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# Review Paper on Microfinance Institutions Barriers in Product Diversification in Kenya

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***Abstract***
*Today, Microfinance Institutions (MFIs) play an important role in the economic development of poor communities. MFIs include non-governmental organizations (NGOs), credit unions, non-bank financial intermediaries, and even a few commercial banks. The World Bank estimates that there are now more than 7,000 microfinance institutions, serving some 16 million poor people in developing countries. To the extent that these MFIs become financially viable, self-sustaining, and integral to the communities in which they operate, they have the potential to attract more resources and expand services to clients. The majority of these microfinance organizations are donor funded, which is an obstacle to their sustainability. Micro credit and microfinance have changed the lives of people and revitalised communities in the world's poorest and also the richest countries.*
*We have seen the enormous powers that access to even modest financial services can bring to people. With access to a range of financial tools, families can invest according to their own priorities – school fees, health care, business, nutrition or housing fraction. However, studies have shown that micro finance institutions face some barriers. it is in this light that the project aimed at finding out the extent and how to deal with it.*
*An important component of financial sector reforms is the liberalization of interest rates. It is argued that this would raise real interest rates, increase saving and the supply of inventible resources in the economy. There should be no social classes for the people and if so attractive market segments should be made for the poor.*
*There is a need for a policy that advocates for better access to capital sources and investment opportunities for microfinance sustainability, and also encourages MFIs to increase their accessibility, build capacity, be more transparent, adopt acceptable performance standards, and promote professionalism that in turn enhances service deliver (Matu and Jeffrey, 2003).*

## 1. Introduction

The World Development Report (2000-06) acknowledges that the reach of micro finance has been limited to moderately poor sections rather than the poorest and recommends greater flexibility in loan size and repayment schedules to reach poorer sections in many regions.

In the past two decades, the number of microfinance institutions (MFIs) offering micro credit has grown markedly. At the same time NGOs and governments have augmented efforts to increase literacy rates and to reduce dropout rates in schools. However, traditionally, micro credit and education programs have not worked with each government programs relating to education have focused on increasing the number of schools and teachers, while microfinance programs have focused on providing credit for the acquisition of working capital in micro-enterprises. Microfinance and education can and should integrate).

However, there are also strong reasons to think that developing credit markets for education, thus removing important demand-side constraints on its acquisition, is very important to help families get out of the vicious circle of poverty. Low and variable incomes lead to deficient levels of educational attainment, thus leading to the intergenerational transmission of poverty. There are also institutional reasons why most MFI programs have developed a single-product credit.

If micro credit is used for investing in education, it can have a deeper and longer impact through the creation of vicious cycles out of poverty by making the younger generation in a family have more skills than their parents did, and so greater opportunities in terms of access to more and better jobs in the future. The challenge in this respect, however, lies in finding out how to design microfinance products that are effective in removing the financial constraints that poor families face in sending their children to school, but at the same time making sure that the outcome is not just greater indebtedness for the client and that it is sustainable for the MFI.

There is need for micro finance to increase their services MFI *Transparency* plans to use the grant to increase its industry presence and visibility, secure additional long term funding, and progress towards its near and long term goals. (Michael, 2009)

MFIs in Kenya still face major challenges with efficiently and effectively delivering microfinance services in the country. As the demand for these services continues to grow, the limited sources of available capital have greatly undermined the capabilities of MFIs to efficiently operate their services and expand their various microfinance activities. This has led to a financial gap in the supply of microfinance services, and consequently reducing the opportunities for the poor to access basic socio-economic benefits that could potentially improve their wellbeing. The widening financial gap in the microfinance sector has been attributed to self-governance issues, capacity building issues, non-compliance with reporting requirements, and a lack of appropriate performance criteria. (Matu and Jeffrey, 2003).

### *1.1. Ownership Structures*

MFIs can be government-owned, like the rural credit cooperatives in China; member-owned, like the credit unions in West Africa; socially minded shareholders, like many transformed NGOs in Latin America; and profit-maximizing shareholders, like the microfinance banks in Eastern Europe. The types of services offered are limited by what is allowed by the legal framework of the provider: non-regulated institutions are not generally allowed to provide savings or insurance.

