NEWPORT UNIVERSITY, CA

USA

AN EFFECTIVE MICROFINANCE PROGRAM TOWARDS POVERTY ALLEVIATION: CHARACTERIZATION OF SELECTED MICROFINANCE INSTITUTIONS (MFIs) IN UGANDA

A DISSERTATION SUBMITTED IN PARTIAL FULFILLMENT FOR THE REQUIREMENT FOR THE AWARD OF A DEGREE OF DOCTOR OF PHILOSOPHY (PhD) IN BUSINESS ADMINISTRATION

BY

GEORGE LUKWAGO

SEPTEMBER 2005

ABOUT THE AUTHOR

George Lukwago was born in Mpigi, Central Uganda in 1961 and had his primary education in St. Kizito's Primary School, Kyengeza, Mityana from 1968-1975. He joined Mityana and Nyakasura Schools for Ordinary and Advanced Levels respectively from 1976-1982. He obtained a BSc. Degree in Agriculture (Management Option) in 1985. He joined Kawanda Agricultural Research Station in 1987 as a Scientific Officer and was subsequently posted to Kituza Coffee Research Sub-Station.

In May 1992 he obtained a MSc degree (Agricultural Economics) from University of Florida, Gainesville, USA. In 1993 he joined Uganda Coffee Development Authority as a Principal Research Officer and in 1997 and later became the Manager of Research and Development. He has published a number of papers on aspects of rural development, smallholder farmers, coffee farming and development and organization management. He has spearheaded a number of development projects and research undertakings such as impacts and containment of the Coffee Wilt Disease, Coffee Replanting Programme, socio-economics, and farmer empowerment. His interests include microfinance, fund management, institutional reforms, poverty alleviation and policy. He is married with six children.

ACKNOWLEDGEMENTS

I would like to thank my Supervisor, Prof. John Muhumuza PhD, for the supervision, guidance, patience and encouragement during the study. Dr. E.R. Chikwado and Dr. Girma Hunder Wakene owed my gratitude for the expert advisory roles they both played after reading through the Draft of this Dissertation. I also appreciate the input of Dr. Boniface Kakaire which has ensured that I complete the study. My heartfelt thanks go to my wife and the entire family for the priceless support and sacrifice they have made during the course of the study.

I also thank Ms. Mary Muhumuza (Research Assistant), Ezra Munyambonera and the staff of UWESO, CERUDEB, SAO, RUCREF, Feed The Children Fund, NEDA and Wekembe whose contributions towards data collection and analysis were tremendous. Finally I would like to thank Mrs. Sylvia Nakitende Kakinda who typed this dissertation.

Any errors that may arise are however my sole responsibility.

DECLARATION

This work is original and has never been undertaken elsewhere. Acknowledgement of secondary sources has been made where applicable. I, however, remain responsible for any errors that may arise.

APPROVALS

This Dissertation of

GEORGE LUKWAGO ID No. 9907-0038

is approved and is acceptable in its present quality

and form

Signed.. Date September 15 2005

Prof. John Muhumuza, PhD.

Signed.. Date..................................

Dr. Boniface Kakaire

Director, International Institute of Education, Kampala, Uganda.

SEPTEMBER 2005

DEDICATION

This work is dedicated to my parents Mr. Ibrahim Musisi-Lukwago and Teopista Natulo Namatovu of Luzira-Mpenja; Mpigi District, Uganda.

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Acronyms and Abbreviations

ALO	Assistant Loan Officer
AROA	Adjusted Return on Assets
AROE	Adjusted Return on Equity
BRI	Indonesian Peoples Bank
CERUDEB	Centenary Rural Development Bank
CEO	Chief Executive Officer
CMFL	Commercial Microfinance Limited
GDP	Gross Domestic Product
IFS	Institutional Financial Self-Sufficiency
KREP	Kenya Rural Enterprises Program
LO	Loan Officer
MEP	Muluelles d'Epargne et de Pret
MFIs	Microfinance Institutions
MIS	Management Information Systems
NEDA	National Enterprise Development Association
NGOs	Non Governmental Organizations
OER	Operating Expense Ratio
PaR	Portfolio at Risk
PMA	Plan for Modernization of Agriculture
ROA	Return on Assets
ROE	Return On Equity
RUCREF	Rural Credit Finance Company Limited

SAO	Share An Opportunity
SACCOS	Savings and Credit Cooperative Societies
SMEs	Small and Medium Scale Enterprises
UGAFODE	Uganda Forum for Development
UMU	Uganda Microfinance Union
UWESO	Uganda Women Efforts to Save the Orphans
UWFT	Uganda Women's Finance Trust
Wekembe	Wekembe Microcredit Scheme

EXECUTIVE SUMMARY

A new approach for poverty reduction has emerged spearheaded by microfinance institutions (MFIs). However in spite the existence of numerous MFIs in Uganda and overwhelming financial support to them, poverty still remains rampant in Uganda despite the wide adoption of using MFIs to reduce it. Few poor people have accessed credit through MFIs. Impact created by MFIs on poverty assault is insignificant as many people have remained below the poverty line. Information on the effectiveness of MFIs in terms of sustainability and outreach is insufficient. Also lacking is information regarding the program design characteristics and context which determine the success of MFIs as vanguards of poverty alleviation. Reliable information on characteristics, performance and conditions of individual MFIs is in demand but has become difficult to obtain. Factors that influence outreach and sustainability and hence effectiveness of MFIs have not been established. The result study is therefore designed with the general objective to appraise outreach and sustainability of selected MFIs in Uganda towards poverty alleviation and their effectiveness. Specifically the study will determine outreach and sustainability of selected MFIs and analyze how they are influenced by program and contextual characteristics.

The research study will attempt to answer questions related to what an effective MFIs ought to be in terms of outreach, sustainability, program design and

contextual characteristics. Also to be answered are how Uganda MFIs performing in the poverty alleviation efforts and what best practices would enable these MFIs be prepared for this cause.

The study has set a number of hypotheses to be tested. These are:1) That program variables such as loan size, interest rates and savings influence outreach and sustainability of an MFI; 2) That No MFI in Uganda is sustainable; and 3)That Contextual factors do not have an influence on outreach and sustainability of MFIs in Uganda.

The study is significant as it will enrich knowledge on MFIs in terms of sustainability and outreach, and hence guide policy makers, donors and other related groups on how to improve on usage of funds channeled through MFIs. Capital is a scarce resource and in order to allocate it wisely, donors, creditors and investors need timely, objective and reliable information to actual and potential client MFIs. The study will therefore address the inflation gap.

The research design focuses on characterization of seven MFIs in Uganda namely Uganda Women Efforts to Save the Orphans (UWESO), Centenary Rural Development Bank (CEDRUDEB), Share An Opportunity (SAO), National Enterprise Development Association (NEDA), Wekembe Microcredit Scheme (Wekembe), Rural Credit Finance Company Limited (RUCREF), and Feed The Children Fund. The research study used a register of MFIs from the Association of

Microfinance Institutions of Uganda and purposively drew MFIs from Kampala and Luwero districts whose clientele is wide, concentrated and have been in existence for a considerable period. Cross sectional data were collected using a questionnaire, processed and analyzed to determine outreach and sustainability indicators. A regression model was run to establish the relationships between program and contextual variables and outreach and sustainability.

Results indicate that outreach of MFIs is good as reflected by scope, breadth and depth. Number of clients increase across the years implying more access to loans by the poor. Financial ratios indicate that CERUDEB, UWESO and RUCREF are sustainable. Ratios derived for financial sustainability have reflected that some MFIs are effective. Return on assets ratio as an indicator of financial sustainability shows that the three MFIs: CERUDEB, UWESO and RUCREF are sustainable. Return on equity (ROE) also reflected similar results on sustainability for the same MFIs. ROE is a proxy for commercial viability. It reflects the profitability of MFIs and is a measure of the return on investment. As such these MFIs are commercially sound and therefore reflect sustainability. Again ROA is only calculated for. Trend analysis indicates a relatively stable ROA across the periods for RUCREF, UWESO and CERUDEB implying also that these MFIs are sustainable and hence effective. Regression results on programme characteristics indicate that loan size impacts significantly on sustainability indicators: cost per borrower, risk coverage ratio and portfolio quality. The larger the loan the more sustainable the MFI is. It is therefore concluded that the loan

size, a program variable, determines sustainability of MFI and hence its effective and its overall objective of poverty alleviation. The best practices that the study has identified for an effective microfinance are: increasing loan sizes, modern management practices, and good governance under reduced costs per borrower, high risk coverage ratio and a good portfolio quality. The other practices whose results are qualitatively positive and are expected to play a role in sustainability and effectiveness of MFIs towards poverty alleviation are: a good ROE, ROA, loan officer productivity and provision expense ratio and positive interest rates which should cover costs.

The set hypotheses have been tested and have been accepted or rejected as shown in table below:

Hypothesis	**Accepted**	**Rejected**
Hypothesis I That program variables such as loan size, interest rates and savings influence outreach and sustainability of an MFI.	√	
Hypothesis II No MFI in Uganda is sustainable		√

Hypothesis III Contextual factors do not have an influence on outreach and sustainability of MFIs in Uganda.	√	

The study makes a number of recommendations for improved effectiveness of MFIs. These are: the need to expand on scope and breadth of MFIs in order to increase on number of clients served and with a variety of financial products, the evidence available indicates that the interest rates and other charges could be reduced for better efficiency and full disclosure of timely and correct information in this modern era of cutthroat competition is extremely important to enable appropriate decision making for efficiency and attraction of investment. Also government should get involved in the capitalization of MFIs given that Government has looked at MFIs as vanguards of rural development and poverty alleviation. In most of their development programs, MFIs are identified as sources of funds to drive the SMEs to good performance and generation of wealth. The study identifies areas below for further studies:

- Effects of interest rates on performance of MFIs. Specific emphasis be put on ability of clients to pay.
- Subsidies given to MFIs and their effects on competitiveness
- Further analysis of contextual factors on outreach and sustainability

CHAPTER ONE

1.0 INTRODUCTION

1.1 BACKGROUND TO THE STUDY

Uganda's economy is dominated by the agricultural sector which accounts for 43% of the GDP, 85% of the export earnings and 85% of the employment. A recent survey indicates however that 44% of the country's 21 million population do not meet the basic requirements (Uganda 2000). The survey further indicates that disposable incomes of the poor are as meager as 60% of their incomes are spent on food. Access to credit from commercial banks is limited as the poor lack physical collateral always demanded by these banks. Generally poor households in Uganda are characterized by inadequate incomes, insufficient food, few assets of production, vulnerability and various forms of exclusion. Lack of financial services in highly ranked as a causal factor of poverty in Uganda (Uganda 2000). Various approaches in the past have been made to reduce poverty in Africa and Uganda in particular but have not produced significant results of economic growth (Lewis and Kallab 1986). A new approach for poverty reduction emerged in late 1980s and 1990s spearheaded by microfinance institutions (MFIs) where elements of minimal credit, entrepreneurship, business knowledge and empowerment of the poor were promoted (Dichter 1999).

1.1.1 A Synopsis on MFIs in Uganda

The Uganda microfinance sector is relatively young (the typical MFI only started operations 3-5 years ago) but remarkably dynamic. There are around 70 MFIs competing for business in the more densely populated parts of the country. Among these are commercial banks and NGOs with independent microfinance programs and registered MFIs under Central Bank's Financial Statute of 1993. These institutions provide comprehensive financial packages to micro, small and medium enterprises and agricultural sector throughout Uganda. Outstanding of these are Commercial Microfinance Limited (CMFL) which has over 12,000 borrowers, 38,000 savings accounts with 31000 loans valued at shs. 10 billion and shs. 1.7 billion as savings; FAULU, FINCA, DEMISE, Pride Africa and MEDI-Uganda (New Vision 2002). The approach of commercial banks towards issuing credit to MFIs has also changed from 100% cash guarantee to MFIs loan portfolios, good governance and evidence of good systems. There is evidence of rising competition among MFIs to clients. The emerging problem widely recognized for MFIs is taking of multiple loans with different credit officers from different MFIs (McIntosh et al. 2003). Almeyda (2002) praises the performance of Uganda Microfinance Union with over 16000 clients and a loan portfolio of US $ 1 million. Its financial sustainability is 92%. She identified financial sustainability, improved financial structure, outreach and good governance as pillars to this superb performance (Almeyda 2002). The current situation indicates that the demand for microfinance in Uganda far exceeds the supply and government policy of improving education and adjustment reforms has enabled MFIs to thrive.

1.2 PROBLEM STATEMENT

Poverty still remains rampant in Uganda despite the wide adoption of using MFIs to reduce it. Few poor people have accessed credit through MFIs. A lot of funds have been expended in institutionalization of MFIs for purposes of making them credit intermediaries of the poor. Impact created by MFIs on poverty assault is insignificant as many people have remained below the poverty line. Information on the effectiveness of MFIs in terms of sustainability and outreach is lacking. The characteristics of MFIs for effective poverty assault are not known. Information regarding the program characteristics, designs and context which determine the success or cause failure in the performance of these MFIs is lacking. The "best practices" of successful MFIs have not been well documented. Reliable information on characteristics, performance and conditions of individual MFIs is in demand but has become difficult to obtain.

1.3 OBJECTIVES

1.3.1 General Objective

The general objective of the study is to appraise outreach and sustainability characteristics of selected MFIs toward their efforts to alleviate poverty in Uganda.

1.3.2 Specific Objectives

The specific objectives are:

- To determine outreach of selected MFIs
- To determine financial sustainability of selected MFIs
- To analyze the influence of program and contextual characteristics on outreach and sustainability of selected MFIs.

1.4 RESEARCH QUESTIONS

The study will characterize selected MFIs in terms of outreach and sustainability. Effectiveness of MFI is determined by outreach and sustainability, through such characterization the effectiveness of selected MFIs will be gauged. Influencing factors on outreach and sustainability and hence on the effectiveness of MFIs will be determined. The study will specifically focus on the interactions between program design and contextual factors on outreach and sustainability of MFIs. The best practices for successful and effective MFIs will then be defined. The study will answer the following questions:

- What is an effective microfinance as assessed by outreach and sustainability characteristics?
- What are the program design and contextual characteristics of an effective MFI and how do they impact on outreach and sustainability?

- How do Uganda's MFIs perform in terms of sustainability and outreach and hence how effective are they towards poverty alleviation?
- What are the best practices of a typical MFI for better outreach and sustainability?

1.5 HYPOTHESES TO BE TESTED

The following hypotheses have been formulated:

- That program variables such as loan size, interest rates and savings influence outreach and sustainability of an MFI.
- That No MFI in Uganda is sustainable
- That Contextual factors do not have an influence on outreach and sustainability of MFIs in Uganda

1.6 JUSTIFICATION AND SIGNIFICANCE OF THE STUDY

The study will describe how a MFI can improve on its performance through analysis of critical areas of its service to the poor. It will help in guiding policy makers, donors, and other related groups on how to improve on usage of their funds channeled through MFIs towards the poor. In addition, there is little information generated on sustainability, outreach and program characteristics of MFIs in Uganda making the study significant in the quest for efficiency in the performance of the MFIs towards their noble cause of providing financial services and alleviating poverty. If the characterization of successful MFIs and their elements are identified, and the information generated is recommended to other MFIs for better performance, then the crusade against poverty will be redirected. Capital is a scarce resource and, in order to allocate it wisely, donors, creditors and investors need timely, objective and reliable information on actual and potential client institutions. The study intends to address this information gap. The study will generate indicators and benchmarks that can be used in evaluating MFIs. In so doing several benefits to the microfinance industry will be realized. These will include the following:

- To help management of MFIs to identify relative weaknesses, to take steps to improve such weaknesses and make better decisions from an informed point of view.
- It will enhance the information available to potential creditors and investors, which in turn improves the flow of risk capital and the other forms of financing to the microfinance industry.
- It will assist the supervisory authorities in designing appropriate prudential norms for institutions involved in microfinance which is key to ensuring the long-term viability of the industry.

It should however be noted that several of the values or indicators to be generated are not a measure of performance, rather illustrate certain characteristics of MFIs. Information to help increase the transparency of MFIs is also to be generated by the study. All the above will lead to transformation of MFIs to become successful and sustainable. More poor people will then access microcredits leading to increased economic activities and hence reduced poverty levels.

1.7 SCOPE OF THE STUDY

Geographic Scope

The study will be conducted in Uganda and will focus on 7 MFIs involved in providing small credits to poor people. These MFIs are: Uganda Women Efforts to Save the Orphans (UWESO), Centenary Rural Development Bank (CERUDEB), Share An Opportunity (SAO), National Enterprise Development Association (NEDA), Wekembe Microcredit Scheme (Wekembe), Rural Credit Finance Company Limited (RUCREF), and Feed The Children Fund. These seven MFIs have been purposively selected as they address the scope and objectives of the study. They currently offer credit to a big portion of the poor population of Uganda and have been in place for a considerable period of time. The elements of outreach and sustainability to which the study is focused are , to a great extent, covered by these MFIs. Given the time scope of the study which is about one year, the proximities of the MFIs are seen as an advantage. The study will focus on the major objective of determining the effectiveness of these MFIs towards poverty alleviation through analyses of their outreach and sustainability characteristics. The ability of these MFIs to meet the challenges required of them as intermediaries to poverty alleviation will be determined.

1.8 ORGANIZATION OF THE DISSERTATION

The dissertation is comprised of an executive summary and six chapters each with numerous sections and sub-sections. Chapter One is the Introduction and it gives the background to the study problem, the statement problem, justification, objectives, and research questions to which answers are sought. In addition the hypotheses to be tested are set, and scope and significance of the study are given. Chapter Two is the Literature Review where critical citations of the related studies and reviews on the subject matter are presented. A conceptual framework is developed. An overview on the performance of Uganda's economy and MFIs is also further expounded on. Chapter Three gives Methods and Methodology of the study. The econometrics model of multiple regressions is also presented together in form of an equation to show dependent and independent variables. In Chapter Four, data analysis to show results and their significance to the study is carried out. Chapter five draws summary, conclusions and recommendations of the study. Chapter 6 contains references and questionnaire.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 INTRODUCTION

This Chapter is organized in numerous sections. Section 2.0 introduces the Chapter. In section 2.1 the conceptual framework describing the relevancy of MFIs in poverty alleviation and the need for sustainability and great outreach is given. Section 2.2 discusses the program characteristics and their variables such as internal management, leadership, governance of an MFI, presence of voluntary savings, salary levels and their relevancy in sustainability and outreach efforts of an MFI to create an effective MFI. Similarly section 2.3 illustrates environment context of an MFI and related factors which may affect performance of an MFI. In Section 2.4 and 2.5 for outreach and sustainability, respectively, the indicators of an effective MFIs and important pillars in the MFIs industry are discussed. These sections also relate the variables of outreach and sustainability to effectiveness of MFI.

2.2 AN OVERVIEW ON MFIS

Small scale enterprises were identified as pre-requisites to economic development in Africa and methods to finance them through specialized new kind of financial intermediaries were conceptualized (Jackelen 1989). These intermediaries are the MFIs which are now involved in supporting, through credits, individuals and associations to enhance small scale enterprises development leading to improved household incomes, more investments and national economic development. World Bank estimates that there are over 1000 MFIs in over 100 countries reaching a minimum of 1000 clients with a total outstanding loan of US$ 7 billion and equaling 14 million loans to groups and individuals (World Bank 2000).

Microfinance means providing very poor people with small loans in order to enable them engage in productive activities. A microfinance institution is an organization that provides financial services to the poor (Microfinance Gateway 2003). Microfinance clients are low-income persons with no access to formal financial institutions. These include farmers, vendors, shopkeepers, service providers, artisans, and women. Such clients are either poor or vulnerable non-poor who have a stable income. Access of these clients to formal conventional financial institutions is non-existent. Providing financial services to the poor and giving out relatively very small loans is expensive as the size of transaction is small. It is the very reason why commercial banks avoid small loans and small borrowers. On the other hand, informal financial arrangements do not favor these clients. MFIs help the poor to improve on their incomes, build viable businesses and act as shock absorbers to the various vulnerability occurrences (e.g., weather, illness of wage earner) on the poor. These occurrences can claim a big portion on the financial resources of households deepening poverty to the affected. Services of MFIs have evolved overtime to include broader ranges of financial services such as credit, savings, insurance, remittances, foreign exchanges and money transfers.

However, there are cases when MFI is not an appropriate tool to poverty alleviation. The current design of MFIs deliberately excludes extremely poor people who do not have a stable income and loans would only push them further into debts and more poverty. Other programs are normally required to move such extremely poor people to levels of becoming recipients of MFI programs.

The costs of a microcredit in terms of visits of loan officer to client, evaluation of creditworthiness of clients and such related costs can represent 25% of the loan value. Subsequently MFIs charge high interest rates in order to recover the costs of loan administration and also make profits. Most clients are ready to pay such high interest rates as alternatives to higher interest rates from informal financial sector (such as money lenders) and no access to credit are not at all appealing. The poor usually engage in business activities of low return on labor and access to credit provides capital and liquidity and hence enables higher returns which are greater than the interest rates charged by MFIs. MFIs can also reduce the costs of providing microcredit to the poor through improved efficiency levels hence delivering timely loans, better financial products, and quick access to loans by the poor and lower interest rates.

