A Survey Of Term Structure And Determinants Of Interest Rates: The Case Of Moneylenders In Nairobi

BY

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DECLARATION

I declare that this research project is my original work and has not been presented for a degree award in any other University.

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DEDICATION

"To the little understood moneylender and the desperate borrower who must suffer as a result..."

ACKNOWLEDGEMENT

I must confess that this research project has been an uphill task, and one for which I cannot claim full credit.

I wish to acknowledge and sincerely appreciate my supervisor Angela Kithinji for her insight, encouragement and patience all of which have been invaluable in the completion of the project.

My husband George who provided the financial and emotional support and knew better than to stress me even when it was taking forever…

My Uncle Pete, who did (stress me) and thankfully got me to meet deadlines.

In carrying out this research I was much encouraged by the fact that we are only four people away from any person in the world. To all of my numerous and trusted friends who helped me access the moneylenders, – thank you for being my 'four people'.

Most of all, I thank the Lord Jesus Christ for His grace, favor and mercies which are new every morning.

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ABBREVIATIONS

AI	- Average Monthly Income
AE	- Administrative Expenses
AV/LA	- Average Loan Amount
C/BASE	- Customer Base
CBs	- Commercial Banks
CF	- Cost of Funds
DIRC	- Differential Interest Rates Charged
ED/STAT	- Educational Status
EST.ILP	- Establish Intended Loan Purpose
F/R	- Friends or Relatives
II	- Investment Income
LL	- Loan Loss
LPP	- Loan Processing Period
MFIs	- Micro-financial Institutions
MAX/LA	- Maximum Loan Amount
MIN/LA	- Minimum Loan Amount
MNT	- Month(s)
M/STAT	- Marital Status
O/S	- Own Savings
PCWSP	- Proportion of Clients Paying ***Within*** the Stipulated Period
PCLSP	- Proportion of Clients Paying ***Later*** the Stipulated Period
PCNP	- Proportion of Clients ***Not*** Paying
PLB	- Period in Lending Business
PROF	- Profession
RESP	- Respondent
RI	- Rate of Inflation
RoSCAs	- Rotating Savings and Credit Associations
RPT	- Repeat
SACCO	- Savings and Credit Co-operatives
WKS	- Weeks

EPILOGUE

Francesca who lives in Nairobi, Kenya, runs a fruit and vegetable stand. She inherited the stand from her mother. Francesca has contracts to provide fruit and vegetables to several Nairobi restaurants. She knows the restaurants would also buy juice from her if she could provide it. But Francesca doesn't have a juice machine. She cannot go to the main bank to get a loan because although she is a successful business woman, she has no capital. Because women in Kenya generally don't inherit land which would give them collateral, many Kenyan women are faced with similar obstacles. When they need loans, their only options are the 'loan sharks' who roam the marketplaces looking for people in desperate circumstances –

(http://unpac.ca/economy/altmoney.html 'Where credit is due – African market women film series, video recording' 1991)

ABSTRACT

The variety of financial needs that exist can not always be adequately met by the formal financial sector. Even formal micro-financial programs created to bridge this gap, often still manage to sieve out those regarded as the "hardcore poor" through their screening processes. Where the majority of the population has limited access to formal finance, informal micro-lending becomes the alternative business practice. However, one of the main accusations leveled against moneylenders (individuals who provide loans routinely with the expectation of profiting), is that they charge exorbitant interest rates, thereby exploiting the mostly low income borrowers who have no alternative credit sources.

The irony is therefore that although moneylenders offer a necessary service to society, there remains widespread misunderstanding in both formal finance and economic development literature about how they operate. This research project therefore explores by survey design, the term structure of interest rates charged by money lenders in Nairobi and the stated or implied determinants of those interest rates. Using questionnaires as the data collection method, a sample of thirty respondents was identified through convenience sampling and analysis carried out on the findings.

The research findings indicate that money lending previously thought to be restricted to rural areas is rapidly becoming an urban phenomenon and moneylenders are increasingly a skilled lot. Interest rates charged for periods between 1 week and 12 months range from an average of 20% to 55%, significantly higher than those charged by formal financial

service providers. The interest rates are set at the moneylender's discretion with minimal reference, if any, to others in the market or to traditional determinants of micro financial interest rates (administrative expenses, loan loss rate, cost of funds, capitalization rate, and investment income).

In spite of the above the moneylenders do not lack for customers, most of whom are loyal repeat clients – evidence that they provide important financial services. It is therefore recommended that policy makers recognize that the poor are not a homogenous group and that very different delivery organizations (including informal moneylenders) will be needed to serve them all. In so doing the informal financial sector may finally be able to enter into the arena of licensed, regulated and supervised intermediation thereby realizing its full potential for poverty alleviation.

CHAPTER ONE

1.0 INTRODUCTION

1.1 BACKGROUND

Informal credit markets have been at the center of policy intervention in developing countries for many years with disappointing results probably due in part to the inadequate understanding of how they work. Microfinance or Microcredit institutions as used interchangeably are institutions offering small scale financial services – primarily credit and savings – to people who operate small or micro enterprises. They may be formal or informal. In Kenya, despite the rapid growth of the money-lending industry, informal financial markets remain relatively unexplored and unregulated and consequently, information on them is very scarce.

The term "moneylender" as used in this paper includes individuals whose only or primary occupation is money lending, pawn brokers and individuals who provide loans routinely with the expectation of profiting. Moneylenders have often been regarded as parasites who exploit impoverished peasants. Pejorative and emotive terms such as "monopolist" "usurer" "shylock" "loan shark" and "exploiter" color discussion on this topic (Adams, 1991). In his notes, world renowned philosopher Karl Marx observed that in all countries with a non-capitalist mode of production usury was a salient feature. He further characterized it as the lowest and worst form of capitalism (Binayak, 1989).

However, given that the formal financial sector is generally self-deterred from financing the informal sector by characteristics typically associated with them such as their non-legal status, frequent lack of business location, small size of transactions and perceived riskiness of the business (Robinson, 2001), contemporary research suggests, contrary to popular belief, that informal lenders are rapidly gaining respectability by providing efficient financial services to a broad clientele that is badly served by formal sector intermediaries (Bolnick, 1992). It is therefore quite likely that the biases as cited above stem from the natural tendency to fear and dislike activities that are poorly understood or even mysterious.

1.2 STATEMENT OF THE PROBLEM

Although financial services in Kenya have evolved significantly over the years, the variety of financial needs that exist can not always be adequately met by the formal financial sector. This is because formal financing tends to be accessible only to those with significant amounts of assets due largely to the high transaction costs and the exhaustive and lengthy loan processing period. These highly restrictive collateral requirements are due to their risk averseness as well as requirements imposed by banking regulators.

Where the majority of the population has limited access to formal finance, micro-lending becomes the alternative business practice. However, one of the main accusations leveled against moneylenders is that they charge exorbitant interest

rates and by so doing, exploit the mostly low income borrowers who have no alternative credit sources. The illegality of the trade in Kenya has resulted in a scenario where the few lenders willing to risk the trade enjoy monopoly profits.

The irony, therefore, is that although moneylenders offer a necessary service to society there remains widespread misunderstanding in both formal finance and economic development literature about how they operate. Moreover, the information available on the range of interest rates they charge and what drives these rates is at best scanty. Whereas there are conventional methods for deriving interest rates charged by micro-financial institutions no known study has been undertaken in Kenya on the sources of funds; the range, term structure and determination of interest rates charged by moneylenders; the demand for this type of credit, and the level of risk faced by lenders.

1.3 OBJECTIVES OF THE STUDY

The scope (objectives) of this study is:

- To determine the term structure of interest rates charged by moneylenders in Nairobi.
- To identify the stated or implied determinants of these interest rates.

1.4 IMPORTANCE OF THE STUDY

Micro-lending is without doubt an essential business practice in Kenya as in most developing countries where the majority of the population has limited access to finance.

The paper is therefore expected to be useful to the following parties:

- To policy makers in developing a comprehensive policy on micro-credit that facilitates micro-lender's potential to provide financial outreach to a significant segment of the country's poor households.
- To Micro-finance Institutions in regulating controlling and sustaining the growth of the sector thereby significantly decreasing the bad practices in Micro-financing such as malicious monopolistic money-lending.
- To Consumers in ensuring consumer rights are protected, and that lenders are registered and comply with the relevant regulations.
- To Stakeholders and Academicians in the creation of awareness on some micro-finance issues - the dynamics of its processes, the speed of its progress and its possible role in economic and social development.

CHAPTER TWO

2.0 LITERATURE REVIEW

Micro and Small Enterprise (MSE) financial products differ radically from those employed by formal lending institutions, particularly those products directed at micro enterprises[1]. These financial products arise to meet the demand for financial services not met by the formal financial sector.

2.1 SOURCES OF FINANCE FOR LOW-INCOME CLIENTS

The potential sources of finance may be broadly categorized as informal sources and formal sources. Formal finance may be defined as all financial transactions that are supervised, regulated and monitored by some central financial or monetary authority. It typically involves large loans and deposits, secure collateral, relatively long-term financial instruments, and legal backing (Adams, 1991).

The term informal finance on the other hand, encompasses all other financial activities in the economy and in contrast to formal finance frequently involves

[1] To illustrate, commercial banks have established systems for disbursing loans in such a way as to minimize the risk of loan default. However as opposed to MSE credit institutions, these systems are oriented toward analysis of larger loans typically a minimum of $10,000. To offset the costs incurred through disbursing a loan of this size the bank earns interest income on this amount. An MSE credit institution with an average loan size of $100, on the other hand, would have to make 100 such loans in order to lend an equivalent of $10,000. Furthermore, if the MSE institution's loan term is 4 months for example, these 100 loans must be processed 3 times per year in order to keep the same amount of money loaned out and yield interest income equivalent to that earned by one $10,000 loan with a one-year loan term. In other words, for both systems to be sustainable at the same interest rate, the MSE institution must be 300 times as efficient in loan disbursement as the commercial bank hence the case for an appropriate and sustainable credit methodology that deviates significantly from the standard formal lending institution practice.

small loans and deposits, commonly functions without collateral, typically deals with short term transactions, and often operates in the legal shadows. Many participants in the informal market are poor people, operators of small businesses, small farmers and the landless – people who are often unable to obtain formal financial services (Ibid). Informal credit can be commercial (moneylenders, traders, employers, wholesalers and landlords) or non commercial (family, friends and neighbors).

Among the economically active poor of the developing world, there is a strong demand for small scale financial services to help improve household and enterprise management and thereby increase incomes. However this demand is seldom if ever met by the formal sector. There are some served by government or donor financed non-bank financial institutions like NGOs and Village banks but these are often capital constrained and can meet only a small fraction of the demand. Other households are served by state-owned formal financial institutions but again they are often riddled with problems of high arrears and large losses and the cost of borrowing is increased because of widespread corruption and inefficiency (Robinson, 2001). The bulk of low-income client demand is hence met by informal credit sources.

2.1.1 Types of Informal Finance

In developing countries, both rural and urban, micro-financial markets are typically composed of informal lenders, deposit takers and semi-formal bodies. The categories of informal financiers are usually constructs rather than mutually

exclusive. Reality often falls within a continuum with some individuals or households participating in more than one category (Alila, 1993). These categories include: Semi-formal institutions; Moneylenders; Merchants; Pawn brokers; Friends and relatives, and Rotating Savings and Credit Associations (RoSCAs)

2.1.1.1 Semi –formal institutions

The term "semi-formal" as used here refers to grass root financial networks supported by a formal institutional structure by way of affiliation. They offer deposit and loan services packaged appropriately for SMEs and low-income households and are informal only in the sense that they are not regulated. Several studies suggest that these organizations charge reasonable interest rates and operate with modest transaction costs (Nayar, 1982; Vogel, 1988; Zinzer and others, 1986)

2.1.1.2 Moneylenders

These include individuals whose only or primary occupation is money lending and who give loans typically over short periods of time and generally unsecured by collateral. They mostly operate on a small scale and extend loans mainly out of their own funds to a restricted number of clients. These lenders tend to charge interest rates that are high relative to other informal lenders but they grant loans quickly and impose few transaction costs on borrowers. They often have highly personalized relationships with their borrowers.

2.1.1.3 Merchants

These are individuals who extend loans linked to the sale or purchase of commodities (Bardhan, 1980). Many of the loans extended over a short period of time carry no explicit interest charge and the lender may adjust the price of the commodity involved in the transaction as compensation for the loan.

2.1.1.4 Pawn brokers

Closely related to merchants are pawn brokers who also require borrowers to exchange collateral for loans. Unlike the others however pawn brokers need almost no information about their borrowers unless they are wary about receiving stolen goods. The pawn broker realizes revenue from the interest on loans and from the difference between loan amounts and sales receipts from items received as security on defaulted loans.

