Governance of Microfinance Institutions in Nairobi, Kenya

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ABSTRACT

The purpose of this study was to assess the governance factors affecting microfinance institutions in Nairobi County. Applying descriptive research design, the study targeted senior managers, management and supervisory board members. Data was collected using structured questionnaire and analyzed to obtain both descriptive and inferential statistics. Results show that financial controls and staff competency, significantly impact on the performance of these firms in terms of compliance, internal audits, reporting and payment systems, ethical and integrity values, risk assessment staff experience, training and skills match, employment procedures. It is recommended that financial controls in micro finance institutions should be sustained, while, ensuring continuous adhering to the regulations governing the operations of micro finance institutions. There is need for continuous provide capacity building to staff to ensure that they are updated with current issues in the sub-sector for purposes of making sound decisions to the benefit of the institutions as well as the clients.

Key Words: Financial Controls, Governance, Regulations, Staff Competency

I. INTRODUCTION

Microfinance is considered a special type of impact investing, defined as the provision of financial services to the poor and low-income clients including households for their microenterprises and small businesses; aimed at raising their income levels and improve their living standards, for those who have little or no access to conventional banking system (Rosenberg *et al.*, 2009; Bakker *et al.,* 2014; O'Hara, 2018). The services range from deposit taking, provision of loans, payment services, money transfers and insurance products among others. The core operating principle of microfinance is that the poor needs access to appropriate financial services and that they have the capability to repay loans, pay the real cost of loans and generate savings. Microfinance is an effective tool for poverty alleviation. These services are provided for by Micro finance institutions (MFIs) that also aim at providing financial services to an increasing number of disadvantaged people. The aim of these institutions is to achieve a positive societal, environmental or sustainability and social impact through capital investment (Cull *et al.*, 2006; Karlan & Goldberg, 2011, Bakker *et al.,* 2014, Washington, 2018).

Micro finance institutions also provide access to and/or offer financial services that contribute to women empowerment, create employment for the youth and also play key role in the sustainability of businesses (Easley, 2017). In spite of the importance of these institutions, there have been concerns relating to their governance worldwide. For instance, a number have been embroiled in financial scandals attributable to weak management practices, financial and lending regulations as well as incompetence of the board members. Good corporate governance is important for the continued operations of organizations including MFIs. This is because good corporate governance improves economic efficiency and growth, enhances investor confidence, and also facilitates access to external financing by firms; while lowering cost of capital and improving operational performance (OECD, 2004; Ofoeda, 2017). Similarly, good governance significantly influences growth prospects of an economy due to reduction in investor risks. This attracts investment capital and improves the performance of companies (Spanos, 2005; Ofoeda, 2017).

In the recent past, there has been a considerable interest in the corporate governance practices of the financial services sector including MFIs (Ofoeda, 2017). The sector relies heavily on the trust of customers and a slip in confidence could generate huge contagion effects and trigger runs and failures, with disruptive consequences for the economy. Globally, cases of poor corporate governance continue to be reported which in the process has impacted negatively on the performance of MFIs (Ashbaugh & Warfield, 2014; Freeman, 2016; Easley, 2017; Ogola & Martin, 2017; Clarkson, 2018; Miles, 2018; O'Hara, 2018). Regionally, a few MFIs continue to face institutional factors such as staffing, policies, regulations and ethics that affect their governances (Denis, 2018). In Kenya, there have been numerous cases of financial fraud and mismanagement of MFIs attributed to poor governance practices in the operations of the institutions. The most recent case was the National Youth Service (NYS) scandal in which three MFIs were charged in a court of law for disregarding sound financial practices and abetting sloppy management (Omino, 2018). In one such case, it was estimated that three SACCOs lost Kshs 3.6 billion primarily due to mismanagement and financial frauds (Dennis, 2018). In a Central Bank of Kenya report of 2019, a number of SACCOs were reported to be undergoing liquidation process after losing millions of Kenya shillings partly associated with governance challenges in their operational systems (Central Bank of Kenya, 2019).

