

**EFFECT OF COMPETITION ON THE LOAN PERFORMANCE OF DEPOSIT  
TAKING MICROFINANCE INSTITUTIONS IN KENYA: A CASE OF NAIROBI  
REGION**

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**ABSTRACT**

Competition between microfinance institutions (MFIs) in developing countries has increased dramatically in the last decade. This study sought to investigate the effects of competition on the loan performance of deposit taking microfinance institutions in Kenya. The study also sought to investigate the effects of multiple loan taking, cost efficiency, selection standards and customer relationship on the operational performance of deposit taking microfinance institutions in Kenya. The study found that there is a relationship between multiple loan-taking, selection standards and customer relationship cost efficiency and loan performance of the microfinance institutions. In addition, the study also established that multiple loan-taking negatively affects loan performance deposit-taking microfinance institutions. This study therefore recommends that MFIs should not offer multiple loans to customers so as to improve their loan performance.

**Key Words:** *multiple loan taking, customer relationship, selection standards, cost efficiency, loan performance*

## **Introduction**

Competition in microfinance sector started in the last decade in some countries such as Bolivia, Nicaragua, Bangladesh and Uganda (Rhyne and Otero, 2006). In other developing countries such as India, it has just started. The rapid growth of microfinance movement by socially committed nonprofit institutions has proved that the poor are bankable. Realizing this fact, profits maximizing formal lending institutions have started to penetrate into this market (Pagano, 2009).

Competition between microfinance institutions in developing countries has increased dramatically in the last decade (McIntosh and Wydick, 2005). Further, greater bank penetration in the overall economy is associated with micro banks pushing toward poorer markets, as reflected in smaller average loans sizes and greater outreach to women (Cull, et al. 2009). Now it is the global scenario that nonprofit organizations are facing competition from profit driven lenders. This has made the socially motivated nonprofit lenders re-think about their strategies of reaching the poor.

## **Statement of the Problem**

The microfinance movement is growing at a very rapid rate. In Kenya, for example, the average year-on year increase in the portfolio of the Kenyan microfinance sector over the period 2004-2009 was 107% (as compared with a mere 4% increase in commercial bank lending in 2008-09). According to FSD (2010), in the year 2009 microfinance institutions in Kenya were serving 17.9% of the total number of individuals in the financial sector as compared to 7.5% in the year

2006. While East Africa is at an earlier stage of competition, the major urban centers in Kenya, especially Nairobi, are becoming saturated by competition among numerous MFIs.

According to Motta (2004) competition in the microfinance industry increases the welfare of consumers by promoting productive efficiency such as lower production costs and lower interest rates. Competition also encourages the development of new products and efficient technologies which subsequently influence the loan performance of microfinance institutions.

However, from an economic perspective competition means more firms are competing for a limited market share and thus having to adjust ever closer to the needs of the customers as well as lowering prices down to a point where marginal revenue equals marginal cost. However, in most places the increase in competition among MFIs has not only brought benefits such as better access and lower interest-rates, but has also introduced problems (Armendariz de Aghion & Morduch, 2004). These adverse effects fall back not only on the MFIs, which are struggling to maintain their performance level, but also on the clients. Borrowers are facing serious problems from paying back their loans, which eventually increases the risk of over-indebtedness to increasing sociological and psychological constraints. Multiple factors contribute to this problem, mainly changing lender and client behavior but also information asymmetries. Srinivasan (2009) also indicates that intense competition lowers borrower selection standards, weakens relationships with customers and leads to multiple loan-taking thus high defaults. According to Bikker & Haaf (2002), 25% of borrowers in microfinance institutions take loans from six or more different financial institutions which eventually lead to repayment crisis in the microfinance industry. Repayment crisis subsequently lead to liquidity problems which negatively influence the operational performance of microfinance institutions.

Despite its importance due to the increasing competition in the microfinance industry in Kenya, there is no record available to this study on the effects of market competition on the loan performance of deposit taking MFIs in Kenya. Several research studies have been conducted on competition in the microfinance industry. For instance, Nyaga (2008) conducted a study on the nature of competition within micro finance industry in Kenya and Mutua (2011) did a study on the linkages between micro finance institution and commercial banks in Kenya. However, none of these studies focused on the effects of competition on the loan performance of microfinance institutions.