2.1.1.5 Employers, Landlords, Friends and relatives

These represent other common forms of informal finance. In some countries these types of credit make up half or more of all informal loans. Most are short-term with minimal amount transactions at zero or near zero nominal interest rates but a few are larger in amount for special occasions like weddings, funerals, buying a house or land. The reciprocity that characterizes these types of loans is an important factor in managing uncertainty and risk. They also tend to be non fungible and therefore can not be diverted for any other purpose than that stated (Robinson, 2001).

2.1.1.6 Rotating Savings and Credit Associations (RoSCAs)

Nearly every culture has developed an informal financial system by which members form a self-selected group and agree to each contribute a regular fixed amount every week or month. The members then take turns collecting the full contribution for that period until all members have had an opportunity to receive the money. The associations explicitly pool money and tie loans to deposits. This represents a slightly more sophisticated form of finance than those that have been discussed above. Recent research by Schreider (1989) in Cameroon suggested the volume of deposits moving through RoSCAs may be larger than the amounts held in banks.

While RoSCAs provide the advantage of discipline for savings that might not otherwise occur and bonding for the members socially thereby allowing them to respond to each others emergency needs, their primary limitation is their relative lack of flexibility (Waterfield, 2001). The rotating nature of the distribution system reduces the likelihood that a member will be able to receive their disbursement at the time when she can make the best use of the money. The lack of flexibility is also apparent in the loan amounts regardless of their precise needs. Disbursement amounts are usually limited in size thus denying members with more ability to absorb and productively use credit the opportunity to do so. Finally there is always the risk that a member may default before everyone has had a turn to receive credit thereby causing the group to disintegrate.

2.1.2 Size of Informal Credit Markets

The World Bank World Development Report of 1999-2000 estimates that in 1998 about 1.2 billion people, approximating 24% of people living in developing and transition economies, lived on less than $1 per day. In 1999, 4.5 billion people or 75% of the world's population lived in low and lower-middle income economies and of these, 80% do not have access to formal sector financial services. They therefore form most of the demand for micro-finance (Robinson, 2001).

Although there is little accurate knowledge about the market shares of informal credit markets, available empirical evidence suggests that it is significant. In Thailand for example, the loans provided by informal lenders were reported to have reduced from 90% of the rural credit market in 1975 to 50% in1985 (Siamwalla and others 1993 p 161 as quoted in Hoff, 1993). Miracle (1973) observed that an estimated 90% of credit provided to small farmers in most developing countries went through the informal credit market (Von Pischke and others, 1983).

Other examples drawn from the OECD volume (Germidis, Kessler and Meghir 1991 p 42-44) include: Bangladesh where studies indicated that the mean size of credit from informal sources was estimated at 60% in 1983 and that moneylenders met 77% of farmers credit needs; in Nigeria the 1985 OECD review indicated that 95% of loans to farmers were from informal sources; in Thailand it was estimated in 1988 that 52% of the loans to the agricultural sector was from informal sources

and in Zimbabwe only 13% of small farmers received loans from formal sources in 1986.

2.1.3 Relationship Between Formal and Informal Credit

An intriguing concept that has been on the table for discussion for several years now, is to service small borrowers and savers by linking formal and informal financial markets (Bolnick, 1992). This is because whereas the differences between informal and formal credit are significant as are observable in the table below, their co-existence within the financial sector suggest a relationship worth exploring.

Table 2.1.3: Comparison of Informal and Formal sources of Finance

Informal Sources		**Formal Sources**
RoSCAs	**Moneylenders/Middlemen**	**Banks and Cooperatives**
▪ Client selection through peer review	▪ Client selection based on personal knowledge of borrowers	▪ Client selection based on exhaustive analysis and loan processes
▪ Repayment pressure through peers	▪ Repayment pressure usually through brute force	▪ Personal guarantors to pressure repayment
▪ Ability of participants to self- manage their own programs	▪ Loaning with informal collateral requirements	▪ Rigid collateral requirements
▪ Inflexible timing of loans	▪ Rapid response to credit needs	▪ Loan available when required but with a waiting period
▪ Limited and inflexible loan amounts	▪ Often limited loan amounts	▪ Loan amounts based on collateral

▪ Low interest rates	▪ Extremely high interest rates	▪ Interest rates based on market forces. The longer the term the lower the interest rate
▪ Low transaction costs	▪ Low or non-existent transaction costs	▪ Very high transaction costs

Adopted from 'Designing Microfinance Loan Products' by Charles Waterfield (2001) p 6

Informal and formal credit are not distinctive spheres but rather interlocking parts of a larger more complex network of borrowing and lending. This is to say that the parts compete, co-operate or co-exist and in some cases individuals, households or groups participate in more than one.

The analysis of the relations between informal and formal credit calls for a broad view to include any transfer of goods and services between one person/group and another or to any of its members with expectation of a return at a later time (Ibid). The overlay between informal and formal finance can hence take various forms e.g. institutional lenders through special credit schemes may seek to undercut the informal lender or long delays in co-operative loans may result in farmers arranging secondary loans among themselves to complete the necessary activities in time.

Although informal credit is generally non-institutional and unregulated, this is not to say that they have no custom or etiquette. Indeed formal institutions can learn much from them, for example, their knowledge of the micro-credit market; their

development of personal relationships with clients; their tested methods of evaluating repayment capacity of borrowers; their methods of containing costs; their quick and easy credit procedures and their capacity to achieve repeat lending (Robinson, 2001). Issuing from this premise, one proposal has been to use informal lenders as agents or alternatively to provide financial leverage and secure deposit facilities for them (Bolnick, 1992). However owing to the fact that it is hard to find policy measures that lead successfully to this end, it may be best to let links develop spontaneously as is often the case (Ibid).

2.1.4 Policy Responses to Informal Financial Markets

Micro-enterprises have in the past been perceived by policy makers to be the result to economic dysfunction – an indicator that the structure and growth rate of the formal economy were inadequate to absorb the labor force (Robinson, 2001). The typical policy response to this trend has been to improve the management of the formal economy in a bid to absorb this excess labor force or to create cheap institutional credit as an alternative in a bid to drive the traditional money lender out of the market. There has therefore been little or no focus on the contributions of the micro-financiers or the need to improve the environment in which they operate. Government plans and budgets, economist's models and national policies have been mostly silent on the issue (Ibid).

This approach has however failed to neither eliminate moneylenders nor drive their exorbitant interest rates down. In addition high default rates have prevented

the alternative credit institutions from being self-financing hence requiring recurrent and often large injections of government funds (Hoff & Stiglitz, 1990). The relative lack of success of policy intervention comes as no surprise to the proponents of the school of thought that considers credit markets as classical competitive markets whose interest rates are actually a reflection of the risks of default (Ibid).

However, the traditional and perfect market view alone cannot explain the strong survival skills evident in informal finance. The moneylenders' shrewd business sense; experience and knowledge of the market; extensive informal support and communication networks and fundamental understanding of flexibility all go to contribute towards their staying power (Robinson, 2001).

Given both the pros and cons of informal money markets, the right approach to the informal lender seems to be neither to seek to wipe him out nor romanticize him but rather to help him seek out alternative methods of risk management and intensify competition within a facilitating legal environment (Bolnick, 1992). This is because due to his lack in most cases of all the tools of risk management the money lender has often been forced to adopt the alternative approach of treating the risk of lending to an unsecured borrower as a fixed cost and of loading that very high fixed cost on to the interest rate as a loan loss provision. A price which would be borrowers have no option but to pay due to the conditions of local monopoly often prevailing in the rural financial setting.

The 1980's have seen marked improvements in developing countries' macro-economic management. The growth of the informal sector is now seen as a predictable and rational response to structural adjustment programs implemented by many of them and consequently policy makers in some countries have re-examined their approach to informal financial institutions viewing them not as a problem but an important solution to crucial aspects of problems caused by poverty (Robinson, 2001). This renewed interest in the informal sector is related to the recent recognition on the part of policy makers that the informal sector is very large and is here for the foreseeable future. The resulting increased prioritization of micro enterprises by many governments and donors is welcome considering the fact that without the routine harassment at the hands of law enforcer's, moneylenders would be more likely to invest in their enterprises thereby contributing to the society (Ibid).

2.2 MICROFINANCE METHODOLOGIES

The three dominant MSE methodologies – Individual lending, Solidarity Group lending and Village Banks evolved over a period of time. The first significant MSE credit institutions appeared in the early 1970s and used individual methodologies which were primarily adaptations of bank and cooperative methodologies (Waterfield, 2001). These institutions with time improved with respect to operational efficiencies, repayment rates and their willingness to charge higher interest rates. Many of these lessons came from studying the experiences of

the moneylenders and resulted in the second generation of individual credit methodologies which appeared in the 1980s (Ibid). Individual lending institutions were first established in urban centers to take advantage of density of population and demand for credit.

The Grameen Bank of Bangladesh was the first to use the solidarity approach in 1976 (Ibid). Founded by economist Mohammed Yunis, this bank, as opposed to the individual lending institutions, had its origins in rural villages of Bangladesh. He had noticed on a visit to these rural villages the exploitation of farmers at the hands of rural moneylenders and started to issue small loans as an alternative. The Grameen Bank used an initial savings period followed by a sequentially-disbursed credit among a small group of self selected borrowers. Group members were involved in decision making and loan approval.

The Grameen experience soon received worldwide attention and institutions using individual methodologies started looking into ways of incorporating it. The result was the emergence of Solidarity groups which appeared in the early 1980's. This approach used a small peer group much like that of the Grameen, but opted to retain loan approval and administration in the already existing systems.

The final step in the evolution to date occurred with the appearance of Village Banking in the mid-1980s (Ibid). Advocates of this approach felt that not enough had been done in developing the abilities of the group to manage their own affairs.

Whereas Grameen participants were never graduated from receiving services, the Village Banking had a highly structured three-year process where groups would be graduated into independence from other lending institutions. In other words Village Banking was philosophically focused on the creation of a mini-bank owned and operated by and for the poor.

2.3 THE KENYAN MICROFINANCE INDUSTRY

The Kenyan Microfinance industry is arguably one of the most established in Africa. Interest in the informal sector was initiated as far back as the early 1970's following an ILO report that identified the informal sector as a potentially important contributor to economic growth[2]. Since then it has evolved from a service to the agricultural sector and the rural poor to multilateral and bi-lateral funding directed at large industrial and infrastructural projects in the hope of a trickle down effect to the poor, to the development of special development banks for small farmers and business people, and finally to the setting up of credit programs and self-help groups.

Kenyan Microfinance organizations can be categorized into three 'sub-systems' namely the informal system which is not regulated and not subsidized; the formal subsidized system, which receives financial aid from foreign aid agencies and the formal non subsidized system which is regulated and covers its costs (Dondo, 2001).

[2] http://www.amfikenya.org/html/evoltion.asp '*Kenya Microfinance Industry*'

Table 2.3: Distribution of Microfinance Organizations by Type of Organization

	Type of Microfinance Organization	Number
A	**Formal Microfinance Institutions**	
1.	Commercial Bank (K-Rep Bank)	1
2.	NGO's	56
3.	Societies (KSTES)	1
4.	Companies Limited by Shares (Faulu Kenya and WEDCO)	2
5.	Companies Limited by Guarantee	Various
6.	Non-Bank Financial Institutions	2
7.	SACCOs (By December 1999)	3,168
8.	Wholesale lending Institutions (Jitegemee Trust and MESP)	2
9.	Joint Loan Board Schemes	Various
B	**Informal Microfinance Organizations**	
1.	ROSCAs	Various
2.	Money Lenders	Various
3.	Unregistered Family/Neighbor/Friends Groups	Various

Source: K-Rep Occasional Papers series No. 33 – Microfinance in Kenya: An overview

2.3.1 The Formal Financial Sub-system

2.3.1.1 The Formal Subsidized System

The origins of the subsidized system can be traced back to the mid 1950s with the establishment of the Joint Loan Board Scheme by the then colonial government (Dondo, 2001). Since then the Government has widely used subsidized rural micro-credit programs in its development strategy. Today these institutions mainly comprise Microfinance NGOs with credit programs for micro and small Enterprises (MSEs) who operate formally and benefit from aid agencies towards

operational costs. In the 1980s a number of these NGOs introduced alternative credit delivery mechanisms for the poor consisting of small amounts of loans without collateral thereby accessing financial services to the poor (Ibid).

2.3.1.1.1 Microfinance NGOs

Ranging from small charitable units within a vicinity to large institutions covering the entire country, NGOs like Kenya Women's Finance Trust (KWFT) and Small and Micro-enterprise Program (SMEP) a subsidiary of the National Council of Churches in Kenya (NCCK) have over the years developed assistance models to deliver cost effective and sustainable micro financial development (Dondo, 2001). However, to their detriment these NGOs extensive reliance on donor-funding often means they last only as long as donors are willing to fund them.

