FACTORS AFFECTING PROFITABILITY OF DEPOSIT TAKING MICROFINANCE INSTITUTIONS IN NAIROBI:
A CASE STUDY OF FAULU KENYA

BY

OCHIENG OLIVER OTIENO

UNITED STATES INTERNATIONAL UNIVERSITY-
AFRICA

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OCHIENG OLIVER OTIENO

A Research Project Report Submitted to the Chandaria School of Business in Partial Fulfilment of the Requirement for the Degree of Masters in Business Administration (MBA)

UNITED STATES INTERNATIONAL UNIVERSITY – AFRICA

SUMMER 2018
STUDENT’S DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than the United States International University- Africa in Nairobi for academic credit.

Signed: __________________________ Date: __________________________

Ochieng Oliver Otieno (ID 647100)

This project has been presented for examination with my approval as the appointed supervisor.

Signed: __________________________ Date: __________________________

Mr. Kepha Oyaro

Signed: __________________________ Date: __________________________

Dean, Chandaria School of Business
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ABSTRACT

The purpose of this study was to examine the factors affecting profitability of deposit taking microfinance institutions in Kenya. The study intended to answer the following questions: What is the impact of lending rates on the profitability of MFIs in Kenya? What is the impact of competition on the profitability of MFIs in Kenya? What is the impact of government regulations on the profitability of MFIs in Kenya?

A descriptive research design was adopted to carry out data collection for this study as it sought to identify and explain variables that exist in a given scenario. This method was considered appropriate for application in this study as it provided information that facilitated response to the research questions. The study population comprised of one of the major deposit taking microfinance institutions in Kenya, Faulu Kenya Deposit Taking Microfinance Limited. Data obtained was through primary data achieved through means of questionnaires.

Data obtained was analyzed by use of descriptive statistics and inferential statistics with the help of Statistical Package for Social Sciences (SPSS) version 24. Descriptive analysis involved frequency distribution, variances and standard deviation that helped determine the level that the variables impact the profitability of these institutions. Inferential statistics comprised of correlation analysis to look at how lending rates, competition and government regulations have an impact on the performance of the deposit taking microfinance institution.

The study examined the factors affecting profitability of deposit taking microfinance institutions in Nairobi. The study established that there is no definite relationship between lending rates and profitability recorded in the deposit taking microfinance institutions. Aspects that contributed to this conclusion were: customer sensitivity towards increases in lending rates set on loans, uptake of loans by customers based on the loan periods given to them which was established that the uptake was not influenced by the loan period. Not only limited to these two aspects, it was also established that the cost of capital as a contributing aspect is likely to influence the lending rate that a deposit taking microfinance institution sets.
Findings on the impacts of competition and government regulations were that they both do not have a negative impact towards profitability of deposit taking microfinance institutions. The study revealed that competition greatly impacted profitability in the sense that it has facilitated innovation in the deposit taking institution, it also contributes towards a greater customer focus for better service delivery. Assumptions based on multiple loan taking by deposit taking microfinance institution clients came out negative in the sense that it was established that competition does not contribute towards the multiple loan taking by clients which would then lead to high customer indebtedness.

With regards to government regulations, it was established that they have in a great way helped contribute positively towards the institutions’ profitability. This was achieved from the aspects of great customer focus created through great customer outreach since the institution put in place better products and services to gain more customers. It was discovered that some aspects of government regulations such as stringent reporting requirements and capital adequacy requirements had some negative impact towards profitability. The basis of this was that it was discovered that the institution’s resources would be diverted towards fulfilling these requirements rather than towards creation of productive output. But in a greater view of this factor, it was established that government regulations have minimal impact towards profitability of deposit taking microfinance institutions.

Findings from the correlation analysis of the three objectives towards profitability of deposit taking microfinance institutions established that there was a positive relationship between profitability and lending rates, competition as well as government regulations. This was based on the responses provided by the respondents that showed that the stated objectives have a contribution towards the level of profitability recorded within a deposit taking microfinance institution thus leading to the result of a positive relationship between the element of profitability against the lending rates, competition and government regulation objectives.

As a recommendation, the research proposed that the management of deposit taking microfinance institutions should consider the setting on the cost of loans which would be inclusive of taxation costs, transaction costs, return on equity and management fees which would all contribute to the determination of lending rates to be set. Policies also came up
as part of the recommendation towards the research from the basis that there is an influence of competition towards profitability which is largely attributed to the fact that financial services are undergoing rapid changes. Regulatory policies were also part of the recommendations such as the capital adequacy requirements which should be preceded by the consideration of whether deposit taking microfinance institutions possess the capacity to meet the stated requirements since some are operational on a small-scale basis. It is therefore advisable that if someone wants to conduct another study on this topic, the researcher must consider other measures that contribute towards profitability of deposit taking microfinance institutions such as size and composition of credit portfolio, size of deposit liabilities, risk level, institution size and the management quality of the institution.
ACKNOWLEDGEMENT

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I would also like to express my sincere gratitude to my supervisory, Mr. Kepha Oyaro, for his continuous guidance and support throughout my research. His immense knowledge and expertise in the field of Finance was of great importance in the research process.

I would like to appreciate my friends for their continuous prayers and moral support.

Last but not least, I would wish to convey my sincere gratitude to my family: my parents and siblings, for the material and spiritual support throughout my MBA program.
DEDICATION

This research is dedicated to my family, for their love and endless support to ensure that I acquire this quality education.
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<tr>
<td>ASA</td>
<td>Association for Social Advancement</td>
</tr>
<tr>
<td>ASCA</td>
<td>Accumulation and Rotating Savings and Credit Associations</td>
</tr>
<tr>
<td>CBK</td>
<td>Central Bank of Kenya</td>
</tr>
<tr>
<td>CGAP</td>
<td>Consultative Group to Assist the Poorest</td>
</tr>
<tr>
<td>DTMFI</td>
<td>Deposit Taking Microfinance Institution</td>
</tr>
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<td>GoK</td>
<td>Government of Kenya</td>
</tr>
<tr>
<td>MFI</td>
<td>Microfinance Institution</td>
</tr>
<tr>
<td>NGO</td>
<td>Non-Governmental Organization</td>
</tr>
<tr>
<td>SASRA</td>
<td>Sacco Societies Regulatory Authority</td>
</tr>
<tr>
<td>SACCO</td>
<td>Savings and Credit Co-operative</td>
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<td>ROSCAs</td>
<td>Rotating Savings and Credit Associations</td>
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CHAPTER ONE

1.0 INTRODUCTION

1.1 Background to the Study

According to Robinson, 2003, Microfinance refers to the various types of financial intermediation services such as credit funds transfer, savings, insurance and pension remittances among others, that are provided to low income households and enterprises in both urban and rural areas, including employees in both the public and private sectors and the self-employed. These services become effective in the long term through microfinance institutions that adhere to the key principles endorsed by the Consultative Group to Assist the Poorest (CGAP) and its 28 member donors, which have been endorsed further by the Group or eight leaders at a summit on June 10, 2004. According to CGAP, one of the key principles states that “Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people.

According to the International Monetary fund (2002), the term ‘Microfinance Institutions’ is a term used to refer to those financial institutions that are characterized by their commitment to assisting the typically poor households and small enterprises in gaining access to financial services.

MFIs are referred to as institutions whose major business is the provision of microfinance services with an aim of gaining some profits so as to be able to withstand their own business operations and expand their microfinance services. The MFIs that provide a wide range of financial services vary in terms of their legal structure, mission, methodology and also offer the financial services to the clients who do not have access to mainstream banks or other formal financial service providers.

Within the category of microfinance institutions, IMF argued that institutions tend to share some common characteristics but also differ in the nature of their operations, size and their financial performance. They all provide a wide range of services and the best known activity within MFIs is credit provision to poorer households and small enterprises. Not only limited to this, IMF still brings out that some MFIs also take
deposits, others offer financial services such as insurance and trainings to their clients in business management (IMF, 2002).

Microfinance is intended to reach out to all those who have not fully benefited from the development process. For people falling in this particular group, investments should be financed through own savings, equity or credit and according to Aryeetey (1995), less than 15 percent of the population in developing countries has an access to mainstream financial services and it with this regard that this concept of microfinance, is a strategic tool of poverty reduction and development in a country. Microfinance therefore, as a term, can be defined not simply as banking, rather, it involves making financial resources available to the productive poor and for this to be performed as a creditable function for poverty reduction and development tool, good performance of these microfinance institutions is of critical importance in terms of profitability.

Microfinance has established itself as an integral part of financial sector policies of emerging and developing countries over the past few decades. Within the field of international finance, microfinance is well-known for its bottom-up approach because of the main role that non-governmental organization (NGOs) played in the establishment and development of the sector, with the financial support of donors. The classification of the sector is done by mapping the institutions into two axes which include; the profit motive (profit vs not-for-profit) and the decision-making style (centralized vs un-centralized) (Gentil et al., 2000).

The Association for Social Advancement (ASA) is a non-governmental organization that began providing banking services to nearly 2.3 million customers in Bangladesh at the end of 2003. Their target clients were more leaned towards women, who were wives and mothers of landless laborers and small-scale farmers with average monthly incomes of around 50 dollars, borrowing on average around 120 dollars per loan. To the traditional commercial banks or financial institutions, the loans are so small that the profits are hard to find plus the lending seems just as risky since the borrowers have little to offer in terms of collateral (Armendariz & Morduch, 2010).

Like ASA and for many observers, microfinance is a collection of banking practices built around providing small loans, without collateral and accepting small savings deposits. By
the 1970s, some commercial banks in the parts of Asia had gained vast experience in mobilization of large amounts of saving from the rural people. Africa at this time was still behind in the development of microfinance programmes illustrated by the fact that Africa’s microfinance institutions were smaller and also less advanced when put in comparison with Asia and Latin America. Although, there is a common factor that is noticed in this region, that is; microfinance programmes are designed for the poor. Furthermore, development practitioners have become more convinced with the importance of this microfinance financial system for the poor. Efficient and well-functioning financial systems are crucial in the channeling of funds towards productive uses and in allocation of risks to those who can best bear them, thereby boosting economic growth, improving opportunities and income distribution and reducing poverty (World Bank, 2008).

Microfinance, therefore, has and is being used by NGOs and the UN, among other agencies, because it builds on the fact that financial services are needed to make investments in physical and human capital in order to smooth consumption and to overcome unforeseen shocks. It can be seen as a solution to include on a large scale previously excluded poorer groups without any access to capital into the financial system so that they may rise out of poverty by themselves (BancoSol, 2006). NGOs providing microfinance and dedicated MFIs have come to develop over time. In the 1980s and 1990s, NGOs started microcredit schemes based on group solidarity with using reference to the Grameen Bank model, as part of their integrated development projects. After a while, the microfinance units of some of these projects were then consolidated into independent MFIs, but still holding strong links to the ‘parent’ NGOs, which are often internationally based. Some of the other main players in the microfinance landscape also include the government and their programmes (International Trade Centre, 2011).

Microfinance may appear to be a small idea but may turn out to have enormous effects in a greater view. When Muhammad Yunus, an economics professor at a Bangladesh University, began offering small loans to the local villagers in the 1970s, it did not seem clear where that was heading. But unlike state-run banks and other formal financial institutions which felt like lending to the poor would leave them with a legacy of inefficiency, corruption and millions of dollars of squandered subsidies. Muhammad
Yunus opted to make one day profits based on the argument that his poor clients would pay back the loans reliably and because of such a move, he is still recognized as a visionary in the ‘Microfinance Movement’ that has spread globally, claiming over 64 million customers by the end of 2002 (Armendariz & Morduch, 2010). This has facilitated the delivery of financial services to the poor and low-income people. The assumptions that the poor cannot be good clients of the financial institutions was challenged by Yunus.

The basic roots of microfinance, as illustrated by Muhammad’s actions, are based on a social mission of enhancing an outreach of alleviating poverty. The beginning of formal microfinance programs can be traced back to the early 1950s after the Second World War (Maanen, 2004). The microfinance programs increased in the period between 1960s and 1970s, when the Grameen Bank came into light and at this time, lending methodologies suitable for the low income clients both in the rural and urban areas were developed.

With the growth of the microfinance movement, more than 100 million customers worldwide are now borrowing small loans from around 10,000 microfinance institutions (MFIs). From the works of McKinnon and Shaw (1973), microfinance has gained importance as an important tool for development in developing countries. According to Ledgerwood (1999), microfinance refers to the provision of financial services to low-income clients, including the self-employed; whereby the financial services generally include savings and credit. Not limited to the only two services, some microfinance organizations also provide insurance and payment services. In the past few decades, a great deal of attention and funding has been directed towards microfinance by the development community. However, the level of success of one MFI, will vary across different institutions. Some of them fail and cease to be, while others grow to reach out to millions of borrowers thereby covering their costs in the long run. In 2011, microfinance institutions provided microcredit to more than 124 million households living in extreme poverty, according to the 2013 State of the Sector report.

One major obstacle to growth in Africa is the lack of access to credit because a large majority of households do not have adequate collateral to secure a loan. (Thorsten, Demirguc- Kunt, & Levine, 2007). They rely on both the informal sector and money-
lenders or shylocks where they borrow at outrageous interest rates, or may just as well be
denied access to the credit itself and forced into investment. It is at this point that
Microfinance institutions expand the frontier of financial intermediation by providing
credit to those who are excluded from financial markets.