## 2. Services Offered by Micro Finance Institutions

The financial services offered by micro finance institutions are in form of loans the loans include: Micro Finance Credit Loan (Curran, 2005)

- Micro Enterprise Development- This product is aimed at financing both Micro Finance Institution (MFIs) and Partner Organisations (POs) for on lending to clients earning above sh1500 per month. Funds will be wholesaled at the rate ranging from 6%-8% per annum.
- Poverty alleviation- This product is specifically aimed at financing Partner Organisation for on lending to clients earning less than shs1500 per month with emphasis on development projects. The maximum exposure including the micro-enterprise developmental loan. Funds will be wholesaled at the rate ranging from 6%-8% per annum.
- Capacity Building Fund- This product is aimed at equiping Partner Organisations and Micro Finance Institution with funding on building infrastructure to ensure that they are functional, effective and sustainable.
- Savings Mobilisation Fund- This product is aimed at providing funding to enhance savings mobilisation. The maximum fund will be made available to capacitate existing Savings Schemes.
- Tatua loan- these are loans offered when there is an emergency in form of hospital bills, stock loss, fire or burglary,machine breakdown.
- Mkopo maisha bora –for starting up business and offered to groups only. This becomes a barrier to the clients who wants to start up on his own. This also helps in buying of domestic assets such as farm machinery television sets and fridges.
- Mkopo kilimo- loan facility designed to address special needs of the farmers.
- Payments (including money transfer services, card services)- this constitutes the medical cover for whole family. That is hospital admission, theatre and surgical charges X-rays and laboratory charges.
- Other services offered are: business skills training and leadership these are not offered by the ion of great returns, solar systems and Simu ya Jamii, Networking, market linkages.

## 3. Need for Micro Finance Institutions to Increase Their Products

In competition with commercial banks, MFIs are in many aspects at a distinct disadvantage. First, they often rely on loans from the very same banks they are in competition with, and have to mark-up the interest rates to cover their costs. Not only do MFIs offer smaller loan sizes, which have a lower return, they generally have higher overhead costs because they go to the clients, rather than have the clients come to them as is the case for commercial banks. Furthermore, clients may be dissuaded by the relatively involving terms and conditions of MFI loan products, including attending weekly meetings and adhering to strict repayment schedules. Banks on the other hand may offer easier terms and more flexible repayment schedules of up to 48 months.(Gerhard, 2007)

The tragedy for microfinance is that its business model is expensive. The low income access small loans and require frequent monitoring thereby excerbating the institution costs leading to high interest rates that sometimes overprices institutions out of the market.(Njoroge, 2009).

## 4. Barriers to Diversification

The macro business environment includes all extraneous factors that influence decision making on resource use and performance of any business. Some of the reasons that make the micro finances not to give loans are, political instability and legal framework and interest,social constraints, financial and economic stabiliy. Macro business environments have also been found to influence availability of credit (Aghion et. al., 2005), contract enforceability (Acemoglu et. al. 2007), investor protection (Rui et al., 2004) and business entry costs (Aghion et. al., 2006).

### *4.1. Political and Legal Framework*

These refer to government policy such as the degree of intervention in the economy. What goods and services does a government want to provide? To what extent does it believe in subsidising firms? What are its priorities in terms of business support? Political decisions can impact on many vital areas for business such as the education.

**Legal**-these are related to the legal environment in which firms operate. Increase in the minimum wage and requirements for firms to recycle are examples of relatively recent laws that affect an organisation's actions. Legal changes can affect a firm's costs (e.g. if new systems and procedures have to be developed) and demand (if the law affects the likelihood of customers buying the good or using the service). Regulation of Financial Service Firms: to what extent are financial service firms regulated and do clients know that they are regulated? Consumer Protection: what is the scope and effectiveness of regulation on supervised financial service firms? Voluntary Codes of Practice: do they exist and how effective they are. Client Compensation: what are the arrangements and procedures for compensating consumers in the event of bank failure? (Lynne,2005).

Political and social instability has also contributed to the under-development of micro finance. political pressure that has direct impact on the stability of a state is given a priority over micro finance. Governments naturally prioritise health, environment and other disaster-related issues instead of focusing on initiatives that could provide solutions to these problems like micro finance.(Paulo,2009)

The effects of this are quite visible. Just think of the effect of changing taxes, or raising interest rates. If the legal system, pushed by politics lowers the acceptable emission rates, companies may have to invest in new equipment or close down. *Tax laws inhibit the nonprofit sector, they inhibit it unnecessarily.* The majority of the laws in question could be repealed without creating economic hardship for the country. nonprofits are "major taxpayers." More importantly, their exemptions were are unjustified because the organizations provide valuable aid to society and should therefore be supported. According to (Paul, 2003) , tax relief is more flexible than other forms of aid, because it increases as an organization's income increases, and because tax benefits are not usually subjected to the same level of public comment and constraint as direct grants or other public expenditures.