2.3.1.1.2 Government Agencies

The earliest government-sponsored support for micro-enterprises dates back to pre-independence when by a policy termed "Africanisation" or "Kenyanisation" the government sought to catalyze African entrepreneurship by removing bottlenecks, the foremost of which was access to credit (Ibid). Although they have since changed in form and substance, these organizations still exist to date as the Industrial and Commercial Development Corporation (ICDC); Kenya Industrial Estates; District Joint Loans Board and Kenya Tourist Development Corporation (KTDC).

2.3.1.2The Formal Non-subsidized System

Formal non-subsidized institutions providing microfinance include the Kenya Post Office savings Bank, the K-Rep Bank (the only microfinance bank in Kenya) and the Co-operative Bank which provides loans and banking facilities to its member Savings and Credit Co-operative Societies (SACCOs). These SACCOs in turn provide their individual members with loans.

2.3.1.2.1 Kenyan Savings and Credit Co-operatives (SACCOs)

These are financial institutions that mobilize savings and use those savings to grant loans to its members. In Kenya these institutions are supervised by the Commissioner of Do-operatives rather than by the Central Bank. With over $1 million in savings[3] SACCOs tend to be payroll or crop based, i.e. they receive their payments from companies whose workers are members or who purchase agricultural products from the members. Whereas in the past moneylenders were the main providers of financial services useful during emergencies like hospital and burials expenses, these service are now also increasingly being provided by credit unions. These unions have expanded their services to meet not only the planned lending needs of members, but also their emergency borrowing needs, business needs and saving for the future.

Originally, Kenyan credit unions only offered loans secured by a non-withdrawable share account. Members could borrow two or three times the amount

[3] http://www.amfikenya.org/html/financial_system.asp

in their account. Eventually, if the members left the SACCO, the money in the share account was refunded. While this type of "back office" operation once served members' needs, today credit unions are recognizing the importance of providing "front office" operations with competitively priced withdrawable savings and convenient lending products[4].

2.3.2 The Informal Financial Sub-system

These include the Rotating Savings and Credit Associations (RoSCAs), the traditional money lenders and financial arrangements between relatives and friends.

2.3.2.1Kenyan Rotating Savings And Credit Associations (RoSCAs)

In Kenya RoSCAs are found in both rural and urban settings and may be registered as Social Welfare Groups or unregistered as a group of friends or family members. Studies have shown that more than 80% of the RoSCAs in Kenya comprise of 5 to 10 members, but that some groups comprise of up to 60 members. Moreover 76% of those who belong to the groups are women (Dondo, 2001). Although there are minor variations from one group to another, RoSCAs typically operate as a revolving fund where the members pay a fixed amount agreed upon, which consolidated amount is given to each member in turn. Not only do they serve the members financial needs but their social needs as well.

[4] http://www.woccu.org/pubs/cu_world/article.php?article_id=126

In some instances RoSCAs also serve a credit function especially those registered as Social Welfare groups who are able to obtain loans from microfinance institutions like K-Rep and subsequently grant loans to their members as necessary. Such loans are repaid by members at a higher interest rate than charged by the bank and the difference retained as income to the RoSCA (Ibid).

2.3.2.2Financial Arrangements Among Relatives and Friends

Although the exact magnitude of these transactions in Kenya has not been subjected to extensive empirical study the limited evidence available suggests that it is substantial. In many instances credit from relatives and friends constitutes an important source of start up capital for many entrepreneurs (Dondo, 2001). In a study carried out in Vihiga, Siaya, Bungoma, Kisumu and Kakamega on access to credit by small scale enterprises it was found that 43% of the respondents obtained credit from informal sources and of those 14% was from family and friends (Atieno, 2001). This is not surprising considering that social responsibility is very strongly ingrained in the traditional African culture.

2.4 MONEY LENDING

Despite the fact that the role of informal commercial money lending in local financial markets has been debated for decades, there still remains widespread misunderstanding both in the formal financial sector and in economic development literature about how moneylenders operate (Robinson, 2001). The demand for credit among low-income borrowers is typically for short-term working capital

loans made available at convenient locations with easy processes, appropriate payment schedules and quick delivery within interest rates payable from household income sources. The emerging view is that with the exception of the last feature, moneylenders generally perform this function (Ibid). They supply services desired by their clients without the cost.

The three main strains of debate surrounding money lending have hence been whether it is a 'malicious' monopolistic business, whether it provides good value for borrowers or whether it is a form of monopolistic competition.

2.4.1 Moneylenders and Interest Rates

While it is true that moneylenders provide important financial services to the poor, they typically charge very high interest rates. Hoff and Stiglitz (1990) suggest that these high interest rates are a response to either one or a combination of the challenges they face including the screening problem as a result of the borrowers difference in their likelihood of default; the incentives problem as a result of the costliness in ensuring that borrowers take actions which make repayment of the loan more likely and the enforcement problem due to the difficulty experienced in compelling payment.

Given the excesses in interest rates charged by moneylenders, few long term investment opportunities can support the high cost of capital. Only investment activities with fast turnaround can benefit (Waterfield, 2001) hence the

monopolistic hold that middlemen often have over small producers particularly in the agricultural sector[5]. A variant of the monopolistic money lender is the lender whose primary aim is to make the borrower default in order to gain his land, force him into bonded labor or get him to sell his products at below market prices as are documented in hundreds of cases and reports in India (Robinson, 2001).

However, in spite of the fact that interest rates charged by moneylenders may exceed 75% and sometimes credit is unavailable at any price (Hoff & Stiglitz, 1990), the benefit of quick access to money without too many questions is seen to far outweigh this disadvantage. It is important to note that while the transaction cost of a loan from the bank is higher than that from an informal lender, the difference in interest rates makes the cost of a loan from a formal institution lower to the borrower. The widespread use of informal finance especially in rural areas however suggests that it is well suited to most rural conditions.

> 'A strongly held view by traditionalists is that money lenders are evil and charge exorbitant rates of interest. The emerging view is that money lenders generally perform a legitimate economic function. Their operations are frequently more cost-effective and useful to the poor man than those of the specialized farm credit institution, Co-operatives and commercial banks that governments use to supplant money-lenders. The emerging perspective is that informal financial arrangements based on voluntary participation by rural people are generally robust and socially

[5] When producers lack cash to pay for inputs middlemen will provide them in the form of a loan. The producers output is used as collateral for the short term loan. The middlemen often inflate the price of the inputs, charge a specific and high interest rate, require the producer to sell his/her output to the middleman at suboptimal prices or apply some combination of the above. In any case the producer loses a great deal of potential income due to lack of alternative credit sources.

useful. Widespread use of informal finance suggests that it is well suited to rural conditions' (Von Pischke, Adams and Donald 1983, p 8)

Many scholars have in like manner argued extensively against what came to be known as the myth of the malicious moneylender to demonstrate that the interest rates they charge reflect primarily their transaction costs and risk. To illustrate further, each money-lender tends to have a range of interest rates for different customers primarily due to the fact that a lender can not ever fully discern the extent of risk of a particular loan (the pool of applicants for a loan at any given interest will consist of borrowers with projects in different risk categories). The interest rates take on the dual function of a price as well as an instrument for regulating the risk composition of the lender's portfolio (Stigler and others, 1987).

It is safe to conclude then that while some lenders are malicious and exploitive, many are not and offer useful services. Even so, ironically, poor borrowers are often charged more because they have fewer options and therefore are low on bargaining power (Robinson, 2001).

2.4.2 Money Lending as Monopolistic Competition

Monopolistic competition has been defined as the market situation in which there is a large number of firms whose outputs are close but not perfect substitutes either due to product differentiation or geographical fragmentation of the market. The non-homogeneity of the product means one firm may raise its price relative to

others and not experience significant loss in sales. The combination of a large number of firms as if in perfect competition with down-ward sloping curves as in monopoly, is responsible for the term "monopolistic competition" (Penguin, *A Dictionary of Economics*, 1975, p.289 as excerpted in Robinson, 2001)

Informal lenders are imperfect substitutes because they have good information and interlinked transactions with a limited number of borrowers who then find it difficult to change creditors. Although entry is free as is the character of monopolistic competition, there is variation in that informal credit markets have free entry only so long as new lenders find borrowers not already being served by existing lenders. Because there is therefore no real competition, lenders are able to enjoy long-term profits.

2.4.3 Features of Informal Commercial lenders

Some of the features observable within the informal commercial lenders includes the fact that they co-exist with the formal sector despite the differences in interest. There is also a sense of segmentation whereby interest rates of lenders in different areas vary by more than can be plausibly accounted for by differences in the likelihood of default (Hoff & Stiglitz, 1990). Local events such as the failure of a harvest have a significant impact on the availability of credit and there exists inter-linkages between the credit transactions and transactions in the other markets such as produce markets – the borrower is also the lender's commodity supplier,

employee and tenant (Robinson, 2001). The financial services are also often extended on the understanding that there may later be a reversal of roles.

Informal credit markets are known to operate within an informal atmosphere where there is minimal protocol hence translating into minimum transaction costs for the borrower. The informal lenders are usually close in proximity, often residing in the same village as the borrowers. They provide quick credit and all time access to credit facilities even without standard forms of collateral. This is because lenders exchange money today for a promise of money later and take specific actions to make it more likely that those promises will be fulfilled (Hoff & Stiglitz, 1990). Although the borrower is free to use the loan money for whatever purposes he chooses, information acquisition regarding the characteristics of the loan applicant and an enforcement element is put in place as insurance against default.

The scarcity of capital available to the informal credit market leads to small scale operations and transactions depending on the ability of the lender (usually an individual or family) to accumulate enough funds to lend and to collect enough information on his potential clients. Their non-legal status, lack of authorized business premises and operation in non-regulated markets makes for easy entry into the market (Robinson, 2001). The amount of interest charged and loan payment periods are at the lenders discretion, the trade being unregulated.

Informal lenders often have non-formal education, low skills levels, irregular working hours and small inventories (Ibid).

2.4.4 Characteristics of Informal Commercial Loans

2.4.4.1 Flow credit and stock credit

Low-income clients typically borrow for short term expenses like consumption, medical expenses, ceremonies, emergencies and the like. The slightly better off borrow for larger investments like purchase of house, land, business expansion or consumer durables like vehicles and furniture. For *flow credit* (loans with repayment periods of less than a year usually for consumption) information relevant to the creditor concerns the borrower's income flow. The transaction is quick with no paper work and no collateral. In contrast, for *stock credit* (usually for long-term investment with terms of a year or more) the lender is primarily interested in the borrower's assets, liabilities and collateral. The number of borrowers are limited to people the lender knows well and with whom he maintains extensive interlinked transactions in other markets. Often collateral of value more than the loan amount is required (Robinson, 2001).

2.4.4.2 Availability of loanable funds

In general loanable funds are not scarce. There is no evidence that the volume of business in informal credit markets is ever constrained by availability of funds. This is primarily a result of the common pattern of multiple lenders with multiple

income sources (even formal sources) and each serving relatively few borrowers (Ibid)

2.4.5 Money-Lending in Kenya

Although money-lending is known to exist in Kenya, the Money-lenders Act was repealed in 1987 rendering the trade illegal (Malkamaki and others, 1991). Beyond non-commercial money lending among relatives and friends, there has been a proliferation of informal commercially oriented moneylenders whose business is unregulated in both urban and rural areas. Although they run illegally, their adverts are often seen in mainstream media with telephone contacts only. The fact that they are increasing in number means that there is demand for their services. It is notable that moneylenders in Kenya as in other countries such as Bolivia and Malawi habitually take collateral often like a pawn broker in the form of mortgage on jewelry or other loose asset.

The following extract is taken from the magazine 'Market Intelligence' (Economic Intelligence, 2002) who on undertaking a journalistic investigation of shylocks in Nairobi found that:

> "The entrepreneurs set the rules individually, but generally offer cash against household items such as TVs, VCR, HiFi etc and kitchen appliances like cookers, gas containers, microwaves, ovens fridges etc. They also issue loans against office equipment and machines like computers, cars, share certificates and title deeds. The interest rates and terms & conditions of repayment vary from one shylock to the other and may be as high

as 60 percent per month. The loan repayment period also varies failure to which the collateral item is sold. Some will let you pay the accrued interest while they still hold onto your item until you are able to pay the principal amount while others charge compound interest every month.

