Financial Sustainability in Micro Finance Institutions in Central Uganda

Ssendagi Muhamad[1] PhD, Mabonga Eric[2] PhD
[1]Department of Finance, Kigali Independent University, Rwanda
[2]Department of Accounting, Kigali, Independent University, Rwanda

***Abstract* -The purpose of the study was to establish the level of financial sustainability of Microfinance institutions in Central Uganda. We employed descriptive survey design with a sample of 287 obtained statistically from the population. The study found that there is high level of financial sustainability among the Microfinance institutions considered for the study. The study found several factors at institutional level threaten the level of financial sustainability. If microfinance institutions do not change and improve the way they do their business soon or later some of them will be out of business.**

***Key words:* financial sustainability, profitability, operating efficiency, financial self sufficiency, financial efficiency**

I. INTRODUCTION

As the microfinance industry has evolved and rapidly expanded both globally and in Uganda, questions regarding sustainability have come to the fore. For example, [12] and [6] ask whether microfinance can meet the full promise of reducing poverty without ongoing subsidies. They also noted that high repayment rates recorded by MFIs cannot be translated easily into profitability. [4] Questions whether MFIs are any different from past holder rural and co-operative finance of the 1960s and 1970s, suggesting that they may not be sustainable without either substantial donor subsidies or a shift toward less poor clients.

The closure of banks and bank branches as well as the drive for prudent operations and efficiency of the banking industry gave microfinance institutions the chance to fill the gap and expand rapidly from the mid-1990s onwards. The microfinance industry in Uganda was a natural offshoot of the general dynamics of the country's economy, which left rural and other low income people lacking financial services in the last three decades. The economic breakdown of the late 1970s and 1980s caused many banks to close upcountry branches and community based financial institutions like SACCOs also closed down. Attempts to reverse this through massive branch opening by the then UCB in the 1980s was not successful as many of the branches made perpetual losses and were closed down. This was exacerbated by the massive failures of four banks in 1998, including the Cooperative Bank which then had the second largest branch network and agency arrangements for its microfinance sub-branches. The issues highlighted above left rural and other poor people in Uganda without formal financial services. As it has been argued" unsustainable MFIs might help the poor now, but they will not help the poor in the future because the MFIs will be gone" [18]. Moreover, it has been reported that it may better not have MFIs than having unsustainable ones [14] and [9]. This shows how indispensable the sustainability of MFIs is.

The late 1990s and 2000s registered an unprecedented amount of growth for the Uganda microfinance industry. There are over 1900 MFIs in Uganda mainly operating in the Urban and semi-urban areas. These institutions have affected the population both in a positive and negative way: they have provided ready financial services for all, but they have also cheated the unsuspecting public by taking the deposits and paying the executives excessive amounts and/or closing off business without paying the depositors. A negative contribution of MFIs in Uganda has been the frequent failure of institutions, leaving their clients/members with no suitable financial services. The census of tier 4 MFIs [11] financial Sector Deepening Project Uganda (FSDU) had identified only 628 active MFIs compared to a total of 1274 registered with the ministry of trade, Tourism and Industry (MTTI). The study on the unaccounted for MFIs to find out the story behind the 646 variance, established that a good number of the missing institutions were registered and once operational but had collapsed.

II. LITERATURE REVIEW

The term sustainability is widely used interchangeably with other concepts such as profitability, self sufficiency, financial self sufficiency, self sustainability, financial sustainability, financial efficiency, institutional sustainability and financial viability. [21] Defines sustainability as the ability of the organization to meet the cost of operations and build enough reserves for capitalization while Robinson [17] defines sustainability to break even in an accounting period while compensating all factors of production at their opportunity cost. The same Robert continues to argue that in most discussions, sustainability is taken to mean full cost recovery or profit making and is associated with the aim of building business that can last into the future without continued reliance on government subsidies or donor funds. Financial sustainability refers to the ability of an organization to continue with its operations for over a long period [8]. It is synonymous with the accounting concept — going concern, which assumes that a business will continue to operate for an indefinitely long period. For financial sustainability to occur there should be profitability, financial prudence and purpose driven management [13]. With financial sustainability, a MFI meets its operational expenses and generate reserve funds from its operating income to enable it continue in existence for the foreseeable future. Operating income refers to the money or other assets received periodically from one's investment. Income includes accounts receivable, interest incomes from loan repayment, etc. Operating expenses are costs incurred in doing a business such as paying salaries, purchasing stationary, etc [7].

Financial sustainability means that the organization has available sources of financing that it utilizes to finance and grow its operations in a manner where the income earned by such activity is sufficient to pay the providers of the source of finance in a satisfactory manner after the people running the organization are paid a living income. Essentially this concept involves an organization to act as a sustainable business in terms of meeting all its financial obligations while continuing to have access to or generating financial resources for its growth. According to [1], a financially sustainable microfinance institution will need to cover all its costs and risk provisions from the interest income that it generates. They also defined financial sustainability as the ability to cover costs independent of external subsidies from donors or government. One indicator of performance of a microfinance institution is its financial sustainability [3]. [10] Noted that the poor needed to have access to financial services on long-term basis rather than just a onetime financial support. The same [10] also stated that the financial un sustainability in the Microfinance Institutions (MFIs) arises due to low repayment rate or un-materialization of funds promised by donors or government. [15] Notes that financial sustainability will enable organizations to cover their administrative costs and to prioritize their activities so as to accomplish their missions. The same Patricia notes that knowing how to manage resources is as essential to achieving financial sustainability as knowing how to generate income. She gives the six essential requirements for achieving financial sustainability in an organization as long-term commitment, leadership, investment of time and money, business plan, effective management team and team work.

