been put forward to explain the difficulties that MFIs face in accessing funds to disburse to potential clients. Among them MFIs access to the formal financial sector is constrained by high risk and transaction costs brought about by information asymmetry, difficulties in enforcing contracts, and lack of appropriate instruments to manage the risk involved. In some cases the problem is aggravated by supervisory and capital adequacy requirements that restrict banks from extending uncollateralized loans to small firms (Wright, 2000).

Commercial sources of funds can play a greater role in relaxing the financing constraints facing MFIs. This source of finance although driven by different considerations than those for donor funding has not been used widely to fund microfinance. Commercial finance is arguably a viable alternative for providing massive long-term resources for growth. This research will suggest that successful commercialization of microfinance will provide innovative sources of development finance for MFIs.

1.1.2 Financial Performance

Financial measures as a form of business performance measurement still remains an important part of running a growing business, especially in the current economic climate. Most growing businesses ultimately target increased profits, so it is important to know how to measure profitability. The key standard measures used include liquidity, profitability and solvency. Liquidity measures the ability of the firm business to meet financial obligations as they become due, without disrupting the normal, ongoing operations of the business. Liquidity can be analyzed both structurally and operationally. Structural liquidity refers to the balance sheet (assets and liabilities) and operational liquidity refers to cash flow measures (Du Rietz and Henrekson, 2000). Two recommended measures of liquidity are the current ratio and working capital**.**

Profitability measures the extent to which a business generates a profit from the factors of production: labor, management and capital. Profitability is the most important measure of success of the business. A business that is not profitable cannot survive, yet a highly profitable one has the ability to reward its owners with a large return on their investment. Profitability analysis focuses on the relationship between revenues and expenses and on the level of profits relative to the size of investment in the business (Mesquita & Lara, (2003). Four useful measures of firm profitability are the rate of return on firm assets (ROA), the rate of return on firm equity (ROE), operating profit margin and net firm income. The ROA measures the return to all firm assets and is often used as an overall index of profitability, and the higher the value, the more profitable the firm business. The ROE measures the rate of return on the owner's equity employed in the firm business.

Unlike liquidity, solvency is concerned with long-term as well as short-term assets and liabilities. Solvency measures evaluate what would happen if all assets were sold and converted into cash and all liabilities were paid. The most straightforward measure of solvency is owners' equity, using the market value of assets and including deferred taxes in the liabilities. As with working capital, adequacy of equity depends on business size, making comparisons difficult without using ratios (Hammes, 2003). Three widely used financial ratios to measure solvency are the debt-to-asset ratio, the equity-to-asset ratio and the debt-to-equity ratio. These three solvency ratios provide equivalent information, so the best choice is strictly a matter of personal preference. The debt-to-asset ratio expresses total firm liabilities as a proportion of total firm assets and the higher the ratio, the greater the risk exposure of the firm.

1.1.3 Financial constraints and its effect on financial performance

Several studies have looked at the linkage between a firm's financial constraint and firm performance. There is the argument that a lesser financial constraint through a firm borrowing has the possibility of affecting managers and reducing agency cost through the threat of liquidation which causes personal losses to managers' salaries, reputation, perquisites etc. (Grossman and Hart, 2002), and also through pressure to generate cash flows to pay interest expenses (Jensen, 1986). Emanating from the foregoing discussion, a lower form of financial constraint is considered an appropriate method to employ in order to mitigate conflicts between managers and shareholders.

Berger and Bonaccorsi di Patti (2005), state that, whereas a reduced financial constraint to a firm may reduce the agency costs of outside equity, the opposite effect may occur for

the agency costs of outside debt arising from conflict between debt holders and shareholders, and that when leverage becomes relatively high, further increases may generate significant agency costs of outside debt from risk shifting or reduced effort to control risk that result in higher expected costs of financial distress, bankruptcy, or liquidation. Such agency costs leads to higher interest expenses from firms to be able to compensate debt holders for their expected losses. Thus, a firms capital structure which is defined as total debt to total assets at book value, impacts on both the profitability and riskiness of a firm (Bos and Fetherston, 2003), and when a firm exhibits greater gearing, it has a higher possibility for failure in the event that cash flows fall short of the required volume to honor debt obligations.

The pioneers of microfinance developed new credit techniques that did not require collaterals but reduced risk through group guarantees, appraisal of household cash flow, and small initial loans to test clients (Littlefield and Rosenberg, 2004). They pointed out that such arrangement will at the same time reduce the level of financial constraints to micro-finance institution due to the improved repayment rate to the institutions. Repayment of loans by group members depends on the stability of the group and this may be enhanced or threatened by two conflicting features of this methodology (Navajas and Schreiner, 1998). First, non-defaulting members undertake repayment for defaulting members or harass defaulters to avoid loss of their own relation with the institution. Secondly, default by some members may prompt default by others if the cost of repayment of the defaulters' loan is higher than the relationship to the group.

1.1.4 Micro Finance Institutions in Kenya

Extreme poverty makes Kenya a candidate for microfinance small loans. The microfinance industry started in Kenya about 20 years ago, but it only gained the status of an industry in the past ten years, where it is generally categorized along two lines (Hospes et al., 2002 pp. 23-5). First and most common is the formal versus informal. Formal providers are registered by Kenyan law. Informal providers are subject to self-regulation or group-based rules. Second, microfinance in Kenya can be categorized as client- or member-based. In member-based organizations, members provide the resources as well as constituting the main target group for the loans. These are cooperatives. In client-based organizations, the customers are distinct from the owners.

Microfinance is the supply of loans, savings, money transfers, insurance and other financial services to low income people. In Kenya, the Government recognizes that greater access to, and sustainable flow of financial services, particularly credit, to the low-income households and MSEs is critical to poverty alleviation. Microfinance institutions (MFIs) which encompass a wide range of providers that vary in legal structure, mission and methodology offer these financial sources to clients who do not have access to mainstream banks or other formal financial service providers (Lafourcade, et al 2005).

The microfinance industry in Kenya took its present shape on the set of economic liberation between 1992 and 1994 and has a result; Kenya has developed a network of microfinance institutions that extend loans to small farms, business and entrepreneurs. At present, over 100 organizations, including about 50 NGOs, practice some form of

microfinance business in Kenya (Waweru, 2011). About 20 of the NGOs practice pure Microfinancing, while the rest practice Microfinancing alongside social welfare activities. Major players in the sector include Faulu Kenya, Kenya Women Finance Trust (KWFT), Pride Ltd, Wedco Ltd, Small and Medium Enterprise Programme (SMEP), Kenya Small Traders and Entrepreneurs Society (KSTES), Ecumenical Loans Fund (ECLOF) and Vintage Management (Jitegemee Trust). The Kenya Post Office Savings Bank (KPSOB) is also a major player in the sector but only to the extent of providing savings and money transfer facilities. Many microfinance NGOs have successfully replicated the Grameen Bank method of delivering financial services to the low-income households and MSEs.

The Micro Finance Act was enacted recently, and it is aimed at regulating the sector and out of the same Act, MFIs will now be subjected thorough audits by Central Bank of Kenya (CBK) and are expected to comply with these new guidelines which attract fines for every one broken. Before the Act, Code of conduct and ethics were non-existent and everyone was doing business the best way they knew how, it was free- for- all and this was rectified through the coming into place of the Act. The need to regulate the sector came out of the requirement of having a framework of conducting the micro finance business due to the critical role that Micro finance Institutions play in the economic development of poor communities. Currently, interest and knowledge about the microfinance industry has grown substantially. The focus of these institutions has gradually changed from emphasis on the very poor to the enterprise, as the demands on these institutions to become financially sustainable have increased. Therefore their

structures and strategies will tend to change from time to time; hence there should be a balance to make them 'fit' to cope within then environment of operations.

