

INFLUENCE OF INTEREST RATE ON FINANCIAL PERFORMANCE OF MFIS IN IMENTI NORTH SUB COUNTY, KENYA

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Abstract

Microfinance is a financial institution that is involved in provision of small scale financial services to low income people. Thus microfinance institutions (MFIs) enhance the ability of the low income people to be involved in sustainable economic activities that help to alleviate and improve the social welfare of the poor. In order to attain their goals, MFIs need to be sustainable. To some extent sustainability of these firms is dependent on their financial performance. The null hypothesis was that Interest rates do not exert significant influence on financial performance of MFIs. Given the sensitivity of financial issues to some organizations, the some respondents concealed some of the much needed information. The researcher however assured the respondents of the confidentiality of the information provided. This study adopted a descriptive research design. The location of the study was Imenti North Sub-County, Kenya. The target population was 42 respondents which included all the branch managers, operational managers and credit managers of the 14 microfinance institutions operating in Imenti North Sub-County. All the 42 targeted respondents were included in the study. This study utilized both primary and secondary data. Both descriptive and inferential methods were used in data analysis. Descriptive methods included measures of central tendency measures of dispersion. Inferential statistics included measures of relations and associations, correlation and

regression. It was concluded that interest rates charged by MFIs significantly influence their financial performance. This conclusion is based on the finding that there is a positive correlation between the interest rate charged by MFI and liquidity. This implies that an increase in interest rates results in an increase in liquidity for the MFIs. MFIs should charge interest rates that are in the range of commercial banks to increase loan uptake. This will ensure maximization of liquidity. This recommendation is based on the finding that an increase in interest rate results in an increase in financial performance of a firm in terms of liquidity.

Keywords: Influence, Interest Rate, Financial Performance, MFIS, Kenya

INTRODUCTION

Microfinance is a financial institution that is involved in provision of small scale financial services to low income people (Platteau & Hedwig, 2009). Microfinance entails the provision of credit, savings and other basic micro-financial services to the low income clients who do not have access to credit from formal financial sector (Robinson, 2001). Thus microfinance institutions (MFIs) enhance the ability of the low income people to be involved in sustainable economic activities that help to alleviate and improve the social welfare of the poor (Adjasi & Coleman, 2006). Kimando, Kihoro and Njogu (2012) also supported this view by arguing that the provision of microfinance services is an important component of any effort to improve the livelihoods of the low income people in any society. In order to attain their goals, MFIs need to be sustainable (Bogan, 2011). To some extent sustainability of these firms is dependent on their financial performance (Gaspar, 2013). This assertion is complemented by Karlsson (2015) who reported a positive relationship between corporate sustainability and financial performance. According to Kaplan Financial (2012) financial performance is very important in attaining the primary goals of any organization. Financial performance is a measure of how well a firm can use its assets to generate revenues (Kaplan Financial, 2012). The main goal of a profit seeking organization is the maximization of shareholder wealth since shareholders are the legal owners of a firm and hence their interests need to be prioritized. Although MFIs were originally conceived as non-profit firms, this has increasingly changed towards commercialization.

Currently Kenya government is developing more strategies in an effort to encourage the financial performance of the microfinance industry (Warue, 2012). Maina (2011) argues that there has been extensive research carried out on the outreach of rural credit lending and the subsidized loan lending by non-governmental agencies in Kenya. As Kimando, et al (2012) points out microfinance has become an important tool for poverty reduction in many parts of the

world. This is because (MFIs) target the poor through innovative approaches which include group lending, progressive lending, regular repayment schedules, and collateral substitutes. Kimando, et al (2012) argues that a microfinance institution is said to have reached sustainability when the operating income from the loan is sufficient to cover all the operating costs. Thus, to be sustainable, the firm needs to be financially stable. However, there is little understanding of the factors influencing the financial performance of MFIs.

Statement of the Problem

MFIs have for long been known to provide financial services to people who are not able to access such services from established financial service providers like banks (Warue, 2012). Moreover, MFIs are predominantly viewed as instruments of social change that entail poverty eradication and provision of social amenities to the low income earners. However, the instability experienced in financial sector may impede the ability of MFIs to serve the low income persons' financial needs. In the last one year, three financial banks (Imperial Bank, Dubai Bank and Chase Bank) have been placed under receivership in Kenya. Consequently, there is an emerging trend where deposits are being shuttled from smaller banks and deposit taking MFIs to the larger banks (Bloomberg Intelligence report, 2016). Central Bank of Kenya has since launched an emergency kitty for MFIs and commercial banks which come under liquidity pressure arising from no fault of their own. This implies that only MFIs and banks that have a healthy financial performance are likely to benefit from such interventions.

