EFFECTS OF FINANCIAL INTERMEDIATION OF MICROFINANCE INSTITUTIONS ON FINANCIAL SECTOR DEVELOPMENT

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ABSTRACT

The objective of this study was to analyze the effects of Microfinance Intermediation on the financial sector development and growth. It will determine and analyze the gaps in financial intermediation; establish the effectiveness of Microfinance Institutions (MFIs) in financial intermediation and how this has helped develop the financial sector. Financial institutions require prospective investors to produce collaterals before they are granted Loan facilities; this has been a major hindrance to low income earners who form the majority of the population in the rural areas. The target population includes people participating in microfinance which in many cases has been found to be women groups, middle and low income earners. A case study of Kenya women finance trust (KWFT) at Mombasa has been undertaken and primary data collected by means of structured questionnaires developed to address the objectives of the study. A Sample of 150 respondents including an interview schedule with the management of KWFT has been undertaken with Quantitative and Qualitative methods used to analyze the data and presented them using inferential statistics methods. Findings of the study revealed a wide access to the financial sector, improved resource allocations, low transactional costs and development of the rural financial markets. The following conclusions were drawn from the study: MFIs have a positive effect on the development and growth of the financial sector; access to loans that has been a major challenge in the SMEs sector has been increased and the saving culture among the low income earners enhanced. Based on the findings, it is recommended that; beyond the Loans provided, it is prudent for KWFT to operate Savings accounts open to all kinds of customers to enhance Capital accumulation.

Key Words: *financial intermediation, microfinance institutions, financial sector development*

Introduction

Financial intermediation plays an important role in channeling funds between savers and borrowers; by facilitating transactions and making credit and other products available, the financial sector is a crucial building block for private sector development.

A financial sector has an important role to play in achieving:- Strong incentives for investment; Provide broad access to assets and markets; and finally reduce risk and vulnerability. A wider access to financial services generates employment, increases income and reduces poverty since it allows the less disadvantaged establish a buffer against consumption shocks, thus reducing vulnerability.

In order to explore the implications for extending financial intermediation, this paper has taken a case study approach on an organization that is reaching beyond the core market of the main urban-oriented MFIs in Kenya, i.e. Kenya Women Finance Trust (KWFT) a deposit taking microfinance. The review seeks to establish the following: the model of service delivery including the characteristics of services provided, Socio-economic status of clients using the services and financial sustainability of outreach in rural areas. With their innovative program packaging, MFIs have enlarged the financial markets by increasing savings of the households and induced financial dependence among the rural families, Sajjad et al. (1999). Provision of sustainable microfinance activities to the poor has been the main goal for many MFIs, this has in turn facilitated income generation and reduced poverty, Baumann, (2001). Humphrey (2006), argued that most MFIs are institutions that combines a social and financial development objectives which drives the institutions in achieving self-sufficiency and thereby accomplishing sustained service delivery without dependence on subsidies.

Statement of the problem

The poor are exposed to risk due to income fluctuations and are unable to access credit and insurance markets to offset this exposure. As a result of the perceived high risks, high costs involved in small amounts lending and the inability to provide collaterals, most formal financial institutions avoid serving the poor. This is one of the reasons why most of the major banks in Kenya closed shop in the rural areas and remote towns in the late 1990s.

As an afterthought a supplementary credit delivery system was developed by encouraging microfinance institutions to act as facilitators and intermediaries, operating under the non-formal structure thus broadening the infrastructure for credit delivery, increasing the outreach. Their operations through individuals and self-help groups has been propagated as an alternative delivering system of credit to the poorest of the poor. Their financial intermediation to low income group access the formal financial system has been an attempt to make the poor get rid of socially neglected situations and bring them into the banking fold. In this regard their role as intermediaries is similar to that of banks in credit acquisition and disbursement. Finally the services of microfinance has contributed to the development of rural financial markets and strengthening the social and human capital of the less disadvantaged. This study is built on the knowledge of non-banking financial intermediaries motives i.e. promoting access to formal savings and credit facilities through microfinance.

