AN ANALYSIS OF FACTORS INHIBITING THE GROWTH OF MICROFINANCE SECTOR IN KENYA

PENINAH A. OTIENDE [2], VICKY MOBEGI [1], EVANS BANGE MITEMA [2], DAVID M.ACHUTI [1], CHARLES MOMANYI [2], ONKENDI JOSEPH ELIKANAH OMESA [1], MALACH OGETO [2]

[1] Jommokenyatta University of Agricuture and Technology

[2] Kisii University

Corresponding Author:
PENINAH ADHIAMBO OTIENDE,
BOX 46-49500, NYAMIRA
Email: peninahotiende@yahoo.com

ABSTRACT

The aim of this study refers to highlighting the key challenges and prospects for the microfinance sector of Kenya. This study will be carried to find out challenges affecting growth of microfinance institutions, prospects in microfinance, and policy recommendations to boost microfinance sector in Kenya.
The main providers of microfinance services consist mainly of Micro-lenders, Non-Governmental Organizations (NGOs), Savings and Credit Cooperative Societies (SACCOS), Public Financial Institutions (PFI) and to a less extent Commercial Banks (CB).

The level of poverty in Kenya is relatively high. Access to finance is cited as one of factors hampering economic growth and poverty alleviation. Microfinance is seen as one of the effective tools that can address poverty alleviation by engaging the poor in sustainable economic activities. Microfinance services have existed in Kenya since the late 1990s, yet they have not attained growth. The findings have been obtained through Primary data, which has been collected through questionnaires.
The findings of this study revealed that lack of regulatory and policy framework, lack of capital and high operational costs were the main problem areas hampering the growth of MFIs in Kenya.

1.0 Introduction

This chapter covers; background to the study, the statement of the problem, research questions, research objectives and significance of the study, definition of operational terms.

1.1 Background to the Study

Since early 1990s, African countries have been enjoying positive economic trends, with higher economic growth becoming more widespread and more robust over time, as an increasing number of countries share in the impact of improved macroeconomic management and governance, a more conducive environment for the private sector, more open economies and higher commodity export prices, for sustained periods. Despite the positive momentum in economic performance, the incidence of poverty remains a critical issue in most African countries, and many may fail to meet the Millennium Development Goals towards reducing the incidence of poverty and addressing its consequences by the target date 2016.

Furthermore, the slowness of economic prosperity to trickle down and lift the masses in poverty is creating a dangerous inequality divide that could eventually fuel instability and threaten progress on the economic front. Moreover, small enterprises and most of the poor population in African countries have limited access to deposit and credit facilities and other financial services provided by the formal financial institutions. This lack of access to financial services in the formal financial system is quite striking considering that in many African countries the poor represent the largest share of the population and that the informal sector is an important part of the economy.

In this context, there is renewed interest in access to financial services for the poor. In this regard, while there may still be some skeptics concerning the ability of microfinance to alleviate poverty, there is ample evidence to show that the benefits of microfinance outweigh the costs. Many development experts now agree that microfinance can economically empower individuals and micro-enterprises and enable them to contribute to and benefit from economic development by helping them to acquire capital to undertake investments, integrate into the economic systems of their countries and increase their incomes; ensure the creation or improvement of human capital through better education, nutrition and health; and, through insurance and pensions, smooth their incomes, protect themselves against economic shocks and better manage their enterprises and financial situations.

Kenya's micro-finance industry has come a long way since the 1980s, and particularly since the landmark Micro-finance Intermediaries Act of 2006.The country now has five deposit-taking micro-finance intermediaries (MFIs) operating under a regulatory framework assessed by the Economist Intelligence Unit (EIU) as the best in Africa (EIU 2010).1 Overall, the EIU rates Kenya as having the second best business environment for MFIs in all of Africa (and one of the top ten in the world).

Kenya has the second largest borrower base in the continent (MIX and CGAP 2010), and its largest savings and credit cooperatives (SACCO) movement (Johnston 2006). This is not unrelated to the country’s world-l0eading position in mobile banking (EIU 2010), which has been proven to be a significant driving force in financial inclusion (Andrianaivo and Kpodar 2011).

Nonetheless, the microfinance industry globally is meeting difficulties as funding dries up, delinquencies rise and sceptics begin to question its efficacy in driving poverty reduction and development. Much of this critique focuses on some of the bolder claims, made more often by policymakers and consultants than by practitioners themselves (CSFI 2011).