1.2 Statement of the Problem

Small firms in any particular sector will ordinarily face financial constraints resulting from their inability to source for funding from mainstream financial institutions and markets due to a lack of adequate assets to offer as securities, managerial challenges and a higher growth rate that the existing capital might not finance. So far there is a consensus view from theoretical investigation supported by numerous empirical studies that small businesses as opposed to large firms face specific constraints in raising external finance (Berger et al., 2008). To bridge this deficit which the small business units and individuals face, micro finance institutions have come in to fill the void of providing finances to the small business and which until recently the mainstream commercial bank institutions shunned. In Kenya, the demand of funds by the small businesses can be explained by among others the number of MFIs that have started operation over the last 20 years. According to Waweru (2011) there were only 4 MFIs in 1980s but the same number has risen to the current number of over 100 organizations. With the increase in the number of MFIs in the country and coupled with the demand of funds from the small business, the available funds to lend out have continued to reduce over time. The MFIs have not been able to meet sufficiently the financial needs of their potential small business due to many challenges emanating from both internal and external factors (Wright, 2007). This current study will wish to investigate the financial constraints facing these MFIs in Kenya.

The role that MFIs in Kenya play in the reduction of poverty as well as realization of vision 2030 has come to be appreciated by the government which led to the need to regulate the sector by putting it under the supervision of the Central bank of Kenya. The mainstream commercial banks until 1990s shunned the low income cadre of Kenyans and business with the reasons that they were either high risk or costly to operate such accounts. This business philosophy gained currency in 1990s and led to the closure of many branches especially in rural areas and low income locations in major towns. With the risk that many small income Kenyans will become unbanked or not access line of credits, the MFIs have come in to fill in this void which it has continued to do so to date. The MFIs in Kenya have grown in the last 20 years such that a number of them have grown to become fully fledged commercial banks to expand the range of services they offer to their clients. However, the MFIs have had to face a number of challenges in the course of their growth and chief among them is financial constraints (Wright, 2007).

This interplay of organizational financing and corporate performance has been the subject of a number of studies. Such empirical studies on the effect of financing on profitability have tended to concentrate on large firms (Abor, 2005). Fama and French (1998), for instance argue that the use of excessive borrowing creates agency problems among shareholders and creditors and that could result in negative relationship between leverage and profitability. Majumdar and Chhibber (1999) found in their Indian study that borrowing has a negative effect on performance. Gleason et al., (2000) support a negative impact of leverage on the profitability of the firm. In the Kenyan set up, Wachira (2010) undertook a research on the moderating influence of corporate governance on the relationship between a firms financing and the firm value of companies quoted at the

NSE. He found out that the corporate governance structure adopted in a firm will influence the capital structure of the firm with the aim of identifying the debt –equity mix that will optimize the value of the firm. On her part, Kuria (2010) researched on the determinants of capital structure of companies quoted in the NSE. The study found out that among other things, the management risk averseness, competition in the market and the age of the organization will influence structure of capital structure adopted by an organization. Ndirangu (2010) researched on the relationship between capital structure and financial performance of insurance companies in Kenya. As evidenced from the above studies, there has been no study in investing the impact of financial constraint on financial performance of a firm. As a result, this study will seek answers to the following research question; what impact do financial constraints have on the performance of micro finance institutions in Kenya?

1.3 Objectives of the Study

The objective of the study was to investigate financial constraints and their impact on the performance of Micro Finance Institutions in Kenya.

1.4 Significance of the Study

This study will be important to the following group of stakeholders:

To the top management of Micro Finance Institutions: This will help to facilitate increased efficiency in the utilization of available funds since with the knowledge of what financial constraints face the institution, the management will have to come up with measures to use the available resources more efficiently in the face of the challenge. The recommendations of this study will form part of the action plans that will help in

enhancing good service delivery at institutions. This is because the management will be able to make informed decisions on issues of utilization of limited funds and generate maximally from the same.

To Scholars: This study is expected to increase body of knowledge to the scholars of finance in MFIs and especially make them in touch with the internal and external factors influencing financial availability to the organizations in Kenya. It may also encourage further research on other factors influencing availability of finances to the institutions.

To the government and regulatory institutions: This study will benefit the government especially the Ministry of Finance and regulatory institutions such as the Central Bank for making policy decisions whose overall objectives are to accelerate the rate of growth in the micro finance sectors and take advantage of the growing world markets.

Fourthly, the study will form a monograph which could be replicated in other institutions and mainstream commercial banks operating in Kenya. Most important, this research is further aimed at offering some practical suggestions on how to mitigate the problems arising from financial constraint in these organizations now that all organizations will be operating in one form of constraint or another.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This Chapter will have several subsections covering theories and literature by various authors and researchers on the research subject matter. The chapter covers the theoretical framework on financial constraints, factors influencing financing of microfinance institutions, the effect of outside control on MFIs financial capacity and finally an empirical review on the research subject area will be covered.

2.2 Theoretical Framework on Financial Constraints

Finance experts have argued two main hypotheses in relation to the influence of personal characteristics of a micro finance institution upon access to finance and any resultant constraint resulting (Guzman, 2010). First, he points out that there is sufficient and readily accessible finance (but the propositions are perceived as not viable, or the applicants are perceived as incapable of achieving the objectives, or there is insufficient collateral, and so the whole proposition is too risky for the banks). Second, is that some people and organizations exhibit certain characteristics that make it more likely that they will fail to secure the funding that they need.

Loans from banks and micro-finance institutions are the predominant source of small and medium enterprises (SME) finance (Fraser, 2005) and, while financing constraints can lead to business failure, many owner-managers do not wish to use long-term debt finance. This is because it is generally assumed that business owners adopt a "pecking order" of

financing preferences where they use personal finance and funding from family and friends, then banks, before approaching equity sources (Howorth, 2001). Studies on entrepreneurial start ups suggests that liquidity constraints can hinder or even prevent an organization from creating a new venture and also impede the growth of a small firm.

2.2.1 Credit Rationing Theory

The theory of credit rationing under asymmetric information explains that young and small enterprises may not have access to credit because of their lack of a track record and the associated problems of adverse selection and moral hazard (Stiglitz and Weiss, 1981). This position noted by Stiglitz and Weiss is relevant in this current study since with the coming up of micro finance institutions in Kenya, competition for external funding will become stiff since in most cases internal funding will not be sufficient to meet the ever increasing demands from borrowers and this will necessitate the organization to source for external funding. However, due to information asymmetry between the lenders and borrowers, the new entrant MFIs might be challenged in getting necessary finances or if they do access the funds, the organizations might have to borrow at much higher interest rates. However, Besanko and Thakor (2007) note that the credit rationing may be reduced by collateral, which acts as a signaling device through which a borrower reveals his or her default risk. At the same time, collateral acts as an incentive device, motivating the borrower to exert effort and to reveal truthfully the state of his project after having obtained the loan since start-ups and small firms often do not have enough assets that are suitable for collateral. Another mechanism that increases the credit access of small businesses is relationship lending through a close credit referencing relationship which helps to reduce information asymmetry, since the credit referencing firm accumulates

knowledge about the borrower's quality and behavior over time. Therefore, start-ups may be disadvantaged because they have no credit history or extended credit bureau relationship.

The nature and ownership of the micro finance will also affect accessibility of the institution to funds. In the Kenyan case it is expected that these causes of credit restrictions apply even more to foreign based firms and to immigrants in particular, since they tend to have even less of a track record and even greater indications of credit risk than do native firms. Evidence of discrimination against women owned firms has been provided several studies such as one of many studies of the US (Bostic and Lampani, 1999 and Cavalluzzo and Wolken, 2005;), most of which have examined demographic differences in credit denials or loan rates paid which the authors have sought to explain by multivariate analyses. However, it is difficult to determine whether the observed demographic differences in the credit-granting behavior of banks are due to economically justified risk factors or to less justifiable factors.

2.2.2 Corporate Size Theory

Corporate size seems to be one of the most theorized determinants of financial constraints facing firms. In effect, the relationship between size and financial leverage has been explained by virtually all the mainstream capital structure theories (Schoubben and van Hulle, 2004, p. 595). They observe that the small corporation can and does obtain most of the funds it needs from the owner-managers (internal equity); and that high cost of registering and issuing stocks and bonds limit the capacity of small- and medium-sized corporations to access the capital market. This position was further expanded by Coleman

and Cohn (2009) when they stressed the exorbitances in cost of issuing debt and equity securities. They asserted that this situation is directly related to firm size and in turn may force small firms to tilt towards the use of, mostly, short-term debts. In the case of business start-ups, which are known to be relatively smaller at inception, they noted that the non-historicity of such businesses and, consequently, their lack of an established relationship with banks and funds suppliers that could have guaranteed them access to other forms of capital will be a source of financial constraint.

