LINKING SMEs TO SOURCES OF CREDIT: THE APPROACHES APPLIED BY SELECTED MICROFINANCE INSTITUTIONS IN KAMPALA

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A THESIS SUBMITTED TO THE SCHOOL OF POST GRADUATE STUDIES, IN PARTIAL FULFILLMENT FOR THE AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION OF KAMPALA INTERNATIONAL UNIVERSITY.

DECLARATION

I, Andrew N. Kamatu, do hereby declare that this work is a result of my own effort and has never been submitted for any award in any other university or institution of higher learning.

Signature..

Name: ANDREW N. KAMATU

Date: 1/11/07

APPROVAL

This work has been under my supervision as a university supervisor and submitted with my approval.

Signature..

Name: Dr. Isaac Newton Kayongo..

Date.....31/10/2007...

DEDICATION

I dedicate this work to my family, the pillar of my strength, and the special people in my life and those who encouraged and supported me in my endeavor to contribute to knowledge.

ACKNOWLEDGEMENT

The most challenging aspect in the preparation of this thesis was in the formulation of the research questions and determining the scope within which to confine my work. Dr. Isaac Kayongo, who was my supervisor, assisted me greatly not only in the formative stages of my research but through the entire process. He inspired me and his invaluable contribution made this research possible; for that I thank him.

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Special thanks go to the managers of the selected microfinance institutions in Kampala for their patience and without whose support this research would have been impossible. It is my wish therefore that they find their efforts rewarded in the quality of my work and the positive contribution it will make in linking Small and Medium Enterprises to sources of credit.

Recognition also goes to Charles Chukwu who has been assisting me in numerous ways and providing me with groundwork information. I wish to express my most profound gratitude to the entire KIU community for being kind to me and for providing me with a favorable studying environment.

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LIST OF ACRONYMS

AMFIU	Association of Microfinance Institutions of Uganda
AIDS	Acquired Immune Deficiency Syndrome
CGAP	Consultative Group to Assist the Poor
FCB	Financial Clearing Bureau
FL	Financial Liberalization
GOU	Government Of Uganda
HDI	Human Development Index
HIV	Human Immunodeficiency Virus
HPI	Human Population Index
ILO	International Labor Organization
ICT	Information and Communication Technology
LDC	Least Developed Countries
MCAP	Matching Grant facility for Capacity Building
MDI	Micro Deposit taking Institutions
MFIs	Micro Finance Institutions
MFPED	Micro Finance Planning and Economic Development
MSMEs	Micro, Small and Medium Enterprises
MNCs	Multi National Corporations
MOP	Microfinance Outreach Plan
MOU	Memorandum Of Understanding
MSEPU	Micro and Small Enterprise Policy Unit
NGO	Non Governmental Organization
NPART	Non Performing Asset Recovery Unit
NSES	National Self Employing Schemes
PEAP	Poverty Eradication Action Plan
PMA	Plan for Modernization of Agriculture
POR	Portfolio Outreach Reports
SBFC	Small Business Finance Corporations
SME	Small and Medium Scale Enterprise

SSIs	Small Scale Industries
UBOS	Uganda Bureau Of Statistics
UGx	Uganda Shilling
UMA	Uganda Manufacturers Association

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Abstract

This study sought to evaluate the performance of selected Micro Finance Institutions (MFIs) in Kampala District. The industry has experienced significant growth and despite this growth, the rural financial sector is largely underdeveloped, fragmented, and not adequately integrated with the formal financial sector. The costs of operation of MFIs are also generally higher than those of the formal financial institutions since MFI clients are generally located a distance from the branches and require continuous monitoring. Consequently interest rates are higher for loans obtained from MFIs.

The objectives of the study were; to ascertain the extent to which the selected MFIs have linked Small and Medium Enterprises (SMEs) to sources of credit, to evaluate the performance of selected MFIs using Operational efficiency indicators, Outreach indicators, and Portfolio Quality perceptions and finally, to assess the impact of credit on SMEs' sustainability.

The study followed a well defined process that utilized a consortium of techniques which included; collection of secondary data, interviews, administering of questionnaires, and observation. Different data collection techniques were applied at varying stages depending on the situation.

The findings indicate that although the MFIs have performed below a set standard on average due to some industry wide challenges, they have had a significant impact in linking SMEs to sources of credit.

The researcher recommends that the policy makers formulate a strategic plan on the SMEs and the MFIs for prudential operations. They should also make information disclosure by MFIs mandatory. MFIs are encouraged to introduce insurance products to cushion both themselves and the SMEs in the event of problems.

CHAPTER ONE

INTRODUCTION

1.0 BACKGROUND

Uganda's financial system is characterized by the co-existence of formal and informal financial markets. The formal financial markets, which mainly comprise of commercial banks, development banks and credit institutions mainly exist in urban areas and offer a narrow range of financial services. They concentrate on providing working capital mainly to medium and large-scale enterprises. Uganda Bureau of Statistics (UBOS) (2003).

According to the Bank of Uganda, (2004), the formal financial institutions are inflexible in their operations, with respect to the needs of the small-scale enterprises and the poor people in the rural areas who may not have collateral or well-written feasibility studies to solicit for loans.

According to the Micro and Small Enterprise Policy Unit (MSEPU) (2003), the rural areas, where the majority of poor people live, remain either under-banked or served by informal financial institutions. It is estimated that only 10% of the rural population and 5% of the rural poor have access to financing services in terms of saving and credit. This limits the rate of investment and employment creation particularly in rural areas, thus constraining overall economic growth UBOS and MSEPU, (2003).

