# MICROFINANCE AS A DEVELOPMENT TOOL – DOES IT REALLY HELP?

## A DESCRIPTIVE ANALYSIS


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## List of Acronyms

| | |
|---|---|
| ASCAs | Accumulating Savings and Credit Associations |
| BRAC | Bangladesh Rural Advancement Committee |
| BRI | Bank Rakyat Indonesia |
| CIDA | Canadian International Development Agency |
| ICDC | Industrial and Commercial Development Corporation |
| FDI | Foreign Direct Investment |
| GDP | Gross Domestic Product |
| GTZ | Gesellschaft für Technische Zusammenarbeit |
| HDI | Human Development Index |
| HIV | Human Immunodeficiency Virus |
| KTDC | Kenya Tourist Development Corporation |
| LDC | Least Developed Countries |
| MDGs | Millennium Development Goals |
| MFI | Microfinance Institution |
| NGO | Non-Governmental Organization |
| ODM | Orange Democratic Movement |
| PNU | Party of National Unity |
| ROSCAs | Rotating Savings and Credit Associations |
| SACCOs | Savings and Credit Co-operative Societies |
| SHG | Self-help group |
| UN | United Nations |
| USD | United States Dollar |
| UNDP | United Nations Development Programme |
| UNIFEM | United Nations Development Fund for Women |

# 1 Introduction

Microfinance has been hailed as “one of the most significant innovations in development policy of the past twenty-five years” (Besley 1994, p. 23). This movement, which can be synonymously referred to as Microcredit, basically means the provision of small amounts of capital to under-served, predominantly poor, mainly women borrowers and is intended for use in income-generating self-employment activities. Lack of access to credit is often believed to be one of the most important causes why so many people in developing countries remain impoverished. Usually, poor persons are not served with loans by the banking system because they cannot provide acceptable collateral and/or the costs of administration are too high to make lending to them profitable (Hermes, Lensink 2007).

Since the late 1970s, nonetheless, the poor in developing economies have increasingly been given the chance to acquire small loans through the help of so-called microfinance institutions (MFIs). More precisely, the microcredit movement began with the work of Dr. Muhammad Yunus, economics professor at a Bangladesh university and founder of the iconic Grameen Bank in Bangladesh, setting a role model which spread rapidly to other developing countries. Most of these early MFIs, however, relied on government funding and international donors with the justification that they were reducing poverty, unemployment and by that spurring social development (Yunus 2007).

In the 1980s the microcredit model became progressively popular operating in a transformed political and economic environment. Market pressures and competition increased and MFIs increasingly felt the urge to become financially sustainable and cut off donor support in the long run. This led to a need for MFIs to cover their own costs by private ownership, greater commercialization and profit-driven incentives with often exceptionally high interest rates. It was supposed that market forces and the endeavor to make profits would ensure financial sustainability, which has been proven to be only partly correct and is since then a widely discussed question in the academic world (Bateman 2011).

Ever since the idea of microfinance has been created it is seen as an eligible tool to fight extreme poverty. The United Nations (UN) supported this view by declaring the year 2005 to be the "International Year of Microcredit". According to the UN, microcredit can contribute considerably to achieve the Millennium Development Goals (MDGs), which aim at halving extreme poverty by 2015 (United Nations 2011). Furthermore, the role of microfinance as a development and poverty-reduction vehicle was further increased when Dr. Muhammad Yunus received the Nobel peace prize in 2006. The Nobel committee argued that microfinance can help people to escape poverty which in turn is seen as a prerequisite to establish long-lasting peace (Norwegian Nobel committee 2006).

> "The Norwegian Nobel Committee has decided to award the Nobel Peace Prize for 2006, divided into two equal parts, to Muhammad Yunus and Grameen Bank for their efforts to create economic and social development from below. Lasting peace can not be achieved unless large population groups find ways in which to break out of poverty. Micro-credit is one such means."
> (The Norwegian Nobel Committee 2006)

## 1.1 Aim of the paper

The paper has a dual objective. On the one hand, it seeks to give a logical and comprehensive summary on how microfinance works from a theoretical perspective and why it is believed to be a reasonable tool for fighting extreme poverty. This part is also meant to provide the reader with a better understanding of the functionality of microfinance for the upcoming chapters. Furthermore, the paper will focus on the frequently discussed MDGs in order to explain how the availability of financial services to poor households can help to reach them in theory.

On the other hand, this paper attempts to analyze the microfinance sector in Kenya. The target country was chosen due to a relatively elaborate access to information about the industry and also due to its favorable geographical position, lying in the East of Africa with borders to Somalia or the newly-independent South Sudan which both belong to the poorest countries in the world. Scientific findings about the microfinance sector in Kenya could also be of interest and a good starting point for their development. In the beginning, I will sketch the country's political structure and its economic performance briefly in order to work out implications for micro-lending. In the next step, the paper will deeply inform the reader about the various types of MFIs existent in Kenya and the products they offer. At last, the legal and regulatory framework under which they operate will come under close scrutiny.

## 1.2 Structure of the paper

This paper is organized in four main sections. The first section consists of an introduction to the concept of international development and attempts to elaborate a definition for the term. Furthermore, the Human Development Index (HDI) and the MDGs are briefly described and discussed for use in the following chapters.

The second section focuses on the basic theories of microfinance in order to provide the reader with a profound understanding of the functionality as a starting point. Similarities between different microcredit systems will be worked out and presented. The main aim of the third section, however, is to demonstrate how microfinance can help people escaping poverty and how the hailed movement can enhance development on different levels.

Last but not least, the fourth section of this paper is concerned with an analysis of the microfinance sector in Kenya in the light of the theoretical framework obtained before. Finally, the most essential findings will be pointed out again in the form of a concluding summary.

# 2 How to define and measure “international development”?

International development is a concept without a commonly accepted definition for the term, but it is mostly used with reference to human and social development – the improvement of the quality of life for people. It can also be understood as the expansion of human’s freedoms and capabilities, as well as their choices (UNDP 2011). According to the United Nations (UN), in 2002 roughly a fifth of the world population was living in “extreme poverty”, that means earning less than one dollar a day. It seems to be clear that especially those poor and disadvantaged people are the main focus of “human development” since an improvement of their quality of life is vital and often necessary in order to make ends meet. Hence, the concept of “international development” can also be seen as an attempt to lift out people of extreme poverty.

Even more importantly than finding a definition for “human development” seems to be the question on how it could be measured. In order to take potentially effective actions with regard to development, say like microcredit, it is crucial to being able to assess their impact on the target variable and to monitor it over time. For that reason two widely accepted and used concepts – the Human Development Index (HDI) and the Millennium Development Goals (MDGs) - have been created and shall be further discussed in the following part.

## 2.1 Human Development Index (HDI)

The Human Development Index (HDI) is a summarized statistic launched by Pakistani economist Mahbub ul Haq in the Human Development Report of the United Nations Development Programme (UNDP) which basically ranks countries by their level of “human development”. The HDI is a relative measuring system of literacy, education, life expectancy and of a country’s standard of living (UNDP 2011). Moreover, it distinguishes developed countries from undeveloped ones and classifies them into categories ranging from “very high human development” to “low human development”. By doing so, the HDI is a highly comprehensive and useful statistic in order to compare the varying levels of human development in different regions or countries and also to draw conclusions about a country’s individual performance from comparing the latest results with previous ones.

## 2.2 Millennium Development Goals (MDGs)

A giant leap with respect to “human development” was achieved by the 193 UN member states and 23 international organizations at the UN Millennium Summit in 2000 by agreeing on eight goals which all aim at halving extreme poverty by 2015, the so-called Millennium Development Goals (MDGs). Indeed, this was a historical accomplishment, not only with regards to the extent of the development issues, but also because it meant that the global community obliged themselves to a demanding and specific agenda for development. Rooting in the Millennium Declaration, which declares that every human being has the right to freedom, equality, a basic standard of living and dignity, the MDGs operationalize these ideas by applying indicators and targets for poverty reduction and make sure they are reached by 2015. Being more precise, there are eight goals with 21 sub-targets, each defined with a series of measurable indicators (United Nations 2012).


Figure 1: The logo for the eight MDGs. Source: United Nations (2012).

### Goal 1: Eradicate extreme poverty and hunger

The first goal comprises three targets which aim at halving both the proportion of people living on less than $ 1 a day and the proportion of people suffering from hunger. Furthermore, it is declared to be crucial to achieve decent employment for women, men and young people.

### Goal 2: Achieve universal primary education

The second goal focuses on education and shall ensure that by 2015 all children, both girls and boys, can complete a full course of primary schooling.

