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Clients Drop Out And Financial Performance Of Micro Finance Institutions In Uganda

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Abstract

Micro finance Institutions in Uganda seek to provide clients from poor households with a range of money management and banking services. Micro finance is important to the well being of the society because it improves on the welfare, wealth and general standards of living for those people involved in micro finance activities. Despite Micro Finance Institutions effort to support the low income earners by providing financial services, a high rate of clients drop out has persisted. The problem arising out of these excessive levels of client dropout is that they are likely to have negative effects on the financial performance of Micro Finance Institutions.

Basing on the above problem, the study was set; to assess the impact of client dropout on the financial performance of Micro finance Institutions in Uganda and also To determine the factors responsible for clients dropouts in Microfinance Institutions in Uganda The research was based on a qualitative case study design of a descriptive nature and analytical based on structured questionnaires where the sources of data for this research were primary and secondary sources

The findings of the study revealed that Dropouts are the most important factors that lead to losses, which in the long run lead to capital erosion. Dropouts affect profitability by reducing the interest earned on loans. Additionally, they lead to increase in operational costs that have the impact on profitability and Capital Growth since they loose interest earned on loans.

The analysis of the findings, Indicates that the structure of various programs has influenced the dropout's rate significantly. The lack of grace period, high interest rates and poor loan monitoring are structural problems that need to be addressed seriously.

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The research recommends that Microfinance institutions in Uganda should design client responsive products, Introduce client exit surveys, have group guarantee systems, encourage Loan restructuring, train credit officers, Credit reference, charge customer friendly Interest rates, and Increase in loan terms.

Introduction and Background

Dropouts from any programme do not necessary mean problems to that institution. Sometimes, dropouts could help in strengthening of the institution by eliminating troublesome clients (Mugwanya 1999). However, the nature of dropouts and the excessive number in which they exit the programme is what worries Micro Finance Institution practitioners. These excessive levels of exits have a negative effect on the financial performance of Micro Finance Institutions and threaten their future annual reward

A according to Sharif and Wood (1997), The main reasons for client dropouts include:-Voluntary dropout, and involuntary drop out, Closure of an MFI, Increase in the size of the businesses, Default and failure to abide by regulations. The problem arising out of these excessive levels of client dropout is that they are likely to have negative effects on the financial performance of MFIs. The evolution of Micro Finance Institutions is a direct response to the failure of past attempts by government and donor funded rural credit programmes to reach poor families and landless households within the rural areas. Coupled with this is the fact that the small scale business people targeted by MFIs did not have the traditional collateral which is the basis for loan acquisition to the formed banking sector (Abbink et al 2002).

The idea behind micro finance is to provide services that would enable very poor people to become self – employed so that they can generate their own income, there by allowing them to care for themselves and their families. (Kabir,2002).Unlike government credit programs and traditional bank credit programs that emphasis large loans for long repayment periods, micro finance provides small loans that are repaid within a short period of time. Kikonyogo (1997) argues that, Micro finance in Uganda has evolved on an economic development approach, intended to benefit low-income women and men

Despite the substantial worldwide expansion of microfinance in the last two decades, an overwhelming number of poor people continue to lack access to basic financial services (Wiig, 1997). This expansion has reached mainly urban households and micro-enterprises with regular income flows. With activities that may require comparatively larger loan amounts, small-scale enterprises and rural households have less frequent revenue flows, need longer repayment terms and are still largely un serviced. Even rural microfinance institutions still focus mainly on trading and other non-agricultural activities that have a shorter turnover. Successful outreach expansion can be achieved through the entry of financial intermediaries not previously serving micro-clients, or through the broadening and deepening of the coverage of services by already existing microfinance institutions.

Hasan and Shahid (1995), argue that, In rural and remote access regions, strengthening and expanding operations of existing microfinance institutions may work better than trying to lure urban commercial banks to rural areas. The lack of rural lending experience of these banks may constitute a formidable barrier to their entry in rural markets. Microfinance experience shows that the forced expansion of lending operations under supply-led regimes typically leads to poor microfinance institution performance, with declining repayment rates as the quality of the borrowers and the loan portfolio are sacrificed in favor of quantity. Limited branch networks are a bottleneck to the outreach extension of already operating microfinance institutions. This is often a greater constraint for banks when restrictive banking legislation imposes high capital requirements

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for opening new branches, and for limited funds, especially NGO microfinance institutions that are excessively dependent on government and donor financing. Establishing a network of partnerships among microfinance institutions, and between them and other financial institutions can help overcome both constraints, and allow for the necessary growth and expansion (Sharif, 1997). For integration to take place, microfinance institutions must adhere to financial best practice standards and transparency in their financial and operational performance. The increasing availability of microfinance institutions' appraisal mechanisms and rating institutions should facilitate the establishment of such partner networks.