Among the arguments that have been raised to support the positive linearity between a firm size and access of capital include the fact that larger firms are more diversified and as a result have higher capacity to meet up with interest payments, and are more diversified than smaller firms (Pandey, 2004). Such companies are also found to enjoy higher degree of information disclosure and lesser bankruptcy risks. According to Pandey, all these factors are argued to have created more leverage opportunities to larger firms over smaller firms. The theoretical relationship between size and financial level may at the same time help to explain why; large firms seem to be more leveraged in their asset financing. Central to the above general positions is the truth that as a firm grows in size, its ability to borrow increases, and so, its debt-equity ratio increases concurrently. Within the circuit of small firms, need for funds may be limited by the fact that their scales of operations are also limited. Consequently, not only would banks and investors alike be afraid of committing funds in the projects of small businesses, the small firms themselves may be indisposed to exposing themselves to risks associated with distress and bankruptcy, as well as loss of ownership (Dittmar, 2004).

2.2.3 Agency Cost Theory

The other theory of financial structure is associated with leverage costs that arise from the agency cost associated with the separation of management and ownership in the firm. These agency costs increases as managers own less of the firms' equity since the optimal monitoring of managerial decisions and the level of perquisites consumption by management rises. The introduction of debt decreases these stockholder-manager agency costs. However, as the leverage rises, a second agency cost raises - that between stockholders and bondholders - and for sufficiently large leverage this cost will exceed the stockholder-manager agency costs savings. The resulting agency cost function is convex yielding an optimal capital structure at the point where agency cost total is minimized (Jensen and Meckling, 1976).

The agency theory argues that a particular capital structure changes result in different wealth redistribution. The exchange of additional debt for the existing common stock, which is not fully anticipated, causes outstanding debt holders to bear an adverse redistribution of wealth because of the implicitly and possibly explicitly incomplete protective covenants. At the same time the preferred stockholders are made worse off by the conversion of junior claims (common stock) into senior claims (debt). The common stockholders, who are the residual claimants of the firm, gain, since a portion of their junior claims, are converted into senior claims of greater market value. This theory thus implies that there exist certain combinations of the capital components that will minimize the agency conflict between the stakeholders.

2.2.4 Trade-off theory

The capital structure of the firm could be explained, in general terms, by two dominant theories: the trade-off and pecking order theories (Hadlock and James, 2002). According to trade-off theory, optimal capital structure could be determined by balancing the different benefits and costs associated with debt financing. Debt benefits include tax shields (saving) induced by the deductibility of interest expenses from pre-tax income of the firm, reduction of agency costs through the threat of liquidation which causes personal losses to managers of salaries, reputation, perquisites, and through the need to generate cash flow to pay interest payment (Williams, 1987). The high leverage can also enhance the firm's performance by mitigating conflicts between shareholders and managers concerning the free cash flow and the optimal investment strategy the amount of risk to be undertaking (Jensen and Meckling, 1976). On the other hand, debt costs include direct and indirect bankruptcy costs; debt financing brings with it commitment for future cash outflows in terms of periodic interest and the principal borrowed, and these commitments increase the likelihood of firm's financial default and bankruptcy.

Under the agency problem, Kim and Sorensen (1986) argue that debt commits the firm to pay out cash, thus reducing the amount of free cash flow available to managers to engage in self-interest activities. This view is consistent with Harris and Raviv (1990) who suggested that debt can be used as a disciplinary device to mitigate this agency problem by giving debt holders the chance to force liquidation of the firm if cash flows are poor. But the existence of bankruptcy costs is to also induce firms to minimize business risk by decreasing debt levels in their capital structures. Thus, under the trade-off theory, they suggest that more use of debt should be preferred if the expected cost of bankruptcy is

lower than the tax shield or other benefits of using debt. In this way, the trade-off theory suggests a negative relationship between leverage and expected bankruptcy costs

According to Myers and Majluf (1984), the other reason which they postulated will affect the financial position is the financing sequence that a firm follows in raising of capital popularly known pecking order of financing choice. The defining prediction of the model is that firms will not have an optimal capital structure, but will instead follow a pecking order of incremental financing choice that places internally generated funds at the top of the order, followed by the debt, and finally, when the firm reaches its "debt capacity," external equity. This theory is based upon costs derived from asymmetric information between managers and the market and the assumption that trade off theory costs and the benefits of debt financing are of second order importance when compared to the costs of issuing new securities in the presence of asymmetric information. The development of the pecking order based upon costs of adverse selection requires an ad hoc specification of the manager's incentive contract (Dyvig and Zender (1991) and a limitation of financing strategies that may be pursued.

2.3 Financing Microfinance Institutions

Micro finance is the supply of loans, savings, and other basic financial services to the poor. Like anyone else, poor people use financial services to seize business opportunities, improve their incomes, deal with other large expenses, and cope with emergencies (Littlefield & Rosenberg, 2004). The poor rarely access financial services through the formal financial sector. They address their need for financial services through a variety of financial relationships. Providers of financial services to the poor include donor supported, non-profit NGOs, cooperatives, community-based development institutions

like self-help groups and credit unions, commercial and state banks, insurance and credit card companies, wire services, post office and other points of sale (Guzman, 2000).

A micro finance institution (MFI) is an organization that provides financial services to the poor. It can broadly be defined as any organization, credit union, downscaled commercial bank, financial NGO, or credit cooperative that provides financial services to the poor. According to Udeaja (2009) MFIs include formal providers: those that are subject not only to general laws but also to specific banking regulation and supervision (development banks, savings and postal banks, and non-bank financial intermediaries). Semiformal providers are registered entities subject to general and commercial laws but are not usually under bank regulation and supervision (financial NGOs, credit unions and cooperatives). Informal providers are non-registered groups such as rotating savings and credit associations (ROSCAs) and self-help groups. They can be government owned, like the rural credit cooperatives in China; member-owned, like the credit unions in West Africa, socially minded shareholders, like many transformed NGOs in Kenya; and profit-maximizing shareholders, like the micro finance banks in Eastern Europe.

Many NGOs that are now MFIs are still donor dependent (Todaro and Smith, 2006). As a result, they use donor money to subsidize interest rate on loans and other costs of operation and with recent dwindling of donor resources, such MFIs may not provide financial services to the poor on a sustainable basis. In Kenya for example, MFIs have had to struggle to become efficient, and show evidence of prudent financial management in order to attract commercial capital, so that they can expand their portfolio and remain

in business on a sustainable basis. This has necessitated the transformation of microfinance NGOs into regulated financial institutions in various parts of the world. According to Waweru (2007) the change was born out of the desire increase significantly the number of clients that have access to micro finance services in the country, increase institutional efficiencies and reduce donor dependency. The motivation behind transformation derives from the fact that most microfinance NGOs have worked to reach the scale necessary to achieve operational self-sufficiency and to overcome donor dependency. While the donor agencies' budgets are shrinking, and MFIs' funding needs are growing, the success of the latter will increasingly depend on access to commercial capital, ability to mobilize local savings, improved customer service and expanded outreach.

Commercial banks though have the greatest growth potential for microfinance, due to their widespread branch network, profit motive, private governance, competent organization structure, licenses and the need to take deposits (Navajas and Schreiner, 2008). However, they observe that a number of obstacles prevent them from providing microfinance including the high risk and the high cost of taking small deposits, especially in rural areas; the inability to brand the products so as to price microfinance services higher; the fear of competition from subsidized lenders; high start-up costs due to the need for research and development when discoveries cannot be hidden from rivals. The MFIs have however been able to overcome some of these challenges through the adoption of group lending. The virtues of group (solidarity) loans, according to the United Nations Capital Development Fund (UNCDF) (2004), include: the self-selecting

methodology is an effective means of character screening and verification, and this is a fundamental part of credit analysis and risk in any type of financing program; before a group agrees to guarantee a loan, they discuss the business idea with the individual members applying for the loan. This discussion tests the soundness of the idea and serves as a substitute for a costly feasibility study; groups serve as an outstanding method of 'guaranteeing' a loan when no collateral is available. Because a group's credit is 'frozen' until all members are current, groups exert pressure on their members to repay loans on time; many cultures have a tradition of lending money to members of savers' groups and thus principles of group lending are often familiar to target clients.

