INTERNATIONAL JOURNAL OF SOCIAL Sciences and Information Technology
ISSN 2412-0294 www.ijssit.com
http://www.ijssit.com

FACTORS INFLUENCING FINANCIAL SUSTAINABILITY OF MICROFINANCE INSTITUTIONS IN MOMBASA, KENYA

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Abstract

Microfinance is recognized as one of the tools that enhance the capability of the poor to engage in sustainable productive activities, leading to poverty reduction and improved social welfare. Microfinance has become one of the most popular poverty reducing strategies in the world. However, while the surge of microfinance institutions has been unprecedented in the past three decades, their performance and sustainability is still a contentious debate. Worldwide MFIs face an apparent tension between achieving financial suitability and contribution to poverty reduction. Therefore, this study investigated the factors influencing financial sustainability of MFI's in Kenya with specific focus to Mombasa County. The study examined the effect of governance, donor financing and savings mobilization on financial sustainability of Microfinance Institutions. The population of the study consisted of five microfinance institutions operating in Mombasa Town. These MFI's are KWFT, Faulu Kenya, Cardet, SMEP and Yehu. The study found that there is a significant but negative relationship between governance, donor financing, saving mobilization and financial sustainability of microfinance institutions in Mombasa County. The study concluded that good governance, donor financing and saving mobilization statistically and significantly influence financial sustainability of microfinance institutions in Mombasa County in Kenya. The recommended that the management of microfinance institution should institute good governance practices, take advantage all sources of financing including donor financing and savings mobilization to enhance their financial sustainability.

Keywords: donor financing, financial sustainability, governance, savings mobilization, microfinance

INTRODUCTION

Background of the Study

Microfinance Institutions (MFIs) provide financial services to low-income households in developing countries around the world. Microfinance refers to an array of financial services that include credit, savings, and insurance while micro-credit is the provision of credit, which is usually used as capital for small business development. MFIs can operate as Non-Governmental Organizations (NGOs), credit unions, nonbank financial intermediaries or commercial banks (Dehejia, Montgomery & Murdoch, 2005). Microfinance Institutions (MFIs) provide financial services to poor clients who in most cases have no access to formal financial institutions (Alemayehu & Lemma, 2014). Microfinance is thus recognized as one of the tools that enhance the capability of the poor to engage in sustainable productive activities, leading to poverty reduction and improved social welfare (Mulunga, 2010). Microfinance is seen as one of the effective tools that can address poverty alleviation by engaging the poor in sustainable economic activities. The positive impacts of microfinance institutions on the socio-economic welfare of the poor can only be sustained if the institutions can achieve a good financial and outreach performance. Financial sustainability is achieved when service and infrastructure levels and standards are delivered according to a long term plan without the need to increase rates or reduce services (Rusinko, 2005). Thus, financial sustainability of microfinance institutions is probably the key dimension of microfinance sustainability (Kinde, 2012). Microfinance has a dual goal, that of attaining financial sustainability and reducing poverty, simultaneously. The aspect of sustainability is crucial in poverty alleviation because in order to have a long-term impact, microfinance services should be provided on a continuous basis (Mulunga, 2010). Globally, there are more than 67 million households served by microfinance programs. (Armend& Murdoch, 2005). In Africa, Micro finance institutions play a great role in supporting the economic activities of the rural and urban poor in developing countries. MFIs are also important actors in the financial sector, and they are well positioned to grow and reach the millions of potential clients who currently do not have access to mainstream financial services (Alemayehu & Lemma, 2014). Microfinance has emerged as a powerful tool for poverty alleviation through increased financial access to the poor in most African countries (Marwa & Aziakpono, 2015). For instance, many people in East Africa are living below poverty line, hence microfinance institutions have played a very critical to the health of the general economy at large (Tehulu, 2013). Microfinance remains the most cost effective way to alleviate poverty in developing countries (Iezza, 2010). The Microfinance sector in Kenya is organized into various categories which include regulated MFIs; commercial banks, non-bank financial institutions (Post Bank), and the to-be regulated; transforming MFIs under MFIs Act; non-regulated; credit only MFIs; financial wholesalers; micro-insurance providers and capacity providers/development institutions. The micro finance industry in Kenya had for a long time operated under a number of constraints such as: lack of legal framework, weak institutional capacity and unsustainable sources of funding among others. The combination of these factors led to uncompetitive and inefficient micro finance industry and to the failure of some MFIs. Micro finance continues to play a significant role in the lives of the poor in Kenya by responding to their needs, concerns and voices by providing easy access of financial services (Chepkorom, 2013).

