FACTORS THAT DETERMINE FINANCIAL PERFORMANCE OF MICROFINANCE INSTITUTIONS

A CASE STUDY OF MFIs IN NAIROBI COUNTY

BY

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REG NO: D61/74614/2014

A Management Research Project Submitted in Partial Fulfillment of the Requirement for the Award of Master of Business Administration (MBA) Degree, School of Business, University of Nairobi.

OCTOBER 2016

DECLARATION

I declare that this is my own original work and has not been presented in part or in whole for the award of a Degree at the University of Nairobi or elsewhere.

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APPROVAL

This is to certify that this research report has been submitted with my approval as the University

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ACKNOWLEDGMENTS

I would like to thank The Almighty God for the good health during my studies and during the working on this thesis. And for His mercies that endures forever.

My sincere gratitude goes to all friends and colleagues who supported me in the development of this thesis. In a special way, I wish to thank my family and especially my wife Violet for being there for me and for their encouragement and support throughout the study period. It was a period that indeed your tolerance was needed.

My deepest gratitude goes to my supervisor Mr. James Ng'ang'a for holding my hand throughout this journey.

DEDICATION

To the Almighty God, for his endless love, kindness, wisdom and grace that always abounds all the days of my life, my mom Joyce Nekesa, my love Violet Nekesa and my sons; Peace, Prince and Perfect.

ABSTRACT

It's a catch 22 position when managements are puzzled by what to do to enhance the sustainability of MFIs financially irrespective of being either Welfarists or Instututionists in order to continue serving the interest of their clients.

The study adopted the descriptive research methodology in examining the factors that determine financial performance of MFIs in Nairobi. A descriptive survey design was used to collect original data for describing the population and both quantitative and qualitative approaches to data collection and analysis were employed in the study.

The findings were apparent in that MFIs in Nairobi do not survive on donations and as such are not a key determinant anymore for their survival. In earlier studies, it was evident that MFIs relied on donations to be able to achieve their goals, a trend that has since changed going by the findings in this study. This awkward state force MFIs to form partnerships with well-established financing institutions for purposes of easing the liquidity pressures. Significant as well are corporate governance practices have become key in ensuring that these MFIs perform well financially in addition to technological innovativeness that go a long way in ensuring that the well informed clientele gets their expectations met.

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ABBREVIATIONS AND ACRONYMS

AMFI	Association of Microfinance Institutions
BCCI	Bank of credit and Commerce International
BOD	Board of Directors
CBS	Central Bureau of Statistics
CEO	Chief Executive Officer
CG	Corporate Governance
EBIT	Earnings Before Interest and Taxation
ICT	Information Communications Technology
MF	Micro Finance
MFI	Micro Finance Institution
NED	Non-Executive Directors
NGO	Non-Governmental Organization
ROE	Return on Equity
RoPDE	Return on Product Development Expense
SACCO	Savings and Credit Cooperatives Societies
SMEP	Small and Micro Enterprise Programme
SPSS	Statistical Package for the Social Sciences

CHAPTER ONE

INTRODUCTION

1.0 Introduction

This chapter contains the background of the study, statement of the study, research questions, and objectives, significance of the study and the scope of the study on the determinants of financial performance of the MFIs in Nairobi County, Kenya.

1.1 Background of the Study

The provision of financial services via microfinance institutions to those with least financial ability was begun by Professor Yunus in 1972. In his wisdom, Yunus started by giving the financially less fortunate loans who would not otherwise have had such an opportunity through the mainstream banking system. His efforts evolved into the famous Grameen Bank that offered the coveted financial services to this category of people (Yunus, 2008). It is this stage that has established what is known today as the MFIs world over providing a platform for the poor to enjoy banking services. Many of these MFIs are small in size and targeting specific communities and often grow to become mainstream banks.

Bangladesh has experienced a robust growth in the MFIs sector that has been the genesis of banks like the Bangladesh Rural Advancement Committee, Grameen bank and Poshika to mention but a few that have had an impact as far as reducing poverty among the poor in their country is concerned.

Poverty involves deprivation, powerlessness and vulnerability, a state experienced by the poor (Lipton & Ravallion, 1995; Sen. 1999). In 2012, over 2.1 billion people in the developing world lived on US $ 3.10 a day in comparison with 2.9 billion in 1990, a significant number still live with far too little (World Bank Poverty Overview, World Bank 2013). The IMFs Poverty Reduction Strategy Paper (2005) estimated that people living in poverty would have been a staggering 55.4 percent in Kenya by 2001 and later estimated to have risen to more than 56 percent in 2003. In a bid to address this desperate position of affairs, Parker et *al*. (2000) advise that MFIs can play the financing role of

people's economic options in addition to diversifying their incomes and overall improvement of their quality of life.

Meeting the objectives as spelt out by Parker et al (2000) would rather be a mere wish unless we assess the factors that would determine the financial self-sustainability of these MFIs. Mulunga (2010) in his study observed that lack of regulatory, policy framework, inadequate capital and operational expenses were the main constraints. However, the study said nothing about corporate governance practices specifically, dependency on donor funds and how to address the high operational costs via technological innovations.

The most closer study in this area conducted by Alemayehu, Lemma (2014) in Ethiopia sighted client related impediments affecting performance of MFIs related to loan repayment, business condition of borrowers and channeling of loans obtained to unplanned activities in addition to the Institutional related factors including but not limited to shortage of human resources, adequacy of loan capital and lack of economic technologies in addition to political factors. These factors as expounded on have not brought into light corporate governance practices, donor funds dependency by MFIs and though they touch on cost-effective technologies, the findings on the same may not apply in MFIs operating in Nairobi Kenya in the same measure.