A wide range of Micro Finance Institutions (MFIs) have, however, existed in Uganda in many forms and for many years to respond to the resource gap in the market and are working to become more responsive to the real needs of their clients who constitute low income households, thereby contributing to economic growth. However, though Uganda has a long history of informal finance, a more organized micro-finance industry picked momentum in the early 1990s following the liberalization of the financial sector. The industry is therefore still young, but very vibrant. Ledgerwood et.al (2002).

In the last eight years, the industry has grown as high as 70 percent per annum. Despite this growth, the rural financial sector in Uganda is largely underdeveloped, fragmented and not adequately integrated with the formal financial sector. The costs of operation of MFIs are also generally higher than those of the formal financial institutions since MFI clients are generally located a distance from the branches and require continuous monitoring. Consequently, Interest rates are higher for loans obtained from MFIs than those on loans obtained from the formal financial institutions. Ledgerwood et al, (2002).

To reverse this trend, the Government and key stakeholders have started initiating policies aimed at implementing market based rural financial services on a sustainable basis with the major objective of increasing access to and availability of micro finance services in rural areas where the poor people live and work.

Therefore, the role played by MFIs is high in the economical growth strategy of Uganda. In its original form, micro-finance business was considered as 'charity.' As a result, the performance of the schemes was adversely affected by very poor loan recovery, inefficiency and high management costs which consequently led to under-performance or collapse. The view that prevailed for many years was that micro borrowers were too poor to pay back their loans at commercial rates and therefore, any loans to them must be subsidized.

Over the past decade the industry has transformed into a large, dynamic private sector catering for the financial needs of the low -income households and economically active poor. Over the years, the MFIs have demonstrated considerable comparative advantage. Most institutions have embraced a more business oriented outlook and maintaining their target service provision to rural and low -income urban clients.

Furthermore, they also target groups of economically active poor while focusing on achieving operational and financial sustainability. While lending rates range between 11% - 18% for MFIs, they range between 15% and 30% for the formal financial institutions.

Uganda adopted economic reforms in the early 1997, (revised then in 2000). They were popularly known as Poverty Eradication Action Plan (PEAP).
The PEAP was established on four major pillars:

- Creating a framework for economic growth and transformation
- Ensuring good governance and security
- Directly increasing the ability of the poor to raise their incomes
- Directly increasing the quality of the life of the poor.

Financial liberalization ushered in a new socio-economic system in Uganda, where market forces played an increasingly dominant role in the economy. Such market forces quicken the pace of globalization and integration gains momentum. National economies, Uganda inclusive, find it difficult to keep up with such global trends and at the same time ensuring that the poor people secure meaningful livelihood.

The majority of the population in Uganda is increasingly finding it difficult to meet basic requirements. Thus economic reforms in Uganda therefore, have not yielded the expected growth and prosperity in the country with poverty actually on the increase, an estimated 38% of the total population (27.4 million people, as at 2006) live below the national poverty line (2002-2003).

The Government realizes the need for more rapid growth in opportunities for productive employment and overall economic empowerment. In line with the principles that govern market economies. The Government has improved conditions by enabling new firms to enter all sectors of the main stream economy through the removal of existing barriers and through provision of targeted incentives. This has ushered in a social class of "working poor" to run the new firms.

1.1. Statement of the problem

In Uganda PEAP ushered in an era that witnessed the birth of numerous small enterprises designed to complement incomes and create employment for the many retrenched people as well as the school leavers who could not be absorbed in the formal sector. The promoters of such were largely the entrepreneurial poor. This in turn led to the mushrooming of a new breed of financial institutions to offer financial services to this new niche market of micro, small and medium scale enterprises.

Availability and accessibility of financial services by the SMEs and the utilization of the same for productive purposes is believed to be the cornerstone for industrial transformation in Uganda.

However, accessibility has been a major problem to SMEs due to the heavy collateral requirements that MFIs impose to help manage risks. This serves to screen out the vast majority of SMEs.

1.2. Purpose of the Research

i. To contribute to existing literature on the Impact of Financial Liberalization on the SMEs.

ii. To offer policy recommendations to national governments in general and the Ugandan policy makers in particular.

iii. Have a clear understanding on what the MFIs are doing in terms of aiding SMEs to survive and thrive.

iv. To develop local capacity to undertake research in the critical areas of economic and institutional reform.

1.3. Objectives of the Study

i. To ascertain the extent to which selected micro finance institutions have linked SMEs to sources of credit and the impact of such credit.

ii. To evaluate the performance of selected MFIs using:

-Operational Efficiency indicators

-Outreach indicators and

-Portfolio Quality perceptions

iii. To assess the impact of credit on SMEs' sustainability

1.4. Research Questions

- Have MFIs linked SMEs to sources of credit in an efficient manner and to make them profitable?
- How efficient are the selected MFIs in provision of financial services to SMEs?
- How does access to financial services by the SMEs enhance their sustainability?

1.5. Scope of Study

The scope of the research was limited to selected Micro Finance Institutions and the clients they serve, in particular, those who have undertaken SMEs. The selected MFIs were; Finca Microfinance, Centenary Rural Development Bank, Pride Microfinance, Uganda Women Finance Trust, now Uganda Finance Trust, and Frontpage Microfinance.

The main reason for choosing these institutions was that they all have similar target beneficiaries, that is, rural economically active poor women, youths and persons with disabilities, and urban and semi-urban informal sector business groups. Further more, they are also in the secondary network of the Association of Microfinance Institutions of Uganda (AMFIU).