Statement of the Problem

The practices of microfinance services for the poor have grown immensely since its beginning in the 1970s. Microfinance has become one of the most popular poverty reducing strategies in the world (Omunjalu & Fondo, 2014). However, while the surge of microfinance institutions has been unprecedented in the past three decades, their performance and sustainability is still a contentious debate (Marwa & Aziakpono, 2015). Worldwide MFIs face an apparent tension between achieving financial suitability and contribution to poverty reduction (Gashayie & Singh, 2015). In Kenya, the microfinance sector is one of the most vibrant in Sub-Saharan Africa and includes a diversity of institutional forms and a large branch network to serve the poor (Wambugu & Ngugi, 2012). Microfinance Institutions have in Kenya in the recent years, been claimed to be the most suitable vehicles for providing access to sustainable financial services and alleviating poverty among people who are economically challenged (Adoyo, 2013). However, despite the interest in the sector and the subsidies that have flowed into some of the mission-oriented MFIs in Kenya it appears challenging to make an MFI viable over the long term (Adoyo, 2013). In Kenya, Wambugu & Ngugi (2012) found that the quality of service, staff competencies and branches diversification were the major factors that influenced the sustainability but the study did not explore the effect of governance, donor financing and saving mobilization on financial sustainability. Thus, despite the existence of countless studies on the microfinance industry most of the studies have focused on the factors that affect the operational sustainability of Microfinance institutions and other issues affecting their operations especially in Kenya. This presents an empirical gap, which necessitates an investigation on the factors influencing financial sustainability of Micro Finance Institution's in Kenya.

Objectives of the Study

The general objective of the study was to investigate the factors influencing financial sustainability of MFI's in Mombasa, Kenya. The Specific objectives of the study included;

1. To establish how corporate governance influence financial sustainability of Micro Finance Institutions in Mombasa County
2. To find out how donor financing affects financial sustainability of Micro Finance Institutions in Mombasa County
3. To find the effects of savings mobilization to financial sustainability of Micro Finance Institutions in Mombasa County.

LITERATURE REVIEW

Theoretical Literature Review

A Game-Theoretical Approach to Group-Lending

Classical financial institutions typically require the existence of collateral as security before granting loans to a client. However, low income levels and the lack of assets would exclude most people in developing countries from obtaining credit from standard Banks. In contrast, micro finance institutions apply the concept of group-lending. Instead of requiring collateral from each individual, they use peer pressure and social selectivity to increase repayment rates and hedge against default risk. Several individuals are grouped, where each person receives a specific loan, but still the whole group is responsible for repaying credit.

As groups form voluntarily, no group is willing to accept a member whose reputation is questionable and who is likely to take too high risks in investing the loan and risks to be unable to repay by hindsight. In case of Grameen Bank, the sanction for default is lasting credit denial for all group members (Morduch, 2004) by this means, micro finance institution substitutes collateral with the mechanism of social reputation within a group.

This mitigates the risk of default due to adverse selection through asymmetric information in the detriment of the MFI. In addition, group-lending decreases transaction costs, another cause for standard banks to refrain from lending to the poor (Sachs, 2005). At the same time, poor individuals are granted the possibility to access local financial markets and to invest in small businesses. The design of group-lending by Grameen Bank described above can be formalized by means of a game-theoretical approach. However, one or more group members may defect and use the loan to invest in too risky projects that bear higher profit but are also more likely to fail. In the latter case, I assume that the exclusion from further loans is the only sanction, but no repayment claims on the part of the MFI are made.

Theory of Loan Repayment

Microfinance organizations often use high frequency repayments. Borrowers are typically required to repay their loans in regular installments, beginning soon after the loan is given out. This aspect of the repayment schedule is usually explained as inducing 'fiscal discipline' among borrowers. Jain and Mansuri (2003) argue that an alternative rationale for this loan repayment structure lies in the difficulty of monitoring borrowers' actions. The potential for moral hazard Leads MFIs to use innovative mechanisms, such as regularly scheduled repayments, which indirectly co-opt the better-informed informal lenders. Conversely, this installment repayment structure allows informal lenders to survive. Further, they show that this linkage can not only expand the volume of informal lending, but may also raise the interest rate in the informal Sector. Fischer and Ghatak (2009) propose an alternative theory based on present-biased, quasi-hyperbolic preferences in order to capture the belief of many microfinance practitioners that clients benefit from the fiscal discipline required by a frequent repayment schedule. Their work is motivated by a pervasive sense among practitioners that frequent repayment is critical to achieving high repayment rates. The model that captures this is stark in order to highlight one particular effect: if borrowers are present-biased, frequent repayment can increase the maximum loan size for which repayment is incentive-compatible. Intuitively, when borrowers are present-biased, the immediate gain to defaulting on any large repayment is subject to significant temptation. When these payments are spread out, the instantaneous repayment burden at any time is smaller and thus less subject to temptation. Frequent repayment also means that at the time of the first payment, the rewards (typically access to future credit) are further away from the repayment decision and thus more heavily discounted. Frequent repayment imposes an opportunity cost of meeting attendance on borrowers and direct costs on the lender. It might also distort the Investment incentives of borrowers toward projects that generate consistent, if manager returns. The optimal frequency balances these costs against the positive incentive effects.