1.1.1.1 Technological Innovation

In a bid to provide a definition for technology, Malinoski and Pery (2011) state that it encompasses ideation, appraisal, selection, development, bringing into being of new or improved services and products while Wasike (2014) defined innovation as any new or considerably improved product that an organization develops or adopts external to itself, which results to commercial value or profit. Olson et al. 1995 observes that in a market that knows and demands accordingly, these new products and services must be developed according to the client expectations, that fact that is closely associated with the fact that with life cycles of products – some being short, there was need for innovation to avoid death of products (Duranton & Puga, 2001). Adner & Levinthal (2001) adds to the conversation by stating that firms do innovate by altering the existing services or products or introduce new products and services altogether.

While discussing on how to measure product/service innovation, Malinoski and Perry (2011) proposes the use of return on product development costs as it would be a key performance indicator for purposes of measuring how a product or service' innovation and development performs.

1.1.1.2 Corporate Governance Practices

According to Mwangi (2015), corporate governance refers to a wide array of policies in addition to corporate governance practices that those in charge of corporates use to govern and manage corporate operations to the satisfaction of all stakeholders. Much effort in a bid to analyze and measure the impact of corporate governance on corporate performance has proved contradictory and ambiguous (Bhaghat et al. 2008).

Schnyder (2012) arguing for the bundle approach as a measure of the level of corporate governance practices expresses the need for more sophisticated measures to quantify the level of corporate governance meaningfully.

1.1.1.3 Dependency on Donor subsidies

Stanford Journal of International Relations (2009) explains "foreign aid" as the movement of official financing to the developing world, by way of loans with a twenty five percent grant and grants. These movements of funds are concessional and are often referred to as official development assistance. They include multilateral and bilateral aid.

1.1.2 Financial Performance of Microfinance Institutions

Financial performance is the ability of a MFI to cover the set of its expenses by its income and finance its growth (El Kharti, 2013). Financial performance is measured by the financial and operational self-sufficiency in addition to the ability to be profitable thanks to efficiency and productivity i.e. return on equity and return on assets (Sene, 2010; Adair & Berguiga, 2010). The Return on Equity (ROE) is important for commercial entities aiming at profits and to the ratio only used to measure commercial viability by MFIs (Ledgerwood, 1999). Unlike the return on equity (ROE), the MFIs make use of the Return on Assets as a measure of profitability regardless of the underlying funding structure of the institution, making it possible to compare profit and nonprofit MFISs. Fersi and Boujelbéne (2016) advise that financial performance is measured by three accounting ratios; namely the ROA, ROE and the cash flow ratio.

1.1.3.1 Corporate governance practices and Microfinance Financial performance

The Council of the Microfinance Equity Funds in 2012 explained that the use of independent directors should be a prioritized to improve performance among MFIs. In a number of countries, governance reforms require that at least 25 percent of the board be independent appointees especially for committees such as the compensation and audit committees.

These practices are deemed to have an influence on the financial performance of MFIs hence a reason to be studied to determine the extent of influence. Lishenga and Ambaka (2012) documented a positive relationship between governance practices and firm performance.

1.1.3.2 Dependency on donor funding and Microfinance Financial performance

Respondents in the study conducted by Paye (2012) indicated that 63% of the MFIs got their funds from members' savings, 22% of the MFIs got their funds from donor funds and 15% of the MFIs got their funds from internally generated revenue. At over 20%, the amount was significant, meaning that the financial soundness of MFIs significantly depended on the donor funds. This creates a reason to find out if that fact still holds true and the level of significance.

1.1.3.3 Technological Innovation and Microfinance Financial performance

Oware (2012) states that lack of a cost-effective technology deter the affected programs to increase their outreach within their operational areas, irrespective of whether urban or rural. Small transactions generally require nearly as much oversight as larger ones, but with much smaller returns. This reason calls for more innovativeness if MFIs are to be financially sound, hence the study to determine the extent to which this fact holds today.

1.1.4 Microfinance Institutions in Kenya

In Kenya, like in a number of African countries, providing financial services to poor populations in rural areas remains to be the biggest of challenges. Poor communications' infrastructure, inadequate literacy levels, undiversified economies risky economic activities are main characteristics of rural Kenya (Ngema, 2011) making it unattractive to Microfinance Institutions and commercial financial institutions (Johnson et al., 2005).

At the time of his study, Ngema (2011) observed that the microfinance industry had been relatively having been around for 10 years and according to Hopes et al. (2002), in the past 20 years, the sector had seen a number of MFIs open their doors in addition to the boost by both the Kenya government and international donor agencies. Having identified the scarcity of credit as a major obstacle to economic growth, the government of Kenya, brought in the Microfinance Act that came into force on 2nd May, 2008 following the Microfinance (Deposit Taking Microfinance Institutions) regulations by the Central Bank.

The Act covers Deposit Taking Microfinance Institutions (DTMs) as well as non-deposit taking MFIs in addition to providing for banks to establish fully owned subsidiaries to undertake DTM business (FSD, 2010).

The Act has paved way for a much more comprehensive and consistent regulatory environment for MFIs having been designed to promote the performance and sustainability of deposit taking MFIs (DTMs) in addition to protecting depositors' interests better. The Act also enables MFIs to provide more wholesome financial services to the small micro enterprises' Sector (FSD, 2010; Nderi, 2004).

The research findings in Mugo (2012) highlighted that financial innovation contributed to the expansion of the MFIs market share, increase in the number of clients and earnings in Kenya in addition to the study by Ndeeri (2012) that established that the three determinants; self-sustainability commercialization, and automation of customer products and services have a weighty effect on the revolution of MFIs in Kenya.

1.2 Research Problem

Though Microfinance has been a tool that has enhanced accessibility to basic financial services such as savings, loans, money transfer to small entrepreneurs, there are scanty studies on the financial performance of these MFIs since most scholars have carried out studies on the social performance of MFIs.