Collateral items are generally valued at far less than their worth to encourage borrowers to pay up. The majority of shylocks have an upper loan limit of 50,000 Kenyan Shillings and are interested in fast moving goods. These goods have to be accompanied by their original purchase receipts. Transfer documents are signed and a 'contract' entered into. This informal sector largely serves those in informal employment, and who do not have bank accounts but nonetheless need the money urgently without the rigorous screening undertaken in formal lending institutions. "

In a study covering thirty centers in 5 districts carried out on informal sector entrepreneurs in 1989 by Aleke Dondo (Malkamaki and others, 1991), it was found that 49.3% of the moneylenders indicated that they lent money to business colleagues, friends and family the basis of the loans being mainly trust because the lender had assessed to some extent the borrowers business. An analysis of male v/s female moneylenders revealed that 65% of the lenders were male and 35% female. The majority of moneylenders were found to be within the ages of 19 – 40 years and had attained primary level education. Only 7.3% of the money lenders run the enterprise as their sole occupation.

It was also found that there was a short processing time, typically within 48 hours and the loan size ranged from 5,000 – 25,000 Kenyan Shillings disbursed in cash for an average duration of 6 months. Interest rates charged varied from 1% to 40%

and the demand for security was ad hoc, some not demanding at all and there were low default rates and low transaction costs. Most of the businesses were very small ranging from privately owned sole proprietorships to those employing at most 3 people and these operating within locations that were semi-permanent with poor utilities. Very few of the money lenders had received business assistance of any type, usually relying on employment, and of the ones who have only 4% was from formal sources.

2.5 THEORIES OF INTEREST RATES

Theories of interest rate determination follow several conventions. First, models usually focus on determination of the equilibrium level of interest – denoting rest or absence of forces of change – a state that seldom exists because financial markets are constantly approaching equilibrium as they respond to numerous factors that cause an imbalance between supply and demand (Gardner and others, 2000). Second, they rely on several assumptions required to simplify the real world. Third, they focus on a single rate of interest. Although there are various interest rates for different types of securities, the correlation between them is strong enough to justify focusing on one to build the model (Ibid).

2.5.1 The Loanable Funds Theory

This theory focuses on the amount of funds available for investment (the supply of loanable funds) and the amount of funds that borrowers want (the demand for loanable funds). The loanable funds theory categories borrowers and lenders into

five distinct types: households or consumers; businesses; governments; the central bank and the foreign sector (Gardner and others, 2000).

2.5.1.1 Determination of the equilibrium rate of interest

Equilibrium in the output market implies that all output produced in an economy is purchased (Miller & VanHoose, 1993). However, it is evident that economic units always have a choice for disposition of funds – they can spend money on consumables or save it. Saving is by its very nature an act of foregoing current consumption for a future date. In contrast to this, others, especially businesses spend more now than they have by borrowing from those who save. How then is equilibrium achieved?

The main determinant of saving per unit of time is the real rate of interest. When this real rate of interest rises, households save more (thereby supplying loanable funds) and consume less. Conversely, when the real rate of interest falls, households save less and consume more. On the other hand, given their profit expectations, business owners base their borrowing of loanable funds for capital goods on the real rate of interest. As this rate increases, demand for loanable funds decreases. As it decreases, demand for loanable funds increases (Ibid). If this relationship is depicted graphically the demand for loanable funds curve slopes downwards showing the inverse relationship while the supply of loanable funds slopes upwards showing the direct relationship. Where the two curves meet represents the equilibrium rate of interest where everything saved is demanded.

Other factors influencing households include precautionary saving for emergencies, savings for retirement, involuntary savings such as social security and the level of income (Gardner and others, 2000).

2.5.2 The Fisher Theory

This theory depicts the relationship between interest rates and expected inflation. If for instance, investors want a 2 percent real return, and inflation was expected to be 12 percent over the year, they will demand a higher interest rate (an inflation premium) for expected lost purchasing power over the period of investment (Gardner and others, 2000).

2.6 MICROCREDIT INTEREST RATES

Microfinance Organizations often refer to the 'effective interest rates' on their loans which differ from nominal interest rates in the sense that they incorporate interest, fees, the interest calculating method and other loan requirements into the financial cost of a loan (Ledgerwood, 1999). The effective interest rate also includes the cost of forced savings or group fund contributions by the borrower. Where interest is calculated on the declining balance only, and there are no additional financial costs to a loan, the effective interest rate is the same as the nominal rate. Transaction costs such as opening a bank account, transportation etc. incurred by the borrower to access the loan are not included in the calculation of

the effective interest rate because these vary significantly depending on geographical location (Ibid).

MFIs can determine the rate necessary to charge on loans based on their cost structure.

The following section outlines a method for estimating the interest rate that an MFI will need to realize revenue on its loans as well as cover all its costs thus making it sustainable (adopted from Rosenberg, 2002). The model presented is simplified and hence imprecise[6], and assumes a mature MFI with relatively stable costs i.e. start-up costs have already been amortized and the MFI is operating at full capacity. However it yields an approximation that is useful in understanding how MFIs should conventionally establish interest rate.

Pricing formula: The annualized effective interest rate (R) charged on loans will be a function of five elements, *each expressed as a percentage of average outstanding loan portfolio:*[7] administrative expenses (AE), loan losses (LL), the cost of funds (CF), the desired capitalization rate (K), and investment income (II):

$$R = \frac{AE + LL + CF + K - II}{1 - LL}$$

[6] The more rigorous – and much more challenging – method for calculating the interest rate required for sustainability is to build a spread sheet planning model based on a careful monthly projection of an institution's financial statements over a planning period.

[7] To average a loan portfolio over a given period of months, the simple method is to take half the sum of the beginning and ending values. A much more precise method is to add the beginning value to the values at the end of each of the months, and then divide this total by the number of months plus one.

2.6.1 Determinants of Interest Rates for Microfinance Institutions (MFIs)

2.6.1.1 Administrative Expenses

These include all annual recurrent costs excluding the costs of funds and loan losses such as salaries, benefits, rent and utilities. Depreciation allowance must also be included here. Also include are the value of donated services which the MFI is not currently paying for but which it will have to pay for eventually as it grows independent of donors.

2.6.1.2 Loan Loss Rate

This element is the annual loss due to uncollectible loans. The loan loss rate must not be confused with the delinquency rate which may be considerably higher. The former reflects loans that must actually be written off while the latter reflects loans that are not paid on time many of which will be recovered eventually. The institutions past experience will be a major factor in projecting future loan loss rates. MFIs with loan loss rates above 5% tend not to be viable. Many good institutions run at about 1 – 2%

2.6.1.3 Cost of funds rate

The figure computed here is not the MFIs actual cash cost of funds. Rather it is a projection of the future "market" cost of funds as the MFI begins drawing ever-increasing portions of its funding from commercial sources. The computation begins with an estimated balance sheet for a point in the medium term future broken out as follows:

ASSETS	LIABILITIES
Financial – Liquid Assets[8]	Deposits
Cash	Loans – Concessional
Investments	– Commercial
– Loan Portfolio	
Fixed – Equipment etc.	EQUITY

A weighted average cost of capital can be projected by distinguishing the various likely future sources of finance. For each class of funding (deposits, loans, equity) an estimate of the absolute amount of the MFIs annual cost is obtained. This is done by adding together the costs for each class of funding. Divide this total bye the loan portfolio to generate the cost of funds component for the pricing formula.

2.6.1.4 Capitalization Rate

This rate represents the net real profit – over and above what is required to compensate for inflation – that the MFI decides to target, expressed as a percentage of average loan portfolio (not of equity or of total assets).

2.6.1.5 Investment Income Rate

The income expected from the MFIs financial assets other than the loan portfolio. Some of these e.g. cash, legal reserves, will yield little or no interest while others e.g. certificates of deposits may produce significant income.

[8] In the absence of any other basis for projecting assume liquid assets totaling 20 – 25% of loan portfolio

2.6.2 Calculating Effective Interest Rates

The effective rate of interest refers to the inclusion of all direct financial costs of a loan in one interest rate (Ledgerwood, 1999). It is a useful concept for determining the real cost of a loan to a borrower therefore enabling him to compare alternative loan sources. However, the fact that there are many ways in which the effective rate is calculated renders this sort of comparison complicated.

In addition to this, the real cost to a borrower and the lenders real income from loans often deviates from the quoted rate as a result of practices such as computing interest on the original amount of the loan rather than on the declining balance as successive installments of principal are repaid; requiring payment of interest at the beginning of the loan (as a deduction of the amount of the principal disbursed to the borrower), rather than spreading interest payments over the life of the loan; charging a commission or fee in addition to the interest; quoting a monthly interest rate, but collecting principal and interest weekly, counting four weeks as a month or requiring that a portion of the loan amount be deposited with the lender as compulsory savings or a comprehensive balance (Rosenberg, 2002)

As used here, the ***effective*** interest rate of a particular loan contract is the rate that a client is actually paying, based on the amount of loan proceeds actually in the client's hands during each period of the life of the loan. It is equivalent to a rate calculated on a declining balance basis.

2.6.2.1 Calculating an Effective Interest Rate Using The IRR Method

When computing effective interest rates a consistent method is used to determine the outstanding principal balance at any time of the loan. Out of each payment the amount needed to cover the interest on the previous periods balance is computed. The remainder of payment is then assigned to principal, thus reducing the loan balance for the next period. During the earlier payments the outstanding loan balance is relatively large: thus the portion of payment devoted to interest is relatively large, and the amount devoted to reducing principal is relatively low. In the later stages of the loan this is reversed.

There are various alternatives for calculation of the effective interest rates depending on the various loan practices as outlined in the table below (adopted from Rosenberg, 2002).

Table 2.6.2.1: Alternative determination of effective interest rates (IRR method)

Alternative	Description	Calculation
Base Case	Declining Balance	Interest charged only on amount of loan principal that is not yet paid.
1	Upfront interest payment	Same as Base Case except all interest is charged at the beginning of the loan.
2	Initial fee	Same as Base Case except that a loan commission is charged upfront.

3	Weekly payments	Same as Base Case except that four months' worth payments are paid in sixteen weekly installments.
4	Flat interest	Same as Base Case except that a flat interest is calculated on the entire loan amount rather on declining balances, and is then prorated over the four monthly period.
5	Flat with upfront interest payment	Same as Alternative 4 except that all the interest is paid upfront.
6	Flat with upfront interest payment and fee	Same as Alternative 5 but with additional commission collected upfront.
7	Compulsory savings	Same as Base Case except that as a condition to receiving the loan the borrower is required to make a savings deposit of 50 along with each month's payment[9]. The savings account yields interest of 1% per month, uncompounded, and is available to the client at any point at the end of the loan.
8	Flat with upfront interest payment and fee and compulsory savings	Same as Alternative 6 except that as a precondition to the loan the borrower is required to make a savings deposit along with each

[9] The alternative assumes that the MFI itself receives and holds the compulsory savings

		month's payment. The savings account yields minimal interest per month, uncompounded, and is available to the client at the end of the loan.

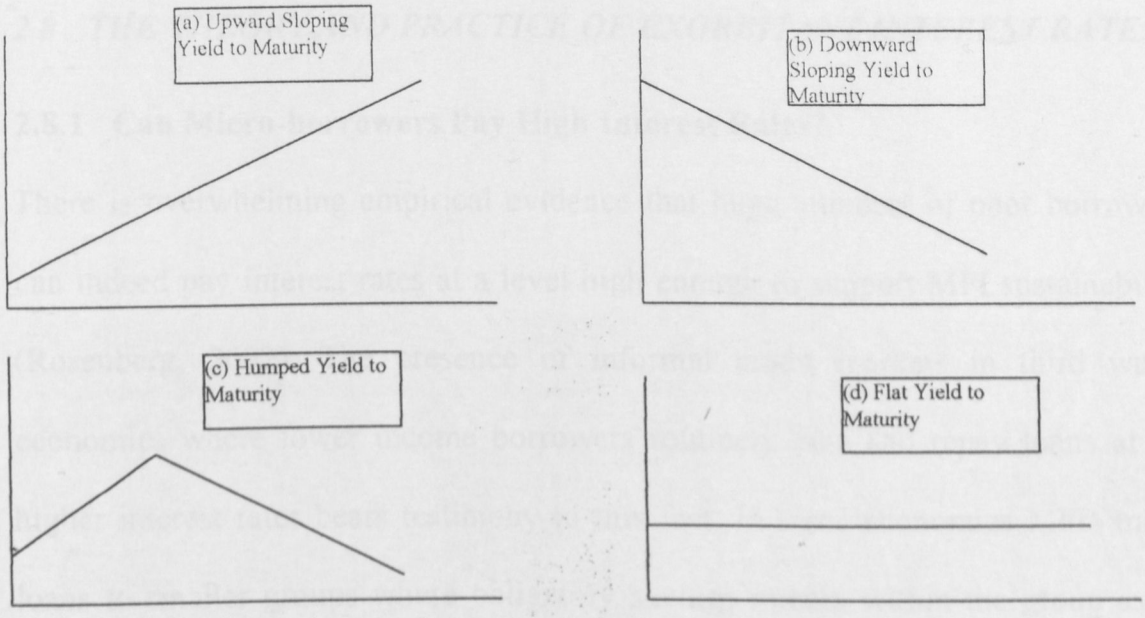
2.7 TERM STRUCTURE OF INTEREST RATES

All else being equal, the term structure of interest rates is the relationship at a specific time between yields on security and their maturities (Gardner, Mills & Cooperman 2000). The graphical depiction of the relationship between the yield on financial instruments of the same credit quality but different maturities assuming that all characteristics (default risk, coupon rate, etc.) are the same is known as the yield curve. The assumption that all other characteristics are the same is important in order to isolate the effect of maturity on yield (Ibid).