Conceptual Framework

According to Kombo and Tromp (2009), the major aims of research should be either be to relate data to theory or to generate a theory from data. The conceptualization is based on the following independent variables; governance and internal controls, donor funding and loan portfolio, savings services and debt financing while the dependent variable is Sustainability of Micro Finance Institutions. Figure 1 graphically presents the conceptual framework

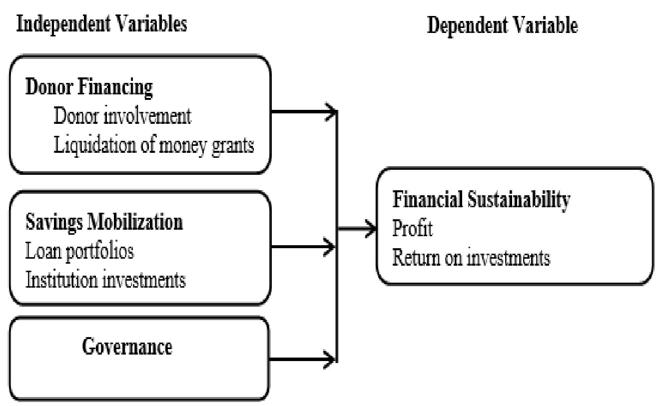

Figure 1: conceptual framework

Research Gaps

The purpose of this literature review is to review the various factors influencing the financial sustainability of MFI's. This study has generally highlighted the various factors that could affect MFI's process of reaching sustainability. The reviewed studies suggest that the evolution of financial sustainability in MFIs to becoming a strategic function has opened a floodgate challenges. The studies have also showed that several factors influence financial sustainability. For instance, Sandhya and Anand (2012 found that the capital/ asset ratio, operating expenses/loan portfolio and portfolio at risk affected financial sustainability of MFIs. Kinde (2012) found that microfinance breadth of outreach, depth of outreach; dependency ratio and cost per borrower affect the financial sustainability. Tehulu (2013) established that that MFIs' financial sustainability is driven by loans intensity and size of the MFI.

However, most of the reviewed studies have focused on the balance sheet factors like dependency ratio, cost per borrower, loans intensity, size, portfolio at risk as the key factors that affect financial sustainability of MFI. Additionally, other studies focus on macroeconomic factors and their effect on financial sustainability of MFIs. Thus, there is no sufficient literature focusing on factors influencing financial sustainability of MFI's in Kenya. This study therefore seeks to add literature on the factors influencing financial sustainability of MFI's in Kenya. Within its defined purpose, this study was to inform practitioners as they design institutional models and regulators in their efforts to boost the effectiveness of microfinance provision in Kenya

RESEARCH METHODOLOGY

This study employed a descriptive research design. A descriptive research refers to research studies that have as their main objective the accurate portrayal of the characteristics of persons, situations or groups. This approach is used to describe variables rather than to test a predicted relationship between variables. The population of the study consisted of five microfinance institutions operating in Mombasa Town. These MFI's are KWFT, Faulu Kenya, Cardet, SMEP and Yehu (Association of Microfinance Institution, 2016). The sampling frame of the study entailed the 60 employees who comprised of 11 managers, 15 officers and 35 other junior employees of the five microfinance banks in Mombasa County. This study carried out a census of the 60 employees. A census was chosen since the population was small and definite. The respondents were selected using simple random sampling where each respondent was given an equal chance of being included in the study. Questionnaires were chosen because they are reliable and unbiased in the sense that they are focused and systematic and as such reduce the probability of error occurrence in the data collection. The study used both primary and secondary data. Primary data was collected using questionnaires. The questionnaires were administered to the sampled respondents by the researcher. The self-administration method ensured that the researcher responds to any concern at hand and ensured that the questionnaires were properly responded to. Secondary data on the other hand was sourced from journals, conference reports, the company's annual reports and other relevant published materials. The data collected was sorted, edited, processed and then analyzed through descriptive and inferential statistics with the aid of the Social Package for Social Sciences. The results of the descriptive statistics were presented using tables. On the other hand, inferential statistics included the multiple linear regression was used to establish the relationship between the study variables.

