THE RELATIONHIP BETWEEN INTEREST RATES CHARGED BY MICRO FINANCE INSTITUTIONS AND THE PERFORMANCE OF MICRO AND SMALL ENTERPRISES IN NAIROBI

BY

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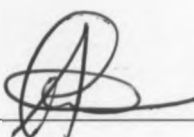
SEPTEMBER 2002

DECLARATION

This Management Research Project is my original work and has not been presented for a degree in any other University.

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To my parents Mr. Elias Mwindi and Mrs. Dorothy Mwindi and my brother Mr. Ken Mwindi who supported me financially and continuously encouraged me throughout the whole MBA Program.

ACKNOWLEDGEMENT

ABBREVIATIONS

AMFIs - Association of Micro Finance Institutions.

CBS - Central Bureau of Statistics.

CBK - Central Bank of Kenya

K.W.F.T – Kenya Women Finance Trust

K-Rep- Kenya Rural Enterprise Programme

K.I.E – Kenya Industrial Estates

MFIs - Micro Finance Institutions.

MSEs - Micro and Small Enterprises.

NGOs - Non-Governmental Organizations.

N.C.C.K – National Council Of Churches Of Kenya

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ABSTRACT

This study establishes the relationship between interest rates charged by MFIs to MSEs and performance of the MSEs in Kenya. The hypothesis of the study was that interest rates charged by MFIs reduced the profit of the MSEs. All the MSEs studied were found to use credit from the MFIs to finance their operations. These operations were mainly the working capital expenditure. The analysis of the data revealed that higher amounts of credit granted was charged higher levels of interest rates but enabled them to meet more of their planned operations. This resulted in higher profitability to the MSEs. The study concluded that a positive relationship existed between the interest rates charged by MFIs and the profits of the MSEs mainly because of the amount of credit associated with these high interest rates. Thus the MFIs should consider increasing the amount of loan that they grant to the MSEs as this enabled them meet their working capital requirements hence improving their performance. The study concluded that interest rates charged by MFIs do not lower the profits of MSEs. This shows that the shift from subsidized to unsubsidized credit has no effect on the performance of the MSEs and hence will continue making profits even in the increased interest rates regime.

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background

The field of microenterprise development has changed considerably during this last decade. Recognition of the employment and income generation contributions of the informal sector, and of credit's ability to stimulate those contributions, has focused increasing attention and resources on the establishment of microenterprise credit programs throughout the developing world.

As those programs accumulate experience and become more sophisticated, they are combining aspects of informal credit with the management systems of formal financial institutions to reach increasing numbers of poor borrowers with improving efficiency (Castello, et al, 1991). They also find that growing focus on the viability of the lending institution, and on the need for external services to meet the enormous demand for credit, is leading many of the institutions away from relatively small projects funded exclusively by grants, towards an approach more closely tied to the formal financial sector.

One critical aspect of this evolution is the treatment of interest rates by microenterprise finance institutions. Most of these institutions began as credit programs to benefit a particular sector of the poor, with heavily subsidized interest rates. Subsidized interest rates however have proved to be an unsuccessful tool for economic development.

In the 1960s, cheap credit was a preferred instrument for promoting growth and development among disadvantaged groups and within selected sectors in developing countries. Governments created development banks to allocate credit to sectors of the economy that were considered Priorities for development. The public sector rationed credit resources and imposed controls on interest rates to keep them at subsidized levels. Unfortunately, these programs of directed credit at subsidized rates have inhibited the mobilization of savings needed for important investments, and undermined the development of sound financial systems in many countries (World Bank, 1989,Fry, 1988).

Directed credit and controlled interest rates have led to distortions and waste in allocation of precious development resources. Governments that have maintained interest rates below inflation or the return available abroad have encouraged capital flight, negatively affecting the balance of payments and the local financial system. Likewise, in countries where an important proportion of credit is allocated by the public sector, there has been a lack of financing for key private sector ventures that have the potential for income generation and employment creation. This scarcity of resources for non-priority sector investments has foreign sources of credit. Development banks offer some of most obvious examples of the negative repercussions of subsidized credit. Their tract record as viable long-term financial institutions is dismal, many are now closed, others are insolvent, and most are unable to cover their operating costs without periodic injections of funds from governments or multilateral lenders. Most have been unable to mobilize substantial domestic resources since they did not offer market rates

of interest to depositors, and thus could not compete with commercial banks. Approximately one-third of the existing developing countries have large percentages of non performing loans and are in serious financial difficulty (Fry, 1988). While subsidized credit is not the only reason for the poor performance of development banks (poor management lending practices based on political preferences instead of risks and costs, staff turnover due to uncompetitive salaries, e.t.c are responsible), it is one of the main contributing factors. The bail out of development banks has usually required government funding, which is often supplied by issuing money, thereby contributing to inflationary pressures and making macroeconomic management more difficult.

There is also widespread evidence that credit programs have not fulfilled their developmental objectives (Castello, et al 1991). Interest rate subsidies do not necessarily contribute to increased access to credit for the poor. In many cases, subsidized agricultural loans have gone mostly to relatively well off-farmers, worsening rural income distribution. Larger borrowers receive greater subsidies (the larger the loan, the larger the subsidy), while those excluded from access to credit do not get any subsidy. Since larger borrowers are those who can usually provide real guarantees and who are willing to absorb high transaction and opportunity costs, subsidized credit often favors the relatively wealthy.

Despite its weaknesses, however, there have always been strong arguments that make subsidized credit popular among policy makers. Credit at unsubsidized rates is argued, is too expensive for poor borrower and does not allow them enough profits to improve

their economic conditions or expand their economic activities. Cheap credit on the other hand, can make even marginal activities profitable. These arguments generally prevailed in the microenterprise field until mid-1980s until that time most microenterprise credit programs set low interest rates to make inexpensive credit available to their poor borrowers.

Gradually, however, micro finance institutions are moving towards higher, unsubsidized rates of interest. They are finding that poor borrowers are able to pay interest rates that reflect the real cost of loans, and still increase their profits and create more jobs. The institutions are also realizing that their own viability, potential growth and capacity to serve their clientele over the long-term depend upon their ability to generate enough income to cover their costs. The sustainability of lending programmes is dependent upon the application of financial markets approach in which loans are awarded on the basis of economic consideration and at commercial rate sufficient to cover the lender's capital and transaction costs. In Kenya the interest rates charged by these organizations on declining balance are above current commercial rates in the country (Dondo, 1995). Lastly, microenterprise institutions can only have a positive impact on the financial systems in which they operate if they are financially sound themselves. But the main question remains whether these interest rates are favorable for the MSEs in Kenya.

This paper examines the shift in the interest rate policy of microenterprise finance institutions in Kenya to establish the implications that this shift of interest rates has for the future of the microenterprises in Kenya.

1.2 Statement of the Problem

Kenya's development challenge largely remains that of identifying sustainable ways of enabling the main sectors of the rural economy (agriculture and micro and small enterprises (MSE) sectors) to achieve their growth potentials. It is realized that a multi-faceted worldwide experience can make significant improvements to the living conditions of the poor. This makes it clear that the development of micro financial services in Kenya is perhaps one of the critical ingredients of its rural development agenda (Dondo, 1999).