Micro finance institutions have challenges in the management of their finances and have reasons to ensure their sustainability is guaranteed in the near and medium future. The critical success factors for the sustainability of MFIs, according to Castello (2002), include: having an extended outreach whereby they will aim to reach as many people as possible which will permit an MFI to reach a certain minimum level of scale necessary for sustainability. Further, the MFI need to adopt an appropriate lending methodology in which group lending and village banking are better suited for scattered populations while individual lending works better in urban settings. Supportive regulatory and supervisory environment is also a necessary virtue. Regulations that apply to mainstream financial institutions need to be modified to take cognizance of the special nature of microfinance portfolio and the transaction cost MFIs incur.

According to Navajas and Schreiner (2008), technical assistance may help to mitigate three types of constraint in the development of microfinance, namely: downscaling banks require help in the development of the loan and deposit services geared to poor households. In addition, upgrading rural financial NGOs requires big technical changes, in products, sustainable organization, technology and psychology. Technical assistance is needed for financial NGOs to revamp their internal accounting, incentive systems, price structures, and overall philosophy. In addition, there is need of improving the supervision of MFIs by providing the supervisory authority with knowledge, based on experience worldwide, on the risk in a portfolio of microfinance.

2.4 Effect of Outside Control on MFI's Financial Capacity

Well run microfinance institutions (MFIs) make better use of scarce funds by providing better financial services and reaching more poor clients. Microfinance practitioners have emphasized that appropriate control and governance mechanisms are critical for the success of an MFI (Campion, 2008). As the microfinance industry grows and matures, the competition for donations and customers, as well as the presence of for-profit firms has made the impact of market discipline even more pronounced. Donors and creditors are increasingly relying on information from audited financial statements and many MFIs now choose to have their financial statements audited and make them available to the public.

2.4.1 Market discipline in microfinance

According to Sironi (2003) markets can discipline financial intermediaries if investors observe and price the risk of these institutions so that management decisions are affected

by the price signals. The market discipline can come in form of market monitoring and market influence. Bliss and Flannery (2001) distinguish between market monitoring as the process of correctly understanding and pricing changes in risk profile, and market influence as the impact that changes in prices have on managers' behavior.

Microfinance institution creditors do not differ from creditors of financial intermediaries – they seek and use information on MFI performance to ensure that their lending is prudent. However, MFI equity differs from that in banks and other financial intermediaries. A substantial part of the asset base of most MFIs is created through grants. Equity providers in MFIs are large (international) donors who do not have the option of selling stakes. Although these donors do not require dividends, they continue to monitor the MFI they created, usually through representatives on the MFI board (Hermalin and Weibach, 2003). MFIs and other financial institutions depend on having access to liquidity to meet current obligations and on external funds to finance expansion. Therefore, the willingness of donors and creditors to provide liquidity and to fund future projects is important. Donors and especially creditors, base their "good will" on information on the performance of MFIs, usually available through audited financial statements.

2.4.2 Audit and Disclosure Requirements

The ability of stakeholders (donors and investors) to effectively monitor managers depends crucially on the completeness and accuracy of the information they rely on. The main objective of external financial reporting is to reduce information asymmetries between the different stakeholders and the firm (Healy and Palepu, 2001). Lower level of

information asymmetry usually translates into lower cost of funds. To an MFI external audit can be an effective external mechanism because it signals to potential investors and donors whether the manager complied with the accounting practices and did not misrepresent financial information. Quality of audit also matters as evidence suggests that it is usually driven by active stakeholders (Ashbaugh and Warfield, 2003). They further note that, there is evidence that firms who voluntarily adopt the International Accounting Standards have lower cost of debt

There are various views on the possible impact of external audit. For example, the general view is that the degree of MFI transparency helps impose market discipline because more transparent MFIs would attract more investors, creditors, and donors. However, if firm ownership is concentrated, stakeholders (donors) with substantial stakes could provide sufficient monitoring and the benefits of external audits may be less pronounced. On the other hand, high concentration may be precisely the reason for requiring audits because large equity providers may collude with management and engage in excessively risky (and more profitable) activities to the detriment of creditors and depositors (Leutz and Verrecchia, 2000).

2.4.3 Rating of Microfinance Institutions

In addition to audit and financial statement disclosure, rating provided by independent market participants may affect the willingness of potential equity holders, donors, and creditors to fund an MFI. Credit rating influences the price of debt directly and it produces information useful to equity provides as equity studies find that investors promptly incorporate rating information in bank stock prices (De Young *et al.*, 2001). On

his part, Kuhner (2001) views rating agencies as information intermediaries and studies their role in helping to overcome information asymmetries. He shows that, in periods of increased systemic risk credit rating agencies have the ability to distinguish between different categories of fundamental credit risk but that, in general, credit rating agencies are developing evidence that the market largely agrees with and this information does not influence the decisions made by investors.

Boot *et al.* (2004) argue that the mechanism of CreditWatch allows the rating agency to interact with the firms it rates and write an implicit contract with the management of a firm that is under a threat of having its credit rating changed. This allows for a "deal" between the firm and the credit rating agency where the firm commits to take actions to mitigate possible deterioration in rating. The rating and the implicit contract are incentive compatible provided that a group (that is, possible investors) conditions its financing decision on the rating. The insights from this model are relevant to microfinance rating where some rating agencies such as M-CRIL provide rating that is valid only for certain period of time and thus, donors and investors are more likely to act on it.

2.4.4 The impact of regulation

The main argument for regulation has been that in most cases regulation enables an MFI to attract deposits (Campion and White, 2009). In the absence of deposits, MFIs could only leverage donated resources by borrowing from formal financial institutions, and large institutional or individual investors or by accepting limited deposits from the public. The need for regulation in institutions collecting deposit is justified because depositors are small, dispersed, uninformed, and cannot effectively monitor managers or exercise

their control rights. In banks, Dewatripont and Tirole (1994) show that a regulator could better represent the interest of depositors by acting on their behalf. The regulator's role is to define the conditions under which equity holders would remain in control of the bank and under which they would lose control, usually through solvency regulations.

Since regulation introduces the regulator as an additional stakeholder in the governance structure of the MFI, microfinance professionals worry about the impact of the new stakeholder on the mission. Regulatory involvement may lead to a mission drift if demands to fulfill regulatory requirements divert attention away from serving the poor and may hold back innovation in lending technology that has been the driving force behind MFIs' ability to serve even poorer borrowers. However, recent empirical studies analyze the impact of banking regulations on bank performance worldwide using newly released World Bank Banking Survey data and find that regulatory power has no impact on bank performance and valuation but that institutional environment supportive of private sector supervision of banks has positive impact (Barth *et al.*, 2004).

2.5 Empirical Studies on a Firms' Financial Constraints

Analysis of bank performance specifies performance as a function of bank-specific variables, macro-economic and institutional factors, and regulatory framework (Barth *et al.*, 2003). With the observance of these variables, they note that a micro finance institution will be able to achieve financial sustainability that enables them to cover all expenses with revenue plus produce a surplus of revenue over expenses to finance future growth. As an elusive economic condition, sustainability has not been achieved by most MFIs, and consequently subsidies are still needed. The findings of this study has a strong

link to the Kenyan micro finance institutions since has Wahome (2009) showed, the sustainability of the Kenyan MFIs will be influenced mostly by firm specific variable and institution factors such as administration cost. Muturi (2012) notes in her study that MFIs have a huge role to play in poverty alleviation though credit accessibility to SMEs. She further notes that the performance of these MFIs was however affected by factors such as limited financial resources, delinquent loans and lack of management information systems. A number of MFIs were showed to face financial challenges that have emanated from their expansionist tendencies without controlling their operational cost while expanding.