According to [10], there are two kinds of sustainability that we could observe in assessing MFIs performance: operational self-sustainability and financial self-sustainability. Operational sustainability is when the operating income is sufficient enough to cover operational costs like salaries, supplies, loan losses and other administrative costs. Financial self-sustainability is when MFIs can also cover the costs of funds and other forms of subsidies received when they are valued at market value. However Meyer is quick to add that measuring financial sustainability requires that MFJs maintain good financial records and follow recognized accounting practices that provide full transparency for income, expenses, loan recovery and potential losses.

A study by [16] in Ghana investigated the impact of competition and gender composition on sustainability of microfinance institutions. The econometric estimates suggest that industry concentration has a negative impact on operational self-sufficiency and a positive impact on subsidy dependency index and women share of total borrowers improves overall sustainability and reduces dependency on donor and government support. The study also found management efficiency indicators and portfolio quality indicators as playing a crucial role in fostering sustainability in the Ghanaian MFI sector. A study by [20] on financial viability of village banking to reassess the past performance and future prospects of village banking indicates that the number of borrowers and cost per borrower were found to be among the variables most highly correlated with financial sustainability. Further [20] examined the determinants of financial sustainability and it was found that productivity was significant determinant of profitability.

III. METHODOLOGY

This study employed a survey design which was descriptive in nature. The aim of this study was to examine the nature of financial sustainability in MFIs. A descriptive study is more rigid, preplanned and structured, and is typically based on a large sample [5]. The purpose of descriptive research is to describe specific characteristics of study variable. The cross sectional study is also referred to as a sample survey, whereby selected individuals are asked to respond to a set of standardized and structured questions about what they think, feel and do [19]. Given the nature of the research objective of the current study, and the adequate availability of prior evidence to financial sustainability for examination, a cross sectional study was the appropriate technique as opposed to a longitudinal study due to time constraints. According to [2] in this type of study design, either the entire population or a subset thereof is selected and from these individuals data is collected to help answer research questions of interest. The design was opted for amongst the many designs because it helps in collection of related data from a homogenous target population at one point in time. It is fast helpful to get data from a large number of respondents at little cost or effort. The study was cross sectional because data was collected once from a cross section of all respondents in a short period. A sample of 287 responses was obtained statistically from the population.

IV. FINDINGS

Level of Financial Sustainability in selected MFIs in Central Uganda

Financial sustainability was broken in two major categories of operating efficiency and financial self sufficiency.

The first indicator of financial sustainability in this study was in terms of operating efficiency. credit staff in selected MFIs in central Uganda were asked to rate the level of operating efficiency of the selected MFIs by rating them on each of the ten items or questions asked by ticking one of the four numbers on the rating scale where 1 = Strongly disagree, 2= Disagree, 3 = Agree and 4 = Strongly agree.

The means in table1 demonstrates that the staff in the selected MFIs in central Uganda rate the level of financial sustainability of selected MFIs as high (overall mean = 3.11)

Table 1

Level of Financial Sustainability (Operating Efficiency and Financial Self Sufficiency)

Category	Mean	SD	t-statistic	Interpretation	Rank
Operating efficiency MFI has always appropriate screening mechanisms for borrowers.	3.42	0.23	14.87***	Very high	1
Loans disbursed are increasing.	3.38	0.19	17.79***	Very high	2
Return on equity is always increasing	3.29	0.1	32.9***	Very high	3
Total earnings on the amounts disbursed always cover all related costs.	3.27	0.08	40.88***	Very high	4
MFI members in this institution are economically active.	3.24	0.05	64.8***	High	5
Return on assets is always increasing	3.24	0.05	64.8***	High	6
MFI charges market based interest rates on loans	3.23	0.04	80.75***	High	7
Default rates in this institution are declining	3.16	-0.03	-105.33***	High	8
MFI provides different number of products in addition to (savings and loans)	3.09	-0.1	-30.9***	High	9
MFI has always mobilizes enough savings.	2.59	-0.6	-4.32***	High	10
Average mean	**3.19**			High	
Financial self sufficiency Ratio or retained earnings to total capital is raising	3.42	0.39	8.77***	Very high	1
Measures to reduce dependency on donors and government are in place.	3.06	0.03	102***	High	2
Financing loans through donated capital is declining	3.05	0.02	152.5***	High	3
All costs of the MFI funds are always covered by the income.	3.05	0.02	152.5***	High	4
MFI always finances its investments out of its own funds	2.58	-0.45	-5.73***	High	5
Average mean	**3.03**			High	
Overall mean	**3.11**			High	

***Significant at 99%; **Significant at 95%; *Significant at 90%

Key for interpretation of means

Mean range	**Response mode**	**Interpretation**
3.26-4.00	Strongly agree	Very high
2.51-3.25	Agree	High
1.76-2.50	Disagree	Low
1.00-1.75	Strongly disagree	Very low

The findings in table1 indicate that there is high level of financial self sufficiency (mean = 3.03) followed by high level of operating efficiency (mean = 3.10).

