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OPERATIONAL COSTS, LENDING POLICIES AND OUTREACH OF URWEGO OPPORTUNITY MICROFINANCE BANK LTD, RWANDA

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A Research Report Submitted to Graduate Research Centre in Partial Fulfillment of the Requirements for the Award of Degree of Master of Science in Accounting and Finance of Makerere University

August 2010

DECLARATION

I Ndyamuba Straton hereby do declare that, this dissertation is my original work and has never been submitted or published for any award in any other University.

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APPROVAL

This Research Report has been under our supervision as University Supervisors. We approve its submission for examination to Makerere University as partial fulfillment for the requirements of the award of Master of Science in Accounting and Finance degree of Makerere University.

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DEDICATION

To Annette, Aaron, Everest, Joseph and Stephen.

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ABSTRACT

This study was carried out to investigate the declining outreach levels as a result of lending policies and high operational costs of URWEGO Microfinance Bank. The objectives of the study were to examine the relationships between operational costs, lending policies, repayment rates and outreach of URWEGO microfinance bank. A sample of 50 staff and 171 clients of URWEGO microfinance bank were used in the study. It was observed that there was a significant negative relationship between operational costs and outreach. The study also revealed that there was a significant negative relationship between operational costs and repayment rate. The study findings also showed that there was a significant positive relationship between lending policies and repayment rate. Further analysis of the results indicates that operational costs and lending policies predict 59% of the variance in the outreach. Therefore URWEGO microfinance bank of Rwanda should adopt technological innovations, product refinements, and strengthen capacity that is needed to reduce costs, increase outreach, and boost overall profitability. There is need by the microfinance to minimize the effective interest rates charged on borrowers which may affect the depth of outreach.

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LIST OF ACRONYMS

AMFIU	Association of Microfinance Institutions in Uganda	
CGAP	Consultative Group to Assist the Poor	
MFI	Microfinance Institutions	
MIX	Microfinance Information Exchanges	
NGO	Non Governmental Organizations	
NIOSR	National Institute of Statistics of Rwanda	
SPSS	Statistical Package for Social Scientists	
UOB	URWEGO Opportunity Bank	

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CHAPTER ONE:

INTRODUCTION

1.1 Background to the Study

Micro Finance means providing very poor family with very small loans to help them engage in productive activities and grow their tiny businesses over the time (Gonzalez, 2008). Today, MFIs have spread around the world, not only in developing countries but also in many richer western countries. Microfinance practitioners estimate that 500 million poor people worldwide demand financial services, while MFIs reach only 15 to 70 million of them (CGAP, 2001).

Expanding the number of clients being served is an ultimate goal of almost all microfinance interventions. Outreach is manifested by the number of borrowers, average loan size, client and portfolio growth which enables the MFI to become self sustainable. Navajas Conning, and Gonzalez – Vega, (2000) state that microfinance outreach includes the breadth of outreach, depth of outreach, quality of outreach, length of outreach, and variety of outreach. Quality of outreach refers to worth, to how valuable microfinance products are for particular clients. Depth of outreach tells us how valuable it is to extend the supply of microfinance products to particular target groups, not from the point of view of a given client, but from the point of view of society (Conning, 1998). Breadth of outreach counts the number of clients of a given depth who are supplied with a microfinance product of a given quality (worth) and a given cost. Only a small proportion of the target group have access to formal and semi – formal financial services, but the more numerous the clients reached, the better (Adams, 1998).

Montgomery and Weiss (2004), state that providing loan or any other financial services to the people is quite expensive for MFI, it involves the operational costs. According to this argument, the cost of providing microfinance to the poorest is so high that MFIs may not be able to sustain the service without cost recovery while the poorest would not be able to afford such a high cost (World Bank, 2001). For the same reasons it's difficult to manage performance for each transaction, hence high administrative costs (Slangen, 2005). According to Crabb (2006), microfinance programs with high operating costs are less viable.

Microfinance lending policy and methodology has proved stringent to the poor because some systems only focus on the largest loans and therefore ignoring small loans altogether (Micro Rate, 2001). Otero (2001) assert that before microfinance lends to borrowers, there should be information about the character, capacity, collateral, capital and condition of the borrower. Stringent lending policy is when MFIs tighten their credit requirements to the borrowers to respond to changes in the economy, leaving out the poor. Applying stringent lending criteria to low-income borrowers may, in effect, lead to their exclusion from the financial system (Cheron *et al.*, 1999). Lenient policy is when MFIs loosen their credit requirements to the borrowers to respond to changes in the economy. Chimombo and Mataya (2000) conclude that a good microfinance institution should always be willing to adopt an appropriate loan delivery mechanism so that its services are attractive and accessible to the relevant target groups, cover the different situations of their client-base and should be appropriately priced, so as to avoid subsidy elements from one side and be competitively attractive to minimize the transaction costs.

Being named the best MFI in Rwanda in 2004 by United Nations, the government of Rwanda and Harvard University, URWEGO Opportunity Bank ltd (URWEGO then) offered its first loans in July 1997 to Rwanda's economically active poor. After 11years of rapid growth, its client base grew to 39,140 active clients through access to credit and savings facilities as well as training (Nubian, 2008). Despite its rapid growth, there has been a reduction in the number of its active borrowers from 17,956 to 16,922; and the numbers of the solidarity groups declined from 54 to 41 during the period between 2007 to 2008 (URWEGO *annual report*, 2007/08).

1.2 Statement of the Problem

Although URWEGO Opportunity Bank of Rwanda Ltd (UOB) strives to expand the number of clients being served, the coverage in terms of outreach is still inadequate. The number of active clients reduced from 51% to 48% and operational costs increased from 118,600,750 Rwandan Francs to 175,464,037 Rwandan Francs (URWEGO *annual report*, 2007/08). This research is therefore intended to find out whether the declining outreach levels could be attributable to UOB's stringent lending policies and high operational costs.

1.3 Purpose of the Study

The study aimed at examining the relationship between operational costs, lending policies and outreach of URWEGO Opportunity Microfinance Bank limited.

1.4 Objectives of the Study

To examine the relationship between operational costs and outreach of URWEGO
Opportunity Microfinance Bank limited.

ii) To examine the relationship between operational costs and repayment rate of URWEGO
Opportunity Microfinance Bank limited.

iii) To examine the relationship between lending policies and outreach of URWEGOOpportunity Microfinance Bank limited.

iv) To establish the relationship between lending policies and repayment rate of URWEGO
Opportunity Microfinance Bank limited.

1.5 Research Questions

i) What is the relationship between operational costs and outreach of URWEGO Opportunity Microfinance Bank limited?

ii) What is the relationship between operational costs and repayment rate of URWEGO Opportunity Microfinance Bank limited?

iii) What is the relationship between lending policies and outreach of URWEGO Opportunity Microfinance Bank limited?

iv) What is the relationship between lending policies and repayment rate of URWEGO Opportunity Microfinance Bank limited?

1.6 Scope of the Study

• Subject Scope

The study aimed at establishing the relationship between the operational costs, lending policies, repayment rates and outreach of URWEGO Opportunity Microfinance Bank limited.

• Geographical Scope

The study was carried out in all the 3 districts that make up Kigali city in Rwanda.

1.7 Significance of the Study

The study is expected to add more knowledge to the already existing literature on operational costs, lending policies and outreach of MFIs.

The study findings are expected to enhance further research in the MFI industry both in Rwanda and internationally on microfinance outreach.

The study is expected to enable the identification of better lending policy strategies that are critical for better outreach of MFIs.

MFI used in the study, will benefit from this research by improving on lending policies for better operational costs management.

1.8 Conceptual Frame Work

MFIs cannot afford to subsidize loans, if the organization is to provide loans on an on-going basis, it must charge interest rates that allow it to cover its costs. These costs tend to be high because providing unsecured, small loans costs significantly more than loans in traditional banking (Lensink,

2006). Lafourcade *et. al.*, (2005) state that operating and financial expenses of MFIs have remained to be high, and on average, revenues have remained lower. Technological innovations, product refinements, and ongoing efforts to strengthen the capacity of MFIs are needed to reduce costs, increase outreach, and boost overall profitability. Wide agreement about the goal of microfinance to improve the welfare of the poor has not led to wide agreement about how best to achieve that goal. Schreiner (2002) asserts that the social benefits of microfinance in terms of outreach can be measured in terms of six aspects: worth, cost, depth, breadth, length, and scope. Zeller and Meyer (2002) show that relatively high repayment rates increases self –sustainability of MFIs. MFIs seek to cover their operating expenses and achieve growth so as to further their outreach to the poor. It's worth noting that high repayment rates generate good returns from the clients which can cover administrative and other costs (Drake and Rhyne, 2002).

Chimombo and Mataya (2000) conclude that a good microfinance institution should always be willing to adopt an appropriate loan delivery mechanism so that its services are attractive and accessible to the relevant target groups, cover the different situations of their client-base and should be appropriately priced, so as to avoid subsidy elements from one side and be competitively attractive to minimize the transaction costs.

Otero (2001) assert that before microfinance lends to borrowers, there should be information about the character, capacity, collateral, capital and condition of the borrower.

Figure 1: conceptual framework



Adopted from: Davis 2002; Drake and Rhyne, 2000; Christen et al 1995; Slangen 2005; Rosenberg 2003; Morduch, 2000; Otero, 2001; Gonzalez 2008 & 2007; Lafourcade et al 2005; Crabb 2006.

