

INFLUENCE OF FINANCIAL PERFORMANCE ON FINANCIAL SUSTAINABILITY OF MICROFINANCE INSTITUTIONS IN KENYA

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Abstract: The study sought to find out the influence of financial performance on financial sustainability of MFIs. This study was conducted through descriptive survey research design. The specific objective was to find out the determinants of financial sustainability of micro finance institutions in Kenya. The target population of this study was all the microfinance institutions in Kenya. A list of all the 44 Microfinance Institutions obtained from the Association of Microfinance Institution formed the sampling frame. Census technique was used because of their small numbers in the population. Linear regression was also carried out to establish into determinants of financial sustainability of microfinance institutions in Kenya. The study used SPSS version (20) to conduct analysis. The study concluded that financial performance was positively but insignificantly associated with financial sustainability. The study also concluded that there exist a positive relationship between financial performance and financial sustainability. Improving financial performance would improve the financial sustainability as this facilitates asset growth. Increased profits lead to increased concentration which leads to sustainability.

Keywords: financial performance, financial sustainability, microfinance institutions.

1. INTRODUCTION

Financial sustainability of microfinance institutions is probably the key dimension of microfinance sustainability. Moreover, it is observed that microfinance organizations have had various degrees of sustainability; one such sustainability is the Financial Sustainability (Rai, 2012). According to Kinde (2012) there are two kinds of Financial Sustainability that one could observe in assessing microfinance institution performance are Operational self-sustainability (OSS) and financial self-sustainability (FSS).

Operational Self-Sufficiency indicates whether enough revenue has been earned to cover the MFI's direct costs, excluding the cost of capital but including actual financing costs (Nyamsogoro, 2010). Financial self-sufficiency on the other hand portrays the actual financial health of MFIs. Thus, FSS includes the cost of capital (adjusted) apart from the components in OSS. He also indicated that measuring financial sustainability requires that MFIs maintain good financial accounts and follow recognized accounting practices that provide full transparency for income, expenses, loan recovery, and potential losses (Kelegama, 2011).

The three stages of sustainability namely survival mode, sustainability, and self-sufficiency were also identified by (Polinger & outhwaite, 2010). In survival mode MFIs barely cover the costs while in sustainability mode, costs are covered using donations and other grants where as in self-sufficiency the income generated will cover all costs (Reid, 2010). They presented five supporting arguments for MFIs to be sustainable. The first two points are that sustainability ensures the survival of the organizations and those MFIs that price products at market levels will be able to attract the

target, non-bankable population. Also traditional lenders may not compete with organizations that enjoy subsidies and that sustainability helps obtain capital from various sources. Lastly, a focus on self-sufficiency will help MFIs control costs (Ongaki, 2012).

Globally financial sustainability of MFIs is a necessary condition for institutional sustainability (Ongaki, 2012). According to Nyamsogoro (2010) it is better not to have MFIs than having unsustainable ones indicating how important the sustainability of MFIs is. Sri Lanka is well known for its significant improvements in human development indicators as it is the fact, Sri Lanka remains a low income country and that the micro finance sector in Sri Lanka has grown to enviable levels and most of the MFIs are deemed financially sustainable (Kelegama, 2011). Though finance is a prerequisite for the economic empowerment, inability to access formal finance has become a critical concern in this regard (Reid, 2010).

East Africa is the least developed region in terms of social economic development (Kinde, 2012). Interventions through the delivery of microfinance services are considered as one of the policy instruments of their governments to leverage the economy. For sustainable economies, the MFIs themselves should be financially sustainable (Hartarska, 2014). Given the relation between the well-being of the microfinance sector and the goal of economic empowerment, knowledge of the underlying factors that influence the sectors financial sustainability is therefore essential not only for the managers of the MFIs, but for numerous stakeholders such as the central bank, governments, and other financial authorities (Yunus, 2010).

Microfinance institutions in Uganda are always often faced with high operating costs to provide financial services to the people. As more microfinance institutions grow and become formal financial institutions, each Microfinance Institution has a unique profile and operational structure that determines which types of controls are appropriate to increase financial sustainability (Rahman & Mazlan, 2014).

Microfinance sector in Tanzania has recently experienced tremendous growth due to the increased number of firms engaging in microfinance services including commercial Banks and other profit oriented firms (Ejigu, 2011). Recent statistics shows that financial sustainability of micro finance institutions in Tanzania is has improved as more than half of them are self-financed and highly efficient and effective in terms of costs and operations (Tehulu, 2013).