The results underscore two principal themes: the weight of history in determining the growth and design of financial institutions and markets, and the importance of idiosyncratic forces that buffet institutions over time. What goods and services does a government wants you to provide? To what extent does it believe in subsidising firms? What are its priorities in terms of business support? Political decisions can impact on many vital areas for business such as the education of the workforce, the health of the nation and the quality of the infrastructure of the economy such as the road and rail system.

Licensing applications will be supported by various information of a commercial, legal, corporate and financial nature as the basis of which the Central Bank assesses the reputation and creditworthiness of the applicants besides the viability of the prospective microfinance venture. The application to incorporate and register a microfinance institution will be reviewed and decided by the Central Bank within 90 days. Political forces play important roles in shaping regulations that in turn altered the course of financial institutions and markets. The results here simply suggest that these political forces appears inconsistently and has no traceable, uniform relationship to the overall political system in place in the nineteenth century. Politics should not be a hindrance to a country's growth as micro finance contributes to the GDP of the country.

In order to make micro finance inclusive, the micro finance policy that is unfriendly to the poor should be revised. Specifically, the Government needs to revise the existing laws and regulations and enhance its supervisory framework. Further, Micro Finance Institutions should establish working relationship with FNCCI and its district chapters to access different facilities and support that may be available. This also develops the efficiency in networking and advocacy which supports to share knowledge, information and experience. Additionally, the civil societies need to educate people against caste-based discrimination as the ethno-caste-based discrimination is the root cause of exclusion of deprived communities in every sector of public life.(Hesselroth, 2007)

The government should foster competition in the microfinance industry by minimizing tough registration requirements and also create an attractive investment environment for the private investors both local and international. The tax policies, the ever changing government agency enforcement and the diverse legislationsthat may be a hindrance should be revised this is to ensure that both the customer and micro finance institution benefit.

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### *4.2. Economic and Financial*

These include interest rates, taxation changes, economic growth, inflation and exchange rates. As you will see throughout the "Foundations of Economics" book economic change can have a major impact on a firm's behaviour. A lot of work has been done on the relationship between financial deepening and economic performance. Many studies find a close link between financial deepening, productivity and economic growth and conclude that policies affecting the financial sector have substantial effects on the space and pattern of economic development (Goldsmith 1969; King and Levine 1993).

It is for example estimated that policies that would raise the GDP ratio by 10% would increase the long-term per capita growth rate by 0.2–0.4% points (World Bank 1994). The financial sector is involved in the mobilization of resources among savers and their allocation to borrowers as well as transformation and distribution of risks and maturities over time. It facilitates saving and the efficient allocation of these savings to investment. In the process, it plays an important role in reducing risks and in the transformation of maturities in the saving-investment nexus (Nissanke et al. 1995).

Financial institutions lower the cost of investment when they evaluate, monitor and provide financial services to the needy. They promote productivity and growth through improved efficiency of intermediation, a rise in the marginal product of capital and or an increase in the savings rate (Montiel 1994). The literature that gives explanatory primacy to the material variables above mentioned explores interesting issues that undoubtedly have accompanied the process of economic reform in developing countries. Poor governance and economic weaknesses, including poor public expenditure management, ineffective public service delivery, and a weak financial sector.

Financially, first the region continues to be in economic crisis and the financial system is relatively underdeveloped compared to any other developing region; second structural adjustment programs require more reliance on the private sector and hence its financing; third the debt crisis and reduction in external savings translates to the need to increase the mobilization of domestic savings for investment; fourth reform is needed if the financial system is to overcome and avoid the problems of financial distress and restore confidence; and fifth the need for international competitiveness requires that the financial system be as adaptable and flexible as possible.