RESEARCH FINDINGS AND DISCUSSION

Introduction

The section shows the response rate, presents the background information, presents findings on governance, donor financing, savings mobilization and financial sustainability. The chapter also presents the inferential statistics results.

Inferential Statistics

Model Summary

Table 1 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.873[a]	.762	.749	.03845

a. Predictors: (Constant), Savings mobilization, Donor financing, Governance

Table 1 indicates that savings mobilization, donor financing and governance (independent variables) explain 76.2% of the variation in financial sustainability (dependent variable) while 23.8% is explained by other variables not considered in the study.

Analysis of Variance

The study findings shows that the F statistics value is 56.653 which is significant at 95% confidence level since p value (0.000 < 0.05). This indicates that the regression model is a good predictor of the factors influencing financial sustainability of microfinance institutions in Mombasa County.

Regression Coefficients

Table 2 Regression Coefficients

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	6.989	.321		21.796	.000
Governance	-.420	.043	-.989	-9.707	.000
Donor financing	-.018	.004	-.353	-4.111	.000
Savings mobilization	-.050	.020	-.306	-2.549	.014

a. Dependent Variable: Financial sustainability

From table 2 the following regression equation was generated.

$$Y = 6.989 - 0.420X_1 - 0.018X_2 - 0.050X_3 + \varepsilon$$

Table 2 shows that there is a significant but negative relationship between governance, donor financing, saving mobilization and financial sustainability of microfinance institutions in Mombasa County. This indicates that there is an inverse relationship between governance, donor financing and saving mobilization financial sustainability of microfinance institutions.

Summary of findings

The general objective of this study was to investigate the factors influencing financial sustainability of MFI's in Mombasa, Kenya. The findings on how does governance influence financial sustainability of micro finance institutions in Mombasa County established that risk management, unclear legal status, internal controls and inadequate stakeholders support are the major governance problems faced by microfinance institutions. The study also found that good governance supports the viability of MFI operations in terms of sustainability and microfinance institutions failures and shortcomings are attributed to bad governance. The study also found a significant relationship between governance and financial sustainability of microfinance institutions. The findings on how donor financing affect financial sustainability of micro finance institutions in Mombasa County established that assistance from donors helps MFIs to build up a strong financial base and donors are instrumental in promoting the practice of MFIs and the supporting the policy environment. The study also revealed that MFIs overreliance to donors undermines the incentive to build strong MFI institutions and that MFIs should limit donor financing to the beginning stages of development. The findings on the effect of savings mobilization on financial sustainability of Micro Finance Institutions in Mombasa County established that adequate savings are crucial for MFIs development and savings enhance capital accumulation and savings reduce the risk of involuntary loan default on the part of MFI borrowers. The study also found that savings generation reduces MFIs overreliance to donor aid and external assistance and savings mobilization increases interest expenses and costs of the microfinance institution.

Conclusion

The findings of the study found a significant relationship between governance and financial sustainability of microfinance institutions. This leads to the conclusion that good governance influences financial sustainability of microfinance institutions. The study also found a significant relationship between donor financing and financial sustainability of microfinance institutions. This leads to the conclusion that donor financing statistically and significantly influences financial sustainability of microfinance institutions. The study also found a significant relationship between savings mobilization and financial sustainability of microfinance institutions. This leads to the conclusion that savings mobilizations statistically and significantly influence financial sustainability of microfinance institutions in Mombasa County in Kenya.

Recommendations

The study concluded that good governance influences financial sustainability of microfinance institutions in Mombasa County. This leads to a recommendation that the management of microfinance institutions should institute and adopt good governance practices to enhance their financial sustainability. The study concluded that donor financing influences financial sustainability of microfinance institutions. This leads to a recommendation that microfinance institutions should take advantage of all source of funds including donor financing as this would enhance their financial sustainability and outreach. The study concluded that savings mobilizations influences financial sustainability of microfinance institutions. This leads to the conclusion that microfinance institutions should strive to mobilise deposits from their clients and institute effective mechanism to protect their clients’ deposits so that they can enhance not only financial sustainability but also outreach.

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