The yield curve has been known to take many forms as a function of different stages of the business cycle or the general level of economic activity (Gardner, Mills & Cooperman 2000). However, the four most common shapes are shown in Figure 1 below. In the first graph (a) yields rise steadily with maturity as is usually the case when interest rates are at low or moderate levels (Reilly & Brown 1997; Gardner and others, 2000)); In the second graph (b) yields decrease as maturity increases. This tends to prevail when interest rates are high (Ibid); In the third case (c) yields increase to a point and then start to decrease as maturity increases, giving a humped yield. In the fourth graph (d) the yield to maturity is not affected

by the term to maturity hence the flat yield curve, a situation that rarely occurs for any period (Ibid).

Figure 2.7: ***Common Shapes for Yield Curves on Treasury Securities***



Source: 'Fundamentals of Financial Institutions Management' by *Cornett & Saunders pp 40*

Market participants typically construct yield curves from observations of prices and yields in the treasury markets.

Although the historical patterns derived from the graphical depictions above provide clues about when to expect shifts in the term structure, they are no substitute for a theoretical understanding of the yield curve. These term structure theories include the unbiased (pure) expectations theory; the liquidity premium hypothesis; the modified expectations theory; the segmented markets theory and the preferred habitat theory all of which are useful for managers who make decisions involving assets and liabilities of different maturities such as mortgage

loan rate or trading securities for an institution's portfolio (Gardner, Mills & Cooperman, 2000) but go beyond the scope of this study.

2.8 THE THEORY AND PRACTICE OF EXORBITANT INTEREST RATES

2.8.1 Can Micro-borrowers Pay High Interest Rates?

There is overwhelming empirical evidence that huge numbers of poor borrowers can indeed pay interest rates at a level high enough to support MFI sustainability (Rosenberg, 2002). The presence of informal credit markets in third world economies where lower income borrowers routinely take and repay loans at far higher interest rates bears testimony to this fact. In some economies MFIs make loans to smaller groups where obligatory savings remain within the group as an internal account that the members can lend out to each other at their discretion. The members commonly charge substantially higher than would the MFI.

MFIs charging high interest almost invariably find that the demand far outstrips the supply and that they have many repeat clients. This suggests that the loans allow clients to earn more than the interest they have to pay (Ibid). Whereas this does not suggest that there is no limit to how much and MFI can charge it does indicate that the limit may be far higher than even the most aggressive of MFIs currently charge.

The economists' law of diminishing returns provides a more general explanation of this phenomenon (Ibid). Any economist has a wide variety of choices for capital investment, each with a different measure of return. Imagine that one has a dozen investment opportunities each requiring Kshs 1000 as capital and each with a different level of return. Further assume that to begin with there is no cash whatsoever. If they should suddenly come upon Kshs 1000 the first choice of investment will be the one with the highest return. The successive 1000 will go to the second best choice and so on until the last. Each time the investment will be less attractive than the one before it. This example though highly stylized illustrates the tendency for returns to diminish as each additional unit of capital is employed. Therefore while Company X cannot afford to pay as much for additional credit because it has already used up most of its best investment options the micro-entrepreneur can get much greater relative benefit from additional units of capital.

Another useful perspective is to look at interest costs in the context of overall income and expense where when interest payments make up a very small fraction of overall costs. What generally emerges from this kind of analysis is that for the poor entrepreneurs access to finance tends to be much more important than the cost of it.

2.8.2 Should Microfinance Institutions Charge High Interest Rates?

Now that we have established that many poor people CAN pay high interest rates, is this the green light for MFIs to charge exorbitant rates? What this boils down to is value judgments and the objective of the firm – profit or people. While many poor people can pay high interest rates it is also clear that some cannot and are thus excluded. The lower the interest rates therefore, the more poor people would have access to it. The onus is on the MFIs to find the balance.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

The research was a survey design and was carried out as follows: -

3.1 Research Setting

The research was conducted in Nairobi. Although money-lending has in the past been largely associated with rural areas, there are indications that it is also rampant in urban areas. Nairobi has a highly skewed distribution of income with the majority of its population living in conditions of extreme poverty. Therefore whereas similar studies have been carried out elsewhere, Nairobi is unique in its demand and supply conditions.

3.2 Population

The target population comprised of all the moneylenders in Nairobi. Although a preliminary census of this population would have been ideal for purposes of weighting, such a census was not carried out due to the fact that the trade is one that is unregulated and therefore most traders work undercover. General queries undertaken prior to the study indicated, however, that some of the moneylenders traded openly under the guise of pawn brokerage.

3.3 Sampling Plan

Given the somewhat secretive nature of lending operations of money lenders and considering that co-operation in this regard would not be readily available a

minimum sample of 30 Moneylenders was identified. This was done through convenience sampling as no known listing of moneylenders in Nairobi existed. In order to locate the respondents the researcher relied on leads given by people who had accessed credit from moneylenders as well as advertisements in the dailies.

3.4 Data Collection

Basic empirical evidence was collected from primary sources through field study using questionnaires as the data collection instrument. The questionnaire had both structured and unstructured questions. Part I of the questionnaire sought the personal information about the respondent which was used for classifications. Part II sought to establish sources of finance. Part III addressed the loan process, term structure of interest rates and determinants of interest rates (See appendix 2).

3.5 Data Analysis

Before processing the responses, the completed questionnaires were edited for completeness and consistency. Descriptive analysis by use of means, percentages and standard deviation was used to summarize the data. Pie charts, tables and graphs were used where appropriate to present the data collected.

Comparative analysis was used to identify differences in responses among various categories of respondents. Due to the fact that the sample size was small, utmost care was taken to assure the heuristic strength of the findings.

CHAPTER FOUR

4.0 ANALYSIS AND INTERPRETATION OF THE DATA

4.1 RESPONSE RATE

The respondents were identified through convenience sampling and the response rate recorded as follows:

Table 4.1: Response Rate

Distribution	Response	Percentage
30	22	73%

Source: Research data

Given the illegality of the trade in Kenya and the fact that the research coincided with the government's investigation of bogus micro financiers, the 73% response rate was encouraging. In addition to this, considering that the moneylenders sampled were only those within the researchers networking reach, the response rate is quite telling of the proliferation of the trade within the city of Nairobi.

4.2 DEMOGRAPHIC ANALYSIS

The demographic analysis in this case focused on the distribution of the moneylenders by gender and age, their educational and professional status and their monthly level of income. These were found to be as follows:

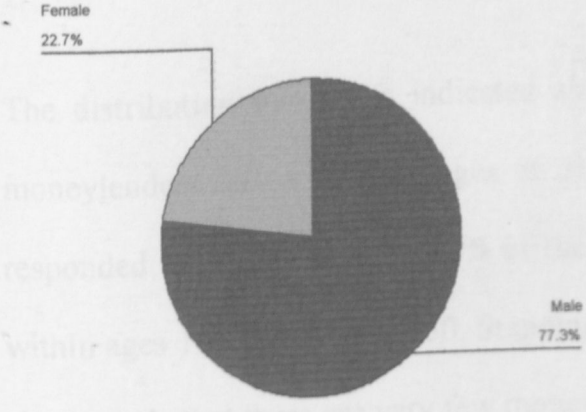
Table 4.2a: Distribution by Gender

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Male	17	77.3	77.3	77.3
	Female	5	22.7	22.7	100.0
	Total	22	100.0	100.0	

Source: Research data

77.3% of the respondents were male while only 22.7% were female. This disparity in distribution by gender is seen clearly in the pie chart depiction below:

Figure 4.2: ***Gender distribution of moneylenders***



Source: Research data

The gender distribution illustrated above is consistent with previous studies undertaken notably by Aleke Dondo (Malkamaki and others, 1991) who found in a study conducted in 5 districts that men dominated the trade (65%). However women seem to have ventured more into money lending in rural areas than have

done so in Nairobi. The hazardous nature of the trade may be explanation for this clear domination of the money lending trade by men.

Table 4.2b: Distribution by Age

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	31 - 40	9	40.9	45.0	45.0
	18 - 30	5	22.7	25.0	70.0
	41 - 50	5	22.7	25.0	95.0
	51 - 60	1	4.5	5.0	100.0
	Total	20	90.9	100.0	
Missing	System	2	9.1		
Total		22	100.0		

Source: Research data

The distribution by age as indicated above further reveals that the majority of moneylenders fall within the ages of 31 – 40 representing 40.9% of those who responded to this question. 45.4% of the moneylenders where distributed equally within ages 18 – 30 and 41 – 50. Standing at 4.5% of the respondents, the research also reveals that there are very few moneylenders aged above fifty.

Enquiry into the educational status of the money lenders revealed an interesting departure from what has been previously discovered about the skills levels of moneylenders. Moneylenders have been said to often have non-formal education and low skills levels. In a previous study on informal sector entrepreneurs done by Aleke Dondo (Malkamaki and others, 1991), it was found that most had attained primary level education.

Table 4.2c: Educational Status

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	University	10	45.5	47.6	47.6
	Secondary	6	27.3	28.6	76.2
	Tertiary	5	22.7	23.8	100.0
	Total	21	95.5	100.0	
Missing	System	1	4.5		
Total		22	100.0		

Source: Research data

The research findings as indicated in the table above show that 45.5% of the moneylenders interviewed had attained university level of education, 27.3% were secondary level, and 22.7% had tertiary training. The level of education evidenced here augurs well for the moneylender's understanding and possible reception of policy interventions in the future.

Table 4.2d: Distribution by Profession

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Business	6	27.3	30.0	30.0
	Accountant	4	18.2	20.0	50.0
	Banking	2	9.1	10.0	60.0
	Administration	2	9.1	10.0	70.0
	Secretary	1	4.5	5.0	75.0
	Librarian	1	4.5	5.0	80.0
	Accounts assistant	1	4.5	5.0	85.0
	Driver	1	4.5	5.0	90.0
	Management consultant	1	4.5	5.0	95.0
	Engineer	1	4.5	5.0	100.0
	Total	20	90.9	100.0	
Missing	System	2	9.1		
Total		22	100.0		

Source: Research data

The distribution by profession shows that 27.3% of the moneylenders are business people. This implies that their primary occupation is money lending. When further asked how long they had been in the business, 59% indicated a period of less than five years. This indicates that over the last five years the money lending trade has experienced significant growth as more entrepreneurs increasingly consider it a viable business venture. The remaining 63.6% of moneylenders are people in diverse professions many of which are related to finance (e.g. banking, accountancy and administration). These are people who possibly provide loans only as a source of supplementary income.

As indicated in the table below the average monthly income of 36.4% of the respondents is over Kshs100000 and only 18.2% earn below Kshs25000

Table 4.2e: Average Monthly Income

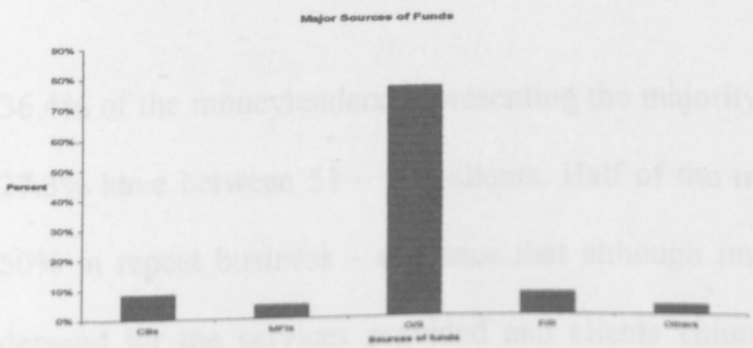
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Over 100,000	8	36.4	38.1	38.1
	25,000 - 50,000	6	27.3	28.6	66.7
	Below 25,000	4	18.2	19.0	85.7
	50,000 - 100,000	3	13.6	14.3	100.0
	Total	21	95.5	100.0	
Missing	System	1	4.5		
Total		22	100.0		

Source: Research data

Considering the fact that typically loan amounts range from an average of KSHS 7950 to KSHS 157500, the moneylenders are quite capable from their average

however, rely on commercial banks, MFIs, and friends or relatives for funding. These stand at 8.4%, 4.6% and 7.4% respectively. Interestingly, the indication is that more moneylenders rely on commercial banks than they do MFIs for funding. These are the moneylenders in employment who have bank accounts and can take advantage of commercial bank loans at lower interest rates than are charged by MFIs. One of the moneylenders obtains 100% of the businesses fund from the bank, a case that demonstrates perhaps the possibilities that exist for servicing small borrowers and savers by linking formal and informal financial markets. Apart from those listed, the other sources of funds mentioned were SACCOs and interest income from the business which arguably fall into the MFI and own savings categories respectively.