Much has been taught in tertiary institutions both locally and abroad on MFIs performance models. Many ideas and approaches have also been put across. It is imperative to understand these approaches in order to establish how MFIs operate and enhance their performance.

This research examined these approaches and relates them to how MFIs performance and operation aid in linking SMEs to credit.

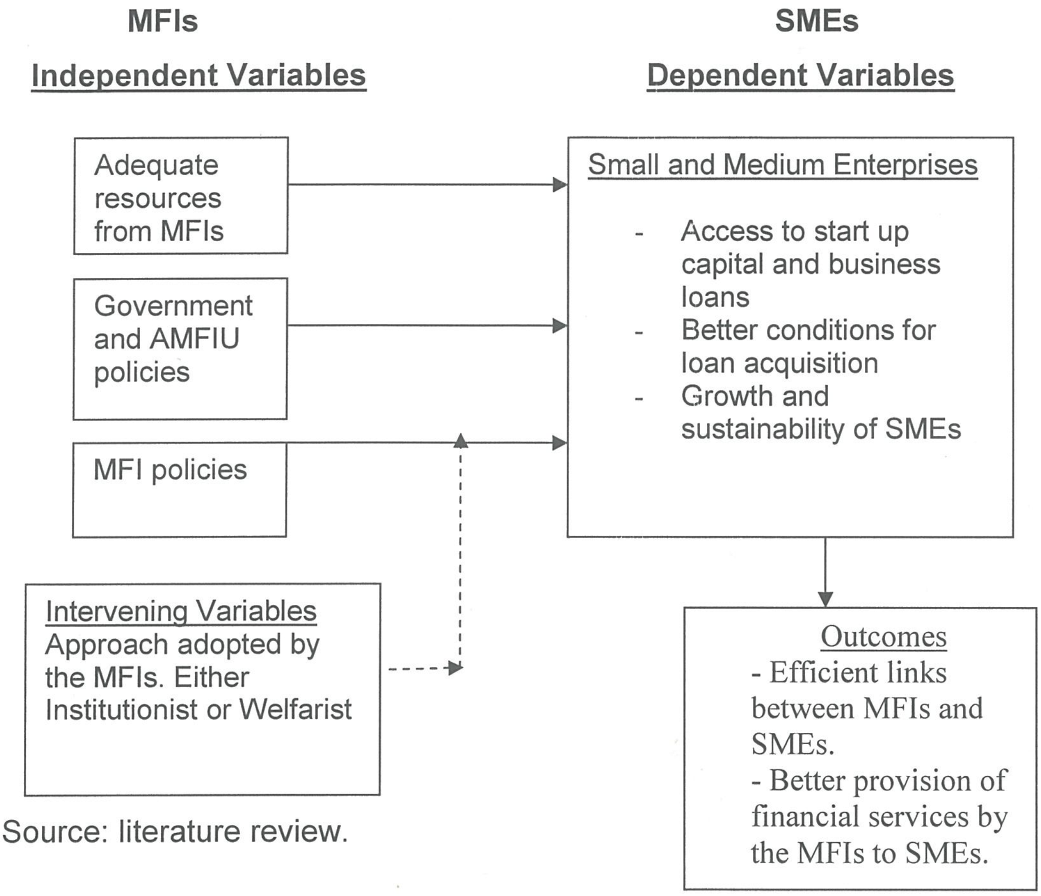
1.6. Conceptual Framework

Adequate resources from Microfinance institutions, policies made by the Government and the Association of Micro Finance Institutions of Uganda (AMFIU), and the policies made by the Microfinance institutions themselves determine the way Small and Medium Enterprises (SMEs) access capital for business start-up, the conditions for acquiring loans for their enterprises and this will reflect on the growth and sustainability of the enterprises.

The approach adopted by the Microfinance Institutions in terms of their operations, mission, vision, and goals which are influenced by the schools of thought of either Institutionist or Welfarist approaches also determines the extent to which they are capable and willing to link the SMEs to credit in terms of access and conditions laid down for them. All these variables will determine the outcome, whether desired or not.

The figure below depicts all these concepts in a diagrammatic manner.

Figure 1.1 Conceptual Diagram



Source: literature review.

CHAPTER TWO
LITERATURE REVIEW

The microfinance industry is characterized by a debate by Woller et.al. (1999); and Elizabeth Rhyne and Otero (1994) between two camps that represent broadly different approaches to microfinance: the institutionists and the Welfarists.
This research was based on the Welfarists approach. The choice of this approach is due to the fact that it emphasizes on direct poverty eradication and their objective tends to be self-employment of the poorer of the economically active poor, which was the basis of this research.

2.0 The Institutionist Approach

In the Consultative Group to Assist the Poor, (CGAP, 2004) view, microfinance should enable “poor people everywhere in the developing world to enjoy permanent access to a wide range of financial services [credit, savings, insurance, and fund transfers], delivered by different types of financial and non-financial institution [non-Governmental organizations (NGOs), credit unions, non-bank financial intermediaries and commercial banks] through a variety of convenient mechanisms [group lending, village banking, individual lending, dynamic lending…].

However, large-scale and sustainable microfinance will only take place if financial services are provided to the poor, that is, if microfinance is integrated into formal financial systems (CGAP, 2004). Indeed, substantial scale requires colossal financial resources that donors are incapable of providing (Woller, et al, 1999).