Literature Review

The financial sector is all the wholesale, retail, formal and informal institutions in an economy; offering financial services to consumers, businesses and other institutions. In its broadest definition, it includes everything from banks, capital markets, insurers, credit unions, microfinance institutions and money lenders. There are many different ways in which the financial sector can be said to "develop" for example where:- The efficiency and competitiveness of the sector has improved; the diversity of institutions which operate in the financial sector has increased; the regulation and stability of the financial sector has improved and where the money that is intermediated through the financial sector has also increased.

Financial intermediaries provide maturity transformation by bridging the gap between those lenders wishing for liquidity and the desire for loans over longer periods by most borrowers. For all these reasons, financial intermediaries are vital to the continued development of modern economies. Microfinance on the other hand is the provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban and urban areas for enabling them raise their income levels and improve their living standards. However, Bouman F.J.A. (1984) argues that most researchers believe, the formal financial sector does not effectively serve the rural population in third world countries. The concept of microfinance has emerged as a viable alternative credit channel to the poor; it has become a useful tool in building the capacity of the poor in management of sustainable self-employment activities. Microfinance thus provides opportunity to the poor and weaker sections of the society for getting the required amount of credit on easy terms and conditions to start any income generating activity, Anitha H.S. & Ashok D. R (2007)

Theoretical Review

The theories of financial intermediation need to reflect and account for the fact that financial systems in many countries have changed substantially over the past. Over this period many traditional financial markets have expanded and new ones come into existence. Transaction costs have fallen, and information has become cheaper and more available. However, these changes have not coincided with a reduction in financial intermediation, in fact, the reverse has happened. Intermediaries have become more important in traditional markets and account for a very large majority of the trading in new markets. Standard theories of intermediation based on transaction costs, Asymmetric information, delegated monitoring and Risk trading/management are difficult to reconcile, with the changes that have taken place.

Informational Asymmetries Argument

Intermediation theories have built on the models of resource, based on perfect and complete markets where transaction costs and asymmetric information are important in understanding intermediation. Informational asymmetries generate market imperfections, which financial intermediaries appear to have overcome at least partially; e.g. Diamond and Dybvig (1983) have considered banks as coalitions of depositors which provides households with insurance against shocks that adversely affect their liquidity position. Berger and Udell, (2002) distinguished between financial statement lending and relationship lending on their studies on Information Asymmetry. Relationship lending is mostly used by Microfinance institutions through data gathered over the cause of their relationship with the borrower, while transaction based lending is often used by Banks.

Transaction Costs Approach

In contrast to informational asymmetries, the Transaction costs approach does not contradict the assumption of complete markets. Fama (1980) argues that financial intermediaries act as coalitions of individual lenders or borrowers who exploit economies of scale or scope in the transaction technology. This argument was supported by Fischer (1983) who argued that the notion of transaction costs also encompasses search costs, monitoring costs, and Auditing costs, i.e. the role of the financial intermediary being transforming particular financial claims into other types of claims, as such they offer liquidity and diversification opportunities. The provision of liquidity function is seen as a key function for savers and investors whereas that of diversification is increasingly being appreciated in personal and institutional financing.