Various microfinance institutions have demonstrated that low-income clients need saving
services as much or more than credit services that they also offer and this has overtime
helped improve the livelihoods of the poor. The World Bank proposed strategies that
would be key in reducing poverty which were; promoting opportunity, facilitating
empowerment and also enhancing security (World Bank, 2000/2001). Blanchflower and
Oswald (1998) argue that the growth and survival of any business, tends to be dependent
on the availability of capital. Refined and flexible financial markets have been developed
over the years to help facilitate the creation and growth of business in various developed
countries such as Canada. Initiatives of encouraging the activities of microfinance
institutions are widely sponsored by a variety of organizations including; the World Bank,
United Nations, national governments and many charitable non-governmental
organizations. Their main aim is to help the poor manage their risk and take advantage of
small income generating opportunities, by employing profit-making banking practices
amongst low income communities (Banerjee & Duflo, 2009; Ahlin & Neville, 2008;
Aron & Hulme, 2008; Swain & Varghese, 2010). By alleviating the poor people’s
financial constraints, microfinance is able to promote small scale investments from
otherwise unrealized market activities which then yield a return on their investment
(Hartarska & Nadolnyak, 2008b; Hilson & Ackah-Baidoo, 2010).

As the industry continues to grow, the microfinance focus is also shifting from being a
social movement to the integration of microfinance into the formal financial sector. This
in turn has developed into arguments that microfinance and formal financial businesses
are irreconcilable and that they also condemn the practice of pursuing profit as deviating
from the mission of microfinance; which is being regarded as a mission drift
(Ledgerwood & Victoria, 2006).

Through innovative lending technology, MFIs have been generating high loan repayment
rates on non-collaterized loans in diverse environments that often exceed 95 percent
(Cull, Demigruc-Kunt & Morduch, 2007). The challenge comes in the translation of high
repayment rates into profits for most of the microfinance institutions. Despite the fact that microfinance is dominated by NGOs and socially-oriented investors, experts believe that at least one percent of all NGO-sponsored institutions are profitable and predict that no more than 5 percent would ever be (Armendariz & Morduch, 2010).

A profitable microfinance industry is key in maintaining the stability of the micro-banking system. Low profitability weakens the ability of microfinance institutions to absorb negative shocks that may be either internally or externally caused. This would eventually affect solvency of the company. Profitability reflects how MFIs are run within the environment that they operate which then represents the capabilities of the institution in terms of efficiency, risk management capabilities, competitive strategies, quality of management and levels of capitalization among others. The role of the microfinance industry is to promote small scale investments that generate sufficient revenues from unrealized market activities while yielding a return on the investment (Muriu, 2011).

A profitable MFI can therefore be defined as its capacity to cover all of its expenses by its revenue and to generate a margin to finance its growth. In other words, it can be referred to as the capacity of a microfinance institution to carry out its activities without the need for subsidies in the form of concessional loans or donations (Ayayi & Sene, 2010).

According to Adongo (2006), in a stable political environment and an enabling large scale economic system, microfinance institutions are important in provision of savings, credit, funds transfers and other financial intermediation facilities to low-income households, microenterprises and marginal small-scale enterprises. Therefore, Bashir (2000) stated that size of deposit liabilities is among the ways through which MFIs can be profitable by means of maintaining high level of deposit accounts relative to their assets; size and composition of credit portfolio also have an effect towards the profitability of these institutions, whereby a large credit portfolio implies improved profitability because if an institution has substandard credits, then they come out as a source of heavy financial losses that then lead to institution failures.

Furthermore, microfinance institutions are to become profitable through their lending rate policy which can be looked at from the perspective of the institution’s policy regarding the interests it pays on deposits received by it and policy regarding the interest rates it receives on credits given by it (Bashir, 2000).
This study intended to address the need for understanding the profitability determinants of Deposit Taking Microfinance Institutions in Nairobi. In the microfinance environment, if an MFI has to become a large force in alleviating national poverty levels, there is need for evidence of the payoffs from the micofinance investments. Therefore, the performance of Deposit Taking Microfinance Institutions in achieving their objective is best measured on financial performance as well as their success in improving the borrowers’ lives. It is important that for a Deposit Taking Microfinance Institutions to prosper, it should be sustainable and continue to have financial resources to help it impact on more lives (Crane & Epstein, 2005).

The microfinance sector in Kenya over the years has grown and currently consists of a large number of competing institutions which vary in formality, commercial orientation, size, visibility, geographical coverage as well as legal status. These institutions range from informal organizations such as the Rotating Savings and Credit Associations (ROSCAs), Savings and Credit Cooperative (SACCOs), Non Governmental Organizations (NGOs) to commercial banks that are down saving (Aleke, 2003).

The Government of Kenya (GoK) has directly provided a boost to the microfinance sector in conjunction with the Central Bank of Kenya. During 1992 to 1994, the GoK implemented a Structural Adjustment Program which promoted the liberalization of the Kenyan economy whereby it identified areas and projects needing external donor support, including small-scale and micro-enterprises (Omino, 2005).

The Kenyan microfinance sector began in the late 1960s with few NGOs setting up pilot programs providing donor funded credit services. Some of these organizations have evolved over time to become commercialized, self-sustaining and very profitable organizations. The institutions also came about as church-based lending programs whereby they were mainly confined to specific church parishes that started with local financing for members before they developed into institutions that could cover a wider number of people in the rural and sub-urban areas of Kenya. Microfinance, as a concept, is rapidly becoming Kenya’s most accessible and affordable financial service (Omino, 2005).
There are nine Deposit Taking Microfinance Institutions in Kenya according to the Central Bank of Kenya report of March 2014 (see Appendix 1). Deposit Taking Microfinance Institutions grew rapidly from 2009 in Kenya. Assets and equity both increased substantially. Kurgat (2009) in his study “The role of savings in Microfinance Institutions”, identified a clear aggregate trend towards a higher leverage, with the total assets tripling while total equity only doubled. This trend has decreased with a nearly balanced 172 percent increase in assets and a 162 percent increase in equity.

In Kenya, SACCOs are supervised by the Sacco Societies Regulatory Authority (SASRA) under the Ministry of Cooperative Development and Marketing. Currently, there are 123 licensed deposit-taking SACCOs (Etzensperger, 2013). By the end of the year 2007, four mainstream banks were undertaking microfinance business in Kenya. These included; Equity, Co-operative, K-Rep and Family Bank while others that are foreign owned such as Standard Chartered and Barclays have shown interest in the sector itself.

The Microfinance Act 2006 of Kenya, in conjunction with the Microfinance Regulations 2008, seek to streamline the operations of MFIs in Kenya by addressing the licencing provisions, minimum capital requirements and minimum liquid assets, submission of accounts to CBK, supervision by CBK and limits on loan and credit facilities. They also seek to protect depositors by requiring that Deposit Taking Microfinance Institutions contribute to the Deposit Protection Fund. The Act sets out the legal, regulatory and supervisory framework for the microfinance industry in Kenya. The new regulatory category supervised by CBK has separate licensing and transparency requirements, deposit protection, dissolution mechanisms, corporate governance and accounting standards (Central Bank of Kenya, 2014).

1.2 Statement of the Problem

To make investments in the development of small scale businesses, microfinance institutions have come out as the most successful concept to deal with this. However, as much as it is a successful concept, institutional strength in terms of profitability needs to be sufficient to guarantee the safety of investments in the small scale businesses and the poor. Meeting the full promise of microfinance to reduce poverty without ongoing
subsidiaries requires translating high repayment rates into profits, which remains a challenge for most Microfinance Institutions.

Previous studies show few Deposit Taking Microfinance Institutions are profitable in Kenya. The reasons for this can be linked to social factors such as lack of enough women participation in microfinance activities and lack of adequate skilled and motivated staff as well as costs of managing the borrowers. Not only limited to these, very few Deposit Taking Microfinance Institutions are large enough. Therefore, for the others, they find it hard to attract capital or funds at larger costs due to higher risks and this brings in a burden of higher interest and large average loan size to the poor people since they cannot afford the higher costs, thus meaning that the profitability of Deposit Taking Microfinance Institutions is compromised. Furthermore, elements in the microfinance sector such as competition, government regulation as well as lending rates contribute largely to the performance of the institutions within this sector since they directly influence their activities. There is therefore a great need to come up with the solution to the question of understanding the determinants of Deposit Taking Microfinance Institutions’ profitability.

1.3 Purpose of the Study

The importance of this study was to find out what were the factors that affect the profitability of Deposit Taking Microfinance Institutions performance in Nairobi.

1.4 Research Questions

1.4.1 What is the impact of lending rates on the profitability of Deposit Taking Microfinance Institutions in Nairobi?

1.4.2 What is the impact of competition on the profitability of Deposit Taking Microfinance Institutions in Nairobi?

1.4.3 What is the impact of government regulations on the profitability of Deposit Taking Microfinance Institutions in Nairobi?
1.5 Importance of the Study

Deposit Taking Microfinance Institutions

The findings of this study would enable Deposit Microfinance Institutions in Kenya to identify the major determinants of microfinance profitability so that they can be able to focus on those variables without excluding other factors in order for them to be profitable and be able to attain some growth and also to be sustainable to be able to achieve their desired objective of poverty alleviation.

Regulatory Authorities

The Central Bank of Kenya would also be able to identify the main determinants of Deposit Taking Microfinance Institutions profitability so that they know how to control and develop the financial market in general so that every participant in the microfinance sector is treated fairly as well as the customers get fair and moderate rates for products and services that these institutions may offer to them.

Researchers

The study could be used as a reference material for future researchers and academicians who would wish to carry out studies or further research into this particular area of Deposit Taking Microfinance Institutions profitability and the contributing factors.

1.6 Scope of the Study

The profits from Deposit Taking Microfinance Institutions provide an important source of equity. If the profits are reinvested, this in turn may promote financial stability. The study therefore aimed to look at the factors of competition, lending rates and government regulations and their impacts towards the profitability of the deposit taking microfinance institutions in Nairobi. The focus of the study was Faulu Kenya Deposit Taking Microfinance, which is one of the major microfinance banks in Kenya regulated by the CBK. The main reason for the choice of this institution was because it has demonstrated a great track record over time which has been illustrated by its enviable growth in its assets and loan books. Furthermore, it has also grown over the past 20 years from one MFI office in 1991 to over 90 service outlets some being banking branches thus enhancing customer outreach. Data was collected on 24th July, 2018 at the institution’s headquarters.
1.7 Definition of Terms

1.7.1 Microfinance

According to Trends in Microfinance, microfinance is the practice of providing small scale financial services to the world’s poor. This is mainly done through loans and savings and other products such as insurance and money transfer (Platteau & Siewertsen, 2010).

1.7.2 Microfinance Institutions

Microfinance institutions refer to those financial institutions that are characterized by their commitment to assisting typically poor households and small enterprises in gaining access to financial services (Hardy, Holden, & Prokopenko, 2002).

1.7.3 Lending Rates

Crowley (2007) defined lending rates as the money that a borrower pays for the use of money that he or she borrowed from a financial institution or lender. He further said that it can also be referred to as a fee that is paid on borrowed assets. Lending rates are fundamental and are expressed as a percentage rate over a given period, mostly a year. As a price of money, lending rates reflect the given market information regarding expected changes in the purchasing power of money or future inflation.

1.7.4 Financial Performance

Financial performance refers to an indicator of how profitable a company is relative to its total assets. This is measured by the return on assets (ROA) which gives a generalization of how efficient management is at using its assets to generate earnings. This is calculated by net income divided by its average total assets.

1.7.5 Profitability

According to Tulsian (2014), profitability is defined as the ability of a given investment to earn a return from its use.
1.7.6 Competition

This is the process of active rivalry between the sellers of a particular product or service as they seek to win and retain buyer demand for their offerings. (Pendleton, Chadwick, & Pass, 2011).

1.8 Chapter Summary

This chapter has given background information to the study. The background states the nature of microfinance globally and in Kenya as well as the services that they have been providing. The chapter also highlighted the purpose of the study, the research questions and the significance of the study. The general objective of this study was to determine the factors affecting the profitability of Microfinance Institutions in Kenya.

The next chapter gives a review of the literature related to the determinants that affect the profitability of MFIs while the subsequent chapter after it describes the methodology and procedures to carry out the study. Chapter four presents the results and findings from the research and the subsequent chapter presents the conclusions of the research and recommendations for further studies.
CHAPTER TWO

2.0 Literature Review

2.1. Introduction

This chapter presents a review of previous literature relevant to the present study on the factors that affect the profitability of microfinance institutions in Kenya. It is within this chapter that the literature review focuses on the main research questions stated in the previous chapter. This chapter also identifies the theoretical approaches that enabled the tackling of the research problem stated.

2.2 Lending Rates and Profitability of Deposit Taking Microfinance Institutions

According to the International Monetary Fund (2012), lending rate is the financial institution’s rate that usually meets the short and medium term financing needs of the private sector. This rate is differentiated according to the creditworthiness of the MFIs’ borrowers and objectives of financing. Not only limited to the creditworthiness of the borrowers, the given terms and conditions attached to the rates also differ from one country to another and one institution to another.

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2.2.1 Borrower Sensitivity to Lending Rates and its Impact on Profitability

According to Rajeev, Montgomery and Morduch (2005), caps on interest rates were often combined with the element of directives on who should get subsidized loans and for what purpose. Such usury laws were common and therefore restricted interest rates on loans to low levels. The belief behind these laws was that high interest rates on working capital would have consumed most of the surpluses generated by small-scale entrepreneur thus leaving borrowers with little net gain. In an example from Brazil in the early 1970s, Rajeev, Montgomery and Morduch (2005) bring out that the interest rates on loans for
working capital were fixed at 17 percent annually while the inflation rates ranged between 20 to 40 percent annually. This therefore meant that even where interest rate caps allowed for positive real interest rates, they were still seldom high enough to permit the financial institutions to cover their costs.