Some MFIs are Non Governmental Organizations (NGOs) whose services are geared towards the low income population. Although NGOs are involved in non-financial activities towards the poor, given that they also provide financial services they are often times included in the list of MFIs. Likewise some commercial banks are engaged in supplying financial services to the poor and are also referred to as MFIs. However in both cases, MFIs refer to those parts of such institutions that offer microfinance services.

However MFIs encompass such organizations as NGOs, credit unions, cooperatives, private commercial banks, non-bank financial institutions and parts of state-owned banks, which are dedicated to providing a wide range of financial services to the poor. Government's role in supporting MFIs can be complicated. Many times there is temptation by government to move microcredits through savings banks, development banks and postal savings banks. Many governments have also set up apex facilities to channel donor funds to MFIs. Some governments have assigned to themselves only the role of a financial regulator as a way to support development of microfinances. In such cases, the financial regulator becomes an institution and only allows viable financial NGOs, credit unions and other community based intermediaries to be licensed to offer depository services to the public and obtain funds through apex organizations. A regulator can also offer credit information, legislate with the infrastructure and examine laws and internal regulations that limit the ability of traditional banks to do microfinance.

2.3 MICROFINANCE IN UGANDA

The Ugandan microfinance sector is relatively young but remarkably dynamic. There are around 70 MFIs typically competing for business in the more densely populated parts of the country, mainly along the roadsides of the strip between Mbale and Mbarara. It is estimated that as of early 1999, around 100,000-110,000 clients are being served if all MFIs are included (Wright et. al 2001). The microfinance industry in Uganda is particularly interesting in that it has adapted well to the renowned FINCA/Grameen inspired models. In addition, Centenary Rural Development Bank and Women Trust Fund which are commercial sector banks are now involved in microfinance activities to serve the poor. Furthermore Centenary Bank lends on an individual, collateral-secured basis.

The largest MFIs and their estimated number of clients are presented in Table 2.1.

TABLE 2.1 PERFORMANCE OF SELECTED MFIS IN UGANDA

Microfinance Institution	Approx. # of Microfinance Clients
PRIDE	20,000
FINCA	17,000
Uganda Women's Finance Trust	9,000
FOCCAS	7,000
UGAFODE	3,000
UWESO	3,000
Faulu	4,000
Co-operative Bank	10,000[1]
Centenary Bank	11,000

1 Cooperative Bank has since collapsed and subsequently closed.

Source: Wright et al 2001.

2.3.1 Challenges and Constraints to Uganda's Microfinance Sector

Uganda's microfinance sector faces a number of constraints. Microfinance institutions have faced a difficult initial period. They are mainly focused on rural communities which are remote are poorly regulated by government.

TABLE 2.2: KEY GOVERNANCE ISSUES AFFECTING MICROFINANCE INSTITUTIONS

MFI	Summary of Key Governance Issues
Bukunda	• Purchase of Ush. 1.9 million plot of land without consulting members • Many Board and all staff have loans in arrears • Very high (70%) arrears/delinquency rate • Poorly/non-functioning Board and Audit Committee (*a new Audit Cmmtt. appointed April 2000)*
Butenga	• High turnover in Audit Committee • No business plan *(business plan now developed – April 2000)*
Kibinge	• High level of "roll-over" borrowing by the Chairman • Possibly risk of "capture" by educated, erudite elite on the basis that they want to create a sound, disciplined, high quality financial institution
Kingo	• Conflict between Board and (two) previous Managers • Conflict within Board over increasing members from outside Kingo • Dominant Chairman seeking to extend his term *(now expected to step down – April 2000)* • No General Meeting for 16 months and no attempts to keep members informed • Many Board members with loans in arrears
Kisseka	• Previous (founder) Chairman and wife delinquent • Under-trained management and Board • Business plan not implemented by Board
Lukaya	• Board/staff (all borrowers) seeking to reduce loan interest rate without consulting members • Risk of "capture" by those members with loans (which are being regularly "rolled over" with few and small repayments being made)
All	• Inappropriate ownership structure • Boards/Audit Committees require additional training and checklists to guide their work • Management needs training (on technical issues and the importance of professional conduct) • Dependent on PMU for "guidance" and supervision

Source: Wright et. al 2000. Rural Financial Services - Background and Theory. Financial services associations in Uganda. A mid-term Review April 2000.

Governance issues have also been identified as constraints and in Table 2.2 is an extract of a sample of 6 MFIs studied in Masaka district. These issues range from separation of powers, ownership, loan portfolio management, and repayment.

The challenge of the relevance of MFIs in poverty alleviation is illustrated by UWFT a MFI that has focused mainly though not exclusively on women. Uganda Women's Finance Trust (UWFT) was founded in 1984 with a mission empower disadvantaged women in Uganda through delivery of an integrated package of services such as awareness creation, savings mobilisation, and credit. As of December 1998, UWFT had 9 branches serving 34,363 clients who had deposited $1 million in savings, and of whom 8,022 had outstanding loans of around $735,000, on which they are paying an effective rate of interest of 66.4% pa. Since emerging from a difficult period during which the UWFT made the transition from individual-based to primarily group-based lending, loans more than 90 days overdue now represent 8.58% of the portfolio. Such services reduce the vulnerability of poor individuals and households by providing access to "chunks" of money to protect against risk and cope with shocks. Wright et al (2000) itemises the relevance to risks as:

- providing chunks of money to build assets (financial, physical, human and social assets);
- providing chunks of money to better manage cash flow and assets;
- increasing the diversification and development of household assets;

- offering a place to safely store savings; and
- increasing women clients' control over assets (particularly human, social and financial – in that order).

Further, Wright (ibid) illustrates the relevance of UWFT to shocks through:

- providing savings or emergency loans to draw upon (though in common with many MFIs, UWFT still does not recognise the importance of providing emergency loans or the "fungibility" of cash, and continues to try to insist on business loans); and
- building assets that can be sold (the research team found little evidence of pawning or mortgaging of assets, and note that the sale of assets is often the last resort).

2.3.2 Sustainability and Outreach of MFIs: An Overview

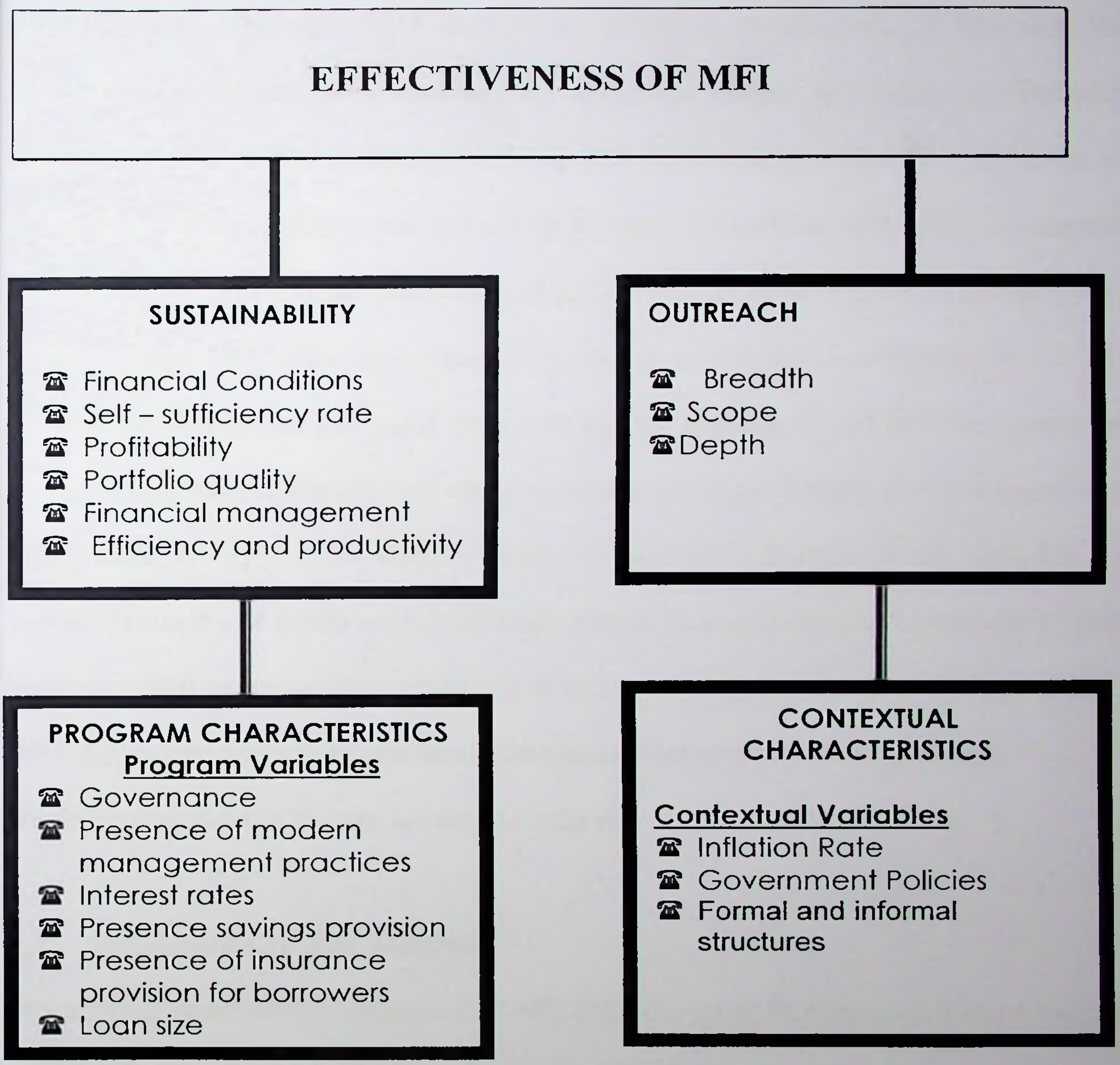
Sustainability is the ability of an MFI to reach large numbers of clients with financial services and is a function of its financial viability. Paxton and Fruman (1999) have indicated that dependency of MFIs solely on donor funds to reach the poor is insufficient and creates dependency syndrome of MFIs. To clients it creates incentives to default as the perception of impermanence and use of external funds takes root. Higher interest rates have been identified as key to financial viability. Successes of microcredit programs in Bangladesh's Grammen Bank and Indonesian Peoples Bank (BRI) in outreach and self sufficiency are described by Snodgrass (1997). Christen et al (1995) demonstrated that microfinance programs can be effective by simultaneously achieving high levels of outreach and sustainability. The merits and demerits of the relevancy of sustainability and outreach have been discussed by a number of authors (e.g., Paxton and Fruman 1999; Rice 2000). This area will be re-visited later.

2.4 CONCEPTUAL FRAMEWORK

2.4.1 Conceptual Model of Effectiveness of a MFI

The relevancy of MFIs in poverty alleviation in developing countries has been dwelt over by various researchers (e.g., Paxton 1996, Rutherford 1996, Dichter 1999). A successful MFI is one whose credit program is designed and implemented to serve the purpose of poverty alleviation among the poor. The components to enable achieve the success are the MFI itself comprising the program variables, the environment under which it operates as well as the MFI's sustainability and outreach characterization. Program variables relate to the MFI and its clients as well as the products or services the MFI offers. These variables include management styles and practices, governance and policies of MFI (such as salary levels, presence of voluntary savings provision and presence of insurance provision for borrowers). Under environment are context variables which broadly cover physical environment, formal and informal institutions, inflation and government policies and regulations (Snodgrass 1997). Context variables influence the MFI program and the operations of the clients'

FIG. 1 CONCEPTUAL FRAMEWORK



enterprises either positively or negatively. The interactions among program variables and with contextual variables determine the effectiveness of the MFI. This effectiveness is depicted by either its financial sustainability or outreach or both. A typical successful MFI would thus be characterized by those variables which influence impart positively on its performance and therefore its effectiveness. The reverse is true. It is therefore appropriate to say that the effectiveness of an MFI defined in terms of either outreach or financial sustainability or both is influenced by the interaction between variables of outreach or sustainability and the program and contextual variables. Snodgrass (1997) further concludes that an effective MFI is one that is designed and implemented for effective operation in its particular environment. The relationship between program and contextual variables and their influence on sustainability and outreach are diagrammatically represented in the conceptual framework in Fig.1. The effectiveness of an MFI is subsequently derived. A further in-depth of these variables and their influences on performance of MFIs indicates that an algebraic equation of the form below can be developed.

$$Y(Y_1, Y_2) = a_0 + a_1x_1 + a_2x_2 + a_3x_3 + a_4x_4 + a_5x_5 + a_6x_6 + a_7x_7 + a_8x_8 + a_9x_9 + a_{10}x_{10} + e_0$$

This is expounded in the subsequent chapter.

2.5 PROGRAM CHARACTERISTICS

Program characteristics refer to the MFI itself as an institution providing financial services to the poor. Delivery of these services is influenced internally by several factors. These factors in both short and long runs do determine the effectiveness of a MFI. These factors are outlined below.

.5.1 Internal Leadership and Management Styles

Leadership and management styles of an MFI greatly influence its effectiveness as a financial service provider. Leadership means initiating and maintaining role structures. It means influencing others towards achievement of the organization's objectives. On the other hand, the management style of an MFI is the pattern of managerial behavior designed to integrate personal and organizational interests and efforts in the pursuit of objectives. Clear guidance and support to operations staff, recruitment, and training of new personnel, incentive systems for personnel and performance evaluation systems are key areas in management which determine institutional strength. Others include institutional culture, structures, capacity, good fit to local environment, competent staff. Under institutional strength are also requirements of a strong business plan for expansion and sustainability and a mission and a vision which create a sense of purpose, belonging, ownership and accountability.

An effective and efficient management requires, among others, accurate management information systems (MIS) to enable decision making, performance motivation and accountability. Loans per officer, operating costs as percentage of average annual portfolio are some of the variables that should be measured for institutional efficiency. Hulmes and Mosley (1996) indicated that successful MFIs use "administration intensive' operational structures in order to reduce on borrower default. Significant degrees of decision -making were also reported (Hulme and Mosley , ibid.). Leadership of

MFIs does influence the behavior of staff and in them determines the quality of output. Leaders stimulate high performance if they provide feedback to subordinates. This feedback should be frequent and specific. Specificity is intended to help direct subordinate to become more competent, successful and self-confident. Coupled with conducive climate, resource input and encouragement for output leaders with such positive behavior tend to have good staff whose performance, self-confidence and enthusiasm exceed minimum performance standards on current and future assignments. Effective team building can then emerge. Leaders with little or no exhibition of encouraging, supportive behaviors tend to have a pathetic staff with marginal outputs.

Management of MFIs should have a business strategy where product market position, the directions in which MFIs seek to grow and change, the competitive tools it would use, and means to new markets, are defined. Under such a strategy the MFI finds a position of sustainable competitive advantage. Fidler and Molhotra (1999) in the study of Zambuko Trust an MFI in Zimbabwe, recommended redress on governance issues, and staff for self-sufficiency of the Trust. In an effort to improve on staff performance and quality of output staff training and motivation, improved customer service, leadership and governance and decentralization were also recommended for Get Ahead foundation an MFI in South Africa (Churchill, 1999). Specifically as MFIs expand their outreach and improve on sustainability effective governance is required.

Under governance Board of Directors through management guides an institution in fulfilling its corporate mission and protects the institutions' assets. Balance between strategic and operational responsibilities is paramount in good governance (Rock et al. 1998).

The microbanking Standards Project has presented institutional performance standards and plans intended for use by MFIs and policy makers in order to establish common standards for donor agencies to apply in their supporting efforts to MFIs. These principles are based on the premise that MFIs seeking support should be able to demonstrate credible plans underpinned by concrete plans. Characteristics looked at under institutional strengths are: Institutional culture, structures, capacities and operating systems that can support sustained service delivery and these encompass a sound governing structure, stable staff and mission and vision which creates a sense of purpose, ownership and accountability. In addition there is a need for accurate management information systems. These systems are essential for effective and efficient management (Srinivas 2003). Training of staff in order to equip them with skills of providing services to the poor has been outlined and identified as a constraint to outreach efforts (Getubig et al 1997).

2.5.2 Governance

While numerous studies have focused on clientele, micro enterprises, household units, sustainability and outreach, few studies have focused on and governance issues of MFIs. Little attention has been focused on assessment of MFIs in management and governance, including organizational structure, performance measurement, enforcement practices and ownership structure. Although governance is area difficult to quantify, it is critical in determining overall risk and future potential of an organization as exemplified by Finannsol an MFI in Columbia and the seven MFIs of Masaka in Uganda (Wright et al 1999; Stauuffenburg et al 2002). Good governance is common to successful NGOs as MFIs which then transform into regulated profit motivated MFIs. Effective governance and clarity about the concept of ownership in a context where there are no real owners is essential factor in the success of such MFIs. Examples given include PRODEM in Bolivia, ACCION Comutana del Peru (ACP), ADEMI in Diminican Republic and Kenya Rural Enterprises Program (KREP) in Kenya (ibid.)

2.5.3 Governance issues in Microfinance

1. The Dual Mission

Most MFIs in Africa and elsewhere combine a social mission of providing financial services to the poorest people with a financial objective of self-sufficiency. The composition of the board of directors and priorities set influence the extent of to which MFIs seek to maintain this dual mission. Rock et al. (1998) urge that these two objectives are not mutually exclusive and that boards through their policies can make MFIs self-sufficient with a vast outreach to the poor. As MFIs evolve into profit making and increased outreach of the poor, the task of balancing the objectives becomes difficult. NGO MFIs lean towards more outreach than profitability. In the profitability objective new entrants are interested in MFI market because of the profit potential. Such entrants seek client coverage only as it relates to expanding the market they reach. NGOs who are MFIs but are also involved in other social programs find balancing the dual mission more complex. This is equally true to a regulated financial institution where microfinance is not a key business segment. It is possible under such circumstances for microfinance issues to have little presentation at the board level and subsequently delegate policies related to microfinance to the staff. In other cases it is possible for the board to divert profits from microfinance activities to other social programs run by the NGO which in turn limits the MFIs ability to achieve the high clientele coverage and good profitability.

The Board of Directors through its composition and priority setting can influence the extent to which the MFI seeks to maintain the dual focus of profitability and client coverage (outreach). Practically the composition of the board would have individual members to represent the necessary balance. For these institutions that are profit focused other professionals such as academicians or community leaders can then agitate for development to influence the institution's goal of client coverage.

An effective board should seek through its own strategic decisions and policies, to move the institution in the direction of the shaded quadrant where superior profitability and high client coverage are achieved. Such an approach affirms the importance of both the social and the profitability mission of an MFI and builds on the experience of those that have achieved it. There is evidence that indicates that the goals of client coverage (outreach) and profitability are not mutually exclusive and that there is no tradeoff between social goals of providing services to the very poor and the unbankable clients and generating profit. Institutions such as Banco Sol (Bolivia), Los Andes (Bolivia), ACCION Communitaria del Peru (Peru), K-Rep (Kenya), ABA (Egypt) and ASA (Bangladesh) among others have illustrated this.

2. Ownership of MFIs

Ownership of MFIs is closely linked with governance. The Board may own or represent interests of owners of MFIs. Alignment of interests of individual directors with the interests of institution is key to realizing effective governance. This is determined by analysis and understanding of the issues associated with each of the four corporate structures of MFIs - public, nonprofit, for profit and credit unions. Although the corporate structure does not in itself define effective governance, for each, factors exist that may strengthen or undermine a board's ability to fulfill its roles and responsibilities. These corporate structures are outlined below.

- **Public Ownership/Government Corporate Structure**

Public ownership of financial institutions chartered to service low-income populations has been a failure worldwide. Despite the good intentions sguided development policies have adversely distorted the market by ecting credit to unsustainable levels of borrower delinquency and a severe dermining of public confidence in government development initiatives. rther, political interference and corruption have undermined performance ındards and confidence. In spite of the above, public ownership of MFIs may cceed if economically sound credit policies and mechanisms to protect the titutions' assets from political manipulation are developed. Extensive branch rastructure, significant financial resources merit the elements that make bllic/government sector involvement in MFIs successful. A good example is ULA a public-private partnership in South Africa. It is a public company eated in 1996, capitalized with public funds and provides the following vices:

Business loans to MFIs

Startup loans for emerging MFIs

Technical assistance to MFIs

Equity investment in businesses and

A Guarantee fund that allows MFIs to borrow from commercial banks. (Rock et al. 1998). KHULA has adhered to market principles in its operations. The government has Board representations.

ner examples include MIBANCO, a microenterprise bank in Peru, Banco del rdeste in Brazil, PRODEM in Bolivia, ACCION Commutaria del Peru (ACP) and NCAP of Argentina. These examples demonstrate an evolution off in the approach by some governments towards public ownership of MFIs and successes are awaited for duplication elsewhere by other governments.

