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CONSTRAINTS TO GROWTH OF MICRO FINANCE INSTITUTIONS IN NAIROBI COUNTY, KENYA

DANIEL AMBUNDO MUNALA ANDDR. KORIR

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CONSTRAINTS TO GROWTH OF MICRO FINANCE INSTITUTIONS IN NAIROBI COUNTY, KENYA

***[1]Daniel AmbundoMunala**

Post graduate student, KCA University, Kenya

***Corresponding email address:daniel munala2010@gmail.com**

[2]Dr.Korir

Lecturer, KCAUniversity, Kenya

Abstract

Purpose:The purpose of this study was to determine the constraints to growth of micro finance institutions in Nairobi County, Kenya

***Methodology*:**The study adopted a descriptive survey research design to study the factors constraining the growth of the MFls. A census of all the 54 MFIs registered with the Association of Microfinance Institutions of Kenya AMFI was carried out. The informants for the study were drawn from the senior employees. Data was collected using questionnaires. Data obtained was analyzed using descriptive statistics by use of graphs and pie charts.

***Results*:** The study findings revealed that Only 36 per cent MFIs offer micro savings as a service, the reason being that the rest (64%) are not registered as Deposit Taking Microfinance institutions by the Central bank of Kenya.

***Policy recommendation*:** The study recommends that loan repayment should be constantly monitored and whenever there is a default in repayment, a quick action should be taken. The Microfinance should also avoid granting loans to the risky customers or for speculative ventures, monitor loan repayments, and renegotiate loans whenever borrowers get into difficulties. Credit analysis of potential borrowers should be carried out in order to judge the credit risk with the borrower and to reach a lending decision.

Keywords: *Constraints, Growth, Micro finance institutions*

1.1 Introduction

Microfinance has nowadays emerged as a growing industry to provide financial services to very poor people. Before then, microfinance focused mainly on providing microcredit to micro businesses. Today, there is a growing recognition that poor people need a variety of financial services, not just credit. According to Mwaniki (2006) current microfinance has therefore moved towards providing a range of financial services, including microcredit, micro savings and micro insurance, to poor people and small and medium enterprises worldwide.

Historically, the main goal of microfinance in Kenya was the alleviation of poverty. Alleviation of poverty was the primary social objective and so traditional microfinance institutions consisted of only of NGOs, specialized microfinance banks and public sector banks (Kaburi, Ombasa, Omato, Mobegi & Memba. 2013). In developing countries it is worth noting that in the recent times the market place has been evolving such that the traditional microfinance institutions have and are transforming themselves into profit seeking institutions. The argument attributed to this is that they want to achieve greater strength, sustainability and market rich. Although most microfinance institutions consider alleviation of poverty their primary goal, experimenting with new techniques and strategies to raise more incomes and create jobs in order to sell more products to more consumers is also a motivation to many new entrants.

For microfinance to fully realize its potential to fight poverty, MFIs and donors supporting microfinance institutions must explicitly adopt a strategy that aims to have social impacts such as reducing poverty, and measures progress towards achieving them, as well as having strong financial strategies and controls. 'Most MFIs have explicit social goals within their mission statements, but these are rarely seen as part of a deliberate and managed strategy. Therefore, it is crucial to know whether microfinance is actually helping customers to better manage their finances and to escape the poverty traps that the poor too often find themselves in according to (World Bank & DFID 2010) report.