In the country, these institutions are regulated under *Microfinance Act of 2008* and supervised by the Central Bank of Kenya (Central Bank of Kenya, 2019). Under the Act, the institutions are required to comply with the provisions, while at the same time put measures that support or enhance sound financial attributes including openness, transparency, credibility, audit trail, partiality, fairness, integrity, professionalism, competence and ethical values (Ogola & Martin, 2017). The institutions are credited for improving financial inclusion amongst the vulnerable, especially the poor and low-income households in the rural and marginalized areas. Over the last decade, there have been twenty-four percent increase in financial access by the poor and middle-income households from microfinance institutions in Kenya (O'Hara, 2018). The proliferation of the institutions has however, come with its share of challenges which hinge on governance related issues including financial controls and staff competency in the affected institutions.

There is evidence that a number of governance related issues were sited to impact on the performance of MFIs. These are associated with lack of clear policies to guide transparency in the institutions' operations; inability of the institutions to keep audit trail leading to wastage of funds and resources; and absence of risk detection and management strategies allowing the microfinance firms to fall victim to cybercrimes, fraud and money laundering activities. These factors have contributed to the major financial scandals or misappropriation witnessed by MFIs in the country. Filippone (2018), reveals that governance challenges affecting MFIs include lack of proper decision-making structures which promote sloppy decisions by key stakeholders including employees and the board. In the process, the institutions suffer financial losses.

As noted in the background, MFIs continue to impact on poverty reduction, promotion of economic growth and improving income level, especially in the developing countries (Saadat *et al.*, 2015). They are perceived as a mechanism of fixing credit markets and unleashing the productive capabilities of the poor who are reliant on self-employment (Cull & Morduch, 2017). In practice, however, microfinance have not lived up to their expectation, in that they have had a minimal effect on customers primarily due to their dismal performance (Arsyad, 2015; Mabonga & Kimani, 2017). The recent financial scandals and mismanagement practices leading to loss of billions in shillings have brought out governance issues of MFIs in Kenya under close scrutiny. In the end, the institutions have not been able to realize their goal of poverty alleviation, economic growth and employment creation.

Whilst, there have been studies on governance issues relating to microfinance, most of them have not been exhaustive. For instance, Kalu *et al.* (2018) focused only on credit risk management and financial performance of microfinance institutions in Uganda, while Mabonga & Kimani (2017) examined only the impact of financial management on financial performance of microfinance institutions in Kenya. Koech & Kawenga (2015) delved only on the effects of bancassurance on performance of microfinance institutions in Kenya. None of these studies specifically addressed governance issues in microfinance and how they impact their performance. It is from this background that this study sought to assess the contemporary governance challenges affecting microfinance firms in Nairobi County to inform steps towards their training and policy development. Additionally, questions have been raised regarding adequacy and effectiveness of current models of corporate governance in terms of their capacity to put in place and implement financial controls, regulatory mechanisms as well as staff competency in the larger majority of the affected institutions. Whereas governance failures have been identified as a leading cause and

significant part of this unfortunate story, critical areas of financial controls and staff competency have largely been ignored. The study sought to investigate governance challenges in microfinance firms by focusing on financial controls mechanism, regulatory policies and staff competency among, MFIs in Nairobi County, Kenya.

II. METHODOLOGY

The study adopted descriptive research design for purposes of collecting information without the change of the environment. The design was suitable since it guided in addressing questions posed by exploratory research by offering solutions to different business issues (Shajahan, 2008). It was also considered appropriate since it allowed for answering questions such as who, how, what, which, when and how much (Blumberg *et al.*, 2008). The target population constituted supervisory, management boards, and managers of deposit and non-deposit taking microfinance institutions registered and licensed in Nairobi County. The study adopted stratified random sampling to objectively determine the sample size guided by Yamane (1967) formula to identify two-hundred and seventy-four respondents from which proportional allocation procedure was applied in the selection of sample elements in each stratum. Structured questionnaires that contained both open and closed ended questions were used to collect data from the respondents. The instruments were evaluated in both content and face validity by sharing with peers as well as use of Cronbach Alpha Coefficient. Research assistants were recruited, trained and involved in the piloting of the tools. The tools were refined and administered to the participants. Data collected was analyzed using SPSS to obtain both descriptive and inferential statistics in terms of frequency tables, charts, correlation, analyses of variance, and regression.