In addition, microfinance can be combined with other social programs resulting in mutual enhancement of their cost effectiveness. There is also evidence that microfinance is more sustainable and has greater impact than other poverty alleviation interventions such as targeted food interventions. Beyond the economic benefits, microfinance also contributes to the poor's involvement in economic development by increasing political awareness and social organization, increasing social empowerment and community participation, and reducing gender biases in the empowering of the poor. In sum, then, while microfinance may not be a miracle solution, and no single intervention could be, it can combine very well with other economic and social programs, in a holistic approach, to meet the diverse needs of the poor.

1.2 Statement of the Problem

The microfinance sector in Kenya still lacks capacity to match the huge needs of the poor. This is because of certain challenges, which conceal the strengths and opportunities at the various levels. At the micro level, African MFIs have structural weaknesses at several levels: governance, portfolio management, internal control, human resources, and lack of financial sustainability. At the micro level, microfinance support services are rare and of unequal quality.

At the macro level, the supervisory and coordinating bodies have limited resources, and the legal framework is in a state of flux. Moreover, in Kenya like many low income African countries, the legal system is too overstretched and not sufficiently reliable to help further develop the financial sector.

1.3 Objectives of the Study

The study will be guided by the following objectives:

- To present a synopsis of the current state of micro-finance institutions in Kenya.
- To identify the main challenges and constraints impeding on the growth of the microfinance in Kenya.
- To provide policy recommendations to boost MFIs growth sector in Kenya.

1.4 Research Questions

The study will answer the following questions:

- What is the present synopsis of the current state of micro-finance institutions in Kenya?
- What are the main challenges and constraints impeding on the growth of the microfinance in Kenya?
- What are the policy recommendations for boosting the growth of MFIs sector in Kenya?

1.5 Significance of the Study

Kenya is characterised by slow economic growth, underdevelopment, poverty and high levels of unemployment. In order for Kenya to meet its policy objectives as outlined in the national roadmap Vision 2030 and the National Development Plan, amongst others, Kenya needs to progress swiftly with the development of the microfinance industry in order to alleviate poverty among the poor.

Poverty alleviation will certainly be achieved once the marginalised poor are integrated in the mainstream of economic activities. Poverty alleviation is a topical issue at a global level, as emphasised in the Millennium Development Goals. Of significance, this research report tackles an area of microfinance, regarded as one of effective tools in poverty alleviation. It is hoped that the findings of this research paper will especially be helpful to the microfinance service providers, policy makers and regulators, in formulating and executing suitable operational guidelines and strategic interventions that would improve the capacity of this sector.

1.6 Definition of operational terms

Microfinance
This entails the provision of financial services to micro-entrepreneurs and small businesses, which lack access to banking and related services due to the high transaction costs associated with serving these client categories.

Financial services
These are the economic services provided by the finance industry, which encompasses a broad range of organizations that manage money, including credit unions, banks, credit card companies, insurance companies, consumer finance companies, stock brokerages, investment funds and some government sponsored enterprises.

Loan
This is a type of debt. Like all debt instruments, a loan entails the redistribution of financial assets over time, between the lender and the borrower.
Saving
This is income not spent, or deferred consumption. Methods of saving include putting money aside in a bank or pension plan.
Insurance
This is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss. Insurance is defined as the equitable transfer of the risk of a loss, from one entity to another, in exchange for payment. An insurer, or insurance carrier, is a company selling the insurance; the insured, or policyholder, is the person or entity buying the insurance policy.

LITERATURE REVIEW
2.1 Introduction
This chapter will introduce and discuss in detail literature related to the study. It will extensively look at the factors that affect the growth of microfinance institutions. This review also highlights past literature that relates to this study, summary of gaps to be filled by the study, and previous research findings.

2.2 TEORETICAL REVIEW
2.2.1 The Concept of microfinance
More than one out five people in the world - about 1.4 billion people - are regarded as living in poverty. In Africa, the figure in proportion to the world's figure is even higher. Having been in existence over the last twenty years, microfinance is seen as one of the most effective tools to fight poverty in Africa. (Biekpe,2007:1).