Those MFIs that focus on maximizing returns for their investors may experience mission drift, as they may find themselves drawn away from their focus on serving the very poor. For example, they may find themselves drawn toward rich borrowers who are cheaper to give loans because they can provide collateral and require bigger loans. MFIs may also attempt to take advantage of regulatory windows or donations to compete with other commercialized financial institutions that are already serving the middle income market. In this case they will not only fail to serve poor people, but also drive out efficient credit providers

The components of microfinance include; microcredit, micro-savings, micro insurance and other financial and non-financial services. These products and services are generally targeted at clients who are poor and lack access to finance from conventional financial institutions**.**

1.2 Statement of the Problem

The potential growth of the microfinance industry is determined by the numbers and needs of those without access to financial services – and these are likely to grow in the long and medium term. Despite strong evidence of progress in the fight against financial exclusion, about one-third (33%) of Kenya's population is still unable to access finance in its various forms (FSD Kenya 2009). Moreover, the global financial crisis of 2008 and the economic downturn that followed made the financial inclusion agenda more challenging for years to come. However, commercial Banks have proven to be successful players in the microfinance industry than MFIs themselves by creating profitable loan portfolios with high returns.

Many commercial banks engaged in microfinance services have several advantages over the other players in the microfinance industry (Herman 2010). Such advantages include owning a large network of branches, thus increasing access for clients, sustainability and financial independence from donors, well-established accounting systems thus more efficiency and experienced staff. Hence there is need to identify which specific constraints hinder performance of microfinance industry in Kenya other than competition from commercial banks. The purpose of this study therefore is to fill this gap by addressing some of these specific constraints that microfinance institutions (MFIs) face in Kenya in their attempt to increase their capacity to reach more poor people to minimize financial exclusion in Kenya.

1.3. Objective of the Study

1. To investigate the effects of high operating costs to MFIs performance in Nairobi County, Kenya
2. To investigate the effects of clients loan default to MFIs performance in Nairobi County, Kenya
3. To investigate the effects of clients drop-outs to MFIs performance in Nairobi County, Kenya
4. To investigate the effects of risk (fraud cases) to MFIs performance in Nairobi County, Kenya

2.1 Literature Review

2.1.1 High operating costs / High cost of capital.

Scarcity of funds for on-lending and capacity building has been cited as a constraint by several studies done in this sector as most micro finance institutions especially those that are not regulated are facing real difficulties raising funds due to scarce donor resources and lack of conventional security to borrow funds from the commercial sector. Most institutions have not yet attained financial sustainability. They lack or have inadequate capital for administrative and program support and expansion, respectively as most of them formally depended on donor funds (Mwaniki, 2006)

2.1.2 MFIs Client Drop-Outs

Client dropout is really a serious problem facing MFIs since it affects not only their profitability and sustainability but also their objectives of reducing poverty in our society. “Dropout is a cost to MFIs both in human and business terms; and it is unwarranted for the institution. No MFI enrolls any member, just to say goodbye. It invests time, energy and money in selecting and training them so that it can have a well-motivated clientele with hopes and determination of overcoming poverty. When someone drops out, it is a loss for the program as it not only decreases the total number of members and borrowers, but also causes a decrease in the amount of loans outstanding and operating income for the MFI. Dropouts create incomplete groups and, in turn incomplete centre’s, leading to breakdown of credit discipline and contributing to low productivity of the staff. It sends a wrong signal to other members and a wrong message to the community. It damages its image and it delays sustainability. Dropouts also contribute to the overall lowering of morale within the program. Not only does the operation of the MFI suffer from the dropouts, but also its progress is hindered and its long term plans disrupted" (Latifee, 2005: 1).

2.1.3 MFIs Clients loan default

According to Credit Kenya 2011 report titled dealing with debt, the problem of over-indebtedness has been attributed to a lack of information: Without a system of credit bureaus or official identification cards for the poor, lenders could not determine a borrower's credit history or the presence of existing loans from other lenders. MFIs that have a good information exchange about clients will be able to see that a client has multiple debts with other organizations hence correctly evaluate the client s loan application

Bichange and Aseyo (2013) noted loan repayment default is largely a result of non-supervision of borrowers by the MFIs, as well as inadequate training of borrowers on utilization of loan funds before they received loans. They also discovered that most borrowers do not commit to spending the loan amount on intended and agreed projects. In order to minimize default, they recommend that MFIs should: educate borrowers on the need to spend less on household consumption, ensure that borrowers meet a minimum threshold in asset value before accessing loans and regularly monitor the borrowers' progress through regular account statements and physical visitations.