Microfinance advocates overtime have challenged the assumptions upon which financial institutions had been built. Donors who are shaping the microfinance policy spend effort to make the argument that raising real interest rates to 50 percent and higher is unlikely and that this will instead dissuade credit-worthy borrowers. The basis behind this stems from two ideas; First is that marginal returns to capital tend to diminish with scale and this would mean that borrowers who have been deprived of capital should have high marginal returns to their investments and in turn, they should be willing to pay high lending rates. Secondly, poor households that already pay very high interest rates to loan sharks can keep them in business and it should therefore not come as a surprise that loans at half the loan-shark rate are welcomed (Dehejia, Montgomery, & Morduch, 2012).

Using data from a SafeSave which was a credit cooperative in the slums of Dhaka, Bangladesh, to determine how sensitive the borrowers of the institutions are to increases in the lending rates set on loans, Dehejia, Montgomery and Morduch (2012) found that elasticity of loan demand ranging from -0.73 to -1.04 were detected and that there was a discovery that less wealthy account holders were more sensitive to the interest rate that relatively the wealthier borrowers and consequently, the bank’s portfolio shifts away from its poorest borrowers when it increases its interest rate. This means that the demand of loan decreases with an increase in the lending rates set by the credit cooperatives thereby meaning that loan demand is very elastic thus showing sensitivity to changes in the lending rates. This was an analysis carried out between branch variations in the interest rates.

In their study, ‘the effects of conventional interest rates and rate of profit on the funds deposited with Islamic banking system in Malaysia,’ Sudin and Ahmad (2010) argued that both the interest rates of deposit accounts of traditional banks and rate of profit declared by the Islamic banks had a strong relationship with the amount of deposits of Islamic banks. This came from the basis that since depositors are motivated by returns, it is of importance that the Islamic banks’ management to understand the extent that rates of
return on deposits influence their customers’ decision to deposit. According to them, the rate of interest has always been featured as one of the important considerations in explaining the saving behavior of an individual. According to the Classical economists, savings is a function of the rate of interest whereby; the higher the interest rate, the more money will be saved and at higher interest rates, people will be more willing to forego their present consumption.

2.2.2 Loan Performance and its Impact on Profitability of Deposit Taking Microfinance Institutions

Loan performance within Deposit Taking Microfinance Institutions are best assessed on the nature of their loan portfolio. This is basically constituted of loans that have been made or bought and are being held for repayment. Within lending institutions, loan portfolios are the major assets are typically the predominant source of revenue but still one of the greatest sources of risk to an institution’s safety and soundness and this is one particular area that should have effective management to safeguard operations and soundness of a financial institution. (Janson, 2003).

According to Amahalu, Nweze and Ikechukwu (2017), credit is one of the many factors that can be used by a firm to influence the demand for the products it offers. Therefore, timely identification of potential credit default is of importance since high default rates tend to lead to decreased cash flows, lower liquidity levels thus leading to financial distress. They go ahead to state that any loan that can reasonably be expected to enter default is what is considered a non-performing loan. Often, when a borrower has failed to make a number of payments within a specified period, the loan is not considered to be in default and in such cases, the lack of payments may go up to a period of 90 days. Such loans can be defined as credits which a financial institution may perceive as possible losses of funds.

The loan pricing theory states that banks cannot always set high lending rates in order to try earning a maximum interest income. It is difficult to forecast the type of borrower in the beginning of a banking relationship and it is because of this reason that financial institutions should be able to consider the problems of adverse selection and moral hazard. It lending rates are set too high, it may induce high selection problems because high-risk borrowers are willing to accept these high rates and once the loans have been
received, chances are that they may develop a moral hazard behavior since they are likely to take on highly risky projects or investments (Amahalu, Nweze, & Ikechukwu, 2017).

The microfinance industry differs in many ways from the conventional banking industry from the basis that the client base of microfinance institutions is made up of very low-income earners and microenterprises that are typically vastly scattered across the county and tend to lack the basic financial education. On the aspect of loan size, MFIs deliver an average loan size that is much smaller and shorter in duration than is done in conventional banking (Pouchous, 2012).

In a study done by Siddiqui (2012) on ‘the impact of interest volatility on non-performing loans in Pakistan,’ which used weighed average lending interest rates published quarterly by the State Bank of Pakistan, had that interest rates and profitability are not directly related. Furthermore, interest rates and microfinance institutions’ profitability have an indirect relationship which follows that rising non-performing loans are significantly but not solely impacted by the volatility in the cost of borrowing.

In a study by Onyekachi and Okoye (2013) on ‘the impact of bank lending rate on the performance of Nigerian Deposit Money banks’ between 2000 and 2010, they analyzed how a bank’s lending rate policy affects the performance of Nigerian deposit money banks. Using secondary data econometrics in a regression analysis, the result confirmed that the lending rate and monetary policy rate has significant and positive effects on the performance of Nigerian deposit money banks.

In a case study of Pride Microfinance, in Uganda on ‘loan performance and profitability of microfinance institutions’, Rodgers (2013) used both quantitative and qualitative information (data) from questionnaires and interviews whereby the design was mainly descriptive, analytical and explanatory. The results revealed that most loan clients are affected by the loan period so as to meet their payment obligations whereby most of them borrow for purposes of businesses of which the loan was not quite adequate, lending rates were very high and the borrowers were not allowed any participation in loan negotiations since the terms and conditions were predetermined by the bank.

Kamau (2008) did a study on determinants of profitability of microfinance institutions in Kenya by use of a survey method with secondary data. The findings were that profits
before tax mainly depended on the interest income, interest expense, shareholder funds, loans and advances to customers. Other determinants of profitability of microfinance institutions included provision for bad and doubtful debts and deposits and balances due from other financial institutions.

In a study done by Ndungu (2003) on ‘The determinants of profit of quoted commercial banks in Kenya’, his findings showed that sound asset and liability management which were found to have significant influence on profitability. High interest rates were found to have an adverse effect on commercial banks’ profitability in Kenya. This is explained further in the study carried out by Grenade (2007) on ‘Establishing the determinants of Commercial Banks interest rate spreads in Eastern Caribbean Currency Union’ over the period 1993 to 2003 where he sampled eight foreign banks and eight indigenous banks with the use of panel data techniques to measure the relevance of micro and macro factors. Results were that spreads were strong and persistently showed little signs of narrowing and that foreign owned banks were operating with larger spreads compared to their indigenous counterparts. The results also showed that the observed spreads were attributed to the high level of market concentration, high operating costs and non-performing loans as well as the regulation of savings deposit rate by the Central bank.

In a study on ‘Relationship between interest rate and return on equity,’ using regression model to investigate the relationship between interest rates and ROE, Kipngetich (2011) established that there is a positive relationship between financial performance and interest rates though the effect of interest rates on profitability is not considered significant in all the financial institutions. According to him, all the other factors which influence profitability needs to be enhanced in order to improve the financial performance of financial institutions in Kenya.

2.2.3 Interest Rate Spread and Profitability

According to Kalsoom and Khurshid (2016), interest rate spread is the difference between the lending rate and deposit rate. Spreads are often set with the interest of the targeted customers in mind as well as the total understanding of the competitive environment of which competition has helped in the reduction of interest rate spread.
In a study on interest rates spread and profitability of commercial banks in Ghana, a sample of 28 banks and an ordinary least square regression mode of analysis was used which brought out that interest rate spread affects profitability of commercial banks in Ghana positively but the relationship was statistically insignificant. In this case, there is a relationship between interest margin and banks’ profitability, but insignificant. This therefore implies that, in order for a bank to improve profitability, it will seek to increase net interest margin by effectively and efficiently increasing interest income and decreasing interest expense. It will also mean that the bank will raise its interest margin to cover its increases in operating costs therefore, the increase in ROA will be a source of encouragement for banks to raise their interest margins (Owusu-Antwi, Banerjee, & Antwi, 2017).

Using a descriptive research design in a study on ‘relationship between interest rate spread and financial performance of commercial banks,’ Mang’eli (2012) states that interest rate spread affects the performance of commercial banks, as it increases the cost of loans charged on the borrowers, regulations on interest rates which have far reaching effects on performance of commercial since they determine the interest rate spread in banks and also help mitigate moral hazards incidental to performance of commercial banks. Non-performing loans affect the performance of commercial banks due to the provision effect and follow up costs involved.

In a research by Simba (2010) using regression analysis, on the ‘relationship between borrowing interest rates and nonperforming loans in Deposit Taking Microfinance Institutions in Kenya’ in a 4-year period of 2008 to 2012, there was a general increase in the borrowing interest rates and nonperforming loans. His results further showed that there was a weak relationship between borrowing interest rates and nonperforming loans thereby meaning that with a higher lending rates, the higher the nonperforming loans in the deposit taking microfinance institutions.

Profitable microfinance providers have an ability to continue serving their clients without needing ongoing infusions of subsidies and can therefore be able to fund exponential growth of services for their new clients by tapping commercial sources which may also include the deposits from the public (Rosenberg, Gonzalez, & Narain, 2009).
2.3 Competition and Profitability of Deposit Taking Microfinance Institutions

Competition, is a crucial factor in driving economic growth in a country and also an institution. The reason for this is that it ensures that more productive institutions increase their market share at the expense of the less productive and also it places pressure on firms to increase their efficiency. Competition over time has developed to becoming an important feature of the microfinance industry. According to Porteous (2006), microfinance has captured the interest of academics and policy makers because the industry is growing at a significant rate and is becoming to be considered a subsector of the finance services industry. The growth of microfinance institutions noted between 2005 and 2010 in some countries was reported to be 70 to 100% per annum with a number of microfinance service providers still on a rise (Sanjay, 2010). Therefore, with the growth of the microfinance industry and saturation of markets, there has been increased competition that has been documented in many countries with Kenya being among them.

In the early stages of development of microfinance, the idea of providing microloans to the poor as a way to alleviate poverty has over time appealed to many and has attracted social investors as well as NGOs. But it is not the element of poverty alleviation that attracts a large involvement of commercial financial intermediaries such as international banks, rather, it is the profit opportunity that brings out this attraction. MFIs that are profit-oriented have become important and some make an argument that the shift in the composition of MFIs from socially oriented organizations with ‘poverty lending’ approach which focus on poverty reduction to institutions that are more oriented with ‘financial systems’ approach that focus on commercial financial intermediation among the poor with an emphasis on institutional self-sufficiency (Hulme & Arun, 2009).

In well-functioning markets, competition protects consumers, it promotes allocative and productive efficiency and also provides incentives for the development of new products. In the early years after their establishment, MFIs were largely operating as a monopolist (CGAP 2001; McIntosh & Wydick, 2005). This kind of market power is however associated with allocative inefficiency which refers to the welfare losses as a result of high prices that a monopolist would charge. But not only limited to welfare losses, there is more loss when inefficient technology is applied because it would then mean that there
is productive inefficiency. Therefore, competition can be beneficial in the context of microfinance market since it may result in improved and new financial product designs, better customer services, lower cost and lower lending rates.

On the other side, some scholars argue that microfinance market is a distinct market that makes use of soft-information and depends on strong MFI-client relationship (Esubalew, Niels, & Meesters, 2013). The basis behind this is that MFIs provide financial services for the poor that main financial institutions consider not being creditworthy. It is for this reason that MFIs are often praised for overcoming the challenges of information asymmetry and provision of loans without collateral requirements. Microfinance Institutions manage to do this by establishing strong personal relationships with clients as well as using other forms of collateral such as the group lending that then generates social collateral. Therefore, the effort that MFIs would put in to win clients and expand market share may lead to low screening and lending standards because increased competition is also associated with an increase in information asymmetry which would then make it difficult for MFIs to know about the general debt level of their clients (Esubalew, Niels, & Meesters, 2013). This in turn, would develop into multiple borrowing, heavy debt burdens, low repayment rates and poor portfolio quality.

2.3.1 Competition and Innovation in Deposit Taking Microfinance Institutions

The effects of competition among MFIs could go both ways. Navajas, Conning and Gonzalez (2003) studied competition in the Bolivian microfinance market by focusing on two major MFIs; BancoSol and Casa Los Andes, which both have an approximate market share of around 40 per cent. The results achieved show that the outcome of competition is open for debate with the reason being that competition leads to innovation thus expanding outreach but reduces the ability of lenders to cross-subsidize less profitable smaller loans. On the same angle, Vogelgesang (2003) indicates that competition is related with multiple loan taking and higher levels of borrower indebtedness; while on the other hand, he still argues that the probability of timely repayment could be higher in areas where there is high competition and high supply of microfinance products and services. In the presence of increased competition, MFIs may be forced into searching for new customers or sustain or increase their market shares. By increasing cost of efficiency, MFIs may in turn end up reducing their efforts to monitor and screen new clients. This would then
mean that the quality of their loan portfolio would reduce as they increasingly approve loans to the risker borrowers.

Mersland and Strom (2009) state that the microfinance industry carries every sign of an innovation in its take-off phase with various aspects having being developed in the early 1980s with over 20 years the industry has experienced a phenomenal growth rate globally. They go ahead to say that the common denominator for microfinance innovations is that they solve information asymmetry and cost problems that are associated with serving poor customers with little or no collateral.

From its main objective, microfinance gives poor people and small businesses access to financial services and therefore most providers of microfinance have a double objective; to serve the poor and to do so in a financially sustainable way (Mersland & Strom, 2009). In their study, the choice of market and technology constitute the defining features of microfinance whereby, the market choice is poor people and small businesses in developing countries while technology is focused on small loans on short durations without formal collateral and often involves a group loan.