Microfinance is about providing financial services to the poor who are traditionally not served by the conventional financial institutions. Three features distinguish microfinance from other formal financial products. These are: the smallness of loans advanced and or savings collected, the absence of asset based collateral, and simplicity of operations. Perhaps most importantly, the poor are more likely to lose their money through fraud or mismanagement in informal savings arrangements than are depositors in formal financial institutions. The concept of microfinance was launched to help the poor population of the world. The significance of microfinance cannot be neglected for the development of any economy.

Microfinance encourages poor households to consume their funds in productive activities by providing them small amount of loans. Poor household refers to low-income people who traditionally lack access to banking and other related financial services. The concept tend to empower would-be entrepreneurs to take up a trade for living, allow them to start earning, and thus to provide their families with income stability. The income that generates from such businesses not only helps in expanding those activities but also contributes to the income of the household bringing benefits for the whole family.

2.2.2Microfinance performance indicators

The microfinance concept is based on the unique foundational principles. The principles are financial sustainability, outreach and impact, which form the basis for microfinance performance evaluation. Each principle should have performance criteria which would then form a basis for evaluation of micro-finance effectiveness. It should however be noted that microfinance performance assessment is multidimensional because these three principles cannot be assessed in isolation as they all symbolise successful microfinance programmes.

Financial sustainability

The concept of financial sustainability highlights the importance of microfinance institutions to operate without direct subsidies from donors or any other external financier. Only independently, financially sustainable and commercially-oriented microfinance institutions in the formal sector can cope with the growth of loan and savings portfolios necessary to attain extensive outreach to the desired target group and improve their livelihoods to a large extent. Building financially sustainable institutions is the only way to reach significant scale and impact far beyond what the donor agencies can fund. Furthermore, the microfinance providers should charge the target group interest rates that enable the microfinance institution to break even without the subsidy and risk, and still generate a profit. In addition to the application of adequate interest, found portfolio quality and effective management to control personnel expenses to be essential to attainment of sustainability (Robinson 2001:12).

Outreach

Outreach refers to the number of clients served. Outreach is an important aspect of microfinance in view of the fact that the fundamental aim of microfinance is to reach the largest number of unserved poor people who do not have access to financial services. Limited outreach can impact on the sustainability in terms of benefits linked to economies of scale.

In order for microfinance to attain greater outreach, the MFIs need adequate funding. Funding would generally be required to cover the cost of reaching the rural areas where poverty is prevalent. The aspect of funding however poses a challenge especially for donor dependent MFIs because of the drying out of donor funds. As such, lack of adequate outreach exposes the MFIs to retard growth (Kereta, 2007:9)

Impact

Microfinance was developed with the aim of enhancing social and economic conditions of the poor. Impact assessment in line with intended outcomes need to be conducted to ascertain the effectiveness of the microfinance programmes. Ledgerwood (1999:46) stresses that evaluating the impact of microfinance interventions is vital especially if the microfinance programme focuses on poverty alleviation in the long run. Failure to assess the level of impact of microfinance provision on the lives of poor, makes it difficult to justify microfinance as a tool for poverty alleviation. Impact assessment can be done by:

i) Assessing the coverage of micro-finance interventions to determine impact. This can be obtained by assessing the volume of transaction, their movement over a long period and the quality of the services offered.

ii) Secondly, impact can be observed on the client's quality of live. This approach assesses movements in income, health, education, quality of food consumed, empowerment of women, etc.

2.3 EMPIRICAL REVIEW

Micro-finance is seen as one of the tools that promote poverty alleviation and community development, the microfinance sector is equally faced with numerous challenges impacting negatively on the MFIs financial sustainability. Morduch (2000:618) notes that even those microfinance programmes committed to financial sustainability, they manage to cover only 70 percent of their costs as almost all programmes still receive considerable subsidization, especially those focusing on social welfare. A survey in the same study that indicated that if subsidies were discontinued, 95% of the industry would face closure, suggesting that no more than five percent of microfinance institutions (MFIs) worldwide will ever be sustainable.

Donor and government subsidy is essential especially in the early stages of the MFI, continuous subsidy can potentially result in a state of dependency and complacency, and consequently to donor fatigue. In light of this, donors are opposed to continuous financial assistance arguing that subsidation should ideally be limited to start up stages (Morduch1999:1571). Furthermore, donors embrace the institutionist perspective endorsed in the CGAP best principles for promoting adherence to microfinance practices. When these principles are adopted, they can enhance sustainability of the MFIs.

