

**THE DETERMINANTS OF FINANCIAL PERFORMANCE OF
MICROFINANCE INSTITUTIONS IN KENYA**

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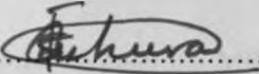
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**A RESEARCH PROJECT REPORT SUBMITTED IN PARTIAL
FULFILLMENT OF THE REQUIREMENT OF A MASTER OF
BUSINESS ADMINISTRATION (MBA) DEGREE, SCHOOL OF
BUSINESS, UNIVERSITY OF NAIROBI**

NOVEMBER 2011

DECLARATION

This research paper is my original work and has not been presented for the award of a degree in any other university.

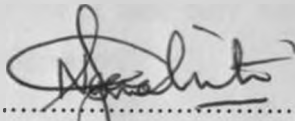
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ACKNOWLEDGEMENT

Special thanks go to my supervisor Mr. Mohammed Mwachiti for the encouragement, invaluable input, incessant guidance and tireless contribution he made to shape the final outlook of this project, without his enormous support this study would not have been successful.

The journey through the MBA course has been long, but I would like to thank all those who have been supporting me in the course of the journey in whatever magnitude especially all students with whom we worked together during this exciting and nourishing experience.

Special thanks also go to all the respondents who were involved in this study. They took time out of their busy schedules to respond to the questionnaires and other crucial information.

Special mention goes to my entire family and friends, who showed high degree of tolerance, during the period of study. Thank you for your patience, love and invaluable and unique support even during hard times. I salute you all.

Glory be to God almighty, for giving me precious life and to have this course finalized.

DEDICATION

This study is dedicated to my family for their special part that they occupy in my life and whom I always get inspiration to keep working extra hard. Also to my mum and dad to whom I feel indebted for their moral support.

ABSTRACT

Microfinance is a term often applied in reference to small-scale financial services- primarily credit, savings and insurance. It is a tool that has been acceptable over time to offer poor people access to basic financial services, such as loans, savings, money transfer services and micro insurance.

In Kenya, Microfinance as a concept has been applied exclusively in attaining financial inclusion of parties earlier excluded from the formal financial system. The industry has various players that range from formal and regulated enterprises to non formal MFIs. This study attempted to investigate the factors that determine the financial performance of the 41 MFIs that are registered and regulated by the AMFI.

From the findings, the various factors identified to influence this performance are either firm specific or market specific. The factors include; inflation rates, corporate governance practices, Distribution networks, Sustainability, Profitability, Outreach, Growth of informal sector, Leverage levels of the institution, Donor Subsidies, Access to capital, Capitalization requirements, Management Information systems, External Intervention, Product diversity, Real Interest rates, Levels of Citizen Income, Donor Support, Education levels of Citizen, Liquidity of the Institution, Communication costs, Transition to service based economy, Operational costs, Existence of Micro - finance market, Risk Management Practices, Information costs, Transaction costs, Education levels of staff and Human expertise.

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LIST OF ABBREVIATIONS

MFI's – Microfinance Institutions

AMFI's – Association of Microfinance Institutions

CBS - Central Bureau of Statistics

MSE- Micro and Small Enterprises

MGD's- Millennium Development Goals

USAID- United State Agency for International Development

GDP – Gross Domestic Product

NGO's Non- Governmental Organizations

CGAP- Consultative Group to Assist the Poor

K-REP- Kenya Rural Enterprise Program

PRSP – Poverty Reduction Strategy Paper

CBK- Central Bank of Kenya

ROSCA's – Rotating Savings and Credit Associations

SACCO's- Savings and Credit Co-operative Societies

AFC- Agricultural Finance Corporation

ASCRA's- Accumulating Savings and Credit Associations

KPOSBS- Kenya Post Office Savings Bank

SPSS- Statistical Package for Social Sciences

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background of the Study

The term “microfinance institutions” is generally used to refer to those financial institutions that are characterized by their commitment to assisting typically poor households and small enterprises in gaining access to financial service. This commitment may replace or supplement other private or public objectives, such as the maximization of shareholder value, the direction of investment into priority sectors, or the mobilization of savings to finance government operations. In common usage, MFIs are distinguished from purely commercial, small-scale, possibly informal financial institutions dealing with the poor (for example, village moneylenders, pawnshops, and informal transfer systems) and from large, perhaps government-sponsored schemes that may hold numerous small accounts more or less as a byproduct of their main business (for example, national savings schemes or post office savings banks) (Hardy, et al, 2002).

Microfinance Institutions refers to those business that receives money by way of deposits and interest which is lent to others or used to finance the business in forms of loan or facilities to micro or small enterprises and low income households, deposit taking and also non-deposit taking (Microfinance Institutions Act, 2006). Microfinance refers to small-scale financial services-primarily credit, savings and insurance. It offers poor people access to basic financial services, such as loans, savings, money transfer services, and micro insurance. Savings services allow savers to store excess liquidity for future use and to obtain returns on their investments. Credit services enable the use of anticipated income for current investment or consumption. Over all, microfinance services can help low-income people reduce risk, improve management, raise productivity, obtain higher returns on investments, increase their incomes, and improve the quality of their lives and those of dependents (Robinson, 1987).

According to World Bank; Microfinance Institution refers to those Institutions that engage in relatively small financial transactions that use various methodologies in

order to serve low income households, micro enterprises, small scale farmers and also those who lack access to traditional banking services (CBS, 1999).

Given the international community's commitment to the goal of halving world poverty by the year 2015, it is imperative to understand the ways in which Microfinance contributes to economic growth and poverty reduction, and to design effective policies that can make that contribution a reality. Two strands of recent literature in development economics and finance are relevant. The first strand has generated a large body of empirical evidence which shows that financial sector development can make a significant contribution to economic growth and development (Levine and Demirguc-Kunt, 2001; World Bank, 2001; Green et al., 2005). However, the exact nature of the relationships among financial sector development, economic growth and poverty reduction is less well understood (Green and Kirkpatrick, 2002; DFID, 2004). The second strand advanced by Snodgrass and Biggs (1996); DFID (2000); and Beck et al. (2005) investigates the role of micro and small enterprise (MSE) development in contributing to poverty reduction and the general achievement of Millennium Development Goals (MDGs).

Dondo and Ongila (2006), states that Microfinance financial performance and growth mainly depends on the interest of the stakeholders. This is due to the fact that different stakeholders require different measures in order to make informed decisions. Many stakeholders are more interested in performance, growth, return on investment and also continued financial stability of the Institution (Situma, 1997).

Small borrowers are limited by collateral requirements, low levels and irregular incomes and highly skewed incomes. They are also exposed to high risk profile which makes them less attractive to formal lenders hence they rely on informal financial markets for credit both for investment and consumption. According to Chipeta and Mkanakwine (1991) and Aryeetey and Gockel (1991) many borrowers prefer informal sector mainly because of favorable terms of lending, easier formalities and no collaterals are required. Bhasin and Akpalu (2001) found that self employment in small and Micro-enterprises requires investment in working capital. Due to low level income, capital accumulation may be difficult. Hence low level income earners results

to loan for them to increase family income in order to accumulate capital and investment in employment.

Many Kenyans especially the small scale entrepreneurs lack adequate access to formal credit largely due to laid down or existing credit policies, associated with the loan provision done by formal financial sector (Ringeera, 2006). In general, MSEs are an integral element of the informal sector in most developing countries. In the majority of cases, these enterprises are initially informal but gradually some of them survive and become formal businesses, thereby providing the foundation of modern private companies (Mkandawire, 1999; Cook and Nixon, 2005). Hence, the growth of these enterprises is part and parcel of a dynamic growth process in the corporate sector, as argued by Liedholm and Mead (1994) and Prasad et al. (2005).

Studies on the determinants of financial performance of MFIs consider the challenges of financial performance as well as factors that influence the financial performance. The factors that determine financial performance as discussed by Goldfajn and Rigobon (2000) and Vander Weele and Markovich (2001) include environmental Factors namely: Macro-economic environment, International environment, Transition to service based economy, Growth of informal sector, Existence of Microfinance market, Infrastructure and geographical framework as well as firm specific factors of; Management skills and product innovation. The challenges of growth and financial performance are the: Strategic issues, Operational issues, Marketing issues and Regulatory provisions.

1.1.1 The Microfinance and Savings Institutions in Kenya

According to Rukwaro (2001) the microfinance movement is real, large and growing. The performance of MFIs in Kenya is a critical exercise owing to the fact that some MFIs fail where others succeed. Microfinance related services play a vital role in Kenya's economy. An estimated 10 percent to 15 percent of the population relies entirely on NGOs and informal associations for financial services. A national survey given in 1999 estimated that 20 percent of the country's total employment was involved in micro enterprises, contributing more than 25 percent of non-agricultural GDP. In 2007, Kenya government passed the Microfinance Bill to regulate microfinance institutions in conjunction with the Association of Microfinance Institutions (AMFI),

based in Nairobi and funded by a large USAID grant. The aim of the bill is to protect the citizens who are out of the scope of traditional banking services from corrupt microfinance institutions (FSD, 2010).