CHAPTER TWO

LITERATURE REVIEW

2.0 Introduction

Although there have been studies on operational costs, lending policies and outreach of microfinance institutions in developing countries, the literature reviewed in this study is cited mainly from studies carried out in developed countries. The related literature reviewed in line with study objectives.

2.1 Operational Costs and Outreach

Over their history, many MFIs have found ways to increase productivity and efficiency and lower costs. These efficiency improvements have helped several MFIs to achieve operational and financial self-sufficiency. MFIs cannot afford to subsidize loans. If the organization is to provide loans on an on-going basis, it must charge interest rates that allow it to cover its costs. These costs tend to be high because providing unsecured, small loans costs significantly more than loans in traditional banking (Lensink, 2006).

MFIs may go at the cost of their outreach, however. Reaching the poor and providing them with credit may be very costly. Making very small loans involves high transaction costs, in terms of screening, monitoring and administration costs, per loan. Several authors therefore argue that the unit transaction costs for small loans to the poor are high as compared to unit costs of larger loans (Hulme and Mosley, 1996; Conning, 1999; Paxton and Cuevas, 2002; Lapenu and Zeller, 2002). Thus, there may be a trade-off between efficiency and outreach, implying that the shifting focus towards increasing sustainability and efficiency reduces the scope for the more traditional aim of many MFIs, which is lending to the poor.

MFIs provide a wide range of services. The best-known activity of MFIs is providing credit to poorer households and small enterprises, but many also take deposits. In addition, some MFIs offer other financial services, such as insurance, or advice and training to their clients. This training is often closely linked to the MFI's main activities; training in business management for example might make a loan more valuable to the borrower and also enhance the chances of repayment. Sometimes MFIs are used as a vehicle to provide other services and education, e.g. in the area of health awareness (Daniel, Holden and Vassili, 2002).

The primary clientele of MFIs consists almost by definition those who face severe barriers to access financial products from conventional financial institutions. These barriers comprise mainly high operational costs, and risk factors. An MFI's clientele may for example be distributed in remote locations, possess few negotiable assets, whether they be physical or financial, and live in an environment where enforcement of formal property rights and other contracts is expensive and uncertain (Vassili, 2002). Holden (2002) noted that the costs of carrying out microfinance business are usually high relative to the value of loans and deposits involved. On one hand, financial transactions often bear significant overhead and fixed costs, independent of the size of the transaction. These costs include the administrative costs of making payments, keeping open offices and cost of loan monitoring. Typically, the largest single expense is salaries, due to the very labor-intensive nature of micro lending. The ratio of administrative expenses relative to assets in the sample is much higher than would be typical for a commercial bank, and declines with portfolio size.

On the other hand, small scale projects or consumer lending to poor is often highly risky, in part because: (1) the borrowers' income stream can be intrinsically risky and more exposed to exogenous shocks (weather, macroeconomic fluctuations); (2) the borrowers are not well diversified; (3) the borrowers cannot provide collateral; (4) loans are bound up with personal finances of poor (e.g. a business might collapse if large medical bill must be met). This often results in high share of impaired loans, which are sometimes bunched (e.g. after a harvest failure or natural disaster). Certain MFIs are very successful in achieving high loan recovery rates, but the potential risk is almost always present.

These high costs generally force MFIs to charge high interest rates on loans, even in real terms. Also the spread between deposit and lending rates offered by MFIs is usually high. MFI borrowers are presumably willing to pay these high rates because the alternative is either borrowing at even higher rates, perhaps from an informal money-lender, or no borrowing at all. An MFI may have to operate in an oligopolistic manner in its local market in order to cover its fixed costs, but its presence could still be welfare improving. Nonetheless, many MFIs lose money.

However, there is also a substantial contingent of "financially self-sufficient" MFIs that manage to at least break even on a sustained basis. They are generally very much larger than other MFIs, both in terms of their loan portfolio and the number of borrowers. Their loans also tend to be larger relative to GDP per head. Their administrative costs tend to be lower relative to total assets, but their interest margin is higher, presumably because they are much more successful in attracting low-cost deposits. Savers at MFIs may be much more attracted by the security and transaction services connected with having a deposit rather than with the interest yield. Financially self-sufficient MFIs also make more

use of commercial borrowing, although the direction of causation is not clear: they may be able to borrow because they are financially self-sufficient, but the borrowing capacity may strengthen their performance. At the same time, even financially self-sufficient MFIs maintain a high ratio of equity to total assets (Wright, 2000).

Holden (2002) further state that available data suggest that MFIs often improve their profitability as they mature, primarily by lowering their average costs. This may reflect (1) learning by doing (the institution learns what operational arrangements and loan mechanisms work best in its environment); (2) sample selection bias (only low-cost institutions survive); and (3) decreases in average costs when an institution with significant fixed/overhead expenses expands over time. Almost all MFIs seem to lose money for an initial period, which implies that most MFIs require substantial capital injection or subsidies during their start-up stage.

Gibson and Meehan (2000) state that to attain profitability (or financial self-sufficiency), MFIs need to build up their equity, so as to be able to leverage debts from formal financial institutions, and to attract private investment and savings deposits (when possible). Yet the most consistent long-term source of equity is retained earnings. In turn, to build up retained earnings, MFIs need to make profits from their loans. In other words, MFIs have to be able to reach large numbers of the poor (by increasing the scale of their operations), to enhance their efficiency (by decreasing operational costs, i.e., both administrative and personnel costs), but also to charge sustainable interest rates on their loans, i.e., interest rates that cover both operational and financial costs over the short term. Christen *et al* (1995) argue that striving for financial self-sufficiency will not prevent MFIs from reaching the

very poor; profitability does not depend on the clientele reached, but on the degree to which the MFI is well designed and managed (Gibbons and Meehan, 2000).

It should be noted that there are also some dispute on the link between financial sustainability and outreach to the poor. According to (Christen *et al.* 1995; Otero and Rhyne 1994), cited in Meyer (2002), outreach and financial sustainability are complimentary this is because as the number of clients increase MFIs enjoy economies of scale and hence reduce costs which help them to be financially sustainable.

On the other hand, Hulme and Mosely (1996) argued that there is inverse relationship between outreach and financial sustainability. Here, the argument is, the higher outreach means higher transaction costs in order to get information about creditworthiness of clients and hence make MFI financially unsustainable. The underlying assumption is that charging sustainable interest rates will not affect its depth of outreach, as "households demand access to credit, not cheap credit" (Morduch, 2000). Yet it also implies that the MFI should maximize its efficiency (by decreasing its total costs, including administrative and personnel costs) so as to minimize the effective interest rates it charges to its borrowers.

This same assumption does not imply, however, that MFIs should, right from the start, charge very high sustainable interest rates for the sole purpose of financial self-sufficiency; but that MFIs should consciously work towards financial self-sufficiency. In other words, profitability is not an end in itself, but a means to reach a substantial number of poor, in order to make a dent in overall poverty (Gibbons and Meehan, 2000).

Sanderatne (2002) concludes that MFIs should follow good banking practices, be operationally efficient and disciplined. The ultimate target is to achieve profitability, so as to cover operational costs of MFIs (Charitonenko and Afwan 2003). MFIs need four sequential stages to become a full-fledged commercial entity. The first stage is the adoption of banking-like operations, such as developing demand-driven financial products, and the implementation of market interest rates to cover operational costs. The second stage is progression towards financial self-sufficiency through increasing operational efficiency and profitability. Operational profitability is vital in providing a basis for MFIs to attain the third stage of commercialization. In this stage MFIs should be capable of mobilizing public savings, and become attractive for equity investments. In the fourth stage, as MFIs become a profitable entity, their financial operations are subject to banking provision and regulations. In practice the microfinance commercialization can be accomplished through a transformation into commercial banks.

However, MFIs will need to lower operating costs further before the industry will be able to attract a significant amount of commercial capital. To improve efficiency and customer satisfaction, many MFIs are exploring the use of new technologies, such as Palm Pilots and smart cards to lower transactions costs and increase outreach. Successful MFIs must keep their costs low through efficient operations such as highly simplified and decentralized loan application, approval and collection processes.

2.2 Operational Costs and Repayment Rate

Microfinance is a high touch, high cost business. As a business model, its greatest challenge is to lower operating costs in order to reduce the cost of service borne by borrowers. An analysis of the cost structure of profitable MFIs (microfinance institutions) reporting to the Microfinance Information Exchange, Inc. (MIX) confirms this assertion: in 2006 operating expenses (both personnel and administrative) represented 62 percent of charges to borrowers, financial expenses 23 percent, profits 10 percent, and losses from defaults five percent. Since operating expenses are the main component of interest rates, identifying their drivers and quantifying them constitute the first steps in finding ways to improve efficiency of microfinance institutions worldwide (Gonzalez, 2007).

Godquin (2004) further states that to estimate the probability of default in payment; a microfinance institution should consider character, capacity, conditions, capital, and collateral of a particular borrower. MFIs clients undertake a variety of enterprises simultaneously; MFIs should be concerned with repayment capacity of the borrower, rather than with selection of a particular activity. Adverse selection and moral hazard will increase the proportion of borrowers who can not repay their loans on time next to those who experienced different adverse shocks (like illness or natural disasters). To achieve scale (significant outreach) and financial self-sufficiency, institutions must cover the higher costs they incur in providing small-scale financial services. Fully self-sufficient programmes charge an effective real interest rate that is high enough to cover all their costs, and therefore these interest rates must be included in the total amount that borrowers will repay (CGAP, 2000).