Although some NGOs have become or established institutions to access larger amounts of capital and offer savings, the vast majority of MFIs worldwide operate as non profit NGOs. It is therefore important to understand the strengths and weaknesses of this governance structure of microfinance NGOs.

In the case of nonprofit NGOs no owners exist. Donors provide capital for nonprofit MFIs as grants or concessionary loans. These may be private foundations, government foreign aid agencies, multilateral institutions or individuals. In this case the NGO Board is accountable to the institutional mission as defined and approved by the current and previous boards. It is therefore imperative that the institutional mission be clearly defined and accurately communicated to the institution's various stakeholders. What drives nonprofit board members to responsibly fulfill their duties of loyalty and care still lies in the accountability to the institutional mission. Strong commitment to the mission is therefore of utmost importance. Directors must also have the ability to responsibly fulfill their duties through:

- Their thoughtful and basic business sense– allowing board members to identify the warning signs of trouble
- Their willingness to pose difficult questions and face other members and management with the problems they identify.

dditionally directors must avoid situations that often lead to concentration of ower in the hands of the executive. Although NGO ownership structure of no eal owners may present a structure weakness in the NGO model, reality has nown that MFIs under this model have moved from weak to very successful. nis is as long as individual board members have strongly identified with the stitutional mission and possessed the ability to strategically guide the MFI and old management accountable to performance objectives. Good overnance is common to successful NGOs e.g., Kenyan Rural Enterprises (K-ep) in Kenya, ABA in Egypt, BRAC ad Association of Social Advancement in angladesh, and SHARE in India. Effective governance and clarity about the oncept of ownership in a context where there are no real owners in an ssential factor in the success of these institutions.

For Profit Corporate Structures

vo types of for-profit MFIs exist: 1) includes existing commercial banks and nance companies, referred to as "traditional financial institutions" that have nosen to extend their services to micro enterprises sector. Sub units or bsidiaries are created within these institutions to carry out microfinance perations and relatively small amount of the total institutional assets make up e microfinance portfolio. As long as MF generates a competitive, risk-adjusted turn for these institutions, their involvement is likely to remain and grow. In ganda traditional commercial banks such as CERUDEB, Allied Bank and anbic Bank have opened up such MFIs which run side by side with core functions. 2) Is an NGO that has established or is establishing a regulated financial institution. Unlike the board of a non-profit MFI, the board of directors in this case comprise of owners of the equity capital invested in the MFI. The owners include private individuals, corporations, investment funds and financial institutions whose objective is profit on investment. Some of the MFIs in Uganda are branches of re-known international agencies created for the purpose. These include FINCA, and PRIDE. For effective governance, such institutions must be able to deploy individuals to the board. Review of reports, financial data, and projections requires time commitment and is necessary for effective participation of the board. For private investors in such an investment, their concerns focus on capital preservation and return on investment. Public entities (such as governments and multinational agencies' concerns are in response to their own policies and to political issues and such investments are motivated by social and economic benefits to microentreprenuers.

- **Credit Union Corporate Structure**

Credit union corporate structure is where owners are also the institution's clients. In several cases NGOs transform themselves into credit unions as away for mobilizing deposits. Regulations of credit unions have been minimal and combined with ineffective governance have resulted into insolvency for many of them (Branch and Baker 1998). Branch and Baker (1998) enumerate governance issues that face credit unions as misalignment of priorities, alance of board members between net savers and borrowers, and lack of dent regulations and supervision.

4 Loan Size

n size is an important program variable and is determined by decisions on jet audience. If the poor are aimed at, then loans should be very small and etitive. If capital requirement of the enterprises targeted are high, loans d to be big. Whatever the case may be, loan size should be just right to enforce repayments. Loan staging meant to enforce repayment where ess to larger loans is dependent on actual and full repayment of initial small ns. Studies on outreach of eight rural finance institutions in Africa indicated single model for successful MFI and depicted a variety of modes in order to rove on savings mobilization, provision of credit and institutional flexibility in ice delivery (Paxton and Fruman 1999). Yaron (1994) identified a number of cators of outreach as percentage of target population served by MFI, the je and number of loans and savings accounts, types of financial services red, number of branches established, participation of women, and annual wth rate of assets. Inadequate resource mobilization, legal constraints, ustainable practices, loose targeting, poor motivation, unskilled labor and cts of government policies, have been identified as constraints to successful each efforts by MFIs (Getubig et al 1997). An interesting outreach program been presented in the case study of Uganda Microfinance Union (UMU), a leading MFI in Uganda. Within a period of 4 years, its equity loan had risen from US$30,000 to $1.5 million, had developed a network of 5 branches, served 16,577 clients of which 70% were women all of who were savers; and 63% as borrowers. By July 2001, UMU's outstanding portfolio was US$1 million and savings over $400,000 with diversified portfolio in agriculture (35%), trade 50%, 12% in services and 3% manufacturing. Its repayment rate has remained at 98% with operational sustainability of 111% and financial sustainability of 72% (Almelyda 2001).

2.5.5 Interest Rates

Gibbons and Meehan (1999) have argued for MFIs to charge high interest rates for self-sustainability which will subsequently let MFIs prosper and grow and be vanguards of poverty alleviation. Sustainability and interest rates are therefore interlinked. Referred to as " institutionalists" many authors have also argued that the poor can afford to pay higher rates of interest and that sustainable interest rates are not a substantial burden to poor borrowers (Castello et al 1995). An examination of the performance of 11 MFIs by FOCUS, a CGAP's primary vehicle for dissemination of best practices of MFIs to governments, donors, private and financial institutions, indicated that fully self-sufficient MFI programs charged an effective, real rate of interest high enough to cover all their costs including the cost of capital fully adjusted to capital (CGAP 1995). On the other hand , advocates of subsidized or low interest rates referred to as "welfarists" see subsidies as a "necessary tool" to be able to bring credit to the poor, and see potential and detriment in charging high interest rates to certain borrowers. Rice (2000) questions the validity of impact studies that have supported high interest rates as the studies depict a variety of methodological shortcomings.

2.6 THE COMMITMENT TO THE POOR

The extent of MFIs' commitment to address issues of poverty and the felt needs of the poor is important in MFIs' crusade against poverty. This commitment seeks to separate out mere public rhetoric about poverty from a concrete and sustained one. Therefore it is absolutely necessary to identify how MFIs practices and actions relate to the main focus on the poor and commitment towards poverty reduction (CGAP 1996). A number of focus areas have been identified towards this cause among which are:

- The stated vision of the program and how leadership commitment and institutional history provides validation for it.
- The targeting strategy and how it reflects the poverty orientation of the program;
- The extent to which the thinking behind product design and changes originate from an understanding of the of poverty and vulnerability

K-Rep, a Kenyan MFI serving both the rural and urban poor has recognized that it has left out significant sections of the poor and has since redefined its roles to combine the microenterprise credit with strategies to reach the very poor (Oketch 1999). Lending to the poor and full sustainability are known to be conflicting. NGOs as poverty lenders and striving to reach the poorest of the poor have to forego economic development goals, will have limited impact and shall depend on subsidies in order to operate (Dichter 1999). However great the outreach and sustainability of the MFI may be, it is vital not to lose the vision of the most MFIs of being poverty focused. This element therefore becomes a guiding factor in the attainment of MFIs goals. There is a significant relationship between serving the poor, outreach and sustainability and arguments for and against either to solely serve the poor or to be sustainable have been forwarded (Morduch 1998, Castello et al 1991; CGAP 1995). This point is re-visited later during the discussion on sustainability and outreach.

2.7 OUTREACH AND SUSTAINABILITY

2.7.1 Outreach

Definition

Outreach is the social value of the output of an MFI in terms of depth, worth to users, cost to users, breadth, length and scope. Outreach is proxied by the sex or poverty of borrowers, the terms of loan contracts, the price and transaction costs borne by the borrowers, the number of borrowers, the financial strengths of the MFI and the number of products it offers including deposits (Navajas et al. 1999).

There are six aspects of outreach which are summarized below but detailed elsewhere (Navajas et al 1998).

- **Worth of outreach:** This is the willingness of users of MFIs to pay. To a borrower worth is influenced by the loan size, amount disbursed and terms of maturity. With deposits, worth increases with interest rates and with fewer restrictions on the minimum balance and unlimited withdrawals. Worth is subjective and thus difficult to measure but profits is a good proxy.

- **Cost to Users:** Cost of outreach to users in the sum of price costs and transaction costs. Price costs are direct cash payments of interest and fees. These prices are revenues to the MFI. Transaction costs are not price costs and do not accrue to the MFI. They include such items as time to apply (noncash opportunity cost) , transport, food, and taxes used during the transactions of a financial contract (indirect cash payments). Price cost is measured by the internal rate of return i.e., the interest rates that would the present value of the cash flows of a financial contract zero. Surplus then becomes the difference between worth to a user and cost to a user. It is the highest cost that the borrower would agree to bear to get the loan less the cost that the borrower bears. To an MFI the cost of supply is the opportunity cost of the resources used by the MFI.

- **Depth of Outreach:** Is the value of that a society attaches to the net gain of a given user. In welfare theory, depth is the weight a user in a social-welfare function. Its measurement is difficult and indirect proxies are use. These proxies include sex, loan size, location, education, ethnicity, housing and access to public services. In Guatemala a measure of outreach using lending performance as scale of outreach for two credit unions in 1996, UPA and Union Popular indicated that Union Popular had a total of 10,732 members of which 60% were men and 40% women compared to 15,871 members for UPA of which 50% were men and 50% women. Of the total membership 41% of UPA members received loans compared to 35% for Union Popular. Again for depth, 19% of Union Popular's 671 outstanding loans were for amounts less than $351 accounting to 3% of the funds loaned; 50% were for loans between 351 and $1228 and accounted for 26% of funds loaned. Union Popular' median loan had by 1997 grown to $527 with high mobilization of savings indicating high liquidity, increased lending based on repayment capacity and increased loan-to share ratios (Sustainable Banking with the Poor. Guatemala 1999). Although credit unions in Guatemala have excelled in providing loans to the poor sustainably, there is a lot required for improvement in the areas of:

1. External prudential supervision to supplement local financial discipline
2. Strengthen of credit union's financial systems,
3. Avail technical assistance to credit unions in the areas of governance, financial management, microenterprise credit methodologies and delinquency control and development and practices of industry standards (Almelyda and Branch 1998).

- **Length** of Outreach is the timeframe of the supply of microfinance and because it occurs in future, it is difficult to measure. Profits are a proxy to length.
- **Breadth** of outreach is the number of clients. Because resources are always limited, the needs of the poor exceed the budget and cannot therefore all be fulfilled. Breadth is highly dependent on the sustainability of the MFI and its ability to attract donations. Self- sustaining organizations with wide breadth may reach as many of the poor as poverty-oriented organizations with a narrow breadth (Rosenburg 1996). Credit unions in Colombia and those of Costa Rica and Guatemala have provided these comparable situations (Paxton and Cuevas 1998).
- **Scope** of outreach is the number of types of financial contracts offered by an MFI. In practice, the MFIs with the best outreach produce both small loans and small deposits. Deposits matter as if the poor people make deposits then they have saved to a finance investment and are therefore creditworthy. Deposits also strengthen the incentives for sustainability and length of outreach. Scope for loans may mean loans to both groups and individuals. A loan may also differ in terms. A loan of $200 with two repayment installments in 2 months is different from one say $400 with amortized installments per month for a year.

Reinke (2003) illustrates social and economic implications of some elements of outreach. By targeting women, women are seen as economically less independent than men in a similar social group and benefits from their economic empowerment extend directly to their children. Therefore women are seen as more desirable lenders socially than men and many MFIs which aim at women empowerment target women lenders. Women are also better repayers, pay more punctually and default less than men. This also improves on sustainability. However, not all lendings based on social aspects are financially sustainable. The youth are mostly unemployed, face disillusion, are impoverished and in many cases are seen as a threat to the social fabric of the society. Many MFIs have therefore targeted them. However, the young borrowers have low repayment rates making such an approach more risky. It is urged that reaching rural poor is expensive as it is costly to maintain outreach structures in rural areas. Goetz and Gupta (1999) urge that even if women are the target, lending to men can contribute to the viability of the MFI. Men, they urge, can still send their wives, sisters, and daughters to apply for a loan making them not directly responsible for repayment and hence increasing default rates.

2.8 FINANCIAL SUSTAINABILITY

- **Definition**

This is the ability of an MFI to meet all its costs with money earned through its activities. These costs include operating costs such as staff salaries, equipment, and supplies, interest due on bank loans. Financial sustainability implies then that all the costs of your loan program are paid for from income earned by the program.

2.8.1 Why is sustainability required ?

The MFI , when sustainable, is no longer dependent on donor funding for support on its activities directly related to its lending and can strand the test of time and last through funding droughts. Financial sustainability is key to MFI performance as donors always want to invest in such programs that have indications of standing on their own. Within the borrowing community, a sustainable MFI has better credit risk and is hence able to compete favorably in an environment of various financial service providers. If a MFI took out loans and paid them back then it would gain dignity and confidence. Many MFIs such as Grameen Bank and Banco de Sol have found it less cumbersome and restrictive to raise funds through financial markets and the key for tapping these markets is becoming sustainable (Butts et al. 2003). Indeed recommendations for Grameen Bank to rely on market rather than on government and donors to finance its activities have been documented (Alam, 2000). A conventional view that since MFIs are aimed at the poor, their financial sustainability is thus not possible has been now dismissed and studies have proved this notion wrong (CGAP, 1995; CGAP 1996. Srivanas (2000) enumerates the principles of sustainable microfinance lending as: a) Streamlining operations to reduce costs (e.g., decentralization of loan approval; standardization of lending process) b) motivation of clients to repay loans (e.g., no formal collateral needed; use of character references or group with joint liability to motivate repayments) and c) charge of full-cost interest rates and fees in order to recover the costs of the loan.

A study on the influence of institution's design, management and policy environments on financial sustainability indicated that MFIs with high financial sustainability have lower arrear rates and subsidy dependence indices. There is also a high correlation between financial sustainability and high interest rates, frequency of loan collection, existence of material incentives to borrowers and lending staff to maximize repayment and availability of voluntary savings facilities (Hulme and Mosley, 1996). The explanation to these observations are: (a) The higher interest rates charged by financially sustainable institutions screen out borrowers whose projects have relatively low rates of return and (b) financially sustainable institutions tend to operate voluntary or compulsory savings schemes and willingness to save screens out borrowers as in (a) and provides borrowing households with a limited degree of insurance should projects not yield the expected level of return (CGAP, 1996)

2.8.2 NGOs as MFIs and Trade-offs between Sustainability and Outreach

The central purpose of an MFI is outreach i.e., to provide large numbers of people especially the poor, the women and other disadvantaged groups. Financial sustainability focuses on MFIs capacity to meet its costs from its activities and become independent of donor and government subsidies. The importance of NGOs as MFIs is on the rise. UGAFODE in Uganda, Pride Africa, FINCA International, and ACCION are examples of single -method microcredit replica networks. Multipurpose international NGOs with microfinance and microcredit components include Plan International, Save The Children, World Vision, CARE, Action Aid and Catholic Relief Services. Achieving a balance between sustainability and outreach has become problematic (Dichter 1999) However as the two goals become prerequisites to donor funding, NGOs in microfinance have tended to make several tradeoffs and adjustments. These include:

- Concentrating portfolio growth in areas with high population density thus focusing less on rural areas.
- Emphasizing rapid initial loan volume growth leading to poor portfolio quality.
- Keeping field staff salaries low (or alternatively raising the number of clients per loan officer) to control costs thus tending toward high turnover and low morale.
- Emphasizing short-term loans a strategy for high repayment and loan size growth, thus eliminating cyclical sectors like agriculture,
- Moving up the poverty scale away from the poorest to maintain loan demand and repayment rates.
- Outreach to more numerical numbers as opposed to poverty levels is also problematic.

NGOs as MFIs have shown a poor performance (Dichter 1999). An analysis of trade-offs indicates that sustainability is only possible with high technology, MIS, positive real interest rates, and cost-conscious management that focuses on high repayment and volume growth. But this may be at the expense of taking higher risk, poorer clients. However, an NGO can maintain low costs at the expense of longer term results resulting into subsidy re-dependence. NGOs in their quest for sustainability do forget contextual factors such as political and regulatory environment and nature of markets.

Dichter (1999) further concludes that NGOs as poverty lenders must let go of full sustainability as it is not possible if they are to reach the poorest with financial services. Paxton and Fruman (1999) compared sustainability and outreach of 8 African MFIs on the bases of savings first and credit first. None of the 8 MFIs was sustainable as they all depended on subsidies. This indicates that majority of African MFIs are heavily subsided by donor community. However, savings first MFIs showed less dependency on subsidies than the credit first MFIs. However, credit first MFIs had deeper outreach. In some MFIs a shift from MFIs to commercial banking where loans are backed with commercial assets, a higher PAR 30 does not necessarily mean a loss (e.g., Financiera Vision, Banco Sol, Caj os Andes, FIE n South America and K-Rep in Kenya). Credit unions or Associations have also indicated a good portfolio management. In Benin for Example, CREP network, a system of credit for agricultural production requires that a village forms a mini-credit association called MEP (Muluelles d'Epargne et de Pret) with the following characteristics:

) The Assets of the MEP comprise the total deposits of its members

) The available balance of MEP is the difference between total deposits and the total withdrawals

3) Credit granted to members cannot exceed the available assets of the MEPs. With such an arrangement, the loan portfolio of PAR30 is 0.9% on average, for most CREPS (Glehouenou and Galiba , 1999).

2.8.3 For and Against Sustainability

Mixed views have been aired on the objectives of MFIs against poverty and the need for sustainability. Those in support of sustainability referred to as "Institutionists" insist that MFIs should charge high interest rates in order to create new financial system consisting of a large number of privately financed, large scale financial intermediaries that provide financial services to the poor. Gibbons and Meehan (1999) in support of such an approach wrote " Working toward Institutional Financial self-sufficiency **(IFS)** is essential for MFIs to reach and benefit significant numbers of the poorest households- those living in bottom 50% of the poverty group-with financial services for poverty reduction." IFS reflects an MFI's ability to operate at a level of profitability that allows sustained service delivery with minimum or no dependence on donor inputs, international agencies or charitable organizations. It is widely held that only by pursuing commercially motivated, for profit strategies, will MFIs particularly those working with the poorest achieve our primary goal of reducing poverty among truly large numbers of the poor and the poorest (Rice 2000). Self sufficiency allows for MFIs to grow and prosper in order to attempt alleviating poverty widespread all over the world. Rice (2000) continues to state that the high repayment rates characteristic of MFIs around the world are empirical evidence that moderately poor and poorest can pay appropriate interest rates charged by efficient MFIs. CGAP (1995) has indicated the demand for loans from MFIs far outstrips the ability to supply implying that high interest rates are appropriate. In the study of 11 MFIs affiliated to ACCION International, Castello et all (1991) show that the poor can afford high interest rates and that they pay nominal rates at levels that are higher or equal to nominal commercial rates. It is further argued that MFIs should work towards reducing on transaction and opportunity costs through improved speed of loan disbursement, availability of second and subsequent loans and having a simple procedure to obtain loans. Other steps proposed in this direction include subsequent repayments, definition of a specific target group or geographical area and good management.

On the other hand are "welfarists" or the "poverty camp" in support of subsidies and other support to MFIs and are against sustainability (Rice 2000). Morduch (1989) is among the supporters in this camp. He criticizes the study of the Christen et al (1995) on the successful 11 MFIs and tradeoff between outreach and sustainability as focus was entirely put on three criteria: breadth of outreach, depth of outreach and reputation for financial strength and hewed closely to their selection criteria. While a large number of impact studies have been published demonstrating the impact of microfinance (e.g., Sebstad et al 1996), nonetheless, the findings of many of these studies are questioned for a variety of methodological failures such as inability to control fungibility of funds, the lack of appropriate control groups and the selection bias (Morduch 1998; Von Pischke and Adams 1983). It is ironic that while welfarists are being held to ever-increasing methodological standards for demonstrating program impact, institutionists routinely make broad inferences based on very small and typically high biased sample sets.

A diversity of approaches has been forwarded following the revelation that sustainable and subsidized MFIs serve different clientele. The proposed diversity would address clientele, cultures, and financial situations in which social welfare through increased depth is targeted as opposed to breadth (Castello et al 1991).