In a study Based on structure performance hypothesis, Guzman (2000) found out that MFIs with monopolistic powers more likely lead to credit rationing, charge higher rates on loans and tend to depress the equilibrium law of motion for the capital stock. Similarly, Dinc̦ (2000), shows that the effect of competition on access to loans depends on the level of competition in the micro finance sector in general and that a more competitive market encourages firms to establish several firm-bank relationships. He shows that there is an inverted U-shaped relation between the amount of relationship lending and the number of banks, in which a less concentrated market financial institutions being able to sustain the maximum amount of relationship lending. Further, Cetorelli and Peretto (2000) show that there are offsetting effects of bank concentration appear in reduced amount of total loanable funds.

In the contrary thread of literature, Cetorelli (1997) explores the role of MFI market power on the financing of credit-constrained firms and shows that banking monopolistic

power may reduce the equilibrium quantity of credit, but it provides better allocation of credit supply. Petersen and Rajan (1995) find that despite the moral hazard and adverse selection problem with small and younger firms the concentrated banking market provides excessive credit supply at discounted rate to them. But later, as firms grow older bank will be compensated by charging high interest rate. They suggest that positive impact of bank concentration diminishes as firms become older and information asymmetries get less severe. Beck et al. (2004) append the institutional development element in bank financial constraint nexus and find that bank concentration increases financing obstacles, but only in countries with low levels of economic and institutional development. Similarly, Cetorelli and Gambera (2001) provide empirical evidence that concentrated bank market is favourable only to developing economies and it appears to insert heterogeneous effects across the industries. The basis of the observations of Cetorelli and Gambera can be that in developing countries there are inadequate mechanisms at both the firm and regulatory point and that with this, there is going to be inefficiencies in the lending-borrowing point and therefore to mitigate some of this challenge, it will be advisable to introduce more competition by licensing more players in the sector. In the Kenyan sector, the prevailing level of competition can therefore be said not to be developed by virtue of the high spread in the deposit-lending rate in both the banks and micro-finance institutions. This implies that more financial institutions will need to operate in the country to bring the competition to the point where interest rates charged on loans and the interest on deposits falls to within the 5% spread acceptable worldwide.

The influential work of Fazzari et al. (1988), claims that, investment significantly relates to changes in internal funds and predicts a positive and monotonic relationship between firm investment and cash flow. Thus, accordingly, one can investigate the role of financing constraints on investment by comparing the investment-cash flow sensitivity across groups of firms classified according to a financial constraint measure and in a study by Kaplan and Zingales (2007), they found out that financially constrained firms are such firms that are left out (partially or entirely) from access to finance from the capital market. Their strategy is based on the qualitative and quantitative information included in the firms' financial and operational reports. Almeida and Campello (2007) include asset tangibility to investigate its impact on the sensitivity of cash flow with investment across constrained and unconstrained firms. Firm's asset tangibility

The relationship between the size of the microfinance institution and their capital structure has also been explored. Both Titman and Wessels (2008) and Coleman and Cohn (2009) stressed the exorbitances in cost of issuing debt and equity securities. They asserted that this situation is directly related to firm size and in turn may force small firms to tilt towards the use of, mostly, short-term debts. In the case of business start-ups, which are known to be relatively smaller at inception, Huyghebaert (2007, p. 105) posited the non-historicity of such businesses and, consequently, their lack of an established relationship with banks and funds suppliers that could have guaranteed them access to other forms of capital. Among the factors that have been used to support the positive linearity arguments include the fact that larger firms are more diversified; they have higher capacity to meet up with interest payments, and are more diversified than smaller firms (Pandey, 2004, p. 84). Such companies are also found to have been enjoying higher

degree of information disclosure, and they have higher collateral values and lesser bankruptcy risks. All these factors are argued by the above-cited researchers to have created more leverage opportunities to larger firms over smaller firms.

The above assertion that size directly relates to financial leverage has not been without some dissenting views. According to Rajan and Zingales (2005, p. 453), large firms may favor equity financing than debt financing due to the relativity of the cost of equity financing owing to asymmetric information which is small for such firms. Such firms may also be enjoying some reputation advantage among prospective investors especially, as a result of their consolidation in the industry/market. Therefore, they may prefer to exploit this opportunity instead of approaching the more expensive bank lending or other covenant-prone capital market debt instruments. Other supporters of the negative linear relationship between size and leverage are Cooley and Quandrini (2001), who find that smaller and younger firms pay fewer dividends, take on more debt, and comparatively invest more than relatively large firms. Faulkender and Petersen (2006), equally support the conclusion that size and financial leverage have negative relationship because, large firms have more access to equity funding than small firms. They specifically demonstrate that by a very wide magnitude, larger firms are less levered, with an increase in market value. This value ranges from a 25th to 75th percentile and has the ability to lower firm's leverage by an almost 3 percentage point.

Another finding on the study of microfinance institutions and there financial constraining factors is that credit rationing of borrowers increases repayment, which Sharma and Zeller (2007) interpreted as an incentive to screen, monitor, and enforce. They also found

that self-selection at the screening stage is correlated with improved repayment behavior. They also found out that more remote groups with minimal credit alternatives were more likely to have better repayment records. The empirical evidence suggests that repayment rates improve when groups consist of unbiased friends and neighbors who have strong social ties but are unrelated in kinship. Acquaintanceship or trust in society has no significance. These characteristics have more impact when there is a shortage of credit, because the relationship is more important to all group members.

There is also empirical evidence that monitoring affects loan repayment rates. Zeller (2008) found that repayment improves if groups have written/formal rules specifying the expected behavior of members. Although the formal and explicit specification of expectations is not monitoring *per se*, it does clarify what is being monitored and thus enhances monitoring. Wydick (2009) found that the communication of weekly sales of members is positively correlated to repayments. Relatedly, Karlan (2007, pp. 78-79) in a data intensive study of FINCO-Peru found evidence that monitoring improves repayment rates. Social connection, which assists with monitoring, is defined as knowledge and awareness of each others' default status and causes, as well as direct evidence of penalties and relationship deterioration.

2.6 Chapter Summary

The role of micro finance institutions in alleviating poverty through financing the businesses of the poor has been expounded in detail both in the literature as well as from the empirical studies done on the subject area. A microfinance institution was found to be an important ingredient in meeting the financing gap of the small business especially

the ones operated by the low income persons with no ability of sourcing funds from the mainstream commercial banks. Due to the high demand of funds for small businesses especially in the developing countries, it was found out those microfinance institutions face financial constraints. The access of finance by the MFIs will be influenced by their ownership structure, size of the micro finance and the collateral offered. At the same time an MFI will need to maintain market discipline in their operations, enforce audit and disclosure requirements and submit to the regulations set by the regulatory authorities.

However, it is evident from the literature and empirical studies undertaken that there has been no study seeking to establish the impact of financial constraints on the performance of micro finance institutions in low income country like Kenya. Instead the literature and studies suggest the operations of MFIs and their roles and impact to society and the economy. It is on the basis of this that the present study will wish to establish the impact of financial constraints on performance of MFIs in Kenya.

CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction

This chapter sets to explain the research design, the population of interest, the type of primary and secondary data that was used, the sources of data, the procedures and techniques of analysis to be used and the data analysis. The subsections give details of the procedures used in conducting the study. It gives a detailed description of the population which in this case is all the microfinance based in Nairobi.

3.2 Research design

This study was based upon the premise that MFIs in Kenya are confronted by financial constraints. As a result, a cross sectional and time series research design will be used in this study. This research design enabled the researcher to document the behaviour of the firms in the market since there could be a problem in specifying and measuring some variables which could still be proxy to for many competing hypotheses (Graham et al., 2005). A cross sectional study was used to determine the interrelationship between the variables under consideration among the different firms in the study at the same time. This permitted the researcher to make statistical inference on the broader population and generalize the findings to real life situations and thereby increase the external validity of the study.

3.3 Population

The population of interest for this research was all the microfinance institutions registered with AMFI as at 31st Dec 2011 (Appendix II). The selection of the organizations is

because all the firms have their headquarters in Nairobi and its environs and this was convenient in terms of time and accessibility to the researcher. Since the number of the respondents is limited, then the study was a census survey.

3.4 Data Collection

Data was collected from annual reports submitted to the AMFI by the micro finance institution. Annual reports of the firms will be obtained between 2008 and 2011 which is the study period. The selected MFIs are purposely selected because the availability of their financial statements and the company's' annual accounts were obtained from the respective MFIs offices. The sampling method was not however be biased because the institutions operate in various parts of the country and also serve different clientele. All firms in the sector which had continually operated between 2008 and 2011 were included to ensure that the sampling frame is current and complete.