Through the early 1990s, MFIs began thinking like for profit businesses and interest rates continued to rise. This way partly to move from operational sustainability to financial sustainability and be able to offer a return to equity investors and partly to generate internal profits that could be used to build up the institution (Castello et al, 19991). Infact in Kenya MFIs are known to charge high interest rates, higher than those charged by commercial banks (Dondo, 1995). The question then is; 'Do high interest rates charged by MFIs stunt the growth of micro entrepreneurs?' Do these high interest rates hinder the ability of MSEs to increase their income and profits? Studies done elsewhere such as one in 1991 on ACCION –affiliated clients in Chile, Colombia and Dominican Republic revealed that average monthly financial costs of loans constituted a minimal proportion of the total costs and that these financial costs had a significant impact on the level of profits i.e they were able to report profits even after paying the financial costs attributed to the loans. This being a different economic set up, findings

are bound to be different elsewhere. In Kenya (Rukwaro, 2001) found that most of MSEs complained of high interest rates charged by MFIs. She then expressed the need for a study on the effects of the interest rates charged by MFIs on the performance of MSEs' businesses. It is with these concerns and questions that this study was carried out to establish the relationship between the interest rates charged by MFIs and the performance of MSEs in Kenya. Are the MSEs going to survive this era of increased interest rates? To be able to achieve this objective, the study assessed the interest rates charged by MFIs in the different loans that they had acquired. The study also assessed the profits made before and after acquisition of the loans to identity any changes as a result of the interest on these loans.

Hypothesis:

H_O: Interest rates charged by MFIs reduce the amount of profits made by MSEs.

H_A: Interest rates charged by MFIs do not reduce the amount of profits made by MSEs.

1.3 Objectives of the study:

The main objective of the study is to determine the relationship between interest rates charged by MFIs and the performance of MSEs businesses in Kenya. This was achieved through the following sub-objectives

1) To determine the amount of interest rates charged by the various MFIs to the MSEs in Kenya.

2) To determine the relationship between interest rates charged by MFIs and the profits made by MSEs in Kenya.

1.4 Significance of the Study:

The study will be important to:

i)   The micro finance institutions in their endeavor to provide more appropriate and effective credit policies towards small-scale entrepreneurs.

ii)   The government and policy makers in their endeavor to create and facilitate favorable credit policies for SMEs.

iii)   Donors of MFIs as they assess the sustainability of these organizations. This will enable them in deciding which MFIs to fund.

iv)   MSEs in making a decision whether to borrow and from which MFIs to borrow from.

v)   The study will contribute to the general body of knowledge and form a basis for further research.

1.45 Justification of the Study:

There has been paucity of literature on the effect of interest rates on performance of SMEs in Kenya. Most researches in this sector have studied the impact of credit on various economic variables like employment, increase in household incomes and enterprises output (Oketch 1991,Coppers and Lybrand 1991). Other scholars have

studied capital and performance of SMES in Kenya (Ondiege, 1996), and influence of credit rationing by MFIs on the operations of SMES (Rukwaro, 2001).

The findings of this study will add to the existing body of knowledge on micro and small enterprises in the area of interest rates. The study will establish the relationship between interest rates charged by MFIs and the performance of MSEs thereby enlightening the MFIs and other lending institutions on the favorableness of their interest rates to the SME sector.

Further the results of this study will contribute to an understanding of the SMEs financing through the MFIs and the influence such financing has on the operations of the MSEs. This knowledge is useful to policy makers in coming up with regulatory framework for MFIs.

CHAPTER TWO

LITERATURE REVIEW

2.1 Definition of Terms

Micro and Small Enterprises:

This study adopts the definition given by the 1999 National MSEs Baseline survey whereby a micro enterprise is taken to be one employing 10 people and below while a small enterprise is one employing between 11 to 50 people (CBS1999).

Employment here refers to people working in the enterprise whether they are paid or not. Business enterprise or firm will be used interchangeably to refer to an economic unit producing goods or providing services for example Kiosks, salons, and shops among others.

Micro Finance:

Micro finance is defined by the Association of Micro finance Institutions (AMFI) as the provision of micro-credit as well as other services such as savings, deposits, insurance services and other financial instruments/products aimed at the poor or low-income people. This study considers only the provision of micro-credit aspects of micro finance.

Micro Credit:

Reinke (2001) defines micro credit as credit extended by formal institutions to individuals or informal groups. The formal institution has been set up or is currently

financed or supported by donor aid. This study defines micro credit as funds provided by MFIs to MSEs that are to be repaid at a cost and under specified conditions.

2.2 Interest Rates:

Interest rates represent the cost of money. They are what a borrower pays in order to have access to money, which is a scarce resource. This section discusses basic types of interest rates that are essential to the management of micro enterprise credit programs.

i)   Nominal Rates of Interest:

Nominal rates of interest on a loan are the rates the lender requires the borrower topay. In formal financial circles, nominal rates are almost always quoted on an annual basis. Because microenterprise loans frequently have terms of less than a year, nominal interest rates are often quoted on monthly basis. Informal sector moneylenders will sometimes have daily interest rates. This aspect of intertest rates is adopted in this study.

ii)   Effective Rates of Interest:

Effective rates of interest bring all of the direct financial costs of a loan together in one interest rate. Effective interest rates include the effects of commissions, fees, and other loan requirements on the total cost of the loan to the borrower. Effective rates can be compared to determine whether the conditions of one loan make it more expensive or less expensive to the borrower than the conditions of another loan (Castello, et al, 1991). The effective interest rate represents the total financial costs of a loan to the borrower.

2.3 Theories of Interest Rates

There are several approaches of interest. Some attempt to explain the in stationary economy; others comprise theories that are from a dynamic economy in which new investments and saving take place.

Irwin Fishers' Theory of Interest

Fisher theory of interest in based on two fundamental concepts of market principles namely:

- Time preference –whose present goods are valued more highly than future goods.
- Investment opportunity: - effect of investing on income streams

Fisher also notes that uncertainty affects the result under the two concepts. He assumed perfect foresight i.e current and future income flowing to an individual is given. He showed that it is possible to determine the demand for and the supply of funds on the part of each individual.

He considered several periods I, which interest changes and came up with the problem of the structure of interest rates. The interest rate for future periods cannot be known in advance, but there are quotations of interest rates of loans of different maturities for example rates on one-year loans etc.

Fisher assumed perfect foresight and ignored costs arising from loans. He regarded the rate of interest on a long-term loan as an average (geometric) of successive short-term rates over the same time span. Thus the determination of short-term rates for the future simultaneously determines the structure of interest rates prevailing in the present time.

Disregarding the assumption of perfect foresight Fisher realized that the rate of interest influenced by new factors especially risk and liquidity of investments. Nevertheless, Fisher' theory has deficiency in that it is a partial equilibrium theory that confines itself entirely to the analysis of the capital market and works with assumption that the prices of goods and services are already determined.

Loanable Funds Theory

This theory was propagated by Swedish Bentil Ohlin and suggests that interest rate is determined by supply and demand in the market for credit. This theory has been found more useful than others have in forecasting changes in interest rates.

The loanable funds framework is based on an analysis for credit demand by sector, type of security offered the amount of loanable funds supplied and the type of security the investor will prefer. According to this theory, participants in the economy can be categorized into borrowers and lenders of funds. These include, households, firms or businesses the central bank and foreign sector.

In considering the bond market for example the analysis of interest rate determination looks at supply and demand in the bond market. Demand curve depicts the quantity of bonds demanded at specific prices (and interest rates), while the supply curve shows the relationship between quantity supplied and price all other economic variables held constant. At market equilibrium the quantity demanded equals the amount people are willing to supply and this is the market determined interest rate in the bond market.