Hudon (2015) observed that the role of donors in microfinance is rapidly growing, particularly since the emergency of social responsible and commercial investors. During the study, Hudon argued that public policy should be premeditated to facilitate the entry

of new private actors without deserting the markets that could not work without public support.

In explaining more on donor dependency, Abrahams and Stauffenberg (2007), argued that development institutions (International Financial Institutions) were concentrating their loans in the strongest MFIs, leaving private lenders to lend to smaller, riskier borrowers.

While discussing on board size, Jensen (1983) concludes that reducing board size improves firm performance because of better communication in smaller boards. Gompers, Ishii, and Metrick (2003) also found that corporate governance is strongly correlated with stock returns during the 1990s. This therefore essentially underpins the need to assess CG practices.

Sravani (2013) argues that being key drivers of economic growth today, technology, innovation and knowledge have become fundamental in the growth of MFIs -as technology brings in the ability to speed up the flow of information and capital, automate transactions, improve customer experience, control and analyze data, reduce transaction costs, and increase efficiency and customer outreach.

Moenga (2015) discussing on corporate governance argues that good corporate governance has been identified as a key holdup in the strengthening of MFIs financial performance. One the other hand, financial innovation is meant to help reduce costs, risks in addition to providing an improved product/service/instrument that better meet clients' interests (Ombachi, 2013). Kenyoru (2013) on the other hand emphasizes that fast changing technology has also greatly influenced access to financial services and widened channels through which financial services are provided.

From these studies, it's evident that corporate governance practices, availability or unavailability of donor funds and adaptation and use of technology in microfinance will influence the financial performance of MFIs that are meant to benefit the poor and so the reason for this study.

The study will therefore answer the question; do corporate governance practices, technological innovation and donor funds determine the financial performance of MFIs?

1.3 Objective of the Study

The objective of this study was to identify the key determinants of financial performance of MFIs in Nairobi County, Kenya.

1.4 Value of the Study

This study contributes in filling the information gap by assessing the key determinants to watch out for in case an MFI is to perform well financially. A study of this nature makes significant contribution by assisting government and other stakeholders to find lasting solutions to problems facing Microfinance institutions in the country.

The study is very significant because it adds to the existing literature of research and works already written on microfinance in Kenya. The study thus helps Microfinance Institutions to put in place credible return bearing policies and programs that will help households and individuals to access their facilities while also remaining afloat financially.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter provides an overview of studies and publications done on factors that determine performance of MFIs around the globe. Emphasize has been put on reviews that highlight the background of MFIs, the theories underpinning MFI, technological innovation, corporate governance and resource management herein referred to donor funding. Six sections shape the outline of this chapter discussion: the theoretical framework around Microfinance; technological Innovation; Corporate Governance Practices; and Dependency on Donor subsidies; and lastly the empirical studies on MFIs. The last section of this summarizes the empirical studies.

2.2. Theoretical framework

2.2.1 Financial constraints theory

The theory of constraints dates back to 1950 when Schumpeter revealed that market imperfections, regulation, operation costs, and taxes necessitate firms to make new innovations to address the constraints and inconveniencies. Silber (1983) also added that financial innovation is done to lessen the financial constraints that limit the firm's earning capacity; therefore, firms innovate to optimize the returns on capital in the light of the firm's goals. Additionally, Silber suggested that in order for firms to prosper, they need to continually improve on service provision to stay relevant in a dynamic environment. It is reported by Tufano (2002) that high-interest rates, taxes, and regulation often lead to financial innovation. Therefore, individuals and firms innovate to circumvent these constraints to lessen the cost of borrowing, reduce expenses and improve investment options. Innovation also seeks to tackle the financial investment constraints through low deposits, less interest income, constrained lending, consequentially less demand for deposits and the desire for efficiency, among others.

2.2.2 Micro Credit Theory

As cited by Anangwe (2014), the theory of Micro Credit was advanced by Yunus (1998) who believed that it's possible to maximize profits and at the same time be considerate to

customers. Anangwe explains that MFIs belong to a group of entrepreneurs who are concerned with the social welfare and therefore incorporate social aspect in their operations unlike the selfish type of entrepreneurs who will ensure that they have positive returns irrespective of the social concerns.

2.2.3 The Economic Theory

The economic theory as elaborated on by Ramenyi (2000) as cited in Anangwe (2014), observed that like any other business, MFIs' success is measure by the ability to serve the needs of the customers while also remaining afloat profit wise. Therefore MFIs may be viewed as infants in their early lives to ensure their survival through subsidized lending endeavors. It is thus expected that as the MFIs grow in capacity and transit to wider coverage in their outreach, the benefits accruing to economies of scale will trickle in enabling them to become profitable.

2.3.1 Technological Innovation

Anangwe in her work commented that investment in ICT makes services provision more efficient and cost effective. However, according to Kateeba (2009), there is no empirical evidence indicating that investment in ICT leads to better performance and growth. Additionally, Evangelista (2000) points out that microfinance institution should make their ICT very compatible to their service offered. The creation and use of ICT play a critical part leading to better performance through activities geared towards service innovation.

Kason (2002) observed that the presence of ICT and its expansion explains the soaring growth in the service industry. Sircar *et al.* (2000) indicated that investment in ICT often has higher revenue and consequently higher returns on assets. However, in their study, Koch, Mayper and Wilner (2006) indicated that investment in ICT did not show any significant increase in productivity. They argue that ICT had in effect of creating 'super smart' human beings who require to be paid huge salaries which may consequently balloon the wage bill. Totolo (2005) contends that it productivity failures should not be blamed on ICT investment, instead encourages investment in human capital that enhances ICT penetration within the firm.

On his part, Ngema (2011) indicates that the informal money lending sector in Ghana has been a rich source of innovation for the formal MFIs. Some of the innovations have been adopted by the formal MFIs and have thus assisted in the development and growth of the industry as a whole.