The model adopted was in the form of $Y = \beta_0 + \beta_i X_i + \varepsilon$

Where Y is the dependent variable which is financial performance; β_0 is the constant; β_i ranges from β_1, β_2 and β_3 and are the coefficients of the independent variables (X_i) which range from X_1, X_2 and X_3 which constitute financial controls, regulatory policies and staff competency. Respectively. Finally, ε is the error term.

III. RESULT

Financial Controls Mechanism and Microfinance Firms

The objective was to analyze the effect of financial controls and the performance of MFIs. This was in terms of observing approved budgets, periodic and timely internal audits, bonding of expenditures, putting in place financial procedures. Others include upholding ethical standards and integrity, risk assessment mechanisms, tracking of financial transactions, among others. The results are presented in terms of correlation, ANOVA and regression analyses. Before conducting regression analysis, correlation analysis was conducted to examine the relationship between financial control mechanisms and the firm performance. The results as summarized in Table 1 show that financial controls have a significant positive correlation with the performance of microfinance ($r=.179$ $p<.031$) at 0.05 significant level.

Table 1:
Correlation between Financial Controls Mechanism and Firm Performance

		Firm Performance	Financial Controls Mechanism
Firm Performance	Pearson Correlation	1	.179*
	Sig. (2-tailed)		0.031
Financial Controls Mechanism	Pearson Correlation	.179*	1
	Sig. (2-tailed)	0.031	

*. Correlation is significant at the 0.05 level (2-tailed).

ANOVA results show that the independent variables is significant in affecting performance of MFIs ($p< 0.031$). This is an indication that the model fits the data, as reported in the Table 2.

Table 2:
ANOVA on Financial Controls on Performance of Microfinance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	3.033	1	3.033	4.735	.031[b]
	Residual	91.577	143	.640		
	Total	94.609	144			

a. Dependent Variable: Firm Performance
b. Predictors: (Constant), Financial Controls Mechanism

Table 3 provides a summary of the regression coefficients. As shown in the table, the coefficient for financial control mechanism is 0.235, implying that with a unit improvement in financial control mechanism, would lead to improved performance of microfinance by 0.235.

Table 3:
Coefficient on Financial Controls on Performance of Microfinance

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	3.095	.248		12.484	.000
	Financial Control Mechanisms	0.235	.108	-.179	-2.176	.031

a. Dependent Variable: Firm Performance

Regulatory Policies and Performance of Microfinance Firms

The objective was to examine the influence of regulatory policies on the performance of microfinance institutions. The results were presented starting with correlation analysis followed by ANOVA and finally regression analysis. Table 4 provides the correlation analysis of regulatory policies and performance of microfinance. The results show that regulatory policies have a negative significant correlation with the performance of microfinance ($p=-.184$ $r<.027$) at 0.05 significant level.

Table 4:
Correlation between Regulatory Policies and Firm Performance

		Firm Performance	Regulatory Policies
Firm Performance	Pearson Correlation	1	-.184*
	Sig. (2-tailed)		0.027
Regulatory Policies	Pearson Correlation	-.184*	1
	Sig. (2-tailed)	0.027	

*. Correlation is significant at the 0.05 level (2-tailed)

The effect of regulatory policies on performance of microfinance was analyzed and results presented as summarized in Table 5. As shown in the table, regulatory policies predicted 3.4% of micro-finance performance, with remaining percentage explained by other factors besides regulatory policies.