Guntz (2011) argues that the need for sustainability and profitability has pushed MFIs towards commercialization. However, Daley-Harris (2009) and Mersland and Strøm (2010) pointed out that most MFIs are small, reach only a few thousand clients and are still costly to operate and risk drifting toward better-off clients. This implies that the impact of outreach on financial performances of MFIs is still unclear. Thus, a systematic study like the current one needs to be undertaken. Moreover, there seems to be inconsistencies on the influence of interest rates on financial performance of MFIs. For instance, whereas a study by Small Industries Development Bank of India (2011) reported that the high interest rates charged by MFIs aim at recovering the cost of the loans, Mwangi (2014) and Miriti (2014) reported a strong positive relationship between interest rates and financial performance. It should however be pointed out that Mwangi (2014) concentrated on deposit taking MFIs while Miriti study examined SACCOs whose operations differs from MFIs. Thus, there is still need to establish the influence of interest rates on financial performance of MFIs. On the influence of subsidies on financial performance, Hudon and Traca (2011) indicated that the influence is only positive to a certain extent especially in fulfilling the social aspect of MFIs in the eradication of poverty. Other studies

by authors such as Park, Ren, & Wang (2003); Levine (2005); Armendáriz & Morduch (2010); Banerjee and Duflo (2011) and Leikem (2012) have however raised controversies on the role of subsidies on performance of firms. Thus, there is need to evaluate financial performance of MFIs in relation to subsidies. Extant literatures on the influence of interest rates have given inconclusive results. The purpose of this study is therefore describe the relationship between the interest rates and financial performance of MFIs

Objective of the Study

To explore the influence of interest rate on financial performance of MFIs.

Research Hypothesis

The null hypothesis was that Interest rates do not exert significant influence on financial performance of MFIs.

Limitation and Delimitation of the study

Given the sensitivity of financial issues to some organizations, the some respondents concealed some of the much needed information. The researcher however assured the respondents of the confidentiality of the information provided. Some respondents might overrate some information especially about their outreach. The researcher used varied types of respondents to overcome this. The study was delimited to MFIs in Imenti North Sub-County. Other financial institutions other than microfinance were not studied in this study. The study was also delimited to MFIs employees and clients. The study was also delimited to evaluating the influence of outreach, interest rate and subsidies on financial performance of MFIs in Imenti North Sub-County.

LITERATURE REVIEW

Micro-credit theory

This study was guided by micro credit theory. The psychological component of the micro credit theory has been advanced by Yunus (1998). The theory argues that a species of profit-making private venture that cares about the welfare of its customers can be conceived. Although altruism is not totally absent, Capitalism is founded mainly on the premise that human beings are selfish by nature. Accordingly, individuals interested in businesses are naturally motivated by the principle of profit-maximization, with little consideration for the interests of their clients. This premise is too limited to be a general model for capitalism, however, because it excludes individuals who are concerned about the welfare of their fellow human beings. A more generalized principle would assume that an entrepreneur maximizes a bundle consisting of

financial return or profit and social return. This assumption creates three groups of entrepreneurs (Elahi & Danopoulos 2004). The first group consists of traditional capitalists who mainly maximize financial returns or profits. The second group consists of philanthropic organizations and public credit agencies that mainly maximize social returns. The third group consists of entrepreneurs who combine both rates in making their investment decisions under the additional constraint that financial return cannot be negative. This group includes the microfinance enterprisers who are to be treated as socially concerned people, and microfinance, which is to be treated as a social consciousness driven capitalistic enterprise. This theory is appropriate in this study since MFIs which are mainly interested in maximization of profits will strive to charge higher interest rates. This may result in optimal financial performance of such firms. On the other hand, MFIs interested in the maximization of social returns may seek to reach as many people as possible, charge lower interest rates in order to serve as many as possible number of low income individuals. This will result in sustainability of such firms with low or average financial performance. Finally, MFIs with entrepreneurs who combine both rates in making their investment decisions may seek to reach substantial number of individuals, charge average interest rates. This may result in maximization of both social and financial performance of the firms.

Empirical Literature

The Influence of Interest Rate on Financial Performance of MFIs

Bella (2011) carried out a study on the impact of the global financial crisis on microfinance and policy implications. The study established that the global financial crisis affected MFIs as lending growth was constrained by fewer borrowing opportunities, while the economic slowdown negatively impacted asset quality and profitability. Bella (2011) also reported that the crisis brought to the fore the relatively high interest rates that MFIs charge to their (low-income) customers. The study established that MFI performance is correlated not only to domestic economic conditions but also to changes in international capital markets. Bella (2011) also presented an empirical analysis of lending rates with the purpose of informing policy decisions, and found that loan sizes, productivity, and MFI age contribute to differences in lending rate levels.