Only private capital is sufficiently abundant to allow MFIs to reach a significant number of poor people. Moreover, even if capital provided by donors were sufficient, it is not a guaranteed source in the long run. But widespread access to private financial capital requires MFIs to be well managed, efficient and, above all, profitable (or financially self-sufficient). Indeed, "the only way for financial institutions to be interested in entering business partnerships with MFIs is for the latter to convince them of the strength of their operational and financial management; that they operate as commercially-minded, for-profit entities" Gibbons and Meehan,(2000).

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) Gibbons and Meehan, (2000). 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, that is, 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). 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 maximise its efficiency (by decreasing its total costs, including administrative and personnel costs) so as to minimise 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).

Although institutionists believe that, in the long run, microfinance should be integrated into formal financial systems, so as to ensure permanent access to financial services for the majority of poor people, they understand the importance of aid in achieving this objective. They consider three essential levels at which donors should act: the micro, the meso and the macro levels (CGAP, 2004). The micro level consists of the core of the financial system, that is, financial institutions that provide services directly to clients. The role of donors should be to build the institutional capacity of service-providers and to support the development of experimental services CGAP, (2004). Secondly, the meso level consists of the overall infrastructure of the financial system, such as rating agencies, credit bureau, and audit capacity. Subsidies should be aimed at extending these services to microfinance CGAP, (2004).

Finally, stable macroeconomic and policy environments (the macro level) are necessary conditions for pro-poor financial systems to flourish. In this respect, government bodies have a constructive role to play in encouraging interest rate liberalization, restraining inflation and in supplying prudential regulation and supervision of institutions that take deposits CGAP, (2004).

Therefore, institutionists believe that the “added value of donors lies in their unique ability to promote innovation through research and development, forge linkage, promote increased transparency and competition among retail providers of financial services, and build capacity at all levels” CGAP, (2004). The emphasis is on intensive technical input, rather than on large amounts of funding, to allow MFIs reach both of their goals, financial self-sufficiency and outreach to the poor CGAP, (2004).

Indeed, institutionists do not believe in the effectiveness of subsidized credit programmes for at least two reasons. First, as was the case with credit programmes in the 1960s and 1970s, subsidized credit can all too often lead to "mis-targeting", that is, end up in the hands of those not-so-poor households which have enough influence and connections to divert scarce credits to themselves, while depriving the poorest Gibbons and Meehan, (2000). Secondly, subsidised credit programmes are more likely to limit the mobilization of savings at acceptable interest rates, as MFIs can generate capital more cheaply from donors than from deposits. Yet savings mobilization makes sense, both for the MFI and its clients.

First, it provides the MFI with a relatively cheap source of capital for re-lending, but also a pool of clients with whom regular relations become possible, and hence a better knowledge about these clients and the local market. For poor clients, savings deposits make it possible to build up assets which can serve as collateral or capital stock for future investment and also smooth consumption over time Wright et al, (1997).

In a nutshell, institutionists believe in the need to develop numerous large-scale, financially self-sufficient MFIs, integrated into the overall financial system, so as to reach a maximum number of poor people, including the permanently very poor. Hence, sustainability is not an end in itself but the means to achieve outreach. In other words, "MFIs that follow the principles of good banking will also be those that alleviate the most poverty": a win-win situation Morduch, (2000).

This vision has been translated into a series of "best practices" , that is, clear standards of sustainable financial 7 Practices that decrease operational costs by increasing institutional efficiency and effectiveness in areas performance, whose "widespread adoption [...] is believed to be an essential" step towards materialising this ideology Woller et al, (1999).

2.1 The Welfarist Approach

The welfarist approach is explicit in its commitment to reaching the very poor first, while it acknowledges the need to tackle world poverty on a large scale and to strive for increased financial self-sufficiency Woller et al, (1999). Yet they do not believe that full financial self-sufficiency, which is, being profitable and independent of subsidies, is a prerequisite for them to be able to fulfill their social mission Woller et al, (1999). "They are less interested in banking per se than in using financial services as a means to alleviate directly the worst effects of deep poverty among participants and communities, even if some of these services require subsidies" Ferreira, (2004).

Welfarists fear that the commercialization of microfinance, more precisely, the need to be financially self-sufficient (profitable) in order to attract private capital, will divert the industry from its paramount goal of poverty alleviation,
Woller et al, (1999).

Indeed, a MFI achieves financial self-sufficiency by increasing its efficiency (which both parties view desirable), but also by charging sustainable effective interest rates. Welfarists do not accept the institutionists' view that raising interest rates does not substantially diminish the demand for loans by poor people Morduch, (2000).

The problem is that there is much semantic confusion surrounding the word "poor". Although they accept that there are poor households that are able to pay high interest rates, they also believe that there are many borrowers, who are poorer and harder to reach, that are unable to pay such high interest rates. In other words, the poorest are not the ones that are necessarily able to pay the highest rates of interest, as the declining marginal return on capital would imply. Rather, the ability to pay high interest rates depends on the amount of capital and other inputs being used, therefore, on the occupation of the borrower and the use made of the loan. Thus, the win-win situation advocated by institutionists is, in practice, much more complicated to achieve than they claim. Morduch, (2000)

Furthermore, welfarists fear that "the drive to define and codify best practices risks the imposition of a blueprint approach to microfinance that will stifle innovation and experimentation in the design of new products and delivery systems for the very poor" Woller et al, (1999).

Finally, welfarists do not agree that donors should concentrate only on programmes which have attained or seek to attain financial self- sufficiency, regardless of the impact of the actual programmes. They argue that, although most programmes targeting the very poor currently rely on subsidies (a study by the Micro Banking Bulletin (1998) shows that MFIs targeting the very poor yield enough revenue to cover only 70% of their total costs) and will most likely continue to do so in the future (some donors believe than only 5% of MFIs will ever be financially self-sufficient Morduch, (2000), this does not imply that these very poor are not creditworthy. If social benefits outweigh social costs, there is no reason why donors' finance should dry up in the long run Woller et al, (1999).