Table 1:
Regulatory Policies on Performance of Microfinance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.184[a]	.034	.027	.79950

a. Predictors: (Constant), Regulatory Policies

The ANOVA results as summarized in table 6, shows that the regression model predicts the dependent variable significantly (p value < 0.027) at 0.05 significant level.

Table 6:
ANOVA on Regulatory Policies on Performance of Microfinance

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	3.204	1	3.204	5.013	.027[b]
Residual	91.405	143	.639		
Total	94.609	144			

a. Dependent Variable: Firm Performance
b. Predictors: (Constant), Regulatory Policies

As shown in Table 7, the coefficient for regulatory policies is negative 0.234 implying that with a unit adjustment in regulatory policies, performance of microfinance would change by 0.234 in the opposite direction.

Table 7:
Coefficient on Regulatory Policies on Performance of Microfinance

	Unstandardized Coefficients		Standardized Coefficients		
Model	B	Std. Error	Beta	t	Sig.
1 (Constant)	3.174	.276		11.518	.000
Regulatory Policies	-.234	.105	-.184	-2.239	.027

a. Dependent Variable: Firm Performance

Staff Competency Factors Affecting Microfinance Firms

The last objective was to examine the impact of staff competency factors on the performance of MFIs. The factors considered included experience, skills match, training, among others. The results were presented in terms of both descriptive and inferential statistics. Correlation analysis as summarized in Table 8 show that staff competency has a significantly positive correlation with the performance of microfinance (p=.211 r<.011) at 0.05 significant level. This results are an indication that improvement in staff competency would enhance the performance of microfinance.

Table 8:
Correlation between Staff Competency and Firm Performance

		Staff Competency	Firm Performance
Staff Competency	Pearson Correlation	1	.211*
	Sig. (2-tailed)		.011
Firm Performance	Pearson Correlation	.211*	1
	Sig. (2-tailed)	.011	

*. Correlation is significant at the 0.05 level (2-tailed)

In order to determine the effects of staff competency on performance of microfinance, regression analysis was conducted and results reported as summarized in Table 9. The results show that staff competency in microfinance institution predicted 4.5% of micro-finance performance. The rest was accounted for by other factors outside this model.

Table 9:
Regression on Staff Competency and Performance of Microfinance

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.211[a]	.045	.038	.79499

a. Predictors: (Constant), Staff Competency

For purposes of ascertaining significance, ANOVA was conducted and results summarized in table 10. As shown in the table, the regression model predicts the staff competency significantly ($p < 0.011$) affect performance of micro finance institutions at 0.05 significant level.

Table 10:
ANOVA on Staff Competency and Performance of Microfinance

Model		Sum of Squares	Df	Mean Square	F	Sig.
1	Regression	4.232	1	4.232	6.696	.011[b]
	Residual	90.377	143	.632		
	Total	94.609	144			

a. Dependent Variable: Firm Performance
b. Predictors: (Constant), Staff Competency

As indicated, in Table 11, the coefficient for staff competency is 0.316, which means that with a unit increase in staff competency, performance of microfinance would decrease by 0.316.

Table 11:
Coefficient on Staff Competency and Performance of Microfinance

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
1	(Constant)	3.267	.275		11.865	.000
	Staff Competency	-.316	.122	-.211	-2.588	.011

a. Dependent Variable: Firm Performance

IV. DISCUSSION

Results have shown that financial control was a significant predictor of microfinance firms' performance, accounting for 3.2% of the MFIs' performance an indication that with necessary financial control mechanisms, the institutions were likely to improve their performance. This could be in terms of observing approved budgets, periodic and timely internal audits, bonding of expenditures, putting in place financial procedures. Others include upholding ethical standards and integrity, risk assessment mechanisms, tracking of financial transactions among others. The finding supports the findings by Musoke & Nyonyintono (2017) which reported that financial controls have a significant effect on profitability of SACCOs. The results also show that majority of the respondents that their firms had developed yearly budget which affected the institution's financial expenditures. This is an indication that whereas a few microfinance institutions had adhered to budgetary controls, a few may not be observing the same. As noted by Miles (2018), the growth of financial institution in the 21st Century continue to be affected by among other factors, budget implementation. Majority of the respondents were in agreement that the institutions