2.3.2 Corporate Governance Practices

The Centre for Corporate Governance defines corporate governance as a way in which power is exercised within a corporate organization to manage its resources and assets for the benefits of stakeholders (Lishenga & Ambaka, 2012). Corporate governance is as old as the entities themselves bringing in aspects of separation of control and ownership (Lishenga & Ambaka, 2012). This separation of control and ownership brings ineffective boards of directors, carrying out their duties with competence and integrity. Effective boards of directors, therefore, put in place mechanisms that ensure that the firm's obligations are met including full-time disclosure of performance of business to the owners and the rest of the stakeholders (Colley et al. (2003).

2.3.3 Dependency on Donor subsidies

According to Ejigu (2009), the need for increased financing coupled with uncertainty of donor funds soaring daily as the MFI industry grows. This predicament creates uncertainty as to the sustainability of MFIs in terms of them covering their costs. Sustainability, being the ability to cover running costs for an MFI from internally generated revenues. Sustainability is therefore used as one of the yard sticks in measuring performance of MFIs.

Basu and Woller (2006) as cited in Ejigu (2009) contributed to this debate by explaining the categories of MFIs into; Welfarists and Instututionists. Welfarists are said to be funded by donors (social investors) and can achieve stability without attaining financial sustainability. As such, social investors do not expect monetary returns. Welfarists often emphasize on elevating poverty and so outreach critical as a measure of success of the MFI in question.

Instututionists on the other had claim that unless there are built sustainable MFIs that are able to run independent of donations, achievement of their objectives may simply remain

a dream. The conclusion of the matter being that both schools of thought would achieve the same goal of poverty elevation.

2.4 Empirical Reviews

This section re-examines literature related to the subject of the study which is based on global view narrowing to the local view. The review entails studies that have been conducted in relation to Microfinance institutions' financial soundness and the related determinants with aspects from different regions of the world.

2.4.1 International Evidence

Okwee (2012) noted that poor financial performance of SACCOs could be caused by noncompliance with corporate governance. Therefore, SACCOs were advised to create awareness amongst the members on corporate governance principles, process and procedures among others.

Dauda and Hawa (2016) in their study, the results found that there was an inverse relationship between board sizes. It is observed that there is a correlation between return on Assets and board composition. This implies that when there are more independent directors on the board, the performance of that bank invariably increases. These results are consistent with prior empirical studies.

According to Sseremba (2012), he holds the position that ownership and corporate governance are significant predictors of MFIs' performance. He argued that in order to streamline the MFI systems, the board must be totally independent. Ndyamuba (2010) recommends in his study that adoption of product refinements and technological innovations is needed to reduce costs, increase outreach and enhance profitability. Hence the adoption of technological innovations as cited as greatly significant in combating operational costs which in effect affects the financial performance of any MFI.

In their study, Labie and Périlleux (2008) found that corporate governance weaknesses in SACCOs were identified as major obstacles and that constrained overall development. The corporate governance weakness accounted to a large extent the performance of these SACCOs.

According to Katera (2011), there is a need to enhance corporate governance by improving fairness, transparency and accountability to spur the performance of any corporate. A strong significant positive correlation exists between fairness, transparency, accountability and perceived performance. Similarly, in another research by DeSantis (2010), outreach and sustainability and the desire to continually improve on a service, was noted to strongly correlate to better Return on Assets.

2.4.2 Local Evidence

Moenga (2015) noted that the implementation of proper corporate governance mechanisms is an important element in the financial performance of microfinance institutions. Just like any other business,

In a study conducted by Anangwe (2014), it was noted that competition amongst MFIs and the utilization of technology in operations ensures rapid growth. In yet another significant study by Mugo (2012), financial innovation contributed to the expansion of the MFIs market share, number of clients and earning.

Ombachi (2013) noted that most organisations have adopted a process of innovation and that this process is used mostly for increasing profit, enhancing quality personnel, saving costs and increasing competitiveness. Mugo (2012) also noted that financial innovation by MFIs lead to an aggregate growth of firms in various dimensions like number of products, market share, loan scales and the overall profitability. It is therefore recommended that financial innovation should be encouraged among the MFIs.

Mbithi (2012) argues that the dependence on donor funds by the local MFIs affected their capacity to advance loans to potential customers. On the other hand, Ratemo (2011) suggests that there is need for a general consensus that if they were to grow enough to reach a long-term basis, the millions of low income people without access to financial services needed more sustainable sources of financing to support their development. He also recommends that there was still a role for donors in the further development of the microfinance industry in Kenya to address a number of constraints including lack of capital for on-lending and institutional capacity of the MFIs.

2.4.3 Conceptual Framework

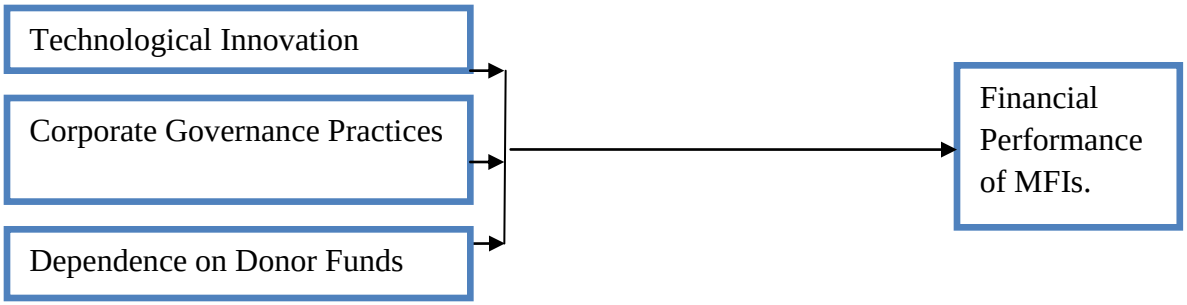


Figure 2.1 Conceptual Framework

2.5. Summary of Literature Review

The study intended to find out if the three independent variables; corporate governance practices, donor funding and technological innovations had an influence on the sound financial performance of MFIs. It is evident from the provisions highlighted in the empirical studies above that corporate governance practices, donor fund subsidies and technological innovation are predictors of the dependent variable – in this case being the sound financial performance of MFIs world over.