Keynes Theory of Interest

John Maynard Keynes brought in other variables in the determination of level of interest rates, using liquidity preference theory. This theory is essentially a monetary focusing on demand and supply for money. It brings out the relationship between interest rates and other variables as discussed below:

Interest Rates and Investments

Keynes observed that investment is a determinant of interest rates, however the reasoning is somewhat circular. He says that the amount of investment is determined by level of interest rates. On the other hand interest rates is determined not by investment (or saving) but by publics desire to hold money balances and the stock of money available for public to hold. He however notes that as income increases, due to increase in investment, interest rate reduces as depicted below:
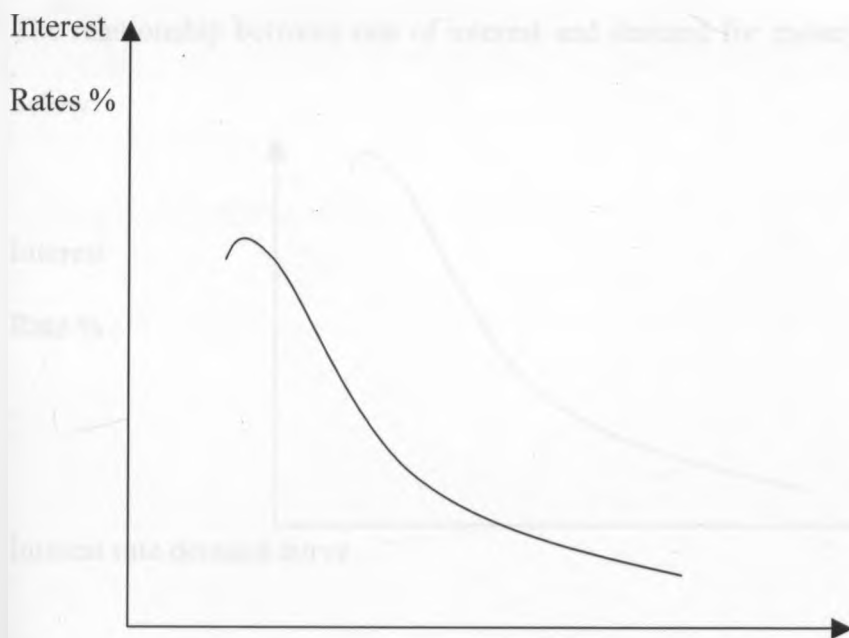
Interest rates Vs income curve

Interest Rates and Demand

The simplest theory of demand is based on the increasing marginal utility for money ie utility maximizing asset holder will plan to hold the money to the extent that the money offers expected net return over its opportunity cost (interest rate). The expected returns to money holding are the convenience yielded by ready cash, the avoidance of cost of credit incurred if the payment of bills is delayed until non-liquid assets are realized. The marginal utility of money is expected to decrease as the stock of money held increases. The expected cost of holding money is the expected return foregone on the most lucrative asset otherwise acquired, plus the expected capital loss of the value of money held (time preference for money considerations causing a decline in the value of money e.g inflation risks etc). As the rates of interest on borrowed funds go up, the net returns decline thus more money is acquired.

The relationship between rate of interest and demand for money is therefore as shown below:

Interest

Rate %

Interest rate demand curve   Demand for money
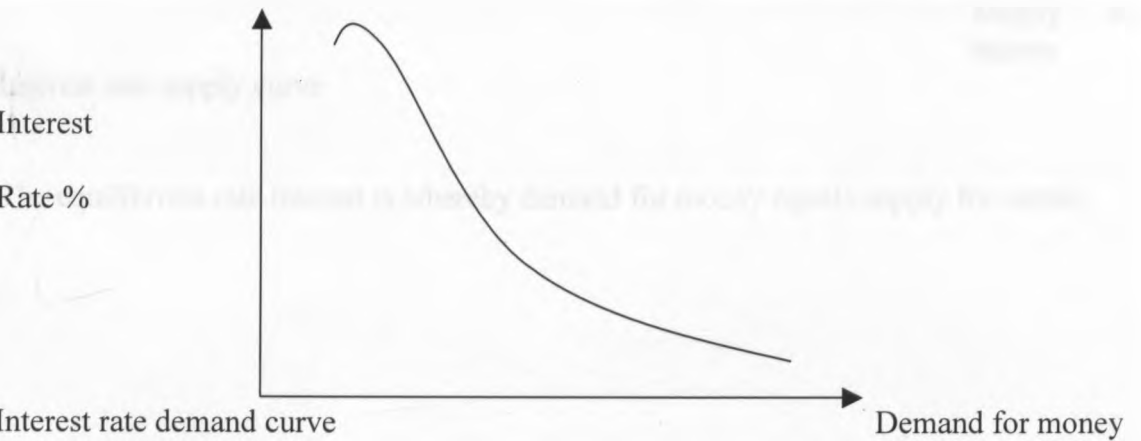
Interest Rates and Supply

An increase in money supply e.g due to expansionary monetary policy will shift the supply curve for money to the right and interest rates will decline. This is the liquidity effect. The relationship between rate of interest and supply for money as developed by economists is depicted below:
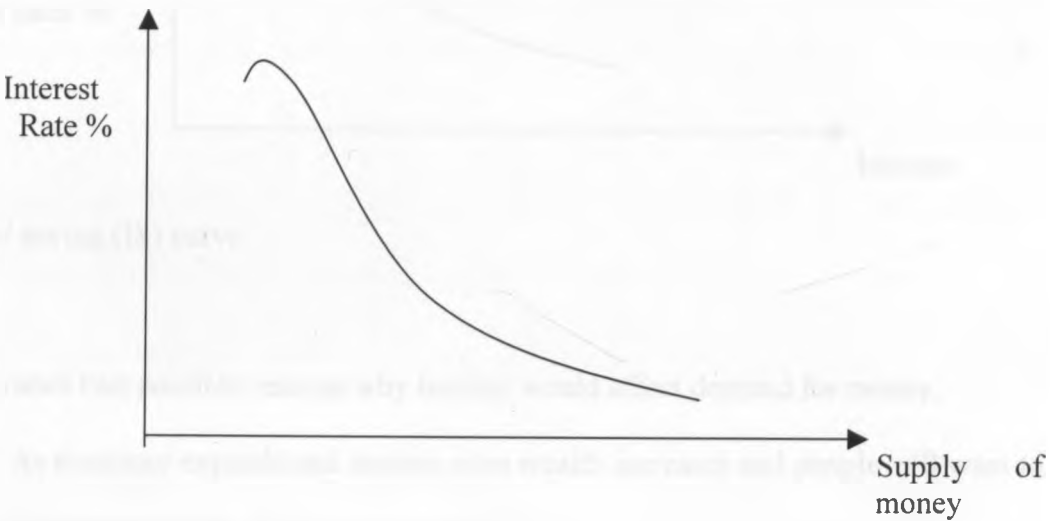
Interest rate supply curve

The equilibrium rate interest is whereby demand for money equals supply for money.

Interest Rates and Income

Macroeconomic theory suggests that the relationship between interest rates income is as depicted in the function below

Interest rates %

Income

Income/ saving (IS) curve

Keyne views two possible reasons why income would affect demand for money.

- As economy expands and income rises wealth increases and people will want to hold more money as a store for value.

- People will also want to carry out transactions using money, resulting to people holding more money. Thus higher level of income causes the demand for money to increase.

It is therefore follows that factors that affect supply for money as well as incomes are likely to affect interest rates.