### Goal 3: Promote gender equality and empower women

This is certainly one of the most important goals to lift poor, under-represented women and their children out of their devastating situation. The target is to eliminate gender disparity in primary and secondary education preferably by 2005, and at all levels by 2015.

### Goal 4: Reduce child mortality rates

In 1990, 97 per 1000 under-five-year-old children died in developing countries (United Nations 2012). This horrifying statistic showed the great need to reduce the under-five mortality rate by desirable two thirds until 2015.

### Goal 5: Improve maternal health

The fifth goal splits into two sub-targets both designed to improve maternal health. Firstly, the maternal mortality ratio should be decreased by three quarters and secondly, universal access to reproductive health is hoped to achieve by 2015.

### Goal 6: Combat HIV/AIDS, malaria, and other diseases

34 million people had to live with HIV/AIDS worldwide in 2010, 99% of the deaths from the disease were in the developing world. Moreover, malaria kills about 780.000 people each year, burdening African economies and households. Economists estimate the disease to cause a reduction in economic growth of up to substantial 1.3% in some African countries (The World Bank 2012). The United Nations tries to tackle these severe problems by setting three targets for the sixth goal. Firstly, HIV/AIDS is wanted to be halted by 2015 and the spread to be reversed. Secondly, universal access to treatment for all those who need it should be provided by 2010. Concerning malaria and other major diseases, like tuberculosis, the target is to halt them by 2015 and to reverse the incidence.

### Goal 7: Ensure environmental sustainability

This goal emphasizes environmental sustainability and consists of four sub-targets. First of all, the principles of sustainable development shall find their ways into country policies and programs. Secondly, the unnecessary loss of environmental resources and biodiversity is expected to be minimized, resulting in a significant reduction in the rate of loss. The third target is to cut the proportion of the population without sustainable access to safe drinking water and basic sanitation in half by 2015. Last but not least, the United Nations declares it as a target to succeed in substantially improving the lives of at least 100 million slum-dwellers by 2020.

### Goal 8: Develop a global partnership for development

Goal 8 is more general with various sub-targets concerning different spheres of development. It is intended to design an “open, rule-based, predictable, non-discriminatory trading and financial system” (United

Nations 2012). Also the special needs of the Least Developed Countries (LDC) and of landlocked developing countries and small-island developing States are targeted to be further addressed. Furthermore, it is believed to be essential to make the debt problem of developing countries more sustainable in the long run through national and international measures. Also, co-operation with pharmaceutical companies and the private sector is believed to provide better access to affordable, vital drugs and advanced technologies, especially information and communications.

The MDGs with their 21 sub-targets play such an essential role in human development nowadays that they will be used in the upcoming chapters to discuss the potential effects of microfinance on their targets and hence on development.

# 3 Microfinance in theory

## 3.1 The rise of a new phenomenon

> "I strongly believe that we can create a poverty-free world, if we want to … In that kind of world, [the] only place you can see poverty is in the museum. When school children will be on a tour of the poverty museum, they will be horrified to see the misery and indignity of human beings. They will blame their forefathers for tolerating this inhuman condition to continue in a massive way …"
>
> (Yunus 1989, p. 18)

The microfinance movement began approximately thirty years ago with the strong belief of social pioneer Muhammad Yunus of a poverty-free world and a simple idea of how to reach it. By turning his dream into reality, Yunus achieved to revolutionize international development and has been awarded numerous high-profile prices and awards for his pioneering work since then. This chapter briefly describes the "discovery" of microfinance and its rise to the enormous influence and power that it is today in the international development community.

The idea of the so-called microcredit was born in Bangladesh in the early 1970s where Muhammad Yunus was chairman of the Economics Faculty at Chittagong University. At that time Bangladesh was just recovering from bloody conflicts associated with its independence in 1971 and people were living in great poverty and inhuman conditions (Yunus 2007). Consequently, Yunus started to think about ways to improve this devastating situation. On frequent visits to a nearby village called Jobra he learned that, besides their traditional work, most of the poor women there were engaged in some kind of income-generating activities (e.g. raising chickens, street food preparation, net-making, …). Their returns, however, were mostly used for their current consumption needs and thus too small to expand and establish their businesses (Bateman 2010). By default, these women had to turn to local moneylenders in order to keep the economic cycle running even though they knew that they would find themselves in the very same situation in the future. The women were caught in a classic “poverty trap” (Bateman 2010).

Yunus believed that if the impoverished want to benefit from their self-employment acitivities, they needed to be freed from so-called local “loan sharks”. A small low-interest loan, known as microcredit, was supposed to be a superior way to expand self-employment activities and by doing so, liberate cash for food, education and even savings. Using his own money, Yunus repaid the debt of all women in Jobra and started giving out microcredits to them. Due to several factors like the focus on women or “solidarity cirlcles”, which I will not explain in full detail at this point, the repayment rate of the innovation was found to be extraordinarily high.

The Grameen Bank was officially founded by Muhammad Yunus in 1983 in the form of an NGO owned by its clients and controlled by Yunus and senior managers. Repayment rates remained at a very high level and the bank grew rapidly with the number its clients. The idea seemed to work – Yunus made the very poor “bankable” (Bateman 2010).

Shortly after the Grameen Bank had been established two other important institutions followed by supplying the poor in Bangladesh with microcredit. The first of them was the Bangladesh Rural Advancement Committee (BRAC) which was founded in 1972. Even state-owned banks like the Bank Rakyat Indonesia (BRI) were dabbling in the new market. Yunus himself helped to set up an important variant of the Grameen Bank model in Malaysia in 1986 – the self-help group (SHG) movement. Without going into too much detail, SHGs allowed a group of poor women to act as a “solidarity group” and receive, amongst other things, a low-interest loan by the formal banking sector. Additionally, MFIs started to offer new types of micro-services to the poor (micro-insurance, micro-savings, …). Therefore, the term “microcredit” was no longer adequate and had to be replaced by a new one – “microfinance” (Bateman 2010).

In the beginning, it was a key issue for Yunus to maintain interest rates as low as possible in order to grant the poor maximum financial space for reinvestments. Even though repayment rates remained extraordinarily high, providing microcredit was a difficult and expensive business and thus the Grameen Bank had constantly been in need of subsidies (Yunus 1989). Naturally, the international development community began to criticize this notion which led to an urge for MFIs to become financially self-sustainable. A reasonable way to achieve this was through a combination of liberalization, privatization and commercialization (Bateman 2010). Basically this meant that market-based interest rates had to be utilized – a break with the original model and start of the so-called “new wave” microfinance.

This new approach of fiscal austerity associated with neoliberalism turned out to be highly successful and constitutes the type of MFIs we can observe nowadays. These “new wave” MFIs made microfinance available to almost every poor individual in almost every part of the world and Yunus’ belief to exhibit poverty “in a museum” seemed to be achievable.

Nevertheless, very large parts of the widely-celebrated success story of microfinance focus on the operational side, such as financial sustainability or reaching the “extremely poor”. This doesn’t mean, however, that microloans automatically have the promised impact on development and poverty eradication. I attempt to answer this essential question in the upcoming chapters.

## 3.2 Definition of microfinance

Broadly speaking, microfinance is the provision of small-scale financial services to people who have no access to the conventional banking system (Armendariz de Aghion, Labie 2011). Unsurprisingly, there is a great variety of definitions used in the literature by the respective authors.

Rahman (1999), for example, defines microcredit as the "extension of small amounts of collateral-free institutional loans to jointly liable poor group members for their self-employment and income-generation". Additionally, microfinance can be understood as "small-scale financial services in general, such as credit and/or savings. The term 'microcredit' is used when reference is made only to credit" (Gulli 1998). Leading microfinance expert Marguerite Robinson (1998) presents a more extensive definition:

> "Microfinance refers to small-scale financial services for both credit and deposits – that are provided to people who farm or fish or herd; operate small or microenterprises where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, draft animals, or machinery, and tools; and to other individuals and local groups in developing countries, in both rural and urban areas."
>
> (Robinson 1998, p. 56)

However defined, microfinance normally implies very small loans to poor customers for the use in a self-employment activity – and to smooth their consumption needs, often paired with the simultaneous collection of savings. Clearly, how we define the terms "small" and "poor" essentially affects the question whether we can refer to microfinance or not. Hence, a definition for "poverty" will be given in the next part of this paper.