For MFIs to operate efficiently, adoption to technological innovation is unavoidable as it would indeed reduce operational costs to ensure financial soundness while the availability of donor funds affords the MFIs the privilege to offer cheap credit, the scarcity of the same straining the operations of these institutions in terms of liquidity.

Bloated boards of Directors, and many board malpractices work against the core objectives of the MFIs and hence the need to adequately take them into consideration for the sake of financial soundness of these Institutions.

CHAPTER THREE

RESEARCH METHODOLOGY

3.0 Introduction

In this chapter, the research methodology used in the study is explained in detail. The study design and the population are also described. The instruments used to collect data, methods applied to maintain validity and reliability of the instrument and research study model are explained.

3.1 Research Design

The study intends to adopt the descriptive research methodology in examining the factors that determine financial performance of MFIs in Nairobi. A descriptive survey design was used to collect original data for describing the population. Polit and Hungler (1993) put it that a survey intends to obtain information from the respondents by use of questionnaires.

Both quantitative and qualitative approaches to collect data and eventual analysis were engaged in the study. It is worth noting that closed questions were analyzed using quantitative analysis and open-ended questions to be analyzed using qualitative analysis.

3.2 Population

Sekarans (1997), as cited in Paye (2012) defined population as the complete assemblage of people, events or things of interest that the researcher aspires to study. The target population 11 licensed MFIs operating in Nairobi County as at 31st December, 2015 as per the Kenya's Annual Bank Supervision Report.

3.3 Sample size and techniques

I used convenience sampling since the population in question was small. I therefore conveniently conducted the research on the 11 MFIs as operated in Nairobi County as at 31st December, 2015.

The management team especially, Branch managers were selected purposively from each of the 11MFIs. A total of 11 officers were served with questionnaires thanks to their

perceived being equipped with adequate knowledge on the MFIs as they operate in Nairobi.

3.4 Data Collection

Both Primary and Secondary data was collected on all the eleven MFIs operating in Nairobi per the Bank Supervision Report (2014) and 2015. Secondary data was obtained majorly from the bank Supervision report for year 2015. Primary data was gathered using questionnaires. Questionnaires were bipartite i.e. A and B, with open and closed-ended questions. A Questionnaire is a printed self-report form come up with to get information and evidence that can be obtained through written responses of subjects.

3.5 Data Reliability and Validity

Phelan and Wren (2005) state that reliability is the level at which a measurement tool produces stable and regular results. The consistency from responses in the questionnaires will determine the level of reliability of the data. While Polit and Hungler (1993) explain validity of an instrument to mean the degree to which an instrument measures what it is intended to measure. Quite a satisfactory mix of questions was included on the questionnaires to achieve validity.

3.6 Data Analysis

Data collected was edited for consistency, accuracy, completeness, uniformity and arranged to enable tabulation coding and before the final analysis. Data was then entered into a computer program called Statistical Package for Social Sciences (version 24) for analysis and interpretation. Descriptive analysis was used to analyze the data received from the different MFIs in Nairobi. This involved descriptive tools such as percentages and frequency distributions. The analysis was to focus on the factors; technological innovation, corporate governance practices, Donor Subsidies and how they influenced financial performance of these MFIs.

The findings were then summarized to determine the extent to which these factors achieved the research objective.

3.7 Analytical Model

A regression model was employed so as to establish the relationship between the financial performance of the MFIs and the independent variables, i.e. Technological innovation, Dependency on donor funds and corporate governance practices. The dependent variable of the study was financial performance of Microfinance Institutions in Nairobi County.

The significance of each independent variable was tested at a confidence level of 95%. The equation representing the algebraic expression of the multiple regression models was of the form below;

Financial Performance $=f$ (Technological Innovation, Corporate governance practices and Dependence on Donor funds)

$Y = \beta 0 + \beta\ 1X1 + \beta\ 2X2 + \beta\ 3X3 + €$

Where Y= Financial performance of the MFIs in Nairobi County as measured by ROA
β0 = Constant which defines financial soundness capacity without inclusion of independent variables.
β1= Coefficient for individual influence of Technological Innovation on the financial performance of MFIs.
β2= Coefficient for individual influence of Corporate governance practices on the financial performance of MFIs.
B3= Coefficient for individual influence of Dependency on donor funds on the financial performance of MFIs.

X1 = Technological innovation

Borrowing from Malinoski, M. and Perry, G.S, (2011), I measured the impact of technological innovation by use of a percentage of Return on Product Development Expense, or RoPDE

The formulae being;

X1 = (Gross margin-Product development expense)/Product development expense.

X2 = Increase in dependency on donor funds by MFIs

On donor funds dependency, I determined the ratio of donations to other sources of funds over the study period and determined the impact on financial performance.

X3 = Increase in corporate governance practices by MFIs

As explained in his study, Schnyder, G. (2012), I adopted the bundles' approach in being able to measure the level of corporate governance practices and how the same affected financial performance of MFIs.

€= Standard Error

3.8 Test of Significance

The significance of the model was be tested by the use of correlation coefficient (R) and the coefficient of determination (R^2) at 95% significance level.

On analysis of Variance, (t-test) was conducted to test the significance and reliability of the developed model.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter expounds at large on the findings, data analysis, results and discussions in line with the methodology of this study. These research findings are on the factors that determine financial performance on microfinance institutions in Nairobi County, Kenya.

4.2 Response Rate

Both secondary and primary data was collected. Secondary data was collected from the Bank Supervision report relating to the 11 MFIs operating in Nairobi County as licensed by the Central Bank to operate as such. Primary data, collected via questionnaires mailed to the management of these MFIs. All the 11 MFIs responded to the questionnaires, representing 100% percent response rate.