Lafourcade et. al., (2005) state that operating and financial expenses of MFIs have remained to be high, and on average, revenues have remained lower. Technological innovations, product refinements, and ongoing efforts to strengthen the capacity of MFIs are needed to reduce costs, increase outreach, and boost overall profitability.

Rhaman (1999) asserts that the first best level of repayment rate which can promote self – sustainability is 100% on – time. If the maximum repayment rate the MFI can reach given its lending methodology is lower than the targeted 100%, microfinance will take long to attain sustainable operations. MFIs find it difficult to achieve high returns because portfolio yield have sunk so low due to older delinquency of their loans (USAID, 2005). Adongo *et.*, *al* (2005) also contends that improving repayment rate might help reduce the dependence on subsidies of the MFIs which will improve on its profitability hence self – sustainability.

MFIs have to be innovative to overcome these barriers. Incentives for loan repayment, for example, can be created through a number of techniques (Morduch, 1999), such as the group lending model, which was pioneered by Grameen Bank in Bangladesh in the mid-1970s. Under group lending, all group members are held responsible for loan repayments even if the loans are made to individuals. In some countries (for example, Indonesia), lending took the form of allocation of funds through village-level management commissions led by village heads. In this case, the village heads are held responsible for loan repayment, but they exploit appropriate enforcement mechanisms with regard to individual borrowers. Perhaps most importantly, credit-granting MFIs often use dynamic incentives, where a borrower initially receives a small sum, but as a satisfactory repayment history is established, the borrower may obtain progressively larger loans. The threat to cut off any further lending when loans are not repaid strengthens repayment incentives.

So far, only a few commercial banks have successfully entered the microfinance business. Where formal commercial banks have enjoyed a certain success in doing microfinance business, key elements were the ability to identify borrowers who would repay on time, and to monitor the loan portfolio to ensure that delinquencies are kept under control. This required either technology that could allow accurate credit scoring, or substantial local knowledge. The case of the *Banco del Trabajo* in Peru is a typical example of the former, while the *Unit Desa* system in Indonesia is an example of the latter. In addition, the creation of a separate, dedicated MFI unit within the commercial bank has often proven to be advantageous.

About half of the MFIs are becoming more cost effective with time and about half are not. In order to determine which MFI characteristics are associated with decreasing costs and which are not, we estimate several auxiliary regressions. Cost reductions are found to be related to several factors. Importantly, lower total subsidies and a lower subsidy per loan are associated with greater cost reductions. MFIs offering deposits tended to improve over time, as did those located in Central Asia. Those MFIs not in networks also tended to achieve cost reductions. Briefly, we find that the group of MFIs that is becoming more cost effective over time is relying less on subsidies and more heavily on deposits as a source of loanable funds. These MFIs are basically transforming themselves into institutions similar to small banks. A second group of MFIs is not showing increased cost effectiveness, and remains dependent on subsidies. Thus, there are good reasons to expect MFIs that have been in operation longer to be able to reduce costs through learning by doing. However, there are also possible reasons why costs may be flat or even increasing with time, including the following factors: (i) screening and monitoring costs may rise as MFIs reach beyond their initial target group, (ii) operating costs may increase if MFIs move into more isolated and rural markets,(iii) operating costs could rise if MFIs begin competing in increasingly saturated markets, (iv) higher collection

costs may be associated with a possible culture of non repayment and may be experienced if the MFI has to address increasing default rates, and (v) village banking methods may simply replicate costs as they are extended into new areas. Given the many potential differences in operating environments, degree of subsidization, organizational structure, and lending technology, it is not clear that any finding of increasing cost effectiveness would apply equally to all MFIs. It is for this reason that we estimate a mixture of cost functions along the lines of Beard, Caudill, and Gropper (1991, 1997).

2.3 Lending Policies and Outreach

Brealey and Myres (1999) assert that the decision to extend a loan to a borrower is followed by a discussion regarding the terms of the loan. The terms of loans determine the loan amount that has to be extended, for what period, and what cost and concession if any is to be allowed.

Expanding the number of clients being served is an ultimate goal of almost all microfinance interventions. It has very seldom been useful for funders to pressure MFIs for rapid expansion. Outreach is manifested by the number of borrowers, average loan size, client and portfolio growth which enables the MFI to become self sustainable. Navajas *et. al.*, (1998) states that microfinance outreach includes the breadth of outreach, depth of outreach, quality of outreach, length of outreach, and variety of outreach. Quality of outreach refers to worth, to how valuable microfinance products are for particular clients. Depth of outreach tells us how valuable it is to extend the supply of microfinance products to particular target groups, not from the point of view of a given client, but from the point of view of society (Conning, 1999). Breadth of outreach counts the number of clients of a given depth who are supplied with a microfinance product of a given quality (worth) and a given cost. Only a small proportion of the target group have access to formal and semi – formal financial services, but the more numerous the clients reached, the better (Adams, 1998).

MFI concerned should inform clients of the conditions under which they may transact with the MFI. It is incumbent upon an MFI to provide information in understandable and accessible form on such matters as loan terms, deposit interest rates, and access to funds. Without such information the MFI may find it difficult to attract new clients, while the existing clients may legitimately claim to have been misled, which may in turn cause borrowers not to repay loans, prompt court actions, or motivate depositors to demand compensation from government in case the institution fails. Such a requirement may be considered as a condition applicable to all businesses, and not specific to financial institutions, but exactly what information needs to be provided needs to be suited to the financial services provided (CGAP, 2000).

Mutenda (2001) also noted that once an MFI is established, it might initially be restricted to a rather narrow range of activities. The range can be expanded over time, but only as the MFI acquires the necessary skills and structures to handle them, and demonstrates to the supervisory authority that it can carry out the new activities in a sound manner and support the heavier regulatory requirements that are entailed. Some MFIs develop from NGO-sponsored lending organizations. Others might start as savings cooperatives, which are in effect "narrow banks," which just take deposits and invest them in fairly safe liquid assets. Before such a narrow bank could start investing in a wider range of instruments, it would need to show that it has a management system in place to determine and maintain a portfolio with appropriate liquidity and risk levels. If it then wished to begin lending to individuals or enterprises, it would need to have established a system for loan evaluation and tracking, and for reporting on its lending activities to the supervisory authority. Throughout the process of development, the supervisory authority will need to verify that the MFI has an internal information system adequate for its own management purposes, and is capable of meeting reporting requirements that match its stage of development. If an MFI is authorized to operate in a relatively free environment, its operations should be subject to some pragmatic limits. These limits (on the overall deposit base, loan portfolio, number of branches, number of staff) would make MFIs too small to pose a threat to the overall stability of the financial sector. However, once an MFI becomes too large to operate within the prescribed limits, it should be required to re-register with the Central Bank or another regulator.

Christen and Rosenberg (2000) concludes that when an MFI begins borrowing significantly or taking deposits from the public, the most important set of prudential regulations that must be met concern the recognition of impaired loans and the making of provisions. In most financial systems, and especially for an MFI, credit risk is the greatest threat to survival. Prompt and full recognition of actual or potential loan losses is the most effective means to contain them, and even if an MFI is forced to close due to loan losses, losses for depositors and other creditors are likely to be smaller if loan losses have been identified early. Loan classification and provisioning criteria create incentives for careful loan evaluation, and limit moral hazard when an institution is failing. If the MFI is to reach sustainability and allocate its resources efficiently, its own management will have to pay close attention to loan repayment rates, so the marginal cost of regulation in this area should be small. However, provisioning requirements need to be carefully designed so as not to create artificial barriers or opportunities for regulatory arbitrage.

Funders who want to reach very poor clients should usually look for MFIs that are already committed to a low – end clientele, rather than trying to encourage higher – end MFIs to change their market. However, it should be noted that low loan sizes do not guarantee a poor clientele. Likewise, growth in average loan size does not necessarily mean that a MFI is suffering a mission

drift. As an MFI matures and growth slows, a lower percentage of its clients are first – time borrowers and average loan size will rise even if there has been no shift in the market it is serving (Rosenberg, 2003). The financial services and the delivery methods should be client targeted and based on simple procedures. If the microfinance institution is spread over a wide geographical area, the selection of the target beneficiaries as well as the delivery method of the services should be decentralized.

The microfinance institution should have a wide outreach and lenient lending policies so that it could accomplish its mission on a continuous basis. This would be ensured by attaining a significantly larger scale of operation and building a wide client base, including the underserved (e.g. women, minority ethnic groups). Schreiner and Yaron (2001) shows that rapid expansion sometimes proves to be unsustainable, especially during an MFI's early years when it needs to design its products and build its systems. Rapid growth will temporarily depress an MFI's profitability because such growth requires new investments in staffs and facilities that take a period of time to become fully productive.

Small business loans may be a prominent part of MFI activities, but lending and deposit taking to smooth consumption by households may be more important for most MFIs and their clients.6 Providing savings facilities not only enables households to smooth consumption, but also is of value, for example, in making and receiving payments, and establishing a financial record. One of the lessons of the recent development of the MFI sector is that even very poor are eager and able to save.

MFIs are not equally dispersed worldwide. They appear to be especially well developed in certain Asian and Latin American countries, such as Bangladesh, Bolivia, and Indonesia. There is some evidence that a comparatively large number of MFIs in Africa take the form of savings cooperatives, while lending operations are relatively more important elsewhere. Why microfinance is not more evenly spread worldwide remains a subject for a further research Ledgerwood (1998) or Morduch (1999).