McIntosh and Wydick (2005) developed a theoretical model which characterizes the effects of competition between MFIs whereby, increased competition can lead to increased information asymmetry. This comes from the fact that as the number of competing MFIs increase in a market, information sharing between them becomes challenging and this would then mean that borrowers may engage in multiple borrowing which would then increase the debt level of clients and high probability of defaults too. For the worse off borrowers who are stuck with a single lender, they would develop a behavior which will create an externality by inciting MFIs to respond to multiple borrowing by adjusting interest rates upwards.

Schumpeterian definition of innovation is the commercial application of invention for the first time. This is not limited to product and process innovation but goes beyond these two. Mersland and Strom (2009) state that it also encompasses new organizational processes and the opening of new markets for inputs or outputs.

Competition weakens long-term relationship between the financial intermediary and the client whereby, with very intense competition, then most MFIs’ focus will be on the most
profitable customers. Previous studies which ones done on financial institutions’ competition have applied a range of measures of competition that have their own benefits and drawbacks. Concentration indices such as the Herfindhal-Hirschman index is one of the early measures of competition which showed that low concentration is associated with an existing high competition among the financial institutions. This measure was however refuted on the basis that the relation between concentration and competition is not straightforward and therefore, a higher concentration does not always imply lack of competition (Bikker & Haaf, 2002).

Empirical literature presented by Hisako (2009) that relates to competition and microfinance profitability was that; competition has no impact on the financial self-sufficiency (FSS) of an MFI and in addition to this, Mersland and Strom (2009) said that higher competition to lower portfolio field among MFIs lowers their profitability.

2.3.2 Impact of Competition on Customer Outreach in Deposit Taking Microfinance Institutions

Freixas and Rochet (2008) in their study of ‘microeconomics of banking’, they said that the lender-borrower relationship contains several informational problems and this may be seen in an instance of a bank facing a new borrower. In this case, the bank does not know the borrower’s type and by focusing on the extremes, the borrower may be trustworthy or not. Freixas and Rochet relate this situation with Akerlof’s (1970) lemon problem which was on adverse selection or simply known as the hidden information problem. If the bank knew in advance, it would have supplied a loan to the trustworthy and not the untrustworthy. In such a case, the bank then would need a signal from a third party to screen the good risks from the bad but this would then mean high cost of monitoring. The aspect of exerting effort to the borrower to repay the loan is the moral hazard or the hidden action problem which is usually solved by setting up an incentive structure to give the borrower an interest in repaying.

Banks present themselves with problems of information asymmetries because of the lack of transparency with each other. Freixas and Rochet (2008) therefore suggest that innovations come out as solutions to asymmetric information problems. To them, such innovations include; targeting of poor customers, targeting of women, new lending technologies, new organizational solutions and new sources of funding.
According to Dary (2013), for microfinance institutions to fulfil their dual mission, it depends largely on their capacity for innovation. This argument comes from the fact that more traditional banks are venturing into microfinance services provisions as more number of players in the microfinance industry is increasing thus also increasing the number of challenges confronting the microfinance industry. At the same time, there is also an increasing complexity in demand for microfinance services among the clients thereby emphasizing the role of innovation, particularly in developing countries.

Barriers to the success of microfinance institutions in developing countries that relate scalability, sustainability, outreach and the impact of various microfinance initiatives can be overcome through the adoption of innovative strategies to maximize outreach and sustainability (Dary, 2013). Innovation therefore gives a provision for easy access to accurate activities such as disbursements, repayments, deposits, withdrawals and money transfer thus making their completion faster and better controlled with minimal room for errors.

Dary (2013) states that there is no set format related to the set of indicators of innovation within the microfinance industry. Innovation therefore can be measured using either an input approach or output approach whereby the input approach looks at activities within the firm that stimulate or induce innovation such as research and development investments, level of education of the staff, level of experience of the staff among others. On the other hand, the output approach looks at the outcomes of innovation inouts as they are more related to product, process, marketing and organizational arrangements. By focusing on the output approach, the Organization for Economic Cooperation and Development (OECD) Oslo Manual (2005) identified four main types of innovation: product innovation, process innovation, marketing innovation and organizational innovation.

A panel fixed-effects regression estimate and and a linear probability model was done by McIntosh, De Janvry and Sadoulet. Their results show that more intense competition can lead to multiple borrowing and a decline in repayment rates. Although their study does not directly examine the impact of competition on MFI profitability, their study indirectly finds a negative impact of increased competition on repayment which is consistent with McIntosh and Wydick (2005).
In April, 2011, Smith did a study on ‘does regulating microfinance work’ by assessing variables of competition and regulation of microfinance institution’s efficiency, outreach and sustainability from a broad survey of 86 countries. He states that the link between competition and profit margin is a strong measure for assessing an institution’s performance. His results show that a one percent increase in competition decreased the average MFI’s profit margin by 0.962 percent meaning that between 2003 and 2009, the average microfinance institutions saw a decrease in profit margin of roughly 8.2 percent in response to an increase in competition of 8.5 percent. His conclusion was that the link between competition and profit margin is almost always negative in the sense that; perfectly competitive markets operate where profit margins are zero. Furthermore, an increase in competition between firms disperses information so that lenders become less informed about the average borrower and also allows borrowers to easily take out multiple loans.

Jegede, Kehinde and Akinlabi (2012) state that the theory of outreach follows that the poorer the borrowers served by a microfinance institution, the better the outreach. This means that institutions that provide small loans to clients increase their outreach since their primary target market is focused on those living in poverty.

According to Abdulai and Tewari (2017), microfinance institutions worldwide are striving to reach out to a large number of clients and this is what is referred to as breadth of outreach. At the same time, the institutions have to ensure coverage for those living with high relative poverty levels that is; in terms of their depth of outreach with financial services needed for both consumption and enterprise development. The breadth of outreach in this case is related to the actual number of poor people reached with financial services while the depth of outreach refers to how deep within the poor population an institution is able to reach.

It is of key importance that institutions recognize the heterogeneity of the poor and they therefore need to design products that meet their needs which is critical in the attainment of an institution’s outreach goals. Several measures of outreach that can be used include: depth, breadth, cost, worth, length and scope (Abdulai & Tewari, 2017). The depth and breadth are the most common dimensions of outreach due to the fast expansion in the
sector which has led to an increase in the breadth of outreach both at the firm level and at the individual level (Quayes, 2012).

In their study ‘determinants of microfinance outreach in Sub-saharan Africa,’ Abdulai and Tewari (2017) empirical evidence on determinants of microfinance outreach included the source of funding, governance and ownership structure, macroeconomic and political environment, population density, loan contract terms, the cost of service delivery and delivery mechanism.

Awusabo-Asare, Annim, Abane, and Asare-Minta (2009) compared data from 1104 non-clients to 1600 clients and computed household level relative poverty scores in Ghana using a microfinance poverty assessment tool and they found out that rural and community banks and financial NGOs had greater outreach to all categories of clients (from extremely poor to the poor) compared to the savings and loan companies and credit unions. They also found out that the source of funds, outreach strategy and MFI mission influence their performance.

On the same basis, Osotimehin, Jegede, & Akinlabi (2011) did a research on finding out the determinants of MFIs outreach in South Western Nigeria using panel data obtained from 80 institutions between the year 2005 to 2010 by employing a generalised least square and ordinary least square regression analyses and found that debt to equity ratio, loan repayment rates and salary were the main positive determinants of outreach.

2.4 Impact of Government Regulations on Deposit Taking Microfinance Institutions Profitability

According to Cull, Demirguc-Kunt and Morduch (2009), microfinance institutions currently reach well over 100 million clients. The rapid growth of microfinance has brought about an increasing need for regulation despite the fact that compliance of these prudential regulations and their associated supervisions can be costly for these institutions.

Governments indeed play an active role in microfinance by setting policies for the microfinance industry most frequently vis-à-vis interest rates set by the Central Bank of the country. Governments also provide lump sum grants to NGOs or other MFIs or they also lend directly to the poor. Before the coming of microfinance, governments supported
agricultural banks and promulgated regulations that required commercial banks to direct a proportion of credit to particular economic sectors (World Bank, 2003). These efforts put in by the governments came to fail because of low repayment rates, politically –motivated loan write-offs and there was also the capture of subsidized credit by the wealthy farmers.

Regulation is considered prudential when it is aimed at protecting the financial system as a whole while at the same time protecting the safety of small deposits in individual institutions (Cull, Dermiguc-Kunt, & Morduch, 2009). In comparison to formal financial institutions, the assets of microfinance institutions remain substantially less thereby meaning they do not pose a risk to the stability of the overall financial system in most countries. Despite this fact, an increasing share of microfinance institutions take deposits from the public and many of the depositors are relatively poor. Therefore this calls for a need for protecting the safety of those deposits hence bringing out the rationale for an improved regulation and supervision of these institutions.

In the banking sector, regulations are meant to preserve stability and protect public deposits. The reason behind is that there exist information asymmetries between shareholders, debtors and depositors and banks, which are more heavily regulated than other banks. This is also attributed to the fact that depositors are vulnerable to the banks engaging in risky high-profit operations that may threaten the security of their deposits. Regulations, as stated before, may either impose constraints thereby deterring their engagement in risky activities (Damji, Yu, Vora, & Anand, 2014).

Regulations can be divided into two: prudential and non-prudential regulations whereby prudential regulations are intended for the preservation of the stability of the bank by establishing penalties that deter institutions from taking excessive risks. On the other hand, non-prudential regulations seek to promote good behaviour in the system by requiring consumer protection, full information disclosure as well as fair business practices (Damji, Yu, Vora, & Anand, 2014). The same regulations extend to microfinance institutions since depositors of these institutions are in a disadvantaged position as compared to the clients at traditional banks. The reason is that the depositors possess only a small amount of money and therefore any failure of an institution would then discourage these depositors from participating in the financial system. Not limited to this alone, regulation of these microfinance institutions serves as a means to build the
confidence of commercial banks in these institutions which are sources of funds for these microfinance institutions. Damju, Yu, Vora and Anand (2014) go ahead to state that prudential regulations on microfinance institutions have included minimum capital requirements, loan-loss provisioning and ownership requirements but the most relevant regulation to microfinance institutions is capital adequacy.

2.4.1 Capital Adequacy Requirements and its Impact on Profitability

Capital adequacy in this context defines the maximum level of leverage that a microfinance institution can reach on its operation and thereby limits the amount of risk that an institution can have in its portfolio (Damji, Yu, Vora, & Anand, 2014). According to the Microfinance Act Number 19 of 2006, the Minister of Finance made the following regulations regarding capital adequacy for deposit-taking microfinance institutions “every institution shall at all times- maintain records including balance sheets and periodic statements of income and expenditure to enable proper computation of the institution’s capital adequacy; and maintain the prescribed minimum capital requirements.” On the same clause on capital adequacy, part 2 goes on to state that “the Central Bank shall determine whether an institution is in compliance with the capital adequacy requirements in accordance with the Act and these Regulations.”

According to Kaloki (2018), capital adequacy requirements could be in the form of capital adequacy ratio or minimum amount of capital to be maintained by a microfinance institution. Haq, Hoque and Pathan (2008) state that capital adequacy ratio is what protects depositors as microfinance institutions grow in size and expand their risk profile. Majority of microfinance institutions in most countries must maintain a capital adequacy ratio at a minimum of 8 per cent of risk weighted assets. In Kenya, the minimum ratio for core capital to the total risk weighted assets is 10 per cent and the total capital to total risk weighted assets is 12 per cent. Microfinance institutions in Kenya are also required to hold core capital of at least 60 million Kenya shillings per year for nationwide microfinance institutions and 20 million Kenya shillings for community microfinance institutions (Kaloki, 2018).

According to Musyoka (2017), capital adequacy is key towards the contribution of financial performance of a financial institution. It is positively related to return on assets and return on equity. Financial institutions holding adequate capital are perceived to be
safe by their depositors thus attracting large deposits. In this case, this means that there are adequate resources to support operations hence leading to increased returns. Although, the question that arises is how much capital is enough because regulations on capital adequacy should not impose disproportionate costs to microfinance institutions which may in turn lead to poor financial performance. Large capital requirements tend to reduce investment opportunities which will negatively affect financial performance. Despite the fact that capital is expensive in terms of expected return, Herrero, Gavila and Santabarbara (2007) argue that highly capitalized banks face lower cost of bankruptcy.

2.4.2 Regulation Theories

2.4.2.1 Public Interest Theory of Regulation

This theory was first developed by Arthur Cecil Pigou in 1932 and it proposes that government regulation is a response to public demands for the government to sort or make changes in situations of market failure through imperfect competition, market disequilibrium, missing markets or market outcomes that are undesirable for social reasons (Kaloki, 2018).

This theory is based on the assumption that market outcome represents a failure and the markets on their own do not have the ability to fix the problem on their own. Only the governments have the ability to fix the failure so that an optimal efficient outcome will be achieved and that the benefits will outweight the additional costs created by the intervention (Kaloki, 2018). This theory acts as a prescription of what governments should do and acts as a description of what they actually do.

2.4.2.2 Regulatory Capture Theory

The proponent of this theory, George Stigler, is a contrary perspective of regulation theory which states that it is the process which regulatory agencies eventually get to be dominated by the same industries that they were charged with regulating. It argues that, although regulation is often introduced to protect the public, some of the regulatory mechanisms are subsequently controled so as to protect the interests of particular groups within the society.

As an example, regulation capture can occure where an agency was established to conduct occupational regulation for quality reasons and became captured by that same
profession to achieve benefits for incumbents through entry restriction (Guerin, 2002). This theory cautions that regulation of an industry may result from the effort of incumbents to create and extract rents and to prevent entry by new competitors.

Mwongeli (2016), in her study on ‘the effect of regulations on financial performance of commercial banks in Kenya,’ stated that in 2013, Forbes Insights carried out a survey in the United States of America.