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 (Ongaki, 2012). A list of various categories of MFIs can be found from the Association of Microfinance Institutions (AMFI). There are 44 are classified as microfinance institutions (AMFI, 2014).

Microfinance institutions in Kenya are regulated under The Microfinance Act (2006) and the Microfinance Regulations issued there under sets out the legal, regulatory and supervisory framework (MF Act, 2006). According to Financial Sector Deepening (2010) just 60% of Kenyans have access to banks or microfinance institutions with 30% of rural users having no access to banking services at all. It further shows shortage in supply of financial services including credit when compared to demand (Hartarska, 2014). Microfinance institutions fill a needed gap within the financial services industry by offering small loans or micro-loans to people unable to access conventional loan services (Gatuhu, 2013). Therefore this study seeks to establish the determinants of financial sustainability of MFIs in Kenya

1.1 Statement of the Problem

MFIs face the challenge of financial sustainability. In recent years, there has been increased internal and external pressure for MFIs to decrease dependence on subsidized or grant funding (Nyaga, 2012). According to Ejigu (2011) consistent and simultaneous provision of massive scale, permanence and continuous efficacy is only possible if MFIs would focus on earning above average returns through doing business. Recent transformation of Faulu Kenya in May 2009 and Global achievement of Equity bank in July 2009 attest to this trend (Obawale & Oladunjoye , 2013).

According to Kinde (2012) as the number of clients increase, liquidity of a microfinance institution increases hence enjoying economies of scale and thus reduces costs which help them to be financially sustainable. However, Hulme and Mosely (2010) argue that expanded MFI outreach increase transaction cost on seeking information about the clients creditworthiness which makes MFIs financially unsustainable.

The concept of social performance has seemed to overshadow the state of health of these Institutions. However, the accepted criteria in a number of studies to study the performance of any MFI have been based on financial sustainability of microfinance institutions (Gatuhu, 2013). It is from this perspective that the researcher sought to fill this knowledge gap statistically using MFIs financial and operational data over the period (2010-2013).

1.2 Research Objective

To determine the influence of financial performance on financial sustainability of Microfinance Institutions in Kenya.

1.3 Research Question

What is the influence of financial performance on financial sustainability of Microfinance Institutions in Kenya?

2. LITERATURE REVIEW

2.1 Conceptual Framework

Conceptual framework is a hypothesized model identifying the model under study and the relationship between the dependent and independent variables (Mugenda & Mugenda 2003). The goal of a conceptual framework is to categorize and describe concepts relevant to the study and map relationships among them. Such a framework would help researchers define the concept, map the research terrain or conceptual scope, systematize relations among concepts, and identify gaps in literature (Kombo & Tromp, 2009). In this study, the independent variable is financial performance and the dependent variable is financial sustainability of MFIs. The relationship is clearly shown below in figure

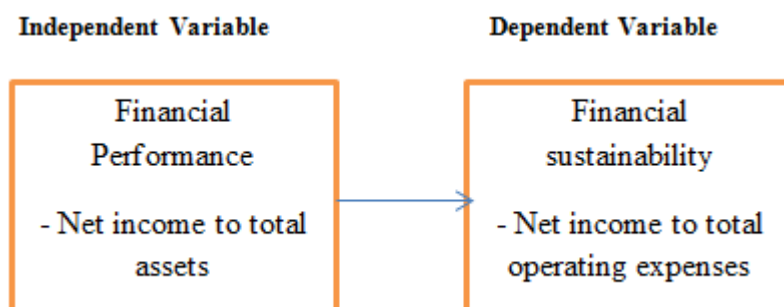


Fig 2.1: The Conceptual Framework

2.2 Review of Variables

2.2.1 Financial Performance

Financial performance of a microfinance institution is measured by Profitability and Return on Assets however Profitability ratios are used to determine the financial institutions bottom line and are important to the managers and owners (Gorton, 2012). According to Gorton (2012) and Schreiner (2013) focused on accounting measures of profitability when examining managerial entrenchment and takeovers in Latin America.