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The relationship becomes clearer from the following questions "what influences a firm, a government or a household in making their decisions to spend?" One of the influences must be the price of holding money i.e. the cost of not spending the money which is defines the interest rate.

The works of fisher, Ohlin and Keynes and other economists such as Hahns, FH and Hicks J.R have brought out the underlying factors that affect interest rates. These are; income levels and rate of savings, expenditure requirements, availability of goods for purchase, price levels, exchange rates, availability of money (from capital markets etc), policy variables, which in turn determine investment opportunities, the rate of economic growth, government expenditure, predictability or level of stability of significant investment consideration factors e.g taxes, security, and legislation affecting operations and risks and uncertainties on the future course of interest rates

2.4 The Role of Interest Rates:

Money is a scarce resource as there is a limited amount of it, and it has value for everyone. Interest represents the costs of money, that is what a borrower pays in order to rent money for a certain period of time. Interests rates help determine the allocation of money because as with other goods in the economy, the demand for money is influenced by its costs (Stearns, 1991).

Apart from determinining the allocation of money, interests rates provide income to lenders.

Interest is cost paid by borrowers that enables lenders to provide an efficient lending service and to generate a reasonable profit. For MFIs, interest income determines whether the institution is dependent on donor funds or able to maintain itself with own earned income.

For entrepreneurs who borrow, interest rates provide a 'hurdle rate' over which investments must pass to be a valid use of scarce resources.

Interest rates on loans are critical to borrowers, lenders and the economy as a whole (Stearns, 1991). The establishment of appropriate interest rates is crucial for the effective operation and financial management of MFIs.

2.5 Capital Structures and the Value of the Firm

The rate used to discount earnings stream is the firm's required rate of return or the cost of capital. Thus the capital structure decision can affect the value of the firm either by changing the expected earnings or the cost of capital or both. If leverage affects the cost of capital and the value of the firm, an optimum capital structure would be obtained at the combination of debt and equity that maximizes the total value of the firm. All does not accept the existence of an optimum capital structure. There are various views as to whether an optimal capital structure exists such as the net income and operating income approaches as identified by David Durand. But more crucial to this particular study is the traditional approach.

The Traditional View

The term " traditional view" is used to refer to the views of finance theorists before 1958, when Modigliani and Miller challenged these views. This view is based on the belief that an optimal capital structure exists and that the value of the firm can be maximized and cost of capital minimized through careful use of debt. It assumes that firms substitute cheaper debt for equity. As long as assets financed by this cheaper debt provide higher returns than the cost of debt, the value of the firm will rise.

2.6 Operation of Micro and Small Enterprises:

Resources of organizations comprise of finances, the human capital, equipment and materials used in the production of goods and services. Processes include location, design, layout and installation of equipment, sourcing of raw materials, management of the human resource, production and distribution logistics. The processes are interrelated. They are performed to produce a product or service, and get it to the intended consumer. Finance used in business processes constitutes capital and working capital expenditure. According to Parker, (1993) MSEs require business finances for; payment of services, license fees; working capital requirements. For example, buying stock, repairs and maintenance and raw materials; and as business capital both initial capital to start up and additional capital to be injected into the business

2.7 Sources of Funds for Firms

Business firms obtain funds from a variety of sources i.e. from other businesses, from banks and from the money market. Nevertheless bank loans provide a major source of short-term and intermediate financing (Ezra and John 1980). Although commercial

banks are the most important of the intermediaries that finance business firms, other financial institutions also supply loans to these firms. Firms, especially the larger more credit–worthy corporations also obtain funds by issuing interest bearing unsecured promissory notes (commercial paper) in the money market.

2.8 Sources of Funds for Micro and Small Enterprises:

Debt and equity are the two sources of finances for a business. Debt refers to finances provided through borrowing while equity is finances provided by the owners of the firm (Copeland and Weston, 1992). In the context of MSEs, the external sources of finance are limited due to their inability to gain access to funds from the mainstream formal financial systems in Kenya (Parker 1993).

Alternative sources of external funds in the form of self-savings are almost impossible to accelerate in Kenya. This is because of many factors inhibiting the saving rate for example, the poor economic status of living and inadequate services provided by the government. In 1990s, there was rapid development of informal finance in form of micro finance institutions. These institutions provide credit to MSEs. The 1999 National MSE Baseline Survey identified various sources of MSEs finances. They include family sources, moneylenders, banks and NGOs among others.

In the early 1980s, most MFIs providing credit to MSEs charged below the CBK controlled interest rates. However, most MFIs have now changed to charging commercial rates of interest. Organizations showing promise of sustainability are those charging high interest rates. The interest rates charged by these organizations on declining balance are above current commercial rates in the country (Dondo, 1995).

2.9 Interest Rates and The Micro Entrepreneurs:

Micro entrepreneurs face several different kinds of costs when they apply and receive a loan. The effective interest rate of each loan, which includes the interest costs as well as all commissions and fees paid to the lending institution, represents the financial costs of the loan to the borrower.

The financial costs of loans to micro entrepreneurs, especially the portion determined by the nominal interest rate, are often considered the most critical borrowing costs for the poor entrepreneurs.

Depending on the source of the loan, however, the financial costs may be a small portion of the total borrowing costs that the micro entrepreneurs pay. Furthermore, the financial costs may be a relatively insignificant portion of the borrower's total operating costs.

According to Castello et al, (1991), low effective interest rates can be more expensive for borrowers than loans with high rates because of transaction and opportunity costs. He also shows that financial costs, though often considered to be the most burdensome for micro entrepreneurs are actually a small percentage of their total costs.

The other borrowing costs that affect the entrepreneur include the transaction costs, opportunity or accessibility costs.

Transaction costs are paid by the borrower but not to the lender. These include costs such as bus fare to the financial institution, fees paid to an accountant to produce

financial statements required for the loan, the cost of obtaining documents required to guarantee the loan, time spent by the borrower collecting needed information and documentation e.t.c. The lender does not receive these cots.

On the other hand, opportunity or accessibility costs reflect the cost of investment opportunities lost due to inefficiencies in lender delivery systems, when credit is not delivered in a timely manner, micro entrepreneurs often lose opportunities to purchase inputs or equipment under favorable conditions or lose important controls.

Taken together, all the three costs (financial, transaction and opportunity) make up the total borrowing costs that a micro entrepreneur pays for a loan.

2.10 Financial Costs and the Entrepreneurs:

Unlike transaction and opportunity costs, financial costs are established explicitly by a credit institution to generate income. The institution determines how much each loan will cost, borrower interest, fees and commissions. How the institution establishes these costs, which determines the effective interest rate for each loan, is critical for both the borrower and the institution. Many institutions have begun charging interest rates equal or even higher than commercial banks (Castello et al 1991).

These institutions are convinced that higher rates do not prevent micro entrepreneurs from working their way out of poverty, and can provide enough income for financial institutions to sustain themselves.

2.11 Interest Rate Policies:

Given the cost structure of micro finance, interest rate restrictions usually undermine an institution's ability to operate efficiently and competitively (Rock and Otero, 1997). Typically restrictions do not achieve their public policy purpose of protecting the most vulnerable sectors of the population. Instead, they drive informal lenders underground, so that poor borrowers fail to benefit from the intended low-cost financial services MFIs need to price their loan products to allow for full cost recovery.

2.12 Loan Pricing by MFIs:

Pricing loans is an important aspect of loan product design. A balance must be reached between what clients can afford and what the lending organization needs to earn to cover all its costs. Generally, MFI clients are not interest-rate sensitive. That is, microentrepreneurs have not appeared to borrow more or less in reaction to an increase or decrease in interest rate (Mwenje, 2001).