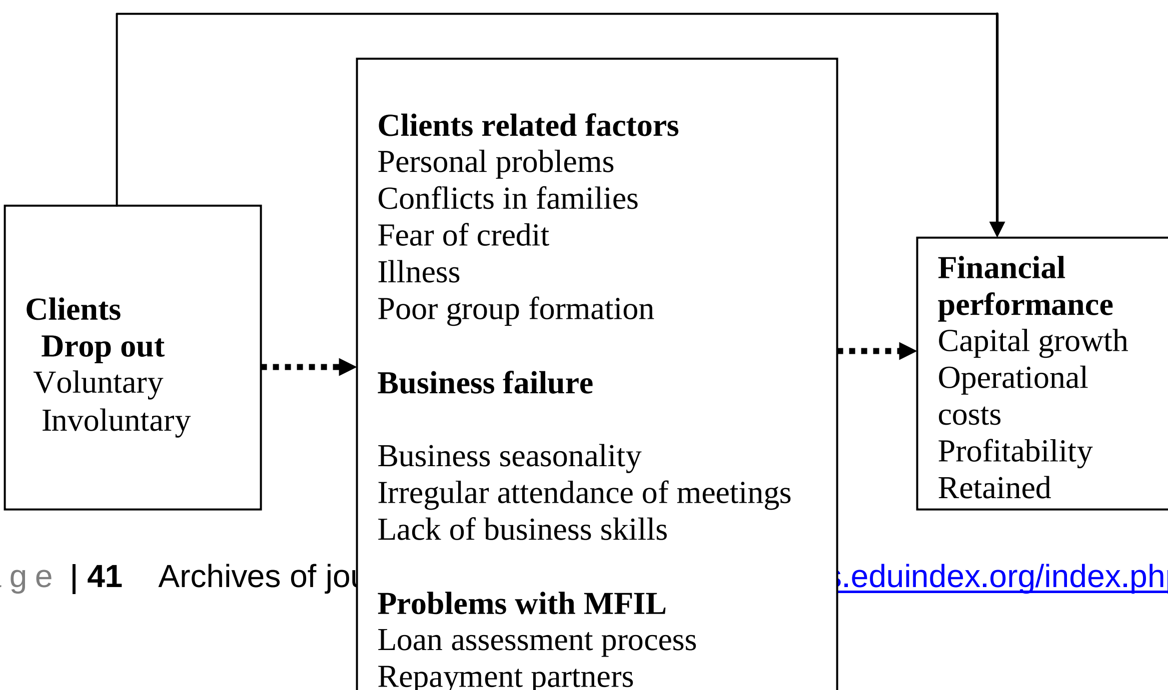
Statement of the Problem

Despite Micro Finance Institutions effort to support the low income earners by providing financial services, a high rate of clients drop out has persisted (often in excess of 25% per annum) (Rutherford and Mugwanya, 1996).And its also Evidenced by the September-December 2002 issue of the Microfinance Banker which noted that the dropout clients in Uganda are expected to rise. This level compared to rates of 7% in other region like West Africa is exceedingly high. The problem arising out of these excessive levels of client dropout is that they are likely to have negative effects on the financial performance of MFIs and has negative implications for efforts to achieve operational and financial sustainability. And it's against the background of excessive dropout that the researcher decided to undertake the investigation

i. *To determine the factors responsible for clients dropouts in Microfinance Institutions in Uganda*
ii. *To establish the effect of client drop out on financial performance of MFIs in Uganda*
iii. *To identify the strategies to be used on how to retain clients to improve financial performance.*

Literature Review

Ledger wood,(1999), states that the profitability of any microfinance institution is affected if interest revenue is not received on delinquent loans. However the most significant effect on profitability, portfolio equity and capital growth occurs when the loan principal and interest on loans are not repaid as a result of high drop outs due to high rates of defaulting. For every loan lost, many additional new loans must be made to generate enough revenue to replace the lost loan capital. In other wards when a loan is not received the entire principal must be expensed through a loss provision. This greatly affects the profitability of the MFI and consequently the amount transferred to the balance sheet as equity if the MFI records a loss the equity is reduced resulting in fewer funds available to finance additional loans.



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Source: Literature.