The Microfinance Act 2006 granted some of the microfinance institutions in Kenya a legal status as deposit taking institutions. MFIs are feeling squeezed from commercial banks which have begun to attract a larger share of what has traditionally been the microfinance market. This trend is occurring as commercial banks are offering more attractive financial products to the best performing microfinance clients, with better terms and more easily met conditions (Hogarth, 2009).

The Microfinance Act 2006, became operational in May 2008, and creates the legal framework for qualified MFIs to accept deposits and mobilize them as loan funds, providing a valuable source of capital for expansion and financial self-sufficiency. The act also opens up the possibility of MFIs tapping into other sources of capital, including equity capital. The regulations for deposit-taking MFIs are strict and include, among other things, operating nationwide throughout Kenya and retaining core capital amounting to between Sh20 million (USD 252 thousand) and Sh60 million (USD 770 thousand) (Hogarth, 2009).

The microfinance industry in Kenya comprises of various types of competing institutions which vary in formality, professionalism, visibility, commercial orientation, geographical coverage and size. These institutions are registered and regulated and/or supervised under different legislations, including commercial banks; development finance institutions such as the Agricultural Finance Corporation (AFC) and the Kenya Post Office Savings Bank (KPOSB); deposit-taking microfinance institutions and several non deposit-taking microfinance institutions. The non-deposit taking institutions are different institutional forms such as companies, trusts and NGOs; saving and credit co-operatives societies (SACCOs); accumulating and rotating savings and credit associations (ASCAs and ROSCAs) and money lenders, among others. As at June 2009, it was estimated that commercial banks, microfinance institutions, SACCOs and KPOSB had over ten million accounts (CBK Annual Report, 2009).

The Kenyan microfinance industry requires various interventions in order to serve the stakeholders and at the same time attain sustainability. Drake and Rhyne, (2002), Wobler, (2002) and consultative Group to assist the poor (C-GAP 2004) states that the increasing commercialization of microfinance has also shed on the limitations of NGO's (MFI's) in achieving the highest level to cater for the large mass of the poor. Also Cracknell (2004) contends that with the financial innovation in terms of new technologies for example, electronic banking, transaction costs of service delivery is likely to lower significantly.

Consultative Group to assist the poor (CGAP) Donor brief (2003) argues that in special cases where other funds are unavailable, the Government funding may be warranted for sound and independent microfinance institutions. Microfinance is a specialized field that combines banking with special goals and therefore skills and systems must be built at all levels which includes Managers and information systems of microfinance institutions where the Central Bank must regulate microfinance. Microfinance works best when it puts in place measures and discloses its performance. There are four commercial banks undertaking microfinance business, namely: Equity Bank, Family Bank, K-REP Bank and Co-operative Bank. However, the number of commercial banks down streaming their business to include microfinance business, particularly to low-income households and small and micro enterprises is growing rapidly (CBK Annual Report, 2009).

Hospes, et al. (2002) asserted that there are two types of microfinance providers in Kenya: client-based, which rely on both formal and informal structures (traders, shopkeepers, moneylenders, family, and friends) and member-based, which rely on either formal SACCOS or informal Rotating Savings and Credit Associations (ROSCAs) and Accumulating Savings and Credit Associations (ASCRA's). Most of these organizations pose a legal challenge because most are self-regulated and rely heavily on international donor support. Most of their programs have adopted a village banking methodology of lending which involves working with existing groups, mainly women, registered at the Ministry of Cultural and Social Services. In addition to these retail institutions, there are three specialized second tier financial service providers (wholesale MFIs) that are offering financial services to MFIs. Some commercial banks are also offering financial services to MFIs.

1.2 Statement of the problem

Many studies have been done to determine and discover key ingredients of MFIs in Africa but not much has been done to determine the financial performance of Microfinance institutions in Kenya. Microfinance programs and institutions are important component of strategies to reduce poverty and promote micro and small enterprise development over the past four decades in a number of countries including Kenya. MFIs are known for their success especially in Indonesia and Bangladesh where MFIs have been much-studied where some MFIs have been transformed into private bank (Remenyi 1997) For instance the Bank of Rakyat of Indonesia (BRI) and Grameen Bank of Bangladesh. In Kenya there has been a rapid growth in the informal sector especially after the retrenchment of employees both in public and private sector particularly after the structural adjustment program (SAP) in the 1990s where these workers joined the informal sector for employment, hence there was need for the MFIs to offer them financial services to those who could not access to basic financial services such as loans, saving, money transfer services and micro insurance.

Hebohm and Kennedy (1999) observed that MFIs tends to improve and support development and also diffusion of entrepreneurship skills and spirit thereby reducing economic disparities between urban and rural areas. The MFIs success and growth may be determined by the number of low income and poor people that the institution has been able to sustain, the youth projects it has started, the population of women that it has empowered and most importantly whether the MFI has managed to utilize the funds so far budgeted for the targeted group. However the legal structures have been presenting challenges in identifying appropriate regulatory approach which is conducive to the financial developments (Omino, 2005).

The studies done in Kenya so far includes; the effects of change in interest rates on micro-finance in Kenya (Kilonzo, 1992-2003), Nderitu, (2006) did a study on responses of MFIs to HIV/Aids cases in Kenya, while Kimathi Benson, (2006) researched on challenges facing K-Rep in implementing its strategic plan, Muthoni, (2006) also did a study on responses of MFIs in Kenya to the turbulent business environment. Reinke, (2001) research in Rwanda suggests that saving schemes are very crucial in assessment of the financial strength of an MFI. Reinke, (2001) research in Malawi and Burkina Faso focused on the ability to repay loans given to

individual. This shows that not much has been done on the MFIs financial performance in Kenya and yet we know that greater access and sustainable flow of financial services particularly credit to the low income household and small enterprises is critical to poverty alleviation since about 60% of the population are poor and mostly out of scope of formal banking services hence they are served by the microfinance industry. This state of affairs of the assessment of micro-finance program remains an important field for researchers, policy-makers and development practitioners with the question; what are the determinants of financial performance and development of the micro-finance industry in Kenya?

1.3 Research Objective

This study attempts to determine the determinants of financial performance of microfinance institution in Kenya.

1.4 Importance of the study

- i. Government;** the findings of this study will be significant to the government in crafting adequate policies that encourage the growth and development of the MFI industry.
- ii. Regulators;** the study will add impetus into the ongoing process of consolidating the sector under a regulatory framework that protects the players' interests.
- iii. Micro finance Institutions Managers;** the study will serve to underscore the challenges encountered in the industry that would be useful to the key players in the MFI sector.
- iv. Academicians;** This study will bring in new knowledge in terms of determinants of Microfinance institutions financial performance in Kenya.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This chapter focuses on review of theoretical and empirical literature on microfinance financial performance and development. The chapter discusses the theory of constraint, theory of financial intermediation and contingency theory. It also reviews the empirical studies on microfinance in general with specific focus on factors that determine the financial performance of Micro finance institutions and the challenges thereon.

2.2 Theoretical Framework

2.2.1 The Theory of Constraint

Silber (1975, 1983) presented the theory of constraint which is one of the most influential theories of financial innovation. This theory considers product innovation as response of organization to the constraints placed up on it. Innovations have many causes. Firms may need to stop the loss of deposits, enter new geographic or product markets and deliver services with cheaper and better technology. In addition, they may want to increase their capital base, alter their tax position, reduce their risk profile or cut operating costs (McConnell and Shwarch, 1992).

White and Frame (2002) stated that profit seeking enterprises and individuals are constantly seeking new and improved product processes and organizational structures that will reduce their costs of production, better customer demands and yield greater profits. Drucker (1998) stated that most innovations result from a concise, purposeful research for innovation opportunities, which are only found in only a few situations. Four areas of such opportunities exists within a company include unexpected occurrences, incongruities process needs and industry and market changes. Sources of opportunity outside a company in its social and intellectual environment include demographic and perception changes.

2.2.2 Theory of Financial Intermediation

Allen and Santomero (1996) observed that in the traditional Arrow-Debreu model of resource allocation, firms and households interact through markets and financial

intermediaries plays no role. When markets are perfect and complete, the allocation of resources is Pareto efficient and there is no scope for intermediaries to improve welfare. Moreover, the Modigliani-Miller theorem applied in this context asserts that financial structure does not matter: households can construct portfolios which offset any position taken by an intermediary and intermediation cannot create value.

Such an extreme view - that financial markets allow an efficient allocation and intermediaries have no role to play- is clearly at odds with what is observed in practice. Historically, banks and insurance companies have played a central role. This appears to be true in virtually all economies except emerging economies which are at a very early stage. Even here, however, the development of intermediaries tends to lead the development of financial markets themselves (McKinnon, 1973).

Leland and Pyle (1977) observed that banks provide cheaper capital to corporations than capital markets. James (1987) and Smiths (1986) underscore that capital market financing were costly and disruptive. They separately document positive returns to corporate shareholders following the announcement that a firm has obtained a loan from a commercial bank but negative return to shareholders following the announcement of new equity security issues.

Leland and Pyle (1977), suggests that an intermediary can signal its informed status by investing its wealth in assets about which it has special knowledge. The authors suggest that financial intermediation which is difficult to explain in traditional models of financial equilibrium, can be viewed as a natural response to asymmetric information. Diamond (1984) has argued that intermediaries overcome asymmetric information problems by acting as "delegated monitors."