## 3.3 Definition of poverty

Poverty, in general, is a very broad concept which is crucial to understand in the context of microfinance. Consequently, a great variant of definitions can be found in the literature. The World Bank, for example, defines poverty as “the inability to attain a minimum standard of living” (Hemmer, Wilhelm 2000). While the UNDP also states rather vaguely that “poverty is a lack of ability to participate in national life, most especially in the economic sphere” the Canadian International Development Agency (CIDA) makes use of a more precise definition:

> “Poverty is deprivation and powerlessness. It is the lack of sufficient assets and income to satisfy basic human needs for food, water, shelter and clothing. It is the lack of education, skills or tools to acquire income or assets. And it is the lack of ability or power to change the situation.”
>
> (Hemmer, Wilhelm 2000, p. 98)

It seems to be clear that poor people themselves are likely to offer a quite different definition for poverty. A man from Kenya, for example, replied the following:

> “Don’t ask me what poverty is because you have met it outside my house. Look at the house and count the number of holes. Look at the utensils and the clothes I am wearing. Look at everything and write what you see. What you see is poverty.”
>
> (The World Bank 2001, p. 23)

Furthermore, “microfinance” as evidenced by its name is undoubtedly about more than just loans, otherwise it is more accurate to refer to it as “microcredit”. In practice, however, those two terms are often used synonymously. Most microfinance programs offer other services in addition to the credit (Armendariz de Aghion, Labie 2011). The most basic service seems to be savings (credit unions, for example, rely massively on savings). Some programs require mandatory savings every week from their borrowers or borrowing groups, even though this is sometimes more adequately referred to as cash collateral, rather than savings. Some MFIs also collect savings on a voluntary basis, allowing their customers to deposit the preferred amount each week. Furthermore, a recent development among MFIs is to offer a greater variety of services, such as skills training, insurance (life and/or health insurance) or remittance services, to name but a few. The international development organization “Freedom from Hunger”, for example, developed a popular form of training instructing their clients not only about business-related but also about health-related topics. Naturally, other MFIs keep their focus on credit and savings, explaining that the poor already have all the knowledge they need in order to be successful entrepreneurs – what they really require most is the cheapest source of credit (Armendariz de Aghion, Labie 2011).

## 3.4 Definition of microfinance institutions (MFIs)

At this point it is important for the reader to learn more about the different providers of microfinance services. The CGAP notes a rather general definition for MFIs:

> “A microfinance institution (MFI) is an organization that provides financial services to the poor. This very broad definition includes a wide range of providers that vary in their legal structure, mission, and methodology. However, all share the common characteristic of providing financial services to clients who are poorer and more vulnerable than traditional bank clients.”
>
> (CGAP 2012)

In fact, it is not exclusively institutions for the poor that engage in the field of microfinance. Commercial and nationalized banks, as well as insurance companies, are beginning to scale down in order to reach new markets and clients. These formal institutions, which are subject to banking regulations and supervision in addition to general laws, used to avoid the very poor clientele due to a lack of sufficient collateral, urban biased loan allocation, higher transaction costs, arbitrariness and patronage (Matin, Hulme, Rutherford 2002).

Moreover, we can distinguish between semi-formal providers, that are registered but not subject to banking regulations and supervision (e.g. financial NGOs, credit unions), and informal providers that are non-registered groups such as SHGs (CGAP 2012). MFIs can further be classified by their ownership structure: either government-owned or member-owned. The latter can be further split up into ownership by socially-minded shareholders or by profit-maximizing shareholders (CGAP 2012).

## 3.5 Key characteristics of microfinance

In practice, not all programs named “microfinance” will fit everybody’s perception of the term. They are likely to vary in their model, target group and/or services offered. However, despite existing differences most programs share a few similarities which qualify them as “microfinance” and make them comparable to each other. The following chapter of the paper will enumerate some of the key characteristics associated with what is generally perceived to be “microfinance”. Armendariz de Aghion and Labie (2011) name at least nine traditional features:

(1) Small transactions and minimum balances (whether loans, savings, or insurance).
(2) Loans for entrepreneurial activity.
(3) Collateral-free loans.
(4) Group lending.
(5) Focus on poor clients.
(6) Focus on female clients.
(7) Simple application processes.
(8) Provision of services in underserved communities.
(9) Market-level interest rates.

It is certainly arguable which of these nine key characteristics are essential for a program to be considered as “microfinance”. Most programs specifically target microentrepreneurs, for example, but they differ as to whether this is a requirement for a loan or not. Whereas some MFIs visit their clients to make sure that loans are used in a self-employment activity other MFIs give out loans without asking many questions, acting more like consumer credit lenders (Armendariz de Aghion, Labie 2011). As mentioned above, the model used can vary greatly from MFI to MFI. Some of the characteristics, however, are almost universal and will, therefore, come under closer scrutiny in the next part of this paper.

### 3.5.1 Group lending

Group lending particularly refers to an arrangement by a plurality of individuals without collateral who come together and form groups with the purpose of receiving loans from a lender (Armendariz de Aghion, Morduch 2005). The striking feature is that loans are granted to the individual persons, but all members of the group face the consequences if any member fails to repay. I will describe this fundamental idea of “group responsibility”, often also called “joint liability”, on the basis of the “Grameen-style” group lending model.

When the Grameen Bank gave out their first loans in the village of Jobra they were granted to individuals without a joint liability clause. It was due to economies of scale that groups were used for the first time (Yunus 1989). Sure enough, Grameen Bank quickly realized that requesting their clients to form groups entailed a considerable advantage: “The costs of screening and monitoring loans and the costs of enforcing debt repayments could be substantially reduced” (Armendariz de Aghion, Morduch 2005).

The “Grameen-style” system intends that two members out of a five-person group receive their loans first. If all goes well and the repayment obligations are met, two other members of the group qualify for a loan, and then, a few weeks after, the last person of the group follows (“2:2:1 staggering”). The core idea behind this is that the group members offer mutual assistance in times of need and step in for each other if a member fails to repay. This way the group can build a credit history and eventually qualify for larger loans that would otherwise be unavailable or too expensive for them. Furthermore, it is a very convenient method for the borrowing groups because the bank comes to them into their village. Clearly, by doing so costs are reduced significantly and in the case of arising problems both sides can try to resolve them on the spot (Armendariz de Aghion, Morduch 2005).

Acting as a solidarity group also has more subtle advantages. More precisely speaking, the joint liability clause can mitigate moral hazard and adverse selection problems that have disabled previous attempts of financial institutions to contract with the poor. Without going into too much detail at this point, moral hazard and adverse selection are outcomes of information asymmetries resulting in inefficiencies that prevent or raise the price of a potential contract. The group lending mechanism manages to produce contracts that generate better information and, thus, leads to efficient outcomes (Armendariz de Aghion, Morduch 2005).

### 3.5.2 Focus on poor clients

The focus on a "poor" clientele is a common feature of most microfinance programs, varying in the definition of the word "poor". While some argue that MFIs should target exclusively the "economically active poor", others advocate a focus on those at or below the poverty line (Robinson 2001). Many experts, however, suggest that microfinance programs should try to reach those in "extreme poverty" (Daley-Harris 2009). The question, whether microfinance is in fact able to reach the indigent, remains.