Various studies have been carried out on the subject of client dropout in Micro Finance Institutions as one unifying factor that dropouts for clients are “multi-dimensional”. Mustafa (1996) and Mugwanya (1990) in their study of dropouts in Kenya, concluded that the reasons for dropout are various. They however narrowed down the causes in major categories that include personal reasons business failure, problems in groups and with MFI producers.

Graham Wright (1999) and Antony Simon Owitz (2001), while carrying out research on clients’ dropout in the Mpulumaga Valley of South Africa came up with five broad reasons for clients exists under personal reasons. These are death in the family and personal or family illness conflicts in family movement, material disasters fear for credits.

Several microfinance indicators, benchmarks and rating systems have been developed to assess microfinance institutions' performance and their sustainability Transaction costs, including credit and economic risks, and interest rates are the main financial factors, together with the cost of funding, affecting the viability and sustainability of the institution.

According to the Micro Banking Bulletin (2002), the adjusted Return on Assets and the Portfolio at Risk are among the most significant indicators of overall financial performance. The adjusted Return on Assets shows the profitability of the microfinance institution, after discounting possible grants and subsidies from government or donors, and therefore its sustainability. The PAR tells how well the microfinance institution achieves its basic goal of lending money and receiving it back. More Detailed microfinance benchmarks, for example, by lending method, by region, by target market.

Microfinance institutions the world over use the group’s lending methodology that has been illustrated and popularized by the Grameen bank of Bangladesh. The group lending methodology or “Group guarantee system” insists that economically active poor people joining MFLs form groups in order to access the services offered by those institutions.

The distinctive feature about the group guarantee system is that the group members guarantee each other by exerting social pressure on the member (s) who default on loans to pay up the principle and interests accruing on the loans. In case any member (s) default group member (s) are obligated to pay up the loan and interest due. Members do not receive a group loan but an individual loan. The group method acts as the substitute to traditional collateral, unlike having traditional collateral such as land titles, buildings, as is the case in the traditional collateral practices.

Orland (2002)**,** observed that while these are methodological difficulties involved in measuring income brought about by provision of credit, studies have demonstrated that the availability of credit can have

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positive effects. Hulme and Mosley (2004), demonstrated the better-off the borrower is the greater the increase in income from borrowed capital. Borrowers who already have assets and skills are able to take risks for use credit to increase their incomes. He argues that the poorest borrower becomes worse off as a result of micro enterprise credit. This is because their business failure is more likely to provoke a livelihood crisis than it is for turnover with a more secure asset base.

According to Pliza and Lopez (2004), Review of Oxfam's experience with income generating projects for women raised serious questions about the profitability of such activities. Full input costing, which would have revealed many income generating activities as loss making were not carried out. Omissions included depreciation of capital, the opportunity costs of labor and subsidization of income generating projects with income from other sources. Market research and training in other skills had often been inadequate.

Maria (1996), suggests that in order to establish the impact of dropout it is vital to understand how they affect interest earned on loans. Clients who dropout are usually with big debts to the MFIs and they fail to realize profits as a result of defaulting hence affecting financial forecasts since the MFIs would have booked the interest as income in their books. Mutesasira (2000) agrees with this view and suggests that a drop interest earned in relation to the operating expense affects the running of these institutions

Joan Ledge Wood (2000), noted that Micro Finance Institutions with excessive levels of dropouts will eventually have their capital eroded as a result of persistent accumulated loses. The lack of capital growth affects the performance of MFIs and their eventual sustainability. In her study of Micro Finance Institutions (MFIs) in Colombia she noted that micro finance institutions which were making had to close down because these persistence losses had led to capital erosion.

The erosion of capital is as result of the accumulated losses of the years, which is a direct result of dropout of clients with large outstanding loans, coupled with failure to recover the accrued interest and related operational expenses.

The lack of capital growth not only affects the capital outlay but also impinges on the expansion of. Micro Finance Institutions Its noted that the source of finance for expansion to other locations and outlets is normally the accumulated profits which cannot realize when MFIs get excessive dropouts.

Research Methodology

The research was based on a descriptive design qualitative study. Due to the nature of the study, the researcher, used a case study which is an intensive, descriptive, and holistic analysis of a single entity that aimed at studying a single entity in depth in order to gain insight into larger cases This design was used because of its suitability in data collection because it enabled the researcher to study small samples in depth. It went beyond merely describing the variables but also explained the attitudes and behaviors of the subjects basing on the data which was collected. The sources of data for this research were primary and secondary sources. The researcher used structured questionnaire and documentary analysis In the process of collecting primary and secondary data, the selection of these tools was guided by the nature of data that was required, as well as by the objectives of the study.