### **General Objectives of the Study**

The general objective of this study was to investigate the effects of competition on the loan performance of deposit taking microfinance institutions in Kenya

### **Specific Objectives of the Study**

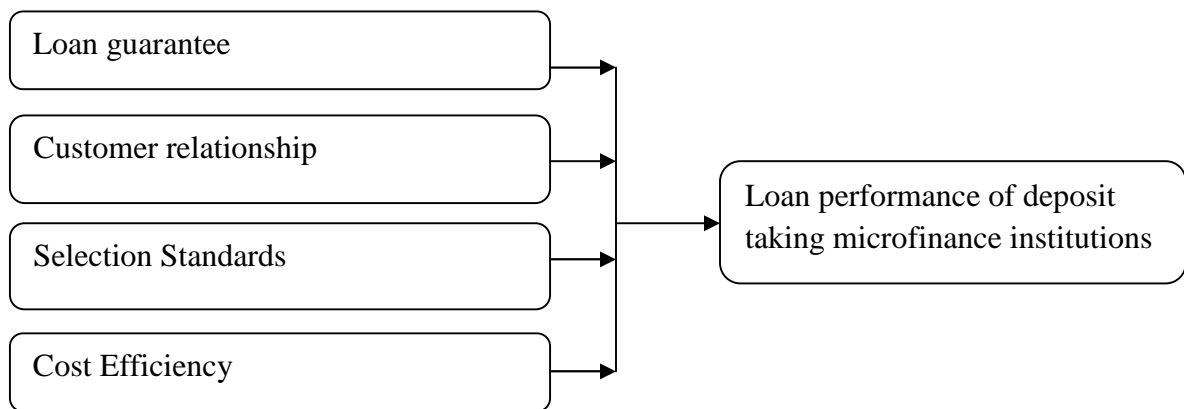
- i. To investigate the effects of multiple loan taking on the loan performance of deposit taking microfinance institutions in Kenya
- ii. To investigate the effects of customer relationship on the loan performance of deposit taking microfinance institutions in Kenya
- iii. To establish the effects of selection standards on the loan performance of deposit taking microfinance institutions in Kenya

- iv. To determine the effects of cost efficiency on the loan performance of deposit taking microfinance institutions in Kenya

**Theoretical Framework**

Prospect theory, a theory about how people make choices between different options or prospects, is designed to better describe, explain, and predict the choices that the typical person makes, especially in a world of uncertainty. In this study, this theory explains why people engage in multiple-loan taking. On the other hand, conventional economic efficiency theory states that companies should structure their output to achieve the lowest possible cost per unit produced. Given the combination of fixed and variable costs typical in business, low levels of output are inefficient because fixed costs are shared out across a relatively small number of units (Fiebig, Hannig & Wisniwski, 2005). Service Recovery is a theory that suggests that a customer who has a bad experience and gets prompt, effective response to their issues will be a more loyal customer than a customer who had no bad experience at all. The theory explains the importance of customer relationship in loan performance.

**Conceptual Framework**



**Indipendent Variable**

**Dependent Variable**

## Critical Review

According to the empirical review above, competition in microfinance institutions can have a positive or negative impact. Cull et al. (2009) investigate the performance of MFIs under the pressure of competition from formal banks, measuring competitive pressure by using bank penetration variables such as the number of bank branches per capita and per square kilometer. Their results show that MFIs faced with high competition tend to reduce the breadth of outreach but will focus more on the depth of outreach, i.e., more loans to women borrowers and smaller loans. However, the effect on other performance indicators, such as profitability, appears to be weak. According to Nyaga (2008), competition as experienced by the players was reported to exist on all the fronts modeled by Porter. MFIs however did not give due credence to the impact of competition on their chances of success relative to other factors. This study however did not focus on deposit taking microfinance institutions. On the other hand, Mutua (2011) established that commercial banks receive services from the micro finance institutions which include savings and deposit mobilization among others. In establishing the linkage, commercial banks are faced by challenges like loan repayment and low interest rate unlike the micro finance institutions whose greatest challenge is geographical location of the small and micro enterprises.