3.5 Data Analysis and Presentation

A regression analysis was applied to the data to examine the impact of the various aspects of financial constraint on the performance of the MFIs. The regression model was run from the financial reports of those firms that have been in operation since 2008 and whose annual reports are available in these periods. Further, observations of items from the balance sheet, and profit and loss accounts showing signs contrary to reasonable expectations will be removed.

A multivariate regression model was used to analyze the relationship between the loan disbursement by the MFIs (dependent variable) and the financial constraints variable

(independent variable). The study adopted the a model by Mehran (1995) and take the following form;

$$Y_{it} = \beta o + \beta_i X + U_{it}$$

Where, i denotes the individual microfinance institutions and t denoting time. In this case, i represents the cross-section dimension and t represents the time-series component. Specifically, the model will be of the form;

$$LD = \beta o + \beta_1 SDR + \beta_2 LDR + \beta_3 SZE + \beta_4 AGE + \alpha$$

Where;

LD = Loan disbursement for firm i in time t;

SDR is short-term debt divided by total capital for firm i in time t;

LDR is long term debt divided by total capital for firm i in time t;

Ln SZE measures the size of the firm and it is the natural log of asset base of firm i in time t;

ln AGE is natural log of age of firm i in time t; (age in this wise is measured by the number of years of operation using the year of incorporation as the reference

point).

To complement the regression analysis, correlation analysis was carried out to find the direction of the relationship between financial constraints and performance, as well as the magnitude. The Statistical Package for Social Sciences (SPSS) was used to analyse the data.

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3.6 Data Validity and Reliability

To increase the reliability of the data collected the researcher employed test-retest technique in those micro finance institutions considered to command a bigger share in the Kenyan market due to their commanding role they play in lending to the poor in the country. At the same time, more than one respondent was identified in each micro finance institution at different times to corroborate the answers that they will provide on the financial constraints that they will be facing in their operations. The researcher undertook a pilot study in which five MFIs were given the questioners to fill and their respondents considered to determine whether the sample can be deemed to understand the questions in the research instruments. This group of respondents in the pilot study was not interviewed in the final study. In case the researcher found out that some data collection instruments were not meeting their intended purpose or not understood by the pilot respondents, then the same shall be modified. In addition to the above measures, the researcher allowed the data collection instruments to be employed in the study to be verified by an expert, who mainly were made up of the Micro finance experts, to ensure that they were valid for the intended purposes.

CHAPTER FOUR

DATA ANALYSIS, FINDINGS AND DISCUSSION

4.1 Introduction

The research objective was to establish the determinants the impact of financial constraints on the performance of MFIs in Kenya. This chapter presents the analysis and findings with regard to the objective and discussion of the same. The findings are presented in mean and standard deviations. Finally a regression analysis will be performed on the results.

4.2 Descriptive Statistics

The descriptive analysis below shows the average, and standard deviation of the different variables of interest in the study. It also presents the percentile values of the variables which help in getting a picture about the maximum and minimum values a variable can achieve.

4.2.1 Causes of Financial constraints on Micro Finance Institutions

The respondents were requested to indicate the factors that influence the level of financial constraints in the micro finance institutions in a five point Likert scale. The range was 'strongly disagree (1)' to 'strongly agree' (5). The scores of strongly disagree have been taken to represent a variable which had mean score of 0 to 2.4 on the continuous Likert scale; ($0 \leq$ S.D <2.4). The scores of 'moderate' have been taken to represent a variable with a mean score of 2.5 to 3.4 on the continuous Likert scale: ($2.5 \leq$ M.E. <3.4) and the score of both agree and strongly agree have been taken to represent a variable which had

a mean score of 3.5 to 5.0 on a continuous likert scale; (3.5≤ S.A. <5.0). A standard deviation of >0.8 implies a significant difference on the impact of the variable among respondents. The results are presented in Table 4.4.

Table 4.1: Financial constraints facing MFIs

Factor	Mean	Std. Deviation
Donor dependence of the MFIs on funding	4.2905	.80359
Low level of efficiency and financial guidelines	4.2667	.79378
Poor screening process of the loan applicants that eventually leads to loan defaults	4.1190	.99271
Low capital base to meet disbursement needs of applicants	3.8571	.75131
The high risk and cost of taking deposits has affected the organization finance	3.8095	.77264
Inability of the MFI to brand its products	3.7381	.70051
High cost and risk from the information asymmetry in the operation of the organizations operations	3.8333	.90841
The MFI has difficulties in enforcing contracts	4.1667	.88115
Supervisory inadequacies affect the loan disbursement and recovery in the organization.	4.0000	.85540
A lack of regulation on the sector has reduced the level of funding in the sector and hence the disbursement level of the MFI	3.8810	.83235
The risk aversion of lenders on the performance of MFIs discourages them to lend to these small institutions.	4.2381	.79048
The level of guarantees' offered by the group on loans taken is not a deterrent enough on the loan default by the customers	3.7619	.90553
The level of customer service in the organization is low which has led to a reduced level capital in the firm	3.9286	.77752

The organization has been unable to adequately mobilize local savings and as a result leading to an inadequate operating capital.	3.8810	.88902

The findings in Table 4.1 above shows that the major cause of the local MFIs financial constraints is the tendency of the institutions to depend on donors (mean 4.2905) to provide the necessary funds to be disbursed to the customers. Dependence on donor funds means that with a change in operating and business condition in the donor country, the level of funding to the local MFIs will be affected. This means that in the case of the recent Euro-zone crisis that affected most of the western Europe countries, any local MFI that depended on the these countries agencies to fund some of their projects will have had their activities affected due to the crisis. Poor screening process of the loan applicants that is adopted by the MFIs (mean 4.2667) also came out as a strong reason that leads to financial constraints to the organizations. The loan disbursement by the MFIs is meant to be repaid in full and within the specified time period. However, for a successful repayment of the money, it is imperative that the MFIs institute an elaborate and more efficient mechanism of screening the applicants such that only those applicants that have the capacity and intention of repaying the loan will be considered for a loan.

Another reason that contributes to the risk of financial constraints in the micro finance institutions is the low capital base that these organizations face to meet disbursement needs of applicants (mean 3.8571) and standard deviation of (.75131). The results found out that most of the sampled organization had their capital base less than Ksh 150M and

with an increased level of disbursement to customers and a slow rate of repayment being witnessed, then such a scenario will lead to the organization having difficulties in meeting the organizations financial obligations. The low capital base that is prevalent in the MFIs is further compounded by the risk aversion of lenders on the performance of MFIs that discourages them to lend to these small institutions (mean 4.2381). Local commercial banks are found to shy away in advancing enough loans to the MFIs that will meet their financial needs and with such risk averseness being witnessed the level of financial strength of the organizations will not be sound enough. The risk averseness of lenders to the MFIs has also been attributed to the lack of regulation on the sector. However, this impediment has been reduced by the publishing and passing of the Micro Finance Institution Act which has attempted to regularize the operations of these institutions as well as making their operations be under the supervision of the central bank. These changes have brought about increased confidence in the micro finance sector in the country and this is expected to lead to an increased funding to the organizations.

The other factors that came out for the research on factors that contribute to the financial constraints to the MFIs in Kenya were supervisory inadequacies in the loan recovery process of the organization (Mean 4.0) with a standard deviation of .8554. It was found out that the organization management should come up with effective collection policy that can vary between aggressive and conservative collection policy that will depend on the level of outstanding debt. The debt collection department should also be staffed with trained and motivated staff that will be able to follow promptly at the time set. In some cases, the level of guarantees that is given out as security and even the group support was found led to financial constraint to the MFIs. This is because in the case of default assets

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recovered from the borrowers has not been found to be adequate enough to make good the loan outstanding. The level of guarantees' offered by the group on loans taken is not a deterrent enough on the loan default by the customers. In addition the results also show that the level of customer service that is offered by a given MFI will impact on the loan uptake by the organization.