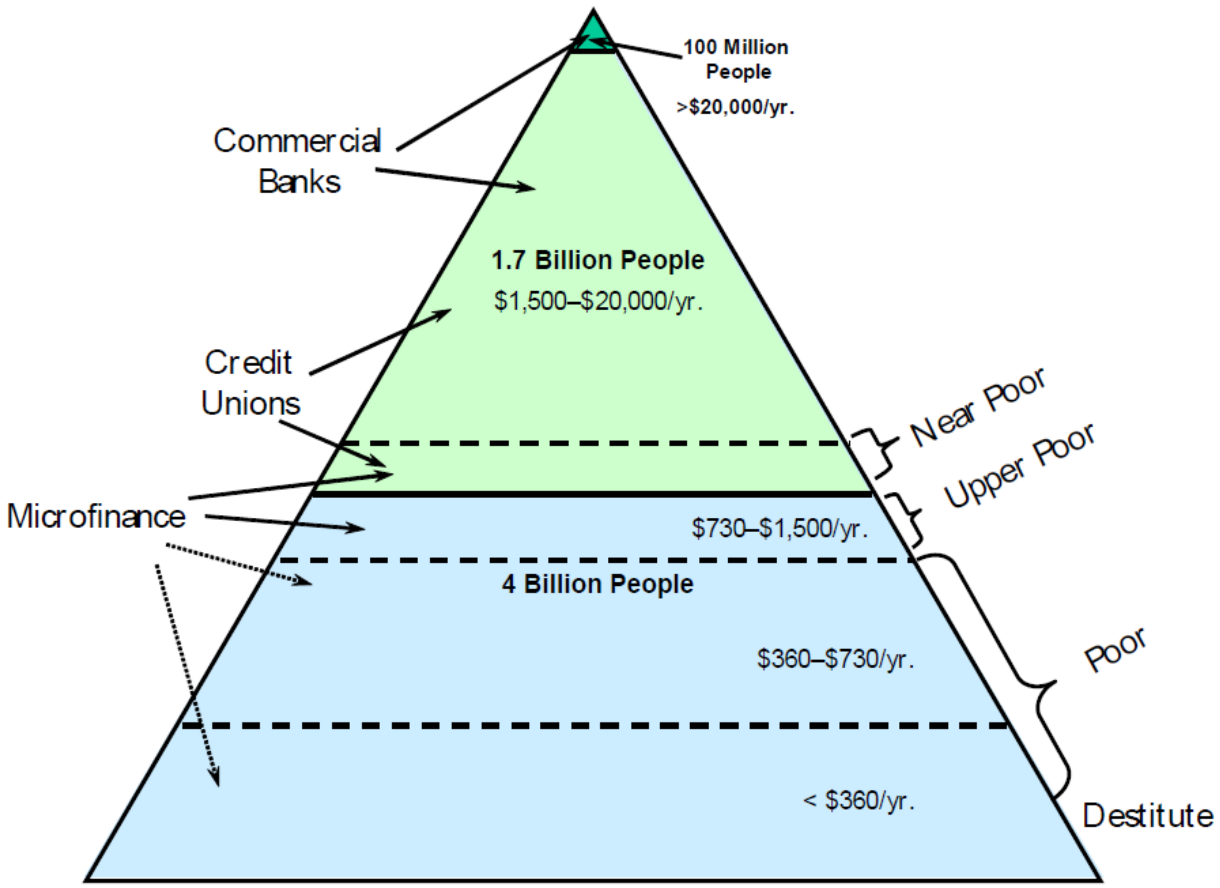


Figure 2: Microfinance can reach the lower income levels. Source: VISA International, The World Bank, Prahalad (2010).

Figure 2 presents the answer to the question raised above graphically. It shows the wealth pyramid made widely popular by C. K. Prahalad in his book “The Fortune at the Bottom of the Pyramid”. The blue area underneath the solid horizontal line represents an approximate for people living in poverty. The two dashed lines within that blue area correspond to 2-dollars-a-day and 1-dollar-a-day spending per capita. The figure demonstrates that commercial banks only reach the top of the pyramid (marked in light and dark green). Interestingly, credit unions have traditionally, and mostly still do, succeeded in reaching further down the pyramid, especially due to their favorable cost structures and cooperative principles. However, neither credit unions generally manage to encompass clients below the international poverty line.

Figure 2 clearly shows that the innovation of microfinance (notably with the nine key characteristics mentioned above) made it commercially possible to reach the vast bottom of the pyramid (area from “near poor” to “destitute”). In fact, it does not make a difference if the provider of the small loan is a specialized MFI or another institution (e.g. commercial bank, credit union) seeking to go down market (Dunford 2006).

### 3.5.3 Focus on female clients

The United Nations Development Fund for Women (UNIFEM) notes that women conduct two-thirds of the world’s labor but only receive 10% of a male income (Wolff 1998). According to the World Bank (2012) women even make up more than 80% of the total labor force in some African countries. Women advocates see microfinance as an opportunity for those impoverished and unequally treated women to improve their situation and reduce their economic dependency (Khandker 1998). Not all microfinance programs focus particularly on women, but according to the Microcredit Summit Campaign (2000) 80% of all microfinance clients worldwide are female. Nonetheless, the proportion of women as microfinance borrowers varies greatly by region, with the highest percentages in Asia and the fewest in North Africa (Armendariz de Aghion, Labie 2011). This part of the paper will address the so-called "gender issue" by pointing out advantages of microfinance for women from both the lender's and the borrower's perspective.

Traditional commercial banks are likely to favor men, mostly due to the fact that men run the larger companies that are also favored by commercial banks and men also control most of the assets that banks need as collateral (Armendariz de Aghion, Morduch 2005). With microfinance the picture is quite different. Small businesses in the informal-sector are concerned and beyond doubt women make up a great segment of this sector. There are at minimum three considerable advantages of female micro-entrepreneurs from a microlender's viewpoint.

Firstly, women are likely to be more conservative in their investment strategies and are also more easily influenced by peer pressure and interventions of the MFIs. This purely financial advantage makes women more reliable in terms of repayment. Many studies, like Khandker, Khalily and Khan (1995), found this to be factual. The following two advantages address mainly institutions that pursue social objectives. Firstly, granting women with financial resources might cause better development impacts. Armendariz de Aghion and Morduch (2005) state that one reason for this is that female borrowers are more concerned about their children's health and education than males. Consequently, they spend their additional income better. Tinker (2000) concludes that "women spend their income according to the family needs, whereas men spend it according to their own needs." Another interesting study was presented by Khandker in 2003. He finds that while a 100% increase in the volume of borrowing by a woman would cause a 5% raise in per capita household non-food expenditure and a 1% augmentation in per capita household food expenditure, a 100% increase in borrowing by men only leads to just a 2% rise of non-food expenditure and to no increase in food expenditure at all. This confirms again that aiming resources at women delivers better development results.

Secondly, microfinance can be seen as a road to “gender empowerment”. The World Bank explains in its “World Development Report 1990” that women lag behind in many key indicators of economic development (e.g. literacy rate). Furthermore, the report states that women in developing countries are subject to much greater social, legal and economic obstacles. A limited role of women in society and violence in their own households are other major problems. Advocates claim that microfinance can improve a women’s bargaining power vis-à-vis their husbands or other family members (Armendariz de Aghion, Morduch 2005). Moreover, microfinance is likely to reduce violent acts and abuses by men against women. For example, a female micro-entrepreneur is obliged to interact with her peer borrowers on a frequent basis. Clearly, in the case of household violence the peer group will want to know why the woman suddenly stopped attending repayment meetings.

### 3.5.4 Market-level interest rates

While it is universally accepted that charging interest rates on microloans is a necessity, there appears to be a lot of dispute over the optimal level of interest rates charged by MFIs. This is such a highly controversial issue because interest rates essentially affect profits of MFIs on the one hand and the degree of social impact on the other hand. While high interest rates increase profits, and therefore the financial sustainability of MFIs, the positive social effects of microcredit are reduced by burdening higher costs to the impoverished borrowers. Consequently, we can observe a trade-off between financial and social performance of lenders – a problem known as “mission drift” (Woller 2007).

In general, microloans are designed to be given out at market rates of interest, high enough for the MFIs to recover their costs, but not so high that they make extraordinarily high profits on the backs of the poor. This is a key characteristic of microcredit because programs that charge excessively high interest rates can hardly be cheaper than the loan sharks they were created to replace and institutions that offer subsidized rates are likely to distort markets by undercutting competing MFIs that are trying to recover their costs (Armendariz de Aghion, Labie 2011).

Determining a socially accepted yet profitable interest rate is certainly not an easy task for any institution. Most Austrians would start getting uncomfortable at annualized rates of 20%, and when they hear that in some places interest rates as outstandingly high as 100% and even above are charged, they would certainly not classify those loans as “social”.

When we ask ourselves “how high is acceptable?”, it is vital to examine the factors that determine international microfinance interest rates. The ten following determinants are important to be considered when talking about responsible pricing (Fehmeen 2010):

**Determinant 1: Cost of funds**

A vast proportion of a microfinance provider’s funds is obtained from commercial banks. More precisely speaking, MFIs have to pay the market interest rate for their debt which is also one of the main determinants of the rate priced by them. According to Gonzalez (2010) the costs of funds make up considerable 23% of the interest rate charged by profitable providers.

**Determinant 2: Operating expense**

Operating expenses, such as administrative and personnel expenses account by far for the largest part (62%) of interest rates (Gonzalez 2010). In general, the larger the number of small-sized loans, mostly given out to clients in geographically dispersed areas with a lack of infrastructure and security conditions, the greater the operating expenses of MFIs are.

**Determinant 3: Contingency reserves**

Contingency reserves are a regulatory requirement for some formal institutions but also other types of MFIs realized the importance of a “safety cushion” for the risk of loan defaults. Consequently, so-called “provisions for bad debt” form 6% of interest rates, according to the study carried out by Gonzalez (2010).

**Determinant 4: Tax expenses**

As some MFIs undertake their operations in the form of a formal banking institution they are obliged to pay business taxes that are sometimes even higher than those of other businesses (Fehmeen 2010). Clearly, those costs are reflected in the microloan interest rate (2%).

**Determinant 5: Profits**

This determinant is probably the most controversial part of the interest rate. The motivation of MFIs to generate profits is essential for a lot of reasons and it seems to be clear that profits form a component of the rate charged by a sustainable microfinance provider. The challenging and vital task is making sure that the generated profits are reasonable but not greedy.