A good microfinance institution should always be willing to adopt an appropriate loan delivery mechanism so that its services are attractive and accessible to the relevant target groups, cover the different situations of their client – base and should be appropriately priced so as to avoid subsidy elements from one side and be competitively attractive to minimize the transaction costs, while ensuring liquidity and rapid availability, on the other (Chimombo and Mataya, 2000). It should be noted however, that if the institutions fail, their clientele too would fail. Such failures are too costly, because it would cause the poor to lose their confidence in the very system which is supposed to help them. Once the confidence is lost, regaining the same would not only be difficult but also would take time. It would also drive the poor back to the dependency syndrome, one of the bottlenecks for alleviating poverty in a sustainable manner (Brand and Gerschick, 2000).

2.4 Relationship between Lending Policies and Repayment Rate

Microfinance Institutions serve as important providers of credit to poorer borrowers and thus can play a significant role in programs to alleviate poverty and promote economic opportunity in nations around the world (Morduch 1999, Zohir and Matin 2004). These institutions make loans to borrowers who seek relatively small amounts and who may be viewed as too risky by larger conventional lenders. Quite often, MFIs operate with subsidies from charitable or governmental agencies. There appears to be considerable heterogeneity in the microfinance industry in terms of institution size, sustainability, and clientele served. Worldwide, the leading 10% of MFIs (about 150 institutions) serve approximately 75% of all microfinance clients, with the remainder served by thousands of small and heterogeneous institutions with varying degrees of sustainability (www.themix.org). Given their important role in providing credit to underserved individuals and the use of subsidies from various sources to support them, MFI operations should be well understood. One important question is whether MFIs are becoming more cost effective over time.

Gallardo (2001) assert that besides the costs incurred by the supervisor, complying with regulations and satisfying on- and off-site supervision can be administratively burdensome and expensive for an MFI. These costs are ultimately passed to the MFI's clients in the form of higher fees and interest rate spreads, and slower growth in the provision of financial services to disadvantaged groups. It is possible that the often poor clients of MFIs could bear significant costs of regulations to protect the other groups in society.

Hardy *et al.*, (2003) further state that regulation and supervision may restrict the ability of MFIs to experiment with new forms of loan agreement and systems to attract deposits by discouraging or prohibiting innovations that are not foreseen in the regulatory framework. MFIs often have to be innovative to overcome the barriers to participation in the financial system faced by their clients and to be financially viable, and these innovations may differ from institution to institution and from country to country. Regulations may make it onerous to introduce such innovations, for example, by requiring higher provisioning and capital against loans that are not backed by collateral, even where some other mechanism provides security. Regulatory restrictions and the costs of complying with regulations may also discourage MFIs from competing with each other or new MFIs from being established, thus preserving local monopolies.

It should be noted that there has been weaknesses in the operational structure and the poor lending policies and decisions of MFIs due to the high costs of allocating adequate information on new clients and clients' business in loan appraisal, and as a result of inadequate loan supervision and follow – up, lending to low income from the loan portfolio, hence retardation in sustainability (Slangen, 2005). Due to the small loan amounts and the large number of individuals' loans, the default rate of MFIs is normally high. For the same reasons it's difficult to manage performance for each transaction hence high administrative costs.

To provide large numbers of very poor people with access to quality financial services, attention to outreach is critical because there are millions of households and enterprises that lack access to financial services. If these millions are to be reached, MFIs must have the capacity that allows for significant expansion. The most successful examples of large-scale outreach have been accomplished through specialized financial institutions. Successful microfinance schemes are characterized by non-subsidized interest rates linked to competitive market rates. Interest rates should allow sustaining the MFI operation. The administration of many small loans, including processing and tracking services, is a costly operation. Consequently, MFIs need to charge higher interest rates than what commercial banks charge, yet can continue operations at rates that remain lower than the informal financial sector.

Interest rates must cover operational and financial costs and growth, to achieve the objectives of a sustainable, healthy, growing microfinance industry reaching increased numbers of the poor, especially in rural areas. Microfinance interest rates cannot be expected to fall below the minimum costs necessary for MFIs to survive, so they will not be "affordable" for some purposes, for which

alternative approaches are needed. Interest rates are "too high" if they result from inefficiencies. Increased competition and performance based capacity-building are appropriate strategies to improve efficiency for lower costs and interest rates. Consumer education, disclosure of interest rates and fees, and a code of conduct will help clients to make better choices and force MFIs to compete transparently. These strategies would put downward pressure on interest rates without retarding growth of the industry, as typically happens under interest rate ceilings (AMFIU, 2006).

In the first place, profitable credit administration requires screening out borrowers who are not likely to repay, charging interest rates high enough to cover costs, and responding vigorously to late payments—all of which run counter to the practical incentives. One of the most controversial issues in microfinance has been the extent of the trade-off between financial sustainability and reaching poorer clients. It would seem evident that there are some circumstances in which the two objectives would conflict. In the first place, there are some potential borrowers who are extremely poor, have no reliable source of income from which a loan could be repaid, and lack the opportunity (not just the capital) to start a micro business. Clearly it cannot be profitable to lend to people who are unlikely to repay. Secondly, some very poor people live in remote and sparsely populated areas where administrative costs of lending are extremely high, and where interest rates would have to be correspondingly high to cover those costs. The conventional wisdom has been that micro credit clients are relatively insensitive to interest rates. But obviously there is some limit to the interest rate that poor borrowers can pay without nullifying the benefits of the loan arrangement.

Zeller and Meyer (2002) shows that relatively high repayment rates increases self – sustainability of MFIs. MFIs seek to cover their operating expenses and achieve growth so as to further their outreach

to the poor. Financial sustainability allows MFIs to expand their operations and increase the level of their service distribution to the poor (Drake and Rhyne, 2002). It's worth noting that high repayment rates generate good returns from the clients which can cover administrative and other costs.

Freimer & Gordon (1965) concludes that the borrower will default on his loan when the duration of this loan is inferior to the minimum duration. An increase in the duration along with irregular repayment schedules may also increase his probability of default. For a given borrower and duration of the loan, it is argued that the repayment probability decreases with the size of the loan, where the probability of default may be due to external factors such as illness or accidental destruction of the borrower's productive assets.
CHAPTER THREE

METHODOLOGY

3.0 Introduction

This chapter presents a description of research methodology that was used to carry out this study. It covers the research design, study population, sampling design and size, data sources, data collection instruments, reliability and validity of research instruments, measurements of research variables, data processing/analysis, and limitations to the study.

3.1 Research Design

For the purpose of this research, a cross – sectional research design was used combined with descriptive methods. This is because the study was carried out as a snapshot as there was no time and resources to carry out a longitudinal study.

3.2 Study Population

The study population of 400 people was used and it included 50 employees and 350 active clients of URWEGO Opportunity Microfinance Bank Limited as of January 2010.

3.3 Sample Design and Size

A total of 221 respondents represented the sample size. This was arrived at by taking a census of 50 employees while 171 clients were determined using Krejcie and Morgan (1970) table guide for sample selection. Simple random sampling technique was used to choose these 171 clients from 350 Active clients.

3.4 Data Sources

• Primary Sources

Primary data was collected using closed ended questionnaires from URWEGO Opportunity Microfinance Bank Limited. The respondents included employees and active clients of URWEGO Opportunity microfinance Bank Limited.

• Secondary Sources

Secondary data on figures and percentages about operational costs, lending policies, repayment rate and outreach was collected from Association of Microfinance Union of Rwanda Reports, Rwanda Microfinance Support Centre, URWEGO Opportunity MFIs' Annual Reports, Microfinance Institutions' Annual Report, Bank of Rwanda, NIOSR, and World Bank Reports. The reason for this is to make comparison of secondary data with primary data that was collected in order to compare operational costs, lending policies and outreach in order to come up with meaningful interpretations.

3.5 Data Collection Instruments

Self administered 5 point likert – type closed Questionnaires were used to collect data from the employees and active clients of URWEGO Opportunity Microfinance Bank Limited.

Table 1 below shows the response rate obtained from the different categories of respondents used in the study.

Table 3.1Response Rate

Category of Respondents	Instruments Distributed	Instruments Received	Response Rate
URWEGO Employees	50	50	100%
URWEGO Clients	171	171	100%

Source: Primary data

3.6 Reliability and Validity of Research Instruments

Closed questionnaire was developed in harmony with the guidelines specified by Sekaran (2000). First, an item analysis was done to see whether the items in the instrument belong there and a pre – test was carried out to check validity and reliability so as to minimize on vagueness of the results to be generated. Reliability (internal consistency and stability) of the instruments was tested using Cronbach's Alpha Coefficient which was above 0.5 (50%) (Cronbach, 1946). The researcher tested inter – item consistency reliability to ensure that there was consistency of respondents' answers to all items in the measure. The findings of the reliability test showed that all the variables were above the accepted alpha coefficient of 0.5. This is shown in table 3.2 below.

Study Variables	Anchor	Cronbach Alpha
Operational Costs	5 Point	0.6649
Lending Policies	5 Point	0.7256
Repayment Rate	5 Point	0.8463
Outreach	5 Point	0.7108

Table 3.2:Cronbach's Alpha Coefficient for the Variables under Study

Source: Primary data

3.7 Measurements of Research Variables

Operational Costs were measured using the dimensions of administrative costs, supervision costs, and training costs on loans given to borrowers, as stipulated by CGAP (2000) which states that microfinance loans attracts high supervision costs of borrowers by loan officers who move out to the field to supervise the clients.