2.9 NEED FOR BENCHMARKING

Reliable information on MFIS is in demand but is difficult to obtain. Capital is a scarce resource and in order to allocate it wisely, donors, creditors and investors need timely objective and reliable information on actual potential client institutions. In order to attract new sources of funds, MFIS should provide a high degree of disclosure of to potential creditors and investors. Disclosure can pose a significant challenge to many MFIS whose historic reliance on donor financing and internally generated funds has neither encouraged the use of standard financial indicators nor a general culture of transparency. Without industry-wide benchmark indicators, there are no meaningful reference values that can be used by donors, creditors and investors in evaluating the performance and the conditions of individual institutions. Benchmark indicators have several attributes:

- It helps management of MFIs to identify relative weaknesses, take steps to improve such weaknesses, and make informed decisions.
- It enhances the information available to potential creditors and investors. This helps in the flow of risk capital and other forms of financing to the industry.
- It assists supervisory authorities in designing appropriate prudential norms for institutions involved in microfinance, which is key to ensuring the long term viability of the industry.

It should be noted, however, that several of the indicators are not measures of performance but rather illustrate certain characteristics of the institutions. Judgments and normative comparisons using these references should be made with caution. The summary of these ratios is given below.

2.9.1 Asset Structure

Financial institutions normally dedicate 60-80% of their assets to lending activities. While diversification of assets in important, a large proportion of assets dedicated to non-lending activities particularly fixed assets, may indicate that the institution is not allocating its resources in an optimal manner or that it is facing difficult conditions in the local market.

2.9.2 Structure of Cost of Capital

The debt/equity ratio illustrates the amount of borrowed funds in relation to the institution's own equity or in case of the institution is not shareholder based, its net worth. The use of borrowed funds allows the institution to maintain a larger loan portfolio and achieve higher returns on equity than would otherwise be possible. However, it also increases risks. With a high debt/equity ratio, a relatively small change in the value of the loan portfolio can have a dramatic impact on the institutions net worth.

2.9.3 Portfolio Analysis and Portfolio Quality Indicators

Portfolio focuses on the quality, price, and availability indicators. High quality means low delinquency. Portfolio at risk (PAR) is a standard used in portfolio reports as high risk due to late payment of a loan depicts diminishing ability to recover loan and hence putting the entire loan balance at risk. Assessment of portfolio risk has other attributes. In the restructuring and refinancing of loans, PAR may ignore old loans and only concentrate on new ones. Such an approach may lead to excess accumulation of arrears which can end in bankruptcy (Tor et al 2002). Loan repayment frequency also is useful in the assessment of PAR. The higher the frequency of loan repayment the higher the PAR if such a loan defaults. Conventional measures of PAR (30,60,and 90) for loans tied to crop cycles is meaningless. Indicators of portfolio analysis include also write off, Provision Expense Ratio and Risk Coverage Ratio. Write off is calculated by dividing total write-offs of the period by the period's average gross portfolio. These loans that the MFI removes from its books to prevent assets from being inflated by non-recoverable loans. Provision Expense Ratio is calculated by dividing the loan loss provisioning expense for the period by the period's average gross portfolio. MFIs need strict provisioning practices since loans are less collateralized. 1--10% provision expense ratios are taken as adequate. Risk Coverage Ratio is calculated by dividing loan loss reserves by the outstanding balance in arrears over 30 days plus refinanced loans. The ratio measures the percentage of the portfolio risk recoverable by actual loan loss reserves. It presents the worst case scenario.

2.9.4 Efficiency and Productivity

Efficiency and productivity indicators are performance measures which reflect how well an MFI has streamlined its operations. Productivity indicators show the output per unit of input while efficiency indicators reflect the cost of inputs vis-vis the price of outputs. These indicators are important because they can be directly controlled by management through rationalization of expenditures. Efficiency and productivity determine the competitive edge of an MFI (Natilson, et al 2001). These sets of indicators are readily comparable across MFIs. The ratios considered under include operating expense ratio, cost per borrower, cost per unit of money lent and staff productivity ratio.

2.10. INDICATORS OF SUSTAINABILITY

Sustainability is one of the measures of performance of MFIs is measured through a number of indicators. These indicators are: return on equity (ROE), return on assets (ROA), and portfolio yield. These ratios have been defined in the glossary. Others are outlined below:

2.10.1 Cost Effectiveness:

Cost effectiveness is derived from the following parameters: Average Loan Size, Total costs per loan, portfolio amount per credit staff, number of loans per credit staff, percentage loans with past due payments, liquid funds as percent of portfolio and rate of return.

2.10.2 Growth (%age Change)

Growth is derived from a number of parameters. These are loan portfolio, savings deposits, operating expenses, break-even amount, interest income, average loan size and total costs.

2.10.3 Portfolio Quality

Portfolio quality is another indicator of sustainability and is measured by portfolio at risk. Portfolio at risk is the outstanding balance on arrears over 30 days plus total outstanding refinance/restructured portfolio/total outstanding Gross Portfolio.

2.11 A GLOSSARY OF COMMON MFI TERMS, LOAN TERMS AND FORMULAE

A. Definition of Terms

Assets

Anything to value. Any interest in real or personal property which can be appropriated for payment of a debt.

Bad debt

A debt that is not collectible and is therefore worthless to the creditor.

Balance Sheet

Financial statement presenting measures of the assets, liabilities and owner's equity or net worth of business firm or nonprofit organization as of a specific moment in time.

Bridge Loan

Short-term loan to provide temporary financing until more permanent financing is available.

Business Plan

A document that describes an organization's current status and plans for several years into the future. It generally projects future opportunities for the organization and maps the financial, operations, marketing and organizational strategies that will enable the organization to achieve its goals.

Capital

Broadly, all the money and other property of a corporation or other enterprise used in transacting its business.

Capitalization

Long-term debt, preferred stock and net worth. The loan capital of a community development loan fund; includes that which has been borrowed from and is repayable to third parties as well as that which is earned or owned by the loan fund (i.e. "permanent capital").

Capital Markets

Those financial markets, including institutions and individuals that exchange securities, especially long-term debt instruments.

Cash Flow Financing

Short-term loan providing additional cash to cover cash shortfalls in anticipation of revenue, such as the payment(s) of receivables.

Collateral

Assets pledged to secure the repayment of a loan.

Covenant

An agreement or promise to do or not to do a particular thing; to enter into a formal agreement; a promise incidental to a deed or contract. The following are functional objectives guiding most covenants: full disclosure of information, preservation of net worth, maintenance of asset quality, maintenance of adequate cash flow, control of growth, control of management, assurance of legal existence and concept of going concern, provision for lender profit or program goals.

Current Asset

Assets that will normally be turned into cash within a year.

Current Liability

Liability that will normally be repaid within a year.

Current Ratio

Current assets divided by current liabilities -- a measure of liquidity. Generally, the higher the ratio, the greater the "cushion" between current obligations and a firm's ability to meet them.

Debt

An amount owed for funds borrowed. The debt may be owed to an organization's own reserves, individuals, banks, or other institutions. Generally, the debt is secured by a note, bond, mortgage, or other instrument that states repayment and interest provisions. The note, in turn, may be secured by a lien against property or other assets.

Debt Service

Amount of payment due regularly to meet a debt agreement; usually a monthly, quarterly or annual obligation.

Debt Service Reserve

Term used to refer to cash reserves set aside by a borrower, either by internal policy or lender covenant, to repay debt in the event that cash generated by operations is insufficient.

Default

A failure to discharge a duty. The term is most often used to describe the occurrence of an event that cuts short the rights or remedies of one of the parties to an agreement or legal dispute, for example, the failure of the mortgagor to pay a mortgage installment, or to comply with mortgage covenants.

Delinquent

In monetary context, something that has been made payable and is overdue and unpaid.

Due Diligence

Refers to the task of carefully confirming all critical assumptions and facts presented by a borrower. This includes verifying sources of income, accuracy of financial statements, value of assets that will serve as collateral, the tax status of the borrower and any other material facts presented by the borrower.

Endowment or Trust

A fund that contains assets whose use is restricted only to the income earned by these assets.

Equity

The value of property in an organization greater than total debt held on it. Equity investments typically take the form of an owner's share in the business, and often, a share in the return, or profits. Equity investments carry greater risk than debt, but the potential for greater return should balance the risk.

Equity Participation

An ownership position in an organization or venture taken through an

investment. Returns on the investment are dependent on the profitability of the organization or venture.

Financial management

This is a broad topic in microfinance operation management including interest rate setting, revenue generation, cost analysis, delinquency management, profit centres, credit bureaus and general accounting. Human Resources This key term relates to personnel incentive schemes, staff recruitment, profiles, establishing an institutional culture and staff management.

Fund Balance

Net worth in a nonprofit organization, total assets minus total liabilities.

General Recourse

Rights to demand payment from the general assets of the debtor, without seniority in access to any specific assets.

Governance

Anything related to the activities of governing the organization (e.g., Board of directors, bylaws, and so on)

Guaranteed Loan

A pledge to cover the payment of debt or to perform some obligation if the person liable fails to perform. When a third party guarantees a loan, it promises to pay in the event of a default by the borrower.

Individual Lending

Single-client lending where repayment relies solely on the individual.

Interim Financing

Short-term loan to provide temporary financing until more permanent financing is available.

Intermediaries

Non- or for-profit institutions that have specialized lending capacities. They obtain capital in the form of equity and low interest loans from a variety of sources, including foundations and other funders, to form a "lending pool." They then serve as "wholesalers" who process large numbers of small loans or investments. This "economy of scale" often allows intermediaries to be more efficient than a foundation or funder could be if it considered each investment individually. Also, intermediaries often develop expertise in a particular field or region that foundations or funders cannot afford to develop. In the context of this study, non-financial intermediaries include community foundations and financial intermediaries include credit unions, venture capital and loan funds, banks, etc.

Leverage

Using long-term debt to secure funds for an organization. In the social investment world, often refers to financial participation by other private, public or individual sources.

Liabilities, Total Liabilities

Total value of financial claims on a firm's assets. Equals total assets minus net worth.

Limited Liability

Limitation of shareholders' losses to the amount invested.

Limited Recourse

Rights only to specifically stipulated assets to satisfy an unpaid debt.

Line of Credit

Agreement by a bank that a company may borrow at any time up to an established limit.

Linked Deposit

A deposit in an account with a financial institution to induce that institution's support for one or more projects. By accruing no interest or low interest on its deposit, a foundation essentially subsidizes the interest rate of the project borrowers.

Loan Agreement

A written contract between a lender and a borrower that sets out the rights and obligations of each party regarding a specified loan.

Loss Reserves

That portion of a fund's earnings or permanent capital designated by the board of directors as a reserve against possible loan losses and, as such, unavailable for lending purposes. Generally accepted accounting principles governing for-profit and regulated financial institutions require that loan loss expense be deducted as an annual expense on an accrual basis and that the loan loss reserve be shown as a contra asset reducing loan assets. To date, no accounting convention has been established to govern loan loss reserve accounting for unregulated nonprofit institutions. The technical treatment is to establish the reserve through periodic charges against earnings, and actual losses, when and if incurred, and are charged against the reserve. For balance sheet purposes a loan loss reserve (should) be shown as a deduction from the loan portfolio to suggest that its true economic value should be reduced by the estimated loss exposure.

Market Rate

The rate of interest a company must pay to borrow funds currently. Program-related investments generally are offered at below market rates or at no interest rate.

Negative Covenants

Statements of actions or events of the borrower must prevent from occurring or existing, for example, additional borrowing without the lender's consent.

Net Working Capital

Current assets minus current liabilities.

Net Worth (Fund Balance in nonprofit. organizations)

Total assets minus total liabilities. Aggregate net value of the organization. Total assets minus total liabilities. Aggregate net value of the organization.

Opportunity Cost

The potential benefit that is foregone from not following the best (financially optimal) alternative course of action.

Outreach

Active attempt to find/interact with clients in selected populations, geographic catchment areas or targeted initiatives. This term will often relate to impact studies and would also include market research and delinquency studies.

Peer Lending

See also solidarity group lending, group of groups lending

Peer lending relies on the peer pressure of group members to act as a guarantee in place of more traditional forms of collateral and credit scoring.

Portfolio

A combination of assets held for its investment benefits, including financial and non-financial returns. The asset mix is usually varied in kind and size to maintain an acceptable level of risk and return.

Principal

In commercial law, the principal is the amount that is received, in the case of a loan, or the amount from which flows the interest.

Program-Related Enterprise

A business or enterprise designed to promote the social purpose goals of an organization as well as generate revenue. Among nonprofits, products and services are usually, but not exclusively, identified with the purpose of the organization. Activities can range from fee-for-service charges to full-scale commercial ventures.

Program-Related Investment

Broad, functional definition: A method of providing support to an organization, consistent with program goals involving the potential return of capital within an established time frame. In the context of this study, program-related investments include loans, loan guarantees, equity investments, asset purchases or the conversion of asset(s) to charitable use, linked deposits, and, in some cases, recoverable grants.

Promissory Note

Promise to pay. Written contract between a borrower and a lender that is signed by the borrower and provides evidence of the borrower's indebtedness to the lender.

Receivables

Accounts receivable; an amount that is owed the business, usually by one of its customers as a result of the ordinary extension of credit,

Recourse

Refers to the right, in an agreement, to demand payment from the person who is taking on an obligation. A full recourse loan refers to the right of the lender to take any assets of the borrower if repayment is not made. A limited recourse loan only allows the lender to take assets named in the loan agreement. A non-recourse loan limits the lender's rights to the particular asset being financed – an approach that is common in home mortgages and other real estate loans.

Recoverable Grants

Funds provided by a philanthropist to fulfill a role similar to equity. A recoverable grant may include an agreement to treat the investment as a grant if the enterprise is not successful, but to repay the investor if the enterprise meets with success.

Restructure

A revision of a financial agreement that alters the conditions or covenants of the original agreement. For example, parties may agree to restructure a loan agreement, easing the payment schedule, when a borrower is delinquent or otherwise faces default on a loan.

Roll Over

Prior to or at the time of the maturity of an investment or loan, the interested parties agree to continue to carry over the investment or loan for another, successive period of time.

Security

A pledge made to secure the performance of a contract or the fulfillment of an obligation. Examples of securities include real estate, equipment stocks or a co-signer. Mortgages are a form of security with strong legal standing, because they are publicly registered following a formal legal procedure. A mortgage gives the lender holding a mortgage security the right to reclaim the asset being financed, if repayment is not made.

Senior Debt

Debt that must be repaid before subordinated debt receives any payment in the event of default.

Subordinated Debt (Junior Debt)

Debt over which senior debt takes priority. In the event of bankruptcy, subordinated debt-holders receive payment only after senior debt is paid in full. A subordination of security interest in property allows another creditor to have the rights to the proceeds of the sale of that property before the claim of the subordinated creditor.

Sustainability

Organizational financial and operational self-sustainability meaning the ability to cover costs plus the imputed cost of capital and other expenses; long-term organizational viability

Term

Refers to the maturity or length of time until final repayment on a loan, bond, sale or other contractual obligation.

Total Liabilities

Total value of financial claims on a firm's assets. Equals total assets minus net worth.

User

A non- or for-profit entity that receives a program-related investment directly from a funder for use in its programs or ventures.

Warranties

Statement attesting that certain statements are true. For instance, the borrower may warrant that it is a corporation, that it is entering into the agreement legally and that financial statements supplied to the bank are true.

Working Capital

Technically, means current assets and current liabilities. The term is commonly used a synonymous with net working capital. The term often also is used to refer to all short-term funding needs for operations (excluding debt service and fixed assets). A company's investment in current assets that are used to maintain normal business operations. Net working capital, which is the excess of current assets over current liabilities, is also interchangeable with working capital. Both reflect the resources in circulation to meet operating needs and obligations as they come due.

Write off

When an investment, such as a loan, becomes seriously delinquent or in default and is determined to be uncollectible, the lender may choose to charge the outstanding investment amount as an expense or a loss.

B. Performance Standards: Organizational performance indicators/ performance standards.

<u>Financial Sustainability</u>

Selected Financial Rates

- **Sustainability/Profitability**

1. **Return on Equity (ROE)** = $\dfrac{\textbf{Net Operating Income less taxes}}{\textbf{Average Equity}}$

Calculates the rate of return on the average equity for the period. Because the numerator does not include non-operating items such as donations the ration is a frequently used proxy for commercial viability.

2. **Adjusted return on Equity (AROE)** = $\dfrac{\textbf{Adjusted net operating incomes less taxes}}{\textbf{Average equity}}$

The ratio may be collected on adjusted basis to address the effects of subsidies inflation, loan loss provisioning, and other items not normally included in an MFI's net operating income.

3. Return on Assets = (ROA)

$$\text{Return on Assets (ROA)} = \frac{\text{Net operating income + taxes}}{\text{Average Assets}}$$

Measures how well the MFI uses its total assets to generate returns.

4. Adjusted return on Assets= (AROA)

$$\text{Adjusted return on Assets (AROA)} = \frac{\text{Net Adjusted operating income + Taxes}}{\text{Average Assets}}$$

This ratio may also be calculated on adjusted basis to address the effects of subsidies, inflation, loan loss provisioning, and other terms that are not normally included in an MFI's net operating income.

5. Operational Self sufficiency

$$\text{Operational Self sufficiency} = \frac{\text{Operating Revenue}}{\text{(Financial expense + Loan loss provision expense + operating expense)}}$$

Measures how well an MFI can cover its costs through operating revenues. In addition to operating expenses, its recommended that financial expense and loan /provision expenses be included in the calculation as they are normal (and significant) cost of operating.

6. Profit Margin

$$\text{Profit Margin} = \frac{\text{Net Operating Income}}{\text{Operating Revenue}}$$

Measures what percentage of operating revenue remains after all financial, loan loss provision and operating expenses are paid.

7. **Financial self sufficiency** = $\dfrac{\textbf{Adjusted Operating Revenue}}{\textbf{Financial expense + Loan loss provision expense + Adjusted operating expense}}$

Measures how well MFI can cover its costs taking into account a number of adjustments to operating revenues and expenses. The purpose of most of these adjustments is to model how much well the MFI could cover its costs if it is operations were unsubsidized and it were funding its expansion with commercial liabilities.

- **Assets/Liability Management**

1. **Yields on Gross portfolio** $\dfrac{\textbf{Cash financial revenue from loan portfolio}}{\textbf{Average gross loan portfolio}}$

Indicates the gross was portfolio's ability to generate from interest, fees and commission. It does not include any revenues that have been accrued but not paid in cash or any non-cash revenues in the form of post-dated cheques, seized but unsold collateral e.t.c

2. **Current Ratio** = $\dfrac{\textbf{Short term assets}}{\textbf{Short term liabilities}}$

Measures how well the MFI matches the maturities of its assets and liabilities. Short term are assets on liabilities or any portion of the same that have a due date, maturity date or may be readily converted into cash with in 12 months.

3. Yield Gap = $\dfrac{\text{100\% - Yield on net portfolio}}{\text{Expected annual yield}}$

Compares revenue actually received in cash with revenue expected under the terms of loan contracts. While a small gap is common, a substantial yield gap (>10%) may indicate significant past due payments (arrears), fraud, inefficiency or accounting error. In this formula, expected annual yield means the loan contracts effective interest rate (the declining balance - equivalent rate) for a single payment period, multiplied by the number of period in a year.

4. Funding Expense Ratio = $\dfrac{\text{Interest and fees expenses of funding liabilities}}{\text{Average gross loan portfolio}}$

Shows the blended interest rate the MFI is paying to fund its financial assets. This is ratio can be compared with yield on Gross portfolio to determine the interest margin.

5. Cost of funds ratio = $\dfrac{\text{Interest and fee expenses on funding liabilities}}{\text{Average funding liabilities}}$

The ratio gives a blended interest rate for all of the MFI's funding liabilities. Funding liabilities do not include interest payable or interest on loans to finance fixed assets.

- **Portfolio Quality**

1. PAR Ratio = $\dfrac{\textbf{Portfolio at risk (x days)}}{\textbf{Gross Loan Portfolio}}$

The most accepted measure of portfolio at risk is the outstanding principle of all loans that have one or more installments of principal past to due by a certain number of days. When referring to PAR, the MFI should always specify the number of days.

2. Write - off Ratio = $\dfrac{\textbf{Value of Loans written off}}{\textbf{Average gross loan portfolio}}$

Represents the percentage of the MFI's loans that have been removed from the balance of the gross loan portfolio because they are unlikely to be repaid. A high ratio may indicate a problem to the MFI's collection efforts. The ratio may be represented on adjusted basis to provide for uniform treatment of write-offs.

3. Adjusted write off ratio = $\dfrac{\textbf{Adjusted Value of loans written-off}}{\textbf{Average Gross loan portfolio}}$

4. **Risk Coverage Ratio** = $\dfrac{\text{Loan loss reserve}}{\text{Portfolio at risk> x days}}$

Shows how much of the portfolio at risk is covered by the MFI's loan loss reserve. MFIs should provision according to the aging of their portfolio at risk : the older the delinquent loan, the higher the loan loss reserve. For example a ratio for PAR>90 days may be close to 100%, whereas the ratio for PAR>30 days is likely to be significantly less. Thus a risk coverage ratio of 100% is not necessary optimal.

- **Efficiency /Productivity**

These indicators reflect how efficiently an MFI is using its resources particularly its assets and its personnel. The most used denominator related to assets are: Gross Loan Portfolio, Performing assets and average total assets. Using total assets as the denominator for efficiency / productivity ratios is more relevant for MFI's that manage to deposit and/or share accounts in addition to loans.