According to Barclay (2012) discovered that profitability persist to a moderate extent. Persistence suggests that departures from perfectly competitive market structures may not be large. The study further shows that all specific determinants, with the exception of size, influence performance in the anticipated way (Barclay, 2010). A study by Ongaki (2012) to examine the determinants of financial sustainability of deposit taking MFIs in Kenya, found that there is a positive relationship between profitability and financial sustainability.

A study by Gregoire and Tuya (2016) established that profits are positively correlated with movements in the business cycle. A study by Berger and Mester (2015) on investigating the profit structure relationship in banking in Australia, providing tests of profitability on financial sustainability of microfinance institutions. To some extent, the relative market power hypothesis was verified; since there was evidence that minimizing operational risks raise profits. In contrast, weak evidence was found for the efficient structure hypothesis. It explained that efficiency not only raises profits, but may lead to market share gains and, hence, increased concentration, so that the finding of a positive relationship between concentration and profits could be a spurious result due to correlations with other variables (Berger, 2009).

A study by Muriu (2011) to examine the determinants of financial sustainability of deposit taking MFIs, found that there is a positive relationship between profitability and financial sustainability of micro finance institutions. Therefore, an increase in profitability leads to an increase in financial sustainability.

2.2.2 Financial Sustainability of Microfinance Institutions

Financial Sustainability refers to the ability of a microfinance institution (MFI) to cover all of its costs through interest and other income paid by its clients (Consultative group, 2012). MFIs are becoming more concerned with financial sustainability. International foundations and donors have recognized that efficiently run MFIs can cover a large portion of their costs, and demand an increasing level of self-sufficiency from them. According to Woller (2010) financial self-sufficiency is a non-profit equivalent of profitability. Also Kinde (2012) noted that the poor needed to have access to financial service on long-term basis rather than just a one-time financial support. Meyer also argued that financial unsustainability arises from low repayment rate or un-materialization of funds promised by donors.

The few existing empirical literature on the performance and sustainability of microfinance offers mixed results. For example the findings from Namibia concluded that almost all microfinance is not sustainable (Forbes, 2010). The study was investigating leverage of the institutions, profitability and outreach as key determinants of financial sustainability of microfinance institutions. A study on Nepal microfinance showed that most of rural microfinance institutions are not sustainable (Acharya, 2015). This study examined among others operational expense, profitability and business risk as determinants of financial sustainability of micro finance institutions. In this study financial self-sufficiency will be used as a dependent variable since the study seeks to identify determinants of financial sustainability of MFIs.

3. RESEARCH METHODOLOGY

The descriptive survey design was used because according to Sekaran and Bougie (2011) this design enables one to capture all pertinent aspects of a situation while employing a unit study and investigation. The researcher systematically collected data, presented it, analyzed it and finally made conclusion and recommendations. The population of this study was all the 44 microfinance institutions in Kenya. A list of all the 44 Microfinance Institutions obtained from the Association of Microfinance Institution formed the sampling frame for the research .

The sample size for secondary data was determined by Census technique and thus the study therefore adopted a sample size of 44 microfinance institutions. Microfinance institutions disclose their financial information through AMFI web portal. The data collected for both the dependent and independent variables was adjusted ratios and averages derived from the MFIs financial statements. A form for secondary data collection was then used to summarize relevant data on total assets, total operating expenses, total debt, total equity, total operating expenses, net income, and total customer deposits from the financial statements in order to calculate relevant ratios, descriptive measures and regression analysis.

Information was sorted, coded and input into the statistical package for social sciences (SPSS) version 20 for production of graphs, tables, descriptive statistics and inferential statistics. A multiple regression model was used to test the significance of the influence of the independent variables on the dependent variable. Correlation was used to test the relationship of independent and dependent variables

Model:

$$Y = \beta_0 + \beta_1 X_1 + \varepsilon$$

Where:

Y = Financial sustainability

β_1 =Regression coefficient

X₁ = Financial performance

ε = standard error

β_0 = Constant term

4. RESEARCH FINDINGS AND DISCUSSION

4.1 Descriptive Analysis

The study established the measures of central tendency (mean) and standard deviation of the variables. In addition, Jarque Bera test was used to establish the normality of the variables so as to establish whether transformation of the variables into logs was necessary. The null hypothesis for JB test is that the data is normally distributed