For the most part, an interest rate far above the commercial bank rate is acceptable since borrowers have such limited access to credit. However, an MFI must ensure that its operations are as efficient as possible so that undue burden is not put on its clients in the form of high interest rates and fees.

MFIs can determine the interest rate they need to charge on loans based on their cost structure. MFIs incur four different types of costs, viz, financing costs, operating costs, loan loss provision, and cost of capital.

In general, an MFI incurs relatively low financing costs if it funds its loan portfolio mainly with donated funds. If compulsory savings are used to fund the loan portfolio, they can affect the average financing costs of an MFI (Ledgerwood, 1998).

2.13 Interest Rates and the MFIs:

The interest rates charged for loans to small and micro-enterprises by MFIs range from 0% (e.g Provide International) to 27% on reducing balance (e.g K-REP) .In the 1970s and early 80s most of the MFIs providing credit to small and micro enterprises charged below the then central Bank controlled interest rates (Dondo, 1991). Most MFIs providing credit to SMEs have now changed to charging commercial rates of interest. A few who still persist in lending below the commercial rates consider that market rates are exploitative of the poor, indeed they believe that the poor should have the benefit of subsidized interest rates.

In contrast to these perceptions, there is ample evidence that low interest rates distort programmes intended to assist the poor, do not really reflect the ability of entrepreneurs with SMEs to repay, and undermine the organization's ability to achieve sustainability so they become chronically dependent upon outside funding. It is not surprising therefore that organizations showing promise in terms of achieving high levels of sustainability in the coming years are those that have adopted the principles of the well-known Grameen Bank of Bangladesh and charge interest rates of 27% on reducing balance, such as K-REP and CID/K (Dondo, 1995).

The best if not the only way to ensure ongoing access by the poor to credit is to charge a rate that will cover the full costs of the credit operation, thereby enabling it to be financially self-sustaining. The fact that the cost of capital (credit) is well illuminated by

the informal financial markets in Kenya i.e. moneylenders who charge up to 360% for small loans to SMEs (Mutua and Dondo, 1990).

2.14 Related Researches:

Various researches done in this area by different scholars revealed the following:

Research on ACCION- affiliated clients in Chile, Colombia and Dominican Republic for ACCION International revealed that even though the programs charge rates of interest equal to or higher than commercial rates, as well as commissions and fees, the average monthly financial costs of the loans are less than 1% of the total monthly costs for nearly half of the borrowers. They concluded that the financial costs of these loans are a relatively insignificant portion of total costs for micro entrepreneurs.

Bate, (1998), observed that financing costs constituted an insignificant portion of microenterprises' total costs, even in programs that demand effective real interest rates of almost 10% a month. The explanation being that microenerprises usually carry low levels of debt.

There is also overwhelming empirical evidence that huge numbers of poor borrowers can indeed pay interest rates at a level high enough to support MFI sustainability. One typically finds lower-income borrowers taking and repaying repeated informal loans at interest rates much higher than any formal financial institution. MFIs always find that demand far outstrips their ability to supply it. Most of their customers repay their loans, and return repeatedly for new loans, this pattern demonstrates the customers' conviction that the loans allow them to earn more than the interest that they have to pay (CGAP Occasional Paper No. 1,1996). This phenomenon does not appear to be restricted to

particular regions or countries. Thus, there is abundant poor that poor people's tiny businesses can often pay interest rates and still remain profitable.

Back in Kenya, a study by Ondiege, (1996) on Capital and performance of Small enterprises revealed that enterprises that secured credit from MFIs had the highest mean values in terms of sales and savings made. Those firms that did not have credit had the lowest average values of the same. These results suggest that credit by MFIs has a positive impact on income in the informal sector and MSEs.

2.15 Theoretical framework

The demand for loanable funds – that is, the willingness to borrow money – is negatively related to the interest rate. That is, the lower the interest rate, the more money people are willing to borrow.

amounts of money firms are willing to borrow depend on expectations and interest rates.

This can be illustrated by the graph below:

Interest rates

%

| 12 |
| 10 |
| 8 |
| 6 |
| 4 |
| 2 |
| 0 |

Amount of loanable funds
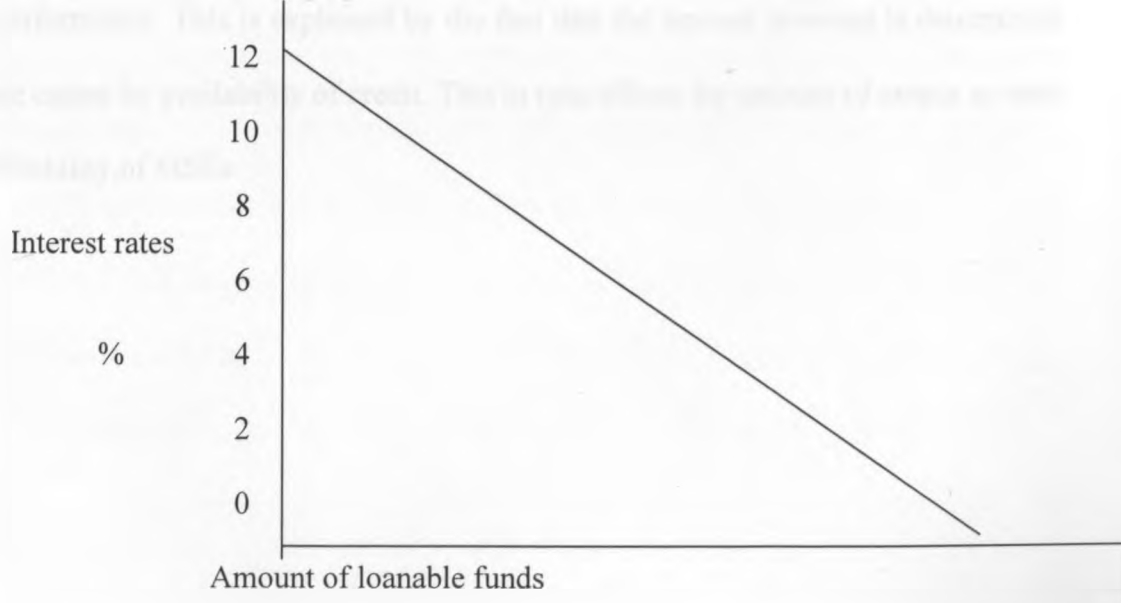
The supply of loanable funds is sensitive to interest rates. The quantity of loanable funds increase when interest rates rise and the quantities drop when interest rates fall. After all, bankers are in business to make money, and a higher interest does a better job in that respect than a low interest. The figure below illustrates this:

Amount of loanable funds
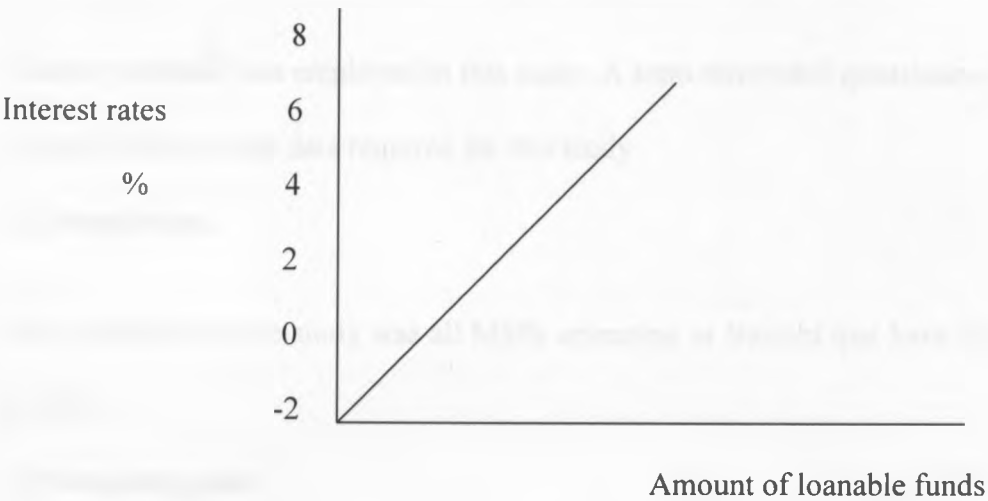
Impact on Performance

Regardless of the circumstances accessibility and availability of credit to firms affects their performance. This is explained by the fact that the amount invested is determined to some extent by availability of credit. This in turn affects the amount of output as well as profitability of MSEs.