Figure 4.3: ***Major Sources of funds***



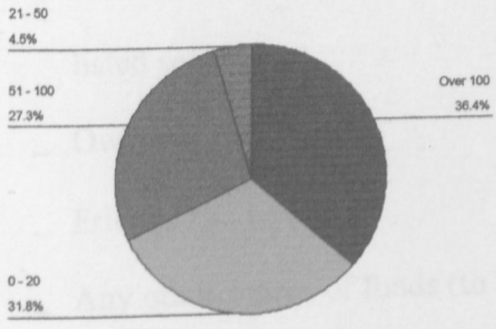
Source: Research data

4.4 DETERMINANTS AND TERM STRUCTURE OF INTEREST RATES

The main objective of this study was to determine the term structure of interest rates charged by moneylenders in Nairobi and to identify the determinants of those

interest rates. Preliminary questions posed to establish their mode of business, however, enquired on the moneylender's customer base and loyalty, their determination of credit-worthiness, requirement and amount of collateral demanded and finally whether they established the intended use of the loan. The findings were as follows:

Figure 4.4: ***Approximate customer base***



Source: Research data

36.4% of the moneylenders, representing the majority have over 100 clients while 27.3% have between 51 – 100 clients. Half of the respondents claim upwards of 50% in repeat business – evidence that although interest rates are high, there is demand for the services provided and clients voluntarily or involuntarily come back for more. The moneylenders establish credit-worthiness mainly by examining the credit history of these clients. Other means of determination include presentation, references, security, employment, the pay slip, asset base, bank statements and valid identification.

monthly income to fund their businesses. There was no indication of a scarcity of loanable funds.

4.3 SOURCES OF FUNDS

The research sought to find out what were the principle sources of funds for the moneylenders interviewed. These sources of funds were categorized as:

- Formal financial institutions (Commercial banks and MFI institutions were listed separately)
- Own savings
- Friends and relatives
- Any other source of funds (to be specified)

The findings were as follows:

Table 4.3: Major Sources of Funds

	Frequency	Percent	Valid Percent	Cumulative Percent
Commercial Banks	4	8.4	8.4	8.4
MFIs (e.g. K-rep)	3	4.6	4.6	13
Own Savings	21	76.3	76.3	89.3
Friends/Relatives	4	7.4	7.4	96.7
Others	3	3.3	3.3	100
Total		100	100	

Source: Research data

The data collected reveals, as had been inferred earlier, that most of the moneylenders (76.3%) use their own savings for the business. A small minority

About 77% of the moneylenders interviewed indicated that they demand for collateral for purposes of security. Some however indicated that they only demanded collateral items for what they considered larger loan amounts. Those who do not ask for any security are mainly moneylenders in employment who lend to business colleagues on the basis of mutual trust and understanding. The following table shows the minimum and maximum values of collateral items demanded for different loan amounts and the number of respondents who indicated numerically what they demand as collateral for the specific loan amounts. (see appendix 3 for details)

Table 4.4: Collateral demanded

	N	Minimum	Maximum	Mean	Std. Deviation
Loan amount up to 10,000	7	2000	30000	18857.14	10123.052
Loan amnt 10,001 - 20,000	4	20000	60000	38750.00	17500.000
Loan amnt 20,001 - 30,000	2	50000	75000	62500.00	17677.670
Loan amnt 30,001 - 40,000	2	60000	105000	82500.00	31819.805
Loan amnt 40,001 - 50,000	2	80000	135000	107500.00	38890.873
Loan amnt over 50,000	2	100000	200000	150000.00	70710.678

Source: Research data

The large standard deviations of minimum and maximum values of collateral items demanded for the various loan amounts though largely due to the fact that only a few of the moneylenders indicated a numerical value to the collateral item, may also be indicative of the non-homogenous nature of services offered by

moneylenders. What was revealed however is that after establishing that the item is not defective, a market value is attached to it that is usually significantly below its purchase price. This is the reason why incredibly, for a loan amount less than KSHS 10000 one of the moneylenders asks for a laptop while another for a vehicle. Typically, however, the money lenders demand for collateral valued at between 2 – 3 times the amounts loaned. They then enter into an informal contract with the clients to sell the item without further consultation as penalty for delayed or non payment.

The arguments leveled against imposing interest rate ceilings on MFIs postulate that they bear the greater delivery cost of tiny transactions. This is because in many cases they use personal contact in the place of formal collateral. In addition to this, while the cost of capital and the loan loss risk vary proportionately with the loan size, administration costs do not. Hence MFIs bear the same costs of screening, processing of loans, collection of payments etc as commercial banks do but for the numerous smaller loans that they give. However, given that most moneylenders demand for collateral as security for the loans provided as evidenced above, the dynamics of the loaning processes they undertake are significantly altered. Costs of identification or screening, disbursement and follow-up on non-payment are virtually non existent.

Asked whether they established the intended purpose of the loan, the moneylender's responses were distributed equally with 36.4% responding "yes,

always", 36.4% "no, never" and 27.3% saying "sometimes". This again is consistent with the fact that having secured a collateral item of value greater than the loan amount absents the need to inquire about the intended purpose of the loan. Conversely, because the clients stand to loose greatly if the item is sold, 68.2% of the respondents indicated that over 75% of their clients paid within the stipulated period. They also indicated that between 6 – 20% of them paid later than the stipulated period while only 0 – 5% of their clients did not pay at all indicating that the default rate is very low.

This brings sharply into focus the fact that owing to the observed differences amongst the various micro financial delivery organizations efforts at policy intervention must take into account these differences and adopt them accordingly.

4.4.1 Determinants of Interest Rates.

Drawing from the conventional methods of determination of interest rates among Micro financial institutions, the respondents were asked to indicate the factors they considered when determining the interest rates charged. Listed among the factors were Administrative expenses (such as salaries, rent, utilities etc.), Loan loss rate (from uncollectible loans), Cost of funds (such as those from commercial sources), Rate of inflation and Investment income from other financial assets. They were also asked to specify any other factor not listed.

These factors were then graded as "extremely important" (5), "important" (4), "somehow important" (3), "not important" (2), and "not important at all" (1). The following table represents a summary of the responses received:

Table 4.4.1a: Summary of responses

		Importance level						Total
Factor in interest rate determination		Not important at all	Not important	Somehow important	Important	Extremely important	Not specified	
Administrative expenses	Count	6	0	2	8	4	2	22
	Expressed as % of total	27.3%	.0%	9.1%	36.4%	18.2%	9.1%	100.0%
Loan loss rate	Count	3	3	2	8	4	2	22
	Expressed as % of total	13.6%	13.6%	9.1%	36.4%	18.2%	9.1%	100.0%
Cost of funds	Count	6	3	0	2	7	4	22
	Expressed as % of total	27.3%	13.6%	.0%	9.1%	31.8%	18.2%	100.0%
Rate of inflation	Count	6	2	4	2	4	4	22
	Expressed as % of total	27.3%	9.1%	18.2%	9.1%	18.2%	18.2%	100.0%
Investment income from other sources	Count	6	2	1	4	4	5	22
	Expressed as % of total	27.3%	9.1%	4.5%	18.2%	18.2%	22.7%	100.0%
Other	Count	2	0	0	1	1	18	22
	Expressed as % of total	9.1%	.0%	.0%	4.5%	4.5%	81.8%	100.0%
Total	Count	29	10	9	25	24	35	132
	Expressed as % of total	22.0%	7.6%	6.8%	18.9%	18.2%	26.5%	100.0%

Source: Research data

To analyze the data, the total sum of values attached by the respondents (i.e. 22) to each of the factors was obtained and then expressed as a percentage of the total sum of values attached to all factors as indicated in the table below:

Table 4.4.1b: Determinants of interest rates charged

Factor in interest rate determination	N	Sum	Mean	Std. Deviation	% of Total Sum
Administrative expenses	22	64	2.91	1.770	22.5%
Loan loss rate	22	67	3.05	1.647	23.5%
Cost of funds	21	55	2.62	2.012	19.3%
Rate of inflation	22	50	2.27	1.804	17.5%
Investment income from other sources	22	49	2.23	1.926	17.2%
Total	109	285	2.61	1.830	100.0%

Source: Research data

Out of the five factors outlined, the loan loss rate at 23.5% was ranked highest amongst factors considered in determination of interest rates. Administrative expense at 22.5% is ranked second. The Cost of funds and rate of inflation follow in order of importance at 19.3% and 17.5% respectively. Investment income from other sources is the least important in the determination of interest rates.

On a scale of 1-5 the mean score for each factor as a determinant of interest rates ranges between 3.05 for loan loss rate and 2.23 for investment income. This indicates that when all the respondents are taken into account, none of the factors is considered as being extremely significant in the determination of interest rates. On the contrary they range from being "somehow important" to "not important". This is consistent with the generally held belief that moneylenders set interest

rates in an ad hoc manner. The standard deviations of responses on all the factors may be rounded off to 2 implying that the moneylenders are not very diverse in their estimation of the factors' importance in determination of interest.

4.4.2 The Term Structure of Interest Rates

The term structure of interest rates measures the relationship between yields and maturities, all else being equal. In determining the term structure of interest rates charged by the money lenders in Nairobi, it is assumed that the extraneous factors are to some extent controlled due to the similarity of geographical location. However it is not possible within the scope of this study to ascertain this.

The respondents were asked to indicate the interest rates charged for different loan terms ranging from less than 1 week to over twelve months. Out of a total of 57 indications of interest rates charged, 34 fell within the periods less than three months. This indicates that the majority of moneylenders typically lend on short-term basis rarely exceeding the 3 months loan term. Owing to the fact that few respondents indicated interest rates charged for periods greater than three months, the statistics may not be conclusive beyond the 3-month mark.

To aid analysis all of the responses were tabulated (see appendix 3 for details), the means and standard deviations of the various interest rates charged by the respondents for each loan term was then obtained. A summary of the findings is depicted below:

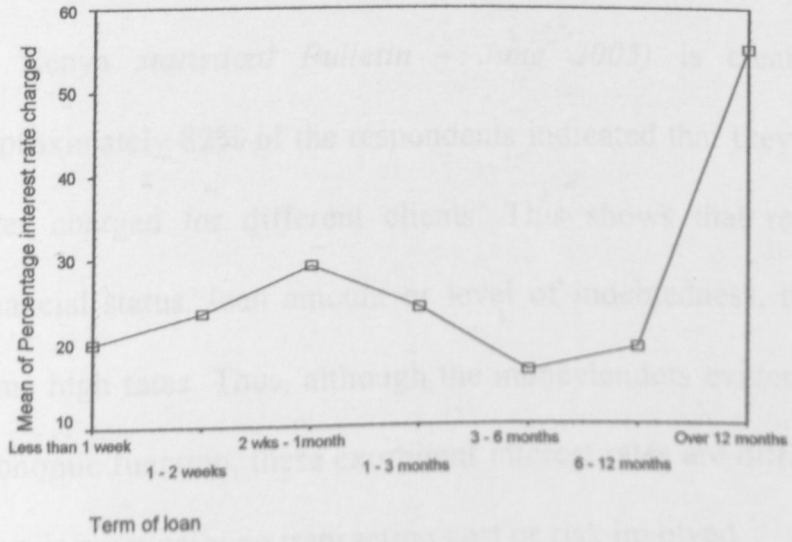
Table 4.4.2: Term structure of interest rates charged

Term of loan	Mean	N	Std. Deviation
Less than 1 week	20.07	14	10.781
1 - 2 weeks	23.50	10	16.168
2 wks - 1month	29.17	12	16.629
1 - 3 months	24.00	12	16.270
3 - 6 months	16.50	4	3.109
6 - 12 months	19.33	3	1.155
Over 12 months	55.00	2	49.497
Total	24.35	57	16.390

Source: Research data

The relationship between the interest rates and the loan terms are depicted graphically as follows:

Figure 4.4.2: ***Yield curve on moneylender's loans***



Source: Research data

The curve slopes upwards until the 1 month mark and then slopes downwards to the 3 month mark and beyond, giving what is known as a humped yield to maturity. This is a shape often seen when the shorter and longer-term yields are

very close to each other. Historically, when the general level of interest rates has been relatively high, term structures have tended to slope downwards. Alternatively they have sloped upwards when the general level of interest rates has been relatively low (Gardner and others, 2000). It is also seen when the market expects that interests will first rise during a period and fall during another. In this case the similarity in interest rates charged for terms between one week and three months is probably the reason for the humped curve.