**Determinant 6: Credit rating of client**

As with ordinary loans the credit rating of an individual client or of a borrowing group plays a considerable role in the pricing process as it determines whether a risk-premium is charged to compensate for the probability of default and maintain the desired return to investors.

**Determinant 7: Inflation levels**

According to the Fisher Equation (Buckley 2004), inflation uses the equity levels of lenders up. As a consequence, MFIs are forced to raise nominal interest rates in order to make sure that the real value of their funds remains the same over time.

**Determinant 8: Higher competition**

In general, higher competition among MFIs leads to lower interest rates in many countries. In the case of Uganda, however, a recent study shows that increased competition has forced microfinance providers to serve niches that are characterized by smaller-sized loans and more profitable interest rate spreads (Cull, Demirgüc-Kunt, Morduch 2009). This means that poorer clients in more dispersed areas are acquired and charged relatively high interest rates. Interestingly, this increases the effectiveness of microfinance.

**Determinant 9 & 10: Other factors impacting the interest rate**

According to Fehmeen (2010) two other factors influencing the interest rate can be named. Firstly, a competent management could improve efficiency or vary the offered products and thus decrease operating expenses and interest rates. Secondly, the financial literacy of clients has an impact on their ability of comparing prices and helps to negotiate lower rates.

These ten determinants have to be taken into account when we think about an interest rate that is supposed to be socially reasonable on the one hand and financially sustainable on the other hand. While this part of the paper provided the reader with a basic understanding of the principles of microfinance and its key characteristics the next part will stronger emphasize microfinance's potential to act as a poverty reduction vehicle.

# 4 Microfinance as a development tool

> "Microfinance is much more than simply an income generation tool. By directly empowering poor people, particularly women, it has become one of the key driving mechanisms towards meeting the Millennium Development Goals, specifically the overreaching target of halving extreme poverty and hunger by 2015."
>
> (Brown 2004, p. 2)

This quote by Mark Malloch Brown, administrator of the UNDP in 2004, emphatically states what is commonly believed in the international development community: Microfinance is one of the most promising weapons in the fight against worldwide poverty. As described in chapter 2.2 of this paper, the MDGs are an ambitious international initiative framed as eight goals aiming at improvements in the areas of education, nutrition, health, equity, gender and environment. Hence development work in these particular areas will naturally be closely linked and partly driven by the MDGs. This part of the paper reviews the substantial amount of studies showing that the availability of financial services to the "extremely poor" is a striking factor for development with significant impact on the achievement of the MDGs.

Evidence from the millions of worldwide recipients of the tiny loans shows that the access to microfinance makes it possible for poor households to increase their incomes, build assets and makes them less vulnerable to the crisis that affect them so heavily in daily life.

The accessibility of financial services also supports healthier nutrition and better health outcomes. It allows borrowers to educate more of their children and send them to school for longer. Furthermore, female clients are becoming more confident and assertive and hence find themselves in better positions to confront gender inequalities enhancing their status in the family and in society. In essence, poor people, especially women, have a chance to make plans for their future (Littlefield, Morduch, Hashemi 2003).

Microfinance is, for this reason, doubtlessly a multisectoral tool that makes various contributions, both direct and indirect, to achieving at least six out of eight MDGs (GTZ Experience 2005). Nonetheless, microfinance can only be an essential contributor to development when it creates direct and positive effects on the “extreme poor” and the better-off poor (Dunford 2006). As demonstrated in section 3.5.2, microfinance is indeed a reasonable tool to reach those at bottom of the income pyramid.

In the following part of this paper I want to review the evidence on the impact of microfinance on the achievement of the MDGs. Specifically, the impact on the first six MDGs, which relate to the areas of poverty eradication, promoting children’s education, improving health outcomes and women empowerment will be assessed in greater detail.

## 4.1 Eradication of extreme poverty and hunger (MDG 1)

Microfinance allows poor households not only to increase, but also to protect and diversify their sources of income, a vital step out of poverty and hunger (Littlefield, Morduch, Hashemi 2003). Through diversification poor people become more resilient to external shocks. Furthermore, increased income means that poor people gain the ability to take advantage of business opportunities or pay for school fees, often an initial step to break out of the poverty cycle. In fact, if the additional income is spent appropriately, it will help improve the borrower’s living conditions and nutritional status (GTZ Experience 2005).

Combined with other financial services such as a savings account and/or insurance, microloans are a way to smooth out income fluctuations and maintain consumption levels even during difficult times. Microfinance, therefore, acts as a safety cushion for emergencies, seasonal slumps or natural disasters such as a flood or an earthquake (Littlefield, Morduch, Hashemi 2003).

These hypotheses are supported by the following studies:

- According to MkNelly and Dunford (2001) two-thirds of CRECER clients, a Bolivian MFI, report that their income has increased after joining the program. Furthermore, Simonwitz (2002) reports that clients diversified their income sources and purchased food in larger quantities leading to a significant “consumption smoothing”. He also found that 86% of the clients were able to build or increase savings.

- MkNelly and Dunford (2001) conducted another study in Ghana finding that borrowers had augmented their incomes by 36 USD in relation to only 18 USD for non-clients. Substantially diversifying their income sources, 80% of clients had other sources of income while only 50% of non-clients had diversified.

- BRAC (1996) presented an elaborate impact assessment study in Bangladesh finding that members, who had been in the program for longer than four years were able to build up assets by 112% and increase their household expenses by 28%. Furthermore, Zaman (2000) analyzed household level data and demonstrates that the accessibility of financial services to BRAC clients makes them less vulnerable through smoothing consumption and building assets.

- A comprehensive study of the Grameen Bank found statistical evidence of economic improvement. Incomes generated by Grameen members were 43% greater than incomes by non-member villages and 28% higher than incomes achieved by non-members in Grameen villages. Moreover, in times of a crisis Grameen members were better able to rely on their own savings rather than having to borrow from a local moneylender (Hossain 1988).

## 4.2 Promoting children's education (MDG 2)

Increased access to financial services enables poor households to invest in the future of their children. One of the first things that poor people, especially females, do with additional income is to invest it in their children's education. Littlefield, Morduch and Hashemi (2003) argue that the chance for children of micro-entrepreneurs to go to school is higher and they also stay in school for longer. Moreover, student drop-out rates in those households are substantially lower. MFIs have recognized this priority and started to come up with new credit and savings products tailored to school expenses.

The following studies confirm a positive effect of microfinance on children's education:

- The World Bank conducted a study in 1998 finding that children of microcredit program participants generally had a higher level of schooling. This was especially true for children in Grameen households: 81% of Grameen boys were going to school compared to only 54% of non-Grameen families. Interestingly, almost all Grameen girls had some schooling while solely a significantly lower 60% in the comparison group received education (Khandker 1998).

- In 1997 school enrollment for kids of working-class families aged 11-17 years in Ahmedabad was 65% for boys and 55% for girls. Chen and Snodgrass (2001) found in their study about the impact of SEWA Bank in India that borrowing created positive effects on secondary-school enrollment rates of boys, which substantially increased to 70% in 1999. Nevertheless, no evident relationship between SEWA participation and the girls' secondary-school enrollment rates could be proven.

- Another interesting study about the positive effects of microfinance on children's education was undertaken by Marcus, Porter and Harper in 1999. They found that participating in a credit and savings program in Honduras remarkably increased their member's earnings and available resources. This helped them to provide their children with education and additionally decreased student drop-out rates.

- A comprehensive study in a BRAC area in Bangladesh demonstrated that basic literacy skills of children aged 11-14 years in BRAC households had augmented from 12% in 1992 to 24% in 1995. This means the number of kids being able to read and write has doubled within three years after the start of the program. Interestingly, only 14% of non-member children were able to pass the literacy test in 1995 (Chowdhury, Bhuiya 2001).

## 4.3 Promote gender equality and empower women (MDG 3)

Most microfinance programs worldwide generally target women as primary clients. As mentioned in chapter 3.5.3 of this paper, women have proven to be more financially responsible than men translating into better repayment rates. Furthermore, whereas men often consume positive cash-flows of their microloans, female clients have found to be more likely to invest additional income in the well-being of their families and their households (Littlefield, Morduch, Hashemi 2003). Having access to financial services helps women to become more confident, more assertive and better able to participate in family and community decisions.

Financially independent women are also in a better position to confront gender inequalities. Microfinance, therefore, helps women building up assets, playing a more active role in society and increasing investment in their families.

Several studies confirm the positive effects described above:

- MkNelly and Dunford (2001) demonstrate in their study that participating in a microfinance program in Bolivia and Ghana led to greater self-confidence of women and a better status within society. Women in Ghana took more active actions in community ceremonies, while women in Bolivia were even involved in the local governments.