Wright (2000) states that much of the scepticism of MFIs stems from the argument that microfinance projects “fail to reach the poorest, generally have a limited effect on income drive women into greater dependence on their husbands and fail to provide additional services desperately needed by the poor”. In addition, many development practitioners not only find microfinance inadequate, but that it actually diverts funding from “more pressing or important interventions” such as health and education. There is a danger that microfinance may siphon funds from other projects that might help the poor more. They state that governments and donors should know whether the poor gain more from microfinance, than from more health care or food aid for example. Therefore, there is a need for all involved in microfinance and development to ascertain what exactly has been the impact of microfinance in combating poverty.

Considerable debate remains about the effectiveness of microfinance as a tool for directly reducing poverty, and about the characteristics of the people it benefits (Chowdhury, Mosley and Simanowitz, 2004). It is notoriously difficult to measure the impact of microfinance programmes on poverty. This is so she argues, because money is fungible and therefore it is difficult to isolate credit impact, but also because the definition of ‘poverty’, how it is measured and who constitute the ‘poor’ “are fiercely contested issues”. Poverty is a complex issue and is difficult to define, as there are various dimensions to poverty. For some, such as World Bank, poverty relates to income, and poverty measures are based on the percentage of people living below a fixed amount of money, such as US$1 dollar a day (World Bank, 2003).

2.4 Factors Inhibiting Growth of Microfinance Institutions in Kenya

2.4.1Governance and regulatory deficiencies

The weaknesses in the contractual framework, high degrees of corruption, risks of expropriation, lack of capacity of the regulatory institutions and inefficient bureaucracies as well as information asymmetries put certain limits to the effectiveness of government interventions and to the extent to which the benefits from financial sector reforms can reach the majority; they also explain the focus on short-term transactions rather than long-term commitments.

2.4.2 High exposure to economic and socio-political shocks

The high exposure to economic and socio-political shocks, including crop failures, sharp changes in prices of traded commodities, civil unrest, and unexpected changes in government or government policies not only limits the time horizon of savers and investors alike, but also reduces the horizon over which governments can plan.

2.4.3 Intermediation deficiency

The inefficiencies, high risks and lack of effective competition result in expensive banking services, reflected by high interest rate spread and margins, high minimum deposit requirements, and high lending interest rates. Meanwhile, banks, which dominate the system, remain highly profitable and liquid.

2.4.4 Dominance of the banking sector

The dominance of the banking sector, which underlines the importance of encouraging banks to be involved in the microfinance subsector. However, bank lending in general and funding of microfinance is still heavily geared towards the short end of the market for various reasons: bank balance sheets are dominated by short-term deposits; banks face acute problems of lack of information about creditworthiness of potential clients and difficulty of enforcing contracts and creditor rights that increase the risk of loan default.

Weaknesses of the legal system (laws, registry, operation of courts), especially regarding property rights, limit the number of credit worthy borrowers and the capacity of financial institutions, and other deficiencies in the governance structure in many countries (high degrees of corruption, the risk of expropriation and inefficient bureaucracies).

2.4.5 Structural fragility of most MFIs

One distinguishing feature of microfinance in most African countries is the relative fragility of several MFIs, which generate internal risks to the strength and sustainability of their operations, thereby constraining them from playing a fully effective role in financing the private sector, enterprises and households.

There is a serious governance problem among cooperative institutions that make up the vast majority of MFIs in African countries. The market as a whole is thus made more fragile. Several difficulties are apparent: Volunteer work may make some elected heads not as motivated and lead to frequent departures before the end of terms. The need to engage in remunerated activity is not always compatible with their mission, some managers lack the training and skills in management and finance to carry out their duties effectively, some social behaviors are inconsistent with the cooperative principle: favoritism in extending credit, embezzlement, and setting poor examples regarding loan repayment.

The cooperative institutions often are poorly managed as a result. Relationships between salaried technicians and elected officers are sometimes tense, particularly regarding decision making and allocation of work within institutions.