CHAPTER THREE

3.0 METHODOLOGY

This section discusses the research design, sampling method, data collection method and data analysis.

3.1 Research Design:

A survey method was employed in this study. A semi-structured questionnaire was used to collect the primary data required for this study.

3.2 Population:

The population of the study was all MSEs operating in Nairobi that have been financed by MFIs.

3.3 Sampling plan:

Due to the large number of the MSEs, cluster-sampling method was used to select the MSEs. The MFIs were clustered under three clusters namely; government, private, and NGOs . From these clusters, the MFIs were then selected proportionately (three from government, three from private and six from the NGOs) to make a total of twelve MFIs. Credit officers of the selected MFIs advised the researcher on the days that their clients held meetings. The researcher then attended these meetings and randomly selected five MSEs who had received a loan from each MFI and had been operation for at least five years. This made a total of sixty MSEs studied.

3.4 Data collection:

The study was facilitated by use of primary data and secondary data. The primary data was collected through the use of questionnaires, which were administered to the MSE entrepreneurs.

The secondary data was obtained from relevant literature and records available in libraries, government offices and receptive offices of MFIs and MSEs.

3.5 Data Analysis:

The data collected was analyzed using SPSS statistical package and excel package.

The data was presented using tables and descriptive statistics.

The data was analyzed using descriptive statistics (frequencies and percentages) and inferential statistics (correlation analysis and t Test). Descriptive statistics enabled the researcher to describe the distribution of the various variables in the study such as sources of funds, ownership of the businesses and business activities carried out by the entrepreneurs.

Correlation analysis was used to correlate changes in interest rates charged for the loans with those in profits made by the MSEs. This enabled the researcher to identify whether there is a relationship between interest rates charged by MFIs and the profits of MSEs. Correlation measures the degree of association between two variables, which are not necessarily independent. This technique was used since it does not imply causation but rather shows how two variables move together. The t test was also used to test the Hypothesis of the study.

CHAPTER FOUR

DATA ANALYSIS AND INTERPRETATION

This chapter presents the data findings on the Relationship of interest rates charged by MFIs and the Performance of MSEs in Kenya.

The study had two objectives namely to determine the amount of interest rates charged by MFIs to MSEs in Kenya, and to determine the relationship between interest rates charged by MFIs and the profits of MSEs in Kenya.

Data on operations of MSEs, the interest rates charged by MFIs and the profits earned by the MSEs before and after the loan were collected to help determine the relationship between the interest rates charged by MFIs and the performance of MSEs.

Data was collected from the MSEs and presented, analyzed and interpreted under data collection and response rate, background of studied MSEs, MSEs business activities, operations and financial needs of MSEs, interest rates charged by various MFIs funding the studied MSEs, opinion on interest rates and problems affecting operations and performance of MSEs.

The chapter concludes accepting the hypothesis that there is a positive relationship between interest rates charged by MFIs and the performance of MSEs and that these interest rates do not lower the profits of the MSEs.

4.1 Data Collection and Response Rate

Data from 39 out of 60 selected MSEs was obtained through a questionnaire using direct interview method. A response rate of 65 per cent was achieved. The cases of

non-response were attributed to the fact that the MFIs sampled to help in identifying the MSEs for interview had a policy of not releasing information about their clients hence it proved difficult to reach some of the MSEs that they had funded. This was so with most of the commercial banks that extend loan to small businesses. Secondly, some of the identified MSEs termed the information confidential and were hence not willing to participate in the exercise. Table I below indicates the response rate.

Table 4.1: Response Rate

Number of targeted questionnaires	Number of questionnaires filled	Percentage
60	39	65

Source: Research Data

The findings and conclusions were based on the 65 per cent response rate from the MSEs which is considered reasonable for use as a basis for drawing conclusions on this study.

4.2 Background of Studied Micro and Small Enterprises

The survey targeted MSEs located in Nairobi that have been financed by MFIs. Most of the MSEs financed by MFIs are located in the low class areas of Nairobi such as Kawangware, Kangemi, Uhuru market, N.C.C.K sheds and Gikomba market. The businesses were established through the initiatives of the entrepreneurs and the businesses were sole proprietors (90%), partnerships (5%), or companies (5%). The businesses studied employed between 0 to 20 employees thus the businesses selected were both micro and small businesses.

4.3 MSEs Business Activities

The activities of MSEs ranged from hardware shops to sale of water as shown in Table 4.2

Table 4.2: Type of business Undertaken by MSEs

Business	Frequency of MSEs	Percentage Entrepreneurs
Hardware Shop	6	15
Hotel	5	13
Clothing	4	10
Cereals	2	5
Rental Houses	2	5
Printing	2	5
Grocery	2	5
Wholesale	1	3
Welding	1	3
Weaving	1	3
School	1	3
Saloon	1	3
Sale of Water	1	3
Retail Shop	1	3
Polythene Supply	1	3
Pharmacy	1	3
Matatu Business	1	3
Knitting	1	3
Farming	1	3
Butchery	1	3
Bookshop	1	3
Barber	1	3
Bar	1	3
Total	39	100

Source: Research Data

The most popular activities included, hardware shops (15%), hotel (13%), and sale of mitumba/ clothing (10%). The other businesses were as shown on the table 4.2.

The enterprises were either pure trading activities or some small scale processing. The main objective of the studied MSEs was to make profits and earn a living, as most of the entrepreneurs had no other source of income apart from the business. A few of the business studied had a second objective of training and creating job opportunity especially those whose activities involved weaving and screen printing found in the N.C.C.K sheds.

4.4 Operations, Financial Needs and Sources of Finances for MSEs

4.4.1 Sources of Finance for the MSEs

The MSEs surveyed stated that their main source of finances is business income, MFIs and friends and relatives. The contribution from each source was as shown in table 4.3

Table 4.3 MSEs Sources of Finances

Sources of finance	Average percentage contribution
Business Income	50
MFIs	40
Friends and relatives	10

Source: Research Data

Thus, the highest proportion of MSEs' sources of finances was business income and the lowest was from friends and relatives. The MFIs also formed a substantial part of the sources of finance for the businesses compared to business income. Most of the MSEs surveyed had only one MFI financing their activities. This can be attributed to the weekly meetings and repayments that the entrepreneurs found costly and time

consuming hence preferred to stick to one MFI. For others it was difficult to save the required amount for them to be able to receive a loan from more than one MFI.