The Welfarists share the institutionists' vision of financial deepening. But this is not the limit of their vision. They foresee an industry in which the two approaches work in tandem to reach different, but equally deserving, populations of poor clients. They do not eschew profits, but neither do we eschew "subsidies." Nor, finally, do we dispute the institutionists' principled commitment to poverty alleviation.

2.2 Financial Liberalization and Poverty Eradication Action Plan.

Financial liberalization encompasses a lot of economic issues such as interest rate deregulation, relaxation of entry requirements into the sector, competitive offer of banking and other financial services as well as general restructuring of the finance sector in line with market demands McKinnon, (1989). It is thus a process and not an event with one development leading to another.

In Uganda, the Poverty Eradication Action Plan is supported by a number of relevant policies so as to achieve the stated goals. Financial reforms are a crucial cornerstone of the package in full realization of the central and fundamental role played by the financial sector in economic development. Promoters of financial liberalization argue that it should lead to growth through increased savings. The process should encourage the mobilization (given a positive real deposit rate) and redirection of this resource to the most profitable ventures. This should lead to allocative and operational efficiency of the financial system as the rates of interest will be determined by the free interplay of demand and supply forces. McKinnon (1989).

Moreover the financial deepening that results tends to promote competition. This is an essential ingredient for the availability of financial products to different sectors, the government included. Competition should force down the cost of intermediation and allow broader access to credit by all. Barriers between the formal and the informal markets however, persist even when markets are liberalized. Even MFIs that have proved their credit worthiness still face problems in accessing formal institution credit because of their perceived riskiness. McKinnon (1989).

2.3 Micro Finance Institutions (MFIs) in Uganda

According to the Consultative Group to Assist the Poor CGAP, (2003), a microfinance institution (MFI) is an organization that provides financial services to the poor. This very broad definition includes a wide range of providers that vary in their legal structure, mission, methodology, and sustainability. However, all share the common characteristic of providing financial services to a clientele poorer and more vulnerable than traditional bank clients.

Broadly defined micro finance includes both financial and social intermediation for the low-income men and women. Financial inter mediation refers to the provisions of a variety of financial products/services such as small savings and credit, insurance and payment services. The social component relates to group formation, development of self-confidence, training in financial issues as well as the imparting of entrepreneurial management skills.

The Microfinance Sector Informal finance refers to financial transactions outside the regulated formal financial sector with key players being relatives/friends, savings and credit co-operatives/associations, money lenders, community-based organizations, Non-Government Organizations (NGOs) Wamatsembe (2001).

According to Mugwanya (1999) the registered informal sector operators include one savings and credit union, the Post Office Savings Bank, registered operators that provide microfinance services and consist of co-operatives, Non-government Organizations(NGOs) and other savings and credit associations.

In the context of Uganda, the MFIs are the registered and institutionalized microfinance providers constituted mainly of NGOs (both local and foreign), savings and credit co-operatives and even some commercial banks like Centenary Rural Development Bank (CERUDEB). The MFIs provide micro finance services to mainly small and medium scale enterprises (SMEs).

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According to Wright and Rippey (2003) over 45% of the potential small business lending market is un-banked. The MFIs established an umbrella organization the Association of Micro Finance Institutions in Uganda (AMFIU), which is a member based organization incorporated in1999 under the NGO Act and as a company limited by guarantee. The creation of AMFIU was motivated by the need to bring MFIs in Uganda together to share experiences and to create professionalism in the industry through development of industry standards. In addition AMFIU was created with the motive of having a uniform voice to lobby the government to create a legal framework that enables the growth and development of microfinance within a healthy and strong financial sector.

AMFIU played a key role in the consultative process for the development of the Microfinance Deposit taking Institutions Act (2003). AMFIU membership includes banks, credit institutions, NGOs, credit and savings co-operatives/ institutions and special government credit programmes Wright & Rippey; (2003).

To ensure increased access to microfinance by the poor, a project called
The Microfinance Outreach Plan (MOP) was created under the Ministry of Finance, Planning and Economic Development (MFPED) to coordinate the efforts to ensure that well-managed, professional MFIs expand their services to cover the currently under-served areas in the country. MOP plans to achieve this through a number of strategies that include capacity building of MFIs and the matching grants facility (MCAP) for remote rural outreach. This is an incentive mechanism to motivate MFIs to open branches in the rural areas.

Many MFIs in Uganda started as NGOs with missions and objectives for poverty eradication, social development and economic empowerment of poor communities. In general terms, MFIs operated outside the regulatory framework of the Financial Institutions Statue 1993, though they provided both savings and credit services. Katimbo-Mugwanya, (1999) and Hannig and Bohnstedt, (1999).

The microfinance sector was designed with the overriding goal that microfinance must be run as a business and guaranteeing the safety of public deposits. For this reason, the critical issues that were covered in the policy included sustainability and outreach, capital adequacy requirements, liquidity requirements, ownership and governance. The MDI Act (2003) was subsequently enacted by parliament and promulgated into law in May 2003.

The sustainability issue concerns the ability of the MFIs to sustain their operations without undue reliance on donor funds which are not sustainable. The challenge here is that most MFIs have hitherto been reliant on donor grant funds to subsidize their operations. The policy change therefore focuses to ensure that MFIs have sustainable growth to guarantee continuity of access to financial services by the poor, thus increased outreach. Of course financial sustainability actually is all about profitability which is expected to have a number of positive effects.