4.3 Quantitative Analysis

For quantitative analysis the study used two methods. At first, correlation is used to measure the degree of association between different variables under consideration. As multiple variables are influencing the problem, the study identified the crucial factors associated with financial constraints on the MFIs. Pearson and Spearman correlations are calculated for all variables used in the study starting with the Pearson's correlation results. Secondly, a regression analysis is contacted on the data to establish the regression analysis between the variables under consideration.

4.3.1 Pearson and Spearman's Correlations

Table 4.2 below shows the Pearson and Spearman's correlation coefficient generated from the data. Consistent with Shin and Soenen (1998), the spearman's rank correlation coefficients are on the upper right triangle while the Pearson product moment correlation coefficients are on the lower left triangle. Pearson's Correlation analysis is used for data to see the relationship between variables such as those between independent variables and financial distress level of the firms.

Table 4.2: Pearson and Spearman's Correlation Coefficient

		LD	SDR	LDR	SIZE	AGE
Correlations						
LD	Pearson Correlation	1	-.045	.359[**]	.241[*]	.126
	Sig. (2-tailed)		.707	.002	.040	.288
	N	73	73	73	73	73
SDR	Pearson Correlation	-.045	1	.032	.288[*]	-.007
	Sig. (2-tailed)	.707		.789	.014	.950
	N	73	73	73	73	73
LDR	Pearson Correlation	.359[**]	.032	1	.153	.226
	Sig. (2-tailed)	.002	.789		.197	.054
	N	73	73	73	73	73
SIZE	Pearson Correlation	.241[*]	.288[*]	.153	1	-.154
	Sig. (2-tailed)	.040	.014	.197		.192
	N	73	73	73	73	73
AGE	Pearson Correlation	.126	-.007	-.226	-.154	1
	Sig. (2-tailed)	.288	.950	.054	.192	
	N	73	73	73	73	73
**. Correlation is significant at the 0.01 level (2-tailed).						
*. Correlation is significant at the 0.05 level (2-tailed).						

Source: Researcher data

If an independent variable increases financial performance of an organization, then one should expect a positive relationship between the measures and increase in loan disbursement level OF the MFI. The results from the above table show that there is positive relationship between the level of MFIs loan disbursement level and the long term debt level and the, age of the firm and the organizations size. However, the level of long term debt level (LDR) was the variable with the strongest association with the

performance of the MFIs loan disbursement level (correlation 0.3590) and is also significant the 95% confidence level. This means that if an organization has borrowed funds to be repaid after a long term period, then the same can be advanced to the clients with a higher reward in terms of interest to the organization. This result is contrary with that of the relationship between the MFIs short term debt (SDR) and the loan disbursement performance of the organization.

The short term debt in proportion to total assets (SDR) had a negative correlation (-.045) with the level of loan disbursement performance. This negative correlation shows that a high level of short term debt in the financial structure of an organization will reduce the level of loan disbursement since the MFIs will be reluctant to disburse a short term loan which will be due in a short period in future. Similarly the age and size of the organization has a positive correlation on the loan disbursement level of the firm. This is because with an increased age of the MFI, it is possible that the organization will have accumulated adequate retained earnings that will form the capital base of the firm and therefore available for disbursement. The size of the firm was proxied by the natural log of the total assets and it was found out that it had similarly a positive correlation with performance of the level of loan disbursement. A firm with a large asset base means that it will have accumulated adequate capital base to fund the assets and this implies that the organization can advance a high portfolio of funds that can be disbursed.

4.3.2 Regression Analysis

The determinants of the impact that financial constraints have on the loan disbursement of the 21 micro finance institutions investigated is presented below. From Table 4.3 , the established multiple linear regression equation becomes:

LD= -17934.450 - 36101.721 X_1 + 26876.149 X_2 + 18280 X_2 + 16332X_4

Table 4.3: Results of General Least Square

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-17934.450	3683.284		-.487	.628
SDR	-36101.721	347.234	-.119	-1.038	.303
LDR	26876.149	943.524	.324	2.849	.006
SIZE	18280.172	960.826	.223	1.902	.061
AGE	16332.921	962.093	.019	.170	.866

Source: Researcher data

Where;

LD = Loan disbursement for firm i in time t;

SDR is short-term debt divided by total capital for firm i in time t;

LDR is long term debt divided by total capital for firm i in time t;

Ln SZE measures the size of the firm and it is the natural log of asset base of firm i in time t;

ln AGE is natural log of age of firm i in time t; (age in this wise is measured by the number of years of operation using the year of incorporation as the reference point).

The results of this regression indicate that the coefficient of the short term debt level of the organization is negative and is significant at the 95% confidence level with a p-value of -1.038. This direction means that level of the firm's short term debt has a negative

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influence on the firms' loan disbursement performance and if an MFI wishes to increase its disbursement, then it will have to reduce its dependence on the level of short term borrowings and instead opt for long term borrowing. The results also show that the long term debt financing adopted by a firm will yield a greater effect on the level of loan performance that the MFI will achieve than any other independent variable that is included in the model. The long term coefficient in the regression is +26876 though not significant at 95% confidence level with a p-value of 2.849. the size of the micro finance and the age of the organization was also found to have a positive coefficient and were also significant at the 5% level of significance with the respective p-values of 1.902 and 0.17.

Table 4.3: Model Summary for debt collection with the predictor variables

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.542[a]	.294	.149	247.886

a. Predictors: (Constant), AGE, SDR, LDR, SIZE

The adjusted R^2, also called the coefficient of multiple determinations, is the percentage of the variance in the dependent variable explained uniquely or jointly by the independent variables (short term loan to total capital, long term debt to total capital, size and age of the firm) and is 54.2 %. This means that 54.2 % of the changes in the level of loan disbursement by the MFIs can be explained by the changes in the independent variables and control variables in the model. The remaining 45.8% of the changes in the revenue from debt collection will be explained by other factors not in the model.

4.4 Summary and Interpretation of findings

The growth rate of microfinance initiative in Kenya has been high, but the funding levels in the industry have not matched this growth. This is particularly of concern when the traditional sources of finance are considered and the uncertain capacity of MFIs to access alternative funds. For MFIs identifying factors that enhance successful attraction of leveraged funds could potentially reduce their funding constraints and the growing scarcity of donor funds and increasing MFI competition for funding has sparked increased interest from the financial markets.

As small business compared with the mainstream commercial banks, MFIs face specific constraints in raising external finance and as a result, microfinance institutions (MFIs) have come in to expand the frontier of finance by providing loans and other financial services to diverse client base in the lower cadre. The reasons that have led to the financial constraints include that small firm's access to the formal financial sector is constrained by high risk and transaction costs brought about by difficulties in enforcing contracts, information asymmetry, and lack of appropriate instruments to manage the risk involved. In some cases the problem is aggravated by supervisory and capital adequacy requirements that restrict banks from extending uncollateralized loans to small firms. This findings was found to be similar to the one made by (Wright, 2009).

The findings of the study were that micro finance institutions will need to source for long term funding as opposed to short term in order to increase their capacity to lend out for long term periods to customers. In addition, subscribing to the regulations of the CBK,

increasing their level of customer service as well as enhancement of their financial management guidelines will reduce the level of their financial constraints which in turn will increase the organizations level of funding that can facilitate increased loan disbursement performance.

Kaplan and Zingales (2007) in their study of the effects of concentration banking on financial constraints on MFIs IN Britain found out that similar financial challenges face the MFIs but recommended that concentration banking will be more applicable in more developed economies. The financial constraints facing the Kenyan MFIs can also be attributed to the low degree of information disclosure and high bankruptcy risks. Such factors as highlighted by Pandey (2004) have created less leverage opportunities for such firms.

CHAPTER FIVE
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The study aimed to investigate the impact of financial constraints on the performance of micro finance institution in Kenya and towards the realization of the research objective both a descriptive analysis and correlation and regression analysis was undertaken.