According to Donor Brief 18 (2004) many countries have established interest rate ceilings to protect consumers from unscrupulous lenders. Governments often also face political or cultural pressure to keep interest rates low. The Donor Brief 18 (2004) also argues that despite good intentions, interest rate ceilings generally hurt the poor by making it hard for new MFIs to emerge and existing ones to stay in business. In countries with interest rate caps, MFIs

often withdraw from the market, grow more slowly, become less transparent about total loan costs, and/or reduce their work in rural and other costly markets. By forcing pro-poor financial institutions out of business, interest rate caps often drive clients back to the expensive informal market where they have no or little protection. Thus, it is most likely that the interest rates charged by MFIs may determine their financial performance.

Mwangi (2014) investigated the effect of lending interest rates on financial performance of deposit taking MFIs in Kenya. Mwangi established that there is a strong relationship between lending interest rates and financial performance of deposit taking MFIs. The study also indicated that Kenya had witnessed an increase in the number of MFIs in the five years preceding the study. Mwangi (2014) indicated that these MFIs are mainly established to target the poor by providing cheaper credit. However, the study indicated that the high interest rates charged by MFIs often hinder most of poor people from accessing the much needed credit.

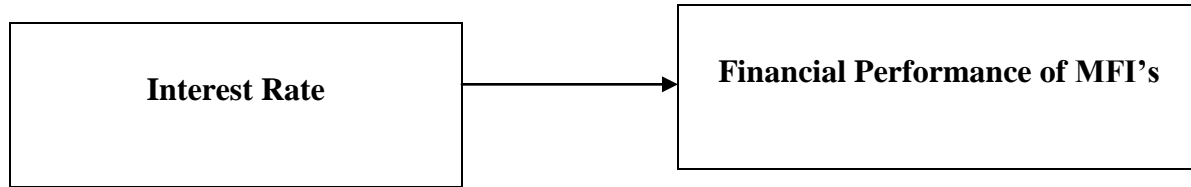
Cotler and Almazan (2013) sought to find out the determinants of lending interest rates in the microfinance sector. The study used data from 1299 MFIs in 84 countries and established that different approaches are used to determine lending interest rates in MFIs. The determinants included funding cost, the loan size, and the efficiency level of MFIs. With respect to competition, results are mixed. Cotler and Almazan (2013) reported that only in Asia is a negative correlation between competition and lending interest rates detected. For other subsamples, it was found that the competition is more likely to be negatively correlated with the size of loans. Based on these findings, it is possible that lending interest rates might determine the growth of MFI.

Ridder (2010) sought to establish whether the interest rates charged by MFIs are excessive and too high for the poor. The study established that MFIs are forced to charge high rates due to high operational costs than commercial banks. However, Ridder (2010) argues that the high interest rates are contrary to the core function of reducing poverty since many are unable to access such loans. It is therefore, apparent that high interest rates might not be a true reflection of profitability since this caters for the high costs incurred. Thus, the current study seeks to provide empirical data on whether there is a relation between the interest charged and the performance of the MFIs.

Chikalipah (2014) investigated the determinants of microfinance lending interest rates in sub-Saharan Africa. The study used unbalanced panel data comprising of 292 MFIs drawn from 34 Sub-Saharan African (SSA) countries and covered a period of 2003 to 2011. The study affirmed that the finance costs, operating expenses, return on assets and inflation largely drive microfinance lending interest rates in SSA. The results here do not clearly indicate whether the

lending rates charged determine the performance of an MFI. Thus, there is need to carry out an empirical study to establish the effect of interest rates on the financial performance of MFIs.

Figure 1. Conceptual framework



RESEARCH METHODOLOGY

This study adopted a descriptive research design. According to Donald and Pamela (1998), a descriptive study is concerned with finding out the 'what' and 'where' of a phenomenon and is used to develop a snapshot of a particular phenomenon of interest since they usually involve large samples.

The location of the study was Imenti North Sub-County, Kenya. The choice of Meru Town as a location of the study was based on the fact that the town has several branches of most of MFIs found in Kenya (County Government of Meru, 2014; Association of MFIs in Kenya, 2013). This provided a good representation for studying factors contributing to the financial performance of MFIs.

The target population was 42 respondents which included all the branch managers, operational managers and credit managers of the 14 microfinance institutions operating in Imenti North Sub-County as shown in Table 1. The management was targeted because they are in a better position to tell the indicators of financial performance.