- Hashemi, Schuler and Riley (1996) carried out a survey of 1300 female microfinance clients and non-clients in Bangladesh finding that clients were substantially more empowered than non-clients based on physical mobility, ownership and control of productive assets. Interestingly, the study further showed that domestic violence increased among microfinance members in the short term. After some time, though, men became more accepting of the new situation and thus violence eventually decreased again.

- Projects assisted by the GTZ in Niger and Côte d'Ivoire showed that women gained greater financial autonomy by taking up business activities which, as a result, is reflected in their status in the family and in the local community (GTZ Experience 2005).

## 4.4 Children’s health, maternal health and diseases (MDGs 4, 5 & 6)

Illness is undoubtedly the most severe tragedy that can happen to a poor family. Death of a family member, inability to work when sick and health-care related expenses can entirely consume income and savings. Furthermore, it can urge families to sell assets or prevent microcredit clients from repaying their loans (Littlefield, Morduch, Hashemi 2003).

Microfinance households, in general, seem to have better nutrition, health outcomes and health practices relative to non-client households. Large and stable incomes have a tendency to improve nutrition, living conditions and preventive health care. Higher income, moreover, allows borrowers to treat health problems immediately before conditions get worse.

Additional to financial services, some MFIs offer health education, customarily in the form of short and simple preventive care messages on safe drinking water, immunization and pre/post-natal care (Littlefield, Morduch, Hashemi 2003). Other MFIs even offer specially tailored credit products for water, sanitation and housing.

The following studies indicate a positive relationship between health improvements and microfinance:

- CRECER offers basic health education to their clients in Bolivia. MkNelly and Dunford (2001) find in their impact study that borrowers had better breast-feeding techniques and were better able to give rehydration therapy to children with diarrhea.

- MkNelly and Dunford (2001) found the same to be true in Ghana. Microfinance clients’ one-year old children were significantly healthier in terms of weight and height than non-client children. Furthermore, a positive change in various health practices could be proven.

- A study of BRAC clients in Bangladesh conducted by Chowdhury and Bhuiya (2001) points out that, compared to the control group, a remarkably smaller number of clients suffered from critical malnutrition and even more meaningfully the degree of malnutrition decreased as the duration of membership extended.

- Another study of the impacts of microfinance on health care in Bangladesh indicated that the use of contraceptive measures was with 59% substantially higher for Grameen clients than with 43% for non-clients. Microfinance clients are consequently more aware of the use of such contraceptive measures largely due to regular meetings with other group members and a greater mobility that enables women to seek out those services (Schuler, Hashemi 1994).

## 4.5 Environmental sustainability (MDG 7)

The role of MFIs in sustainable environmental development is essential since many developing countries often lack awareness and management in this area. As a result, many MFIs started to integrate environmental concerns into their credit products (Setboonsarng, Parpiev 2008).

Unfortunately, there are no studies that particularly discuss the relationship between microfinance and improvements in safe drinking water and sanitation. Nevertheless, there is good evidence that additional income generated by the access to financial services leads to larger investments in housing, water and sanitation, which in turn contributes to better health outcomes. Moreover, there are many MFIs that offer products specifically designed to finance those investments (Littlefield, Morduch, Hashemi 2003). In India, for example, some MFIs provide credit to upgrade community infrastructure such as paved roads, drainage, tap water or toilets. Other institutions show a lot of effort to finance organic agriculture in developing countries. This places not only a positive note on environmental sustainability but also fosters global partnerships between consumers in developed countries and poor farmers in developing countries (Setboonsarng, Parpiev 2008).

## 4.6 Develop a global partnership for development (MDG 8)

Since the development of a certain trading and financial system is the prime target of the eighth MDG, the provision of financial services by MFIs to the poor can be considered as a MDG target itself. In fact, MFIs are the key players in the development of microenterprises that are run by the poor. These microenterprises enable poor people to produce and sell products in markets – very often export markets. As a result, it can be argued that microfinance contributes to global partnerships for development (Setboonsarng, Parpiev 2008).

## 4.7 Conclusion – Does it really help?

As demonstrated above, there is a direct link between microfinance and at least five of the MDGs. An effective microfinance product can also be a promising way to improvements in the remaining MDGs. It is clear, though, that no single intervention can eradicate poverty. Impoverished households need employment, education and health care to escape their devastating situations. Additionally, sometimes immediate income transfers are required. The accessibility of financial services to the poor is the most important and fundamental basis on which most of the other vital interventions depend. Furthermore, the interventions can only be sustained when poor families have increased incomes and are more flexible in the use of financial resources. As explained in this part of the paper, financial services are able to reduce poverty in multiple ways.

Extensive evidence shows that the impacts range from increased income, better nutrition, improved housing and lower child mortality to better access to education, empowerment of women and higher participation in social and political activities.

# 5 Case study: Kenya

## 5.1 Introduction

The following case study tries to inform the reader about the microfinance sector in the Republic of Kenya. The country, lying in East Africa on the equator, shares borders with Tanzania to the south, Uganda to the west, South Sudan to the north-west, Ethiopia to the north and Somalia to the north-east. Interestingly, Kenya is named after Mount Kenya, the second highest mountain peak in Africa. Its capital city, Nairobi, is a regional commercial hub. The Kenyan economy is the largest by GDP (about 71 billion in 2011) in East and Central Africa, being mainly driven by agriculture and services (International Monetary Fund 2012). Furthermore, Kenya has a relatively well-developed microfinance sector.

From a socio-cultural point of view, it is quite difficult to identify a single Kenyan culture as each tribe has its own rituals and traditions making Kenya a highly diverse country. It is the home of more than seven ethnic groups with the Kikuyu (22 %) and the Luhya (14 %) being the largest (Kenyainformationguide 2011). Most people are bilingual in English and Swahili in addition to the mother tongue of their tribe. One of the harshest social problems in Kenya is an extremely high HIV rate. Around 6.3 % of the population is already affected while HIV protection and treatment services are making only slow progress (Avert 2011).

This chapter is divided into two sections. The first part provides the reader with a quick overview of the political and economic situation in Kenya. The second part, then, focuses on an analysis of the microfinance sector including a description of the most important providers, products offered and the legal framework.

## 5.2 Political structure

Kenya became independent on 12 December 1963 after having been ruled by Britain for more than 70 years. Since then it has been a presidential representative democratic republic with the current president Mwai Kibaki being both the head of state and the head of government. While the executive and legislative power is executed by the government and the National Assembly respectively, the Judiciary is formally independent and carried out by judges. However, most institutions are subservient to the president, who also appoints high court and judges. According to experts, this extraordinary presidential power is a hangover of the colonial times and restricts democracy to a certain extent considering that the president is also responsible for the federal budget (Hanson 2008).

Furthermore, Kenya is a multi-party democracy with the Party of National Unity (PNU) and the Orange Democratic Movement (ODM) being the main two political players. The members of the parliament are elected by the citizens, which happened to take place in 2007 for the last time. Although President Mwai Kibaki of the PNU was re-elected the elections were seen to be flawed and below international standards which led to severe protests and civil riots. These protests escalated resulting in death of around 1,000 people and displacement of approximately 600,000. It remains unclear what the 2013 elections will bring, but according to Calestous Juma, a Kenyan professor at Harvard University, the political environment in Kenya cannot be seen as stable and its institutions as independent (BBC News 2007, Hanson 2008).

Moreover, corruption is a serious matter of concern in Kenya destroying trust in political institutions. In fact, Kenya ranks 154 out of 180 countries on Transparency International's Corruption Perceptions Index 2010, only slightly before countries like Sudan and Somalia, which just emerged from civil war and far behind neighboring countries like Uganda and Ethiopia

(Transparency International 2010). Although the government has made serious effort to battle corruption the situation is not likely to improve in the short-run (Euromonitor International 2011).

Another interesting index showing the ease of doing business in 183 countries ranks Kenya 98. This index therefore shows us that running a business in Kenya is relatively easy compared to most African countries including Eritrea (rank 180) and Sudan (rank 154). Especially the ease of getting funds is assessed beneficially in Kenya (The World Bank 2010).

| | |
|---|---|
| Official name: | Republic of Kenya |
| Form of state: | Unitary republic |
| Legal system: | Based on English common law and the 1963 constitution |
| National elections: | December 2007; next presidential and legislative elections are to be held in March 2013. |
| Head of state: | President, directly elected by simple majority and at least 25% of the vote in five of Kenya's eight provinces |
| Main political parties: | Orange Democratic Movement (ODM), Party of National Unity (PNU) |
| President: | Emilio Mwai Kibaki (PNU) |
| Prime minister: | Raila Odinga (ODM) |

Figure 3: Political structure of Kenya. Source: Economist Intelligence Unit (2012).