The study found out that the dependence on donor funds by the local MFIs affected their capacity to advance loans to potential customer and there is need to reduce this present level of dependence. Such dependence affects the local MFI whenever there are changes in the donor country operating environment. The inability of some of the borrowers to service their loans and therefore affecting the financial capacity of the organization was identified to result from poor screening process. The loan disbursement by the MFIs is meant to be repaid in full and within the specified time period. However, for a successful repayment of the money, it is imperative that the MFIs institute an elaborate and more efficient mechanism of screening the applicants such that only those applicants that have the capacity and intention of repaying the loan will be considered for a loan. The study found out that most MFIs had a low capital base and that is way they tend to depend mostly in donors and the low capital base is further compounded by the risk aversion of lenders on the performance of MFIs that discourages them to lend to these small institutions. Local commercial banks are found to shy away in advancing enough loans to the MFIs that will meet their financial needs and with such risk averseness being witnessed the level of financial strength of the organizations is found to be wanting. The other factors that came out for the research on factors that contribute to the financial

constraints to the MFIs in Kenya were supervisory inadequacies in the loan recovery process of the organization.

The p-statistic values and R^2 were used to determine the significance and magnitude of the relationship between the dependent variable and the independent variables while to test for correlation of the variables a Pearson rank correlation analysis was also undertaken. In general, the results of general least squares method with cross section weights indicate the financial constraints as the independent variables affects the capacity of the level of the loan disbursement by the micro finance institutions in Kenya by 54.2%. The study found that the regulation of the operation of the MFIs will help in increasing the confidence of these organizations and at the same time streamline the operation of the organization which will give it the necessary confidence to can result in their capital base being shored up.

5.2 Conclusions

This paper attempted to investigate the impact of financial constraints on the loan disbursement performance of the micro finance institutions in Kenya. By using both descriptive and regression analysis it shows that the financial constraints facing micro finance institutions has a great effect on their capacity to advance loans to their customers. From the study it can be concluded that the greatest challenge on the capacity of the MFIs to disburse loans to their customers is the inadequate capital base, the risk averseness of lenders to lend to these institutions due to a lack of adequate disclosures and earlier on due to the lack of regulations by the central bank though the same as been made in Kenya.

From the results above, it can also be concluded that micro finance institution have a great potential in dealing with the funding challenges experienced by the poor and due to their critical role, they need to increase their level of transparency to attract more funding and also shift their operations to include deposit taking that will also increase the funds available for disbursement. On the part of the organizations screening, it can also be concluded that there is need for the MFIs to institute an elaborate and efficient procedure for screening the potential applicants so that a higher degree of repayment could be realized by the organization.

The results in chapter 4 also suggest for greater growth and deepening of MFIs to their target clientele and there is need to get alternative sources of capital. The dependence of donors for funding was curtailing their growth as donor funds compete for various social needs other than micro lending. To enhance their level of transparency MFIs will need to disclose more of their financial positions through public disclosures and adherence of prudent financial management policies.

5.3 Policy Recommendation

This study makes a few recommendations that have policy implications for decision makers. The study found out that not all micro finance institutions have in place adequate screening procedures on potential borrowers and it is recommended that these institutions should establish appropriate screening procedures that include the adoption of 5 Cs

criteria that will assess the capacity, capital, market condition, and previous records of the borrower.

It is also recommended that other micro finance institutions especially the smaller ones that was not covered in the study considers the findings of this study and implement actions that will reduce their level of financial constraints. The government should also take the initiative to encourage optional adherence of the prudential guidelines on the management of the micro finance and also ensure that they all subscribe to the guidelines since it is through such regulations that it is possible to achieve increased funding to the MFIs.

The government should also consider encouraging the setting up of segment of the Nairobi Security Exchange that will trade on micro finance shares and this will help the institutions raise adequate capital to finance their operations. To encourage growth of certain sectors in the economy such as Agriculture and Tourism, policy makers in government to need to create pool of funds to cater for Small and Micro Enterprises in these sectors of the economy such funds would be on revolving basis to allow more SME's to benefit from such funds. In line with this the government can encourage the development of MFIs that will lend funds to such sectors of the economy to encourage their growth.

5.4 Limitations of the Study

The study only concentrated with the major micro finance institutions that operate in Kenya at present. The study did not cover all the micro finance institutions and still all the institutions do not have the same financial constraints and therefore the extent of their

loan disbursement will vary. In addition some MFIs are wholly or to a great extent financed by donors and as a result the challenges that they will be facing different degrees of financial constraints.

In addition the study did not differentiate between the sizes of the micro finance institution. This is because different MFIs will be facing different financial constraints depending on their sizes and also depending on the age of existence of the same. A well established MFI that has been in operation for a long period of time will be expected at the same time to have accumulated adequate capital and internal mechanism of disbursing the loans and therefore their level of financial constraints will vary.

Further the study concentrated with micro finance institutions and it would have been preferable to compare its results with those of commercial banks especially in tier three of the central bank classification whose capital base and operations is still low. It is therefore limited in scope and there is need to cover more than one type of the financial institution in order to get a more representative result. In addition, the time constraint was the other limitation faced by the researcher and there is need of a more exhaustive research to be undertaken that will involve more funding and time coverage.

5.6 Suggestions for further Research

The study confined itself to major micro finance institutions in Nairobi who are considered to have maintained books of accounts and better trained management team. It is therefore recommended that a study be undertaken to cover the other micro finance

institution with a smallest level of operations and also a study on the comparison between the effect of financial constraints on the MFIs and the mainstream commercial banks.

With the recent enactment of the Micro Finance law there is need to undertake an event study on the performance of MFIs before and after the enactment of the law. Such study would test any positive change as a result of CBK regulations on factor captured in Table 4.1.

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APPENDIX I

QUESTIONAIRE

The questionnaire seeks to collect information on the impact of financial constraints on performance of micro finance institutions.

PART A: GENERAL INFORMATION

1) Name of the MFI (optional)…………………………………………………

2) For how long has your organization been operating?

   Less than five years   [   ]   10 -20 years   [   ]

   5 - 10 years   [   ]   Over   20 years   [   ]

PART B: Financial Constraints Facing MFIs

3) In a scale of 1-5, to what extent do you agree with the following statement concerning the nature and cause of financial constraints facing your organization? (Please Tick)

   Key   5) Strongly agree   4) Agree   3) Neutral   2) Disagree

           1) Strongly disagree

Statement	5	4	3	2	1
The MFI is donor dependent and does not have enough funds to finance its operations in the case the donors cut down on the funds					
The level of efficiency in the organization is low and this is due to a lack of prudent financial management					

The existence of poor screening process in the organization has lead to a low repayment rate of the firm disbursement and this has affected its capacity to fund new applicants					
The organization has a low capital base to meet its disbursement needs					
The high risk and high cost of taking small deposits has affected the organizations finance					
The inability to brand the products so as to price microfinance services higher has led to a low return on loans which has affected the firms level of capital					
There is high risk and transaction costs brought about by information asymmetry in the operation of MFIs					
Difficulties in enforcing contracts					
The organization lacks an appropriate instruments to manage the risk involved in lending to the poor					
Supervisory inadequacies affect the loan disbursement and recovery in the organization.					
A lack of regulation on the sector has reduced the level of funding in the sector and hence the disbursement level of the MFI					
The risk aversion of lenders on the performance of MFIs discourages them to lend to these small institutions.					
The level of guarantees' offered by the group on loans taken is not a deterrent enough on the loan default by the customers					

The level of customer service in the organization is low which has led to a reduced level capital in the firm					
The organization has been unable to adequately mobilize local savings and as a result leading to an inadequate operating capital.					

APPENDIX II

List of Microfinance Institutions

1. Agakhan Foundation
2. BIMAS – Business Initiatives and Management
3. Elite Microfinance
4. Equity Bank
5. ECLOF – Kenya Ecumenical Church Loan Fund
6. Faulu Kenya DTM Limited
7. Jamii Bora Trust
8. Jitegemee Trust
9. K-rep Bank Ltd
10. K-rep Development Agency
11. KADET
12. Kenya Eclof
13. Kenya Entrepreneur Empowerment Foundation (KEEF)
14. Kenya Post Office Savings Bank - Postbank
15. Kenya Women Finance Trust
16. MIC Microcredit limited
17. Micro Kenya
18. Micro Enterpise Support Trust (MESPT)
19. Pride Kenya
20. SMEP
21. WEEC – Women Economic Empowerment Consortium
22. Yehu Enterprises Support Services

Source: Association of Microfinance Institutions (AMFI) 2012