4.3 Data Validity

Validity means how precise a test measures what it is purported to measure (Phelan & Wren, 2005). The secondary data was gotten from the Bank Supervisory report of Kenya as at December 2015 while the primary data was gathered by way of a bipartite questionnaire being a preferred tool (Polit & Hungler, 1993).

4.4 Descriptive Statistics

As shown on the table 4.4.1, majority (72.7%) of the respondents were aged between 21-34 years. 3 (27.3%) of the respondents aged 35-44 years. The number of those that had a higher diploma and bachelors were the majority (54.5%), those with masters being 36.5%.With regard to gender, majority of the respondents were female at 54.5% and 45.5% for male. With regards to the role in MFI, the directors were majority (72.7%) while the supervisors formed 27.3%. With regard to the length of employment, the majority were 3-5 years making 81.8% and the rest were less than 2 years in employment.

Table 4.1: demographic characteristics of respondents

Characteristic		**frequency**	**Percentage**
Age (years)	21-34	8	72.7
	35-44	3	27.3
Total		**11**	**100**
Education level	Higher Professional Certificate	1	9.1
	Higher diploma/Bachelors	6	54.5
	Masters	4	36.4
Total		**11**	**100**
Gender.	Female	6	54.5
	Male	5	45.5
Total		**11**	**100**
Role in MFI	Directors	8	72.7
	Supervisors	3	27.3
Total		**11**	**100**
Length of employment	Less than 2 years	2	18.2
	3-5 years	9	81.8
	Total	**11**	**100**

Source: Research findings 2016

4.4.2. Financial Performance as represented by ROA of the MFIs in Nairobi.

Of the eleven MFIs, 8 (72.7%) of them have positive returns on assets each as follows, 0%, 0.1%, 0.2%, 0.3%, 0.7%, 0.7% and 2.2%. 2 (18.2%) of them had 7% return on assets by 31st December 2015 and on the same note, 4 MFIs had negative returns on assets, -1.9%, -12.4%, 32.3% and 54.2% by the same date, 31st December, 2015. A frequency table 4.4.1 gives the analysis.

Table 4.2 ROA

ROA		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	-.542	1	9.1	9.1	9.1
	-.323	1	9.1	9.1	18.2
	-.124	1	9.1	9.1	27.3
	-.019	1	9.1	9.1	36.4
	.000	1	9.1	9.1	45.5
	.001	1	9.1	9.1	54.5
	.002	1	9.1	9.1	63.6
	.003	1	9.1	9.1	72.7
	.007	2	18.2	18.2	90.9
	.022	1	9.1	9.1	100.0
	Total	11	100.0	100.0	

Source: Bank Supervision report

4.4.3 Percentage score on CG Practices by MFIs

Two (18.2%) of the MFIs scored 80% on a number of CG practices, Two (18.2%) of them scored 40% and others, each scored, 92%, 90%, 88%, 85%, 70%, 50% and 30% on the same evaluation. It is clear that36.4% scored 50% and below while 63.6 scoring above 50%, Table 4.3.

Table 4.3 Percentage score on CG Practices by MFIs

% Score on CG		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	30.00	1	9.1	9.1	9.1
	40.00	2	18.2	18.2	27.3
	50.00	1	9.1	9.1	36.4
	70.00	1	9.1	9.1	45.5
	80.00	2	18.2	18.2	63.6
	85.00	1	9.1	9.1	72.7
	88.00	1	9.1	9.1	81.8
	90.00	1	9.1	9.1	90.9
	92.00	1	9.1	9.1	100.0
	Total	11	100.0	100.0	

4.4.4 Percentage Return on Product Development Expense (% RoPDE)

2 (18.2%) of the respondents had a return of 10% on product development expense, 1, (9.1%) of the respondents had 20% and 30% each. 3 (27.3%) respondents had 40% each, while 4 (36.4%) had a RoPDE of 50%. The analysis is hereby tabled in table 4.4.4.

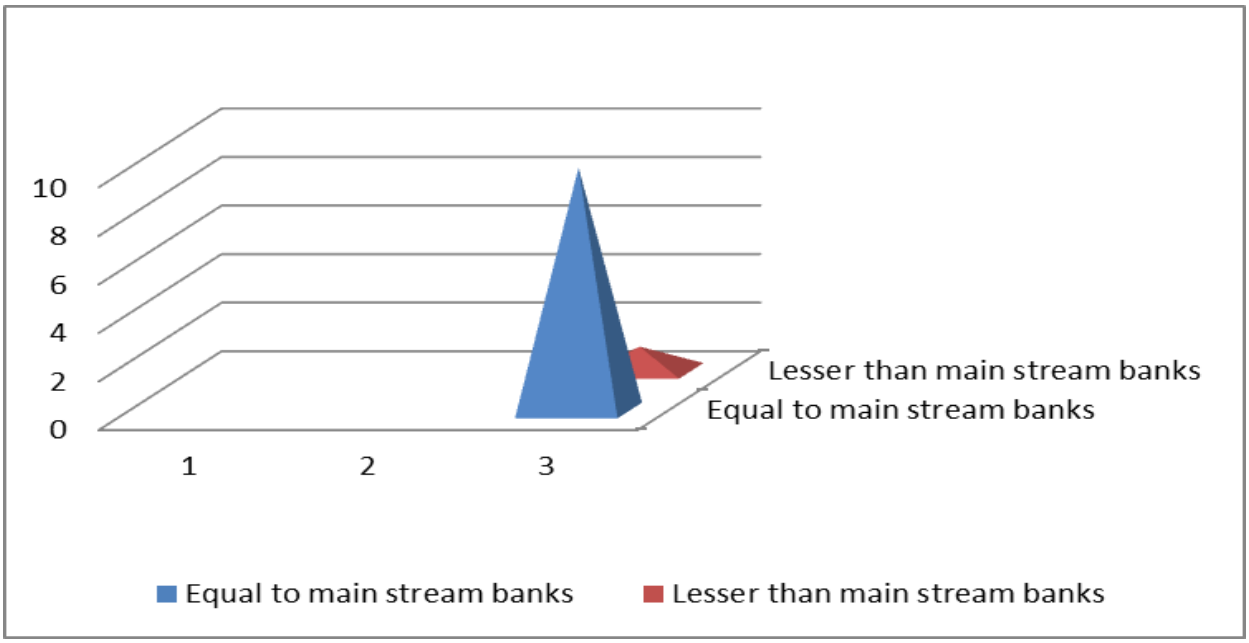
Table 4.4 Percentage Return on Product Development (% RoPDE)