2.2.3 Contingency Theory

Contingency theory is a class of behavioral theory that claims that there is no best way to organize a corporation, to lead a company, or to make decisions (Galbraith, 1973). Instead, the optimal course of action is contingent (dependent) upon the internal and external situation. Several contingency approaches were developed concurrently in the late 1960s.

Contingency theory (Galbraith, 1973 and 1977) has defined uncertainty as the variable which makes the organization contingent upon the environment. Hence, organization design, and organizational choice, depends on the concept of uncertainty. Briefly, uncertainty can be associated with the mathematical concepts of probability and fuzziness (Klir & Folger, 1988) or propositions of bounded rationality (Nobre, 2008).

These two approaches to uncertainty are complementary to each other since the greater the amount of information that the organization needs to have in order to perform and to complete a task, the greater is the degree of cognition that the organization needs to have in order to process and to manage this information for task execution and completion (Nobre et al, 2009).

The contingency theory can therefore be used to explain that each of the changes in the business environment present a unique challenge to managers to come up with responses to fit the situations. Thus, the uncertainty caused by the environment is an important ingredient for a manager's decision.

2.3 Empirical Literature

Swain and Wallentin (2007) carried out a study to determine whether Microfinance does actually empower women. The results indicated the evidence for a general increase in women empowerment for the members over time. This however, did not imply that each and every woman who joined the program was empowered to the same degree or they all progressed at the same pace. Some of the women members might have been more empowered than other members within the program, prior to their participation in this programme. But on the average the members were empowered over this time period.

It is difficult to say which factors are more important for empowering women. The differences in pace of empowerment might be a result of various factors. Household and village characteristics, cultural and religious norms within the society, behavioural differences between the respondents and their family members, the kind of training and awareness programs that the women have been exposed to. All these factors together are responsible for the empowerment process. The nature and types of

activities and the kind of program that the women is exposed to, critically determines how empowering the impact of the microfinance is on women. The minimalist microfinance approach is not sufficient. An important direction for future research, is a need to find which of these factors have a greater impact on empowering women. Strong (2008) in his research titled "Beyond Microfinance: Entrepreneurial Solutions to Poverty Alleviation" concluded that although microfinance has become extremely popular as an approach to poverty alleviation, there are still various controversies associated with it. For instance, he argued that microfinance is primarily used for debt and consumption rather than real investment in revenue-generating businesses.

With an estimated 110 million micro entrepreneurs around the world, receiving loans through many thousands of organizations, often in remote and impoverished regions, it is unlikely that we will ever have definitive data regarding exactly what percentage of the loans result in investment versus what percentage are used for consumption. It is fair to assume that insofar as individual borrowers are freely choosing to take loans from microfinance organizations rather than borrowing money at exorbitant rates from local loan sharks, it is likely that microfinance does, in fact, benefit the world's poor, even if much of the money is used for consumption rather than investment. But merely "better than loan sharks" is not quite the beautiful dream that has inspired so many people to support microfinance.

Dichter et al as cited in Strong (2008) in their research on the contribution of microfinance to economic growth concluded that not much contribution came from that angle. They observed that developed societies are wealthy because they are efficient. Today a tiny percentage of the U.S. population produces many times as much food as did 40 percent of the U.S. population who were farmers a hundred years ago. Most poor nations remain largely agricultural nations, whereas all wealthy nations experienced a transition from primarily rural to primarily urban, with a corresponding decrease in the percentage of population that are farmers. Realistically we can expect all poor nations to experience a transition from primarily rural to primarily urban. As agriculture around the world becomes as efficient as U.S. agriculture, a tiny percentage of the world's people will grow far more food than is grown today.



If Dichter is correct, then microfinance is a stop-gap measure that does not accelerate the pace at which economies transition from rural to urban, from populations largely engaged in agriculture to populations largely engaged in manufacturing or IT careers (In the last ten years many in both India and Ireland leaped directly from agriculture to IT careers, skipping the manufacturing stage). Mbogo and Ashika (2011) investigates the factors that influence product innovation in microfinance institutions in Kenya, including the legal environment, competitive pressure and organizational factors such as leverage, liquidity and risk management challenges, distribution and human resource challenges. Results from the study establish that there is a positive correlation between legal environment, liquidity management and human resources for MFIs and product innovation.

Cook and Onjala (2009) study Microfinance in the Water Supply and Sanitation Sector in Kenya. The findings conclude that Household “retail” loans, including group lending, appear promising for water supply. However, there are very few cases in Africa of ongoing programs that lend for improvements in water supply without external donor support. Further, the case for retail loans for sanitation is less clear. Most of the failures observed in microfinance have been in sanitation programs. Though simple pit latrines are inexpensive in rural areas, these households may wish to borrow for more durable, hygienic toilets however. Community-based lending in Water Supply and Sanitation may help predominately middle-class consumers and not the rural poor, though this is not necessarily a problem. There may well be poor rural villages which are willing and able to pay both Operational and Maintenance costs and debt service. These villages can identify themselves to MFIs through a well crafted borrowing arrangement. In many cases, however, it may be relatively better-off communities or households who are most interested in using microfinance to improve their Water Supply and Sanitation situation.

Von (2006) studies the role of Apex Mechanisms in Kenya and Uganda. The research investigates apex mechanisms as one device for channelling support to microfinance. In particular, it aimed at understanding how apex mechanisms function and how they contribute to sustainable expansion of microfinance. The research findings support both cautious and encouraging views on micro - finance apex mechanism.

Atieno (2001) assessed the role of the institutional lending policies of formal and informal credit institutions in determining the access to and use of credit facilities by small-scale entrepreneurs in rural Kenya. Conclusions drawn from this study are; a large number of potential borrowers who did not seek credit do not mean that they did not need credit, as only 15% of the sample was found to be not credit constrained. This result suggests that the lack of supply creates a lack of demand, displayed in the low revealed demand. This has resulted in credit rationing by both the formal and informal credit markets observed from the results and the creation of a credit gap in the market. Hence, although the potential borrowers need credit, the lending terms and conditions prevent them from seeking credit. In the formal sector, these terms focus on concerns with default risk and high transaction costs. In the informal sector, the study suggests that the failure to seek loans is due to the failure by the different lenders to offer the credit package required by specific borrower categories. Atieno (2001) further conclude that informal credit sources provide easier access to their credit facilities for small and micro enterprises. The main reasons explaining this scenario are the lending terms and conditions reflected in collateral, application procedure and repayment period. However, given that different segments serve specific credit markets, their ability to meet the credit needs of certain enterprises, especially those requiring large amounts of credit as they grow is limited.

Marek (2003) as cited in Matovu (2006) – “Microfinance and Poverty Alleviation - a case study of Uganda finance trust”. In his research on how the social capital findings relate to micro- enterprise development and specifically to microfinance used Chambers (1983) literature to help him to put together the “poverty trap”. Marek argues that poverty is a complex web of disempowering relationships, which don’t work. Households trapped in this spider’s web suffer from material poverty, vulnerability, powerlessness, physical weakness, isolation and spiritual poverty. Therefore, addressing the problem of material poverty through microfinance services is vital and critical, but it will not be enough for the poor households to escape from the poverty trap. Marek argues that it is not possible to neglect other aspects of human nature and the multi-sided nature of poverty.

Hulme et al (1996) carried out a study on poverty and savings. According to Hulme most institutions regard low-income households as “too poor to save”. He suggested

that in order to generate higher incomes, savings and more investment, there is need to inject capital in the form of microfinance. However capital is only one ingredient in the mix of factors necessary for a successful enterprise. Most importantly it requires entrepreneurial skills and efficient markets to reduce poverty.

Roth (1997) in his study on microfinance and successful enterprise was critical of the microfinance evangelists who create a vision of the rural poor as a collection of budding entrepreneurs, waiting for salvation from credit agencies, which on receipt of credit, will develop successful micro enterprises and leave poverty forever. Their promotional activity gives rise to worrying spectre of a return to a “blueprint”, implicit in the new microfinance approach to development. To respond to a potential demand for a good or service, a rural micro-entrepreneur may need access to one or more of the following: transport, communications, power, water, storage facilities, a legal system for enforcing contracts and settling disputes. Apart from infrastructure, micro entrepreneurs need access to information about market trends and skills to run their macro enterprises.

Roth cited Weber (1958) who argued that hard work, skills and enthusiasm are essential ingredients for an enterprise to be successful. Non-numerate people struggle to start enterprises by themselves as it is extremely difficult for them to keep track of the flows of income in their enterprise.

Ledgerwood (1999) identified the following objectives in development offered by Microfinance which include; to reduce poverty, to empower women or other disadvantaged, population groups, to create employment, to help existing businesses grow or diversify their activities, to encourage the development of the new businesses. There is however, much debate in the field of microfinance as to whether access to financial services benefit the “the poorest of the poor”. It has been argued that while there are now many credit institutions serving the poor, there is less experience of successfully serving the very poor, the destitute, and the disabled. Copestake (2002) - According to Copestake, microfinance has a polarizing effect as there is discrimination in favour of richer clients, who benefit from better access to credit, and exclusion of poorer people. If one of the aims of microfinance is to assist the “poorest of the poor” then microfinance is not always the most appropriate intervention.