The mean percentage interest rates charged by money lenders range from 20% to 55%. This compared with the highest lending interest rate (per cent) amongst formal financial institutions charged by building societies at 18.75 (Central Bank of Kenya *statistical Bulletin – June 2005)* is clearly staggering. Notably approximately 82% of the respondents indicated that they did not vary the interest rates charged for different clients. This shows that regardless of the client's financial status, loan amount or level of indebtedness, they are subjected to the same high rates. Thus, although the moneylenders evidently perform a legitimate economic function, these exorbitant interest rates are difficult to justify given that there is practically no transaction cost or risk involved.

CHAPTER FIVE

5.0 SUMMARY AND CONCLUSIONS, LIMITATIONS, RECOMMENDATIONS AND SUGGESTIONS FOR FURTHER RESEARCH

5.1 SUMMARY AND CONCLUSIONS

5.1.1 Summary of findings

Money lending previously thought to be concentrated in rural areas is increasingly becoming an urban phenomenon. The research findings indicate that moneylenders in Nairobi are mainly male (77.3%) and that the majority of them have attained University level of education, meaning that they are now more skilled than had been previously held. A good number (approximately 30%) have money lending as their main source of livelihoods. With incomes upwards of KSHS 100000, the moneylenders are able to rely mostly on their own savings for the business.

The traditionally known benefits of moneylenders to loan seekers are observed in the fact that most of them are not concerned about the intended use of the loan, depend mainly on one's credit history and collateral item to determine credit-worthiness and dispense the loan within a maximum of two weeks (and this only when the collateral item is a title deed) but in most cases immediately.

82% of the moneylenders demand for a collateral item typically 2 – 3 times the value of the loan amount. There is therefore practically no risk involved as they

enter into a contract with the client that allows them to sell the item at any point beyond the stipulated period of repayment without further notice. Further, 54.5% of the moneylenders indicate that only between 0 – 5% of their clients fail to pay completely. Despite this implied low loan loss risk, the loan loss rate is ranked as the most important factor in their determination of interest rates. It is instructive to note however that its mean score of 3.05 means that though the loan loss rate is the highest ranked of all the factors it is not an extremely important factor in the determination of interest.

The term structure of interest rates generates a humped yield curve typical of periods when general rates of interest are high and when the interest rates charged for short and long-term loans are close. However due to the fact that very few moneylenders lend for longer than 3 months, the research findings on yields generated beyond this period are not conclusive. The interest rates charged for different loan terms ranging from a mean of 20% for loans whose terms are less than a week to one of 55% for loans of over 12 months term, are extremely high in comparison with rates charged by formal financial institutions. They also indicate that there is a direct relationship between interest rates charged and length of loan term.

5.1.2 Conclusions

It could be for a new tool, a machine or a shop in the market place – small loans have been known to improve poor people's lives. While it is clear that micro

financial services can be an effective and powerful instrument for poverty reduction by enhancing the ability of poor people to increase incomes, build assets and reduce their vulnerability in times of economic stress, there still remains an estimated untapped market of nearly a billion poor people.[10]

Closer to home, the Minister for Finance, addressing a gathering of officials from savings banks at the opening of the 11th World Savings Bank Institute Africa group meeting in Mombasa[11], said it was easier for a camel to get through the eye of a needle than a low-income earner to get a loan from a multinational bank. He was appealing to the savings banks to fill the gap that the withdrawal of multinational banks from rural areas as a cost-cutting measure had left on low-income earners access to credit.

Whereas Microfinance programs were created to provide financial outreach to clients who were not being served by the commercial banking sector, their screening processes still manage to sieve out those referred to as the 'hardcore poor'. This demonstrates that the poor are not a homogenous group. One may even venture so far as to say that there are people in salaried jobs who contrary to appearances, fit the description of poverty because they own no agricultural land and as a result of falling into the debt trap, survive in a situation of endemic insecurity often leading to eviction.

[10] CGAP III strategy 2003 – 2008
[11] The *'The Standard'* Tuesday, June 28th 2005

Although demand for the informal financial services provided by moneylenders is evident among the urban poor and people in employment alike, demonstrating their capacity to fill the gap alluded to earlier, discussion on informal money lending as a significant form of micro finance has been shrouded in mystery and suspicion. It would seem that moneylenders are a lot that policy makers would much rather like to sweep under the carpet.

Considered "friend" when they lend much needed money without too many questions, but "foe" when they come to collect, the interest rates charged by moneylenders remain the main hiccup in their discharge of financial services. Significantly higher than those charged by other financial service providers, these interest rates seem to be determined on an ad hoc basis, as the moneylenders do not attach much importance to any of the factors conventionally used to determine MFI interest rates. In addition to this, decisions concerning interest rates charged and collateral items demanded etc. are made with little reference to others in the market indicating that moneylenders are not a homogenous group and enjoy monopoly profits. In spite of this they enjoy a significant amount of customer loyalty and risk attached to the trade is low owing to the fact that collateral is provided in most cases and evidence suggests that the default rate is low.

Unfortunately, short of being defined as one of the categories of microfinance suppliers whose numbers are often described in such general terms as "numerous" or "significant", policy literature is largely silent on the role that informal financial

service providers like moneylenders and pawn brokers might be able to play in lifting the poor out of poverty.

5.2 LIMITATIONS OF THE STUDY

As mentioned earlier information specifically on the money lending trade is very scarce even within publications on microfinance. This made the compilation of the literature review quite challenging. The handful of authors who have broached the subject are therefore widely cited in the paper.

There is widespread suspicion among the traders due the illegality of the trade. Many of them simply declined to be interviewed as a result. The research was also carried out at a time when the government was cracking down on bogus microfinance institutions which made data collection difficult. To that extent the study has been denied the extra data that would have further enriched the findings.

While it would have been useful, for the purposes of weighting, to have an indication of the total population of moneylenders in Nairobi, it was not possible because no known listing exists. The convenience sampling method used may have also served to further skew the research findings. However, although the research is thus limited to the researcher's networking reach, the links to the respondents were drawn from varied sources (friends, work colleagues, relatives, church members, newspaper advertisements etc) thus validating the findings.

In the determination of the term structure of interest rates the extraneous factors are assumed to be controlled by the fact that the moneylenders are located within the same geographical area and are therefore likely to be subjected to similar trade conditions. This can however not be ascertained within the scope of the study. In addition to this, the fact that most lenders lend in the short term (between 1-3 months) means that the findings beyond this period are not conclusive.

5.3 RECOMMENDATIONS

It is crucial that policy makers recognize the vast differences between poor people and realize that very different delivery organizations with varied but complimentary objectives will be needed to serve them all. Failure to do so results in the current scenario where informal financial service providers who might be able to provide alternative financial services, are instead reduced to instruments of quick fixes for shortages in rent, fees, debt repayment and so on, thereby deepening the vicious cycle of debt and driving people ***to*** rather than ***away*** from poverty. In view of the above the following recommendations are reiterated:

Firstly, in order to reach its full potential, the informal financial industry must be able to enter the arena of licensed, regulated and supervised financial intermediation. Having in this way the "permission to lend" will inject a measure of security and perhaps motivate entrepreneurs to invest more in the trade. It would also have the effect of increasing the amount of competition in the market and hopefully drive interest rates down. Once regulated, policy makers could

explore ways in which small borrowers and savers can be serviced by linking the formal and informal financial sector.

Secondly, regulation of this "permission to lend" should be relatively simple in order to avoid excessive supervisory costs. This may entail some form of registration and permit issuance with clauses that enable government action in case of abuse. To protect consumer interests and avoid the over-indebtedness that has been alluded to previously there should be minimum guidelines on examination of the borrower's repayment capacity and acceptable loan collection techniques.

Thirdly, whereas the imposition of interest rate limits on formal microfinance institutions have been discouraged owing to the greater delivery costs of tiny transactions *vis-à-vis* their cost of funds, loan loss rate and administrative costs, the research findings indicate that the money lending industry is suitably immune from these transaction costs and hence may benefit from interest rate caps.

Finally, before regulators can decide on the timing and design of these regulations there should be a more concerted effort to understand the market penetration, growth and performance of informal financial service providers in order to assess how their financial system works, the lessons that can be learned from them, the gaps within the system and to determine what can be done to facilitate them so as

to best meet the needs of those being served. This means that there should be an injection of support for extensive research on the subject.

5.4 *SUGGESTIONS FOR FURTHER RESEARCH*

Money lending is a very scarcely researched subject and therefore immense opportunity exists for further inquiry. This study has focused on the supply side of informal money lending and therefore possibilities for further research exist in the consideration of the demand side of informal finance. This includes but is not restricted to inquiry into the size of this informal market and the amount of money circulating within it. This would make for interesting information especially to the exchequer.

Specifically from the borrower's point of view, research could be undertaken to uncover what is considered in the choice of moneylender and whether they are interest sensitive; one may also wish to find out their reasons for preference of moneylenders over formal sources, maximum loan amounts from informal sources and specific purposes for such loans.

Further research should be carried out to examine in greater detail the sources of funding for moneylenders and whether there are enough loanable funds to meet the demand. In addition to this the range of services offered by the moneylenders should be examined to establish the possibilities that exist for the extension of

their services beyond just lending. This may be done using an expanded sample size.

Based on these exploratory findings, future research may also be undertaken to test the hypothesis that moneylenders ***do*** set interest rates on an ad hoc basis. In this way it would be possible to determine whether there are indeed some transaction costs incurred by the moneylenders that justify the rates that they charge.

It would also be instructive to explore further the loan processes involved in money lending: that is the contracts entered into, the similarities and differences from one moneylender to another, the screening problems if any and the collection methods. This would be especially useful amongst those moneylenders who do not demand for collateral.

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APPENDIX 1: Letter of introduction to the respondents

UNIVERSITY OF NAIROBI

FACULTY OF COMMERCE

MBA PROGRAM – LOWER KABETE CAMPUS

Telephone. 732160 Ext. 208
Telegrams: "Varsity", Nairobi
Telex: 22095 Varsity

P.O. Box 30197
Nairobi, Kenya

DATE 14/09/05

TO WHOM IT MAY CONCERN

The bearer of this letter CAROLINE A. OKIRO

Registration No: D/61/P/7970/00

is a Master of Business Administration (MBA) student of the University of Nairobi.

~~He~~/she is required to submit as part of ~~his~~/her coursework assessment a research project report on some management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate if you assist ~~him~~/her by allowing ~~him~~/her to collect data in your organization for the research.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

JACKSON MAALU
CO-ORDINATOR, MBA PROGRAM

APPENDIX 2: A sample of the questionnaire sent to respondents

QUESTIONNAIRE

PART I

Please indicate the following (Tick ☑ as appropriate)

1. Gender
   - Male ☐ 1
   - Female ☐ 2
2. Age
   - Under 18 ☐ 1
   - 18 – 30 ☐ 2
   - 31 – 40 ☐ 3
   - 41 – 50 ☐ 4
   - 51 – 60 ☐ 5
   - Above 60 ☐ 6
3. Marital Status
   - Married ☐ 1
   - Single ☐ 2
   - Divorced ☐ 3
   - Widow/Widower ☐ 4
   - Separated ☐ 5
   - Other (specify) ☐ 6
4. Household size _____
5. Educational status
   - University ☐ 1
   - Tertiary ☐ 2
   - Secondary ☐ 3
   - Primary ☐ 4
   - Literate ☐ 5
   - Other (specify) ☐ 6
6. Profession _____
7. Please indicate average level of income per month (in Kenya shillings)
   - Over 100,000 ☐ 1
   - 50,000 – 100,000 ☐ 2
   - 25,000 – 50,000 ☐ 3
   - Below 25,000 ☐ 4

APPENDIX 2: A sample of the questionnaire sent to respondents

PART II

8. Please indicate your sources of finance for the business.

Source	%
A. Formal Financial Institutions	
a. Commercial Banks (e.g. Barclays)	_____
b. MFI Institution (e.g. K-rep)	_____
B. Own Savings	_____
C. Friends/relatives	_____
D. Others (specify)	_____