4.4.2 Operations and Financial Needs of MSEs at the time of loan acquisition

Inquiring from the MSEs the purpose and their financial needs at the time they were requesting for the loan, 90% of the loans were acquired for working capital purposes. Only 10% wanted the loan for additional capital. This can be attributed to the fact that most of the MFIs were required to have began their operations and saved enough at the time of borrowing.

4.4 Interest rates charged by MFIs

Table 4.4: Interest rates charged by various MFIs

MFIs	Annual Interest Rates in Percentage
Co-op Bank	2.5
Sunlink	25
K.W.F.T	22
Faulu	22
Kadet	20
Jitegemea Trust	20
K-Rep	18
K.I.E	12.5
N.C.C.K	12
Classic Co-op	12

Source: Research Data

The annual interest rates charged by the MFIs were between 25% and 2.5%. Co-operative Bank one of the commercial banks having a micro credit department had the lowest interest rate of 2.5%. The highest interest rates were for loans obtained from

Sunlink (25%). Although these were the annual interest rates, the MSEs were charged the interest on loans depending on the credit period and the amount of loans given. For larger amounts of loans, the credit period tended to be higher so was the interest rates.

4.5 Effect of interest rates on the profits of MSEs.

Inquiring from the MSEs, 87% of the businesses were able to make the periodic repayment of loan and interest rates from their business income. The 13% that reported inability to meet the periodic repayment had to source for extra funds of about 5% from their own savings to be able to meet these repayments. Nevertheless, they indicated that it was not all times that they failed to make the repayments from the business income. The results therefore show that the businesses were able to make the periodic repayments of loan and interest rates from their business income. 74 per cent of the interviewed MSEs indicated that the interest rates charged by MFIs did not lower their profits. A minimal percentage of 26 percent indicated reduction in profits due to the interest rates. Thus the results from the data clearly indicate that interest rates did not reduce profits for most of the studied MSEs.

Asked about their opinion about the interest rates charged by the MFIs that finance their businesses, 64% of the studied MSEs indicated that the interest rates were high, 31% found them sufficient, while 5% found the interest rates to be low as shown in table 4.5

Table 4.5: Opinion on Interest rates

View on Interest Rates	Frequency	Percentage
High	25	64
Sufficient	12	31
Low	2	5
Total	39	100

Source: Research Data

Thus the results show that most of the MSEs viewed the interest rates that they are charged by MFIs to be high. On the other hand inquiring from the businesses whether these profits affected their profits in terms of reducing them, most of the MSEs said that the interest rates did not affect their profits (74%). Only 26% of the studied MSEs indicated that the interest rates lowered the profits of their businesses. It is evident that although the MFIs seem to be charging high interest rates these rates do not actually reduce the profits made by the MFIs. This fact could be attributed to the fact that the interest rates increase with increase in the loan amounts and the credit period. The higher the loan amount, the higher the increase in the working capital for the business hence the high probability for the business to increase its profits. The interest rates spread over a long period of time do not have a negative effect on the profits of MSEs.

4.6 Problems experienced when applying for the loan

85 per cent of the entrepreneurs interviewed indicated that they did not experience any problem while applying for the loan. Only 15 per cent indicated that they experienced problems when applying for the loan. Some of the problems experienced were those related to, delay in loan processing, difficulty in saving enough to qualify for a loan, problem in getting a guarantor and difficulty in setting up a premise. The results

therefore show that the MSEs hardly experienced any problems when applying for the loan. This indicates that the MFIs are offering efficient services to their clients.

4.7 Testing of the Hypothesis using the student t Test and correlation analysis.

The hypothesis for testing was:

H_O: rates charged by MFIs to MSEs lower the profits of MSEs

$_{HA}$: Interest rates charged by MFIs on MSEs do not lower the profits of MSEs.

Test statistics: T test and at 5 per cent level of significance and correlation at I percent. Since the computed t (6.518) is greater than the tabulated t (2.896), we reject the null hypothesis and conclude that interest rates charged by MFIs do not lower the profits of MSEs. The correlation analysis revealed a positive relationship between interest rates and profits.

Table 4.6 Correlation of Interest rates and Profits

		INTEREST RATE	PROFIT
INTEREST RATE	Pearson Correlation	1	0.917
	Sig. (2-tailed)	.	0
	N	10	10
PROFITS	Pearson Correlation	0.917	1
	Sig. (2-tailed)	0	
	N	10	10

** Correlation is significant at the 0.01 levels (2-tailed
Source Research Data

Table 4.6 t Test at 5 per cent significance level

		t at 95% Confidence
	Tabulated t value	2.896
DF 8	Calculated t value	6.518

Source Research Data

The computed t is greater than the tabulated t.

Since the correlation between the interest rates and profits is positive, it means that as interest rates increases as the profits of the MSEs increase. The strength of this association as indicated by the R squared is .82, which means that 82 percent of the variance of the profits of MSEs was explained by the interest rates.

4.7.1 Interpretation of the Hypothesis

From the research findings, it is evident that the interest rates do not lower the profits made by the MSEs after the acquisition of loan. This is evident from the responses received fro the entrepreneurs themselves where 74 percent indicated that they experienced no reduction in profits due to interest rates. This is also confirmed by the test statistics. The correlation analysis indicated a positive relationship between the interest rates and the profits. This can be attributed to the fact that, as indicated in the responses, the interest rates were increasing with the amount of credit granted and the credit period. The credit period also tended to increase with the increase in the loan amount. Since the loan was mainly used as working capital, and the profitability of the business depends on the level of working capital then it is expected that increase in the loan amount will help increase the working capital for the businesses hence increase in

profitability. It then follows that increase in loan amount, increases the credit period hence the interest rate and thus the seen positive correlation between the interest rates charged by MFIs and the profits made by the MSEs. This relationship (of 82%) as explained by R squared seems to be strong enough. The rule of thumb is that if R^2 is above 80% this indicates a strong relationship hence the relationship is deemed strong enough.

CHAPTER FIVE

SUMMARY OF RESEARCH FINDINGS AND CONCLUSION

5.1 Summary of Research Findings

This study set out to determine the Interest rates charged by MFIs to MSEs in Kenya and determine the Relationship between these interest rates and the performance of the MSEs.

The study established that the MSEs financed by MFIs are in the low class areas of Nairobi, mainly Kawangware, Gikomba, Uhuru market and Kangemi. The businesses were both micro and small enterprises employing between 0 to 20 employees. Majority (90%) of the businesses were sole proprietor owned. The most popular activities carried out by the businesses were hardware shops (15%), hotel business (13%) and clothing (10%). Other activities included sale of cereals, rental houses, printing and grocery each representing (5 %) of the response while, welding, weaving, wholesale shop, school, saloon, sale of water, sale of polythene paper, pharmacy, knitting, poultry farming, books and stationery, barber shop, and bar each represented 3%.

The study also found out that the main sources of finances for the MSEs was business income which contributed 50% of the total finances, MFIs 40% and friends and relatives which contributed only 10% of the finances. Generally the MFIs financed working capital for MSEs. This is because the MSEs had raised the initial capital for their businesses and had begun their operations before they acquired a loan from the MFIs.

The interest rates charged by the MFIs ranged between 2.5% and 25%. Most of the entrepreneurs (74%) indicated that the interest rates charged by the MFIs were too high.

However, these profits did not lower the profits that the MSEs made after acquiring the loan. From the test statistics it was revealed that the profits tended to increase with the increase in the interest rates as these rates increased with the increase in the amount of loan. 87% of the studied businesses were also able to make the periodic repayment of loan and interest rates from their business income without having to substitute it with another source of funds. This clearly indicates that the interest rates do not impair the performance of the MSEs in terms of reducing their interest rates.