## Research Gap

There is immense of literature on competition in microfinance institutions. Globally, Cull et al., (2009) did a study on microfinance meets the market; McIntosh and Wydick (2005) did a study on competition and microfinance; Vogelgesang (2003) conducted a study on microfinance in

times of crisis: the effects of competition, rising indebtedness and economic crisis on repayment behaviour and Navajas, Conning and Gonzalez-Vega (2003) did a study on lending technologies, competition and consolidation in the market for microfinance in Bolivia. In Kenya, Mbogo (2009) conducted a study on the factors Influencing Product Innovation in Micro Finance Institutions in Kenya: A Case Study of MFIs Registered with the Association of Microfinance Institutions, Nyaga (2008) conducted a study on the nature of competition within micro finance industry in Kenya and Mutua (2011) did a study on the linkages between micro finance institutions and commercial banks in Kenya. However, none of these studies focused on the effect of competition on the loan performance of deposit taking microfinance institutions in Kenya. In addition, none of these studies focused on multiple loan taking, customer relationship, section standards and cost efficiency which will be the variables in this study.

### **Research Methodology**

This research study used a descriptive research design. In addition, the study incorporated both qualitative and quantitative research. The target population that was used in this study was the staff working in the headquarters of the 6 licensed deposit taking microfinance institution in Nairobi Region. According to CBK (2012) licensed deposit taking MFIs include UWEZO Deposit Taking Microfinance Limited, SMEP Deposit Taking Microfinance Limited, Remu DTM Limited, Rafiki Deposit Taking Microfinance, Kenya Women Finance Trust DTM Limited and Faulu Kenya DTM Limited. There were 44 officers working in the headquarters of each of the 6 microfinance institutions. The target population for this study was therefore 264 respondents. Stratified random sampling was used to select 30% of the target population. The

sample size of this study was therefore 78 respondents. This study used primary data. Quantitative data was analyzed by use of inferential statistics such as multivariate regression analysis and descriptive statistics such as mean, standard deviation, percentages and frequency then presented in form of table and figures. On the other hand, qualitative data was analyzed by use of content analysis. Multiple regression analysis was used to determine the relationship between the dependent and the independent variables.

## **Research Findings and Discussion**

### **Effects of Multiple Loan-Taking on Loan Performance**

It was established that multiple loan taking adoption affects the loan performance of deposit taking microfinance institutions in Kenya to a great extent. According to Hermes, Lensink and Meesters, (2009) multiple borrowing has gained a considerable amount of negative reputation during the past years. It is perceived to be one of the main causes for over-indebtedness - borrowers can take on too much debt from different lenders that they eventually may not be able to repay. The study also found that most of the deposits taking microfinance institutions were offering multiple loans to customers.

### **Effects of Selection Standards on Loan Performance**

The study revealed that selection standard affects the loan performance of deposit taking microfinance institutions in Kenya to a great extent. According to Stauffenberg (2001) increased competition may put pressure on MFIs to increase output and lower costs, which may lead them



to relax lending and client selection standards and reduce costly monitoring and screening procedures. The study also established that most of the deposit-taking microfinance institutions were using selection standards in offering credit to customers. These findings agree with Pagano (2009) argument that the demand for selection standards from microfinance institutions (MFIs) and banks has increased sharply and a number of institutions have started implementing selection standards solutions and their number is likely to grow significantly over the next few years.

### **Effects of Cost efficiency on Loan Performance**

This study revealed that competition leads to cost efficiency. The institutions improve its services the more the customers retention and hence an increase in profitability and cost efficiency. MFIs also offer better products at lower costs to customers. These findings agree with Stemler (2001) argument that increased competition puts pressure on MFIs to become cost efficient. With increased competition, MFIs need to find ways of delivering services at lower costs to ensure them a competitive edge. The study also established that cost efficiency affects the loan performance of deposit taking microfinance institutions in Kenya to a great extent.