had put in place internal auditing mechanisms aimed at guarding against financial misappropriation. This is in line with a survey by Consumer Insights (2018) which identified inability of the institutions to keep audit trail, as one of the factors that impact the performance of microfinance institutions.

A large majority of the respondents seemed to agree that that in the institutions, financial approval procedures for small purchases in their company were not adhered to which ended up impacting on the financial decisions. According to Perterson (2017), institutions with no proper financial controls, were recipe of challenges in governance in terms of fictitious payment vouchers. Others agreed that their institutions had internal financial reporting procedures which discouraged financial fraud. As observed by Easley (2017) effective governance in microfinance, requires staff to familiarize themselves with reporting policies supporting financial controls. Further, respondents agreed that their firm had segregated financial payment systems for purposes of streamlining financial transactions. This observation is in line with Harelimana (2018) who opined that payment systems are critical factors for the performance of financial institutions. According to the findings, most of the respondents were in agreement, that financial statements were used to track the monetary of goods and services into and out of the organization. This supports Mabonga & Kimani (2017) observation that financial statements are necessary since they are used to maximize capital and reduce potential risk that may exist.

In terms of regulatory policies and performance of micro financial institutions, results showed that regulatory policies are significant predictor of the performance of these firms supporting Kaloki (2018) who noted that legal requirements significantly influence the financial performance of MFIs. Respondents acknowledged that that MFIs are compliant with international financial and accounting reporting standards and procedures which affected the accuracy of their firm's records. Respondents were however not conclusive on whether compliant with Association of Microfinance Institutions of Kenya (AMFI-K) principles affected their firm's image. This compares to Yahaya, Yusuf & Dania (2015) who observed that international financial reporting standards positively impact on the profitability and growth potential of deposit money banks. Okafor & Killian (2011) were of the contrary opinion, and held that international financial reporting standards has no significant effect on microfinance performance.

Most of the respondents agreed, that their institution was compliant with code of ethics for business in Kenya and this affected their staff personnel behavior. This supports Denis (2018) who opined that MFIs in East African have institutional factors such as ethics that affect the management of these institutions. The findings showed that majority of the respondents were in agreement that stringent reporting requirements have affected their firm's operations. As opined by Easley (2017) t reporting policies supporting financial controls are significant in the effective management of microfinance institutions. Most of the respondents were also in agreement that the licensing procedures and costs have affected their company income. This supports Premaratne (2017) whereby he reported that microfinance licensing and associated costs which include annual renewal fee was impacting negatively on the microfinance institutions. Further, it was agreed by a large majority of the respondents that the regulatory framework in their industry had help protect their business from unfair competition. As argued by Laltaika (2014), regulation can be used in addressing competition problems in the market. According to most respondents, market structure and competition in the financial sector had hindered the growth of their firm. In line with this

finding, Kočišová (2016), observed that increased competition in the financial market hinders the growth of customers in the financial firms as they relocate to other institution and this leads to profits decline.