Table 4.1: Descriptive Analysis

	FINANCIAL SUSTAINABILITY	FINANCIAL PERFORMANCE
Mean	1.358	0.049
Median	1.435	0.048
Maximum	1.632	0.057
Minimum	0.930	0.044
Std. Dev.	0.230	0.004
Skewness	-0.748	1.021
Kurtosis	2.512	3.554
Jarque-Bera	0.826	1.494
Probability	0.662	0.474

The study findings indicated that the mean return on asset recorded over the study period was 0.049 with a standard deviation of 0.004 which indicated a small variation in the return on asset on MFIs over the study period. A JB statistic of 1.494 was not significant (P value = 0.474). This implies that the null hypothesis of normality was not rejected at 5% level of significance. The implication is that financial performance was normally distributed hence there was no need of transformation into log.

Financial sustainability indicated a mean value of 1.358 over the study period with a standard deviation of 0.230 which implied that there was a large variation in financial sustainability over the study period. Financial sustainability also had a JB value of 0.826 which was not significant (P value = 0.662) at 95 level of confidence had failure to reject the null hypothesis of normality. The study hence concluded that financial sustainability was normally distributed hence it was not logged

4.2 Correlation analysis

The study used correlation analysis to investigate the association between the independent and the dependent variables

Table 4.2: Correlation Table

		Financial performance	Financial sustainability
Financial performance	Pearson Correlation	1	0.065
	Sig. (2-tailed)	0.000	0.879
Financial sustainability	Pearson Correlation	0.065	1
	Sig. (2-tailed)	0.879	0.000

* Correlation is significant at the 0.05 level (2-tailed).

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

Financial performance had a positive correlation of 0.065. The $p(0.879) >$ showing that financial performance is insignificant to financial sustainability.

4.3 Regression Analysis

The relationship between the independent and dependent variable was established using regression models.

4.3.1 Financial performance

The results for model summary indicated on Table 4.4 indicated that financial performance was positively associated with financial sustainability (R = 0.065). The findings further indicated that financial performance explains 0.4% of the changes in financial sustainability when other factors are held constant (R square = 0.004). An F statistic of 5.752 was significant at 95% level of confidence which indicates that the model was significant in predicting financial sustainability.

Table 4.3: Model summary of financial performance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	F	Sig.
1	.065	0.004	-0.162	0.247895	7.025	0.048

a Predictors: (Constant), Financial performance

The Beta coefficient of 3.73 indicated a positive relationship between financial performance and financial sustainability which implies that an improvement in financial performance leads to an improvement in financial sustainability. The relationship is however not significant at 5% level of significance. The findings are consistent with Ongaki (2012) who established that there is a positive relationship between profitability and financial sustainability.

Table 4.4: Regression coefficients of financial performance

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1.54	1.143		1.347	0.227
	Financial performance	3.73	23.437	0.065	-0.159	0.879

a Dependent Variable: Financial sustainability

Table 4.5: Multiple model coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	0.037	1.619		0.023	0.983
	Financial performance	33.305	20.544	0.579	1.621	0.203

a Dependent Variable: Financial sustainability

The overall regression model indicated that financial performance had an insignificant relationship with financial sustainability since $P(0.203) > 0.05$. The optimal regression model was as indicated below:

$$\text{Financial sustainability} = 0.037 + 33.305 \times 1$$

5. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

The study findings also revealed that financial performance was positively but insignificantly associated with financial sustainability. This implies that an improvement in financial performance leads to an improvement in financial sustainability. Furthermore a positive relationship between financial performance and financial sustainability was also established implying that an improvement in financial performance leads to an improvement in financial sustainability. The relationship is however not significant at 5% level of significance.

5.2 Recommendations

The study also recommended that even though financial performance is insignificantly associated with financial sustainability, MFIs should seek to improve their financial performance through growth oriented strategies since increased profits lead to increased concentration which leads to sustainability. The competitiveness of MFIs should be based on better financial performance.

5.3 Suggestions of Further Studies

Considering other factors in research would give the extent of each factor's influence and determination of the significantly influencing factor. Further research should also be undertaken which would include firms in various sectors of the economy and compare the different experiences created to these institutions due to the influence of the studied factors. This would aid in making general recommendations that would be employed by relevant authorities to ensure efficiency in financial performance of firms

Future studies should also consider employing primary sources of data to collect data for their studies. This would facilitate detailed information collected from original sources which would as well give reliable and accurate results that explain the details of the subject.

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