Risk Trading/Management

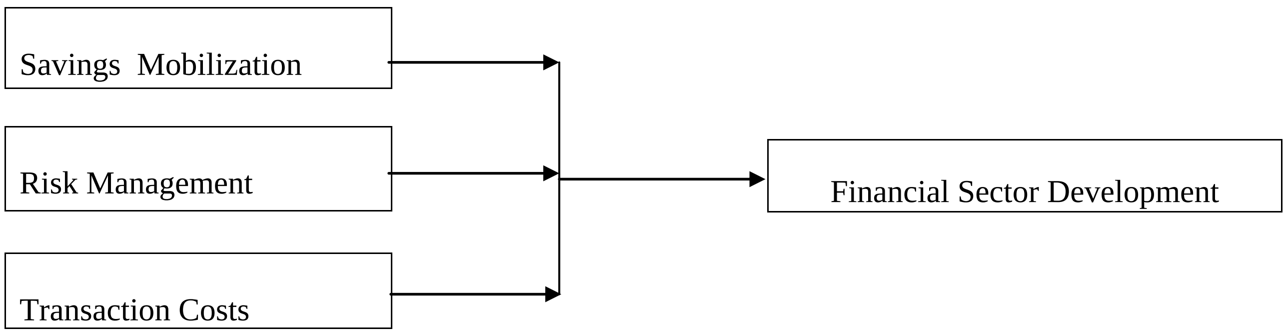
The most important change in intermediary activities that has occurred has been the growth in the importance of Risk management activities undertaken by financial intermediaries. Most current theories of intermediation have little to say about why risk management should play such an important role in the activities of intermediaries. An important exception is the work of Merton (1989; 1993), and Merton and Bodie (1995), which suggests that financial systems should be analyzed in terms of “Functions” and not on “Institutional” perspective. A functional perspective is one based on the services provided by the financial system e.g. economic resource transfer. Merton further argues that another central feature of the sector is the ability to distribute Risk across different participants. A model has been developed where the key value added of intermediaries is that they provide the function of allowing risk to be allocated efficiently at minimum cost. Merton notes that individuals have high trading costs; meaning that intermediaries can create a large number of Synthetic assets through dynamic trading strategies, such as hedging where products with very safe payoffs can be created which are particularly valuable to some of their customers. Stulz (1984) suggests a viable economic reason why firm's managers might concern themselves with both expected profit and the distribution of the firm's return around their expected value. He provided a rationale for why a firm's objective functions may be concave in the process of avoiding risk. Santomero (1995) recently presented a useful review of the explanations Stulz had suggested; he argued that managers prefer stability of the firm's earnings to volatility because, other things equal, such stability improves their own utility, at little or no expense to other stakeholders.

Empirical Review

Poor households in developing countries need access to different financial services than formal bank credits; this is because banks often exclude them as unattractive clients due to the high risk and insufficient assets for collateral, Beck et al., (2008). The provision of microfinance services in the form of small collateral-free loans, and savings facilities has thus evolved as a vital alternative for poor households to smooth consumption, start their own businesses, cushion income shocks and improve living conditions. The microfinance industry is rapidly increasing, recent trends of commercialization of MFI funds and proposals for a highbred structure by combining profit and social objectives imply that microfinance has the potential to become an alternative inflow to the capital markets. Microfinance directly contributes to financial sector development through value created of small entrepreneurship, businesses, positive spillovers, and improvements in human development indicators, reduction in equality and poverty, Ravallion (2001). A strong financial sector development facilitates poverty reduction and therefore the 'roles played by microfinance and mainstream finance in tackling poverty should be regarded as complementary and not overlapping, Honohan (2004). Beck et al., (2004) argue that even when financial sector development does not touch poor people directly; it nevertheless promotes aggregate economic growth, thus benefiting the poorest in a disproportionately better way. To ensure sustainable financial sector development and growth, improved access to finance has to reduce income inequality so that low income households have chances to escape from poverty, Ravallion (2001). Levine, (1997) outlines five functions that financial systems provides in facilitating financial sector development: Savings mobilization, Investment information, Monitoring / governance, Risk management and facilitation in goods and service exchange. Through these functions, financial sector not only promotes private sector development but also supports public sector, infrastructure and households ability to invest in human capital and consumption smoothing. The industry is growing at a significant rate and is being considered as a subsector of the financial services industry, Porteous (2006).

Conceptual Framework

Financial systems provide five functions that facilitate financial sector development and growth. They include the following:- Savings and Credit mobilization, Risk management, Information asymmetry, Delegated monitoring and Transaction costs, Levine (1997).



Independent variables *Dependent variable*

Figure 1: Conceptual Framework

Savings and Credit mobilization

According to Barbara C. et al., (2006), financial intermediaries and financial markets' role is to provide a mechanism by which funds are transferred and allocated to their most productive need. Lenders are looking for safety and liquidity, while borrowers may find it difficult to promise either. Lenders require minimization of Risk (i.e. risk of default and the risk of the asset dropping in value), minimization of Costs (lenders aim to minimize their costs of lending), and Liquidity. Lenders value the ease of converting a financial claim into cash without loss of capital value therefore they prefer holding assets that are more easily convertible into cash. One reason for this is the lack of knowledge of future events, which results in lenders preferring short term lending to long term lending. Borrowers on the other hand require funds at a specified date, for a specific period of time; preferably long term and at the lowest possible cost, Wright (1999). Savings mobilization is one of the objectives of MFIs in promoting a savings culture amongst their members. Most of MFIs have undertaken marketing strategies that encourages non-member to join their institutions in a bid to mobilize savings. Savings have a close relationship with wealth, a higher rate of savings leads to faster accumulation of wealth, Bernake (2001).