1. **Loan Officer Productivity** = $\dfrac{\text{Number of active borrowers}}{\text{Number of loan officers}}$

Measures average caseload of each loan officer. However it should be noted that some MFI's may use number of loans for number of borrowers or number of financial services officers for loan officers.

2. **Personnel productivity** = $\dfrac{\text{Number of active borrowers}}{\text{Number of personnel}}$

Measures the overall productivity of MFI's total human resources in managing clients who have an outstanding loan balance and are thereby contributing to the financial revenue of the MFI. Alternately, the MFI may wish to measure the overall productivity of the MFI's personnel in terms of managing client. This is a useful ratio for comparing MFIs.

$$\textbf{Personnel productivity} = \frac{\textbf{Number of clients}}{\textbf{Number of personnel}}$$

$$\textbf{3. Average Disbursed Loan size} = \frac{\textbf{Value of loans disbursed}}{\textbf{Total number of loans disbursed during the period.}}$$

Measures the average loan size that is disbursed to clients. MFI's should be careful to distinguish between disbursed loan size and outstanding loan size.

$$\textbf{4. Average outstanding Loan size} = \frac{\textbf{Gross loan portfolio}}{\textbf{Number of loans outstanding}}$$

Measures the average outstanding loan balance by client which may be significantly less that the average disbursed loan size.

$$\textbf{5. Operating Expense Ratio} = \frac{\textbf{Operating expense}}{\textbf{Average gross loan portfolio}}$$

Includes all administrative and personnel expenses and is the most commonly used efficiency indicator. Sometimes average total assets is more appropriate denominator for financial intermediaries when calculating the operating expense ratio.

6. Cost per borrower = $\dfrac{\textbf{Operating expense}}{\textbf{Average number of active borrowers}}$

Cost per client = $\dfrac{\textbf{Operating expense}}{\textbf{Average number of client}}$

Provides a meaningful measure of efficiency for an MFI, allowing it to determine the average cost of maintaining an active borrower or clients.

7. Other expense Ratio = $\dfrac{\textbf{Any expense}}{\textbf{Average gross loan portfolio}}$

Expense ratio can be created for nearly any expense account on the income statement.

Operating Expense Ratio (OER) is calculated by dividing all expenses related to the operation of the MFI (all administrative and salary expenses, depreciation, and board fees) by the period average gross portfolio. Interest and provision expenses, as well as extraordinary expenses are not included. OER is the best indicator of the overall efficiency of an MFI and its the MFIs cost of delivering loan services. The lower the OER, the higher the efficiency of the institution.

Source of definitions: Loren Renz and Cynthia W. Massarsky, "Program-Related Investments: A Guide to Funders and Trends". The Foundation Center.

CHAPTER THREE

3.0 METHODS AND METHODOLOGY

3.1 RESEARCH DESIGN

The research design focused on characterization of 7 selected MFIs in Uganda by determining their effectiveness by either sustainability or outreach.

3.2 STUDY POPULATION

The study population comprised of about 70 microfinance institutions of Uganda.

3.3 SAMPLING DESIGN AND PROCEDURE

Using the register of microfinance institutions of Uganda from the Association of Microfinance Institutions of Uganda, a list of MFIs was drawn. Given the purpose of the study whose focus is on outreach and sustainability, MFIs of Kampala and Luwero districts were drawn given that these MFIs have been in place for a considerable period of time. MFIs from other districts have not yet achieved the outreach and sustainability features given their short periods of existence. There was a total of 40 MFIs. Using the criteria of the population served, the clientele size, concentration of the clients, period of existence and guidance from Uganda Cooperative Alliance and Microfinance Support Ltd. a final sample of 7 MFIs was drawn. These MFIs are: Uganda Women's Efforts to Save the Orphans (UWESO), Centenary Rural Development Bank (CERUDEB), Feed The

Children, Share An Opportunity (SAO), of Kalerwe, Kampala, National Enterprise Development Association (NEDA), Wekembe Microcredit Scheme (Wekembe), and Rural Credit Finance Company Limited (RUCREF).

3.4 SAMPLE SIZE

A total sample size of 7 MFIs was drawn from Kampala and Luwero districts.

3.5 DATA COLLECTION

3.5.1 Sources of Data

The study has used both primary and Secondary Data.

3.5.2 Primary Data

Primary data were collected using a questionnaire that was administered to each of the MFIs sampled.

3.5.3 Secondary Data

The major sources of secondary data were annual reports, performance reports, research papers and various documentations on microfinance institutions both in Uganda and outside. Internet was a major source of this information that was gathered from the various web sites that happen to house data on MFIs.

3.5.4 Methods and Instruments of Data Collection

The model estimation was based on cross-sectional data. The cross-sectional data was collected from the 7 MFIs using a questionnaire that was earlier developed and pre-tested to achieve the study's objectives. Both quantitative and qualitative data were collected. The cross-sectional data collected focused on included history and description of MFIs, leadership, and governance, contextual factors, sustainability and outreach indicators.

3.6 DATA PROCESSING, PRESENTATION AND ANALYSIS

Data were processed, presented and analyzed using appropriate tools in order to generate information relevant to the study objectives. Descriptive statistics were generated to describe the profiles of the MFIs. Similar approach was used to describe outreach indicators and general qualitative parameters of governance. The outreach indicators were breadth (number of clients), scope (number of financial contracts offered) and depth (loan size, number of female clients), eligibility to borrow, and the borrowing costs (other than interest rates).

The governance parameters identified are: presence of Board of trustees, presence of Board structures, duty of care, understanding dual mission of MFI and democratic representation. Presence of two or more of these parameters would "pass" the MFI as having good governance. The converse was also true. Likewise for management indicators were selected as small span of control for quick decision making, Integration of activities/coordination, proper planning, delegation of loan approval and separation of responsibilities between Board Chairman and Chief Executive Officer (CEO). Good leadership was then taken to be one which has two or more of these parameters.

Income statements and balanced sheets for the various MFIs were analyzed to determine sustainability of the MFIs focusing on the financial ratios, portfolio quality, assets/liability management, and efficiency. Return on Assets, Return on Equity, Risk coverage ratio, provision expense ratio and portfolio at risk are calculated and analyzed. Number of loans disbursed per loan officer is used as an indicator for staff efficiency. These financial indicators are compared across the MFIs and against known standards.

Contextual variables identified are presence of government policy and law that regulates MFIs and other financial intermediaries, inflation, and presence of informal and formal institutions of similar functions. Results from these analyses are then used to test the hypotheses and to answer the research questions set.

Regression analyses were then carried out in order to further test the hypotheses. These analyses would then help to establish the influence of selected elements of program and contextual characteristics on outreach and sustainability and hence the effectiveness of MFIs.

3.7 MODEL AND THEORY

The multiple regression model has been developed from the fact that the effectiveness of MFI is derived from its sustainability and/or outreach which are in turn influenced by program and contextual variables. The model is commonly used in econometrics to establish relationship among economic variables. Changes in one variable referred to as dependent variables are explained with reference to changes in the variables called independent variables. This approach therefore enables to characterize a given MFI in terms of its effectiveness.

$$Y(Y_1, Y_2) = a_o+a_1x_1+a_2x_2+a_3x_3+a_4x_4+a_5x_5+a_6x_6+a_7x_7+a_8x_8+a_9x_9+a_{10}x_{10}+e_0$$

The description of these variables are summarized in the table below:

TABLE 3.1: DESCRIPTION OF VARIABLES

Dependent Variable	
Y =	Effectiveness of MFI
Y_1, = (Portfolio quality, Efficiency, Assets/Liability Management and Financial ratios)	Sustainability
Y_2 = *(Breadth, Scope)*	Outreach
Independent Variables	
Program Variables	
x_1 =	Loan size
x_2 =	Number of clients per staff
x_3 =	Presence or absence of savings
x_4 =	Good or not good governance
x_5 =	Presence or otherwise of modern management practices
X_6 =	Interest rates
contextual variables	
x_7 =	Inflation rate
x_8 =	Presence or otherwise of Government policy on regulation_
x_9 =	Competition from other microfinances

$a_1 - a_9$ are coefficient parameters to be estimated.

Literature cited in many cases have shown the a priori expectations of the regression coefficients as below:

- There is high correlation between financial sustainability and high interest rates
- Loan size can either positively or negatively influence sustainability. Positively the bigger the loan the less the %age cost on recovery and vice versa; small loans increase outreach.
- Modern management practices are expected to impart positively on effectiveness of MFI
- Government policy can exert positively or negatively on the effectiveness of MFI
- Inflation can either be negative or have no effect on performance
- Savings are highly correlated to sustainability of MFI.

3.8 LIMITATIONS

1) Reluctance of MFIs to release information especially that related to financial matters.
2) Poor information management systems of most MFIs
3) Time to carry out research was also a limitation

Despite these limitations, data collected and conclusions reached are generally varied and any error is for limitations especially non-disclosure of the important information.

CHAPTER FOUR

4.0 FINDINGS, ANALYSIS AND INTERPRETATION OF THE RESEARCH STUDY

4.1 INTRODUCTION

This chapter presents results obtained from the study. The presentation is done both in tables and simple statistics. A summary of the general descriptions of the MFIs is given. Governance issues pertaining to MFIs are presented and discussed. Outreach and financial sustainability findings are presented. Regression results are also given.

4.2 BRIEFS ON THE MFIs

4.2.1 National Enterprise Development Association (NEDA)

National Enterprise Development Association (NEDA) is a limited company by shares. Founded in 1995, it has a governing board of 6 members. Its MFI activities are carried out by a management team comprising of a general manager and loan officers.

4.2.2 Uganda Women Efforts to Save Orphans –UWESO

Uganda Women Efforts to Save Orphans (UWESO) was formed in 1986 with a mission to give a helping hand to orphans by the then mainly war-orphans. Following the onset of HIV/Aids epidemic, the orphans have increased hence the activities of UWESO have also been enlarged. It operates 11 branches spread nationwide with over 45 permanent staff. Headed by an Executive Director, UWESO has created a UWESO UK Trust to help in fund raising and carrying out specific activities. UWESO runs women organizations and helps them in vocational training and support to SMEs. It pays school fees for the orphans and runs orphanage homes in Kakiri and Masuliita sub-counties of Wakiso district. The organization has also started a secondary school and a big farm in Migyera, Nakasongola district. It works also through church organizations. UWESO MFI was formed specifically to separate charity functions from business with a view to make the organization sustainable.

4.2.3 Wekembe Microcredit Scheme-- Wekembe

Wekembe Microcredit Scheme commonly referred to as Wekembe is an MFI incorporated by guarantee and is a non-profit organization. Founded in April 1998, Wekembe is governed by a Board and is under the Catholic diocese of Kasana-Luwero. It operates in 10 catholic parishes in Luwero, Wakiso and Nakasongola districts through village banks where lending solidarity group lending is mainly used. By 2004 Wekembe had a membership of 2448 members.

4.2.4 Rural Credit Finance Company Limited --RUCREF

RUCREF was formed in 1990 as a MFI and it stands out alone as thus. It has grown since then to form two big branches. It is privately owned but falls under the private-public partnership. It has a full board of trustees. Its vision encompasses customer-focus, provision of financial services and improvement of quality of life for Ugandans. It provides credit, savings, depository and training services to its customers.

4.2.5 Centenary Rural Development Bank --CERUDEB

Centenary Rural Development Bank (CERUDEB) started in 1982 as a credit trust: Centenary Rural Development Trust and began to provide financial services in 1985. It faced difficult times during 1987-1989 and was restructured in 1992. In 1993 it was registered as a full-service bank. During the 10 years 1993-2003 the bank has become the largest microfinance bank with a customer base of about 400,000 and a network of 20 branches nationwide. Total revenue of the Bank grew by 43% from shs. 20.9 bn in 2002 to shs. 29.9 bn in 2003 while depositors' numbers increased by 26% from 316,650 in 2002 to 397,810 in 2003. Likewise number of borrowers grew by 42% from 13,296 to 44,796 for 2002 and 2003 respectively. Its ownership comprises of shareholders: Uganda Catholic Secretariat, (24%), the Catholic dioceses of Uganda (31%), S.I.D.I., a French Investment Bank at 10%, Hivos-Triodos a fully owned subsidiary of Triodos Bank, a Dutch Investment Bank at 15% and DCFU at 19% (this is in the process of complete divesting out) and individuals who comprise 1% of the shares.

CERUDEB has a Board of Directors and a Management Team. Its microfinance component comprises of 78% of the total lending.

4.2.6 Feed The Children Fund

The microfinance component of Feed the Children Fund is a part of the community banking division and is profit seeking to differ from the mainstream Feed the Children, a charity organization. This microfinance component was formed in 1997 and is governed under the Feed the Children International Board of Directors. It has a network of 5 branches nationwide with staff of 85 of which 14 are managers.

4.2.7 Share An Opportunity (SAO)- Kalerwe- Kampala

The MFI was formed in December 2002 and its activities are relatively low. It has recently opened up another branch in Zirobwe, Luwero district. Located in the slum area of Kampala, SAO _Kalerwe aims to provide to the poor credit facilities of the smallest size possible making a big outreach. By 2003 its outreach had covered 144 members from only 4 members in 2002. Its loans are focused on school fees, petty trade and agriculture.

4.3 GOVERNANCE

Governance looks critically at the Board of Directors for the various MFIs, leadership and management of these MFIs. The results are presented and discussed.

4.3.1 Board of Directors

In all the MFIs there is a Board of Directors (table 4.1). The importance of a Board of Trustees in MFIs is paramount for proper governance. Legally the Board would ensure that the MFI complies with its articles of incorporation, bylaws, policies and procedures and maintains its legal status. The Board also makes binding decisions for the organization. In the absence of a Board of Directors, there is likely to be ineffective governance implying that responsibilities on management accountability, strategic planning and policy making would be lacking. This in turn implies fiduciaciary responsibilities of MFIs are not fully fulfilled. However, given the existence of this important element of the program design, the implication on effectiveness is derived.

TABLE 4.1: GOVERNANCE CHARACTERISTICS: BOARD OF DIRECTORS AND BOARD COMMITTEES

Name of MFI	Presence of Board of Directors	Number of Board Members	No of Committees/ Presence of Board Committees
RUCREF	√	7	2
UWESO	√	15	2
SAO	√	9	2
NEDA	√	6	2
CERUDEB	√	11	4
FEED THE CHILDREN FUND	√	8	3
WEKEMBE	√	11	2

Source: Primary data

It is because of good governance and its merits that an MFI should have a Board of Trustees. While physical observations of good governance could not be ascertained, merits of good governance are implied. In case of external funding, investors and donors consider the involvement of the Board as an assurance that their funds will be used properly.

4.3.2 Board Composition

Number of board members varied from MFI to another (Table 4.1). NEDA has the lowest number of board members while UWESO has the largest. The skills and characteristics of these members could not be ascertained. However the number of board members has implications. All MFIs do not necessarily have big numbers so they can have frequent meetings as required of them, can monitor portfolio quality and quorum is easy to raise. There were variations among factors considered in choosing board members. The members are chosen either by shareholders as is the case of NEDA or is composed of founders as the case of SAO.

4.3.3 Board Structures

In all MFIs there exists board structures composed of small committees to ease up board work (Table 4.1). These committees are:

- Audit and Finance Committee
- Fundraising (resource mobilization) committee

- Loan Committee
- Audit Committee
- Marketing Committee

The significance of these committees in good governance focus on the following attributes:

- Smaller committees are more efficient than the larger board.
- Smaller committees are likely to discuss issues with greater in-depth resulting into improved efficiency and quality prior to making decisions.

All MFIs have an audit and finance committee given the importance of money in the day to day business of the MFIs. The finance committee provides an oversight in safeguarding the MFIs institutional resources. It also assesses the risks of the MFI. Although management designs and implements an effective internal control system, it is the board which has the responsibility of overseeing the control measures hence the presence of audit in the committees. Generally the Finance and Audit committee reviews budget proposals where it makes suggestions to management for improvement prior to consideration by full board. Presence of other committees varies and it is only Wekembe with a marketing committee.

Factors that influence the choice of board members are presented in table 4.2. In most MFIs the following factors were considered in choosing membership. These are:

- Skills and characteristics

- Understanding MFIs mission and
- Democratic representation.

Skills and characteristics of the individual members have a bearing on effective governance of MFIs. All MFIs show high regard of this factor. The end results of such boards include diverse set of experiences, backgrounds, and areas of expertise (Rock et al 1998).

4.3.4 Factors that Influence Choice of Board Members

Table 4.2 presents a summary of factors which influence the choice of Board Members for the various MFIs. Skills and characteristics and understanding the mission of MFI's mission are the most observed factors. Although understanding the MFI's mission is inclusive of its dual mission, the study went further to separate the two. Understanding the dual mission is an important factor in the choice of board members. It aims at balancing social and financial objectives. Social objective implies seeking to provide loans to as many members as possible in the lowest income population category. The financial objective focuses on ensuring financial self-sufficiency of an MFI and less dependency on subsidies. Feed The Children Fund and RUCREF indicate an influence of "Understanding the dual mission" as one of the factors considered when choosing board members. Other MFIs do not mention it as an important factor. The implication of this observation is that as profitability becomes a major motive for most MFIs the social objective is getting out of priority areas.

TABLE 4.2: GOVERNANCE CHARACTERISTICS: FACTORS INFLUENCING CHOICE OF BOARD MEMBERS

MFI	FACTORS					
	Skills and characteristics	**Understanding of Dual Mission**	**Duty of Loyalty**	**Understanding of MFI's Mission**	**Democratic representation**	**Gend**
WEKEMBE	+	-	-	+	-	-
UWESO	+	-	-	-	+	-
FEED THE CHILDREN	+	+	-	+	-	-
SAO	-	-	+	+	+	-
RUCREF	+	+	-	+	+	-
NEDA	+	-	+	+	+	-
CERUDEB	+	-	+	+	+	-

+ Strong
- missing or weak, not considered
Source: Primary data

For MFIs with dual mission, the presence of such board members ensures that the MFIs respond adequately to both objectives. However, understanding the MFI's mission was highly regarded by all MFIs in the selection of board members. Equally taken as important is the democratic representation and duty of loyalty.

Gender is a factor lowly regarded in all MFIs during the selection of board members. For example, CERUDEB has 11 board members of which only 1 is a female. This would generally imply that in the policy discussions by the board, gender issues are not adequately covered which in turn may have a negative impact on governance. In this era of social equality, it is important that issues both social and economic, that relate to both sexes are given due attention. This is the reason why in many policy frameworks such as Plan for Modernization of Agriculture, National Agriculture Advisory Services, and local councils, 'engenderization' is a critical factor in their implementation and performance. Also in the corporate social responsibility, a phenomenon highly regarded in modern management, gender issues are stressed.

4.3.5 Ownership of MFIs

Ownership of MFIs is presented in Table 4.3.

TABLE 4.3 GOVERNANCE CHARACTERISTICS: OWNERSHIP OF MFIS

MFI	OWNERSHIP		
	PRIVATE	PUBLIC	NOT CLEAR
WEKEMBE	√		
UWESO			√
FEED THE CHILDREN			√
SAO	√		
CERUDEB	√		
NEDA	√		
RUCREF	√		

Source: Primary data

Most MFIs are privately owned except for Feed the Children Fund and UWESO whose ownership could not be ascertained. Following the Uganda Government's policy of economic liberalization of 1989 onwards, the public role or government's role in the economy grossly diminished and it is therefore not unusual to find no direct public role in MFIs. This development can however, be detrimental to the development of MFIs as vanguards of economic development as is the case in Uganda. Capital and assets base which form a solid base of such MFIs can be lacking. In addition, the fact that government has a social responsibility of fighting poverty among its populace, and the fact that MFIs' role in this endeavor has a multiplier effect, as seems to be the case in Uganda non- involvement of government in day to day management of MFIs can work against this expectation. It is also a fact that microfinance is a major pillar in PMA.

However, because of the minimal role of government in microfinances the operationalization of PMA has virtually been weak. Public and government involvement in ownership of MFIs could therefore be justified to strengthen such a role but also to protect their assets from political manipulation. Government could also capture the poorest population and focus on them in its poverty alleviation efforts. Coverage of the MFIs above is limited as private capacity to do so is weak implying that few population is reached. Building up of sound capital base is also an advantage of government and other public related involvement. In South America for example, Banco del Nordeste, a government owned bank that has rolled into microfinance field has developed a big network and has been successful in providing loans to the poor (Rock et al 1998). Without the involvement of government/public investment in the formation and capitalization of MFIs, such MFIs may remain small and weak and reaching few clientele.

MFIs ownership structure with no owners may present a structural weakness in the MFI model. The choice of board members under such arrangement may also be questionable as interests are likely to be divergent and conflicting.