2.1.4 MFIs Risk management

From the findings of his studyChege (2010) concluded that credit risk management practices enhance profitability of the MFI, improve profitability, that diversification across MFIs lead to improving shareholders values and improved savings, loan policy procedure adopted by MFIs improve investment and that human-based expert systems payment capacity help in reduction of defaults improving the performance on MFIs. The study further concluded that there was a positive relationship between credit risk management practices and the financial performance of MFIs.

3.0 METHODOLOGY

The study adopted a descriptive survey research design to study the factors constraining the growth of the MFls. A census of all the 54 MFIs registered with the Association of Microfinance Institutions of Kenya AMFI was carried out. The informants for the study were drawn from the senior employees.

4.0 RESULTS FINDINGS

4.1 Response Rate

Semi-structured questionnaires were distributed to the 59 MFIs in Nairobi. 54 of the questionnaires were returned making a response rate of 91.5%.Thisfell within Mugenda and Mugenda's (2003) prescribed significant response rate for statistical analysis, established at a minimal value of 50%.Fincham(2008) stated that low response rate can give rise to sampling bias while higher response rates assure more accurate survey results and recommended a minimal response rate of 60%.

Table 1: Response Rate

Questionnaires	Frequency	Percentage
Filled in Questionnaires	54	91.5%
Unfilled Questionnaires	5	8.5%
Total	**59**	**100**

4.2 Demographics of the Respondents

This section consists of information that describes basic characteristics such as gender, age, position of the respondents and level of education.

4.2.1 Gender of Respondents

The respondents were asked to indicate their gender. Majority of the respondents were male who represented 74.1% of the sample while 25.9% were female. This implies that the leadership of the MFIs in Nairobi County is male dominated.Figure 1: Gender

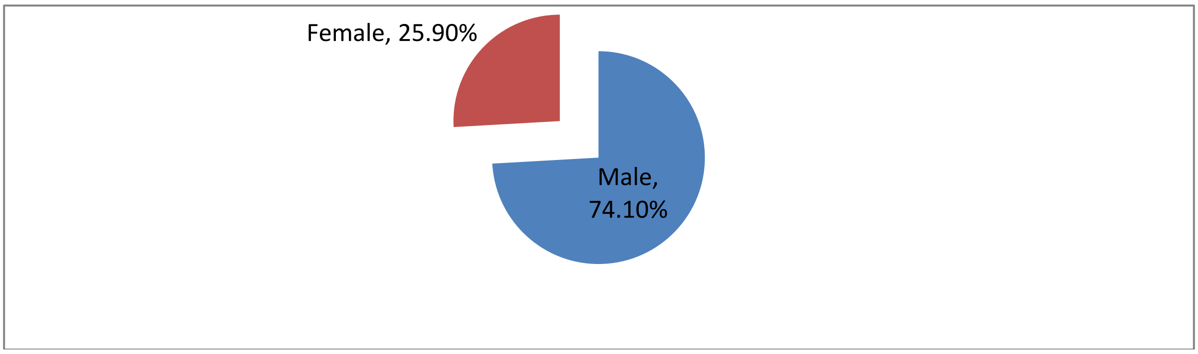

Figure 1: Gender

4.2.2 Level of Education

The respondents were asked to state their levels of education. Results in Figure 2 show that 26% of the respondents had diploma qualifications, 37% had undergraduate qualification and, 37% had a postgraduate qualification. This implies that the leadership of the MFIs had education up to the advanced level.