Findings

Reasons for MFI Clients Drop out

Client's Personal Problems

Reasons	Frequency	Percentage	Valid Percentage

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Death /Illness	60	75	75
Conflicts in the family	52	65	65
Fear of credit	20	25	25
Poor group formation	40	50	50
Movement	13	16.25	16.25
More than one loan	55	68.75	68.75

Source: Primary Data

Death and illness in the family which accounts for 75% were sited as some of the reasons for drop out of clients. Respondents confirmed that due to the social structure of Uganda, death or illness comes with added responsibilities like expensive funeral arrangements, funeral rites and medical expenditures

Conflicts in the family: 65% of respondents suggested that family conflicts where men did not welcome women's financial empowerment therefore amongst interviewed respondents, said that family conflicts is a potential problem though not the main reason for exit. Movement or relocation from one geographical area to another led to exit of micro finance clients. A few cases were met as a result of relocation and other had simply left the areas where these institutions are located and could not be traced 16.25% of the respondents confirmed this.

Fear of credit: Lack of access to finance services and the literacy levels of the great majority of the population created fear among the poor towards the financial institutions.
Though the emergency of Microfinance institutions in Uganda have tried to reduce fear, 25% of respondents revealed that there are some clients who still fear credit, two major reasons were put forward for fear of credit: First, the financial requirement involved in accessing loans forced weekly savings in addition to weekly payments; highly loan processing fees are proving to be a big turnoff. Clients also cited that having more than was one of the factors for drop out and it accounted for 68.75% and also poor group formation accounted for 50% respectively.

Business Failure

Reasons	Frequency	Percentage	Valid Percentage
Business seasonality	73	91.25	91.25
Lack of business skills	52	65	65
Appropriate loan size	70	87.5	87.5
Poor utilization	20	25	25
Natural disaster	10	12.5	12.5

Source: Primary Data

91.25% of respondents confirmed that seasonal changes affect Microfinance institutions client's income and expenditures especially rural based clients who depend on agriculture as the main source of income. Most rural based clients borrow money to boost their agricultural activities which is subsistence in nature, however, unlike their counterparts where there is business allover the year. From the research carried out, information got shows that during harvesting season savings shoot up because of a boom in business activities and loans are rapidly. Then during the dry season, savings are too low, poor attendance of meetings, many loan defaulters hence exits. Kasangaki (1999) observed that businesses are adversely affected by their seasonality since most on them depend on some sort of crop, when in the off season all they can afford is to survive on subsistence crops.

In addition, in the rural setting people are more vulnerable to seasonal variations in income/expenditure

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flows and have fewer opportunities for making money than the urban settings where there are more opportunities to diversify. The researcher believes that it is these seasonal variations, together with the rising loan sizes and most MFIs' rigid loan disbursement systems, that require clients to take loans at a specific date or not at all, has lead to many clients opting out or "resting".Natural disaster is one of the major causes of client exit in Uganda's Microfinance Institutions; this was confirmed by 12.5% of respondents. In Uganda circumstances of disasters are common but differ from area to area.

Lack of business skills is one of the factors for business failure. Business skills refer to the ability of client to process a good business plan and elementary book keeping when closing the business. According to the survey made, 65% cited business failure as their cause of exit accepted and that they lack business skills and this is because or due to;
Lack basic education, they therefore find it difficult to record business transactions and draw up essential plans.
Microfinance institutions put tight emphasis on their clients on business modules. Most clients conduct business by instinct, they do not know when, how and where to invest. For Microfinance institutions to maintain this client base, they must train clients in acquiring business skills for them to conduct profitability business.

Appropriate loan size. For the purpose of this research, the appropriate loan sizes refer to a situation when clients request for loan amount which is in excess of the business requirement. 87.5% of the respondents confirmed this; clients often assume that their businesses can accommodate any amount loaned to them. The end result is that clients often divert excess money to other users, leaving the business to pay loans they did not benefit from. Business usually can not cope with excess demand and often fails, leading to client's drop out. It was discovered however, that the weakness in the loan appraisal system helps aggravate the situation. The findings were supported with Wright and Ahmed (1999), arguments that *'due to the weaknesses in the appraisal system, the discretion is left to the borrower to decide how much is appropriate to their business.'*

Poor loan utilization refers to a situation where the money borrowed is deliberately not put to its intended use. The problems regarding poor utilization are shared between the clients and Microfinance institutions. It was however noted that 25% of dropouts in this category blame the Microfinance institutions for; not carrying out proper loan monitoring, not enforcing the group guarantee requirement of peer loan monitoring.