In a study by Vianney (2013) on ‘the relationship between regulation and financial performance of Rwanda commercial banks,’ he found out that regulations are not a significant predictor of financial performance of financial institutions in Rwanda. Instead, he says that regulation is a key pillar of financial institutions’ operations and by extension to financial prosperity and stability. He therefore made a recommendation that the government of Rwanda should develop policy that will help financial institutions operate in a conducive environment which can in turn create financial stability of financial institutions in the country.

In a study by Cull, Demirguc-Kunt and Morduch (2011) on ‘microfinance tradeoffs,’ they used an updated MIX market dataset and examined the effect of regulation on the profitability of microfinance institutions. In particular, they investigated how regulated institutions manage the financial and administrative obligations of complying with regulation, looking at profits and business orientation. Through econometric analyses, regulation, competition and financing datasets of a subset, 154 institutions that reported detailed financial information were subject to regulatory supervision. Their results showed that being regulated often permits institutions to collect deposits and thereby gain a cheaper and/or more stable source of capital.

In a study by Crafts (2006) on ‘regulation and productivity performance,’ noted that regulations have an ability of resulting resources to be directed to compliance rather than the creation of productive output. He further stated that they can also impose constraints on the choice of production techniques for instance preventing the use of inputs and this may in turn lead to mis-allocation of resources.

Smith (2011) in a study on ‘does regulating microfinance work,’ showed that regulated MFIs showed a 1.016 percent decrease in their profit margin in response to a 1 percent
increase in competition. Unregulated MFIs only showed a 0.613 percent decrease in their profit margins in response to a similar increase in competition.

The undertaking of regulatory reforms by abolishing financially repressive regulations, adjusting prudential standards is for the purpose of reflecting the specialized nature of microfinance as well allowing foreign equity participation in microfinance. This is because in many countries, foreign equity participation in MFIs had been limited or prohibited yet foreign presence in microfinance can bring in a catalytic and strengthening effect. Foreign investors find it unable to invest in MFIs in developing countries and yet they are interested and this is due to restrictions imposed by governments.

Improving the business environment by strengthening the banking system and developing infrastructure especially in rural areas. The government can also put some focus on the macroeconomic stability of the financial sector. Macroeconomic instability widely affects the overall economic growth and this limits the productive economic opportunities and potential for sustainable microfinance. In the event of high inflation rates, it leads to erosion of capital financial institutions and this in turn makes it difficult for mobilization of resources to expand services. All in all, general macroeconomic instability tends to increase the volatility of interest rates, exchange rates and also relative prices and also imposes additional costs and risks on the financial institutions and their existing and potential clients.

The core basis of the regulations set in place for the MFIs is to create a financial ecosystem with a sharp focus on customer centricity and it is with this sharp focus that stringent client protection measures have been put in place to ensure that MFIs refrain from adopting practices that ignore the social aspect that defines the microfinance activity as it is. Therefore, governments both at national and local levels have an ability to create a legal and regulatory environment that encourages market entry and competition in microfinance. It is within this concept that CGAP states the central government bodies can involve the private sector in formulating poverty reduction strategies and also recognize microfinance as a leader in the financial sector development. By including the participation of the private sector, it will help to embed microfinance firmly within financial systems, with private and non-government actors taking the lead, unlike the functions of government bodies such as ministries and local authorities.
In the process of developing a technical guide for microfinance investors Forster, Lahaye and McKee (2009) argued that client protection is a lead principle of microfinance and therefore it is of importance that the sector is regulated along with prudential reforms which then enables the MFIs to mobilise their deposits (Arun, 2005). It is therefore important to have prudential regulation and supervision of MFIs since some of the largest MFIs mobilize public deposits and particularly from the relatively poor households (Hartarska & Nadolnyak, 2007). It is therefore a relevant issue to have these public deposits protected.

That notwithstanding, MFIs regulation by the government raises costs of lending for MFIs. Cull, Demirguc-Kunt, & Morduch (2011) did a test to find out whether MFIs are able to maintain profitability in the face of additional costs of complying with supervision using data from 245 of the world’s largest MFIs. By use of OLS estimations, they found out that profitability declines with supervision. Upon control of the non-random assignment of supervision via treatment effects and instrumental variables regressions, they confirm that supervision is not significantly associated with profitability. True to this finding, Tchakoute-Tchuigoua (2010) did a study to find out whether there is a difference in performance by the legal status of MFIs and found out that the performance of commercial MFIs is better than that of NGOs but this only applies when portfolio quality is used as the proxy of measuring performance.

Glass, McKillop and Rasaratnam (2010) study shows that 68 per cent of the Irish credit unions do not incur any extra opportunity costs in meeting regulatory guidance on bad debt, which then explained the unions’ good performance.

2.5 Chapter Summary

This chapter has provided a critical and constructive empirical focus on microfinance and the various impacts of the MFIs lending rates, competition and impacts of government regulations on the profitability of microfinance institutions. This chapter has provided insight on the extent that competition has its adverse effects on performance and profitability of MFIs mainly due to rising information asymmetry and also that government regulation in the microfinance industry can be a positive factor in the boost of financial performance of MFIs if regulations are followed. The main aim of this
chapter was to provide literature review of studies that have been done in relation to the factors impacting profitability of MFIs in Kenya, as brought out in the previous chapter’s objectives. The next chapter describes the methods and procedures which were used to carry out the study. This is specifically the research design, population and sampling design, data collection methods as well as the research procedures.
CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

The specific objective of this research was to determine factors affecting profitability of deposit taking microfinance institutions in Nairobi. This chapter presents a detailed description of the methodology used in the study. It includes research design, target population, data collection, validity and reliability, and data analysis methods.

3.2 Research Design

A descriptive study research design was employed to investigate the effects of competition, lending rates and government regulation on the financial performance of deposit taking microfinance institutions in Nairobi. A descriptive study usually attempts to describe or define a subject, often by creating a profile of a group of problems, people or events, through the collection of data and tabulation of the frequencies on research variables or their interaction (Cooper & Schindler, 2013). Descriptive study research design is the investigation whereby quantity data was collected and analyzed so as to describe the specific phenomenon in its current events, trends and linkages between different factors at the current time. This research design stands out as the best because it facilitates the establishment of a relation between variables and also defines the questions, people to be surveyed and the method of analysis before data collection.

All variables were to use the above stated descriptive research design as well as cross sectional survey method. This allowed for prudent comparison of the research findings from the basis that a cross sectional and descriptive research design attempts to describe or define a subject by creating a profile of a group of problems, people or events through the collection of data and tabulation of the frequencies on research variables or their interaction as to be indicated.
3.3 Population and Sampling Design

3.3.1 Population

In statistics, a target population is the specific population from which information desired to be collected will be gathered or collected from. Borg and Crall (2009) described a target population as a universal set of study of all members of a real or hypothetical set of people or objects to which an investigator would wish to generalize the result. In this study, the target population was from the departments in Faulu Kenya Deposit Taking Microfinance Limited dealing with the financial aspect of the institution.

3.3.2 Sampling Design

3.3.2.1 Sampling Frame

Nachmias and Nachmias (2008) defined a sampling frame as a list of all elements where a representative sample that is closely related to the population is actually drawn from. The sampling frame that was used for this study consisted of departments that deal with the financial aspect of the bank which included the banking operations department, the risk management department and business development department.

3.3.2.2 Sampling Technique

A sampling design refers to a technique or procedure that a researcher adopts in selecting sampling units from which inferences about the population is to be drawn (Kothari, 2005). This study employed a stratified random sampling technique in the selection of data. Stratified random sampling involves the division of the target population into various subgroups known as strata and then samples are collected from these strata. In this study, the strata were in relation to the various departments within Faulu Microfinance Bank but limited to those that are financially related, that is; banking operations, business development and risk management as illustrated in the table 3.1.

3.3.2.3 Sample Size

According to (Churchill, 2003), a sample size can be described as a subgroup of a large population with an assumption that the information gathered will infer something in regards to that population. The sample size that was used to undertake this research was derived from a population of one deposit taking microfinance institution with a
representative sample being drawn by use of Mugenda and Mugenda (2003) where they stated that a sample size of 10 percent of a given population is considered adequate for a descriptive study. In this case therefore, 10 percent of a population of 770 employees gave a sample size of 77.

**Table 3.1: Faulu Bank Departmental Structure**

<table>
<thead>
<tr>
<th>Departments in Faulu Microfinance Bank</th>
<th>Number of Employees</th>
<th>10% of Selected Department Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking Operations Department</td>
<td>595</td>
<td>59</td>
</tr>
<tr>
<td>Human Resources Department</td>
<td>53</td>
<td></td>
</tr>
<tr>
<td>Business Development Department</td>
<td>40</td>
<td>4</td>
</tr>
<tr>
<td>ICT Department</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Department of Risk Management</td>
<td>35</td>
<td>4</td>
</tr>
<tr>
<td>Internal Audit Department</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>Legal Department</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Department of Corporate Affairs</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>824</td>
<td>77</td>
</tr>
</tbody>
</table>

### 3.4 Data Collection Methods

Primary data was used to ensure that the study is accurate and reliable. The questionnaire included both closed and open ended questions for collection of the data. This was collected from the institution’s employees in the banking operations, risk management and business development departments to evaluate the effects of the three variables on the performance of DTM. The study used a questionnaire which sought to gather descriptive data based on the study objectives.

A four point Likert scale, which is an ordinal scale, was adopted the questions in the survey excluding open-ended questions. The Likert type scale comprised of an array of qualitative variations of a given entity which has a least to most, sequential order with every statement or question having a provision of five choices. The choices portrayed a
degree of agreement in relation to a given question and they were ranging from strongly disagree, disagree, uncertain, agree and strongly agree. The questionnaire was divided into four sections which included the demography of the respondents, the impact of lending rates on profitability, the impact of competition on profitability and the impact of government regulations on profitability.

3.5 Research Procedures

The questionnaires were designed based on the research questions and were pilot-tested to ascertain their suitability before the actual administration. A pilot study, a trial run of an investigation conducted on a small scale, was carried out to determine whether the proposed methods or instruments were appropriate for the study. The pilot study was aimed at testing the reliability and validity of the questionnaires. It involved a random selection of 5 respondents that did not participate in the final survey.

The research involved collection of data from random employees within the strata and the questionnaires were administered to all respondents sampled through drop and pick at the agreed times. This approach helped in clarification of any issue that required an explanation and also helped in reducing delayed responses.

3.6 Data Analysis Methods

Data collected used a quantitative method of data analysis. The data was coded and entered into the Statistical Package for Social Sciences (SPSS) version 24 for analysis. Descriptive analysis involved frequency distribution, variances, standard deviation and regression that helped determine the level that the variables impact the profitability of these institutions.

3.7 Chapter Summary

This chapter discussed the methodology that was used in carrying out the study. A descriptive survey design was adopted to assess the impact that competition, lending rates and government regulations have on the profitability of deposit taking microfinance institutions in Kenya. The study’s population consisted of Faulu Kenya Deposit Taking Microfinance Limited. The subsequent chapter presents the study findings derived from the respondents.
CHAPTER FOUR

4.0 RESULTS AND FINDINGS

4.1 Introduction

This chapter presents the results and findings of the study on the stated research objectives with reference to the data collected from the respondents. The first subsection provides the background information of the respondents followed by the impact of lending rates towards profitability of the Deposit Taking Microfinance Institution. The third sub-section provides coverage of the impact of competition on the profitability of Deposit Taking Microfinance Institutions. The last sub-section provides the respondents views in terms of the government regulations imposed in the microfinance sector and how it has impacted on the profitability of the Deposit Taking Microfinance Institution after which, the subsequent subsections look at the conclusion and recommendations for further research.

4.2 Response Rate and Background Information

The background information was considered to be meaningful by the researched because of the role it plays in enabling the understanding of the logic of the responses given by the respondents of the Deposit Taking Microfinance Institution.

4.2.1 Response Rate

A total of 58 questionnaires were returned out of 77 questionnaires that had been issued thereby indicating a 75 percent response rate. This was sufficient for the study as indicated in table 4.2.

Table 4.2: Response Rate

<table>
<thead>
<tr>
<th>Variable</th>
<th>Frequency</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Filled and returned</td>
<td>58</td>
<td>75</td>
</tr>
<tr>
<td>Non-response</td>
<td>19</td>
<td>25</td>
</tr>
<tr>
<td>Total</td>
<td>77</td>
<td>100</td>
</tr>
</tbody>
</table>
4.2.2 Background Information

In this sub-section, background information that is related to the respondent was provided. This included the level of education, number of years in the financial sector and number of years in the organization.

4.2.2.1 Level of Education

To analyse the literacy levels, the results brought out that majority of respondents accounting for 51.7% were master’s degree holders while 29.3% had a university degree and 12.1% were diploma holders and doctorate holders represented 6.9% as shown in table 4.3 below. This implies that the data received from the responses was precise as the respondents were literate to comprehend the questions asked and that the institution is well endowed with capable and knowledgeable staff.