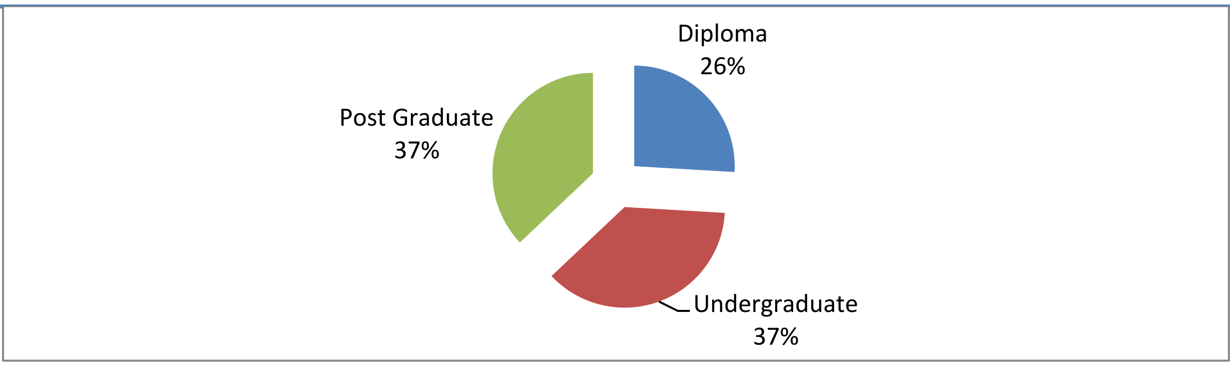

Figure 2: Level of Education

4.2.3 Position Held

The respondents were asked to indicate what position they hold in the running of MFIs. Results in figure 3 shows that 24% of the respondents hold top management positions, 41% were middle level managers while 35% were supervisors.

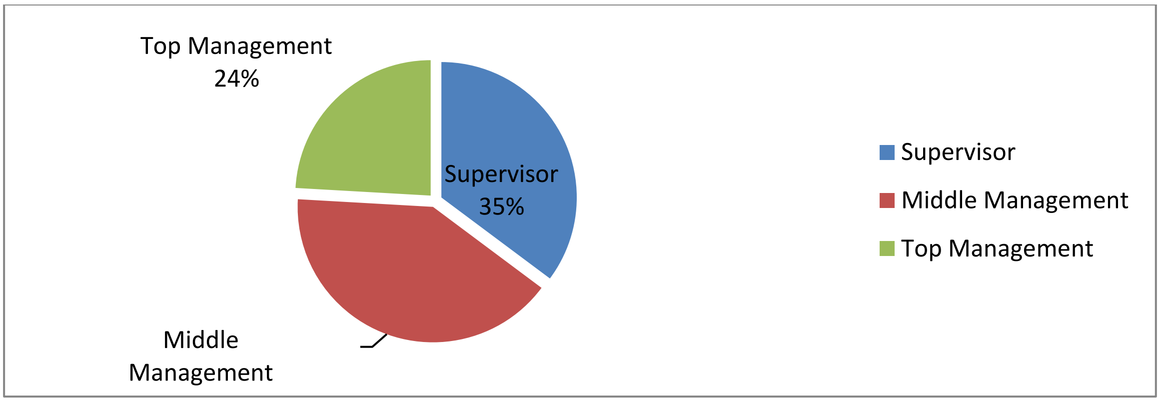

Figure 3: Position Held

4.2.4 Age of the Respondents

The respondents were asked to state their age. Results in Figure 4 show that 13% of the respondents were aged between 21-30 years, 18% aged 31-40 years, 26% aged between 41-50 years and 43% indicated they were over 51 years old. This implies that the leadership of the MFIS had respondents mature enough to understand the questions being asked.