Microfinance Institutions Procedures

Procedures	Frequency	Percentage	Valid Percentage
Repayment partners	74	92.5	92.5
Transport costs	62	77.5	77.5
Loan assessment	30	37.5	37.5
Credit monitoring	45	56.25	56.25
Skills, Experience	26	32.5	32.5
Motivation	40	50	50
Poor decision making	62	77.5	77.5

Source: Primary Data

92.5% of respondents noted that MFIs have a very short grace period, a client who meets on Wednesday the loan he is expected to start paying the following Wednesday. This gives the clients a short grace period for business which has a monthly yield on those sell seasonal items. Clients suggested that for the most parts

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they use this loan to settle their weekly obligations when their businesses are not performing. Clients also blame MFIs on their conditions of borrowing which dictate when to borrow. This inflexibility is due to poor credit monitoring policies and lack of skills and experience indicated by 56.25% and 32.5% respectively. Short grace period affects client's business performance and many who can not afford to make weekly payments are expelled from the program.

Another complaint amongst clients was with the way that some credit officers made decisions as evidenced by 77.5%. Credit officers have been given latitude to assess the clients' capabilities to service loans and take decisions on the size of the loan to be issued. This has caused some dissatisfaction and drop-out, particularly in the context of issues surrounding clients' perceptions that they are paying to borrow their own savings.

32.5% of the respondents said that there is a tendency of credit officers to refer all problems back to the group, leaving the onus on the group and its leadership to resolve them. This has caused high levels of dissatisfaction, particularly in view of the fact that often the problems arise from enquiries about disparities in book-keeping, attached savings or delayed disbursement of loans

Other Reasons for Clients Drop Out

During the course of carrying out the research, the study discovered some other reasons for client's exit, which were not included in the conceptual frame work.

Multiple borrowing: Multiple borrowing refers to a situation where a clients borrow from more than one institution. Clients agreed that it's possible to access credit from more than one institution. This is done to "Patch" loans together to create loans large enough to make business investments.

The formation of parallel Microfinance institutions by clients is another cause of exits. Many clients join MFIs as well as organized groups such as Shoe shiners, butchers and motorcyclists eventually start credit schemes, then they solicit funds from NGOs, and government to start revolving funds and subsequently parallel Microfinance institutions.
During the research, clients who had been members of MFIs formed two groups; the Kampala shoe shiner credit schemes and Owino Women's market credit scheme.

Clients being afraid of the closure of the Financial Institutions. Most of Microfinance institutions insist of client saving as a group and also saving individually. The 1999 closure of cooperative bank a fore runner in Microfinance institutions activities credited tension and fear. However, Uganda Microfinance institutions continue to attract clients especially among the poor. Situational factor Political factor/wars Legal factors, environmental factors/flood, Social factors/polygamy

Areas Affected by Clients Drop Out

Response	Frequency	Percentage	Valid Percentage
Capital growth	7	70	70
Profitability	9	90	90
Retained earnings	6	60	60
Portfolio equity	3	30	30

Source: Primary Data

Capital growth: MFIs have been experiencing capital erosion due Clients dropout by reducing the earnings (interest earned on the loans) while at the same time leading to an increase in direct and operational costs. 70% of the respondents noted that Clients drop out lead the erosion of capital as result of the accumulated

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losses of the years, which is a direct result of dropout of clients with large outstanding loans, coupled with failure to recover the accrued interest and related operational expenses. Excessive levels of dropouts will eventually have capital eroded as a result of persistent accumulated loses. The lack of capital growth not only affects the capital outlay but also impinges on the expansion of Micro Finance Institution.

It should be noted that however, MFIs other factors apart from clients drop out also cause the erosion of capital and they include huge administrative costs and the ambitious expansion programs as it was noted by Woods (2000), clients dropouts are the main cause of poor performance of MFIs because they cause short fall in revenue and increase operational costs.

Profitability: It was observed that dropouts do affect the interest earned on loans. MFIs use the "SALT" method (Saving and Loan Tracking) system that tracks interests lost on disbursed loan for clients who have exited the program. This analysis clearly showed that revenue is lost as a result of dropouts. Clients who dropout are usually with big debts to the MFIs and they fail to realize profits as a result of defaulting hence affecting financial forecasts since the MFIs would have booked the interest as income in their books as reflected by 90% and 60% respectively of the respondents this is further evidenced by Maria Otera (1996), who suggested that in order to establish the impact of dropout it is vital to understand how they affect interest earned on loans.