In terms of staff competency and performance of MFIs. Analysis show that staff competency predicted 4.5% performance of microfinance significantly. As reported by Clarkson (2018), MFIs with experienced, qualified, skilled, exposed and adequately trained staff, which describes staff competency, were financially and corporately managed well contrary to financial institutions that had inexperienced, unskilled, unexposed, untrained and unqualified employees. Like it was noted by Ssekakub, Ndiwalana & Lwanga (2014) there is a positive connection between managerial competency and financial performance of savings, credit and cooperative societies. Specifically, they found that managerial competence and corporate governance accounted for 39% of the variance in the financial performance of the Savings, Credit and Cooperative Societies. Similarly, almost all the respondents supported the fact that their respective institutions had qualified and experienced staff who influenced performance in the organization. In line with this finding, Bourne (2018) argued that qualified and experienced financial staff are able to make decisions that protect the future financial goals of the microfinance institution. Again, it was supported that firms that had staff with management skills affected their performance. This resonates with the finding by Alfayo, Malenya & Musiega (2015) wherein it was reported that managerial skill impacted positively on the performance of investment banks. In addition, half of respondents accepted that their firm had regular training program for their staff partly contributed towards positive results. This result agrees with the findings by Ninsiima (2014) that showed a positive correlation between training and financial performance of microfinance institutions.

Additionally, majority of the respondents disagreed, that on-the-job training they received was applicable to their job and it had enhanced organizational performance. Contrary to this finding, Barzegar & Farjad (2011) noted that on-the-job training influence performance among employees to some extent, however this was below the desired standard. It was extensively agreed, 39.6% strongly agreed and 42.4% agreed that employee experiences have contributed to increased efficiency in this organization. This contradicts Hill & Jones (2018) who reported that most micro financial companies do not have experienced and qualified financial employees to intelligently and rationally manage the financial obligations and responsibilities of the firm. Despite this they noted that an experienced financial staff is capable to guide the company through economic turmoil and financial doldrums. Most of the respondents accepted agreed, that employees had appropriate technical/functional skills and knowledge required to work in the financial sector. Appiah (2012) argues that employee knowledge, skills, attributes and competencies contribute to employee performance and organization performance. It was also accepted among respondents that employees had been trained on problem solving which had enhanced their work performance. This is in line with the observation by Giampaoli, Ciambotti & Bontis (2017) that problem solving has a direct influence on organizational and financial performances. Lastly, results showed that, most of the respondents were in agreement, that employees had been trained on decision making which had enhanced their work performance. In line with this finding Filippone (2018) highlights that poor decision making will lead to financial losses.

Conclusion

From the foregoing, there is no doubt that microfinance institutions are affected by the financial control mechanism that institutions have put in place. This is because the institutions operate in a highly regulated environment which add onto operational cost due to compliance costs. The efforts and time exerted on meeting financial control mechanisms such as observing approval procedures and reporting procedure, will weigh in negatively on the performance of the institutions. This is likely to contribute towards improved performance, if appropriately handled. Regulatory policies affect the performance of microfinance firms in that an improvement in the regulatory policies in the sector, would affect negatively their performance. This could be accounted for by issues relating to cost incurred in order to adhere to the established regulatory mechanisms. For instance, regulatory requirements such as reporting procedures and consumer protection requirement affect the microfinance business. Staff competency lead to better performance of microfinance firms. Competent workforce in the institutions improves the services rendered to customers since having a technical/functional skilled workforce for a microfinance firm would help the microfinance perform effectively in their financial services. The competency of employees in the microfinance sector entail, decision making, problem solving, team work, financial literacy skills and management skills.

Recommendations

Even though the financial controls are necessary in a microfinance sector, the controls should be well thought out to mitigate against the very objectivity of empowering the poor and the vulnerable in the society. Financial controls in the sector, should be reviewed from time to time to ensure that they remain relevant and avoid stagnating the growth of the firms. Where possible, the controls should be weighed on their benefits and costs for a win-win situation. Regulatory bodies should come up with workable policies that are friendly to microfinance taking into consideration their nature of business and target population. The policies should however, provide a conducive environment for microfinance to thrive. Microfinance firm should develop appropriate recruitment system that will enable them attract, recruit and retain competent staff, with the capacity to help them acquire efficiency in operation. They should also put in place staff training and development system that will ensure that employees acquire skills and knowledge critical in handling dynamisms in the sector. Staff should be empowered in the organization to ensure that they have all the necessary resources and capacity to perform at their best in their position in the organization.

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