4.3.6 Vision, Set goals and Strategic Planning of MFIs and implied Roles of Board

Boards of MFIs are required to define goals and set targets for them. They identify key areas in which the executive should perform effectively. Among these is the vision. Vision is management's capacity to define long term-term view of the MFIs' future critical to its sustainability. The vision should be articulated in a strategic plan and expected results indicated. All MFIs have visions and set goals which have been summarized below.

4.3.7 RUCREF

Set goals

- To provide credit facilities to smallholder farmers and micro-enterprises
- To encourage clients to save
- To establish accounting systems among the groups to ensure accountability and full loan recovery
- Operate on a sustainable basis.

4.3.8 SAO's goals are enumerated as:

- To promote growth as most effective strategy for mobilizing domestic savings
- To attain, improve and sustain high portfolio quality with minimum delinquency
- To render affordable services to members and to

- Promote their economic welfare
- To achieve operating efficiency that will ensure survival, growth and sustainability.

4.3.9 UWESO's set goals

- Promote the development of income generating activities for foster families
- Improve business skills and management ability of clients
- Increase self-employment opportunities for target beneficiaries
- Create sustainable savings and credit schemes
- Promote growth and maintenance of members' savings

4.3.10 Feed The Children Fund

The vision of Feed The Children's Fund is " To be a sustainable MFI that develops the potential of low income earners through supporting viable enterprises that contribute to higher standards of living."

4.3.11 CERUDEB

CERUDEB's mission statement is "to provide appropriate financial resources especially microfinance to all people in Uganda particularly in rural areas, in a sustainable manner and in accordance with the law."

4.3.11 WEKEMBE

The vision of Wekembe is to empower the poor economically through timely provision of small loans to make big changes in their livelihoods.

The presence of vision and set goals for these MFIs is a good indication with positive attributes. The vision is eventually articulated in strategic plans which also outline the main program areas for MFIs and the results that are expected. It is therefore true to conclude that these MFIs have, tended, due to the presence of vision and set goals, towards these attributes. In addition, the roles of MFI Boards in management accountability are fulfilled. The Board's role in the definition of the vision means the Board can set clear and measurable goals as well as being able to monitor the performance of the executive and help in comforting weaknesses.

The relevancy of vision, set objectives and strategies cannot be overemphasized in MFIs performance. MFIs need business plans, clear goals and proper strategies to keep their organizations healthy and sustainable. An MFI should commit itself to viability and therefore embed service-oriented commercial aspects in its vision. In the area of institutional policy setting and strategic planning, the board is expected to provide input in charting strategic course, provide guidance in setting policy, and provide guidance in developing and mobilizing solutions. The Board would also be tasked in maintaining continuity, renewal of leadership and self-evaluation.

A further analysis of governance characteristics looks at how board members and management avoid conflict. The results are summarized in Table 4.4. All MFIs reported the presence of a code of conduct of board members. Similarly all MFIs' boards have clearly defined roles and responsibilities. RUCFREF and UWESO are however the only MFIs that prioritize professionalism in the selection of board members. The avoidance of conflict of interest is important as related party transactions, double standards, and nepotism are eliminated or at least minimized.

TABLE 4.4: GOVERNANCE CHARACTERISTICS: AVOIDANCE OF CONFLICT AMONG BOARD MEMBERS AND MANAGEMENT

Name of MFI	Defined roles and responsibilities	Code of Conduct	Professional Members selected on Board
RUCREF	+	+	+
UWESO	+	+	+
SAO	-	+	-
NEDA	+	+	-
CERUDEB	+	+	-
FEED	+	+	-
WEKEMBE	+	+	-

\+ Strong and a priority
\- Weak and not a priority
Source: Primary data

4.4 MANAGEMENT STYLE

In all MFIs there existed a hierarchical structure reflecting the existence of span of control, unit of command and delegation of activities. A typical structure of the sampled MFIs consisted of the Board of Directors, Chief Executive Officer and then managers up to below the loan officers and then assistant loan officers. All MFIs have this structure although some have slightly bigger ones. The presence of hierarchical structure has implied attributes. These include:

- A small span of control for quick decision making
- Integration of activities/coordination
- Proper planning

4.4.1 Decision Making-- Loan approval levels

The study focused on loan approval levels as an indicator of decision making and hence a major component of governance. The results are summarized in table 4.5. Loan approval levels varied from MFI to MFI, however the basic observation is that it is not a one-man decision indicating that there is involvement and delegation of decision making at various levels. As the MFI grows its structure becomes elaborate, decision making is further lowered down and the size of loan approval required of the Chief Executive increases. However, for young or small MFIs whose capital is also small, the relatively small loans say one million need the approval of a manager and below.

In all MFIs decision to lend does not necessarily lie with the Chief Executive Officer alone. Loan approval limits have been set for each level of management. Furthermore, for all MFIs there is a procedure of analyzing a loan application and involves the lower cadres of the MFIs i.e., loan officers and assistant loan officers. There are minimum steps taken:

- Visiting the client's home and may involve screening
- Appraising the business for which credit is applied and studying its cash- flow.
- Visiting and appraising the guarantors
- Credit evaluation
- Age of business
- Legal status
- Credit disbursement if approved
- Credit monitoring and recovery

In all MFIs a maximum of 4 weeks is given for loan approval.

TABLE 4.5 LOAN APPROVAL --- LEVELS OF DECISION MAKING

MFI	Loan Approval limit (shs)	Responsible Officer
SAO	50,000-100,000 100,000-1,000,000 >1,000,000	ALO LO Branch Manager
NEDA	5,000,000 10,000,000 >10,000,000	LO Manager Chief Executive Officer/Credit Committee
CERUDEB	100,000 - 25,000,000	Loan officer to Chief Manager
UWESO	50,000-5,000,000 >5,000,000	Loan officer Branch Manager/ Credit Committee
FEED THE CHILDREN FUND	<10,000,000 10,000,000 >10,000,000	Loan officers, Managers, Operations Director. Country Director
RUCREF	50,000-1000,000 1,000,000-5,000,000 >5,000,000	LO Manager Chief Executive/Credit Committee
WEKEMBE	<1,000,000 >1,000,000	LO General Manager

Source: Primary data

The general interpretation of these program characteristics discussed above namely modern management practices and governance depict an overall good outlook for MFIs. This is turn contributes well to the effectiveness of MFIs as outreach and sustainability implications are in-built. It is on this basis that hypothesis one is acceptable as these program variables will definitely influence on outreach and sustainability. A regression of these variables on outreach and sustainability indicators will further be carried out to confirm these results.

4.5 OUTREACH INDICATORS

The study focused on various variables to determine the outreach of the MFIs. The outreach indicators identified and discussed are scope, depth, and breadth. These indicators are summarized in Tables 4.5, 4.6 and 4.7.

4.5.1 Scope

Scope refers to the different kinds of financial services that MFIs offer. The services offered are indicated in table 4.6. These are credit, savings, deposits, shares, insurance, and training of clients in business and credit management and capacity building. Most MFIs offered a variety of services with RUCFREF, CERUDEB, and SAO offering a maximum total of six financial services followed by NEDA with 5 and FEED The Children as the least of all with only 2 types of services.

All MFIs offer credit as a financial service. It is the primary purpose for which they were formed in the first place. Indeed by definition, MFIs are institutions that disperse small loans to clients who cannot have access to banks. To most, microfinance means providing very poor families with very small loans (microcredits) to help them engage in productive activities or grow their tiny businesses. It is also true that the poor and the very poor who lack access to traditional formal financial institutions require a variety of financial products.

In practice, MFIs with the best outreach are those who give small loans to clients. Embedded in the concept of microfinance institutions as sources of loans are :

- MFIs extend small loans to entrepreneurs to poor to qualify for traditional bank loans
- The small size of the loans implies small frequencies and shorter payment periods
- MFIs are options to move out of poverty through creations of enablement

A number of MFIs provide workshops and trainings on business topics to clients who borrow from them. Indeed in Uganda it is a common practice to pass to - would be clients into a series of such trainings in order to enable clients put the money to proper usage and reduce on fungibility. Trainings vary in length but may take initially over two weeks. A sense of belonging is also imparted on customers. Group lending is getting more adapted in Uganda and groups of 15 clients are put in one group and offered funds as one. It is upon this group to ensure that members pay back on agreed periods. Failure by one member to fulfill this obligation implies that the rest of the group must contribute towards that customer's failure to pay. Training as such enables such a group to develop a sense of responsibility and hence improve on periodical payments. Training also exposes clients to issues related to business risks.

Savings, insurance and depository services are offered by some MFIs. The law in Uganda has cautioned MFIs against taking customers deposits and savings unless allowed by The Bank of Uganda. Among the requirements for such allowance is the minimum depository at Bank of Uganda which many MFIs do not seem to have risen. Uganda's recent legislation, the Microfinance Deposit-Taking Institution Act 2003 (MDI Act 2003) only allows licensed microfinance institutions to mobilize public deposits and encourages greater integration into the formal financial system.

Therefore given the scope of these MFIs as indicated, it is concluded that the services offered have an influence on the effectiveness of these MFIs. Also given that the provision of small loans is a service offered to the poor, it is inferred that the MFIs are effective given this outreach characteristic. Hypothesis one on the program variable's influence on outreach is further accepted as given program variables of savings provision, insurance and charging interest rates are part and parcel of the scope.

TABLE 4.6 OUTREACH INDICATORS- NUMBER OF FINANCIAL TRANSACTIONS OFFERED (SCOPE)

MFI/Year	Credit	Savings Mobilization	Deposits Mobilization	Shares	Insurance	Training in Financial Management	Capacity Building of Borrower	Other Financial Services[1]	Total
RUCREF	√	√	√	√	√	√			6
UWESO	√	√			√		√	√	5
SAO	√	√	√	√	-	√	√		6
NEDA	√			√	√	√	√		5
CERUDEB	√	√	√	√	√			√	6
FEED	√		-			√			2
WEKEMBE	√	√	√				√		4

[1] Other financial services offered by CERUDEB and UWESO are mainly under mainstream banking and include domestic transfers, letters of credit, ATM Center cards, remittances, and international transfers.

Source: Primary data

4.5.2 Breadth and Depth

The results of breadth (number of loans, number of clients) and depth (percent female clients) over the years 2002- 2004 are summarized in table 4.7. The general trend is that the number of clients seem to increase over the period. Overall CERUDEB has the largest number of clients and number of loans. SAO and NEDA fall in the lowest category. Percent of female clientele is least with CERUDEB and highest with UWESO. However, the small female percentage of CERUDEB seems to be compensated with absolute numbers as CERUDEB's clientele base is large. Known as breadth, the number of clients matters as it has budget implications. In addition, the size of numbers has implications to budget and poverty. A bigger number of clients as indicated by CERUDEB and UWESO means that their budgets for loans are big and hence they are able to reach more clients than others. Relatedly implied is that the number of poor people reached by these MFIs is higher given their big numbers. The number of loans likewise follows a similar trend over the years as more clients mean increased number of loans. Where the number of loans is bigger than the clients it means that clients go back for more loans in a specific period.

TABLE 4.7 OUTREACH INDICATORS- BREADTH: NUMBER OF LOANS, NUMBER OF CLIENTS, PERCENT FEMALE CLIENTS

MFI/YEAR	2,002			2,003			2,004		
	L	C	F	L	C	F	L	C	F
RUCREF	1,750	1,750		3,500	3,500	60	3,450	3,450	60
UWESO	22,662	11,261	55	20,232	14,233	75	46,780	35,600	78
SAO	4	4	50	144	144	30	101	101	35
NEDA	292	292	45	209	209	30	200	200	35
CERUDEB	21,815	21,815	11	31,500	31,500	24	44,796	44,796	28
FEED	12,459	12,459	55	15,860	16,840	60	15,500	17,565	69
WEKEMBE	5,700	5,700	45	8,700	9,220	45	12,350	11,560	46

L Number of Loans
C Number of clients
F % female clients
Source: Primary data

It is therefore concluded that given these outreach characteristics, the MFIs are likely to be highly effective.

The research question on what an effective microfinance should be in terms of outreach is answered by the discussion above. Number of loans, number of clients and female clients all point to the fact that these MFIs have strived to be effective given these outreach indicators. Therefore an effective microfinance is one whose outreach indicators encompass these outreach indicators.

4.6 PROGRAM CHARACTERISTICS

4.6.1 Loan Size

Loan size follows the decision of the target audience, the poor are usually targeted by small loans. Results show that the minimum loan size is comparable across the MFIs except for NEDA and CERUDEB whose minimum loans for the periods stood at shs. 500,000 and 100,000 respectively (table 4.8). SAO also has a minimum value of 500,000. The maximum loan size for the MFIs ranged from shs. 1,000,000 to 25,000,000/-. CERUDEB has the highest loan size of shs. 25 ml. The size of loans has implications on outreach and sustainability. As indicated above, the smaller they are, the better for the poor. Most MFIs start with small loans and use staged credit programming to enforce repayment. Access to future larger loans is then made dependent on punctual and full repayment of small initial loans. Loan size is also a function of the capital requirements of the business, the higher the requirements the bigger the loan. Loan size determines the depth of a MFI. Given that the depth is the value the society attaches to the net gain of a client, MFI's overall vision has an influence on depth. If the MFI is meant to reach the poorest, the more clients reached with small loans the better. Likewise smaller amounts or shorter times of maturity between installments means greater depth. All MFIs seem to share all these attributes implying that they all have great depth. For example, minimum loan sizes for UWESO, RUCREF, UWESO's, FEED and SAO is 20,000- 50,000/ implying that other factors constant, they reach more poor for a given amount of money. However, administrative costs and other costs related to small loans tend to be high and more cumbersome from borrower perspective.

Time of repayment ranges from 1-36 months depending on the size of loan and MFI. However, all in all MFIs there seems to be much flexibility to cater for clients' specific needs.

4.6.2 Interest Rates, Other costs and Eligibility to Borrow

Table 4.9 summarizes the nominal interest rates, repayment intervals, eligibility to borrow and other costs related to program characteristics. The nominal interest rates range from 30-45.6% per annum with RUCREF having the highest for group lending. Eligibility to borrow ranges from clients who are members of MFIs to those who receive monthly salaries. There is therefore a variety of potential customers enabling MFIs build solid clientele bases. This is an attribute to outreach. By focusing on small business enterprises (SMEs) all MFIs have included them as clients. This is not a deviation as SMEs create wealth and are therefore potential patterns with MFIs. Again this has implications on outreach and sustainability and therefore effectiveness. Salaries are a constant monthly income and acts as a guarantee for potential borrowers. The salary earner gets the flexibility to borrow more money beyond the amount he earns making it possible to make investments and hence generate wealth.

TABLE 4.8 **PROGRAM CHARACTERISTICS: LOAN TERMS: LOAN SIZE-MINIMUM AND MAXIMUM AND TIME OF REPAYMENT**

MFI/YEAR	2,002			2,003			2,004		
	MIN	MAX	TR	MIN	MAX	TR	MIN	MAX	TR
RUCREF	50,000	10,000,000	6-12	100,000	10,000,000	6-2	50,000	10,000,000	6-12
UWESO	50,000	3,000,000	3-6	50,000	3,000,000	3-6	50,000	3,000,000	3-6
SAO	500,000	3,000,000	3-6	500,000	3,000,000	3-6	500,000	3,000,000	3-6
NEDA	500,000	10,000,000	3-6	500,000	10,000,000	6-2	500,000	10,000,000	6-12
CERUDEB	100,000	15,000,000	1-36	100,000	15,000,000	1-36	100,000	25,000,000	1-36
FEED	50,000	15,000,000	4-24	50,000	15,000,000	4-24	50,000	15,000,000	4-24
WEKEMBE	20,000	1,000,000	6	20,000	1,000,000	6	50,000	1,000,000	6

MIN-- Minimum Loan Size (SHS)
MAX-- Maximum Loan Size (SHS)
TR-- Time of repayment (months).

Source: Primary data

Group lending as an avenue through which clients can borrow has become common as the group provides the guarantee for the MFI as members have to check themselves to ensure prompt payment and hence avoid default. In case of default the group is held accountable and members must contribute to cover the gap. By avoiding to extend credit to individuals without collateral and without group pressure the MFIs reduce their vulnerability towards free-riding and opportunism. This is a good decision for eventual sustainability and overall effectives of MFIS. It would make economic sense for interest rates and charges to cover costs of MFIs. This would however imply that if inefficient MFIs charged such charges in order to cover their costs then they would experience problems.

4.6.3. Savings First

All MFIs, save Wekembe, require their clientele to first accumulate savings before they can borrow (Table 4.9). Savings have a number of attributes both to the MFI and the client. People who save are more prudent hence more reliable customers.

TABLE 4.9 PROGRAM CHARACTERISTICS: NOMINAL INTEREST RATES, OTHER COSTS, TERMS, AND ELIGIBILITY TO BORROW

MFI/YEAR	INTEREST RATE (PER ANNUM)	ADMINISTRATION FEE	GUARANTEES	SAVINGS FIRST	REPAYMENT INTERVAL (days)	ELLIGIBILITY TO BORROW
RUCREF	30[2], 45.6[3]	2	GROUP, SAVINGS	√	30	a,b,c,d
UWESO	36		SAVINGS	√	7-30[1]	a, b, c, d
SAO	36	1	INDIVIDUAL	√	30	a
NEDA	36	3	GROUP	√	30	b,c,d
CERUDEB	22	2[4]	INDIVIDUAL	√	30	b,c,d
FEED	36	2	GROUP	√[5]	7	a, b, c,d
WEKEMBE	30	1	GROUP		7	b,c,d

[1] Group loans repayment interval is 7 days, individuals is 14 days, salary or school fees is 30 days
[2] Individual lending
[3] Solidarity Group and commercial lending
[4] Acceptance fee. Also there is monitoring fee of 0-2% per month
[5] For group loans

a- group members who have shares or savings
b-any person with ability to pay
c-a salaried person as a member of an institutional group
d-one who has business
Source: Primary data

Savings can also be used as collateral. Self-selection, screening and enforcement may to some extent be aided by savings accumulation (Reinke, 2003). As such the savings first principle depicted by most MFIs above is a contribution towards their effectiveness as the sustainability factor is embedded in . It can thus be concluded that the program design characteristics of loan size, savings first, high interest rates which cover costs, and eligibility to borrow as depicted by these MFIs contribute positively towards their outreach and sustainability and hence to their effectiveness. These are some of the best practices of MFIs for better outreach. Subsequently their effectiveness towards poverty alleviation is implied.

4.7 FINANCIAL SUSTAINABILITY AND PROFITABILITY

4.7.1 Profitability and Sustainability Indicators

These ratios reflect the ability of the MFI to continue operating in future.. This is regardless of whether the MFI is nonprofit or for - profit. The end point is sustainability. Using balance sheets and income statements, the financial ratios to determine sustainability of the various MFIs are derived.

4.7.2 Return on Equity (ROE)

Return on Equity is the ratio of Net Operating Income and Average equity and is thus expressed as

ROE = Net Operating Income less Taxes/Average Equity

It shows the rate of return on average equity over the years. Since non operating items such as subsidies and donations are excluded in its calculation, ROE is a proxy for commercial viability. It reflects the profitability of MFIs and is a measure of the return on investment. Table 4.10 summarizes the results.

TABLE 4.10: RETURN ON EQUITY

MFI/YEAR	2001/02	2002/03	2003/04
RUCREF	0.59	0.06	0.22
UWESO	0.84	0.18	0.19
SAO	-	-	-
NEDA	-	-	-
CERUDEB	0.23	0.18	0.24
FEED THE CHILDREN	-	-	-
TWEKEMBE	-	-	-

- Data not available

Source: Primary data

Data available was sufficient to analyze the ROE for RUCREF, UWESO and CERUDEB. Trend analysis across the years shows that ROE has varied for these MFIs. This is an indication that there are changes in the net incomes and average equities for the MFIs in these years. UWESO's and RUCREF's ROE reduces a lot over the periods 2001/02 and 2002/03 while that of CERUDEB does not oscillate much. In the 3rd year the ROE shows that all three MFIs are commercially viable. It is generally true that at the formation of MFIs there is a high level of subsidization and tax-exempted, hence the high ROEs in the first year. This, in turn, exaggerated their net incomes and reduced on their equity. Subsequent years have seen these MFIs being restructured towards commercial viability. ROE is also influenced by a combination of efficiency, high leverage, and average portfolio yields. It can therefore be concluded that from the ROE ratio, the element of sustainability is implied. Therefore hypothesis II which states that no MFI in Uganda is sustainable is rejected partially at the moment basing on this finding.

4.7.3 Return on Assets (ROA)

ROA is calculated by dividing net income (after taxes and excluding any grants or donations) by the period average assets. It is an overall measure of profitability that reflects both the profit margin and efficiency of the MFI. It is a reflection of how well an MFI utilizes its assets towards making profits. It answers the question of how many shillings the MFI generates for every shilling of its assets. The results are summarized in Table 4.11.