Client dropouts reduces the earning of MFIs which affects the profitability since the costs associated with running of MFIs in this case are constantly increasing, previously, MFIs was able to recover the monies from dropouts when clients were at a lower loan stage.

It was noted that increase in transport costs directly attributed to the cost of dropouts as part of its cost identification exercises, MFIs had an account code under transport expenses relating to dropouts. Credit officers have to incur transport costs to access client's premises.

Considering all other factors that contribute to persistent losses in MFIs dropouts affect profitability and performance most. They affect profitability and performance in the following ways; MFIs earn their monies from interest earned on loans. However, from the research, dropouts caused shortfall, this affected profitability and performance since other costs associated such as budgets, transport costs are increasing.

Conclusions

In the researcher's analysis, it was found out that the structure of various programs has influenced the dropout's rate significantly. Under business failure, poor loan utilization, appropriate loan sizes, lack of business skills, business seasonality and natural disasters, poor group formation, situational factors like social problems like polygamy were main reasons for client's exits Personal reasons and lack of grace period, the fixed regime and poor loan monitoring are structural problems that need to be addressed seriously.

Much as clients drop out do affect financial performance, Uganda finance trust remains profitable because of its improvement in portfolio, intermediation of clients' savings and clients who join are more than clients who exit microfinance programmes. However, It should be noted that, in the case of MFIs other factors apart from clients drop out also affect financial performance and they include huge administrative costs and the ambitious expansion programs.

With competition in Uganda expected to intensify, Uganda Finance Trust will find itself at an increasing

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competitive disadvantage, unless operating expenses are drastically reduced. Operating expenses should ideally be at less than half their present level. This being said, Uganda Finance Trust has successfully managed to increase yields, which is tough in a market as competitive as Uganda, Uganda Finance Trust management should resort to an increase in the Gross loan portfolio through continued shift towards larger individual loans and also improve in loan terms.

Recommendations

MFIs should respond to the problem of high drop-out rates. It should incorporate drop-out rate monitoring into its management Information System, by analyzing trends, conducting market research with clients and former clients, and modifying policies and products. There is a clear need for the Microfinance Institution to record and analyze drop-out rates as a performance indicator.

Design client responsive products. In the face of it due to increased competition in Uganda, MFIs have to design products that are responsive to their client's needs and not just organizational system. Presently in Uganda, a few systems and products on offers can be described as client friendly. They are expensive, conservative, driven more by needs of the organization and distrust of the clients items by a desire to offer a client responsive product.

Introduction of client exit surveys**.** Microfinance Institutions should initiate client's surveys to analyze the needs of the poor. MFIs in Uganda collect a lot of information but do not seem to use it to their benefit. Needs assessment survey should be conducted on a regular basis and findings implemented.

As discovered, weaknesses in the group guarantee systems, MFIs should adopt a strict and discipline group guarantee system in the first few cycles in order to screen out the clients. In the long run, members of group based loans, after the clients prove their worthiness and discipline.

Loan restructuring must be encouraged; there is a tendency of patching up for defaulting clients by quick deducting funds from good clients which discourages members. The aim should be to nurture the good clients and also help those who are genuinely having problems.

Training of credit officers: There is need to look at the services delivered by credit officers .Persuading credit officers to see the group members as ''clients'' not ''beneficiaries''. Continued training of officers like in customers care and to be encouraged to bridge the gap between credit officers and clients, must be enforced.
Micro Finance Institutions should look on how meetings are conducted, contents and system and whether it cost effective and time to teach the clients to maintain their own books of accounts.

Credit refrence: There is need for Micro Finance Institutions to be very vigilant when vetting clients in order to eliminate those who borrow from more than one institution. Further more; Micro Finance Institutions should form credit beaureus that would help detail the financial dealing of individuals thus reducing their chances of borrowing from more than one institution at a time. And also assess clients who request for loan amount which is in excess of the business requirement

Interest rates of microfinance institutions should cover all costs including costs of funds, administrative costs and provision for loan losses and inflation. But the interest must be customer friendly .Microfinance institutions often charge interest rates of 2 to 3 percent per month or even more; these rates are mainly a result of high transaction costs and risks in financial intermediation. Loan administration costs in terms of

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personnel and resources are approximately the same irrespective of the loan size, and thus have a higher impact when dealing with small loans.

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