## 5.3 Economic overview

This chapter of the report analyses Kenya's economic environment focusing on key economic indicators such as GDP per capita, Foreign Direct Investment (FDI) and inflation rates.

Kenya's GDP per capita steadily increased over the past ten years by an average growth rate of 3.72% to an absolute value of USD 1,784.04 in 2010 (International Monetary Fund 2012). Admittedly, this sound economic growth may not seem impressive compared to neighboring countries like Sudan (average GDP growth rate of 7.24%) or Ethiopia (8.55%), but fluctuations in Kenya's GDP growth rate are relatively small and the absolute value of GDP exceeds its reference values hence a stronger real growth is implied (see figure 4).

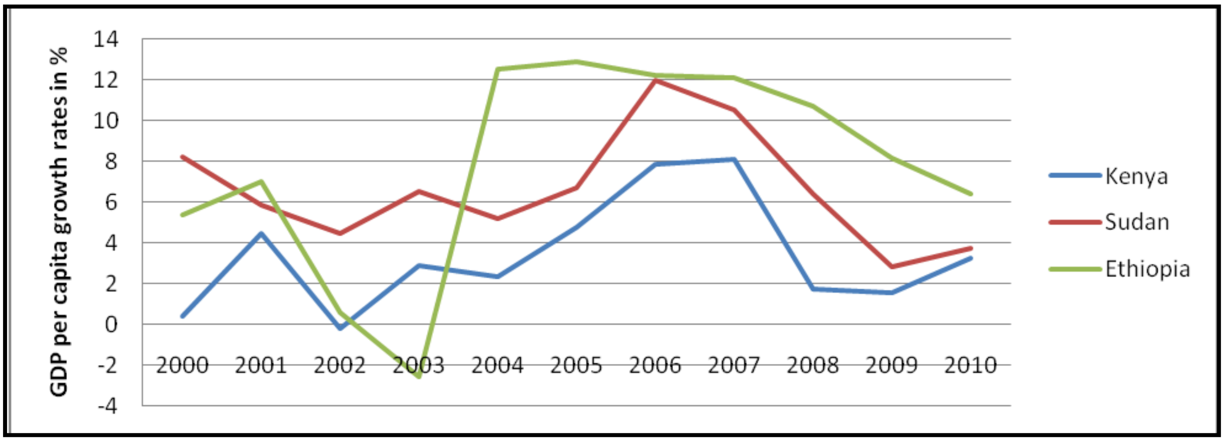


Figure 4: GDP per capita growth rates. Source: International Monetary Fund (2012).

As far as FDI is concerned Kenya miscarried to attract satisfactory amounts of international funds in the past years. Tanzania, for example, has a much smaller economy but is able to lure higher levels of FDI each year. Nevertheless, Kenya's capital inflow was increasing from 0.3 % of total GDP in 2008 to 0.5 % of total GDP in 2009, which constitutes a vital raise in funding for the economy, especially for small sized enterprises. FDI as a macro-economic indicator is particularly important, as it shows the general confidence in a nation's economy and is based on various evaluations of individual investors (Euromonitor International 2012).

Kenya recorded an inflation rate of 4.105% in 2010 (see figure 5), which is significantly lower than the inflation rate of comparable countries like Sudan (10% inflation in 2010) or Uganda, with an inflation rate of 9.4% in 2010 (International Monetary Fund 2012). Kenya's inflation rate is expected to increase slightly to a range of 5.5% to 6% from 2012 to 2015 (The Economist Intelligence Unit 2012). In fact, such a low and stable rise in consumer prices is favorable for the economy as it reduces uncertainty and encourages investments in non-monetary assets. As a result, the Central Bank of Kenya increased the benchmark interest rate from 5.75% to 6% in 2011 (Trading Economics 2012).

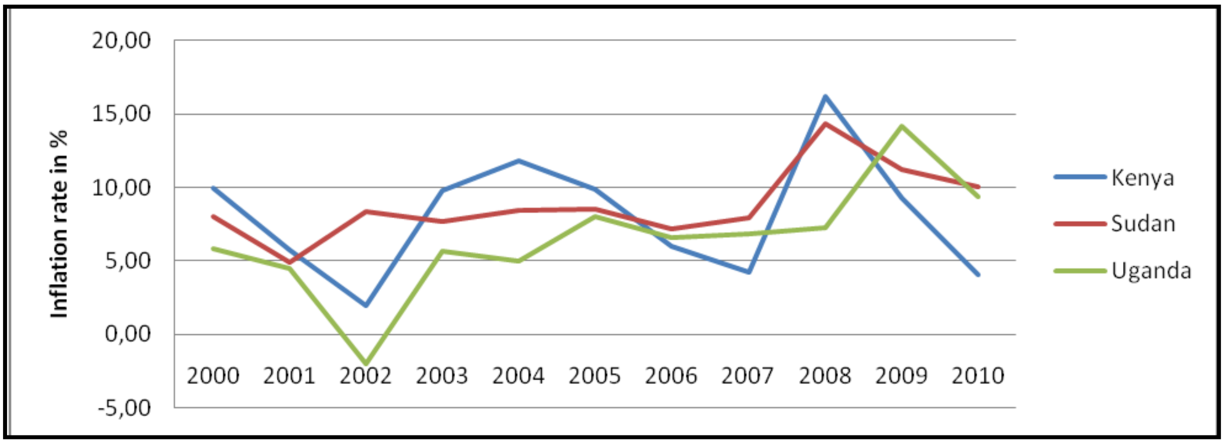


Figure 5: Inflation rates. Source: International Monetary Fund (2012).

## 5.4 Microfinance in Kenya

The potential of microfinance for poverty reduction in Kenya is undoubtedly existent. About 18 million people, in other words 60% of the population, are considered as poor and by that mostly uninteresting for the formal banking sector. In the past, MFIs established either as an NGO or a savings and credit co-operative society stepped in to fill this gap and provided a large number of low-income households in the rural and urban areas of Kenya with credit (Omino 2005). These institutions, however, have largely operated without an adequate policy and legal framework. The Government of Kenya, consequently, recognized the MFIs' importance for poverty alleviation and developed a legal and regulatory framework to promote a sustainable system of microfinance which will be further discussed in the upcoming chapter. Firstly, nevertheless, this part of the paper will have a closer look at the various types of organizations that compose the Kenyan microfinance sector. Secondly, I want to address the variety of products offered and eventually the previously mentioned legal and regulatory framework shall be discussed.

### 5.4.1 Microfinance institutions/organizations in Kenya

The relatively well-prospered microfinance sector in Kenya consists of various institutions/organizations that can be categorized into three "sub-systems" (Dondo 1999):

(1) The informal system

(2) The formal, subsidized system

(3) The formal, non-subsidized system

A brief examination of the three sub-systems according to Dondo (1999) follows.

#### 5.4.1.1 The informal system

By the informal financial sub-system we understand economically active people that rely on traditional and informal financial systems due to a lack of access to the formal financial system. There are three distinct informal sub-systems that are generally unregulated, membership-based, not subsidized and often involve savings transactions.

##### *5.4.1.1.1 Financial arrangements among relatives, neighbors and friends*

These traditional financial arrangements between relatives, neighbors and friends make up an essential source of capital for many micro-entrepreneurs in urban areas and small farmers in the more rural areas of Kenya. According to Dondo (1999) the contribution of this type of informal sub-system to all informal loans is up to 40%. It is vital to point out that these financial arrangements are deeply rooted in the culture of many Kenyan ethnic groups and constitute a social obligation in many closely linked communities.

Furthermore, the geographical proximity between borrower and lender ensures higher repayment rates and facilitates a potential extension of the credit by building on a more personal financial basis. Additionally, most of these loans do not need collateral, charge low interest rates and tend to be open-ended (Omino 2005).

##### *5.4.1.1.2 Traditional money lenders*

Traditional money lenders exist in both the rural and urban parts of Kenya, even though they are not as popular as in other parts of West Africa. These commercially oriented money lenders, often landlords or large-scale farmers, are frequently accused of charging excessively high interest rates (Dondo 1999).

##### *5.4.1.1.3 Rotating Savings and Credit Associations (ROSCAs) and Accumulating Savings and Credit Associations (ASCAs)*

Thousands of ROSCAs and ASCAs can be found in rural and urban Kenya supplying millions of poor households with credit. According to Dondo (1999) these associations are either registered social welfare groups or unregistered groups of friends and family members typically comprising 5 to 60 members. Their main function is the provision of credit to those who would be ineligible to borrow from formal sources but ROSCAs and ASCAs also mobilize savings, serve a social function and offer insurance. As they spring from local initiative, a feeling of ownership and loyalty among the members is created that often allows the associations to charge higher interest rates (Central Bank of Kenya 2008).