TABLE 4. 11 RETURN ON ASSETS

MFI/YEAR	2001/02	2002/03	2003/04
RUCREF	0.01	0.04	0.02
UWESO	0.05	0.08	0.04
SAO	-	-	0.13
NEDA	-	-	-
CERUDEB	0.04	0.03	0.03
FEED THE CHILDREN_	-	-	-
TWEKEMBE	-	-	-

- Data not available.

Source: Primary data

Again ROA is only calculated for RUCREF, UWESO and CERUDEB. Trend analysis indicates a relatively stable ROA across the periods for all MFIs whose ROA have been calculated. This stability is highly observable with CERUDEB. For all the MFIs ROA is less than 10% an indication of under utilization of the assets.

However, given that RUCREF and UWESO have received substantial grants and donations at their inception as reported, the ratio's low value is therefore understandable. While there is room for improvement, the overall picture is reflective of sustainability and implied effectiveness. Again this observation further indicates that hypothesis II is rejected.

4.7.4 Portfolio Yield

This is a ratio of total cash financial revenue (all income generated by the loan portfolio, but not accrued interest) by the period of average gross portfolio. It is the indicator of an MFI's ability to generate revenue with which to cover its financial and operating expenses.

TABLE 4.12: PORTFOLIO YIELDS

MFI/YEAR	2001/02	2002/03	2003/04
RUCREF	0.46	0.48	0.31
UWESO	0.38	0.39	0.19
SAO	-	-	0.54
NEDA	-	-	-
CERUDEB	0.78	0.49	0.45
FEED	-	-	-
WEKEMBE	-	-	-

- Insufficient data to generate ratios

Source: Primary Data

Portfolio yield shows how much on average the MFI receives in interest payments and other lending rates such as training fees, upfront fees, and discounts from disbursed amounts, needed for MFIs to survive. Results are tabulated in Table 4.12. Due to poor and unreliable data, portfolio yield for the MFIs other than RUCREF, UWESO and CERUDEB could not be calculated.

RUCREF and UWESO show a declining portfolio yield while that of CERUDEB is incremental. Both movements are good as they show high ability of the MFIs to generate revenue. This means they are capable of generating revenue with which to cover their financial and operating expenses. However, it significantly changes across the periods. RUCREF's portfolio is stable for the 2 years 2002 and 2003 at above 45% but falls to 31% in the final year. UWESO's portfolio yield similarly diminishes in the final year to 19% down from 39% the previous year. It is highly held that as the microfinance industry matures portfolio yield is supposed to decrease as increased competition leads to increased efficiency and the capacity of MFIs to generate increasing profits from lower yields. The MFI industry in Uganda seems to be taking that trend albeit slowly.

Generally profitability summarizes performance in all areas of MFIs and is therefore an aggregate of so many factors. For example, if portfolio quality is poor, or efficiency is low, profitability will also reduce. Therefore profitability indicators shown above can be difficult to interpret if taken in isolation. It is therefore prudent and recommended that further analyses on operational efficiency and portfolio quality be undertaken. UWESO and other MFIs which were previously NGOs are known to have been subsidized and received grants at their inception which calls for caution when interpreting results of profitability analysis. Also through changing accounting or merely being creative, it is possible to dramatically improve on profitability of MFIs by reducing on the levels of loan loss reserves. In mainstream banking this is not possible as banks loan reserve levels are set up by regulators and tax authorities.

All in all, profitability analysis is a good indicator of economic viability and combined with other analyses, can provide much information on sustainability and effectiveness of MFIs.

4.7.5 Portfolio Quality

Loan portfolio is the largest asset an MFI has. It is therefore the biggest source of risk. In most MFIs loans are not collateralized by banks making quality of the portfolio extremely crucial. Indicators of portfolio quality analyzed and discussed below are Portfolio at risk (PaR), write-off ratio, Provision expense ratio and Risk Coverage Ratio.

4.7.6 Portfolio at Risk >30 (PaR30)

This is the ratio of outstanding balance of all loans with arrears over 30 days plus all restructured loans and outstanding gross portfolio as of a given date. For the various MFIs analyzed their respective PaR 30 are given in Table 4.13. The results reflect the loan portfolio "contaminated" by arrears as a percentage of the total portfolio. PaR 30 for SAO, FEED, NEDA, and Wekembe could not be derivatives due to inadequacy of data. CERUDEB's PaR was the lowest across the three years, while that of RUCREF and UWESO kept decreasing reaching 1.8% and 5.4% for the year 2003/2004 respectively.

TABLE 4.13 PaR > 30 DAYS

MFI/YEARS	2001/2002	2002/2003	2003/2004
RUCREF	4.5	2.3	1.8
UWESO	3.79	6.7	5.4
SAO	na	na	na
NEDA	na	na	na
CERUDEB	2	2	2
FEED	na	na	na
WEKEMBE	na	na	na

- na– Data not available or insufficient

Source: Primary data

Generally speaking PaR 30 at less than 10% should not raise any worry. Given PaR is a measure free from subjective manipulations, it is a measure of risk. Therefore UWESO, RUCFREF and CERUDEB 's portfolios are not at much risk at all for the three years under consideration. They all reflect a very low risk.

4.7.7 Provision Expense Ratio

This is the ratio of loan loss provisioning expense for the period by the corresponding gross portfolio. It measures the extend to which a MFI has catered for anticipated future loan losses. For given MFIs the provision expense ratios are presented in Table 4.14. RUCREF's anticipation is the lowest and hence provides for least provision expense ratio across the years. UWESO has the highest provision expense ratio for the three years. Data for other MFIs was unreliable to derive the ratio and were hence not considered.

TABLE 4.14 PROVISION EXPENSE RATIO

MFI/YEAR	2001/02	2002/03	2003/2004
RUCREF	0.07	0.21	0.13
UWESO	5	2.5	5
SAO	-	-	-
NEDA	-	-	-
CERUDEB	1.1	1	1.24
FEED	-	-	-
WEKEMBE	-	-	-

- Data inadequate to calculate derivatives

Source: Primary data

Uganda's banking and tax laws have aimed at prescribing for the minimum rate at which provisions for loan losses must be made. Over-provision is a behavior of some MFIs order to hide profits that may otherwise inhibit them from accessing donor subsidies. Likewise , MFIs may simply scale down on provision expenses in to reflect a profit instead of actual loss. None of these behaviors could be ascertained among MFIs of Uganda an indication of good portfolio management. Indeed any figure less than 10% is good.

4.7.8 Risk Coverage Ratio

This is the ratio of the loan loss reserves and outstanding balance on arrears over 30 days plus refinanced loans. It reflects the percent of portfolio at risk that is covered by actual loan loss reserves. It is an indication of the preparedness of an institution for a worst case scenario. A higher risk coverage is preferred as microfinance portfolios are not often collateralized. Results are summarized in table 4.15.

CERUDEB has the least ratio overall and it decreases over the period. The reason to this could be that CERUDEB is actually a bank which has taken risks elsewhere as is required by the bank laws. When collateral-backed lending composes the majority of the portfolio as is the case with CERUDEB, then a lower ratio well below 100% should not be taken as problematic. UWESO's ratio decreases significantly in the second year but recovers in the third year to about 400%. The ratio for RUCREF increases across the years. Given that Uganda's economy no longer suffers from extreme economic shocks, the ratios for these MFIs are sufficient to cover risks. Moreover, it has been established that these MFIs have taken collaterals not necessary as the law requires but as a precaution. RUCREF for example, takes over borrowers' land titles in cases of big loans as collateral. Group lending has also been preferred to individual lending as a way to ensure repayment. Risk coverage ratio should be analyzed with PaR. As noted above the PaR > 30 for the three MFIs is below 10% and is therefore an indication of sustainability. These loans are likely to be rapid given the vigilance of loan officers of these MFIs and the fact that most loans are individually collateralized with assets as guaranteed by group lending.

TABLE 4.15 RISK COVERAGE RATIO

MFI/YEAR	2001/02	2002/03	2003/2004
RUCREF	74	217	277
UWESO	132	37	395.56
SAO	-	-	-
NEDA	-	-	-
CERUDEB	98.7	65	69.5
FEED	-	-	-
WEKEMBE	-	-	-

- Data insufficient to generate ratios.

Source: Primary data

The sustainability ratios discussed above for the MFIs show that these MFIs are operating profitably and are therefore sustainable. The best practices towards better sustainability are therefore implied by these ratios. Uganda's MFIs are thus sustainable. The hypothesis that no MFI in Uganda is sustainable is therefore rejected.

4.8 EFFICIENCY AND PRODUCTIVITY

Efficiency and productivity indicators are performance measures that show how well the institution is streamlining its operations. Productivity indicators reflect the amount of output per unit of input, while efficiency indicators also take into account the cost of the inputs and/or the prices of outputs. Given that these indicators are not easily manipulated by management decisions, they are more readily comparable across institutions than say profitability indicators such as return on equity, and assets. However, productivity and efficiency are less comprehensive indicators of performance than profitability.

4.8.1 Operating Expense Ratio (OER)

This is calculated by dividing all the expenses to the operations of the MFIs including all the administrative and salary expense, depreciation, and board fees) by the period average gross portfolio. Interest and provision expenses as well as extraordinary expenses are not included. OER is the best indicator of overall efficiency of a MFI as it measures the institutional cost of delivering loan services. OER for the various MFIs are presented in table 4.16.

TABLE 4.16 OPERATING EXPENSE RATIO

MFI/YEAR	2001/02	2002/03	2003/2004
RUCREF	30.5	41.9	15.2
UWESO	62.6	63.2	24.4
SAO	56.3	27.5	32.9
NEDA	9	8.3	6.1
CERUDEB	55.2	38.9	33.6
FEED	-	-	-
WEKEMBE	-	-	-

- insufficient data to generate ratio.

Source: Primary data

Given that the lower the ratio the more efficient a MFI is, NEDA becomes the most efficient MFIs across the periods and keeps reducing from 9% to 6.1%. This is because NEDA has kept its operating expenses low. However, given that its other ratios could not be calculated NEDA's efficiency should be taken with a pinch of salt. UWESO's OER is highest in the year 2001/02 but eventually decreases to 24.4%. RUCREF's eventually settles at 15.2% down from 41.9% in the previous year. CERUDEB's OER stands at 34.8% in the final year. However, it is important to note that OER is highly influenced by portfolio size, loan size and salary incentives.

4.8.2 Cost per Borrower

Cost per borrower is the ratio of operating expense and average number of active borrowers. It is a measure of efficiency for a MFI as it indicates the average cost of maintaining an active borrower. The ratios for the various MFIs are indicated in table 4.17.

TABLE 4.17 COST PER BORROWER-- SHS

MFI/YEAR	2001/02	2002/03	2003/2004
RUCREF	96,657	82,698	34,481
UWESO	60,607	66,954	27,885
SAO	112,500	60,375	109,203
NEDA	112,329	159,808	169,000
CERUDEB	603,404	528,360	497,701
FEED	-	-	-
WEKEMBE	-	-	-

- Data insufficient to generate ratios

Source: Primary data

CERUDEB has the highest cost per borrower ratio across years although it keeps reducing. RUCREF's and UWESO's ratio are the lowest and decreasing over the years.

4.8.3 Loan Officer Productivity

This is the ratio of number of active borrowers to number of loan officers. The ratio captures the productivity of MFIs' loan officers. The higher the ratio the more productive the MFI. It reflects how well the MFI has adopted to its processes and procedures to its business of lending money. Results are summarized in Table 4.18. UWESO has the highest ratio across the years reflecting good efficiency of its processes. Generally the same applies across all the MFIs except NEDA whose ratio keeps lowering across the periods.

TABLE 4.18 LOAN OFFICER PRODUCTIVITY

MFI/YEAR	2001/02	2002/03	2003/2004
RUCREF	159	350	345
UWESO	363	431	460
SAO	-	-	-
NEDA	146	100	50
CERUDEB	145	315	224
FEED	-	-	-
WEKEMBE	215	408	400

- Ratio not derived due to insufficient data

Source: Primary data

Overall, these figures are influenced by both the internal and external factors such as incentive structure, lending methodology, decision making all which seem to be good across the MFIs. The study could not isolate reasons why UWESO has the best ratio as compared to others in absolute terms. Based on the results of financial sustainability and efficiency indicators above for RUCREF, CERUDEB, NEDA, UWESO, and SAO, it is deducted that these MFIs are effective. An effective MFI is expected to have a reducing cost per borrower across the years, a high loan officer productivity, and a low operating ratio. All these characteristics are reflected in at least each of these MFIs implying that they are sustainable and effective.

4.9 CONTEXTUAL FACTORS

The study identified contextual issues which are relevant and found them to be inflation, government policies and regulations, rural of law and presence of formal and informal institutions that may have direct impact on MFIs performance. These are discussed below.

4.9.1 Government Policies and Regulations and Rule of Law

All MFIs indicate that they operate within the rule of law abiding to the government regulations and policies. It is also established that the micro enterprises financed by the MFIs are legal. Government regulations on MFIs have been released in a number of laws that Parliament has passed including the Microfinance Deposit-Taking Institution Act 2003 (MDI Act 2003) which allows licensed microfinance institutions to mobilize public deposits and encourages greater integration into the formal financial system. Government under the possible mechanisms to regulate tier 4 MFIs in Uganda has proposed changes in the laws and regulations any of which are in the pipeline to become laws. The areas seriously considered are:

- Amendment of the Non-Governmental Act Statute 1989 that inter alia would require inclusion of microfinance specific requirements in the subsequent law.
- Companies Act amendment required to include a requirement that companies engaged in microcredit must be registered with a self-regulatory organization and to authorize Bank of Uganda to make regulations under this Act.
- Cooperative Societies Statute 1991. The Act has been amended to cater for Savings and Credit Cooperative Societies (SACCOS) to be supervised under central bank or Ministry of Finance.
- Repealing of the Money-Lenders Act 1952 and
- Capacity building (Staschen 2003).

4.9.2 Inflation

Inflation remains an important factor in Uganda's economic development and more importantly to the finance sector, including microfinance institutions. Since 2002 inflation has kept at the rates of 5% for 2002, 7% for 2003 and 7% for 2004. All these are nominal inflation rates and no attempt was made to get the real values due to time limit and other necessary data. However, it is observable that during the period, there are marked astronomical increases in the prices of both local foods and oil which would otherwise have led to higher inflation rates. As a deliberate policy, government has always targeted an inflation of not more than 5% (exclusive of food crop prices).

4.9.3 Informal and Formal Institutions

The presence of both formal and informal institutions is reported by all MFIs. These include other MFIs with which they compete. It is reported that they offer stiff competition to them. Although not reported, the presence of money lenders is common. Other institutions listed include NGOs who offer charity, the decentralized local governments which offer new challenges to performance and registration, as well as the modern issues of accountability and corporate social responsibilities.

The influence of contextual factors on sustainability and outreach is therefore just inferred. However, direct influence of these contextual factors on outreach and sustainability of MFIs in Uganda could not be ascertained. It is on this basis that hypothesis III which states that contextual factors do not have an influence on outreach and sustainability of MFIs in Uganda is accepted.

4.10 REGRESSION RESULTS

Selected variables of both financial sustainability and outreach were regressed against identified program and contextual variables in order to determine the effectiveness of MFIs. The results are expected to confirm or reject some of the hypotheses set. The results are presented in Table 4.19.

TABLE 4.19 REGRESSION RESULTS

Dependent Variable	Independent Variables	Coefficient	P-value
1. Cost-per borrower (Y18)	Maximum loan size (K13)	0.994	0.072*
2. Risk Coverage Ratio (Y16)	Maximum loan size(K13)	-0.995	0.062*
3. Portfolio Quality (Y13)	Minimum loan size (K12)	0.999	0.035**
Note *; Significant at 10%		**; Significant at (5 and 10%)	

Source: Primary Data

Cost per borrower, a variable of efficiency and productivity that in turn shows how the MFI streamlines its operations, gives significant results with maximum loan size. This means that cost per borrower has an influence on the maximum loan size a borrower can get from an MFI. This is a true indication in the performance of MFIs. If the cost per borrower is high, it reflects inefficiency and poor productivity of MFIs. Generated funds are then mainly used in non-loan costs such as administrative costs leading to less funds available for loans. Subsequently the size of loans given to clients is affected. It is therefore important that the cost per borrower is controlled to lower values to enable more funds reserved for access by the clients in order to boost maximum loan sizes.

Risk coverage ratio also influences the maximum loan size that a client receives from an MFI. Risk coverage ratio is a portfolio quality variable that reflects the percent of portfolio at risk that is covered by actual loan loss reserves. It is an indication of the preparedness of an institution for a worst case scenario. The higher the risk coverage ratio, the bigger the maximum loan size given to clients. A higher risk coverage is preferred as microfinance portfolios are not often collateralized. Therefore as it rises, the MFIs feel secure to also increase on the maximum loan sizes offered to clients as risks reduces. The coefficient sign unexpectedly turns out to be negative. These results therefore show that programs with large loan sizes are likely to be more viable than those with small loan sizes. It is on this basis that hypothesis I which states that program variables influence outreach and sustainability of a MFI is accepted.

Efforts to regress sustainability and outreach indicators against contextual variables gave insignificant results. Hypothesis III is therefore accepted which states that contextual factors do not have an influence on outreach and sustainability of MFIs in Uganda.

From the hypothesis set on the behavior of program variables on sustainability, the study has indicated that loan size has an influence on financial sustainability of an MFI.

The current situation of MFIs Uganda is mixed both with good and not good situations. The Finance and Trade newspaper of July 2005 has summed this up: *"Increasing microfinance outreach is one of the strategies Africa Banks have adopted---- small savings, and loans and collateral substitutes; quick and repeated loans. Despite considerable vibrancy and fast growth in many African states, microfinance services are still out of reach of many deserving entrepreneurs and farmers. ...there is also a need for microfinance institutions to focus on long-term sustainable operations as opposed to short-term return on investment".*

CHAPTER FIVE

5.0 SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 INTRODUCTION

The study has reached a number of summaries and conclusions which are given in this chapter under outreach, sustainability, program characteristics and contextual factors for effective microfinance. Recommendations and policy issues are also presented.

5.2 OUTREACH AND SUSTAINABILITY CHARACTERISTICS FOR EFFECTIVENESS OF MFIs

5.2.1 Outreach

The scope of the MFIs is good and widespread ranging from provision of small loans to insurance and training. All the six MFIs at least provide a minimum of 2 financial services among which are credit, savings, deposits, shares, insurance, training of clients in business management and credit behaviors and capacity building. Most of important of all is the loan provision where small repetitive loans are offered to the poor. The poor who lack access to traditional formal financial institutions are able to get loans from MFIs. In practice, MFIs with the best outreach are those who give small loans to clients and this applies to all the sampled MFIs. Generally the scope of MFIs in Uganda is good as they offer credit to poor clients. It is a challenge however to them to promote other financial related services.

Breadth, as presented by number of loans, number of clients and female clients is satisfactory and it increases across over the years. This implies that as breadth increases, the number of the poor who access small loans would likewise increase leading to further assault on poverty. The involvement of gender-tailored MFIs such as UWESO means that the issues of women access to loans are fully addressed. However, there is room for improvement. The number of clients is still low given that most Ugandans are very poor and lack access to formal banking sector. Therefore using this breadth, outreach indicator, as a determinant of effectiveness of MFIs, it can be concluded that there is much stride by MFIs to cover as many clients as possible which indirectly contributes towards poverty alleviation. However, the absolute numbers (number of clients, female clients, number of loans disbursed) are still low given the poor people who are in need of loans. Therefore there is need to look into ways of improving on these numbers through improved accessibility, more aggressiveness using approaches such as opening up more branches, outright campaigns to potential clients and more training of clients.

5.2.2 Sustainability

Ratios derived for financial sustainability of MFIs have reflected that some MFIs are effective. However those MFIs whose ratios could not be calculated conclusions cannot be made. Return on assets ratio as an indicator of financial sustainability shows that the three MFIs: CERUDEB, UWESO and RUCREF are sustainable. Return on assets is a sustainability indicator while Return on equity (ROE) also reflected similar results on sustainability for the same MFIs. ROE is a proxy for commercial viability. It reflects the profitability of MFIs and is a measure of the return on investment. As such these MFIs are commercially sound and therefore reflect sustainability. Again ROA is only calculated for RUCREF, UWESO and CERUDEB. Trend analysis indicates a relatively stable ROA across the periods for all MFIs whose ROA were calculated implying also that these MFIs are sustainable and hence effective. Profitability analysis done shows economic viability and combined with other analyses, provides good information on sustainability and effectiveness of MFIs. Portfolio quality indicators analyzed for the three MFIs: RUCREF, UWESO and CERUDEB all reflected good performance thus implying effective of these MFIs. Efficiency and productivity indicators also reflect that MFIs are effective in their functions as the indicators showed MFIs's operations are well-streamlined. It is therefore proper to conclude that MFIs: RUCREF, UWESO and CERUDEB are sustainable. The hypothesis set therefore which states that no MFI in Uganda is sustainable is rejected. Sustainability has been shown to exist for the mentioned MFIs. However, there is room to improve on the sustainability.