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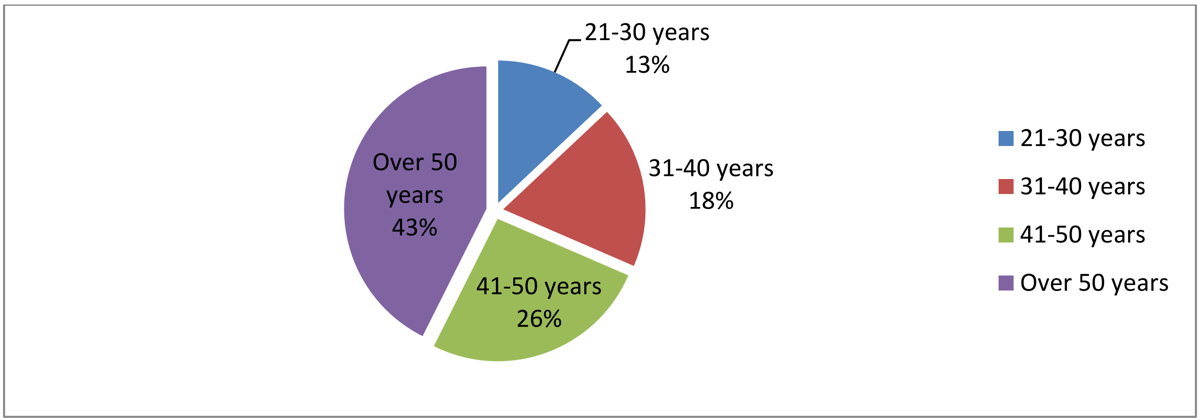

Figure 4: Age of Respondents

4.3 Effects of High Operating Costs to MFIs Performance

4.3.1 Descriptive Analysis

The study sought to determine to what extent operational costs affect performance of the MFIs. 1.9% of the respondents indicated that operational costs affect performance of the MFIs to a low extent, a slight majority, 55.6% indicated performance was affected moderately while 42.6% indicated operational costs affected performance to a high extent.

Table 2: Effects of High Operating Costs (a)

Question		Frequency	Percent
To what extent do operational costs affect performance of the MFI	low extent	1	1.9
	moderate extent	30	55.6
	high extent	23	42.6
	Total	**54**	**100**

The respondents were further asked to indicate the proportion of the total budget that Human Resource, marketing and credit management costs take up.The aggregated of frequencies for Below budget, Above budget by 0-10%, Above budget by 11-20%, Above budget by 21-30% and Above budget by over 30% responses were used to guide the interpretation of the results. Majority of the respondents 92.6% indicated that the Human Resources cost are above budget, 90.7% indicated that marketing costs were above allocated budget and 8% indicated that credit management costs were above its budgetary allocation. These results indicate that MFIs are facing high operational costs. These findings are consistent with that of Brown *et al* (2013) that indicated that African MFIs face many challenges. Operating and financial expenses are high, and on average, revenues remain lower than in other global regions. Efficiency in terms of cost per borrower is lowest for African MFIs.

Table 3: Effects of High Operating Costs (b)

	Response	Frequency	Percent
Human Resource	Below budget	4	7.4
	Above budget by 0-10%	14	25.9
	Above budget by 11-20%	7	13
	Above budget by 21-30%	14	25.9

	Above budget by over 30%	15	27.8
	Total	**54**	**100**
Marketing	Below budget	5	9.3
	Above budget by 0-10%	10	18.5
	Above budget by 11-20%	17	31.5
	Above budget by 21-30%	10	18.5
	Above budget by over 30%	12	22.2
	Total	**54**	**100**
Credit Management	Below budget	7	13
	Above budget by 0-10%	8	14.8
	Above budget by 11-20%	9	16.7
	Above budget by 21-30%	15	27.8
	Above budget by over 30%	15	27.8
	Total	**54**	**100**

4.3.2 Probit Regression Analysis

A probit regression was conducted to establish the constraints to MFIs growth. The coefficients were presented below. It was revealed by results that an increase in costs significantly decreases the predicted probability of high performance by 0.903, holding all other factors constant.The implication is that high costs may be associated with low rates of

MFI growth. Hence, decrease in the operational costs can be associated with higher MFI performance and growth. These findings agree with that of Mulunga (2010) who identified the problems that impact on the growth of microfinance finance institutions (MFIs).The findings of this study revealed that, lack of capital and high operational costs were the main problem areas hampering the growth of MFIs.