The country's economy has gone through a cycle of accelerated growth with a relatively strong macroeconomic position, but the ability to export to a highly competitive global market is questionable. Serious reforms will be needed to protect macro balances, and improve economic competitiveness. As threats of the insurgency reform implementation seems to have gained momentum and resolve, and less significant progress has been made in the financial sector, public expenditure management, service delivery, anti-corruption efforts, and donor coordination. Given the nature of on-going reforms, the micro finance institutions will move to scenario and start developing a programmatic approach to financial assistance. When interest rates go up because of inflation, the government is trying to slow business growth. Money is more expensive to borrow. International trade is affected by government tariffs and local labor costs and union organizations.(Levy, 1993)

Their effect is possibly the most visible. For example, the exchange rate difference between two banks could mean millions of extra loss or profit. Their guarantee may be needed for large projects, but aside all that, the most important thing is that they insure functionality day to day.Countries have made great strides in improving the macro environment for business, but more remains to be done, often including efforts on the legal and good governance front. Enforcement of the rule of law, including enforcement of contracts and elimination of corruption, often remain problem areas for business. An important component of financial sector reforms is interest rates liberalization. It is argued that this would raise real interest rates, increase saving and the supply of the would be invested resources in the economy. The productivity of investment also rises as these resources are channeled to projects that have higher rates of return than hitherto. Liberalization of interest rates would also discourage capital flight and help to stabilize the economy.(Jannat,2009)

The development of a strong, global financial system is a priority for the governments of all the countries in the Southern African Development Community (SADC) region, not only as a tool to promote economic growth and alleviate poverty but also as a first step towards monetary integration among member countries.

The structural and institutional mechanisms can be best categorized as crisis prevention: including the development and implementation of good practice standards and transparency codes, and incentives for both borrowers and lenders to act prudently; and crisis resolution: emphasizing the creation of a more orderly environment for restructuring (Waxman 1999).

Financial sector reforms have also included amongst other things firstly, reducing direct and indirect taxation of financial institutions through reserve requirements, mandatory credit ceilings and credit allocation guidelines; secondly, reducing barriers to competition in the financial sector by scaling down government ownership through privatization; and facilitating entry into the sector by domestic and foreign firms; and lastly, restructuring and liquidation of solvent banks (Inanga 1995).

The list is growing and it is possible to do micro finance in Africa today. However, it will cost us much more and demand a greater commitment. Give us time to develop and evolve. Micro finance cannot be rushed. It is not a factory with a production line that operates 24 hours a day because it is a powerful tool for economic development that is beyond quest.A meaningful diagnosis of the impact of the financial crisis on MFIs requires a segmentation of the sector by the most critical defining dimensions. The sector should be segmented according to the characteristics that are most influential in determining an MFIs experience during the crisis: country location and capital structure. Country location is a critical factor due to the formative influences of an MFI's economic and regulatory operating environment. Government can either alleviate or exacerbate the impacts of the financial crisis through Central Bank lending policies, fiscal stimulus measures, and monetary policies.

Micro finance institutions are vital requirement in a country. Wealth disparity and a lack of economic growth present a challenge in the provision of their services. Currently the richest who are 10 percent of the Kenyan population controls almost half of the nation's wealth while the poorest 10 percent hold less than 1 percent. The continuous extraction of resources from the poor by the rich perpetuates many negative economic influences, including a lack of hope that hard work will pay off a belief that is vital to the economic growth and motivation of developed nations. Poverty is not only a condition of low income and lack of assets, but also of lack of opportunities, vulnerability, exclusion and powerlessness. The hardcore poor rarely choose or control the conditions under which they earn their livelihoods. And, as a consequence, offering credit facilities is not going to change their lives unless it is done in conjunction with reducing vulnerability, creating opportunities, improving skills and capabilities and addressing issues of exclusion and powerlessness. (Ferrand,2007)

GDP growth has been low and is limited to only a few sectors – tourism, manufacturing, horticulture, and services. The government's failure to radically improve the nation's investment and savings habits drastically threatens growth, since substantial growth cannot occur without sufficient capital. Encouraging the systemized implementation of savings and capital accumulation strategies will allow Kenya to swiftly grow GDP at rates that far exceed the current pace. At the grassroots level, microfinance and micro-enterprise growth play a critical role in bringing capital, financial strategies, and economic opportunity to underserved communities throughout Kenya. It is through micro financing that we can help alleviate poverty. (Stanley,2003)

*4.3. Social Aspect*

Changes in social trends can impact on the demand for a firm's products and the availability and willingness of individuals to work. In the UK, for example, the population has been ageing. This has increased the costs for firms who are committed to pension payments for their employees because their staff are living longer. It also means some firms such as Asda have started to recruit older employees to tap into this growing labour pool. The ageing population also has impact on demand: for example, demand for sheltered accommodation and medicines has increased whereas demand for toys is falling. This will also affect the financial system too. (Foundation of Economics, 2007)

Little support from the government: Government should support the industry by maintaining macroeconomic stability and avoid policies that cap interest rates. Speedy passage of the Microfinance Bill to provide a legal and regulatory framework for the industry would suffice. Further, to improve the capacity of AMFI to enable it attract more members and also ensure good practices in the industry.