Table 4.3: Level of Education

<table>
<thead>
<tr>
<th>Level of Education</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diploma</td>
<td>7</td>
<td>12.1</td>
</tr>
<tr>
<td>Degree</td>
<td>17</td>
<td>29.3</td>
</tr>
<tr>
<td>Masters</td>
<td>30</td>
<td>51.7</td>
</tr>
<tr>
<td>Doctorate</td>
<td>4</td>
<td>6.9</td>
</tr>
<tr>
<td>Total</td>
<td>58</td>
<td>100</td>
</tr>
</tbody>
</table>

4.2.2.2 Number of Years in the Financial Sector

In order to retrieve the relevance and understanding of the questions asked, the study sought to analyze the number of years the respondents had been in the financial sector. Majority of the respondents had at least 41.4 percent experience in the financial sector, while 24.1 percent had less than 2 years experience and 22.4 percent had 6-8 years’ experience while those with 9 years and above accounted for 12.1 percent.
Table 4.4: Number of Years in the Financial Sector

<table>
<thead>
<tr>
<th>Number of Years in the Financial Sector</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2 years</td>
<td>14</td>
<td>24.1</td>
</tr>
<tr>
<td>3-5 years</td>
<td>24</td>
<td>41.4</td>
</tr>
<tr>
<td>6-8 years</td>
<td>13</td>
<td>22.4</td>
</tr>
<tr>
<td>9 years and above</td>
<td>7</td>
<td>12.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>58</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

4.2.2.3 Number of Years in the Organization

Table 4.5 presents a summary of the findings with regards to the number of years the respondents had worked for the organization. As indicated, those respondents with less than 2 years experience accounted for 13.8 percent, those with 3 to 5 years accounted for 36.2 percent while a greater share of the respondents were between 6 to 8 years were at 39.7 percent. A small share of the respondents comprising of 10.3 percent had 9 years and above work experience in the organization.

Table 4.5: Number of Years in the Organization

<table>
<thead>
<tr>
<th>Number of Years in the Bank</th>
<th>Frequency</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 2 years</td>
<td>8</td>
<td>13.8</td>
</tr>
<tr>
<td>3 - 5 years</td>
<td>21</td>
<td>36.2</td>
</tr>
<tr>
<td>6 - 8 years</td>
<td>23</td>
<td>39.7</td>
</tr>
<tr>
<td>9 years and above</td>
<td>6</td>
<td>10.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>58</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

4.3 Impact of Lending Rates on the Profitability of Deposit Taking Microfinance Institutions.

The study first sought to establish what the impact of lending rates was towards the profitability of Deposit Taking Microfinance Institutions in Nairobi. This sub-section presents a detailed analysis of the findings with regards to the various elements that affect lending rates.
4.3.1 Range of Lending Rate

To establish the range of lending rate the deposit taking microfinance bank had been adopting, all respondents indicated that they offer a rate of 19 percent and above.

4.3.2 Borrower Sensitivity to Increases in lending rates set on loans

All respondents responded that the borrowers were very sensitive to any increase in the lending rates set on loans.

**Table 4.6: Borrower Sensitivity**

<table>
<thead>
<tr>
<th>Valid</th>
<th>Strongly Agree</th>
<th>Frequency</th>
<th>Percent</th>
<th>Valid Percent</th>
<th>Cumulative Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>58</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

4.3.3 Client Distress over loan Period Allocated

The study sought to establish whether most loan clients were likely to be affected (distressed) by the loan period given to them in order for them to meet their payment obligations. Figure 4.3 presents a summary of the findings with regards to how respondents thought about this issue. The results of the study as seen in figure 4.3 show that 50 percent strongly agree, 41.4 percent disagree while 8.6 percent of the respondents were uncertain.

**Figure 4.1: Presence of Client Distress Over Loan Period Allocated**
The study findings indeed indicated that their clients are affected by the loan periods they are granted for them to meet their payment obligation.

4.3.4 Interest Rate Spread Impact on Performance

The study sought to establish whether interest rate spreads are likely to affect the performance of the deposit taking microfinance institution and the findings were that 63.8 percent of the respondents disagreed while 25.9 percent strongly agreed and 10.3 percent were uncertain. This has been illustrated below in figure 4.4.

![Figure 4.2: Interest Rate Spread Impact on Performance](image)

4.3.5 Impact of Non-Performing Loans on Performance

The study sought to find out how non-performing loans have an impact on the deposit taking microfinance institution’s performance and the findings as illustrated in figure 4.6 show that 63.8 percent of the respondents agreed, 24.1 percent agreed while 12.1 percent were uncertain. This therefore confirms that non-performing loans are a contributor to the financial performance of the institution.
4.3.6 Impact of Return on Equity on the Lending Rate Set by the Bank

Figure 4.7 presents a summary of the findings with regards to how return on equity (cost of capital) impacts the lending rate set by the deposit taking institution. 50 percent of the respondents disagreed, 44.8 percent strongly disagreed and 5.2 percent were uncertain. This therefore confirms that the cost of capital (ROE) indeed has an impact on the lending rate that the deposit taking microfinance institution sets.

4.3.7 Nature of relationship between Lending Rate and Profitability

From the objectives set as a guideline, this study aimed to find out whether there is indeed any positive or negative relationship between lending rate and profitability within the deposit taking microfinance institution. Results of the study was that 50 percent of the
population disagreed, 44.8 percent strongly disagreed, 3.4 percent agreed and 1.7 percent were uncertain. This has been illustrated below in figure 4.8 and therefore means that there is a negative relationship between lending rates and profitability recorded in the institution.

![Figure 4.5: Nature of Relationship between Lending Rate and Profitability](image)

**4.3.8 Loan Type Practiced**

As part of the many elements contributing towards lending rates, this study also sought to find out what type of loan interest rate the deposit taking institution undertakes from which most of the respondents represented by 19 percent stated that the institution takes up a reducing balance kind of interest rate after selecting any other then stating the type of loan interest rate. A majority of the respondents represented by 81 percent were uncertain of the type of loan interest rate is applied by the institution. This has been illustrated in the figure below.

![Figure 4.5: Nature of Relationship between Lending Rate and Profitability](image)
4.3.9 Lending Rate Dictates Profitability

This study sought to establish whether lending rate dictates the profitability of the deposit taking microfinance institution. On a Likert scale set from very low, low, moderate, great and very great, the findings indicated that to a very low extent do lending rates dictate the profitability of the institution. This was represented by a 39.7 percent saying very low, while 36.2 responded low and 24.1 percent responded moderate. These findings have been illustrated in figure 5.0.

![Figure 5.0: Lending Rate Dictates Profitability](image)

4.3.10 Lending Rate Induces Competition

This study sought to establish whether lending rate leads to competition from other financial institutions and the findings revealed that 67.2 percent of the respondents said that to a great extent lending rate has induced competition from other financial institutions, 27.6 percent responded to a very great extent while 5.2 percent said that to a moderate extent lending rate induces competition from other financial institutions as represented in the figure below.

![Figure 4.7: Lending Rate Dictates Profitability](image)
4.3.11 Lending Rate Affects Feasible Investment Opportunities

Figure 5.2 presents a summary of the findings with regards to how lending rates affect feasible investment opportunities in the deposit taking microfinance institution. 48.3 percent of the respondents said that to a very low extent do the lending rates affect feasible investment opportunities while 44.8 percent responded low and 6.9 percent responded that to a moderate extent do lending rates affect feasible investment opportunities. This therefore means that it is not true that lending rates set by the deposit taking microfinance institution affects their feasible investment opportunities.

Figure 4.8: Lending Rate Induces Competition

Figure 4.9: Lending Rate Affects Feasible Investment Opportunities

The study first sought to establish what impact competition had towards the profitability of Deposit Taking Microfinance Institutions in Nairobi. This sub-section presents a detailed analysis of the findings with regards to the various elements that affect competition.

4.4.1 Competition and its Impact on Innovation

The results of the findings on the impact of competition towards increased innovation within the institution to expansion of its means towards delivering better services to the customers saw that 63.8 percent strongly agreed, 29.3 agreed and 6.9 percent of the respondents were uncertain. The following table illustrates the above findings and it is a true representation meaning that competition has indeed increased innovation within the bank thereby expanding its means of delivering better services to the customers.

Figure 4.10: Competition and its Impact Towards Innovation

4.4.2 Increased Innovation impact towards Customer Outreach

In figure 5.4, the findings of this element revealed that 58.6 percent strongly agreed that through increased innovation has increased customer outreach in the bank, while 13.8 percent agreed and 27.6 percent were uncertain.
Figure 4.11: Increased Innovation has Increased Customer Outreach

It is therefore true that increased innovation has helped in facilitation towards customer outreach for the deposit taking microfinance institution.

4.4.3 Competition and its impact towards Cross-subsidizing of Loans

From the findings of the study, 55.2 percent disagreed, 10.3 percent strongly disagreed and 34.5 percent of the respondents were uncertain. As illustrated in figure 5.5, then it follows that competition has led to a reduction of the bank cross-subsidizing less profitable small loans.

Figure 4.12: Competition’s Impact Towards Reduction of Cross-Subsidizing Loans

4.4.4 Competition’s Direct Relation to Multiple Loan Taking

According to the findings of the study, a majority of the respondents represented by 43.1 percent disagreed and 25.9 percent strongly disagreed that competition is directly related
to multiple loan taking thus leading to higher levels of borrower indebtedness. 29.3 percent of the respondents were uncertain, while 1.7 percent of the respondents agreed. These findings have been illustrated in Figure 5.6 below.

![Figure 5.6](image)

**Figure 4.13: Competition’s Relationship Towards Multiple Loan Taking**

**4.4.5 Competition’s Impact on the bank’s Marketing Skills**

This study sought to find out whether competition has made the bank increase its marketing skills so as to gain new customers. Figure 5.7 below illustrates the findings which show that 62.1 percent agreed while 37.9 percent strongly agreed that competition indeed does increase marketing skills so as for the bank to gain new and more customers.

![Figure 5.7](image)

**Figure 4.14: Competition’s Impact on the Bank’s Marketing Skills**

48
4.4.6 Impact of Competition between the Bank and its Clients

This study sought to find out whether competition has weakened some long-term relationship between the bank and its clients by focusing on the most profitable ones. The findings as illustrated in Figure 5.8 were that 82.8 percent agreed, 13.8 percent strongly agreed while 3.4 percent were uncertain. This therefore means that a lot of focus within the institution shifts towards the most profitable clients as they seem to boost the performance of the deposit taking institution. This in turn means that some clients over the long run tend to get neglected.

![Bar chart showing the impact of competition between the bank and its clients.](image)

**Figure 4.15: Impact of Competition between the Bank and its Clients**

4.4.7 Impact of Competition on Bank’s Portfolio

Figure 5.9 presents a summary of the findings with regards to how competition lowers the bank’s portfolio and in turn lowering profitability. 44.8 percent of the respondents agreed while 15.5 percent strongly agreed and 39.7 percent of the respondents were uncertain. These findings therefore show that indeed competition has an impact towards profitability by lowering the bank’s portfolio.
4.4.8 Impact of Competition on the Bank’s profitability

Figure 6.0 presents a summary of the findings with regards to how competition may impact the bank’s profitability negatively. 22.4 percent of the respondents disagreed while 77.6 percent were uncertain. These findings therefore show that it is not definite whether competition may negatively influence the bank’s profitability or not.

4.5 Impact of Government Regulations on the Profitability of Deposit Taking Microfinance Institutions.

The third objective of the study sought to establish impact of Government Regulations on Profitability of Deposit Taking Microfinance Institutions. Respondents were asked
several questions that they were rating with (1) Strongly Disagree (2) Disagrees, (3) Neutral, (4) Agree, and Strongly Agree (5). This sub-section presents a detailed analysis of the findings with regards to the various elements that affect government regulations.

4.5.1 Stringent Reporting Requirements Impact on Financial Performance

Figure 6.1 presents a summary of the findings with regards to how stringent reporting requirements may have an impact on the bank’s financial performance. 56.9 percent of the respondents strongly agreed, 37.9 percent agreed while 5.2 percent of the respondents were uncertain. This therefore means that it is true that stringent reporting requirements have an impact on the bank’s financial performance.

![Bar Chart](image)

**Figure 4.18: Stringent Reporting Requirements Impact on Financial Performance**

4.5.2 Licensing Costs and Procedures Impact on Financial Performance

Figure 6.2 below presents the findings of whether licensing costs and procedures have an impact on financial performance. 70.7 percent of the respondents strongly disagreed, 22.4 percent disagreed while 6.9 percent were uncertain. These findings therefore indicate that the costs of licensing and procedures set for deposit taking microfinance institutions do not have an impact on their financial performance.
4.5.3 Government Regulations’ Impact on the Bank’s Resources

Figure 6.3 below illustrates the findings of whether government regulations are likely to redirect the bank’s resources to compliance rather than the creation of productive output. The findings were that 65.5 percent agreed, 25.9 percent strongly agreed and 8.6 percent were uncertain. This therefore means that indeed deposit taking microfinance institutions’ resources tend to be redirected towards compliance rather than towards the creation of productive output.

Figure 4.20: Government Regulations’ Impact on the Bank’s Resources
4.5.4 Government Regulations’ Impact on Customer Focus

The figure below illustrates the findings of whether government regulations have helped put in place sharp customer focus within the bank and 65.5 percent of the respondents strongly agreed, 31 percent agreed and 3.4 percent were uncertain. This therefore means government regulations have indeed facilitated the move of this institution to become more focused on the customer so as to deliver.

Figure 4.21: Government Regulations’ Impact on Customer Focus

4.5.5 Government Regulations’ Impact on Bank’s Cost of Lending

Figure 6.5 presents the results of the findings of whether government regulations have raised the bank’s costs of lending. 77.6 percent of the respondents agreed, 12.1 percent were uncertain and 10.3 percent strongly agreed. This therefore means that government regulations have indeed raised the costs of lending in the bank and this in turn would reflect back on the bank’s poor financial performance.
4.5.6 Government Regulations’ Impact on Customer Outreach

Figure 6.6 presents the findings in regards to government regulations impact towards the deposit taking institution’s customer outreach. 56.9 percent of the respondents disagreed, 36.2 strongly disagreed, 3.4 percent agreed and 3.4 percent were uncertain. This therefore means that government regulations do not have an inhibiting factor towards the bank’s customer outreach.