Lending Policies were measured using the dimensions of lenient, moderate and stringent policies on loans given to borrowers as stipulated by Chimombo and Mataya (2000) who states that microfinance lending policies can be lenient, moderate or stringent depending on the current situation of the individual borrowers.

Repayment Rate was measured using the dimensions of frequency and intervals of repayments of outstanding loans by borrowers, as stipulated by Davis (2002) who states that some borrowers pay on time while others delay to play; therefore there is always difference in the repayment frequency of the microfinance loans by different individual borrowers.

Outreach was measured using the dimensions of breadth, depth, worth, costs, length and scope of outreach as stipulated by Schreiner (2002) who states that the outreach levels of microfinance will be based on the breadth, depth, worth, costs, length and scope depending on the coverage.

3.8 Data Processing and Analysis

Data collected from the primary source was compiled, sorted, edited for accuracy and clarity, classified, coded into a coding sheet and analyzed using a computerized data analysis package/tool known as SPSS 17.0. Regression analysis was used to predict the MFI's operational costs and

lending policies and Spearman's correlation analysis was run to determine the existence and significance of the relationship between the independent variable and dependent variable respectively, and later conclusions to the study was drawn.

3.9 Limitations to the study

The following problems were encountered in this study:

- Respondents withholding information due to fear of being victimized as a result of confidentiality of the organization's data but this was overcome by assuring the respondents of utmost good faith by the researcher;
- Accuracy of the research tools and methodology, they might have not given 100% level of accuracy of the results;
- iii) Respondents having a view of not obtaining any direct benefit from the research results.

CHAPTER FOUR

PRESENTATION, ANALYSIS AND INTERPRETATION OF THE FINDINGS

4.1 Introduction

This chapter presents the results of data analysis and findings compiled from the field. It is divided into three main sections. The first section deals with the general/demographic characteristics of the respondents. The second section discusses the findings from the study. Section three analyses and discusses the relationship between the variables in the study.

4.2 Demographic Characteristics of Respondents

The demographic characteristics of the respondents include the gender, level of education and working status.

4.2.1 Gender of the Respondents

The finding in the table 4.1 below shows gender of the respondents.

Table 4.1Gender Distribution of the Employees

	Gender	Frequency	Percent	Valid Percent
Valid				
	Male	39	78.0	78.0
	Female	11	22.0	22.0
	Total	50	100.0	100.0

Source: Primary data

The data summary in table 4.1 above reveals that majority (78%) of the employees of URWEGO microfinance bank who responded were male while, only 22% were female. This implies that majority of URWEGO employees who responded were male.

4.2.2 Level of Education of the Respondents

The finding in the table 4.2 below shows the level of education of the respondents.

	Level of Education	Frequency	Percent	Valid Percent
Valid	A Level	1	2.0	2.0
	Diploma	24	48.0	48.0
	Degree	25	50.0	50.0
	Total	50	100.0	100.0

Table 4.2Level of Education of Employees

Source: Primary data

According to table 4.2 above, majority (50%) of the employees had attained University degree, while 48% had diploma qualification. However, there were only 1 (2%) employees who had attained advanced level certificate. This shows that majority of the employees who responded in the study were degree holders, followed by diploma holders and advance level certificate holder.

4.2.3 Job Position of the Respondents

The finding in the table 4.3 below shows job position of the respondents.

	Job Position	Frequency	Percent	Valid Percent
Valid				
	Loan Officer	34	68.0	68.0
	Loan Underwriter	8	16.0	16.0
	Lending Associate	8	16.0	16.0
	Total	50	100.0	100.0

Table 4.3Job Position of Employees

Source: Primary data

Table 4.3 above illustrates that of the 50 URWEGO employees who responded, 68% were loan officers, while 16% were loan underwriter and lending associates respectively. The data reveals that majority of the respondents were loan officers followed by loan underwriters and lending associates of URWEGO microfinance bank.

4.2.4 Number of Years worked for the Institution

The finding in the table 4.4 below shows the number of years worked for the institution by the respondents.

	Years	Frequency	Percent	Valid Percent
Valid				
	Less than 1 year	8	16.0	16.0
	1-3 years	4	8.0	8.0
	4-6 years	13	26.0	26.0
	7 years and above	25	50.0	50.0
	Total	50	100.0	100.0

Table 4.4Work Tenure of the Employees

Source: Primary data

Table 4.4 above indicates that majority (50%) of URWEGO employees who responded had worked for more than 7 years, while 26% had worked for 4 - 6 years. Further analysis also shows that 16% of the respondents had worked for less than 1 year, while there were 4 (8%) employees who had worked for 1 - 3 years. This means majority of URWEGO microfinance bank had worked for more than 7 years with the microfinance.

4.2.5 Period Spent with URWEGO of the Respondents

The finding in the table 4.5 below shows the number of years the clients have spent while borrowing from the microfinance.

	Years	Frequency	Percent	Valid Percent
Valid				
	1-3 years	33	19.3	19.3
	4-6 years	71	41.5	41.5
	7 years and above	67	39.2	39.2
	Total	171	100.0	100.0

Table 4.5 Period of Years Spent as URWEGO's Client

Source: Primary data

From table 4.5 above, of the 171 clients, majority (42%) had spent 4 - 6 years dealing with URWEGO microfinance bank, while 39% had borrowed for more than 7 years and above. There were only 33 (19%) of the respondents who had borrowed for a period of 1 - 3 years. This implies that majority of the clients had dealt with the microfinance for 4 - 6 years.

4.3.6 Types of Business Venture of the Respondents

The finding in the table 4.6 below shows types of business ventures of the respondents.

	Business Types	Frequency	Percent	Valid Percent
Valid				
	Cloth Vending	34	19.9	19.9
	Animal Husbandry	26	15.2	15.2
	Electronics	29	17.0	17.0
	Farming	38	22.2	22.2
	Retail	44	25.7	25.7
	Total	171	100.0	100.0

Table 4.6 Types of Business Venture of the Clients

Source: Primary data

From table 4.6 above, majority (26%) of the clients were in retail business, while 22% were in the farming business. The analysis further reveals that 19% of clients were in clothe vending while 17% were in electronics business. There were only 15% of the clients in the animal husbandry business as revealed by the table above. This shows that majority of the clients of URWEGO microfinance bank were retail business owners.

4.2.7 Findings on Lending Policies of URWEGO

Table 4.7 below shows the Means and Standard Deviation of findings on the clients' perception about the lending policies of URWEGO microfinance bank. The significance of table 4.7 is to show how URWEGO's clients feel about the lending policies of the microfinance and how it impacts on their businesses.

Std. Ν Min Max Mean Deviation **Lending Policies** The loan staff always visit my business within 24 hours if I don't pay my loans 171 4.00 5.00 4.65 0.48 4.65 I can only get a new loan after completion of payment of my outstanding loans 171 4.00 5.00 0.48 Approval of my loan application is only determined by on-time repayment history of 171 4.005.00 4.65 0.48 my borrowings I have always paid all my loans without any legal action being instituted on me by the 171 1.00 5.00 3.84 1.04 microfinance My repayment behavior has always been key factor in securing loans from the 171 4.00 5.00 4.70 0.46 microfinance I am always required to provide collateral and guarantor before i am given a loan 171 4.00 5.00 4.71 0.45 171 The microfinance always treat us equally when we apply for loans 2.005.00 3.51 1.27 171 3.00 5.00 4.67 0.53 I am always required by the microfinance to save prior to my loan approval 171 1.77 I can always get a new loan before paying all my existing old loans 1.00 5.00 1.20 The lending terms and conditions of the microfinance has always been favorable to 171 1.00 5.00 2.38 1.16 my business venture My loan approval has always been determined by the group members where i belong 4.00 5.00 4.55 0.50 171 The loan officers frequently visit and closely supervise my business after loan 5.00 171 4.00 4.26 0.44 disbursement I have never been denied loans as a result of defaulting over the past years 171 2.005.00 4.16 0.64 171 5.00 2.89 I am always given all the full amount of loans that i apply for from the microfinance 2.001.08 The numbers of my friends who have ever got loans from the microfinance has 2.00 5.00 0.96 171 3.46 rapidly increased over the past years All my friends who have borrowings from the microfinance are loyal borrowers 171 2.004.00 3.13 0.99 All our loans do not exceed the borrowers' established borrowing days 171 2.00 5.00 2.28 0.79 171 I have always paid all my previous loans on-time in the past years 2.005.00 4.04 0.57 The loans officers have never complained about my repayment characters 171 1.00 5.00 3.98 0.67 My group members have always paid all their old loans previously disbursed to them 171 3.00 5.00 4.21 0.44over the past years