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Table 4: Probit regressions

Probit regression	Number of obs	=	54
	LR chi2(1)	=	10.96
	Prob > chi2	=	0.0009
Log likelihood = -30.116209	Pseudo R2	=	0.1539

performance	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
avgcost	-.9035938	.332426	-2.72	0.007	-1.555137	-.2520509
_cons	3.216867	1.119405	2.87	0.004	1.022873	5.41086

4.4 Effects of Client Loan Default to MFIs Performance

4.4.1 Descriptive Analysis

The study sought to determine to what extent client loan default affect performance of the MFIs. 18.5% of the respondents indicated that client loan default affect performance of the MFIs to a low extent, a slight majority, 46.3% indicated performance was affected moderately while 35.2% indicated client loan default affected performance to a high extent. These findings agree with those of Kato (2013) who investigated the effect of loan performance on profitability of financial institutions. The findings indicated that there was a negative relationship between loan default and profitability of MFIs:the level of loan default kept on increasing; that is, loan defaulters were many thus leading to high collection costs which cut down the profits of the MFIs

Table 5: Client Loan Default (a)

Question	Response	Frequency	Percent
Loan Default	low extent	10	18.5
	moderate extent	25	46.3
	high extent	19	35.2
	Total	54	100

The study further sought to establish the proportion of total loans that bad debt and non performing loans represented in the MFIs.The aggregated of frequencies for 0-5% of total loans, 6-10% of total loans and Over 10% of total loansresponses were used to guide the interpretation of the results. 18.5% of the respondents indicated that NPL represented 0-5%

of the total loans, 48.1% indicated that NPL represented 6-10% of the total loans while 33.3% indicated that NPL represented over 10% of the total loans. Results bad debts represented a proportion of the total debt. These results indicate that MFIs are faced with a problem of client loan default.Wangai et al., (2014) established that, credit risk significantly affected financial performance of MFBs.The credit risk negated the MFBs' financial performance. It was deduced that, increase in credit risk would significantly reduce the MFBs' financial performance.

Table 6: Client Loan Default (b)

Question	Response	Frequency	Percent
Non Performing Loans	0-5% of total loans	10	18.5
	6-10% of total loans	26	48.1
	Over 10% of total loans	18	33.3
	Total	54	100
Bad Debt	0-5% of total loans	9	16.7
	6-10% of total loans	29	53.7
	Over 10% of total loans	16	29.6
	Total	54	100

4.4.2 Probit Analysis

A probit regression was conducted to establish the constraints to MFIs growth. The coefficients were presented below. It was revealed by results that an increase in client drop out significantly decreases the predicted probability of high performance by 0.8691, holding all other factors constant. The implication is that high client drop out may be associated with low rates of MFI growth. Hence, decrease in the client dropout rate can be associated with higher MFI performance and growth.

Table 7: Probit Analysis

```
Probit regression                          Number of obs   =        54
                                           LR chi2(1)      =      8.67
                                           Prob > chi2     =    0.0032
Log likelihood = -31.259556                Pseudo R2       =    0.1218
```

performance	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
avgdropouts	-.8691475	.3104327	-2.80	0.005	-1.477584	-.2607106
_cons	2.845337	.9288994	3.06	0.002	1.024727	4.665946

4.5 Effects of Client Drop Out to MFIs Performance

4.5.1 Descriptive Analysis

The study sought to determine to what extent client drop out affect performance of the MFIs. 42.6% of the respondents indicated that corporate client drop out affect performance of the MFIs to moderate extent while 57.4% indicated corporate client drop out affected performance to a high extent. On the question of retail client dropout rate, 29.6% indicated this affected performance to a moderate extent while a large majority 70.4% indicated performance was affected to a high extent. This confirms the findings by Meyer and Al(2011) who examined the determinants of borrower dropouts. Findings revealed that retaining clients is very important for MFIs because it reduces MFI's administrative costs, lowers default risks and increases the average loan balance as well as the institution's productivity.