First the more profitable the MFIs operations, the higher the stake of the shareholders and the more they will take all actions to safeguard the collapse of such an institution. This ranges from design of policies and procedures that enhance the sustainability of the MFIs, hiring competent staff to manage the MFIs, monitoring and supervising the senior management, maintain a high portfolio quality.

Secondly since the licensed MFIs will be allowed to intermediate deposits, the sustainability of the MFIs will ensure the safety of deposits. The shareholders will take prudent investment decisions that will ensure that the deposits are safe. It should be noted that sustainability of MFIs is directly linked to the stability and deepening of the financial system. The act of deposit taking entails accepting the risk that these deposits can be lost either in the process of safekeeping or through intermediation. So the BOU policy clearly focuses on the safety of these deposits to enhance the stability of the financial system.

According to the Bank of Uganda Working Paper (2003), in Uganda there are over 500 MFIs and they have mobilized savings amounting to over shs 65 billion and with a total credit portfolio of shs 53 billion. These MFI's among others include community based organizations and NGO's. Although the number of MFI's appears large especially in a small country like Uganda, there is still unmet demand for flexible, market responsive and sustainable financial services in the rural areas.

While Government of Uganda has divested itself from direct financing of borrowers, there is still need through the Ministry of Finance Planning and Economic Development and other stakeholders to develop an enabling environment for microfinance institutions including an appropriate regulatory framework for MFIs that shall take deposits from the public.

In July 1999 Government approved Bank of Uganda policy on Microfinance regulation. The structure of Microfinance business in Uganda was developed under a four tier system as follows:

Tier 1 - Commercial Banks
Tier 2 - Credit Institutions
Tier 3 - Micro deposit taking institutions accessing public deposits and intermediating these deposits.
Tier 4 - Member based Microfinance institutions, not taking deposits from the public.

The regulation and supervision of microfinance business by Bank of Uganda covers Tiers 1, 2, 3. The tiered approach gives room for smaller MFIs to continue to deliver their services with professionalism and grow while it enables strong MFIs to expand their services and offer diversified financial products. While tiers 1 and 2 are governed under the Financial Institutions Statute 1993, tier 3 will be covered under a new law. The draft law titled the Micro Deposit taking Institutions Bill 2002 has been presented to parliament for consideration. Tier 4 institutions continue to do business as per registration under the NGO statute or other appropriate law in force. The key fund providers for the MFIs in Uganda have been the donors (at least 55%), the government/donors (estimated 40%) and the private sector providing the balance. This funding arrangement tends to cause repayment problems for some recipients in that the clients view this as "cheap money". On other hand some MFIs tend to be lax in their clients follow-ups.

2.4 Small and Medium Scale Enterprises (SMEs)

The definition of SMEs as postulated by the SMEs Development Policy of Tanzania using the size criterion depending only on the employment, the policy has classified SMEs as comprising of 5-49 employees and 50-99 employees, respectively, Matambalya (2001).

Part-time. Cheap. On the side. Small. Low quality. Lowly paid. Sloppy. Copycat. Unprofessional work. Unlicensed. Without set systems and procedures. Survival-type activity. These are some of the perceptions that most people have about Small and Micro Enterprises (SMEs). Indeed, there is no universal definition of what constitutes SMEs. Kelly, (2006)

According to Ndungu et.al, (2006), established researchers and analysts, the scale of enterprise can be measured in terms of total workforce, turnover, investment and number of business units. In a labor-intensive industry the turnover of a firm might be large despite little investment. On the other hand, in the case of capital and skill intensive industries, an enterprise might have a large turnover with few skilled workers.

In India, SMEs are referred to as small-scale industries. They are defined as industrial undertakings in which the investment in fixed assets in plant and machinery whether held on ownership terms or lease or on hire purchase does not exceed $ 218,373 (Rupee 10 million).The structure of employment in East Africa — Kenya, Uganda and Tanzania — is such that the majority of the population depend on small business. Today, small enterprises are found in every corner of the three countries and have great potential to create a variety of jobs, while generating widespread economic benefits. Ndungu et.al (2006).

Many international donors and non-governmental organizations have targeted the sector as the best way of tackling the region's unemployment problem and enhancing the national skills base. One of the sector's worst enemies is the attitude of East Africans who dismiss products from SMEs as inferior. The sector suffers from low demand as markets are saturated due to dumping, over-production and high transaction costs. "The jua kali sector faces numerous challenges especially recognition of the products and subsequently market access," Bwatuti, (2006), chairman of the East African Confederation of Informal Sector Organizations. Compare this with India where SMEs are referred to as Small Scale Industries (SSIs). They have emerged as a very dynamic sector of the economy, which contributes nearly 40 percent of the total industrial production and over 34 percent of national exports. The Ministry of Small Scale Industries website indicates that by last year, there were nearly 30 million people employed in the sector.

According to Lal (2005), the Governments need to provide basic and technological infrastructure to SMEs without which firms can't use ICTs effectively. Lal says the infrastructure has to be provided at a globally competitive rate so that SMEs can withstand the onslaught posed by large firms and multi-national corporations (MNCs). "Without adoption of appropriate ICT, firms may not remain competitive in the era of liberalization and globalization, Lal says.

2.5 SMEs in Kampala

In Uganda, there are 800000 SMEs that comprise more than 90 percent of the country's private sector. They are largely informal, employing about 90 percent (1,5mn) of the total non-farm workers. Adyeri, (2006).