Theories on Savings and Credit mobilization relates to maturity transformation. In practice with a continuous flow of deposits and withdrawals from customers and repayment of loans with interest from borrowers, the MFI (or any other financial intermediary) is able to operate with only a proportion of its assets in liquid form. Size transformation on the other hand is based on the premise that, generally, savers/depositors are willing to lend small amounts of money than the amounts required by borrowers. BFIs and NBFIs collect funds from savers in the form of small size deposits and repackage them into larger size loans. For liquidity transformation, financial intermediaries provide financial or secondary claims to surplus units (depositors) that often have superior liquidity features compared to direct claims Barbara C. et al., (2006).

Risk Management

Individual borrowers carry a risk of default (known as credit risk) i.e. the risk that they might not be able to repay the amount of money they borrowed. Savers on the other hand, wish to minimize risk and prefer their money to be safe. MFIs are able to minimize the risk of individual loans by diversifying their investments, pooling risks, screening & monitoring borrowers and holding capital & reserves as a buffer for unexpected losses. Managing risk is becoming increasingly important in the light of the new Basel Accord (Basle 11) that introduced a link between minimum regulatory capital and risk. It is not only regulators that have placed an increased emphasis on risk management in an attempt to transfer financial stability and economic development (such as the central bank of Kenya); it is also all the more important for the intermediaries to manage their capital more efficiently in order to maximize risk adjusted returns from their business activities.

Other risk management tools include a comprehensive credit management program that addresses credit risk environment, sound credit-granting processes, credit administration, measurement and monitoring process coupled with adequate controls over credit risk. Other theories advanced by, Barbara C. et al., (2006) in regard to risk transformation relates to delegated monitoring and commitment mechanism. Delegated monitoring is one of the main theories put forward as an explanation for the existence of financial intermediaries. It relates to the role of financial intermediaries as 'monitors' of borrowers. Since monitoring credit risk is costly, it is efficient for surplus units (depositors) to delegate the task of monitoring to specialized agents such as MFIs who have the expertise and economies of scale in processing information on the risks of borrowers.

Information asymmetry and Transaction costs

Different types of financial intermediation providers deal differently with the transactions costs and risks involved in intermediation and therefore can be expected to have different degrees of potential in serving rural areas. There are four major types of costs involved in providing credit, Johnson (2001). These are: Cost of funds (i.e. Interest and transaction costs of mobilizing deposits); Screening and monitoring (i.e. Transactions costs of making loans and installments recovery). Default costs (i.e. Costs of enforcing repayment where necessary); and Profit (i.e. return to equity of investors in the institution which should be taken into account when setting interest rates). Individual savers and borrowers are unable to collect and process information on different enterprises and market conditions to enable them choose where to invest. This means high information costs will always prevent capital from flowing to its highest value use. This problem has at least been overcome partially by financial intermediaries. MFIs that provide group-based loans have relied on the local knowledge of clients to help lower the costs of screening and monitoring, as well as enforcing payment in cases of default. Group approaches also gain economies of scale in the administration of screening and monitoring through dealing with multiple small loans at a time. With the introduction of MFIs' individual loan products, this often builds on the clients' history in the group-based program.

Information about possible investment opportunities is not free. Economic agents may find it worthwhile to produce such information. For instance, surplus units could incur substantial search costs if they were to seek out borrowers directly. MFIs have economies of scale and other expertise in processing information relating to deficit units (borrowers). This information may be obtained upon first contact with borrowers but in reality is more likely to be learned overtime through respected dealings with the borrower. As financial intermediaries build up this information they become experts in processing this information and depositors are willing to place funds with them, knowing that these will be directed to the appropriate borrowers without the former having to incur information costs. The microfinance market is a distinct market that makes use of soft-information and depends on strong MFI-client relationship in providing loans without collateral requirements. They do so by establishing strong personal relationship with clients as well as by using other forms of collateral (such as group lending that generates social collateral). According to Avendo (1993), and Bauman (1984), they argued that the average scale of operation and cost of lending and recovery for informal financial sector is small; information gathering is kept to the minimum while trust and firsthand knowledge of a participant are important. MFIs have always relied on information based lending technology as opposed to collateral based approach being used by commercial banks.