2.4.6 Supply of credit not fully meeting demand

Inadequate supply of credit by MFIs in Kenya and generally Africa show a higher level and volume of deposits than of credits. According to MIX (MIX, 2009), the situation was exacerbated in 2008, reflecting a worldwide trend, and growth of borrowers slowed dramatically to 12 percent, from 25 percent in 2008. There are several reasons for the generally limited number of borrowers compared to depositors, and especially also for limited medium and long-term lending: (i) methodological shortcomings, such as requiring real guarantees that microenterprises and poor clients have difficulty providing; (ii) the attractiveness for MFIs in many countries of placing assets in Treasury bills (BTAs)40 with high rates as compared to loan portfolios; and (iii) the fact that most deposits are short-term provides no incentive for MFIs to grant medium- and long-term loans to private entrepreneurs.

RESEARCH METHODOLOGY

3.0 Introduction

This chapter will examine the various research methods and techniques that will be used to collect the data for analysis and it will try to define the population from which the sample will be drawn from. The research method will contain elements such as sampling methods, target population and a sampling size which will be used in conducting this research study on analysis of factors inhibiting the growth of the micro-finance sector in Kenya.

3.1 Research Design

A research design is a method of collecting information by interviewing or administering a questionnaire to a sample of individuals. The research design to be used will be descriptive design. This design can also be used when collecting information about the people's attitudes, opinions, habits or any of the variety of other issues Olive M. Mugenda and Abel G. Mugenda (2003).

3.2 Sampling Technique

The research study will use stratified sampling design. This will try to identify, clarify, and define the nature of the problem and variables used in the study. A ratio of 20% will be used by the researcher when drawing elements from the study population. This technique will ensure that each element in the study population have an equal and independent chance of being selected Olive M. Mugenda and Abel G. Mugenda (2003).

3.3 Sampling Procedure

The researcher will consider probability sampling method because it is fairly simple, precise and it reduces bias especially when all elements of the population have similar characteristics Olive M. Mugenda and Abel G. Mugenda (2003).

3.4. Study population

This represents the cumulative elements of the study from which the researcher will use to collect the information from the environment. The elements of study that exist in this study population will be represented in the form of chosen target population.

Fig 3.1 Study Population

Strata	Population No	Percentage %
MFIs	50	20
NGOs	50	20
Co-operative Societies	50	20
Commercial Banks	50	20
TOTAL	**200**	**100**

Source (Author 2012)

3.4.1 Target Population

This is the selection of specific desired elements by the researcher to provide information that will be used in the research study. This research will target both in urban and rural parts of Kenya.

Fig 3.2 Target population

Strata	Population No	Percentage %	Sample size
MFIs	50	20	10
NGOs	50	20	10
Co-operative Societies	50	20	10
Commercial Banks	50	20	10
TOTAL	**200**	**100**	**20**

Source (Author 2012)

3.5 Data collection procedures

The researcher will get permission from willing respondents and authorities before collecting data required for the research study. The data collection procedure will be guided by the use of data instruments such as questionnaires, interviews and use of emails where necessary.

3.6 Data collection instruments

Data collection will be done using questionnaires and interviews. The open and closed administered structured questionnaires will be used to collect data related to the themes of the study. The questionnaires will be given to respondents to answer. The researcher will also assist respondents in case they enconter problems in filling the questionnaires. Observations as an instrument and procedure of data collection will also be used. Olive M. Mugenda and Abel G. Mugenda (2003).

3.7 Data analysis

After collecting data, it will be organized and broken into manageable units before subjecting it to statistical analysis. The data will be analyzed both qualitatively and quantitatively to enable the researcher to make certain inferences about population value. The data will be presented in table, pie charts and graphs. Finally after the analysis of data a final report about the findings, conclusion, recommendation and area of further study will be made on the current research study.

3.8 Ethical issues

The ethical issues in this research will be the accuracy of information provided, acknowledgement of findings or information sourced from other researchers or authors and respondents. Information will be sought with consent from respondents without violating their human rights or through forceful obtaining of information.

Appendices

3.9.2 Budget

This section includes all the costs incurred or is likely to be incurred when carrying out this research study.

ACTIVITY	COST PER UNIT	NO. OF UNIT	TOTAL COST [Kshs]
Flash Disk	2,000	1	**2,000**
Typing and Printing	40	30	**1,200**
Binding	40	2	**80**
Travel Expense	500	10	**5000**
Total	**2,580**		**8,280**

Source (Author 2012)

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