 Table 4.7:
 Findings on Lending Policies Descriptive from URWEGO Clients

Source: Primary data

From table 4.7 above, the results show that there was agreement among the clients that loan officers visited their businesses within 24 hours upon failure to repay their pending loans (mean 4.65). The clients also agreed that they were in position to get new loans only after payment of their outstanding loans (mean 4.65). Further analysis also reveals that the clients were in agreement that approval of their loan application was only determined by on-time repayment history of their past borrowings (mean 4.65). Majority also agreed to paying all their loans without any legal action being instituted on them by the microfinance (mean 3.84). There was also further agreement by clients that the microfinance considered behaviors as a key factor in giving loans to them (mean 4.70), and also they further agreed on provision of collateral and a guarantor before the microfinance give them loans (mean 4.71). But they were uncertain on whether there was equal treatment of all loan applicants by the microfinance (mean 3.51). However, there was strong agreement by clients on the requirement of saving prior to loan approval by the microfinance (mean 4.67), while there was a very strong disagreement on getting a new loan before paying all existing old loans (mean 1.77). They also disagreed on lending terms and conditions that they were not favorable to their business ventures (mean 2.38). The clients further strongly agreed that their loan approval was determined by the group members where they belonged (mean 4.55). There was also agreement by all clients on close supervision of their businesses by loan officers after loan disbursement (mean 4.26). They also further agreed on being denied loans as a result of defaulting (mean 4.16), but they neither agreed nor disagreed on being given all the full amount of loans that they apply for from the microfinance (mean 2.89). Further analysis shows that clients were uncertain on whether the numbers of their colleagues who had ever got loan from the microfinance had increased in the past years (mean 3.46), and also neither agreed nor disagreed on loyalty of all their friends who had loans from the microfinance (mean 3.13). They also disagreed on their loans exceeding their established borrowing

days (mean 2.28). There was also agreement that they paid all their previous loans on-time in the past years (mean 4.04). Further analysis also revealed that the clients were neither in agreement nor disagreement on loan officers complaining about their repayment character (mean 3.98). They also agreed that all group members have always paid all their old loans previously disbursed to them (mean 4.21).

4.3 INFERENTIAL STATISTICS

4.3.1 Factor Analysis

Factor analysis is the carrying out of analysis of factor components/constructs contributing to the variables under study using varimax rotation methods to determine the maximum variance explaining the contribution of the components/constructs. Factor analysis was used to extract the most important factors that measured the study variables. These factors explained patterns of correlation between the dependent and independent variables. The principal component analysis extraction method and varimax rotation methods were used to extract and reduce on the many items into few and relevant factors that can be worked on. Only factors with Eigen values greater than 1 (one) were extracted and correlation coefficients of \pm 0.3 were deleted from the rotated component matrix table. The extracted factors were used to fit the regression models. The rotated component matrix for each variable is outlined below;

4.3.1.1 Operational Costs

The principal component analysis was used to analyze the Eleven (11) dimensions of operational costs to determine factor components/constructs contributing to the variable under study using varimax rotation methods. This is shown in table 4.8 below;

 Table 4.8
 Rotated Component Matrix for Operational Costs

Operational Costs	Administrative Costs	Supervision Costs	Training Costs
Our loan collection costs has greatly reduced over the past years	.954		
There has been increased costs of expanding our loan provision to rural markets in the recent past	.869		
Our loan approval process has been decentralized over the past years	.827		
Our loan collection process has been handled by the different branches over the past years	.778		
Our costs of doing business with our clients has greatly reduced over the past years		.922	
The scale of our operations to reach poor clients has greatly increased over the past years		.893	
There has been low cost of supervision over the past years		.893	
We incur a lot costs in traveling to reach all clients		.542	
Our loan officers always make frequent visits to our clients' premises			.773
We usually incur compliance costs in order to make our clients pay back their loans freely			.718
The budget for recruitment and training staffs has increased in the past years			.661
Eigen Value	5.641	30.137	21.227
Variance %	4.567	25.373	56.710
Cumulative %	4.567	29.940	86.650

Source: Primary data

Three factors were extracted from Eleven (11) items constituting 87% of the Total Variance of operational costs. This implied that the three constructs/factors constituted 87% of operational costs. Training costs (57%) contributed more to operational costs, followed by Supervision costs (25%), and administrative costs (5%). This shows that training costs contributes to high operational costs of URWEGO Opportunity Microfinance Bank limited.

and more should be done to reduce on this cost by the microfinance institution.

4.3.1.2 Lending Policies

The principal component analysis was used to analyze the fifteen (15) dimensions of lending policies to determine factor components/constructs contributing to the variables under study using varimax rotation methods. This is shown in table 4.9 below;

Lending Policies	Stringent	Lenient	Moderate
All our loans are small with the highest numbers of loyal clients	.861		
All our loans exceed the clients' established borrowing days	.846		
All new loans are issued to clients only after completion of payment of outstanding loans	.842		
Our clients have complained about our loan terms and conditions	.677		
All our loans have been disbursed to clients on provision of collateral	.649		
All our loans to clients have been approved on availability of a guarantor by a particular client	.582		
Selection of our target clients have been decentralized over the past years		.881	
Our loans product has always been attractive and accessible to all our clients		.714	
We always give all the full amount of loans requested by the clients		.680	
All our clients always pay their repeat loans within the agreed period by the		.548	

Table 4.9	Rotated Component	Matrix for Lending	Policies
	· · · · · · · · · · · · · · · · · · ·		

Microfinance			
Approval of all our loans to clients is only determined by on-time repayment history of a particular client			.856
We always consider behavior of the loan applicant as a key factor before loan approval			.736
Solidarity group members retain the approval and administration of our loans			.666
Eigen Values	4.566	3.441	2.341
Variance %	35.097	23.742	18.086
Cumulative %	35.097	58.839	76.925

Source: Primary data

Three factors were extracted from Fifteen (15) items constituting 76% of the Total Variance of lending policies. This implied that the three constructs/factors constituted 76% of lending policies. Stringent lending terms (35%) contributed more to lending policies, followed by lenient lending terms (24%) and moderate lending terms (18%). On further analysis of the three constructs/factors identified, it was possible to discover that the strongest component of lending policies was moderate lending terms and weakest component was stringent lending terms. This affirms the fact that what matters most in lending policies microfinance institutions are moderate lending policies.

4.3.1.3 Repayment Rate

The principal component analysis was used to analyze the thirteen (13) dimensions of repayment rate to determine factor components/constructs contributing to the variables under study using varimax rotation methods. This is shown in table 4.10 below;

Repayment Rate	Client Commitment	Payment Patterns
All our clients have had the highest repayment culture in the past years	.896	
All our clients always pay their loan installments promptly and on regular basis without a reminder by the Microfinance	.877	
The funds generated by our loan portfolio is always in excess to cover all loan request by clients	.868	
All our clients pay their outstanding loans on-time before they are over due	.851	
All our existing clients have very high on-time repayment character	.804	
All our clients have well established capacity to repay leading to no default on given loans	.769	
Repayment of late loans by our clients is always before the due date		.901
All our clients have reliable sources of incomes which enable them repay their loans in time		.897
There has been reduced loan default rate among our loan clients		.819
All our clients repay their outstanding loans before the loan due date		.691
We have ever sued some clients because of delay in repayment of their pending loans		.646
Eigen Values	6.286	1.895
Variance %	48.357	29.153
Cumulative %	48.357	77.510

Source: Primary data

Two factors were extracted from Thirteen (13) items constituting 78% of the Total Variance of repayment rates. This implied that the two constructs/factors constituted 78% of repayment rates. Clients' commitments (48%) contributed more to repayment rates, followed by payment patterns (30%). The power of clients' commitment to repay their pending loans here is highlighted, what is important to the microfinance institution in Rwanda is to centre more attention and find ways of improve the payment patterns among its active clients.

4.3.1.4 Outreach

The principal component analysis was used to analyze the ten (10) dimensions of outreach to determine factor components/constructs contributing to the variables under study using varimax rotation methods. This is shown in table 4.11 below.

Table 4.11Rotated Component Matrix for Outreach

Outreach	Depth	Breadth	Worth
The highest percentage of clients being served is located in rural areas	.842		
Our loan procedures are easily understood by all our clients	.836		
Our loan portfolio has changed the living standard of our clients	.613		
Our firm provide loans to clients from all parts of Rwanda	.571		
Our loan portfolio has grown over the past years with limited clients' drop out		.945	
Our loan expansion plan has been very beneficial to all our clients		.828	
Our loan scheme has greatly improved the business incomes of all our clients		.798	
The loan size of this microfinance institution is very small		.709	
The number of disabled clients served is high			.942
Our loan portfolio has been growing over the past			.933
Eigen Value	2.471	1.4085	1.058
Variance %	44.928	25.614	9.616
Cumulative %	44.928	70.542	80.158

Source: Primary data

Three factors were extracted from Ten (10) items constituting 80% of the Total Variance of outreach. This implied that the three constructs/factors constituted 80% of outreach. Depth of outreach (45%) contributed more to outreach, followed by breadth of outreach (27%), and worth of

outreach (9.6%). This means that better costs management improves outreach of microfinance institutions.

4.4 Relationship between the Study Variables

Table 4.12Pearson's Correlation Matrix for the Study Variables

	Lending Policies	Repayment Rate	Operational Costs	Outreach				
Lending Policies	1.000							
Repayment Rate	.584**	1.000						
Operational Costs	742**	853**	1.000					
Outreach	.636**	.663**	589**	1.000				
** Correlation is significant at the 0.01 level (2-tailed).								

4.4.1 Relationship between Operational Costs and Outreach

According to table 4.12 above, there is a significant negative relationship between operational costs and outreach as shown by Pearson's correlation (r = -0.589, P – value >0.01). This means that as operational costs increase, outreach declines and moves in a negative direction. Operational costs therefore negatively affect outreach.