4.5.6 Capital Adequacy Regulations

Figure 6.7 presents the findings in regards to whether capital adequacy regulations have put pressure on the bank in order to perform so as to fulfill these requirements. 62.1
percent agreed, 10.3 strongly agreed, 19.0 percent were uncertain, 8.6 percent of the respondents disagreed. This therefore means that it is true that capital adequacy regulations have put pressure on the bank in order to perform so as to fulfill this requirement.

![Bar chart showing percentages of responses to capital adequacy regulations](chart.png)

**Figure 4.24: Capital Adequacy Regulations**

### 4.5.7 High Capital Requirements Impact towards Low Profits Recorded in the Bank

Figure 6.8 presents a summary of the findings in regards to high capital requirements that have led to low profits recorded in the bank. 65.5 percent of the respondents disagreed, 17.2 percent strongly disagreed, 10.3 percent were uncertain, 5.2 percent agreed and 1.7 percent strongly agreed.

![Bar chart showing percentages of responses to high capital requirements impact](chart2.png)

**Figure 4.25: High Capital Requirements Impact towards Low Profits Recorded in the Bank**
4.5.8 Government Regulations Impact on Financial Performance

The study sought to establish whether government regulations have a positive impact on the bank’s financial performance and this has been presented below in Figure 6.9. 69 percent agreed, 24.1 percent strongly agreed, 3.4 percent disagreed and 3.4 percent of the respondents were uncertain. It is therefore a true fact that government regulations have a positive impact on the bank’s financial performance.

![Bar Chart: Government Regulations Impact on Financial Performance]

**Figure 4.26: Government Regulations Impact on Financial Performance**

4.6 Multi Correlation Analysis

A Pearson correlation was done to establish the relationship between profitability of deposit taking microfinance institutions and lending, competition, government Regulations. The findings revealed that there was a positive relationship between profitability and lending rates ($r=0.522$, $p<0.01$), competition ($r=0.651$, $p<0.01$), government regulation ($r=0.635$, $p<0.01$). Therefore, it was concluded lending, competition and Government Regulations positively and significantly influenced profitability in Table 4.6.
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<th>Perforation</th>
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<tr>
<td><strong>Performance</strong></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Lending (L)</td>
<td>Pearson Correlation</td>
<td>.522**</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>Competition (c)</td>
<td>Pearson Correlation</td>
<td>.651**</td>
<td></td>
<td>1</td>
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<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
<td>0.228</td>
<td>1</td>
</tr>
<tr>
<td>Government Regulations (GR)</td>
<td>Pearson Correlation</td>
<td>.635**</td>
<td>0.02</td>
<td>.597**</td>
</tr>
<tr>
<td></td>
<td>Sig. (2-tailed)</td>
<td></td>
<td>0.88</td>
<td>0</td>
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<tr>
<td>N</td>
<td>58</td>
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</table>

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

4.7 Chapter Summary

This chapter presents the results established from the data analysis done and presents data on employee demography and specific research objectives aimed at establishing the impact of lending rates on the profitability of deposit taking microfinance institutions, impact of competition on the profitability of deposit taking microfinance institutions and the impact of government regulations on the profitability of deposit taking microfinance institutions in Nairobi. The next chapter provides a detailed discussion of the results and findings. Conclusions and recommendations for improvement on each specific objective are provided followed by recommendations for further studies.
CHAPTER FIVE

5.0 DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter consists of four sections, namely summary, discussion, conclusions, and recommendations respectively. The first section provides a summary of the important elements of the study which includes the study objectives, methodology and the findings. The section that then follows offers a discussion of the major findings of the study with regards to the specific objectives. The third Section offers a discussion as well as the conclusions based on the specific objectives, while making use of the findings and results which were obtained in the previous chapter. The last sub-section provides the recommendations for improvement which are indeed based on the specific objectives. It also goes ahead to offer the recommendations for further studies.

5.2 Summary

The purpose of this study was to find out the factors affecting profitability of Deposit Taking Microfinance Institutions in Nairobi. The study was guided by three research questions namely; What is the impact of lending rates on the profitability of Deposit Taking Microfinance Institutions in Nairobi? What is the impact of competition on the profitability of Deposit Taking Microfinance Institutions in Nairobi? What is the impact of government regulations on the profitability of Deposit Taking Microfinance Institutions in Nairobi?

To answer these research questions, the researcher adopted a descriptive research design whereby the study population comprised of employees of the Faulu Deposit Taking Microfinance Bank headquarters based in Nairobi. The study employed stratified random sampling for the selection of respondents. The departments present constituted the strata and therefore the study population was stratified into; banking operations department, human resources department, business development department, department of risk management and internal audit department. After stratification, simple random sampling was used to select a sample size of 75 respondents. Each stratum had the following proportion: banking operations department (35), business development department (17),
department of risk management (10), human resources department (3) and internal audit department (10). Questionnaires were used as the data collection instruments while the collected data was analyzed by the use of SPSS Version 24 software. The analyzed data was then presented and summarized in form of charts, frequency tables as well as graphs.

The findings on the impact of lending rate towards the profitability of deposit taking microfinance institutions revealed that clients of the deposit taking microfinance institutions are very likely to become sensitive towards increases that may be set on loans. This would mean that they would shy away from the uptake of more loans once they clear what they may be having at the time. Furthermore, their uptake of loans was revealed that the clients are not likely to be affected by the loan period given to them in order for them to meet their payment obligation. It was also revealed that interest rate spreads are likely to affect the financial performance of the institution and that the cost of capital that the institution holds is likely to influence the lending rate that it chooses to set for the loans issued to their clients. Furthermore, financial performance of a deposit taking institution is likely to be contributed to by non-performing loans. One of the major findings was that there is no definite relationship between lending rates and the profitability recorded.

The findings on the impact of competition revealed that competition indeed had a great impact towards improvement of innovation so as to pull in more customers, thus greater customer outreach. Increased competition from other deposit taking microfinance institutions had also made Faulu bank increase or improve on its marketing skills so as to gain new customers to enable it sustain itself financially. But in the same line, the study also revealed that competition over time weakens some long-term relationship between the bank and some of its clients. The reason behind this was that the bank would tend to focus more on the profitable customers and neglect those handling and borrowing small loans. It also came to be known that competition does not lead to a reduction of the bank cross-subsidizing less profitable small loans and also, competition is not related to clients undertaking multiple loan taking with other deposit taking microfinance institutions therefore it does not lead to higher levels of borrower indebtedness. Furthermore, it was revealed that competition does not have a negative impact on the deposit taking institution’s profitability. Some degree of uncertainty was only revealed on the concept of competition lowering the bank’s portfolio thus lowering profitability.
The findings on the impact of government regulations on the profitability of deposit taking microfinance institutions revealed that stringent reporting requirements set as guidelines for the operations of deposit taking microfinance institutions have a great impact on the financial performance of the bank. This was attributed to the aspect that the institution tended to redirect their resources towards compliance of the requirements and regulations rather than towards the creation of productive output. But besides these, it was also revealed that government regulations had helped put in place sharp customer focus within these deposit taking institutions for them to provide better services to their customers. Additionally, the study established that high capital adequacy requirements had led to low profits that were recorded in the bank but this did not run down to the fact that the set licensing costs and procedures. Instead, licensing costs and procedures were stated to have very minimal to zero impact on their financial performance. Regulations set by the government were stated to have facilitated customer outreach since the institution put in place better activities and services to gain more customers and therefore, it was established that government regulations do not necessarily have a positive impact on the financial performance aspect of the deposit taking institution since some regulations such as the capital adequacy regulations as required by the Microfinance Act of 2006 had put pressure on the bank to perform so as to fulfill that requirement.

5.3 Discussion

In this sub-section, a discussion of the findings is provided in terms of linking the findings and what already exists as reviewed in chapter two. The first discussion focuses on the impact of lending rates, followed by the impact of competition and finally the impact of government regulations to profitability of deposit taking microfinance institutions in Nairobi.

5.3.1 Lending Rates and their Impact on Profitability of Deposit Taking Microfinance Institutions

The findings on the impact of lending rates towards the profitability of deposit taking microfinance institutions revealed that lending rates had a very low impact towards dictating profitability of deposit taking microfinance institutions. This is indeed a true revelation when put in comparison to a study done by Kamau (2008) whereby his
findings were that profits were mainly dependent on the interest income, interest expense, shareholder funds, loans and advances to customers. Lending rates implemented by the deposit taking institution were based on aspects such as the element of borrower sensitivity towards any increases in the lending rates set on their loans.

A study done by Rosenberg and Mazer (2010) on microfinance client sensitivity to interest rates which showed that existing clients were influenced by the change in interest rates whereby they were more sensitive to rate differentials because they had a baseline from the rate on their prior loans. The findings of this study revealed that deposit taking microfinance institutions customers or borrowers were very sensitive to changes in lending rates which reflects in the uptake of loans by both the existing and new clients in the institution. Therefore, how to retain the client base so as to maintain profitability of a deposit taking institution is dependent on the elements of lending rates that would probably affect loan uptake of the existing and new clients.

An aspect of client distress was discovered not to exist among the institution’s clients over the loan period allocated to them for them to meet their payment obligations. The main reasoning behind this was that the customers reach out to the institution to request for financial aid towards their businesses or projects. The institution's procedures have laid out its processes of how long it should take for a client to repay back the credit allocated. It was therefore brought out that whatever the period had been allocated to the deposit taking microfinance institution’s clients, it had no impact at all towards their distress.

The study also revealed that interest rate spreads are not so likely to affect the performance of the bank as well as cost of capital being unlikely to influence the lending rate that the bank is to set for issuance to their clients. Nkuah (2015) carried out a study on the effects of loan portfolio quality on the performance of banks in Ghana where he used return on equity and net interest margin were used to proxy financial performance. Findings established that loan portfolio quality had significant effect on the financial performance of the banks. In Grenade’s study (2007), his findings were that the interest rate spreads persistently showed little signs of narrowing and this was mostly attributed to high operating costs and non-performing loans as well as the regulation of savings deposit rate by the Central bank.
It was also established that in a great way lending rates have induced competition. Each deposit taking microfinance institution sets its own lending rate and each sets a target to pull in more customers. Therefore, it was established that competition was present as a result of lending rate as each institution wants to out-do the other since a greater customer base was discovered to have a great contribution towards the financial performance of a deposit taking microfinance institution.

Therefore, much of the findings out of the study established that there is minimal impact of lending rates set towards profitability of that the bank recorded as well as that the rate set induced competition from other financial institution.

5.3.2 Competition and Profitability of Deposit Taking Microfinance Institutions

The findings on the impact of competition towards profitability of deposit taking microfinance institutions in Nairobi revealed that majority agreed that competition had increased innovation in the bank and this in turn reflected towards greater customer outreach. Innovation in this aspect was derived on the elements of how the deposit taking microfinance institution had changed its ways of delivering better services and products to its clients and how best they can be easily accessed or provision of services. Since the discovery of the microfinance, the concept has developed and evolved in the recent years and it is still growing and changing to meet the demands of the current demands of the market. Technology has improved and it has seen the evolution of services such as mobile banking which would see microfinance clients repay their loans via means such as the Unstructured Supplementary Service Data codes commonly known as the USSD. Therefore, the study established that the rise in competition in the field of microfinance has made the institution set up better means of delivering services and improved access to make their customers access their services in the simplest and most convenient way possible. It was established that research was still being done on better and simpler ways to make the institution reach out to more of its customers and even bring in more.

It was established that the bank had improved on its marketing skills so as to gain new customers in order for it to sustain itself financially. This therefore meant that much effort was being put in the business development department to find means through which the institution could pull in more customers and still retain their current ones. A good
customer base is a great step towards financial sustainability and that was what was discovered from the aspect of improved marketing skills in order to beat the competition.

With reference to McIntosh and Wydick (2005), competition promoted allocative and productive efficiency by the provision of incentives for the development of new products. They therefore found out that competition was beneficial since it resulted to new and improved financial product designs and better customer services. Gonzalez (2003) revealed that the outcome of competition lead to innovation thus expanding outreach. Customers, not only in the microfinance field, all want the best services given to them. It was therefore discovered that the institution had over time discovered new products and services that target very different customers all characterized by different financial abilities. Therefore, products and services had been customized to best fit the different segments of the customers so as to incorporate many and still have room for more to be served and these have helped in the expansion of the institution’s client base.

Finally, it was also established that majority agreed that competition had negative impact on the long-term relationships between the bank and their clients. This is from the aspect that the bank focuses more on the most profitable customers and therefore some negligence is established to those clients who do not appear to have a great contribution towards the profitability of the institution so as to be able to match up to their competitors.

The study finally established from the findings that competition neither has a positive nor negative impact towards the profitability of the deposit taking institutions. This is majorly attributed to the fact that from one aspect, competition has boosted customer outreach and improved marketing skills so this therefore gives the institution a strong customer base. Competition at the same time also showed that it can still weaken some long-term relationships with the clients since it may only focus on the profitable customers.

5.3.3 Government Regulations’ Impact on Profitability of Deposit Taking Microfinance Institutions

This objective of the study sought to find out how government regulations impacted on profitability. Aspects such as reporting requirements and capital adequacy regulations showed that they do affect the bank’s financial performance. The Microfinance Act of
2006 prescribes that an institution shall ‘maintain the prescribed minimum capital requirements’ and that ‘the Central Bank shall determine whether an institution is in compliance with the capital adequacy requirements.’ This regulation as it is put strain in the bank to perform in order for it to fulfill this requirement as well as the requirements of provisions of balance sheets and financial statements that should be disclosed to the Central Bank within three months after the end of each financial year. These requirements were discovered to create constraints in the bank’s activities as much of the time and resources end up being allocated to fulfill these requirements.