According to Adyeri (2006), a training manager with the Uganda Manufacturers Association (UMA), more needs to be done to ensure the growth of SMEs as an important aspect of the country's development. In his paper entitled: Aspects of entrepreneurship development in Uganda, "Unless there is a substantial increase in the number of micro, small and medium enterprises (MSMEs) both in the rural and semi-urban areas, it will not be possible to accelerate the pace of economic and industrial growth in the country." Adyeri observes that in Uganda there is a growing pool of educated but unemployed persons who can undertake the setting up and operation of MSMEs, as long as business skills training and adequate institutional efforts can be provided.

According to local studies, MSMEs that are managed by people who have studied beyond secondary education account for about 33 percent, (33%). However, the majorities of MSMEs are owned by people whose level of education is below secondary school education or have no formal education at all. The regional mainstream banking sector has tended to ignore the small and medium businesses when providing loans because they perceive them to have weak financial management systems that make data collection and loan monitoring an onerous task. Recently, there has been an upsurge of products tailored for the sector from several banks but majority of MSMEs are still shunned. In Kampala, donors have pulled out of a programme that targeted educated but unemployed youths, which had been decentralized to 11 districts. Dubbed Business Skills Development Programme, the initiative experienced some difficulties reportedly because the government does not have a MSME policy. However, the government says it is keen on developing a policy, which will assist it to target the creation and growth of enterprises. "Informality in

Uganda is rife and a renewed look is needed to encourage formalization to regularize the sector through a targeted business development programme, which will begin to reverse this," National MSME Policy and Strategy Paper (2003).

The World Bank has been key to the debate of why SMEs in the region are just not ticking over as they should. In one of its reports, the Breton Woods institution draws attention to the inability of small, unregistered firms to graduate into bigger ones. It says that due to uncertain legal status, these organizations find it difficult to access credit and public services such as electricity, telephones and water.

This in turn constrains their expansion and graduation to big firms of at least 100 employees. "The heavy collateral requirements that banks impose to help manage risks serve to screen out the vast majority of SMEs. Hence, in addition to improving SMEs access to commercial loans, it will be necessary to develop a range of commercially viable financial instruments to help meet the various financing needs of SMEs," the World Bank's Micro, Small and Medium Enterprise Competitiveness Project document says. But SMEs have registered a lot of success elsewhere largely due to a well thought out implementation programme as illustrated by an example adopted in Pakistan. Here there is a National Self Employment Scheme (NSES) under which young, educated and skilled workers are encouraged to set up their own businesses by obtaining easy term loans from the Small Business Finance Corporation (SBFC), which was specifically set up to promote small business enterprise by advancing loans to entrepreneurs. Mosley (1998).

The objective of the scheme is to expand the private sector and enhance its ability to help the government to reduce rampant unemployment and hence reduce crime. SBFC advances nearly $6,896 to eligible unemployed youth to start off in their chosen line of business. It is advanced on a personal guarantee of a government official, principal/headmaster of a recognized educational institution or any reputable public representative. To avoid being fooled, representatives of the loaning corporation regularly visit the premises of the business to monitor its progress from the time the loan is granted. In Uganda, the Commonwealth secretariat through the Commonwealth Fund for Technical Cooperation has come to the assistance of the government. It is providing technical assistance to the government to develop appropriate policies and strategies that will encourage MSMEs to adopt competitive business practices and contribute to improving the competitiveness of the Ugandan economy." This technical assistance project will help support the government to be able to identify policy reforms that are needed to improve MSMEs' performance," says the secretariat in its report. Mosley (1998).

The poor being targeted by the MFIs in Uganda are the "transitory poor" who are part of what others call the "core poor". Morduch (2000). This kind of poor is just immediately below the poverty datum line. The objective in targeting them is that they access finance and start micro and small enterprises, earn enough income to exit poverty, expand their businesses and improve their quality of life Mosley, (1998), Ogaki et al, (1995) and Alam, (1992).

2.6. Micro Finance Institutions, and SMEs

Leading advocates for micro finance argue that MFIs that follow the principles of good banking will also be those that alleviate the most poverty. This is what is widely known as "Best Practices" Morduch (2000). These good banking principles include, among other things, maintaining financial transparency, standardizing products and achieving scale. However there is limited logic and empirical evidence to support "Best Practices" as observed by Morduch.

The definition of the target group for the MFIs is important to facilitate the determination of the impact of the MFIs based on their underlying objective. The objective could be profit or wealth maximization. General financial minded MFIs want to maximize profit while social minded ones focus on the long-term objective, which is wealth maximization. They are concerned about the social benefits that will accrue to the targets.

There is an acknowledgement from a wider society that past subsidized MFI programs performed dismally on average leading to the wide spread belief that such programs are inefficient and are bound to fail. It is also claimed that these programs were insensitive to efficiency, transparency, and appropriate management incentives.

However Murdoch's counter argument is that these submissions are to a large extent false generalization, which is not consistent will logic or experience. In addition he notes that the majority of programs remain substantially subsidized especially those with explicitly social objectives.

Yunus (1991, 1997), Latifee (1997), Hulme (1991) and Sparrenboom (1996) among many others have written widely about the relationship between the poor and the MFIs. From their arguments the critical issues that emerge are as follows:

Firstly that the major handicap faced by the poor is lack of financial resources rather than skills to operate viable projects.

Secondly those formal financial institutions as they exist today are ill equipped and lack the will to address the unique needs of the poor who lack collateral.