Table 1. Target Population

Respondent	Total
Branch managers	14
Operational managers	14
Credit managers	14
Total	42

The study used a census technique because the target population was less than 100. Thus, all the 42 targeted respondents were included in the study. This study utilized both primary and secondary data. Collection of primary data employed structured questionnaires as research

instrument. Questionnaires are useful instrument of collecting the primary data since the respondents can read and then give responses to each item and they can reach a large number of subjects (Orodho, 2004). Secondary data is the data that have been already collected and recorded by someone else and readily available from other sources (Koziol & Arthur, 2011). Secondary data was collected from MFIs financial reports and Association Institutions in Kenya. Thus, secondary data in this study provided descriptive information to support primary data collected.

Both descriptive and inferential methods were used in data analysis. Descriptive methods included measures of central tendency (mean), measures of dispersion (standard deviation). Inferential statistics included measures of relations and associations, correlation and regression.

A Multiple regression model was used in this study. According to Mogull and Robert (2004), a multiple regression allows simultaneous investigation of the effect of two or more variables. The model was employed so as to establish the relationship between the financial performance of the MFIs and interest rates.

RESULTS AND DISCUSSION

Interest rate and financial performance of MFIs

The objective of the study sought to establish the influence of interest rate on financial performance of MFIs.

Loans offered

The respondents were first requested to state the different loans offered by their firms. It was established that various group and individual loan products are offered by MFIs. Key among these loan products included agricultural loans, consumer loans, school fees loans, SME corporate loans, business loans, church loans, emergency loans and asset finance loans. It was also established that individual loan products range from Kshs. 50,000 to Kshs 5,000,000.

Interest rates charged

The respondents were also requested to state the interest rates charged for each of these loan products. It was established that interest rates for different products in an MFI were similar although they varied from one MFI to another. The results were summarized in Table 2.

Table 1: Interest rates charged by MFIs

Interest rate per annum	2015		2014		2013		2012		2011	
	F	%	F	%	F	%	F	%	F	%
18.0	0	-	0	-	9	22.5	9	22.5	0	-
20.0	15	37.5	0	-	9	22.5	9	22.5	8	20.0
22.0	9	22.5	0	-	6	15.0	6	15.0	9	22.5
24.0	8	20.0	32	80.0	8	20.0	8	20.0	9	22.5
28.0	8	20.0	8	20.0	8	20.0	8	20.0	6	15.0
30.0	0	-	0	-	0	-	0	-	8	20.0

The results indicated that in the year 2015, interest rates for loans in MFIs ranged from 20.0 to 28.0 percent. However, majority (37.5%) of the MFIs charged an interest rate of 20.0 percent per annum. The results also indicated that 22.5 percent of MFI charged an interest rate of 22.0 percent while 20 percent of them charged an interest rate of 24.0 percent. In the year 2014, the interest rate charged by the MFIs ranged from 24.0 percent to 28.0 percent. However, most (80%) of the MFIs charged an interest rate of 24.0 percent while the remaining charged an interest rate of 28.0 percent. In the year 2013 and 2012, the interest rates charged by MFIs ranged from 18.0 percent to 28.0 percent. The interest rates for the two years were constant in the MFIs. In the year 2011, the interest rates charged by MFIs ranged from 20.0 percent to 30 percent. It is clear from the table that the highest interest rate charged by some MFIs was 30 percent in the year 2011 and the lowest interest rate charged by some MFI was 18.0 percent in the year 2012 and 2013.

Factors considered in setting of Interest Rates

The study also requested the respondents to indicate their level of agreement with various statements related to setting of interest rates. The results were summarized in Table 3.

Table 2: Factors considered in setting of Interest Rates in MFIs

Statement	SA		A		U		D		SA	
	F	%	F	%	F	%	F	%	F	%
Funding costs are taken into consideration when setting the interest rates	23	57.5	17	42.5						
Loan size is taken into consideration when setting the interest rates	14	35.0	9	22.5			17	42.5		

Efficiency of loan processing is taken into consideration when setting the interest rates	8	20.0			32	80.0
Rates by competing microfinance institutions are taken into consideration when setting the interest rates	31	77.5	9	22.5		
Finance costs are taken into consideration when setting the interest rates	25	62.5	9	22.5	6	15.0
Return on asset is taken into consideration when setting the interest rates			34	85.0	6	15.0
Inflation is taken into consideration when setting the interest rates	22	55.0	18	45.0		