% RoPDE		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	10.00	2	18.2	18.2	18.2
	20.00	1	9.1	9.1	27.3
	30.00	1	9.1	9.1	36.4
	40.00	3	27.3	27.3	63.6
	50.00	4	36.4	36.4	100.0
	Total	11	100.0	100.0	

4.4.5 Ratio of donations to total MFIs fund

0% of the MFIs have donations in their books of account. 100% in Nairobi MFIs serve the economically middle class clients and small micro enterprises. 10 (90.91%) of the respondents charge interest rates that are equal to the main stream banking institutions.

Graph 4.1 Interest rates charged by MFIs in Nairobi



4.4.6 Statistics

The ROA of the 11 MFIs has a mean of -.08782, a standard deviation of 0.181547, a variance of 0.033 and a range of 0.564 while the mean percentage score of MFIs on CG practices is 67.7273, a standard deviation of 23.18659, a variance of 537.618 and a range of 62. The percentage return on product development expense had a mean of 35.4545, a standard deviation of 15.72491, a variance of 247.273 and a range of 40 while with regards to donations, it's apparent that each of the statistic is 0 as shown in the table below.

Table: 4.5 Statistics

		Name of MFI	ROA	Percentage score on CG Practices	Percentage RoPDE	Percentage of donor funds
N	Valid	11	11	11	11	11
	Missing	0	0	0	0	0
Mean			-.08782	67.7273	35.4545	.0000
Std. Deviation			.181547	23.18659	15.72491	.00000
Variance			.033	537.618	247.273	.000
Range			.564	62.00	40.00	.00

4.5 Correlation Analysis

This analysis gives the extent this study's variables relate. Pearson correlation analysis as per table 4.5.1 shows that there is significant correlation between the dependent variable (Financial Performance) represented by ROA versus the percentage score on CG practices and percentage RoPDE at 0.81 and 0.793 respectively. It's further analyzed that the two key independent variables' percentages; CG practices and RoPDE are significantly correlated at 0.97.

It's also tabled that there is no relationship between donations, ROA and the other two independent variables. It is also shown that to these correlations between the ROA and a percentage score of CG and the percentage of Return on development expense variables are at significance levels of 0.003 and 0.004 respectively. Table 4.5.1 displays this analysis.

Table 4.6 Correlations

		ROA	Percentage score on CG Practices	Percentage RoPDE	Percentage of donor funds
ROA	Pearson Correlation	1	.810**	.793**	.b
	Sig. (2-tailed)		.003	.004	.
	N	11	11	11	11
Percentage score on CG Practices	Pearson Correlation	.810**	1	.970**	.b
	Sig. (2-tailed)	.003		.000	.
	N	11	11	11	11
Percentage RoPDE	Pearson Correlation	.793**	.970**	1	.b
	Sig. (2-tailed)	.004	.000		.
	N	11	11	11	11
Percentage of donor funds	Pearson Correlation	.b	.b	.b	.b
	Sig. (2-tailed)	.	.	.	
	N	11	11	11	11

**. Correlation is significant at the 0.01 level (2-tailed).

b. Cannot be computed because at least one of the variables is constant.

4.6. Regression analysis

Linear regression analysis was used to determine a model on the factors that determine financial performance (as represented by ROA) of MFIs in Nairobi County.

4.6.1 Model Summary

The independent variables were taken to the linear regression model and the default "enter" method chosen. A significance level of 95% was chosen for convenience.

The model summary is as shown in the table 4.6.1.

Table 4.7: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.810[a]	.657	.571	.118927

a. Predictors: (Constant), Percentage RoPDE, Percentage score on CG Practices

The model shows that 65.7% of variability in the ROA is accounted for by the independent variables namely: Percentage RoPDE, Percentage score on CG Practices

The F-test to determine the suitability of the model was significant indicating a good model fit. This test is shown in table 4.6.2:

Table 4.8 ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	.216	2	.108	7.652	.014[b]
	Residual	.113	8	.014		
	Total	.330	10			

a. Dependent Variable: ROA

b. Predictors: (Constant), Percentage RoPDE, Percentage score on CG Practices

Table 4.9 Coefficients

		Unstandardized Coefficients		Standardized Coefficients		
Model		B	Std. Error	Beta	t	Sig.
1	(Constant)	-.505	.146		-3.454	.009
	Percentage score on CG Practices	.005	.007	.692	.813	.440
	Percentage RoPDE	.001	.010	.121	.143	.890

a. Dependent Variable: ROA

The model therefore is;

$Y = -.505 + .005\ X_1 + .001\ X_2 + 0\ X_3 + \epsilon t$

In which case,

Y is the dependent variable being financial performance, measured by ROA

The constant -0.505 is the value for Y in case the independent variables, X_1, X_2 and X_3 are 0

X1 represents the percentage score on CG practices of the MFIs

X2 represents the Return on Product Development Expenditure (RoPDE)

X3 represents donations as part of funding for the MFIs

4.7 Discussion of Research Findings

On technological innovation as measured by Return on Development Expense (RoPDE), this study has established that it is a significant predictor of financial performance (ROA) in line with a study by Sravani (2013).