Matovu (2006) carried out a research on “Microfinance and Poverty Alleviation - a case study of Uganda Finance Trust”. The aim of the research was to explore the impact of microfinance intervention on rural women and the circumstances under which microfinance can help the poor out of their poverty situation. The first question asked in this study was: what impact does microfinance programmes have on the household welfare? According to research findings, it was apparent that the majority of women clients who had registered increased incomes. It is these incomes that can help them to solve some problems of poverty like isolation, physical weaknesses and they can afford a good diet, can deal with vulnerability as they can save and now able to deal with crises, has the capacity to send their children to school and to pay for their health which is critical for their continued well-being and as a consequence break the poverty trap.

The second question was: Can microfinance programme savings reduce vulnerability and risks of clients? The findings reported that clients had increased incomes which enable them to save and to buy property. The savings enables clients to deal with severe crises and to cope up with the shocks and reduce vulnerability and bought property can be sold also to deal with the crises; savings can be used to acquire another microfinance cycle and also to start and expand the existing economic activities. This leads to the third question: Can microfinance promote empowerment of rural women? The majority of women felt that their position in the family had been strengthened, set up businesses and run them, could occupy a political office at local levels and had attained a real change in their lives and self-esteem when they compare themselves to that period before the program. Many felt that they can look after their children, educate them, afford a nutritious diet to the household and are no longer dependents on their husbands.

Finally, the fourth question: under what conditions can microfinance help the poor out of poverty? Microfinance hinges on a number of other conditions if it is to play a meaningful role. Microfinance is just only one factor and requires the support of other factors. These include women entrepreneurial skills in business management, and elementary book-keeping, efficient functioning of markets since they play an important role in the economy and rural development. There is need for access to

markets for their local products and other infrastructure like good feeder roads to transport the merchandise and institutions for example to deal with legal matters to promote sustainable development and a successful microfinance. The network of financial institutions functions in an economy which mobilizes and allocates resources, co ordinate savings and investment which are long term growth and transformation.

Kabeer (1998) in her paper titled 'Money Can't Buy Me Love' argued that many microfinance institutions focus their attention on women's use of the loan and ability to make decisions about her business as the most direct impact of their program. She found that most women do have a say in the utilization and management of their loans although occasionally men pressure MFIs to give their wives loans so that the husband can use it. They also found that a fair number of loans are ultimately invested in "male" activities like rickshaws, for which it is difficult to ascertain the level of control and influence the women may have. In her study of the Small Enterprise Development Program (SEDP) in Bangladesh, Kabeer found that although empowerment and well-being benefits substantially increased when women controlled their loans and used them for their own income-generating activities, just the act of bringing financial resources to the household in the form of credit was enough to secure at least some benefits for the majority of women in her study.

Kabeer further observed that although there have been a few studies that have asserted that women's participation in microfinance leads to an increase in domestic violence, most practitioners have reported the opposite experience. The concerns arise over a "backlash effect" that may occur as a result of women challenging gender norms and asserting their rights. Microfinance programs can strengthen women's economic autonomy and give them the means to pursue nontraditional activities. In some cases, women who begin to assert themselves and their opinions in their households incur the wrath of angry husbands who feel their authority and sometimes their reputations are being threatened by their wives' behavior.

Although there are many good reasons for MFIs to be watchful for potential rises in domestic violence, the bulk of the evidence and experience thus far seems to point to the conclusion that participation in microfinance strengthens and improves family

relationships rather than destroying them. Poverty, scarcity, and feelings of helplessness take an undeniable toll on personal relationships. Many practitioners have found that family relationships can be strengthened when the home becomes a more comfortable place to be, and when each member of the family feels secure in his or her ability to contribute productively to the family. Women at Sinapi Aba Trust in Ghana, for example, clearly attributed the increase in respect from their husband and the reduction in arguments to their economic contribution and a reduction in scarcity. Naila Kabeer's study of SEDP shows women making a direct causal link between their contribution to the household and a reduction in abuse.

Todd (1996) studied Grameen Bank's impact on long-term borrowers in Tangail, Bangladesh. She found that "the most successful families in their small sample were those husbands and wives working in partnership, where both were major economic actors. . . ." She also found that out of the 40 borrowers she interviewed, 10 had no control over their loans. "They were just taking the money and pipelining it to a husband, a son, a father-in-law, or some other male within the household—sometimes a male outside the household, which was an even more exploitative situation." Goetz and Sen Gupta's study found that the percentages of women who had little or no control over loans ranged from 10 percent in the Grameen Bank to 63 percent in RD-12, a government credit program. The overall average of the four programs studied was 39 percent. In an interview with the Micro credit Summit Campaign, Todd commented, "People are using this study . . . to argue that there is less benefit to opening micro credit opportunities to women than the "evangelists" say. . . . That is not the way I interpret this study. Thirty-nine percent having little or no control means that 61 percent have partial or full control. That is a lot better than the kind of powerlessness with which these women begin.

Mayoux (2001) argue that microfinance institutions cannot have more than a limited impact on women's empowerment unless there are changes in wider gender inequalities in the broader social and economic contexts in which they operate. In light of these limitations, Mayoux recommends that MFIs intentionally address women's empowerment as part of their goals, objectives, operations, and product design. In addition to the issue of domestic violence previously discussed, other common concerns raised include the increased burden that micro enterprise activities

place on women's time, MFIs' reinforcing rather than challenging gender inequalities, and the possibility that children will be kept out of school to help in their mother's business.

Cheston and Kuhn (2001) argued that Microfinance has the potential to have a powerful impact on women's empowerment. Although microfinance is not always empowering for all women, most women do experience some degree of empowerment as a result. Empowerment is a complex process of change that is experienced by all individuals somewhat differently. Women needs, wants, and profit from credit and other financial services. Strengthening women's financial base and economic contribution to their families and communities plays a role in empowering them.

In some cases, access to credit may be the only input needed to start women on the road to empowerment. But power is deeply rooted in our social systems and values. It permeates all aspects of our lives from our family to our communities, from our personal dreams and aspirations to our economic opportunities. It is unlikely that any one intervention such as the provision of credit or the provision of training will completely alter power and gender relations. Women often value the non-economic benefits of a group-lending program as much as or more than the credit. Some of the most valued benefits include expanded business and social networks, improved self-esteem, increased household decision-making power, and increased respect and prestige from both male and female relatives and community members.

Targeting women continues to be important in the design of products and services, both because women by default have less access to credit and because they face constraints unique to their gender. Product design and program planning should take women's needs and assets into account. By building an awareness of the potential impacts of their programs, MFIs can design products, services, and service delivery mechanisms that mitigate negative impacts and enhance positive ones. Even when products and services target primarily women, women still face considerable disadvantages relative to men because of more limited business networks and opportunities, greater domestic burden, weaker self-confidence, less education, and, in many cases, a restrictive legal environment. These disadvantages can sometimes be

perpetuated in microfinance programs, with men dominating mixed lending groups and women receiving smaller loan amounts than men.

Zeller and Meyer (2002) estimated the margin of credit on a number of welfare indicators. Their study showed that household income increases by 18 taka for every 100 taka lent to woman. They also found net positive impacts of credit programs on both human and their physical assets. They have found mixed results when measuring the impact of credit programs on education. The education of boys increased irrespective of whether the borrower was male or female; but the education of girls have increased only when women borrowed. Mosely and Hulme (1998) estimated the impact of 13 microfinance intermediaries in seven developing countries and the study was one of earlier done across the international boundaries. Their study revealed that for each of the intermediaries, the impact of lending on the recipient household's income increases with the debtor's income and asset position improved.

2.4 Factors determining financial performance in Microfinance

2.4.1 Macro – economic environment factors

Goldfajn and Rigobon, (2000) shows that macroeconomic stability, determined by stable inflation and real interest rates, plays a major role in financial sector development. According to Rhyne, (2001), the process towards a more stable economy, and especially lower inflation rates, attracts more potential microfinance providers. Vander Weele and Markovich, (2001) provide evidence of the devastating effects of inflation and especially hyperinflation on the performance of microfinance institutions.

Westley, (2005), suggests that borrowers in the Caribbean countries are not used to the high interest rates charged by MFIs due to the long history of macroeconomic stability. Consequently, the demand for micro-financial services is low. Hartarska, (2005) finds that microfinance institutions are reaching more clients in the high inflation countries in the Central and East European states.

Westley, (2005) states that regions with higher levels of income have less developed microfinance sectors. He offers two reasons. Firstly, micro-entrepreneurs with higher incomes have more opportunities to self-finance through savings. Secondly, they may

benefit more easily from informal finance through family and friends, as well as from formal finance. Similarly, Schreiner and Colombet, (2001) argue that one of the reasons why microfinance in Argentina has not developed is due to the higher wages people earn. Traditionally microfinance is also focusing on the poor excluded clients, so microfinance should be reaching more clients in regions that are poor.