5.3 PROGRAM DESIGN CHARACTERISTICS OF AN EFFECTIVE MFI

The study focused on the following program design characteristics and analyzed their implication for an effective MFI.

5.3.1 Governance

All MFIs have a board of directors whose roles in MFIs performance is always contributory to their effectiveness. All board structures such as Audit committee, fund raising committee, and loan committees are in place. The presence of a board also reduces conflict of interest and between management and the board. All these governance characteristics are relevant for effective performance of MFIs. However, ownership of some MFIs remain either unknown r not well-defined. Choice of board members in some cases overlooked duty of loyalty, democratic representation, gender and professionalism. These areas therefore were weak and require redress in order to strengthen governance.

5.3.2 Management-- Decision making

There exists an elaborate structure of management in all MFIs. There are posts of Managing Directors or general managers, senior loan officers, loan officers and assistant loan officers hence a clear unit of command which in turn facilitates decision making and delegation. The structures are also flat.

Loan approval as a decision making indicator shows that decision making is encouraged throughout the organization structure. Depending on loan size, there is involvement of all cadres of officers such as assistant loan officers, loan officers, branch mangers and managers. In other cases a loan committee is in place to make decisions. Such designs contribute towards efficiency ad therefore effectiveness of MFIs.

5.3.3 Interest Rates and Other Costs

The commonest interest rate charge is 36% per annum as interest rate for most MFIs. Most MFIs charge administrative ranging between 1-3% of the total loan disbursed to a client. MFI charges are still viewed in Uganda as being expensive but have of recent indicated a downward trend as many MFIs have come up for competition. Regulation by Bank of Uganda has also tried to minimize unnecessary costs. Interest rates and other charges are influenced by a number of factors such as risks. It is expected that if MFI is highly subsidized, then the interest and other charges do not reflect the market value for them. Charges such as membership fee, can be used to hide the true interest rates. Compared to mainstream banking, interest rates of MFIs are higher as costs of administering small loans is high. It has also been established that low income people, who form majority of MFI clients always show willingness to and ability to pay interest rates higher than commercial banks for services that fit their needs (AMIR, 2003). It can therefore be concluded that MFIs in Uganda charge interest rates enough to cover the costs and make profits and hence sustain them. However efforts to remain competitive in the wake of falling interest rates nationwide should be explored in order to for MFIs to remain in business. Other financial packages could also be introduced to expand on profit-making activities.

5.3.4 Loan Size

Loan size varies from one MFI to another with a minimum loan of shs. 20,000-50,000/- and a maximum of shs. 25 million. MFIs meant to offer services to the poor should have low sized loans a case observed here. This implication has positive merits towards poverty alleviation. Each business activity has specific financial requirements hence the need to segregate minimum and maximum loan sizes. MFIs have focused on salaried clients, farmers, trade and commerce and development loans all of which have varying financial requirements. Such an approach helps the MFI to reach as many clients as possible found in the various social strata differentiated by incomes. The poor, given the wide spectrum, are likely to be reached. These MFIs therefore have an intended role of alleviating poverty.

5.4 CONCLUSIONS ON REGRESSION RESULTS

Regression results on programme characteristics have indicated that loan size impacts significantly on sustainability indicators: cost per borrower, risk coverage atio and portfolio quality. This finding confirms earlier assertions that have been made namely that a microfinance's effectiveness is determined by the way its designed to meet the objectives for which it was set. Given that sustainability is a major requirement, the regression results have therefore rightly shown the influence of program design on performance and sustainability of MFIs. The larger the loan the more sustainable the MFI is. It is therefore concluded that the loan size, a program variable, determines sustainability of MFI and hence its effective and its overall objective of poverty alleviation.

The other program characteristics did not show any significance. This is partly because of the limitations indicated in data analysis. However, qualitatively the indicators were positive indicating their limited influence. It is important to note here that attributes of program design for effectiveness of microfinance are also embedded in positive interest rates and their maintenance, presence of voluntary savings, presence of insurance provisions for borrowers and presence of modern management practices all which have been shown to exist in most MFIs sampled. Regression results do not show significant influence of program variables on outreach indicators indicating that other factors other than them directly impact on number of clients or female clients that access microfinance services. It can also be concluded that contextual factors do not influence outreach and sustainability of MFIs. As long as the credit program is implemented in a favorable context (such as non hyper inflation, good social frastructure) then the program is expected to perform well and largely fluenced by other factors.

ontextual characteristics and their influence on outreach and sustainability of MFIs did not produce conclusive results and is therefore it can be concluded that contextual characteristics do not have influence on effectiveness of MFIs. A MFI is expected to be effective regardless of the environment. This is an area that may need further study. However, without the involvement of government/public investment in the formation and capitalization of MFIs, such MFIs will remain small and weak (not necessarily unsustainable) and reaching few clientele.

5.5 BEST PRACTICES

The best practices that the study has identified for an effective microfinance are: increasing repetitive loan sizes, modern management practices, and good governance under reduced costs per borrower, high risk coverage ratio and a good portfolio quality. These have given significant results.

The other practices whose results are qualitatively positive and are expected to play a role in sustainability and effectiveness of MFIs towards poverty alleviation are: a good ROE, ROA, loan officer productivity and provision expense ratio and positive interest rates which should cover costs. For outreach, number of clients and composition of female clients are ingredients for effectiveness.

RECOMMENDATIONS AND POLICY ISSUES

ults and discussion of the study have generated a number of ommendations and policy issues which are highlighted in this section. They ve been presented in order to help in the streamlining of the performance of ls for better output.

.1 Recommendations

e study has made a number of recommendations for improved efficiency in e performance of MFIs. These are summarized below.

6.2 Need for Increased Scope, Depth and Breadth

e MFIs have a limited scope both in terms of financial transactions undertaken. fforts should be made to expound on the types and number of financial ervices offered. Services related to receiving school fees from parents, foreign xchange transactions, foreign exchange remittances, soft loans to purchase cars and others would give MFIs more opportunities to expand and generate. In n effort to alleviate poverty through MFIs and the fact that mainstay banking as eliminated the poor from accessing loans, MFIs should increase on its scope o cover as many clients as possible. Also, female gender is significant in economic development and given this importance, deliberate efforts should be expended to reach them.

5.7 PROPOSED AREAS OF FURTHER STUDIES

The areas below have been identified for further studies:

- Effects of interest rates on performance of MFIs. Specific emphasis be put on ability of clients to pay.
- Subsidies given to MFIs and their effects on competitiveness
- Further analysis of contextual factors on outreach and sustainability.
- Household incomes and membership to MFIs.
- Impacts of access to or use of credit.

CHAPTER SIX

.0 REFERENCES AND APPENDIX

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APPENDIX (RESEARCH QUESTIONNAIRE)

I.1 Questionnaire on Characterization of Selected Microfinance Institutions

TYPE OF INSTITUTION

Name of Institution

s it a (i) Bank ☐ (ii) MFI ☐ (iii) NGO ☐ (iv) other (specify) ☐

s it (a) Profit seeking Business?

(b) Non – Profit organization

i. If non-profit how does it cover its costs?

(ii) Are you continuously subsidized?

(iii) What are the sources of subsidy?

(iv) What is the amount of subsidy? Yr 1 ☐ Yr 2 ☐ Yr 3 ☐

Does the MFI stand alone or is it part of a complex institution ? .

(i) alone ☐

(ii) part of a complex institution ☐

HISTORY AND DESCRIPTION OF INSTITUTION

Founding date ☐

Governance

Operating within legal framewo... ☐ Ye ☐ No

OW IN NUMBER OF OFFICES/BRANCHES

☐ 1997 ☐ 2000 ☐ 2004 ☐

th in number of staff

☐ 1997 ☐ 2000 ☐ 2004 ☐

ANAGEMENT STYLE AND GOVERNANCE

What does your organization chart look like? Have it appended if possible or let it be described.

How many staff members are employed in different categories?

- Managers ☐
- Assistant Managers ☐
- Officers ☐
- Assistant Officers ☐
- Other categories (please specify) ☐ ☐

3 How do your pay packages compare to government and private business rates for similar types of labor?

- Similar with government ☐
- Below government rates ☐
- Above government rate ☐
- Similar to private rates ☐
- Below private rates ☐
- Above private rates ☐

Do you carry out Research on the following:

a) Costing and Pricing of your services Yes ☐ No ☐

tential markets for services Yes ☐ ☐ No

w services to be provided Yes ☐ ☐ No

Do you train your staff in skills of MFIs Yes ☐ No ☐

s how many have you trained for the past three years
2002 ☐ 2003 ☐ 2004 ☐

s labor turnover a problem to your institution?

☐ No ☐

do you motivate your staff? (You may tick more than one box where
cable)

Achievable targets ☐
Rewarding/recognizing achievements ☐
Involvement in decision making ☐
Promotion ☐

MFI GOVERNANCE

	Yes	No
Do you have a Board of Trustees/Board of Directors	☐	☐

If yes who appoints it?
Clients
Founder members
Others (please specify)

Do you have the following structures within your Board?

Committee Yes ☐ No ☐
Committee Yes ☐ No ☐

Officers Yes ☐ No ☐

many members make up the following?

d of Directors/Board of Trustees ☐

ement

olders

r credit Committee

ACHIEVING THE BEST PRACTICES IN MFI GOVERNANCE

What factors are considered in choosing the Board members?
(you may tick more than one if applicable)
Skills and characteristics
Directors' Understanding of the Dual Mission
Duty of Loyalty
Understanding MFIs Mission
Democratic representation
Others –specify--------

What is the composition of the Board?

Clients
Donors
Government
Founders
Opinion/local leaders

Do clients also have a representative on the Board?
No

Does the Board form smaller committees? Yes No
If yes, which are they (tick below)

Audit and Finance Committee

Human Resource or Compensation Committee

Fundraising (resource mobilization) Committee

How is Monitoring and Evaluation done?

sing independent body
Management does it
oard does it
oth Board and Management do it

Who owns the MFI?

☐ ☐ Public Not clear I don't know

☐ ☐

Type of MFI

Public ☐

Private-Public Patternship ☐

Credit Union ☐

Non Profit NGO ☐

For Profit Organization ☐

Does your MFI have a vision/ set goals?

at are they? In order of priority/preference

1---

2---

3---

4---

5---

Is your vision towards sustainability or outreach or both?

ow do you avoid conflict of interest among Board members and anagement?

Defined roles and responsibilities--------------------------------

Code of conduct--

Professional Members selected on Board------------------------------------

Democratic elections and removal---

Others - specify--

do you ensure separation of roles and responsibilities between Board Management?

oard not involved in daily operations
hairman of Board in consultation with the CEO
oard makes binding decisions (Duty of care)
thers (specify).....................................

ow often does the board meet?

Monthly
Quarterly
Half yearly
As and when need arises
Weekly/fortnightly

CRIPTION OF SERVICES PROVIDED

Financial services provided (you may tick more than one if applicable)

redit ☐ Depository ☐ savings ☐ Training ☐

ares ☐

ble 1 **Types of Shares, Savings and Liquidity Management Services offered**

nn dl				
nt				
erm s				
s				

able 2 Loan Terms: Credit line characteristics

Terms (to complete credit)-months	Requirements	Size of loan (shillings) Minimum and Maximum	Annual Nominal interest rate	Admin fee	Reciprocity	Guarantees	Repayment Rate (e.g., every day, monthly etc)

ble 3 Interest rate Structure to depositors

ount type	Size range (Ug Shs)	Interest rate
ares		
book vings		
Term osits		
Other		

mo is eligible to borrow?

- Members who have shares or savings
- Any person who has ability to repay
- A salaried person
- One who has business
- Others (please specify)

ow long does it take for an application to be approved ?

- 0-2 Weeks ☐
- 4 weeks ☐
- Over 4 weeks ☐

who makes the lending decision?

- A Manager (within limits)
- Credit Officer (within limits)
- Chief Executive Officer
- Specific Officer responsible
- Credit committee

able 4 **Loan approval – Levels of Decision Making**

Responsible	Loan approval limits (ug shs) (US$)
Loan officer	
Manager	
Chief Executive	
Credit Committee	
Board of Directors	

lease list the steps taken to analyze a loan application by credit officers

s credit in cash ☐ Kind ☐ Mixture ☐

o you make any up-front deductions made from the loan being given ut?

Do you offer any form of incentives for prompt and full repayment?

at provision if any is made to insure borrowers against risks that could ke it difficult for to repay their loans on time?

es the institution offer savings account to borrowers and Non borrowers?

avings voluntary ☐ compulsory ☐ borrowers

w do you ensure that repayment is done and on time?

you offer other financial services? e.g. Insurance

NON-FINANCIAL SERVICES

Does the institution offer non-financial services
st them:

- Technical assistance to enterprises
- Organization or social action
- Capacity building to borrower
- Training in management

SUSTAINABILITY INDICATORS

Financial analysis

- Balance sheet for 3 years
- Assets
- Loans
- Investments
- Deposit in other institutions
- Fixed as Assets
- Other

Liabilities and net worth

Reserves (for bad debts and others; list)
Borrowing
Other liabilities
Net Worth

Profit and loss account for the past 3 years

- Incomes
- Interest received
- Fees and commissions
- Other incomes

Expenditures

Salaries and allowances (if possible divide among functional areas)
Interest paid
Rent
Other operating expenses

epreciation
ansfer to reserves
ofit/Loss

ISTORY OF CREDIT PROGRAM(S)

istorical Data for 3 years

Loan descriptions

	No of loans extended	Amount (mn shs)	Loan types	Purpose of loans

REPAYMENT

tlhs	Year	Amounts	Loan Type	Purpose

LOANS OUTSTANDING AT FINANCIAL YEAR --NEW BORROWERS

r	Numbers	Amounts	Loan Type	Purpose

LOANS OUTSTANDING AT FINANCIAL YEAR- REPEAT BORROWERS

r	Numbers	Amounts	Loan Type	Purpose

STATUS OF OUTSTANDING LOAN AT THE END OF 2003/2004 FINANCIAL YEARS

	Numbers	Amounts	On time	Over Due (days)	30 - 60	60 – 90

...UTREACH

...a Lending performance: Scale of Outreach

...mbers	2002	2003	2004
...ans			
...oans ...g shs			
...oans (US$) ...owth			
...oans ...ing			
...ing (Ugshs)			
...ing ...$)			
...ding (Ug ...age			

Ɔ1b Outreach Variables

	Loan size	***No of clients***	Profits made (mn shs)	Types of financial services offered

L.E PROFILE

Ɔ1c Outreach Variables

:ients	Male	female	Total
age			
mounts ed to m shs			

Ɔ1d Depth variables

ation/purpose	Number	Percentage of total borrowers
ure		
erce/Enterprise,		
Employees		
fe		
m		

ow are clients repeated borrowers?

What fees are you charging clients for loan provision

a) Beginning ------------ mn shs
b) Regular basis--------- mn shs
c) Penalty fees---------- mn shs

What is the lowest and highest loan size for these groups?

ble 10 e Lowest and highest Interest rates

roup	Individual lending		Solidarity group lending		Others specify	
ear 1	Lowest	Highest	Lowest	Highest	Lowest	Highest
ear 2	Lowest	Highest	Lowest	Highest	Lowest	Highest
ear 3	Lowest	Highest	Lowest	Highest	Lowest	Highest

Table 10 f Annual interest rate on loans

Year	Interest rate		
	Minimum	Maximum	Average
1			
2			
3			

Table 10 g Loan terms

Year	Days		Months		Year		Average D M Y
	Min	Max	Min	Max	Min	Max	
1							
2							
3							

ble 11 Depth of outreach: Outstanding Loans distributed by size as at 2004

e range	#of loans	Volume

able 12 Depth of outreach: shares distribution by account size

ze range	#of accounts	volume	Average size
000-35,000			
5,000-00,000			
00,000-0000000			
000000-5000000			
5000000-10000000			
otals			

e: 13 SCALE OF SHARES AND SAVINGS OUTREACH

Shares	Year 1 (2002)	Year 2 (2003)	Year 3 (2004)
Numbers of shares (Annual Growth)			
Value of shares (US$)			
Value of average shares (UgShs) (annual growth)			
Average share size per member (Ug shs) (annual growth)			
Average share size per member (US$)			
Savings			
Number of accounts (annual growth)			
Value of savings (ug shs) (annual growth rate)			
Value of savings $			
Value of average savings ug. Shs (annual growth)			
Value of savings US$			
Value of average savings (UgShs) Annual growth			
Ag. Savings balance per member (ug shs) (annual growth)			
Ag. Savings balance per member (US$)			

Shares plus savings			
Shares plus savings per member (US$)			
Loans to Savings			
Number of savers per outstanding loan			
Value of loans outstanding to value of savings plus shares			
Average outstanding loan as a multiple of average shares and savings per member			

OTHER SERVICES PROVIDED FOR THE PAST THREE YEARS

Year	No. of Training Courses	No. of Trainees
1		
2		
3		

ear 1 Number of enterprises assisted
ear 1 Organizing and social action

LOAN ACTIVITY/LOAN TRAFFIC

I Loan activity

le 14 Loan Activity

ar	Loan type	No. of loans	Outstanding balance
ar 1	Individual loans		
	Group Loans		
ar 2	Individual loans		
	Group loans		
ar 3	Individual loans		
	Group loans		

What provisions do you have to loan security and guarantee

- Collateral (state which)--------------------------------
- Group guarantee
- Guarantors
- Insurance
- Salary
- None
- Others (specify)

Are these loan securities effective?

able 15 Delinquency by aging

of months delinquency	#of loans	%#of all loans	% volume of all loans

le 16 Delinquency Distribution by Loan size – 2004

e range	%delinquent loans	%delinquent volume
00-35,000		
000-100,000		
1,000-10000000		
0000-5000000		
0000-10000000		
als		

How much is provided for bad debt? Year 1 2 3

Incomes

ble 16 Incomes for the past three years

dicator/Year	Year 1	Yr 2	Yr 3
embership fees			
come from ans iterest fees)			
ants (cash in nd)			
ther incomes pecify)			

Expenditures

ible 17 Expenditures

penditure item	Yr 1	Yr 2	Yr 3
ent			
alaries			
terest on aving deposits			
oard of			

ctors			
agement tings			
obligations			
k benefits			
phone			
ies			
er expenses ecify)			

Self Sufficiency/Overall Sustainability

Table 18 Indicators of Staff Productivity as of 2004

Leading Operations	Numbers/amounts (MFI1)	MFI2
Number of loan officers		
Number of staff members		
Number of loans disbursed/loan officer		
Total loans disbursed /loan officer		
No. loans outstanding /loan officer		
Outstanding portfolio /loan officer		
Average outstanding portfolio/loan officer		
Number of outstanding loans/staff member		
Total loans outstanding/staff member		
Average outstanding portfolio /staff member		
Shares and savings operations		
Number of accounts (shares and savings)		

Number of accounts/staff member		
Total shares and savings /staff member		
Ave. shares and savings/staff member		

ble 19 PEARLS Indicators Performance (all are %ages)

icator	Yr 1	Yr2	Yr3
otection			
ovisions/Loans linquent>12 onths			
ett provisions/Loans elinquent <12 onths			
fective Financial ructure			
oans/Total Assets			
quid struments/Total ssets			
nancial vestments/total ssets			
eposits/Total assets			
xternal credit/Total ssets			
hares/Total assets			
stitutional apital/Total assets			
ates of returns and costs			
eturn on			

ns/average loans			
rn on dity/average d instruments			
rn on financial stments/average ncial investments			
t of osits/average osits			
t of res/average res			
t of external dit/average ernal credit			
ss rgin/average ets			
erating and ministrative enses/average ets			
wisions for ses/average ets			
t come/average ets			
uidity			
uid instruments-mediate igations/deposits			
uidity erves/deposits			
sh and non-rning liquidity/total sets			
sets Quality			
linquency/Total ans			

productive ts /total assets			
s of growth			
l assets			
ns			
osits			
rnal credit			
res			
itutional capacity			
mbers			

ble 20 Measuring Self-Sufficiency

	Yr1	Yr2	Yr3
tal income			
ancial expense			
dministrative penses			
ad debt provision			
otal expenses			
perational self-ufficiency			
Operating xpenses/average oans outstanding			

Defaulting

What are the causes of defaulting by clients?

- Diversion of funds to other socio-obligations (please specify)
- Poor disbursement schedule
- Poor business management
- Inadequate market for products
- High costs of inputs
- Stiff competition
- High inflation

Competition from other MFIs

What other credit institutions exist in your area ?

Do they pause stiff competition to your MFI

Contextual variables

To what extent do client's enterprises fall under the rule of law?
Are their activities legal?

What alternative services are available to clients? and on what terms?

Do corrupt tendencies of local officials pose a problem to client micro enterprises? If so, describe the nature of problems

4. How competitive are the markets in which clients buy inputs and sell outputs? Can you verify a sufficient deviation from competitors?

5. Can national policies be identified that significantly affect the ability of micro enterprises to compete with other scales of enterprises?