Table 8: Client Drop Out(a)

	Question	Frequency	Percent
Corporate Clients	moderate extent	23	42.6
	high extent	31	57.4
	Total	**54**	**100**
Retail Clients	moderate extent	16	29.6
	high extent	38	70.4
	Total	**54**	**100**

The study further sought to determine the status of both corporate and retail client drop out.The aggregated of frequencies of 0-5%, 6-10%, 11-20%, 21-30% and over 30% responses were used to guide the interpretation of the results. The results are presented below. Results indicate that there are high levels of client drop outs. Foster *et al* (2010) indicated that dropout rates points to the recognition that dropouts affect financial sustainability in both the short and long-term. Put simply, a dropout is a potential client lost, and without clients the MFI cannot exist. A high number of dropouts without replacement will immediately affect the growth and sustainability of a MFI. In the long-run, consistently high dropout rates may worry investors, who will in turn reduce funding and hinder growth.

Table 9: Client Drop Out(b)

	Response	Frequency	Percent
Corporate Clients	0-5%	9	16.7
	6-10%	20	37
	11-20%	6	11.1
	21-30%	12	22.2
	over 30%	7	13
	Total	**54**	**100**
Retail Clients			
	0-5%	5	9.3
	6-10%	17	31.5
	11-20%	5	9.3
	21-30%	16	29.6
	over 30%	11	20.4
	Total	**54**	**100**

4.5.2 Probit Regression Analysis

A probit regression was conducted to establish the constraints to MFIs growth. The coefficients were presented below. It was revealed by results that an increase in client loan default rate significantly decreases the predicted probability of high performance by 1.237, holding all other factors constant. These findings are consistent with that of Ntamoah*et al* (2014) whose main purpose was to study the impact of loan default rate on profitability.Findings revealed that that there is a strong relationship between problem of recovery and overdue of loans and deficient analysis of project viability. These relations are positive, meaning proper management of loans given to clients will results in higher profitability of firms.

4.6 Effects of Fraud to MFIs Performance

4.6.1 Descriptive Analysis

The study sought to determine to what extent fraud affect performance of the MFIs. 16.7% of the respondents indicated that fraud affect performance of the MFIs to a low extent, 22.2% to moderate extent while 61.1% indicated fraud affected performance to a high extent.

Table 10: Effects of Fraud (a)

Question	Response	Frequency	Percent
Fraud	low extent	9	16.7
	moderate extent	12	22.2
	high extent	33	61.1
	Total	54	100

On the question of the status of fraud in the MFI, the respondents were asked to indicate the percentage of employee fraud and third party fraud in relation to total income. Results indicated that fraud cases represented a high percentage of the MFIs total income.

Table 11: Effects of Fraud (b)

		Frequency	Percent
Employee Fraud	0-5% of total income	7	13
	6-10% of total income	17	31.5
	11-20% of total income	22	40.7
	21-30% of total income	3	5.6
	Over 30% of total income	5	9.3
	Total	**54**	**100**
Third Party Fraud			
	0-5% of total income	2	3.7
	6-10% of total income	19	35.2
	11-20% of total income	26	48.1
	21-30% of total income	4	7.4
	Over 30% of total income	3	5.6
	Total	**54**	**100**

4.6.2 Probit Regression Analysis

A probit regression was conducted to establish the constraints to MFIs growth. The coefficients were presented below. It was revealed by results that an increase in fraud significantly decreases the predicted probability of high performance by 1.374, holding all other factors constant. These findings are in line with those of Akwasi (2015) who examined the challenges and prospects of microfinance institutions. The study findings revealed that key constraints faced by MFIs include poor regulatory environment, corruption, frauds and forgeries and poor corporate governance.