PART III

9. What is the approximate size of your customer base?

0 – 20	☐	1
21 – 50	☐	2
51 – 100	☐	3
Over 100	☐	4

10. How do you establish credit-worthiness of a customer?

_____

_____

_____

_____

11. How many of your customers have come to you more than once?

_____

12. Please indicate the collateral that you demand if any.

Loan Amount (in Kshs)	Value of collateral	Collateral item
Up to 10,000	_____	_____
10,001 – 20,000	_____	_____
20,001 – 30,000	_____	_____
30,001 – 40,000	_____	_____
40,001 – 50,000	_____	_____
Over 50,000	_____	_____

APPENDIX 2: A sample of the questionnaire sent to respondents

13. Please state your reasons for demanding collateral.

_____

_____

_____

14. Do you establish the intended purpose of obtaining the loan? E.g. School fees, Rent etc.

Yes (always)	☐	1
Usually	☐	2
Sometimes	☐	3
No (never)	☐	4

15. How much do you lend?

Minimum _____

Maximum _____

Average _____

16. Please indicate the following.

Term of Loan	Maximum Loan Amount	Regularity of Payment	Interest Rate Charged
Less than 1 week	_____	_____	_____
1 week – 2 weeks	_____	_____	_____
2weeks – 1 month	_____	_____	_____
1 month – 3 months	_____	_____	_____
3 months – 6 months	_____	_____	_____
6 months – 12 months	_____	_____	_____
Over 12 months	_____	_____	_____

17. Which of the following factors, if any, do you consider when determining the interest rates charged?

Administrative expenses e.g. salaries, rent, utilities etc.	☐
Loan loss rate (uncollectible loans)	☐
Cost of funds e.g. from commercial sources	☐
Rate of inflation	☐
Investment income from other financial assets	☐
Other (please specify) _____	☐

APPENDIX 2: A sample of the questionnaire sent to respondents

18. Please indicate the extent to which each factor is important in your determination of interest rate:

    1 – Not important at all

    2 – Not important

    3 – Somehow important

    4 – Important

    5 – Extremely important

	1	2	3	4	5
Administrative expenses e.g. salaries, rent, utilities etc.	☐	☐	☐	☐	☐
Loan loss rate (uncollectible loans)	☐	☐	☐	☐	☐
Cost of funds e.g. from commercial sources	☐	☐	☐	☐	☐
Rate of inflation	☐	☐	☐	☐	☐
Investment income from other financial assets	☐	☐	☐	☐	☐
Other (please specify) _____	☐	☐	☐	☐	☐

19. Do you charge different interest rates to different clients for the same loan product?

    Yes ☐ 1

    No ☐ 2

20. If yes, how do you determine what interest rate to charge?

    _____

    _____

21. How long is the period between applying for a loan and receiving it (specify)

Days	1	Number	_____
Weeks	2	Number	_____
Months	3	Number	_____

22. What proportion of your customers pay **WITHIN** the stipulated period?

0 – 5%	☐	1
6 – 10%	☐	2
11 – 15%	☐	3
16 – 20%	☐	4
Over 20%	☐	5

APPENDIX 2: A sample of the questionnaire sent to respondents

23. What proportion of your customers pays **LATER** than the stipulated date?

0 – 5%	☐	1
6 – 10%	☐	2
11 – 15%	☐	3
16 – 20%	☐	4
Over 20%	☐	5

24. What proportion of your customers does not pay at all?

0 – 5%	☐	1
6 – 10%	☐	2
11 – 15%	☐	3
16 – 20%	☐	4
Over 20%	☐	5

25. What reasons do your customers give for non-payment?

Unexpected Emergencies	☐	1
Business failure	☐	2
Loss of employment	☐	3
Other (please specify)	☐	4

_____

_____

_____

26. Please indicate the penalty you charge for delayed payment?

_____

_____

_____

27. How long have you been in this line of business?

0 – 5 years	☐	1
6 – 10 years	☐	2
11 – 15 years	☐	3
16 – 20 years	☐	4
Over 20 years	☐	5

APPENDIX 3: A summary of findings (coded data)

Demographic Analysis						
RESP	GENDER	AGE	M/STAT	ED/STAT	PROF	AI
1	2	2	2	3	1	3
2	2	4	3	3	1	1
3	1	3	1	3	1	1
4	1	2	1	9	1	2
5	1	3	1	1	1	1
6	1	4	1	1	2	1
7	2	9	1	2	3	3
8	1	2	1	1	4	1
9	1	3	1	1	4	1
10	2	5	1	1	5	1
11	1	4	1	2	6	3
12	1	4	1	3	2	4
13	1	3	1	3	7	3
14	1	3	1	2	2	4
15	1	2	1	2	2	4
16	1	2	1	2	2	4
17	1	2	2	1	8	1
18	1	4	1	1	9	9
19	1	3	1	1	6	2
20	1	3	1	1	2	3
21	2	3	1	3	1	4
22	1	9	1	1	9	2

Note: **No response – 9**

Sources of Finance in percentages (%)						
RESP	CBs	MFIs	O/S	F/R	OTHERS	TOTAL
1	0	0	100	0	0	100
2	0	0	100	0	0	100
3	0	0	80	0	0	80
4	0	0	70	0	0	70
5	0	0	100	0	0	100
6	100	0	0	0	0	100
7	0	0	100	0	0	100
8	20	30	50	0	0	100
9	10	10	50	0	30	100
10	0	0	100	0	0	100
11	0	0	100	0	0	100
12	0	0	100	0	0	100
13	0	0	100	0	0	100
14	0	0	100	0	0	100
15	0	0	50	20	30	100
16	0	60	40	0	0	100
17	0	0	20	80	0	100
18	0	0	100	0	0	100
19	50	0	50	0	0	100
20	0	0	80	10	10	100
21	0	0	100	0	0	100
22	0	0	50	50	0	100
Total	**180**	**100**	**1640**	**160**	**70**	**2150**
% of Total	**8.4**	**4.6**	**76.3**	**7.4**	**3.3**	**100**

APPENDIX 3: A summary of findings (coded data)

RESP.	C/BASE	EST. ILP	MIN/LA	MAX/LA	AV/LA
1	3	4	500.00	5000.00	1000.00
2	4	4	2000.00	50000.00	5000.00
3	4	3	1000.00	10000.00	2000.00
4	3	3	1000.00	10000.00	2000.00
5	4	4	500.00	10000.00	2000.00
6	1	1	9	100000.00	9
7	1	1	1000.00	50000.00	10000.00
8	4	1	5000.00	200000.00	20000.00
9	4	3	100000.00	1000000.00	150000.00
10	2	4	5000.00	15000.00	10000.00
11	1	3	500.00	400000.00	30000.00
12	4	4	500.00	50000.00	2000.00
13	3	4	9	20000.00	10000.00
14	1	1	2000.00	10000.00	6000.00
15	1	4	1000.00	10000.00	2000.00
16	3	1	5000.00	50000.00	30000.00
17	4	1	5000.00	300000.00	20000.00
18	4	4	1000.00	500000.00	20000.00
19	1	1	5000.00	60000.00	20000.00
20	1	1	10000.00	9	20000.00
21	3	3	3000.00	9	9
22	3	3	10000.00	300000.00	100000.00
Mean	**3**	**3**	**7950.00**	**157500.00**	**23100.00**

	Term Structure of Interest Rates in percentages (%)				
RESP.	<1WEEK	1 - 2 WKS	2WKS - 1 MNT	1 - 3MNT	3 - 6MNT
1	30	9	50	9	9
2	30	50	9	60	9
3	30	9	50	9	9
4	30	9	60	9	9
5	30	50	9	50	9
6	20	9	9	9	9
7	20	20	20	9	9
8	5	10	20	20	9
9	9	9	9	10	9
10	9	9	9	10	9
11	9	9	9	5 – 20	9
12	10	20	30	9	9
13	20	30	30	9	9
14	1	5	10	20	20
15	20	20	20	20	9
16	9	9	9	18	18
17	5	5	5	10	13
18	30	9	9	30	9
19	9	9	9	9	15
20	9	25	25	9	9
21	9	9	9	30	9
22	9	9	30	9	9
Mean	**20.07**	**23.50**	**29.17**	**25.27**	**16.50**
Std dev	**10.781**	**16.168**	**16.629**	**16.426**	**3.109**

Note: No response – 9

APPENDIX 3: A summary of findings (coded data)

Term Structure of Interest Rates in percentages (%)			Determinants of Interest Rates Charged		
RESP.	6 - 12 MNT	>12MNT	AE	LL	CF
1	9	9	4	2	5
2	9	9	1	4	1
3	9	9	4	1	4
4	9	9	4	4	2
5	9	9	1	2	2
6	9	9	0	0	1
7	9	9	1	4	5
8	9	9	4	4	5
9	9	9	5	5	5
10	9	9	1	1	1
11	9	9	1	4	0
12	9	9	3	1	0
13	9	9	5	4	1
14	20	90	4	3	4
15	9	9	1	3	1
16	18	9	4	2	5
17	20	20	3	5	5
18	9	9	0	0	0
19	9	9	4	5	0
20	9	9	5	5	5
21	9	9	4	4	2
22	9	9	5	2	5
Mean	**19.33**	**55.00**	**2.91**	**3.05**	**2.50**
Std dev	**1.155**	**49.497**	**1.770**	**1.647**	**2.04**

Determinants of Interest Rates Charged					
RESP.	RI	II	OTHER	DIRC	LPP
1	3	4	0	2	1 day
2	1	1	0	2	1 day
3	1	2	0	2	1 day
4	2	9	1	2	1 day
5	2	2	0	2	1 day
6	0	0	0	2	2 days
7	3	5	0	2	5 days
8	3	4	0	1	1 - 5 days
9	5	5	5	1	1 day
10	5	1	0	2	2 days
11	0	0	5	1	1 day
12	0	0	0	2	1 day
13	1	1	0	2	1 week
14	5	5	4	2	2 days
15	1	4	1	2	1 day
16	3	4	0	2	1 wk
17	4	1	0	2	1 - 2 wks
18	0	0	0	1	1 day
19	5	4	0	2	1 - 2 days
20	4	5	0	2	1 day - 2 wks
21	1	1	0	2	1 day
22	3	3	0	2	1 day
Mean	**2.27**	**2.23**		**2**	
Std dev	**1.804**	**1.926**			

APPENDIX 3: A summary of findings (coded data)

RESP.	PCPWSP	PCPLSP	PCNP	PLB	CREDIT WORTHINESS	RPT CLNTS (%)
1	5	5	4	1	Security	20
2	5	2	4	2	Security	60
3	5	4	2	1	Security	70
4	5	3	2	1	Security	50
5	5	2	1	1	Presentation	60
6	5	1	1	1	Payslip/security	50
7	3	4	1	2	Employment	50
8	5	2	1	1	Credit history	90
9	5	4	2	2	Credit history	40
10	5	1	1	1	Salary/security	20
11	5	5	3	1	Personal evaluation	100
12	5	3	2	2	N/A	most
13	3	5	1	2	Identification	25
14	5	2	1	2	Reference	25
15	5	4	1	1	Reference	80
16	5	3	1	2	Credit history	15
17	1	5	1	1	Credit history	100
18	3	2	5	4	N/A	9
19	4	5	1	2	Personal evaluation	50
20	5	2	1	1	Employment	100
21	3	4	2	1	N/A	45
22	3	2	5	1	Payslip/security	many
Mean	**4**	**3**	**2**			**55**

	Collateral demanded					
RESP.	Up to 10000	10001-20000	20001-30000	30001-40000	40001-50000	0ver 50000
1	2000/30%	9	9	9	9	9
2	30000/mobile phone	60000/electronics	9	9	9	200000/vehicle
3	20000/mobile phone	9	9	9	9	9
4	20000/electronics	9	9	9	9	9
5	mobile phone	9	9	9	9	9
6	9	9	title deed	radio	9	9
7	N/A	N/A	N/A	N/A	N/A	N/A
8	20000/payslip	30000/shares	50000/lease transfer	60000/logbook	80000/logbook	100000/logbook
9	140%/motor vehicle	140%	140%	140%	140%	140%
10	10000/tv	20000/fridge	9	9	9	9
11	N/A	N/A	N/A	N/A	N/A	N/A
12	20000	9	9	9	9	9
13	30000	45000	75000	105000	135000	150000
14	N/A	N/A	N/A	N/A	N/A	N/A
15	contract	N/A	N/A	N/A	N/A	N/A
16	tv/radio	fridge	logbook/title deed	logbook/title deed	logbook/title deed	logbook/title deed
17	N/A	N/A	N/A	N/A	N/A	logbook/PDQ
18	20000	tv/music system	9	9	9	furniture/logbook
19	N/A	N/A	N/A	N/A	N/A	N/A
20	share certificates	title deeds	9	9	9	9
21	mobile phone	9	9	9	vehicle	title deed
22	jewelry/laptop	jewelry/laptop	vehicle	vehicle	vehicle	vehicle

Note: No response - 9