The lack of right technical skills for the managers and staff of these institutions would require the government to hire microfinance practitioners to come up with a training curriculum to start offering microfinance courses in all academic levels (degree, diploma and certificates).

Poor infrastructure are hindering the operations of these institutions hence there is need for the government to improve the rural infrastructure thereby enabling these institutions to operate in these areas and reach out to the poorest of the poor.( Hashemi, 2001)

Social exclusion discourse developed in response to poverty describes the process that leads the individuals or groups from being wholly or partly excluded from the full participation in the society. Example in Nepal, a Hindu kingdom for a long time; has the caste hierarchical system that dominate the most social and cultural value. The age long caste-based practices have made "Dalits" - the most deprived group in the society and the representation of Dalits in all socio-economic sectors is negligible. (Bahadur, 2009).

However Micro Finance Institutions should establish working relationship with FNCCI and its district chapters to access different facilities and support that may be available. This also develops the efficiency in networking and advocacy which supports to share knowledge, information and experience. Additionally, the civil societies need to educate people against caste-based discrimination as the ethno-caste-based discrimination is the root cause of exclusion of deprived communities in every sector of public life.

Nepal is home to various caste groups of Dalits accounting 13 percent of the country's population. As per the geo-political and social reality of the country, the Dalits of Nepal are generally grouped on the basis of ecological belts. Firstly, Hill Dalits from hill ecological belt are untouchable to overall. This is also a case scenerio for Kenyan using the Muslim community who do not take interest but term it as illegal (Bahadur 2009).

Social exclusion discourse developed in response to poverty describes the process that leads the individuals or groups from being wholly or partly excluded from the full participation in the society. In order to make micro finance all inclusive, the micro finance policy that is unfriendly to poor should be revised. There should be no social classes for the people and if so attractive market segments should be made for the poor (Siddhartha 2009)

*4.4. Donor Aspect*

This refers to an unconditional and outright gift to a public charity, or a Community Foundation operated as a public charity, which agrees to extend to the donor the privilege of making *non-binding suggestions* with respect to the use and disposition of the contributed funds, and which invests and manages the accumulated funds in a pool until distributed.

Donors should recognize the performance of this industry and capacity build emerging microfinance institutions by providing grants and technical assistance to assist them reach operational and financial self-sufficiency needed to sustain large scale growth.

In order to qualify for component fund treatment, community foundations are required to meet very specific requirements of the I.R.S. Regulations with respect to governance, control over assets contributed to the Foundation, Donor influence over distributions and their timing, and other matters. In order to show compliance with these rules, community foundations may reserve the right to direct a portion of their assets to activities not suggested or recommended by a donor and or to impose other requirements on donor participation.( Charles.2006)

Process that should be followed:

<u>4.4.1. Provide Services Directly</u>

Some international NGOs, public donors, and specialized investors provide advice directly. This approach is only appropriate for agencies with strong technical staff. Dedicate one of its financial systems development specialists to work for two years with a different NGO, a public agricultural bank in the case that applies in Thailand is utilized to attract small savers.

<u>4.4.2. Contract Technical Service Provider</u>

This is the most common approach, which may be most suitable for new institutions that are not yet able to define their own needs. For Pro Credit Bank as is the case for Bulgaria start-up and growth phase its funders hired a specialized firm that have created and managed similar banks in other countries.

<u>4.4.3. Let the Financial Institution Decide</u>

Unrestricted funding allows an institution to make its own choices about the nature and source of technical services, and makes it more likely that the technical support will be used effectively. Funding can go directly to specific institutions or to a fund accessible to all that meet pre-established criteria. This approach works well with institutions mature enough to understand their own weaknesses and to identify high-quality TSPs.

4.4.4. Build a Technical Service Market

In developed microfinance markets, funding agencies may help develop local TSPs by supporting them directly to improve their own technical capacity or providing funds that local financial institutions can use to buy their services, this can be through developing local providers of training and consulting services.

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