Table 12 Probit regression analysis

Probit regression	Number of obs	=	54
	LR chi2(1)	=	13.45
	Prob > chi2	=	0.0002
Log likelihood = -28.871283	Pseudo R2	=	0.1889

performance	Coef.	Std. Err.	z	P>|z|	[95% Conf.	Interval]
avgfraud	-1.374238	.4368694	-3.15	0.002	-2.230487	-.5179901
_cons	3.861407	1.143372	3.38	0.001	1.620438	6.102376

5.0 SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 SUMMARY OF FINDINGS

5.1.1 Effect of High Operation Cost on MFI Performance

Findings indicated that MFIs incurred Human resource, marketing and credit management costs above budgetary allocations and that these high operating costs impacted performance to a high extent. High operating cost was found to have a negative association with performance.

5.1.2 Effect of Client Loan Default on MFI Performance

There were high loan default rates including non performing loans and bad debts. This had a negative effect on performance of the MFIs. Results of the probit regression indicated a negative and significant association between client loan default and MFI performance.

5.1.3 Effect of Client Drop out on MFI Performance

Client dropout rate, both corporate and retail was observed to be high and impacted on performance to a great extent. Results of the probit regression indicated a negative and significant association between client drop out and MFI performance.

5.1.4 Effect of Fraud on MFI Performance

Descriptive results indicated that both employee fraud and third party fraud impacted on performance to a great extent. Results of the probit regression indicated a negative and significant association between fraud and MFI performance.

5.2 Conclusions

5.2.1 Effect of High Operation Cost on MFI Performance

Based on the findings above the study concluded that high human resource, marketing and credit management costs are ideal factors that affect the performance of MFIs. From these finding the study therefore asserts that there is a significant relationship between high operation costs, and MFI growth.

5.2.2 Effect of Client Loan Default on MFI Performance

Secondly, the study concluded that client loan default greatly affect performance. These were guided by the findings that revealed that non performing loans and bad debts were significant. From these finding the study therefore asserts that there is a significant relationship between client loan default and MFI growth.

5.2.3 Effect of Client Drop Out on MFI Performance

The study concluded that client drop out greatly affect performance. This was guided by the findings that revealed that corporate and retail client drop outs were significant in determining performance. From these finding the study therefore asserts that there is a significant relationship between client drop out and MFI growth.

5.2.4 Effect of Fraud on MFI Performance

The study concluded that fraud greatly affect performance. This was guided by the findings that revealed that employee and third party fraud were significant in determining performance. From these finding the study therefore asserts that there is a significant relationship between fraud and MFI growth.

5.3 Recommendations

Several policy implications emanate from the study. MFIs managers to look for other ways in gaining access to new sources of capital to reduce costs of capital (high operating costs) e.g. consider raising capital from financial markets for onward lending to their clients instead of relying on loans from commercial banks which are always expensive.

The study recommends that loan repayment should be constantly monitored and whenever there is a default in repayment, a quick action should be taken. The Microfinance should also avoid granting loans to the risky customers or for speculative ventures, monitor loan repayments, and renegotiate loans whenever borrowers get into difficulties. Credit analysis of potential borrowers should be carried out in order to judge the credit risk with the borrower and to reach a lending decision.

The dropout rate situation demands introduction of innovative micro credit products. These may include Business responsive products, Build client loyalty through range of service and appropriate staff incentives and training.

To mitigate fraud, the study recommends Human resource policies that stress culture of excellence remuneration for hard work and fairness in the treatment of personnel and adequate internal control and segregation of duties especially in areas of cash handling, loan write offs and rescheduling. The study also recommends Credit committee effectiveness with internal and external audit function. Efficient and effective regulatory and anti- corruption institutions at the macro level and the introduction of forensic accounting and enforcement and full implementation of whistle blowing.

5.4 Suggestions for further research

A similar study need to be conducted comparing internal and external factors that affect MFI performance. This study can be extended by exploring the factors that lead to client drop out. With the establishment of the informal financial institutions which were not captured in this study, it would be interesting to examine how those developments have influenced MFI performance in Kenya.

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