4.4.2 Relationship between Operational Costs and Repayment Rate

From table 4.12 above, there is a significant negative relationship between operational costs and repayment rate as shown by Pearson's correlation (r = -0.853, P - value > 0.01). This implies that as operational costs increase, repayment rate declines and moves in a negative direction. Operational costs therefore negatively affect repayment rate in terms of increased interest rates charges on loans.

4.4.3 Relationship between Lending Policies and Outreach

According to table 4.12 above, there is a significant positive relationship between lending policies and outreach as shown by Pearson's correlation (r = 0.636, P – value > 0.01). This implies that as lending policies increase outreach also increases and moves in the positive direction. Lending policies favorable to clients' businesses will increase the outreach.

4.4.4 Relationship between Lending Policies and Repayment Rate

From the correlation table 4.12 above, there is a significant positive relationship between lending policies and repayment rate as shown by the Pearson's correlation (r = 0.584, P – value > 0.01). This means that as lending policies increase repayment rate increase and move in the same direction. Moderate lending policies towards clients increase repayment rate of loans.

4.5 Regression Analysis

Multiple regression analysis was used to find the influence of the independent variable on the dependent variable. Dependent variables considered were operational costs and lending policies of URWEGO Microfinance institution and the dependent variable was outreach. Table 4.13 below presents the regression model of the variables.

Standardized Coefficients Unstandardized Coefficients Т Sig. Model B Std. Error Beta 1.109 (Constant) .380 .343 .000 **Repayment Rate** .729 .171 .776 4.251 .000 **Operational Costs** .345 .158 .474 2.189 .000 .380 Lending Policies .100 .543 3.817 .000 Dependent Variable: Outreach R Square F Change 122.155 0.621 0.594 Adjusted R Square Sig. F Change 0.000

Table 4.13Regression of Operational Costs and Lending Policies with Outreach of URWEGO MFI Bank

Source: Primary data

The multiple regression results in table 4.13 that was generated by Pearson analysis shows that about **59%** of the variations in URWEGO microfinance bank outreach activities to its clients to access loans are explained by a combination of operational costs and their lending policies used on the clients. This means that about 41% of the variations remain unexplained, which could be as a result of other factors which is not part of this study.

CHAPTER FIVE

DISCUSSION OF FINDINGS, CONCLUSIONS, RECOMMENDATIONS

5.1 Introduction

The study was designed and carried out to examine operational costs, lending policies and outreach of URWEGO Micro finance institution in Rwanda. This chapter presents a discussion and summary of the findings based on the objectives and results from the study, and conclusions and recommendations are drawn based on this study.

5.2.1 Relationship between Operational Costs and Outreach

The spearman's correlation coefficient shows that there is a significant negative relationship between operational costs and outreach. This means that as operational costs increase, outreach decrease because of the high costs incurred by the microfinance in its operations. This is in line with Lensink (2006) who asserts that microfinance can not afford to subsidize loans. If the organization is to provide loans on an on – going basis, it must charge interest rates that allow it to cover its costs. These costs tend to be high because providing unsecured, small loans costs significantly more than in traditional banking. However, Christen *et al* (2003) argue that profitability does not depend on the clientele reached, but on the degree to which the MFI is well designed and managed (Gibbons and Meehan, 2000). On the other hand also, Hulme and Mosely (2006) contradict the finding by arguing that there is inverse relationship between outreach and operational costs. Here, the argument is, the higher outreach means higher transaction costs in order to get information about creditworthiness of clients. The underlying assumption is that charging sustainable interest rates will not affect its depth of outreach, as "households demand access to credit, not cheap credit" (Morduch, 2000). Yet it also

implies that the MFI should maximize its efficiency (by decreasing its total costs, including administrative and personnel costs) so as to minimize the effective interest rates it charges to its borrowers. This same assumption does not imply, however, that MFIs should, right from the start, charge very high sustainable interest rates for the sole purpose of financial self-sufficiency; but that MFIs should consciously work towards financial self-sufficiency. In other words, profitability is not an end in itself, but a means to reach a substantial number of poor, in order to make a dent in overall poverty (Gibbons and Meehan, 2000). The finding is supported by Lafourcade *et. al.*, (2005) who state that operating and financial expenses of MFIs have remained to be high, and on average, revenues have remained lower. Technological innovations, product refinements, and ongoing efforts to strengthen the capacity of MFIs are needed to reduce costs, increase outreach, and boost overall profitability.

5.2.2 Relationship between Operational Costs and Repayment Rate

The spearman's correlation coefficient shows that there is a significant negative relationship between operational costs and repayment rate. From the finding, operational costs increase because of the high rate of default among the microfinance clients which call for increased supervision and recovery costs incurred by the microfinance. The above finding is supported by (MIX, 2001) which confirms that microfinance is a high touch, high cost business. As a business model, its greatest challenge is to lower operating costs in order to reduce the cost of service borne by borrowers. Thus, there are good reasons to expect MFIs that have been in operation longer to be able to reduce costs through learning by doing. Given the many potential differences in operating environments, degree of subsidization, organizational structure, and lending technology, it is not clear that any finding of increasing cost effectiveness would apply equally to all MFIs (Beard, Caudill, and Gropper, 2001).

Godquin (2004) and Rosengard (2001) concludes that to estimate the probability of default in payment; a microfinance institution should consider character, capacity, conditions, capital, and collateral of a particular borrower before extending the loan in order to identify possible risks in lending as well as establishing the borrower's ability to repay the loan. MFIs clients undertake a variety of enterprises simultaneously; MFIs should be concerned with repayment capacity of the borrower, rather than with selection of a particular activity. Adverse selection and moral hazard will increase the proportion of borrowers who can not repay their loans on time next to those who experienced different adverse shocks (like illness or natural disasters). This helps to reduce on the interest rates costs on the borrowers.

5.2.3 Relationship between Lending Policies and Outreach

The spearman's correlation coefficient shows that there is a significant positive relationship between lending policies and outreach. Good lending policy of the microfinance institution attracts more clients and this increase the outreach of the microfinance loan. Therefore from the finding above, Rosenberg (2003) points out that financial service and the delivery methods of microfinance institutions should be client targeted and based on simple procedures. If the microfinance institution is spread over a wide geographical area, the selection of the target beneficiaries as well as the delivery method of the services should be decentralized. The microfinance institution should have a wide outreach and lenient lending policies so that it could accomplish its mission on a continuous basis. This would be ensured by attaining a significantly larger scale of operation and building a wide client base, including the underserved. Chimombo and Mataya (2000) further state that a good microfinance institution should always be willing to adopt an appropriate loan delivery mechanism so that its services are attractive and accessible to the relevant target groups, cover the different

situations of their client – base and should be appropriately priced so as to avoid subsidy elements from one side and be competitively attractive to minimize the transaction costs, while ensuring liquidity and rapid availability, on the other. It should be noted however, that if the institutions fail, their clientele too would fail. Such failures are too costly, because it would cause the poor to lose their confidence in the very system which is supposed to help them. Once the confidence is lost, regaining the same would not only be difficult but also would take time. It would also drive the poor back to the dependency syndrome, one of the bottlenecks for alleviating poverty in a sustainable manner (Brand and Gerschick, 2000).

5.2.4 Relationship between Lending Policies and Repayment Rate

The spearman's correlation coefficient also shows that there is a significant positive relationship between lending policies and repayment rate. This means that lenient lending policies encourage clients to repay their loan on time. Freimer & Gordon (2005) argues that the borrower will default on his loan when the duration of this loan is inferior to the minimum duration. An increase in the duration along with irregular repayment schedules may also increase the probability of default. For a given borrower and duration of the loan, it is argued that the repayment probability decreases with the size of the loan, where the probability of default may be due to external factors such as illness or accidental destruction of the borrower's productive assets. However, the above findings is not supported by Slangen (2005) who state that there has been weaknesses in the operational structure and the poor lending policies and clients' business in loan appraisal, and as a result of inadequate loan supervision and follow – up, lending to low income from the loan portfolio, hence retardation in sustainability. Due to the small loan amounts and the large number of individuals' loans, the default rate of MFIs is normally high. The administration of many small loans, including processing and tracking services, is a costly operation. In the first place, profitable credit administration requires screening out borrowers who are not likely to repay, charging interest rates high enough to cover costs, and responding vigorously to late payments—all of which run counter to the practical incentives.

5.3 Conclusion

It is observed from the study that there was a significant negative relationship between operational costs and outreach. This confirms that that microfinance cannot afford to subsidize loans. If the organization is to provide loans on an on – going basis, it must charge interest rates that allow it to cover its costs.

The study also revealed that there was a significant negative relationship between operational costs and repayment rate. Since operating expenses are the main components of interest rates, identifying their drivers and quantifying them constitutes the first steps in finding ways to improve efficiency of microfinance institutions worldwide because it lowers the costs passed onto the borrowers, and in the long run the microfinance may experience customer drop-out.

The major cost which limits the operations of microfinance is always the initial costs of supervision and identifying the loyal borrowers who can repay the microfinance loans on time without default. From the study, it was further noted that there was a significant positive relationship between lending policies and outreach. This confirms to the fact that financial service and the delivery methods of microfinance institutions should be client targeted and based on simple procedures. This is because if the lending policies are so harsh to the borrowers then automatically the microfinance clients' base will never grow in the long run. The study finding also showed that there was a significant positive relationship between lending policies and repayment rate. This shows the fact that a borrower will default on his/her loan when the duration of this loan is inferior to the minimum duration. An increase in the duration along with irregular repayment schedules may also increase his probability of default. Lending policies that are perceived to be helpful by microfinance clients will always attract many to borrow however, any further adjustment or change in these lending policies will deter the clients from borrowing.