Research Methodology

Research Design

The research design used in this study was descriptive and exploratory in nature in the form of a survey and a case study. A case study seeks to describe a unit in detail, in context and holistically, and becomes particularly useful when one can identify a case rich in information in the sense that a great deal can be learned from a few examples of the phenomena under study. In this case the researcher has undertaken study of customers at Kenya women finance trust (KWFT) and used the results of the study to infer on financial intermediation in microfinance institutions and its contribution to financial sector development and growth in the whole of Kenya.

Sample and Sampling Technique

Random probability sampling has been used to select a reasonable number of subjects, objects that will represent the target population. In random sampling, every sample of a given size in the population will have an equal chance of being selected (Mugenda, 2003). The researcher has used a target population of customers and management staff of KWFT totaling to 1,510. The sample has been arrived at by listing the names of all customers and then picking in random order. The sample size was determined by 10% of the population selected which was 141 customers and 10 managers.

Data Collection Instruments and Procedures

In this study, the questionnaire and interview guide has been used to obtain primary data from KWFT customers and managers in relation to the independent variables mentioned in the conceptual frame work. The research strategy that has been used was guided by the research objectives, questions and the extent of the existing knowledge.

Data Processing and Analysis

The researcher has employed both qualitative and quantitative methods to analyze the data. Qualitative data has been collected through direct observation and the interview method i.e. face to face interaction on the researcher and the respondents. The questionnaires have been edited and coded after which the variables were defined and posted to the statistical package (SPSS), to generate data which has been presented in frequencies, percentages, charts, etc.

Findings and Discussion

Contribution of Savings and Credit Mobilization

Findings indicated that 90% of the respondents were banking with MFIs as opposed to Banks and Mobile banking. Majority of the respondents at 75% accessed their credit facilities from MFIs as compared to 20% who accessed their credits from Banks. 89.6% recorded a positive effect when asked whether the existence of KWFT has had any effect on their businesses/well being. This confirms the notion that MFIs have greatly contributed to the access of the financial sector by the poor thereby improving resource allocations which leads to the development of the rural markets.

Transaction Costs

On a comparable note regarding transaction costs charged by various stakeholders in the financial markets such as Banks, Shylocks and Microfinance, 70.8% of the respondents confirmed that, it was cheaper for them to secure loans from MFIs than in Banks and Shylocks.

The reasons advanced, was mainly attributed to the relaxed collateral security requirements and the variety of loan products offered by MFIs. These reasons were collaborated by the fact that 65.7% of the respondents were found to be consistently transacting business with more than one MFI to enable them boost their capital base, expand their businesses and to meet their business capital demands. It remains a fact that one MFI would be reluctant to give huge sums of loans for recapitalization of businesses which results to the multiple borrowings.

Risk management

Results on statements concerning liquidity risk factors revealed the following: 60.4% of the respondents accessed their credit requirements in less than three weeks at most, with 100% of their loan requirements being met. This reduces the risk of running out of capital requirements for replenishing finished stock in small and medium enterprises; and is far well beyond what the traditional banks would process their loans, given the cumbersome and bulky documentations required to process such loans. However 59.4% of the respondents confirmed that the required collateral and other criteria for loan qualification were found to be cumbersome, this confirms why the default rate at KWFT for its portfolio at risk (i.e. less than 30 days) has been currently lower than 2% and has never gone beyond 3% since late 2007 as required by the Central bank of Kenya. This is despite the fact that KWFT has more than doubled its number of active loans and tripled the volume of its loan portfolio.

Interview Guide Findings

This section summarizes the results of the responses regarding the background of KWFT, Savings and Credit mobilization, Risk management, Transaction costs and finally the challenges faced by KWFT in its contribution to the development and growth of the financial sector.