#### 5.4.1.2 The formal, subsidized system

The formal, subsidized financial sub-system includes organizations and institutions that offer micro-financial services to low-income households and receive subsidies in some forms. The main actors in this sub-system are Microfinance NGOs and Government Agencies.

##### *5.4.1.2.1 Microfinance NGOs*

In the past 20 years a great number of NGOs were founded in Kenya to promote microfinance development. These NGOs, ranging from small charitable organizations to large international units, depend on donors to meet their operational costs. Even though they are formal institutions, their financial operations are usually unregulated. The most important concern to NGOs solely focusing on providing financial services to the poor is certainly sustainability. As nearly all of them are donor-based, supported or sponsored, their schemes only last as long as the donor is willing and in a position to support them (Dondo 1999).

##### *5.4.1.2.2 Government Agencies*

The first government-sponsored financial support programs for micro-businesses were founded even before Kenya became independent and were designed to include African entrepreneurs in the economy from which they were antecedently excluded. Many of these programs remain until today even though they changed in form and substance. Industrial and Commercial Development Corporation (ICDC), Kenya Industrial Estates and Kenya Tourist Development Corporation (KTDC) are three well-known examples, to name but a few (Dondo 1999).

#### 5.4.1.3 The formal, non-subsidized system

The banking and formal financial sector in Kenya is comparatively well-developed. It comprises of the Central Bank of Kenya, 47 Commercial Banks and 16 Non-Bank Financial Institutions. Furthermore, 2 Mortgage Finance Companies, 4 Building Societies, 8 Development Financial Institutions, a Post Office Savings Bank, around 4,500 Savings and Credit Co-operative Societies (SACCOs) and 38 Insurance Companies can be named as part of the sector. Nevertheless, most of the numerous institutions do not provide microfinance services (Central Bank of Kenya 2008).

##### *5.4.1.3.1 Savings and credit co-operative societies (SACCOs)*

The Kenyan SACCOs movement is the largest in Africa and plays an essential role in the provision of financial services to their members. SACCOs are registered, regulated and supervised under the Co-operative Societies Act of 1997 (Central Bank of Kenya 2008). Society members typically qualify for borrowing an amount equivalent to twice or thrice their own savings if other members guarantee for them.

According to the Central Bank of Kenya (2008) the number of SACCOs was 5350 in 2008, which constitutes a 4.5% increase compared to the previous year. Astonishingly, their total outstanding loan portfolio even increased by remarkable 8.6% during the same period. This rapid expansion indicates that SACCOs are filling a gap that no other financial institution has been able to close yet.

### 5.4.2 Number and types of microfinance providers

The exact number of institutions/organizations providing microfinance services in Kenya is not known. However, figure 6 below presents an estimate of the various types of microfinance providers operating in the country (Dondo 1999).

| Formal MFIs | Number |
|---|---|
| Commercial Banks | 3 |
| Microfinance NGOs | 56 |
| Societies | 1 |
| Companies Limited by Shares | 12 |
| Companies Limited by Guarantee | 7 |
| SACCOs (by December, 2004) | 4,500 |
| Wholesale Lending Institutions | 4 |
| Joint Loan Board Schemes | More than 20 |
| Post Office Savings Bank | 1 |
| Parastatals | 2 |
| | |
| **Informal MFIs** | **Number** |
| ROSCAs and ASCAs | More than 30,000 |
| Moneylenders | More than 1,000 |
| Unregistered Family/Neighbour/Friends Groups | Various |

Figure 6: Distribution of MFIs by type of organization. Source: Dondo (1999).

### 5.4.3 Products and services offered

As mentioned above, the demand for microfinance services in Kenya is substantial since there is an ever-growing number of poor people who do not qualify for regular loans by the formal banking system. For years, MFIs have stepped in trying to fill this financial gap by giving out credit mainly based on the Grameen group-lending model. Nonetheless, due to regulatory restrictions most MFIs developed as credit-led programs which limited their capability of collecting deposits to increase sustainability (Omino 2005). Even though some of the leading institutions, including Equity Bank, K-Rep Bank and Cooperative Bank, have introduced new credit and savings products, only little has been done to develop micro-insurance, micro-leasing and micro-pensions products. Furthermore, many rural areas are still substantially underserved with microfinance products. Altogether, the Kenyan microfinance sector is characterized by insufficient innovations with inadequate delivery methodologies (Dondo 1999).

It is due to these shortcomings that MFIs in Kenya are unable to meet the high demand for financial services by the poor. Dondo (1999) presented a survey revealing that only 10.4% of micro-entrepreneurs in Kenya have received financial support from any source. Moreover, it seems to be clear that entrepreneurs do not only need credit but also require other financial services.

### 5.4.4 Interest rates

The annualized interest rates charged by MFIs in Kenya for their tiny loans range from 23% to 30% with the majority charging 26% (Herman 2012). According to the experts at Standard Digital (2012) most Kenyan MFIs charge monthly interest rates between 1.8% and 2.5% which translates to 21.6% to 30% per year. In comparison, most commercial banks charge slightly lower annualized interest rates ranging from 21% to 24% (Standard Digital 2012).

### 5.4.5 Regulation for the sector

Generally speaking, in Kenya, like in most other countries with significant microfinance sectors, approaches to regulation are difficult because many different types of organizations with diverse legal forms are involved (see section 5.4.1). The challenge is to develop an appropriate regulatory framework that gives MFIs the necessary flexibility for their activities but is also conducive to a sustainable and safe sector.

In the past MFIs in Kenya operated without an adequate policy and legal framework, which made it difficult for them to effectively provide credit, savings and other financial services to the poor. The Government of Kenya, however, reacted and developed an appropriate policy, legal and regulatory framework that was designed to promote a sustainable system of microfinance in the country. The so-called “Deposit Taking Micro Finance Bill” was created with the help of microfinance stakeholders in order to include their views on the best way to regulate the sector. The bill, in essence, ensures that licensed MFIs contribute to poverty eradication and comply with the requirements of a sound microfinance sector at the same time. Additionally, microfinance units have been installed in the Ministry of Finance and the Central Bank of Kenya to formulate policies and procedures to better face the various challenges of MFIs in the future. Moreover, the units gathered information about the sector and built a database to facilitate regulation and monitoring the MFIs’ operations (Omino 2005).

# Conclusion

I want to conclude my thesis with a quote from Theodore Schultz, an American economist who was awarded the Nobel Prize in Economics in 1979 for his work in the field of development. The quote is short and simple but it perfectly describes the essence of development economics. He stated at his acceptance speech: “Most of the people in the world are poor, so if we knew the economics of being poor, we would know much of the economics that really matters” (Hemmer, Wilhelm 2000, p. 149). The purpose of the first part of this paper was to show how microfinance, a new phenomenon in the development community, can be a promising and reasonable answer to the question raised by Schultz in 1979. As a start, I described in section 3.1 how Muhammad Yunus borne the idea in the small village of Jobra in Bangladesh in the early 1970s and how he founded the iconic Grameen bank to carry on with his vision. In section 3.5, then, I illustrated how microfinance works from a theoretical perspective and determined several key characteristics. The striking features of group lending, focus on poor clients, focus on women and the use of market-level interest rates have been discussed in more detail.

Furthermore, I illustrated in chapter 4 of the paper why microfinance truly deserves its reputation as a poverty-reduction vehicle. For this purpose, I made use of the eight MDGs as frequently discussed indicators for international development in their respective areas. As concluded in section 4.7, there is a direct link between microfinance and at least five of the MDGs. The accessibility of financial services to the underprivileged is a fundamental basis for all other vital interventions that are necessary to escape from poverty. The extensive evidence presented in chapter 4 clearly demonstrates that the impacts of microfinance range from increased income, better nutrition and improved housing to better access to education, empowerment of women and an improved status in society.

As mention in the introductory section, this paper was compiled with a dual objective. As a result, chapter five of this paper analyzed the Kenyan microfinance sector in the form of a case study. After having provided the reader with information about the political structure and the economic performance of the country, I comprehensively described the composition of the microfinance sector including the different types of organizations and institutions that play major roles in lending. Moreover, the paper looks at the products offered and interest rates charged by those MFIs. At last, I pictured the legal and regulatory environment of the sector. In conclusion, it can be said that Kenya has a relatively well-developed microfinance sector, but with deficits in innovative products and adequate delivery methods.

At last, I want to express my personal belief that microfinance, despite ongoing criticism, is a vital weapon in the fight against international poverty. It is clear that not every program, depending on its goal, management and method, is a shiny example of "good" microfinance with positive social impacts, but generally speaking, the tiny financial products have a huge potential to change the world for the better.

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