2.4.2 Infrastructure and geographical framework

Transaction and information costs influence financial development. In some cases, they lead to market failures (Stiglitz and Weiss, 1981). Good interconnectivity between regions, the availability of electricity, communications and sanitation networks diminish these costs. A high population density also plays an important role in lowering these costs. According to Sriram and Kumar (2005), this can lead to two contradictory arguments. One reason could be that formal financial institutions may be more developed in regions with higher population density and good regional interconnectivity. Thus the need for specific microfinance institutions may not be present. The second is that, if the development of the two sectors is complementary, these factors could eventually also stimulate the development of the microfinance sector. Latin American evidence has shown that urban microfinance institutions are more common than rural ones (Rhyne, 2001). Schreiner and Colombet (2001) argue that the absence of an adequate infrastructure plays a hindering role for the development of microfinance. Moreover Yaron and McDonald (1997) see the absence of good infrastructure and sparse populated areas as one of the main reasons why financial sectors in rural areas are so underdeveloped. Hulme and Moore (2006) also support the hypothesis that microfinance tends to develop much faster in dense populated areas.

The role of human capital in financial sector development is widely recognized. In a study for Thailand, Paulson (2002) finds that regions with higher levels of education have more developed financial systems. Guiso, et al. (2004) also find positive effects of social capital on the development of financial systems.

2.4.3 International environment factors

The international donor community has historically played an important role in subsidizing the emergence and further development of microfinance programs. As

most institutions started as non-governmental organizations, external financial intervention was needed (Imboden, 2005).

To gauge the extent of external intervention and international support, the amount of subsidies is a good indicator. During the last decade, the role of subsidies in microfinance has become a more controversial one. Yet, it is widely known that a lot of microfinance institutions still depend on subsidies (Morduch 1999). Although microfinance institutions are encouraged to become independent from donor subsidies, the role of start-up subsidies or 'smart-subsidies' is still seen as necessary and therefore favoured (Armendariz de Aghion and Morduch, 2005).

2.4.4 Firm specific factors on product innovation

Microfinance institutions are affected by internal factors such as lack of leverage, liquidity and risk management challenges, distribution challenges and human resource challenges (Mbogo and Ashika, 2008). Microfinance is a capital-intensive activity, and MFIs require sustained injections of capital for on-lending (Moussa, 2007). Most MFIs need to make intensive investments in promoting new and poor clients. Alarcon (2008) indicates that the most important constraint for MFIs not to expand their outreach is the limited sources of funds. Brugger (2004) notes that MFIs, like any other financial institution, must have a minimum amount of its own capital for reducing the risks of its lenders and depositors and that the costs of doing business are high relative to the value of loans and deposits involved. Smaller MFIs struggle to cover the high operational costs and diversify their product offerings in order to compete with larger microfinance providers (Gupta, 2008).

2.4.5 Other factors

A couple of authors make the link between the transition to a more service-based economy, the growth of the informal sector and the existence of a microfinance market. It is argued that economies that shift away from primary production (industry and mining) to a more service based economy tend to develop a higher demand for micro-financial service as this is the major market for microfinance providers (Marconi and Mosley, 2005).

2.5 Challenges in financial performance and growth of Microfinance

Volscheck (2002) citing Masinde (2001) highlights problems associated with the microfinance sector at four levels. The strategic level focuses on issues of outreach, the education level of staff and management information systems. Level two relates to operational issues such as the profitability and sustainability aspects, relative to the high costs. The third level focuses on the aspect of marketing with regard to the diversity of products offered by the MFI. Finally, the fourth level deals with the capitalization issue with respect to access to capital.

2.5.1 Strategic Issues

Staff productivity and efficiency are important aspects in microfinance service delivery. Ledgerwood (1999) argues that the main responsibility for effective outreach and loan repayments remains with the loan officer. Provision of timely management information is valuable in effective delinquency management. In addition, Mukama (2005) stresses that the education level of staff and management is of utmost importance in that it puts better into perspective the necessary marketing conditions that translate into profitability, financial sustainability, enhanced quality loan book, improved quality service to attract customers, minimal fraud, savings mobilisation, regulatory compliance and shareholders accountability. Furthermore, lack of knowledge can result in unsuccessful implementation of the microfinance programmes. Ledgerwood (1999) alludes to the fact that implementation challenges can occur especially in replication of models that are successful elsewhere, due to differences in the social context and lack of local adaptation.

2.5.2 Operational issues

Adjasi et al., (2006), cited a study by Adams, et al. (1984) that interest rates and savings mobilisation are among the problems that causes the lack of sustainability and eventual failure of such financial schemes. Mukama, et al. (2005) similarly cite the cost component of assessing and processing of loan applications as being the same regardless of the size of the loan. The small loan amounts lead to high operational costs especially in view of the fact that micro-enterprises require relatively smaller loans than larger enterprises to start or expand their business.

While it might be argued that the aim of microfinance is to provide financial services to the unserved people and have positive impact on society, the argument for the high interest rate charged is that, in order for MFIs to be sustainable, they ought to apply interest rates that will result in a break even point to enhance the ability of the MFIs to cover its operational and administration costs. Furthermore, sustainability as a consequence of high interest promotes the probability of the MFIs to achieve greater outreach. Some clients are prepared to pay the high interest rates required to ensure continuous access to credit (The Microfinance Gateway, 2005).

Another cost driver of MFI operations cited is the issue of the perceived risk of lending to people without collateral and credit reference because MFIs need to consider the risk in the borrowed funds (Ruit, 2002). Ruit (2002) and Adjasi et al. (2006) identify the issue of perceived risk of lending to people without adequate collateral and credit references as challenges to the MFIs operations because of possible moral hazard and adverse selection. Moral hazard and adverse selection mainly arise from information asymmetry.

Moral hazard refers to problems of repayments and defaults whilst adverse selection relates to inability to screen out those likely to default. Moral hazard occurs because of the inability of the MFIs to ensure that clients are attempting to fully make their investment projects successful or when the borrower tries to abscond with the money whilst adverse selection arises because MFIs are unable to easily determine the credit worthiness of the clients (Aghion and Morduch, 2005). However, to circumvent the above mentioned challenges, group lending with joint liability can be an effective mechanism to enforce repayment. Peer monitoring in group lending with joint liability reduces the moral hazard of the group member because of the joint liability (Franklin and Manfred: 2006)

2.5.3 Marketing issues

Marketing for microfinance institutions is an important analytical tool to be informed about the client. It tackles questions relating to who the MFI clients are, how many clients there are, the target market, and the market share it hopes to capture (Innovations in Microfinance, 2000). A target market represents a defined market segment that contains identifiable clients who demand or represent a potential demand

for microfinance services. Target markets are defined by the characteristics of the clients, such as poverty level, gender, ethnicity and religion. In selecting a target market for microfinance services, MFIs need to spell out their own objectives, understand what inspires the clients, and assess whether the target market is reachable in a financially sustainable way (The Microfinance Gateway, 2005).

Organisations that do not define their objectives, and hence their target market, or fail to design their products to meet the needs of their market, often have difficulty managing their operations and staying focused (Ledgerwood, 1999). Successful microfinance focuses on both savings and lending products because that is what the clients need. Furthermore, these programmes require savings as a precondition for borrowing (Goodwin, 1998). It is of great importance for MFIs to tailor their services in line with the needs of the clients. MFIs that engage in full intermediation achieve rapid outreach and enhance financial returns than those specialising in credit only (World Savings Bank Institute, 2007).

2.5.4 Regulatory framework

A conducive policy, legislation and regulatory environment, and institutional capacity are prerequisites to a thriving microfinance sector development. The stability of financial and other markets enables micro enterprises and consequently microfinance services to become viable (Ledgerwood, 1999). Regulatory approaches of microfinance range from self-regulation in which the industry develops its own supervisory and governance bodies to full regulation through existing laws specific to MFIs. The aspect of regulation of the microfinance sector should be observed within the broader developmental agenda that recognizes the significance of the sector in reduction of poverty and contribution to wealth creation (Moyo, 2008).

2.6 Summary

Microfinance industry remains a powerful tool for economic growth, poverty reduction and development. It has enabled poor people access to basic financial services with loans saving, money transfer services and microfinance insurance but those who lack access to traditional banking services. It has also enabled those who lack saving and capital to become self-employed both in formal and informal sectors

thereby increasing family income in order to accumulate capital and investment in employment.

By empowering this vulnerable groups, the MFI plays a pivotal role in social economic benefit since the principle of self-help holds the key to economic and social –cultural freedom for million of poor, thereby opening the avenues of a hitherto untapped reservoir of human enterprise. The many MFIs need to be integrated, by having in place proper legal structures, so that their mission can be realized in order to achieve prosperity. By so doing their financial performance are likely to be better, resulting to effectively and effectiveness on delivery of financial services. This is due to the facts that their lending policies are more market friendly in terms of loan amount application procedures, credit relation, terms of payments, required collateral and the provision of supplementary services (Schmidt and Kropp 1987).