5.4 Recommendations

Since it was observed from the study that there was a significant negative relationship between operational costs and outreach, URWEGO should adopt technological innovations, product refinements, and strengthen capacity that is needed to reduce costs and increase outreach.

URWEGO clients should be made aware of the advantages of on-time repayment and the disadvantages of default to the microfinance and to themselves and they should be encouraged to repay their outstanding loans on time to avoid denial of their preceding loan requests.

URWEGO microfinance bank should ensure that its lending policies are perceived to be friendly by its clients; and their financial services and the delivery methods should be client targeted and based on simple procedures. The selection of the target beneficiaries as well as the delivery method of the services should be decentralized. It should adopt appropriate loan delivery mechanism so that its services are attractive and accessible to the relevant target groups, cover the different situations of their client – base and their loans should be appropriately priced.

A good lending policy will always attract more borrowers; therefore the microfinance should ensure that the loan duration is not inferior to the minimum set duration and should fight against irregular repayment schedules so that borrowers can plan for their repayment of the pending loans.

5.5 Areas for Further Research

Why microfinance outreach remains very limited, and no significant programs are currently operating on a sustainable basis;

How microfinance programs can enhance their performance in the critical areas of outreach to the disadvantaged, viability and sustainability, resource mobilization, and policy and macro factors;

How donor agencies and governments can best provide assistance for institutional strengthening and capacity building to see how microfinance institutions can better meet their objectives in terms of outreach and sustainability;

How microfinance institutions can adopt better risk management techniques that can both favor the borrowers and the microfinance itself.

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MAKERERE UNIVERSITY MAKERERE UNIVERSITY BUSINESS SCHOOL

GRADUATE AND RESEARCH CENTRE

Operational Costs, Lending Policies and Outreach of Urwego Opportunity Bank Ltd, Questionnaire for Employees

Dear Respondents,

You are kindly requested to complete this questionnaire appropriately and the information provided will be treated with utmost confidentiality. In case you are interested in receiving a copy of the outcome of the study, please indicate your contact address and at the end of this questionnaire.

Thank you for participating and making this study a success.

SECTION I

BACKGROUND INFORMATION

1.	Gender (Please tick) Male Female
2.	Highest level of Education
	i) "O" Level and below ii) "A" Level iii) Diploma
	iv) Degree v) Postgraduate
3.	What is your job position with URWEGO Microfinance Bank?
4.	For how long have you worked with URWEGO Microfinance Bank?
	i) Less than 1 year ii) 1 – 3 years iii) 4 – 6 years
	iv) 7 years and above

Please circle the most appropriate option on the right hand side of the questions;

Stron	gly Agree (5)					
Agree	(4)					-
Neith	her Agree nor Disagree (3)					
Disag	ree (2)					
Strong	gly Disagree (1)					
	OPERATIONAL COSTS					
OC1	The scale of our operations to reach poor clients has greatly increased over the past years	1	2	3	4	5
OC2	Our loan approval process has been decentralized over the past years	1	2	3	4	5
OC3	Our loan collection process has been handled by the different branches over the past years	1	2	3	4	5
OC4	The budget for recruitment and training staffs has increased in the past years	1	2	3	4	5
OC5	Our loan collection costs has greatly reduced over the past years	1	2	3	4	5
OC6	Assets acquisition to support our supervision has been low in the past years	1	2	3	4	5
OC7	There has been increased costs of expanding our loan provision to rural markets in the recent past	1	2	3	4	5
OC8	There has been high costs incurred in product refinement of our loan portfolio for easy monitoring and supervision	1	2	3	4	5
OC9	All our clients pay their outstanding loans on time before they are over due	1	2	3	4	5
OC10	Costs of searching information about our clients have always been high	1	2	3	4	5
OC11	There has been low cost of supervision over the past years	1	2	3	4	5
OC12	We incur a lot of costs in traveling to reach all clients	1	2	3	4	5
OC13	We always incur high costs of supervision at our different branches	1	2	3	4	5
OC14	We always incur high costs in collecting our over due loans	1	2	3	4	5
OC15	Our loan officers always make frequent visits to our clients' premises	1	2	3	4	5
OC16	We usually incur compliance costs in order to make our clients pay back their loans freely	1	2	3	4	5
OC17	Our costs of doing business with our clients has greatly reduced over the past years	1	2	3	4	5
OC18	The loyalty of clients has reduced supervision costs	1	2	3	4	5
OC19	We employ staff with specific expertise in order to reduce on the costs of monitoring	1	2	3	4	5
OC20	Provision expenses to cater for loan losses has increased over the past years	1	2	3	4	5
OC21	There has been low cost of transaction and loan supervision over the past years	1	2	3	4	5
OC22	It has always been easy to track our loan portfolio performance with less costs	1	2	3	4	5
OC23	The cost of monitoring of loan clients has reduced over the past years	1	2	3	4	5
OC24	Our loan collection costs has greatly reduced over the past years	1	2	3	4	5
OC25	Training always takes a big percentage of our budget	1	2	3	4	5

LENDING POLICIES

LP1	Our loan repayment period has always been favorable to all our clients	1	2	3	4	5
LP2	All new loans are issued to clients only after completion of payment of outstanding loans	1	2	3	4	5
LP3	Approval of all our loans to clients is only determined by on-time repayment history of a particular client	1	2	3	4	5
LP4	We always consider behavior of the loan applicant as a key factor before loan approval	1	2	3	4	5
LP5	All our loans have been disbursed to clients on provision of collateral	1	2	3	4	5
LP6	All our loans to clients have been approved on availability of a guarantor by a particular client	1	2	3	4	5
LP7	Selection of our target clients has been decentralized over the past years	1	2	3	4	5
LP8	Our loans product has always been attractive and accessible to all our clients	1	2	3	4	5
LP9	Our credit committee evaluates the potential of clients' business even after loan disbursement	1	2	3	4	5
LP10	Solidarity group members retain the approval and administration of our loans	1	2	3	4	5
LP11	We always give all the full amount of loans requested by the clients	1	2	3	4	5
LP12	All our loans are small with the highest numbers of loyal clients	1	2	3	4	5
LP13	All our loans exceed the clients' established borrowing days	1	2	3	4	5
LP14	All our clients always pay their repeat loans within the agreed period by the Microfinance	1	2	3	4	5
LP15	Our clients have complained about our loan terms and conditions	1	2	3	4	5

REPAYMENT RATE

RR1	Repayment of late loans by our clients is always before the due date	1	2	3	4	5
RR2	All our clients have reliable sources of incomes which enable them repay their loans in time	1	2	3	4	5
RR3	All our clients repay their outstanding loans before the loan due date	1	2	3	4	5
RR4	All our existing clients have very high on-time repayment character	1	2	3	4	5
RR5	We have never approved any loan at all before considering repayment cycles of our clients	1	2	3	4	5
RR6	All our clients have well established capacity to repay leading to no default on given loans	1	2	3	4	5
RR7	We have ever sued some clients because of delay in repayment of their pending loans	1	2	3	4	5
RR8	All our clients have had the highest repayment culture in the past years	1	2	3	4	5
RR9	Our loans have been repaid by most clients as a result of peer pressure	1	2	3	4	5
RR10	All our clients always pay their loan installments promptly and on regular basis without a reminder by the Microfinance	1	2	3	4	5
RR11	The funds generated by our loan portfolio are always in excess to cover all loan request by clients	1	2	3	4	5
RR12	All our clients pay their outstanding loans on-time before they are over due	1	2	3	4	5
RR13	There has been reduced loan default rate among our loan clients	1	2	3	4	5

OUTREACH

OR1	There has been an increase in the number of our active clients over the past years	1	2	3	4	5
OR2	Our loan portfolio has been growing over the past years	1	2	3	4	5
OR3	There is a constant increasing rate of loan rotation amongst all our clients	1	2	3	4	5
OR4	Our loan products have been valuable to all our clients over the past years	1	2	3	4	5
OR5	We have opened up new branches in other location due to high returns from loan repayments	1	2	3	4	5
OR6	Our loan portfolio has grown over the past years with limited clients' drop out	1	2	3	4	5
OR7	We always receive large numbers of loan applicants on daily basis	1	2	3	4	5
OR8	Our loan expansion plan has been very beneficial to all our clients	1	2	3	4	5
OR9	Our loan scheme has greatly improved the business incomes of all our clients	1	2	3	4	5
OR10	Majority of our loan applicants are given the amount of loans they request for	1	2	3	4	5
OR11	The percentage of clients who are women to the total clients is high	1	2	3	4	5
OR12	The loan size of this microfinance institution is very small	1	2	3	4	5
OR13	Our firm provide loans to clients from all parts of Rwanda	1	2	3	4	5
OR14	The number of disabled clients served is high	1	2	3	4	5
OR15	The highest percentage of clients being served is located in rural areas	1	2	3	4	5
OR16	Our loan procedures are easily understood by all our clients	1	2	3	4	5
OR17	Our loan delivery methods are simple and client targeted	1	2	3	4	5
OR18	Our loan portfolio has changed the living standard of our clients	1	2	3	4	5
OR19	We take appropriate time in supplying our loan facilities to clients	1	2	3	4	5
OR20	There has been growth in our average loan size disbursed to clients in the previous years	1	2	3	4	5

END