It was also discovered that resources in the bank were redirected to help satisfy the requirements laid out in the Microfinance Act that guide the operations of the bank. So instead of the bank focusing on creation of more productive output, it focused on fulfilling the requirements. Crafts (2006) established in his study that the regulations imposed constraints on the choice of production techniques by the prevention of used of inputs.

On the flip side, licensing costs and procedures were discovered that they have very low impact towards the profitability of deposit taking microfinance institutions. These costs and procedures have instead helped towards the operations of the institution as they are a guideline to what they should be doing and they also facilitate fair and safe competition as well.

In another aspect, government regulations helped put in place sharper customer focus by the improvement of services offered and in comparison to a study done by Vianney (2013), he pulled out from his findings that regulations were a key pillar for the sustainability of financial institutions in terms of their operations. This was further supported by Smith (2011) whereby profit margins between regulated and unregulated banks were very large meaning that clients favored regulated financial institutions more than those unregulated. The government regulations such as the Capital Adequacy requirements forces institutions to have some minimal requirement of capital for their operations, and in order for this to be in place, institutions have to create ways and means that would facilitate great customer focus so as to gain more customers which would then contribute towards the institution’s financial sustainability thus resulting to better financial performance or otherwise, greater profitability.
5.4 Conclusion

5.4.1 Lending Rates and its Impact on Profitability of Deposit Taking Microfinance Institutions

The study concludes that various aspects of the specific objectives have a major contributing factor towards determination of profitability of deposit taking microfinance institutions. Lending rates were found to have to some extent, minimal impact towards profitability on the aspects of borrower sensitivity, interest rate spreads, returns on equity as well as inducement of competition from other financial institutions and impact of the rates towards feasible investment opportunities.

5.4.2 Competition and its Impact on Profitability of Deposit Taking Microfinance Institutions

The study also concludes that competition does have an impact towards profitability of deposit taking microfinance institution based on innovation which has helped in customer outreach and service delivery. Furthermore, the study also concludes that competition is not directly related to multiple loan taking by the borrowers and this therefore means that there is no recording of high levels of borrower indebtedness. The study also concludes that competition may tend to weaken some long-term relationships between the bank and its customers due to the fact that the deposit taking institution may choose to focus on the profitable customers only and then neglect other clients.

5.4.3 Government Regulations and its Impact on Profitability of Deposit Taking Microfinance Institutions

The study further concludes that stringent reporting requirements laid out in the government regulations have an impact towards profitability by leading to redirection of resources, pressures to fulfill capital adequacy requirements and licensing costs and procedures. The benefits noted out of the government regulations were that it had helped put in place sharper customer focus thus promoting customer outreach as well.
5.5 Recommendations

5.5.1 Recommendations for Improvement

5.5.1.1 Lending Rates and its Impact on Profitability of Deposit Taking Microfinance Institutions

The study does acknowledge that lending rates currently are sensitive to borrowers in all financial institutions especially after the introduction of the interest rate cap. The study therefore recommends that management of deposit taking microfinance institutions should consider cost of loans which include taxation costs of provision, transaction costs, return on equity and management fees which would then determine the lending rate in the institutions. This is on the basis that lending has been the core of the business operation of deposit taking microfinance institutions and they should therefore put in mind the above stated considerations in order to maintain long-term relationships with both profitable and non-profitable customers since they all play a part in the financial sustainability of the institution.

5.5.1.2 Competition and its Impact on Profitability of Deposit Taking Microfinance Institutions

With reference to the findings and conclusions made in this study, the researcher makes policy recommendations which can be adopted for improvement of the deposit taking microfinance institutions sector. This comes from the basis that competition’s influence towards profitability of deposit taking microfinance institutions is there and this may be attributed to the fact that financial services in the industry are undergoing rapid changes brought about by technological advances and emulation of other international practices. Therefore, to ensure competitiveness, policies should be implemented or improved to foster better innovation in the products being offered to the customers and greater outreach.

5.5.1.3 Government Regulations and its Impact on Profitability of Deposit Taking Microfinance Institutions

The study recommends that before implementation of regulations in the microfinance sector, touching on deposit taking institutions, comprehensive and extensive analyses
should be conducted so as to bring about effective policy reforms that would then lead to better performance of financial institutions.

Also, the study recommends that implementation of regulatory policies such as capital adequacy requirements in Kenya should be preceded by consideration of whether the deposit taking institutions have capacity to meet the stated requirements since some institutions operate on a small-scale basis and therefore high requirements limit their operations. Therefore, the study recommends the Central Bank of Kenya to take a long-term view when structuring or restructuring regulatory framework.

5.5.2 Recommendations for Further Studies

Finally, since past studies by various scholars that were aimed at looking at other factors that affect profitability of deposit taking microfinance institutions have not been fully covered, further studies on other measures that contribute towards profitability of deposit taking microfinance institutions such as size and composition of credit portfolio, size of deposit liabilities, risk level, institution size and the management quality of the institution remain relevant.
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71


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APPENDICES

Appendix I: List of Deposit Taking Microfinance Institutions Licensed by Central Deposit Taking Micro Financial Institutions of Kenya

1. Faulu Kenya DTM Limited
   Postal Address: P.O. Box 60240 – 00200, Nairobi
   Telephone: +254-20-3877290, 38721883/4
   Fax: +254-20-3867504, 3874875
   Email: info@faulukenya.com, customercare@faulukenya.com
   Website: www.faulukenya.com
   Physical Address: Faulu Kenya House, Ngong Lane – Off Ngong Road
   **Date Licensed:** 21st May 2009
   Branches: 27

2. Kenya Women Finance Trust DTM Limited
   Postal Address: P.O. Box 4179-00506, Nairobi
   Telephone: +254-20-2470272-5, 2715334/5
   Email: info@kwftdtm.com
   Website: www.kwftdtm.com
   Physical Address: Akira House, Kiambere Road, Upper Hill,
   **Date Licensed:** 31st March 2010
   Branches: 24

3. SMEP Deposit Taking Microfinance Limited
   Postal Address: P.O. Box 64063-00620, Nairobi
   Telephone: 020-3572799/ 26733127
   Email: info@smepe.co.ke
   Website: www.smepe.co.ke
   Physical Address: SMEP Building – Kirichwa Road, Off Argwings Kodhek Road
   **Date Licensed:** 14th December 2010
   Branches: 6
4. **REMU DTM Limited**
   Postal Address: P.O. Box 20833-00100, Nairobi
   Telephone: 2214483/2215384
   Email: info@remultd.co.ke
   Physical Address: Finance House, 14th Floor, Loita Street
   **Date Licensed:** 31st December, 2010
   Branches: 3

5. **Rafiki Deposit Taking Microfinance**
   Postal Address: P.O. Box 12755-00400, Nairobi
   Telephone: 020-2166401
   Email: info@rafiki.co.ke
   Website: [www.rafiki.co.ke](http://www.rafiki.co.ke)
   Physical Address: 2nd Floor, El-roi Plaza, Tom Mboya Street
   **Date Licensed:** 14th June, 2011
   Branches: 3

6. **UWEZO Deposit Taking Microfinance Limited**
   Postal Address: P.O. Box 1654-00100, Nairobi
   Telephone: +254-2212917
   Email: info@uwezodtm.com
   Website: [www.uwezodtm.com](http://www.uwezodtm.com)
   Physical Address: Park Plaza Building, Ground Floor, Moktar Daddah Street
   **Date Licensed:** 8th November, 2010
   Branches: 2

7. **Century Deposit Taking Microfinance Limited**
   Postal Address: P.O. Box 38319 – 00623, Nairobi
   Telephone: +254-20-2664282
   Email: info@century.co.ke
   Physical Address: KK Plaza, 1st Floor, New Pumwani Road, Gikomba
   **Date Licensed:** 17th September, 2012
   Branches: 1

8. **SUMAC DTM Limited**
   Postal Address: P.O. Box 11687-00100, Nairobi
   Telephone: +254-20 2212587
Email: info@sumacdtm.co.ke
Website: www.sumacdtm.co.ke
Physical Address: Consolidated Deposit Taking Micro Financial Institutions House, 2nd Floor, Koinange Street
**Date Licensed:** 29th October, 2012
Branches: 1

9. **U&I Deposit Taking Microfinance Limited**
Postal Address: P.O. Box 15825 – 00100, Nairobi
Telephone: +254- 20-2367288
Email: info@uni-microfinance.co.ke
Website: www.uni-microfinance.co.ke
Physical Address: Asili Complex Building, 1st Floor, River Road
**Date Licensed:** 8th April, 2013
Branches: 2
Appendix II: Questionnaire

Section 1: Personal Information

1. Name (optional)

2. Position held in the organization

3. Level of education of the respondent
   - Diploma □
   - Degree □
   - Masters □
   - Doctorate □
   - Other (please specify) ………………………………………………………………………

4. How many years have you been working in the financial sector?
   a. Less than 2 years □
   b. 3 – 5 years □
   c. 6 – 8 years □
   d. 9 years and above □

5. How long have you been working in the organization?
   a. Less than 2 years □
   b. 3 – 5 years □
   c. 6 – 8 years □
   d. 9 years and above □
Section II: What is the impact of lending rates on the profitability of DTMFIs

Please respond to the following questions and where applicable, tick (√) the appropriate answer from the alternatives provided for each of the questions.

1. What range of lending rate has the microfinance been adopting as a Deposit Taking MFI
   a. 7 – 9%  
   b. 10 – 12%  
   c. 13 – 15%  
   d. 16 – 18%  
   e. 19% and above

2. Using a scale of 1 – 5, please respond to the following questions and where applicable, tick (√) the appropriate answer from the alternatives provided for each of the questions whereby; 1. Strongly Disagree 2. Disagree 3. Uncertain 4. Agree 5. Strongly Agree

   **Strongly Agree**

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<tr>
<td>i.</td>
<td>Borrowers are likely to become sensitive to increases in the lending rates set on loans</td>
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<td>ii.</td>
<td>Most loan clients are likely to be affected by the loan period given to them in order for them to meet their payment obligation.</td>
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<td>iii.</td>
<td>Interest rate spreads are likely to affect the performance of the bank</td>
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<td>iv.</td>
<td>Non-performing loans are likely to have an impact on the performance of the bank.</td>
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<td>v.</td>
<td>Cost of capital (return on equity) is likely to influence the lending rate set by the bank for the loans issued to your clients</td>
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80
vi. There is a positive relationship between the bank’s lending rates and the profitability recorded in the bank

3. What type of loan interest rate do you practice in your Deposit Taking Microfinance?
   a. Floating interest rates
   b. Fixed interest rates
   c. Any other

Kindly state which one

4. To what extent does interest rate spread affect financial performance of your Deposit Taking Microfinance Institution? Tick (√) the appropriate answer from the alternatives provided for each of the questions whereby; 1. Very Low 2. Low 3. Moderate 4. Great 5. Very Great

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<tr>
<td>i. Lending rate dictates the profitability of the DTMFI</td>
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<td>ii. Lending rate induces competition from other financial institutions</td>
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<tr>
<td>ii. Lending rate affects feasible investment opportunities with future growth potential</td>
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**Section III: What is the impact of competition on the profitability of DTMFIs**

1. To what extent do the following competition factors impact on your bank’s profitability as a Deposit Taking Microfinance Institution. Tick (√) where appropriate from the alternatives provided for each of the questions whereby; **1. Strongly Disagree 2. Disagree 3. Uncertain 4. Agree 5. Strongly Agree**

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<tr>
<td>i.</td>
<td>Competition has increased innovation within the bank to expand its means of delivering better services to your customers</td>
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<td>ii.</td>
<td>Through increased innovation, there is an increase in customer outreach in the bank</td>
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<td>iii.</td>
<td>Competition has led to a reduction of the bank cross-subsidizing less profitable small loans</td>
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<td>iv.</td>
<td>Competition is directly related to multiple loan taking and thus higher levels of borrower indebtedness</td>
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<td>v.</td>
<td>Competition has made the bank increase its marketing so as to gain new customers in order for it to be able to sustain itself financially.</td>
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<td>vi.</td>
<td>Competition has weakened some long-term relationship between the bank and its clients by focusing on the most profitable customers.</td>
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<td>vii.</td>
<td>Competition lowers the bank’s portfolio thereby lowering profitability</td>
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<td>viii.</td>
<td>Competition has a negative impact on the bank’s profitability</td>
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</table>
Section IV: What is the impact of government regulations on the profitability of DTMFIs

1. To what extent do the following regulatory factors impact your profitability as a Deposit Taking Microfinance Institution. Tick (✓) the appropriate answer from the alternatives provided for each of the questions whereby; 1. Strongly Disagree 2. Disagree 3. Uncertain 4. Agree 5. Strongly Agree

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<tbody>
<tr>
<td>i. Stringent reporting requirements have an impact on the financial performance of the bank</td>
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<td>ii. Licensing costs and procedures have an impact on the bank’s financial performance</td>
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<td>iii. Set government regulations are likely to redirect the bank’s resources to compliance rather than creation of productive output</td>
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<td>iv. Government regulations have helped put in place a sharp customer focus within the bank’s activities and services offered.</td>
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<td>v. Government regulations have raised the bank’s costs of lending.</td>
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<td>vi. Government regulations have inhibited your customer outreach</td>
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<td>vii. The capital adequacy regulations required by the Microfinance Act of 2006 puts pressure on the bank to perform in order to fulfill this requirement</td>
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<td>viii. High capital requirements have led to low profits recorded in the bank</td>
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</table>
ix. Government regulations have a positive impact towards the bank’s financial performance.

Please state any other factor(s) (not included above) in which government regulations have an impact on Deposit Taking Microfinance Institutions

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