In an interview with some board members of various MFIs they also revealed *that the majority of MFIs in Central Uganda are not financially sustainable and the low level of financial sustainability was attributed to; rampant embezzlement of funds in MFIs by managers themselves, supervisory committee members or members of the board. Some attributed the poor performance of MFIs to poor assessment of credit applicants due to incompetency of loan officers who at times approve applicants that do not qualify.* Findings also revealed that *board members and supervisory committee members are politicians who are not technical in management of MFIs and also many times use their political influence to get loans and fail to pay which has also threatened the sustainability of MFIs in Central Uganda.* It was further revealed that *many clients get loans from various MFIs using the same collateral security because Clients are* *not screened to establish whether they are credit worthy with other MFIs.* Such clients end up failing to honor their debt obligations and disappear from the MFIs while others completely change location to avoid the legal implications. The poor performance of agricultural sector has also affected loan recovery since majority of clients are either directly or indirectly employed in agriculture. In addition some clients tend to divert loan funds to buying household items instead of financing their businesses.

V. CONCLUSION

In Central Uganda microfinance institutions are sustainable in terms of; operating efficiency and financial self sufficiency. It is clear from the findings there is a contradiction from the results of the interview and results from the questionnaire as far as sustainability is concerned. These findings could therefore imply that as though microfinance institutions are sustainable, it could be for a short period. If microfinance institutions do not change and improve the way they do their business soon or later some of them will be out of business.

REFERENCES

[1]. Adong, J. and Stock. C.(2005) "Factors influencing the financial sustainability of selected microfinance institutions in Namibia," NEPRU Research paper No. 39.

[2]. Amin, E.M.(2005) . Social Science Research. Conception, Methodology & Analysis, Makerere University Kampala.

[3]. Befekadu, B.K.(2007) "Outreach, ERMPD, Paper, at African economic conference, Addis Ababa, Ethiopia 15-17 November,

[4]. Buckley,G.(1997) Microfinance in Africa. Is it either the problem or the solution. World Development. 25(7): 1081-1093.

[5]. Churchill and Lacobuci.(2004) Research Methods: Concepts, Methodologies, Tools, and Applications. 3rd ed. New York.

[6]. Cull, R., Demirguc-kunt, A and Morduch, J.(2010) Financial Performance and outreach: A global Perspective of leading Micro Banks. Policy Research Working Paper Series 3827. The World Bank: Washington D.C.

[7]. Dycheman, R.T, Davis JC and Dukes E. R. (2001). Intermediate Accounting Vol. 1, 5th edition, Irwin McGraw Hill, Boston.

[8]. Evans, J. & Weir, C.(1995) Decision processes, monitoring, incentives and large firm performance in United Kingdom, management decision, Vol, 33, No. 6.

[9]. Ganka, D.(2010). Financial sustainability of rural microfinance institutions in Tanzania. PhD thesis, University of Greenwich, Australia.

[10]. Meyer, R.L.(2002) Track Record of financial institutions in Assisting the poor in Asia" institute research paper, No. 49.

[11]. Ministry of Finance, Planning and Economic Development.(2011). Report on the performance of Micro Finance Institutions in Uganda, Kampala.

[12]. Morduch, J.(1999). "The role of Subsidies in microfinance: evidence from Grameen Bank". Journal of Development Economics 60:229-248.

[13]. Nakazibwe, R.(2010) Governance issues and sustainability of savings and credit cooperatives in Uganda. Unpublished MBA Dissertation, Ndejje University, Kampala, Uganda.

[14]. Nyamsogoro, G.D.(2010) "Financial sustainability of rural microfinance institutions in Tanzania", PhD thesis, University of Greenwich, Australia.

[15]. Patricia, L.(2001) Four pillars of financial sustainability, Arlington, Virginia, USA, International publication program, The Nature conservancy.

[16]. Richman,T.(2010) Impact of competition and gender composition on sustainability of Microfinance institutions in Ghana.

[17]. Robinson, J.(2004) Squaring the circle? Some thoughts on the idea of sustainable development. Ecological Economics, 48, 369 – 384.

[18]. Schreiner,M and Woller, G. (2003). Microenterprise Development Program in the united states and in the developing world. World development 31(9): 1567-1580.

[19]. Sekaran U.(2000) Innovative Methodologies in Enterprise Research. Newbury Park: Sage.

[20]. Woller, R.(2000) Financial viability of village banking to reassess the past performance & future prospects of village banking. Bulletin, Microfinance information Exchange (MIX).

[21]. World Commission on Environment and Development (WCED).(1987) Our Common future. Oxford UK.; New York: Oxford University Press.