The study also found out that most of the businesses did not experience any problem while applying for the loan. The few that had any problem experienced such problems such as delay in loan processing, difficulty in finding a guarantor and establishing a premise and saving enough to qualify for a loan. Most of these problems are attributable to the businesses themselves rather than the MFI hence the MFIs seem to be doing a good job as far credit extension is concerned.

5.2 Conclusions

The study concludes that the MSEs finance their initial capital of their businesses from their personal savings while the MFIs provide loans to pay for the working capital of the businesses. The MFIs provide a substantial proportion of the businesses finances as compared to the other sources.

Further the study concludes that although the interest rates charged by MFIs were indicated to be high, they did not lower the profits made by the MSEs.

Finally the study concludes that there is a positive relationship between the interest rates and the profits made by MSEs. Thus, even if the interest rates seem to be high they do not harm the profits of the MSEs. The study shows that the shift from subsidized credit has no effect on the performance of MSEs and hence increases profits of MSEs even in the high interest regime. Since the MSEs may not access loan from the larger banks, the MFIs whose credit is mainly targeted to the MSEs will work towards promoting profitability and thus the growth of MSEs in Kenya.

5.3 Limitations of the Study

The study findings have to be interpreted with caution due to shortcomings that faced the study. The limitations include

1. Because of the policies held by some of the institutions offering credit to the MSEs especially the commercial bank, it was not possible to access the clients of these institutions. This limited the response rate mainly to the NGO sector of the industry and the government institutions and none from the private sector. This might have introduced limited bias of the data collected.

2. Majority of the MSE entrepreneurs were semi illiterate and the interview had to be conducted in a language that most of them understood. This might have lead to misinterpretation of the questionnaires.

5.4 Recommendations

1. The study recommends that the MFIs should consider increasing the amounts of loans that they give to the MSEs. They should have a credit level commensurate with the business plans instead of having a standard level for all the businesses.

2. The MFIs should also consider introducing a grace period before the MSEs start paying the loan. This would overcome the problem of some of the MSEs using the loaned funds to pay the initial installments especially when the business is not able to generate income fast enough.

3. The MFIs should also consider the payment procedures from weekly to monthly and reduce the weekly meetings as these seem to be taking too much of the entrepreneurs time.

4. The MFIs should also consider reducing the interest rates they charge to the MFIs . Although the interest rates have a positive relationship with profits, reducing the interest rates and increasing the amount given to the MSEs would enable them make more profits hence improving their performance.

5.5 Suggestions for Further Research

1. The study concentrated on the influence of interest rates on the performance of MSEs sector. Other factors may be influencing the performance of the sector and so a research should be carried out to determine other factors influencing the performance of this sector, other than interest rates.

2. Due to time and money constraints the study mainly targeted MSEs located in Nairobi, a nationwide survey can be conducted to include the views of the entire sector.

3. Since the policy shift from subsidized to market rate interest rates has been adopted by the MFIs as a way of enhancing sustainability, a research can be carried out to find out to what extent this policy is achieving its objectives.

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APPENDIX A

Ann G. Mwindi,
C/o Faculty of Commerce,
University of Nairobi,
P.o. Box 30197,
Nairobi.
July 2002.

To whom it may concern

Dear Sir/Madam,
 Ref: Request for Research Data-The Relationship between Interest Rates Charged by Micro Finance Institutions and the Performance of Micro and Small Enterprises.

I am a post graduate student at the University of Nairobi undertaking research in the micro enterprise sector with specific to Interest Rates Charged by Micro Finance Institutions and their relationship to Micro and Small Enterprises performance.

Your business has been selected randomly for this study. I would greatly appreciate if you could provide the requested information in the questionnaire.

All responses are strictly confidential and are only for academic purposes only.
Thanks.

Yours faithfully

Ann Gatune Mwindi

APPENDIX B

QUESTIONNAIRE FOR MICRO AND SMALL ENTERPRISES

BACKGROUND INFORMATION

1) Name of the business_____

2) Nature of the business_____

3) Number of employees in the organization_____

4) Tick the form of ownership

    Sole proprietorship ☐   Partnership ☐

    Company ☐   others (specify) ☐

5) Location of the business_____

6) When was your business established_____

7) What is the main objective(s) of your business?

_____

SECTION II

8) Which of the following formed your financial needs as at the time you received financial funding?

    Initial capital equipment ☐

    Additional capital ☐

    Working capital ☐

    Others (specify)

9) Tick the sources of finance for your businesses.

Micro finance institution ☐   Friends and relative

business income ☐   others (specify)

10) Indicate the percentage of finance from each source

Micro finance institution _____% friends and relatives_____%

Business income_____% Others (specify)_____%

11) How many institutions finance your business?_____-

12) Indicate   the   name(s)   of   the   MFI(s)   that   finance   your

business?_____

13) How many times have you   received a loan from the MFI that finance your

business?

Once ☐   Twice ☐ Three times ☐

Four Times ☐   Five Times ☐ Six Times ☐   Others

specify_____

SECTION III

14) In each of the loans requested for in question 13, what is the amount requested
for from the MFI?

1st 2nd 3rd 4th

Kshs_____   Kshs_____   Kshs_____ Kshs _____

5th 6th

Kshs_____   Kshs_____

15) What total amount did you actually receive for each request (not the installments total amount approved)?

1st 2nd 3rd 4th

Kshs_____   Kshs_____   Kshs_____   Kshs_____

5th 6th

Kshs____   Kshs____   Others specify_____

16) For each of the loans granted, what was the credit term in terms of weeks/ months /years? (Specify accordingly)

1st ☐   2nd ☐   3rd ☐   4th ☐

5th ☐   6th ☐   others specify

17) What is the interest rate charged (in percentage) for each loan applied for? Indicate whether weekly/monthly/or annual

1st _____   2nd_____   3rd_____   4th_____

5th _____ 6th _____ others specify_____

18) What percentage of the credit granted was utilized directly on the business?

0-10% ☐   11-20% ☐   21-30% ☐   31-40% ☐

41-50% ☐   51-60% ☐   61-70% ☐   71-80% ☐   81-90% ☐

91-100%   ☐

19) What was the average monthly profit of your business before you received the loan(s)? (Indicate appropriately)

Year	Amount in KSHs
1992	_____
1993	_____
1994	_____
1995	_____
1996	_____

20) What is the average monthly profit of your business after receiving the loan?

Year	Amount in Ksh
1997	_____
1998	_____
1999	_____
2000	_____
2001	_____

21) Is the income generated from your business able to finance the periodic repayment including interest required by the institution that funds your business?

Yes ☐   No ☐

22) If No, indicate the percentage of other sources of funds that finance the repayments including interest charges?

Personal income_____%

Borrowing_____%

Personal saving_____%

Any other_____%

23) In your opinion, do you consider the interest rates to be low, high, or just sufficient?

Low ☐

High ☐

Sufficient ☐

Others (specify)

24) Do these interest rates have an effect on the profits that your business makes?

Yes ☐   No ☐

25) If yes in what way have the interest rates affected your business? Explain.

_____

_____

_____

26) What problems did you experience when you were applying for the loan(s)?

_____

_____

27) In your opinion, what measures need to be taken by micro finance institutions to make loans easily available for the entrepreneur?

_____

_____

_____

28) List the most pressing problems, which affect your business in order of importance

_____

_____

_____

_____

Thank you for your co-operation