Another important point to note is that there should be a sustainable development of the poor and the rural economy while at the same time improving the financial performance of the MFIs through capital injection for on-lending (Moussa, 2007). MFIs needs to address all the challenges that limits their financial performance which includes the strategic issues, operational issues, marketing issues and finally putting in place conducive policies, legislation and regulatory environment so that the much desired development in this sector in-terms of poverty reduction and wealth creation can be realized. Micro-finance institutions have been rightly referred to as “back to the basic of banking” and have evolved over many years globally.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents the research methodology that was applied in carrying out the study. The study was guided by the research objective in chapter one. First, a presentation of the research design is provided. This is followed by an explanation on the target population, data collection procedures and instruments and data analysis procedures.

3.2 Research Design

The study uses a cross-sectional survey design and attempts to illustrate the factors that determine the financial performance of microfinance institutions in Kenya. The cross-sectional design is preferred to other designs since it is the most commonly used form of survey design when data is to be collected at one point in time across many firms. During the surveys a group of respondents were asked a set of questions at one point in time. To establish the relationship between the factors of growth and growth, the study adopts a correlational research design. As discussed by Mbwesa (2006), correlational research, the relationships between two or more quantifiable variables are studied without making any attempt to influence them.

3.3 Target Population

The target population in this study included all the 41 Microfinance institutions that are registered as members of the AMFI. Only the 41 MFIs who are members of the AMFI were of interest to the study. All the 41 MFIs were surveyed hence no sampling was required. The list of 41 members of AMFI is provided as appendix 3.

3.4 Data Collection Procedures and Instruments

Since the study required primary data only, the researcher proposed to use an interview guide (attached as appendix 2) which was used to conduct face to face interviews with the target respondents who are in charge of product development in the various Microfinance institutions. The interview guide had both open and closed ended questions because standard and supplementary data was necessary. An introductory letter explaining the purpose of the study was used as a proof that the

study was being conducted for academic purposes only. Proper records of all questionnaires distributed were kept for ease of follow up and also to ensure high response rate.

3.6 Data Analysis and Reporting

Once the data was collected, it was examined /edited for accuracy, consistency and completeness. The edited data was coded into numerical form to facilitate statistical analysis. Data was regressed using the Statistical package for social sciences (SPSS) to incorporate the relationship between growth and the identified factors. The closed ended questions was analyzed using descriptive statistics especially percentages, means and standard deviations. The results were presented in tables, charts and graphs.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION

4.1 Introduction

This chapter describes the data analysis and presents the results with intent of meeting the research objectives and answering the research questions. The study discusses the characteristics of respondents and response rate and further presents the findings with respect to the determinants of financial performance of MFI's in Kenya.

4.2 Response rate analysis

This study targeted all the 41 venture capital firms in Kenya regulated by the AMFI. Table 4.1 gives a breakdown of the questionnaires received from the target population.

Table 4.1: Summary of respondents and response rate

	Population	Questionnaires Distributed	Questionnaires Received	Response Rate
Micro Finance Institutions	41	41	32	78.05%

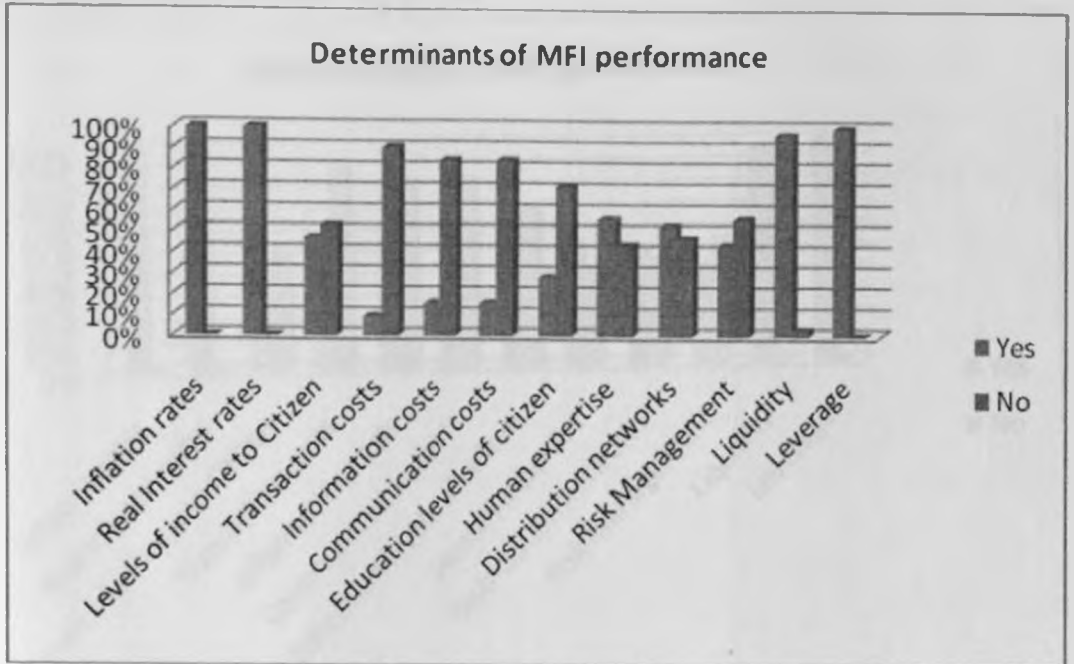
Source: Research Data, 2011

Questionnaires could not be collected from 9 micro finance firms for lack of time to complete the questionnaire. The microfinance institutions are mainly locally owned. In the final analysis, a total of 32 questionnaires were coded and analysed, representing 78.05 percent of the total population. This response rate was considered fair to conduct an analysis and draw conclusions from the findings.

4.3 Determinants of financial performance of Microfinance financial institutions

The respondents were asked to indicate whether various factors affect the financial performance of the respective MFIs and their findings are presented in figure 4.1 below.

Fig. 4.2: Determinants of MFI financial performance



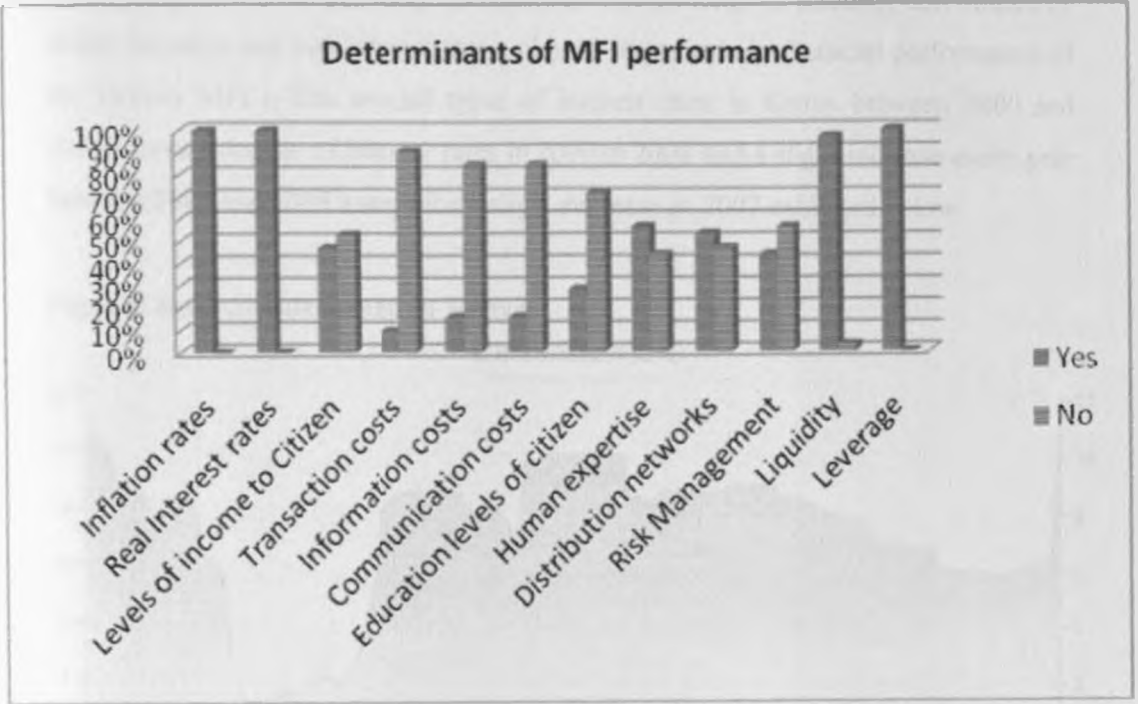
4.3.1 Inflation rates

All the respondents in the study indicate that inflation rates affect the financial performance of MFI's in Kenya. This finding is in line with the general notion that macroeconomic stability determined by stable inflation rates plays a role in the financial performance of the MFI's.