The background of Kenya Women Finance Trust (KWFT)

KWFT was started with the objective of addressing the financial needs of women and has enjoyed rapid growth over the years and is currently worth 21.7 billion (Dec, 2013). It is also the leading and best practice Microfinance Institution in Africa. 80 % of its clients are in the rural areas and it controls 67 % of the market share in the Microfinance industry in Kenya. KWFT has an expansive branch network of 233 offices spread out in 45 counties of the total 47 counties in Kenya, with over 600,000 customers and a workforce of over 2,100 staff. It has an outstanding Loan portfolio of Ksh.15.6 billion and deposits amounting to 15 billion as at end of 2013.

Non-financial services provided by KWFT includes:- Mobile banking services, provision of affordable and good quality phones, Card management system services and Western union services. This saw it win a HP award in recognition of the efforts made in bridging the aforementioned financial gap through technology, becoming the first Microfinance institution in Africa to provide such services. Its delivery channels include:- 184 Marketing outlets, 28 Deposit taking branches and 800 Kenswitch branded ATMs. Collateral securities are required for certain kinds of Loans while other loans are granted based on the savings capacity of the client. The required collaterals include:- Land, Car, Business reference and Group members guarantee.

It is imperative to note that KWFT has helped improve the fortunes of most Households through provision of both financial and non-financial services at Low transaction costs; thereby accelerating the growth and development of Households income, a factor that has seen it generate employment in the sector. The operations of KWFT were also associated with some challenges such as:- Loan defaults, Lack of collateral security, Poor record keeping and Lack of transparency in the business accounts leading to misappropriation of loans granted to such activities as:- financing funerals, paying school fees, solving family matters and financing medical bills instead of using the funds for business.

Summary of Findings

In terms of start-up capital, the research unveils that, MFIs play an important role as most respondents (75%) indicated that the source of their start-up capital was from Microfinance and Financial institutions. Microfinance institutions have provided Small and medium enterprises with a greater access to credit facilities than those given by the Traditional banks, since most respondents indicated that 100% of their Credit demand was being granted. MFIs have also been able to create a platform of enhanced savings culture which enables individuals and small businesses to save their meager income they earn on daily basis with little cost, thus enhancing the activities of MFIs. A majority of SMEs revealed that they have been beneficiaries of Business, financial and managerial training activities, these support services have gone a long way in enhancing their financial management.

Improved technologies used in delivery of financial services such as collective lending, screening tools, alternatives to traditional collateral, repayment incentive schemes, mobile banking, monitoring and evaluation systems, and training programs has improved efficiency, sustainability and reduced transaction costs. MFIs manages their risk factors through monitoring performance of borrowers because individual investors do not have the resources of doing so this has helped ensuring that investors receive returns that properly reflect their enterprises' performance and improved, capital allocation with a subsequent impact on development and growth.

Conclusions

From the research study, MFIs have a positive effect on the development and growth of the Financial sector, notwithstanding the inherent challenges. It has also been noted that, access to Loans which is a major challenge in the SME sector has been increased through the operations of MFIs. MFIs have also contributed to the growth of SMEs through the provision of non-financial services such as Business, financial and managerial training programmes; and the area of Mobilization of Savings through their saving schemes which makes saving more accessible in small amounts and less costly. The savings culture has been enhanced because low income earners who were unable to save with the traditional banks are now being offered an opportunity to do so. This saving culture has helped improve capitalization since a high portion of the savings is used to recapitalize their businesses. It's critical to highlight the challenges that have the tendency of derailing the efforts of MFIs in granting Loans. Some of these are the inability of clients to repay their loans and the rate of Loan misappropriation. None the less MFIs provide a better access to credit facilities than traditional banks. However, the requirement by a good number of MFIs for provision of collateral security before loans are granted has negatively affected both individuals and SMEs since some are unable to provide such collaterals. Despite these challenges, i wish to emphasize that the findings of this research study clearly indicates that MFIs have had a positive effect on the development and growth of SMEs and the financial sector in general.

Recommendations

In view of the findings made and conclusions drawn from the study, the following has been recommended:- MFIs have a great responsibility of ensuring there is proper use of credit which is an important facility in business acceleration. Proper and extensive monitoring activities should be put in place for clients who have been granted loans. Beyond the Loans provided by MFIs, it is prudent to operate the traditional Savings accounts open to all kinds of customers. This suggests that irrespective of the customer base consisting mainly of the poor women, KWFT can also encourage Institutions, Individuals and the general public to save with them in the form of deposits to enhance Capital accumulation.

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