### **Effects of Customer Relationship on Loan Performance**

The study found that customer relationship affects the loan performance of deposit taking microfinance institutions in Kenya to a very great extent. Navajas, Conning and Gonzales-Vega (2008) had earlier indicated that given the significance of retail lending and deposit taking for MFIs, and given that MFIs are a valuable source of personal and consumer loans, understanding

the role of MFIs and retail depositor relationships is important. In addition, complaints regarding the quality of service offered to the customers were often in deposit taking microfinance institutions.

### Regression Analysis

The four independent variables that were studied, explain 72.7% of the loan performance of the deposit-taking microfinance institutions as represented by the  $R^2$ . This therefore means that other factors not studied in this research contribute 27.3% of the loan performance of the deposit-taking microfinance institutions.

**Table 1: Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.853	0.727	0.714	0.4238

The significance value is 0.0221 which is less than 0.05 thus the model is statistically significant in predicting how multiple loan taking, customer relationship, selection standards and cost efficiency influence loan performance of the deposit-taking microfinance institutions. The F calculated at 5% level of significance was 2.345. Since F calculated is greater than the F critical (value = 1.99), this shows that the overall model was significant.

**Table 2: ANOVA**

	Model	Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2.321	4	1.237	2.345	.0221
	Residual	7.912	73	2.313		
	Total	3.532	77			

The regression equation was therefore;

$$Y=1.312- X_10.709 + X_20.654 + X_30.692 + X_40.432$$

The regression equation above has established that taking all factors into account (multiple loan taking, customer relationship, selection standards and cost efficiency) constant at zero, the loan performance of the microfinance institutions will be 1.312. The findings presented also shows that taking all other independent variables at zero, a unit increase in multiple loan taking will lead to a 0.709 decrease in the scores of the loan performance of the microfinance institutions; a unit increase in selection standards will lead to a 0.692 increase in the scores of the loan performance of the microfinance institutions; a unit increase in customer relationship will lead to a 0.654 increase in the scores of the loan performance of the microfinance institutions, a unit increase in cost efficiency will lead to a 0.432 increase in the scores of the loan performance of the microfinance institutions. This infers that multiple loan taking influences most the loan performance of the microfinance institutions most, followed by selection standards, customers' relationship and cost efficiency.

**Table 3: Coefficient of Determination**

	<b>B</b>	<b>Std. Error</b>	<b>Sig</b>
(Constant)	1.312	1.325	0.026
Multiple loan taking	-0.709	0.118	0.020
Customer relationship	0.654	0.231	0.022
Selection standards	0.692	0.212	0.021
Cost efficiency	0.432	0.114	0.024

### Conclusions

The study concludes that there is an inverse relationship between multiple loan-taking and loan performance of the microfinance institutions. In addition, there is a positive relationship between selection standards, customer relationship, cost efficiency and loan performance of the microfinance institutions. Multiple borrowing is perceived to be one of the main causes for over-indebtedness - borrowers can take on too much debt from different lenders that they eventually may not be able to repay. Most of the deposit-taking microfinance institutions were using selection standards in offering credit to customers. The more discriminative the scoring system is, the better are the customers ranked from high to low risk and the quality of the credit scores risk ranking and calibration determines the rate of loan defaulting. Complaints regarding the quality of service offered to the customers are often in deposit taking microfinance institutions. Further, the study concludes that competition leads to cost efficiency. With increased

competition, MFIs need to find ways of delivering services at lower costs to ensure them a competitive edge.

### Recommendations

The study therefore recommends that: MFIs should not offer multiple loans to customers so as to improve their loan performance; Fields' staffs as well as loan officers should put into consideration the borrower's ability to repay their loans and other loans they may be having; MFIs should always use credit scoring when offering loans to their customers; MFIs should come up with more products and services that will lower their cost of offering services; MFIs should fully adopt technology in an effort to reduce cost; and, MFIS should enhance their customers' relationship so as to improve their loans performance.

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