Fig. 4.2: Inflation rates trend in Kenya



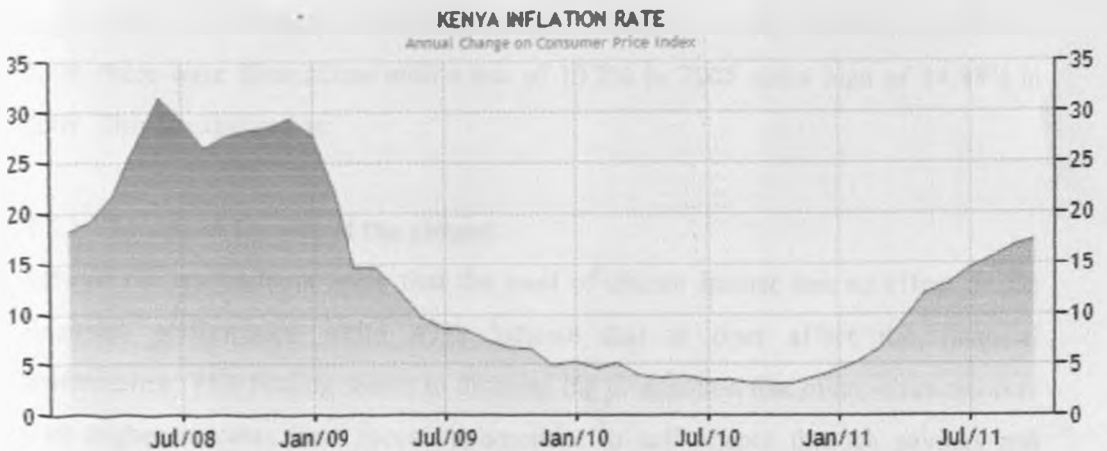
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4.3.1 Inflation rates

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Fig. 4.2: Inflation rates trend in Kenya



source: TradingEconomics.com; Kenya National Bureau of Statistics

4.3.2 Interest rates

All the respondents in the study indicate that macroeconomic stability, determined by stable inflation and real interest rates, plays a major role in financial performance of the various MFI's. The overall trend of interest rates in Kenya between 2000 and 2009 shows a decline of interest rates in 2000 to 2004 and a slight increase every year between 2005 and 2009 except for a slight decrease in 2007 exhibited below.

Fig. 4.3: Interest rates trend in Kenya

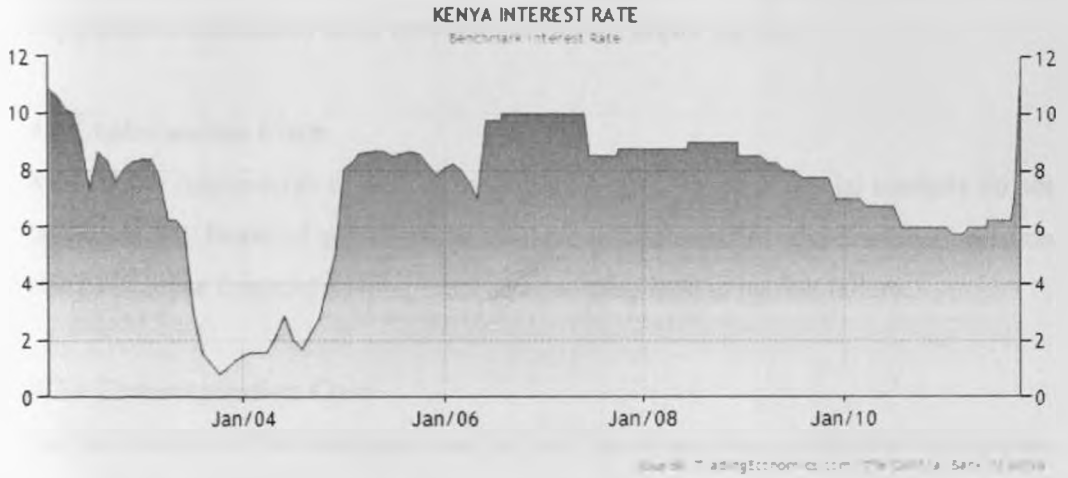


Table 4.2: MFI lending rates

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Int. rate	24%	20%	18.9%	13.5%	12.3%	13.2%	13.7%	13.3%	14%	14.9%

Source: CBK Supervision reports (2009)

Generally, there has been a decline in interest rates over time in Kenya. There was a high of 24% in 2000 and a lowest experienced in 2004 at 12.3%. In between 2005 and 2009, there were fluctuations with a low of 13.2% in 2005 and a high of 14.88% in 2009. This is exhibited as:

4.3.3 Levels of Income of the citizen

53% of the respondents opine that the level of citizen income has no effect on the financial performance while 47% indicate that it does affect the financial performance. This finding seems to discount the proposition that micro-entrepreneurs with higher incomes have more opportunities to self-finance through savings and

with higher incomes have more opportunities to self-finance through savings and micro-entrepreneurs with higher income may benefit more easily from informal finance through family and friends, as well as from formal finance.

4.3.4 Transaction Costs

A majority of the respondents at 91% indicate that transaction costs do not influence the financial performance of the microfinance institutions in Kenya. This implies that the competition in the microfinance sector may not be based on the levels of comparative transaction costs between the various sector players.

4.3.5 Information Costs

84% of the respondents opine that information costs in the financial markets do not influence the financial performance of their institutions. As expected, information costs influence financial development and may also lead to market failure.

4.3.6 Communication Costs

Just as related with information costs, 84% of the respondents opine that information costs in the financial markets do not influence the financial performance of their institutions.

4.3.7 Citizen education levels

The respondents were asked if the education levels of their clientele/ citizen, affects the performance of the MFI's. A majority of 72% indicate that it does not affect their performance. The level of education influences the kind of economy that the financial institutions attempt to serve. A couple of authors make the link between the transition to a more service-based economy, the growth of the informal sector and the existence of a microfinance market. It is argued that economies that shift away from primary production (industry and mining) to a more service based economy tend to develop a higher demand for micro-financial service as this is the major market for microfinance provider.

4.3.8 Human Expertise

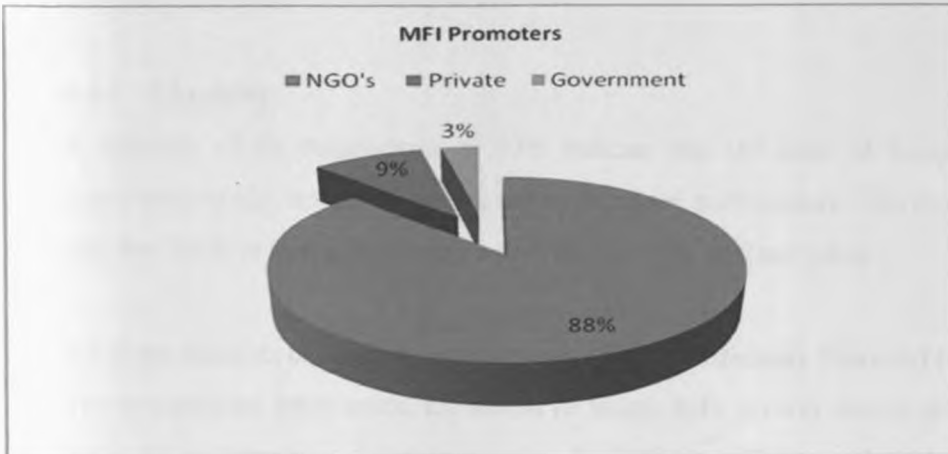
56% of the respondents opine that their human resource expertise influence the level of financial performance. The role of human capital in financial sector development is

widely recognized. It is expected that regions with higher levels of education have more developed financial systems as there are positive effects of social capital on the development of financial systems.

4.4 Firm specific determinants of MFI financial performance

4.4.1 Donors in Microfinance enterprises

Figure 4.4: MFI promoters Structure



Source: Research data, 2011

In Kenya, a majority of 88% of the Microfinance agencies started as non-governmental organizations that benefit from external financial intervention, 9% are privately sponsored while 3% are supported by the government.

4.4.2 Financial Capital and leverage of the MFIs

All the respondents in the study indicate that microfinance is a capital-intensive activity and MFIs require sustained injections of capital for on-lending to their clients. Most MFIs need to make intensive investments in promoting new and poor clients. A notable constraint for MFIs not to expand their outreach is the limited sources of funds.

4.4.3 Distribution networks

53% of the respondents indicate that the distribution network at their disposal for offering their various goods and services influences the financial performance of their respective MFI's. This finding conforms to the proposition that one of the challenges to the development of MFI's is their distribution network.

4.4.4 Risk management

46% of the respondents indicate that risk management practices adopted by the respective MFI's influence the levels of their financial performance. MFIs, like any other financial institution, must have a minimum amount of its own capital for reducing the risks of its lenders and depositors and that the costs of doing business are high relative to the value of loans and deposits involved. Smaller MFIs struggle to cover the high operational costs and diversify their product offerings in order to compete with larger microfinance providers

4.4.5 Liquidity

A majority of the respondents at 97% indicate that the level of liquidity of their organizations also influence their levels of financial performance. The liquidity levels help the MFIs to turn around their assets successfully at faster pace.

4.5 Determinants of financial performance of Microfinance financial institutions

The respondents were asked the extent to which MFI growth factors determine the financial performance of their respective institutions. The growth factors and their importance to MFI growth were measured using a Likert scale ranging from minimum (1&2), moderate (3) and very much (4&5).