On donor funding, the current study shows that 100% MFIs operating in Nairobi county do not have any donor funds in their books of account. This means that liquidity problems do arise in accordance with the findings of Mbithi (2012) who argues that the dependence on donor funds by the local MFIs affected their capacity to advance loans to potential customers. Indeed were there to be donor funds, the returns on assets of those that are reporting negative returns would be positive as they would have capacity to advance loans.

Additionally, it was found out that all MFIs in Nairobi County served the middle level class of clients economically and the small micro enterprises. This is contradictory to the goal and purpose of MFIs as providers of financial services to the unbanked per Yunu's initial objective of eradication of poverty and bank the unbanked (Yunus, 2008).

The study also found out that interests charged by MFIs in Nairobi County are equal to main stream banks. This is not enticing if we are to bank the unbanked (Yunus, 2008) and in as much as all respondents claimed to have had all the liquidity to meet the clientele needs; all of the MFIs would be having positive returns on assets and hence financial performance.

On corporate governance practices, significantly impacted on the financial performance of MFIs in Nairobi County in line with a position held by Katera (2011).

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter summarizes the findings from the previous chapter. It concludes on the study and provides recommendations based on the objectives. The objective of this study was to identify the key determinants of financial performance of MFIs in Nairobi County, Kenya.

5.2 Summary of Findings

The aim of this study was to identify the key determinants of financial performance of MFIs in Nairobi County, Kenya. The study focused on corporate governance practices, technological innovation and dependency on donor funds. Regression Analysis and Pearson correlation were used to analyze a number of factors with in these three variables to determine how they correlated with the dependent variable, ROA in addition to finding out if the relationship is significant or otherwise.

In summary, the study found that under corporate governance practices as analyzed via practices like the board of directors doing self-evaluations and other reviews of effectiveness and under technological innovation as a factor, Favoring high risk projects, exploring new opportunities, Sharing information on successes or failures, customer feedback, Involvement in new initiatives and innovative programmes, offering induction or regular training to board members and presence of independent directors influenced financial performance of MFIs. There was a significant relationship between these variables and ROA. As far as corporate governance practices were concerned, the findings in the study agree to a research by Gompers and Metrick (2008) showing that there was a link between financial performance of firms and corporate governance. The findings also agree with the study by Mbithi (2012) that the dependence on donor funds by the local MFIs affected their capacity to advance loans to potential customers the reason as to why in the absence of these donor funds, small MFIs registered poor returns

on assets. This study also agrees with Mugo (2012) that financial innovation by MFIs led to the overall profitability of firms.

5.3 Conclusion

This study carefully treated the factors that determine financial performance of MFIs in Nairobi County and thus concluded that adherence to good corporate governance practices leads to better returns on assets, the opposite also holds true. Presence of independent directors does not guarantee better returns but the appropriate use of their relevant skills and experience would contribute immensely to this goal.

The study further revealed that dependence on donor funding is not a factor in determining better ROA but there being a need to substitute such a source of funding to enhance the returns. Additionally, the study revealed that MFIs in Nairobi do not support the poor of the poor since they overall target the middle class businesses, lesser riskier SMEs as compared to the angle that would have been taken by the Welfarists.

The study also revealed that MFIs in Nairobi did sustain themselves thanks to how much they innovated in terms of new products, services, and organization.

5.4 Recommendations

As a substitute to donor funding, MFIs should seek financial partnerships with stable financial institutions to be able to maintain adequate liquidity levels. The government can also take this up to allocate funds towards community based MFIs to enable them achieve their critical goal today as this will enhance their liquidity. This study can therefore benefit decision makers especially small MFIs if they are to survive in the market. Carefulness as far as appointing appropriately skilled and experienced board of directors is paramount in addition to having value adding independent directors. Having large number of independent directors who add no value could do a disservice to MFIs.

5.5 Limitations of the Study

The outcome would have been better with a bigger sample size. Issues of context are critical in analyzing the corporate governance mechanisms; the study did not investigate these as they would be different per each case. Other than budgetary percentages, the return on development expenditure was not available, thanks to the inability by the respondents to disclose such information.

5.6 Recommendation for Further Research

Having conducted the identification of key determinants to financial performance in Nairobi County the business hub of Kenya, further research should be done for the entire country and beyond her boarders. Further research should be conducted as to why donor funding to MFIs in Nairobi County ceased. Since the sample used is only eleven of the licensed MFIs operating in Nairobi county, I suggest that a similar study is done elsewhere with a much bigger sample.

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APPENDICES

Appendix One: Letter of introduction

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Nairobi, Kenya

DATE.....

TO WHOM IT MAY CONCERN

The bearer of this letter ..... GODFREY MAKOKHA MASAKA .....

Registration No..... D61/74614/2014 .....

is a bona fide continuing student in the Master of Business Administration (MBA) degree program in this University.

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

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.

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
30 SEP 2016
P.O. Box 30197 – 00100, NAIROBI

PATRICK NYABUTO
SENIOR ADMINISTRATIVE ASSISTANT
SCHOOL OF BUSINESS

Appendix two: List of licensed Micro Finance Institutions operating in Nairobi County as at 31st December, 2015

1. Faulu Microfinance Bank Ltd
2. Kenya Women Microfinance Bank Ltd
3. SMEP Microfinance Bank Ltd
4. Remu Microfinance Bank Ltd
5. Rafiki Microfinance Bank Ltd
6. Uwezo Microfinance Bank Ltd
7. Century Microfinance Bank Ltd
8. Sumac Microfinance Bank Ltd
9. U&I Microfinance Bank Ltd
10. Daraja Microfinance Bank Ltd
11. Caritas Microfinance Bank Ltd