The results indicated majority (57.5%) of the respondents strongly agreed while 42.5 percent of them agreed that funding costs are taken into consideration when setting the interest rates. This implies that funding costs of loans are important when MFI is setting interest rates. The study however, indicated that 42.5 percent of the respondents disagreed that loan size is taken into consideration when setting the interest rates. Nonetheless, 35 percent of the respondents strongly agreed and 22.5 percent of them agreed that loan size is taken into consideration when setting the interest rates. This implies that even though most MFIs take into consideration loan size when setting interest rates, a substantial number of them do not. The results further indicated that most (80%) of the respondents disagreed that efficiency of loan processing is taken into consideration when setting the interest rates. This implies that very few MFIs consider efficiency of loan processing when setting interest rates. The results also showed that most (77.5%) of the respondents strongly agreed and 22.5 percent of them agreed that rates by competing microfinance institutions are taken into consideration when setting the interest rates. This implies that all MFIs take into consideration the rates charged by other firms when setting their interest rates. The results also indicated that 62.5 percent of the respondents strongly agreed and 22.5 percent of them agreed that finance costs are taken into consideration when setting the interest rates. This implies that most MFIs consider prevailing market lending rates especially those set by Central Bank of Kenya when setting their interest rates. The results further showed that 85 percent of the respondents agreed that return on asset is taken into consideration when setting the interest rates. This implies that most MFIs are interested in ensuring better financial performance.

Finally, the results indicated that 55 percent of the respondents strongly agreed and 45 percent of them agreed that inflation is taken into consideration when setting the interest rates.

Influence of interest rate on financial performance of MFIs

In order to establish whether interest rates influenced financial performance, the following hypothesis was tested using regression analysis:

H₀₁ Interest rates do not exert significant influence on financial performance of MFIs

First, the hypothesis was tested using liquidity as an indicator of financial performance against interest rate. The model summary is shown in Table 4.

Table 4: Model Summary for influence of interest rate on liquidity

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	Change Statistics			Sig. F Change
						F	df1	df2	
1	.474 ^a	.224	.204	10.39836	.224	10.994	1	38	.002

a. Predictors: (Constant), INT

From R computed (0.474), there is a positive correlation between the independent variable (interest rate) and the dependent variable (liquidity). This relationship is significant at 95% confidence level since the computed p-value (0.002) is less than the significant value (0.05).

From the computed r-square (0.224) the model:

Liquidity = constant + interest rate + error explains 22.4% of the data. The model was then subjected to ANOVA. The results are shown in Table 5

Table 1: ANOVA^b for influence of interest rate on liquidity

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1188.704	1	1188.704	10.994	.002 ^a
	Residual	4108.782	38	108.126		
	Total	5297.485	39			

a. Predictors: (Constant), interest rate

b. Dependent Variable: liquidity

The results indicate the model was significant. The F-test for the model was significant since it had p-value = 0.002. Thus, the beta coefficients were computed. The coefficients are shown in Table 6.

Table 2: Coefficients^a for influence of interest rate on liquidity

Model		Unstandardized		Standardized		
		Coefficients		Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	18.239	3.348		5.447	.000
	INT	-.694	.209	-.474	-3.316	.002

a. Dependent Variable: Liquidity

The influence of average interest rate ($\beta=-0.694$, $p=0.002$) on liquidity is significant and its coefficient is negative indicating that the higher the interest rate charged by the MFIs, the lower the liquidity. Thus, based on the model the results can be summarized as follows:

Liquidity = $18.239 - 0.694$ interest rate

The findings show that interest rates exert significant influence on liquidity. Thus, the null hypothesis is rejected. This finding could explain why Donor Brief 18 (2004) indicated that many countries have established interest rate ceilings to protect consumers from unscrupulous lenders. The findings also support Mwangi (2014) who established that there is a strong relationship between lending interest rates and financial performance of deposit taking MFIs.

CONCLUSIONS AND RECOMMENDATIONS

The study objective sought to establish the influence of interest rate on financial performance of MFIs. The results indicated that there is a positive correlation between the interest rate charged by MFI and liquidity. The results further showed that there is a positive correlation between interest rate charged by the MFI and ROA. Based on the study results the following model of financial performance was generated: Performance (Liquidity) = $-119.040 + 3.549$ interest rate.

Interest rates charged by MFIs significantly influence their financial performance. This conclusion is based on the finding that there is a positive correlation between the interest rate charged by MFI and liquidity. This implies that an increase in interest rates results in an increase in liquidity for the MFIs.

The study recommends that MFIs should charge interest rates that are in the range of commercial banks to increase loan uptake. This will ensure maximization of liquidity. This recommendation is based on the finding that an increase in interest rate results in an increase in financial performance of a firm in terms of liquidity.

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