Table 4.3: Financial Performance factors and their importance to MFI Growth

Factors	Importance of growth determinants			
	<i>Minimum</i>	<i>Moderate</i>	<i>Very Much</i>	
	<i>F</i>	<i>F</i>	<i>F</i>	<i>Mean</i>
Inflation rates	2	27	105	1.4
Real Interest rates	4	54	50	1.1
Levels of Citizen Income	7	36	65	1.1
Transaction costs	16	33	25	0.8
Information costs	15	36	25	0.8
Communication costs	14	30	40	0.9

Education levels of Citizen	9	36	55	1.0
Education levels of staff	17	36	15	0.7
Donor Support	7	39	60	1.1
Donor Subsidies	1	39	90	1.4
External Intervention	5	36	75	1.2
International Support	17	36	15	0.7
Distribution Networks	0	36	100	1.4
Risk Management Practices	15	36	25	0.8
Leverage levels of the institution	1	36	95	1.4
Liquidity of the Institution	9	36	55	1.0
Human expertise	17	36	15	0.7
Transition to service based economy	12	39	35	0.9
Growth of informal sector	1	36	95	1.4
Existence of Micro - finance market	15	36	25	0.8
Outreach	1	39	90	1.4
Management Information systems	6	36	70	1.2
Operational costs	15	36	25	0.8
Profitability	1	36	95	1.4
Sustainability	2	27	105	1.4
Product diversity	4	54	50	1.1
Distribution networks	0	36	100	1.4
Capitalization requirements	5	33	80	1.2
Access to capital	5	36	75	1.2
Corporate governance provisions	2	27	105	1.4

As outlined above, all the identified factors influence the financial performance and growth of the Micro finance institutions with response mean of 1.4 for inflation rates, corporate governance practices, Distribution networks, Sustainability, Profitability, Outreach, Growth of informal sector, Leverage levels of the institution, Donor Subsidies, a response mean of 1.2 for Access to capital, Capitalization requirements, Management Information systems, External Intervention, a response mean of 1.1 for Product diversity, Real Interest rates, Levels of Citizen Income, Donor Support, a response mean of 1.0 for Education levels of Citizen and Liquidity of the Institution, a

response mean of 0.9 for Communication costs and Transition to service based economy, a response mean of 0.8 for Operational costs, Existence of Micro - finance market, Risk Management Practices, Information costs, Transaction costs, a response mean of 0.7 for Education levels of staff and Human expertise.



CHAPTER FIVE

5.0 SUMMARY AND CONCLUSION

5.1 Introduction

In this chapter, Section 5:2 contains the summary of the findings, while section 5.3 provides the conclusion. On the hand section 5.4 provides the recommendations while section 5.5 points out the limitations of the study and finally section 5.6 gives the suggestions for further research.

5.2 Summary of the Study

The study sought to establish the factors that determine financial performance of MFIs in Kenya. Based on the primary data analyzed and the results presented in chapter four, various factors determine the level of financial performance of these institutions to differing levels. All these identified factors influence the financial performance and growth of the Micro finance institutions with response mean of 1.4 for inflation rates, corporate governance practices, Distribution networks, Sustainability, Profitability, Outreach, Growth of informal sector, Leverage levels of the institution, Donor Subsidies, a response mean of 1.2 for Access to capital, Capitalization requirements, Management Information systems, External Intervention, a response mean of 1.1 for Product diversity, Real Interest rates, Levels of Citizen Income, Donor Support, a response mean of 1.0 for Education levels of Citizen and Liquidity of the Institution, a response mean of 0.9 for Communication costs and Transition to service based economy, a response mean of 0.8 for Operational costs, Existence of Micro - finance market, Risk Management Practices, Information costs, Transaction costs, a response mean of 0.7 for Education levels of staff and Human expertise.

All the respondents in the study indicate that inflation rates and interest rates affect the financial performance of MFI's in Kenya. This finding is in line with the general notion that macroeconomic stability determined by stable inflation rates plays a role in the financial performance of the MFI's. Additionally, leverage and liquidity are cited by all the respondents as the other factors that influence financial performance.

5.3 Conclusions

From the study findings, the following may be noted; there is a relationship between MFI's financial performance and the explanatory variables considered in the study namely; inflation rates, corporate governance practices, Distribution networks, Sustainability, Profitability, Outreach, Growth of informal sector, Leverage levels of the institution, Donor Subsidies, Access to capital, Capitalization requirements, Management Information systems, External Intervention, Product diversity, Real Interest rates, Levels of Citizen Income, Donor Support, Education levels of Citizen, Liquidity of the Institution, Communication costs, Transition to service based economy, Operational costs, Existence of Micro - finance market, Risk Management Practices, Information costs, Transaction costs, Education levels of staff and Human expertise. Since some of these factors are firm specific while other are environmentally influenced, the MFI's that seek to attain improved performance concentrate of the firm specific factors by influencing them to motivate profitability and consequently MFI's growth.

5.4 Recommendations

From the study findings, there is an indication that a positive relationship does exist between MFI financial performance on one hand and firm specific factors. The study therefore recommends that for improved growth in this industry and for its impact on the industry players, the players should work on improving the necessary factors within their ability that influence its vibrancy.

5.5 Limitations of the study

The study only captured 32 MFIs regulated by the AMFI. There are a number of non regulated MFIs that have not been included in the study. Some of the respondents were very reluctant to fill the questionnaire and a lot of persuasion was needed, some respondent took long time to respond due to their busy work schedule. Finally the research had to take longer time than anticipated since some respondents were not understanding what was required and its significance.

5.6 Suggestions for future Research

On further research, the study recommends that there is need to replicate the study to involve more MFIs especially the ones that are currently not regulated. Comparative studies should also be undertaken on MFIs within the East African (EA) and the Sub Saharan Africa (SSA) region where MFIs activities seem to be new but dominant.

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APPENDIX ONE: INTRODUCTION LETTER

Dear Respondent,

This questionnaire is designed to collect information on **“The Determinants of financial performance of micro finance institutions in Kenya”**. This study is being done for academics purpose only that is for a project research paper in partial fulfillment of requirements for the degree of the Master of Business Administration, School of Business University of Nairobi.

I promise that the information given in the questionnaire will be treated with utmost confidentiality and at no time will your name be mentioned in this research paper. Furthermore, no information provided will be used for any other purpose other than this academics research.

Yours assistance in facilitating this research will be highly appreciated.

Thanks in advance.

Sincerely,

.....
Simon Njogu G.

MBA Student

.....
Mr. M. Mwachati

Supervisor

APPENDICES

APPENDIX TWO: INTERVIEW GUIDE:

PART A

Factors that affect the financial performance of Microfinance Institutions

1. In your opinion, do the following factors affect the financial performance of your institution? (Tick appropriately)

Factor		Response	
		Yes	No
1	Inflation rates		
2	Real Interest rates		
3	Levels of income to Citizen		
4	Transaction costs		
5	Information costs		
6	Communication costs		
7	Education levels of citizen		
8	Human expertise		
9	Distribution networks		
10	Risk Management		
11	Liquidity		
12	Leverage		
13	Donor support		
14	Donor subsidies		
15	International support		
16	External intervention		
17	Growth of informal sector		
18	Existence of Microfinance market		

Factor		Number
1	Inflation rates	
2	Real Interest rates	
3	Levels of Citizen Income	
4	Transaction costs	
5	Information costs	
6	Communication costs	
7	Education levels of Citizen	
8	Education levels of staff	
9	Donor Support	
10	Donor Subsidies	
11	External Intervention	
12	International Support	
13	Distribution Networks	
14	Risk Management Practices	
15	Leverage levels of the institution	
16	Liquidity of the Institution	
17	Human expertise	
18	Transition to service based economy	
19	Growth of informal sector	
20	Existence of Micro - finance market	
21	Outreach	
22	Management Information systems	
23	Operational costs	
24	Profitability	
25	Sustainability	
26	Product diversity	
27	Distribution networks	
28	Capitalization requirements	
29	Access to capital	
30	corporate governance provisions	

Thank you for your co-operation

APPENDIX THREE: LIST OF MFIs

The members of AMFI are of diverse status since some are large while other is small institutions. They include wholesale MFI's, microfinance banks, retail MFIs, insurance companies and development institutions. The list of members is as follows:-

1. Faulu Kenya
2. Equity Bank
3. K-Rep Bank Ltd
4. Co-operative Bank
5. Kenya Micro-Finance Trust
6. World vision
7. Kenya Post Office Saving Bank
8. Elite microfinance
9. CIC insurance
10. Bimas
11. Jitegemee Trust
12. Family Finance
13. Jitegemee Credit scheme
14. Jamii Bora
15. Juhudi Kilimo Company Ltd
16. Pride Africa
17. Wedco
18. Rupia Ltd
19. Micro Africa
20. Molyn Credit Ltd
21. Sisdo
22. Pamoja Women Development Program
23. Kenya Entrepreneur Empowerment Foundation(KEEF)
24. Micro Enterprise Development Services Limited
25. Taifa Option Microfinance
26. Oiko Credit
27. Kenya ECLOF

28. Barclays Bank of Kenya Ltd
29. AAR Credit Service
30. Fusion Capital Ltd
31. Chartis Insurance
32. Sunlink
33. Canyon Rural Credit Ltd
34. Greenland Fedha Ltd
35. Biashara Factors Ltd
36. Opportunity International
37. SMEP
38. KADET
39. U & I Microfinance Ltd
40. SWISS Contact
41. WEEC