Thirdly they argue that the poor are bankable. The repayment rate for Grameen Bank has averaged 97% over the decades the bank has been in existence. They concur that given the right assistance this fast growing group can significantly increase their income levels. For instance Yunus (1997) notes that Grameen Bank was started in 1976 with a USD 27 loan to 42 poor but able bodied, hard working skilled people. By 1991 one third of its 2.1 million clients had been pulled out of poverty (they had crossed the poverty datum line). It is important to stress the key qualities of the recipients of micro credit- that they should be of good health, diligent and skilled to productively utilize the facilities. Should this assumption not hold, it is possible that the micro credit may not change their economic situation even if the MFI was objective in its outreach. Hulme, (1991).

2.7 Model for MFIs Performance Measurement

Performance is crucial for any enterprise be it profit motivated or not. Set standards serve as yardsticks for the stakeholders to assess their actual results in light of original goals. The performance of MFIs can be best measured in terms of three sets of indicators. The first measure relates to financial performance indicators. These measure the financial soundness of an MFI in terms of its profitability, long-term sustainability and viability even without donor or government support. A financially sound institution is better placed to channel the much-needed resources to the poor and the SMEs.

The second measure is administrative performance of the MFI. This basically relates to the institutional, ownership and power sharing arrangements that will have a bearing on the internal policies of the organization. This measure becomes significant mainly when the MFI is not performing well financially.

The third broad category relates to client profile. This is in realization that not all institutions registered as MFIs or moneylenders as is the case in Uganda are serving the intended purpose. There is always a danger that some may target the wrong borrowers or apply other unethical methods simply to boost their financial performance. The caliber of the administrators again becomes an issue, as they are responsible for policy formulation. Thus these indicators seek to assess the type, number, gender and socio-economic status of the targeted borrowers.

For the purposes of this research, the Micro Banking Bulletin Standards will be used.

These are preferred for a number of reasons. Firstly, they have been endorsed and adopted by a number of regional associations including the Association of Microfinance Institutions of Uganda.

Secondly, the Micro-banking standards tend to consolidate various aspects of the three-fold measurement criteria discussed above. The resultant criterion (summarized into ratios) is user friendly and allows for the appraisal of MFIs by people of different orientations. More over it is relatively simple to apply borrowing mainly from data contained in the balance sheets, income statements and portfolio reports. It thus becomes easy to reconstruct most of the figures from source documents where necessary provided there are records.

In this research paper performance of MFIs will be evaluated using, operational Efficiency indicators, client outreach and portfolio quality perceptions.
These take a long-term view of the institution. There is a danger that an institution may perform very well in financial terms while only reaching a few and/or targeting the wrong group. The other possibility is that the repayment rates could be impressively high while in essence the target group that was supposed to be empowered was actually being ripped off. Yunus (1991, 1997) considers this to be a serious problem of exploitation, as the fund recipients have no meaningful return to their labor. The outreach indicator and portfolio quality perception check on these concerns.

2.7.1 Performance Measurement of MFIs

MFIs' performance will be measured using, operational efficiency indicator, outreach and portfolio quality indicators as discussed above. To analyze the data that was gathered from the MFIs, formulae in Table 1 below were applied.

Table 2.1: Performance Indicators.

Performance Indicator	Formula used	Indicator
Operational Efficiency		
Cost per unit of money lent	Operating costs / total amount disbursed	Indicates efficiency in disbursing loans (In monetary terms).
Number of loans per officer	Number of loans for the period / Number of loans per officer	Indicates performance of loan officers and efficiency of methodology
Outreach		
Number of Clients	Number of Active Clients for the Period	Indicates the numerical outreach of the institution
Number of Women Clients	No. of Female Clients /Total No. of Active Borrowers	Indicates the Gender Sensitivity of the MFI given previous biases against women.
Portfolio Quality		
Portfolio at Risk	Payments in Arrears / Value of Loan Outstanding	Measures Amount of Default Risk in Portfolio.
Loan Loss Ratio	Amount Written Off / Average Loan Outstanding	Indicates Extent of uncollectible loans over the past period.
Portfolio in Arrears	Payment in Arrears / Value of Loans Outstanding	Indicates amount of loan payments past due.
Reserve Ratio	Loan Loss Reserve / Value of loans Outstanding	Indicates adequacy of reserves in relation to portfolio.

Source: Micro Banking Bulletin Standards. www.microbanking-mmb.org

CHAPTER THREE

METHODOLOGY

3.0 Research Design

The study followed a well-defined process that utilized a consortium of techniques which, among other things, included collection of secondary data, interviews, administering of questionnaires and observation. Different data collection techniques were applied at varying stages, depending on the situation.

3.1 Population

Two areas in Uganda, in Kampala region were chosen to form the SMEs sub-population samples. These areas were Makindye Division and Kampala City. The latter represented an urban set-up while Makindye Division represented a rural set-up. More importantly, the two areas provided average figures in terms of the Human Poverty Index (HPI) and Human Development Index (HDI),
Raftopoulos et. al. (1998).

In these two main sub-population samples, the researcher acknowledges that there are pockets of significant differences in the population composition. To minimize the effects of such differences, probability sampling was used especially a combination of simple and stratified random sampling methods.
A total of 5 MFIs were targeted, which are members of the Association of Microfinance Institutions of Uganda (AMFIU). These were, Finca Microfinance, Centenary Rural Development Bank, Pride Microfinance, Uganda Women Finance Trust, now Uganda Finance Trust, and Frontpage Microfinance.

3.2 Sampling Methodology and Sample Size

For the purposes of this research, respondent lists were obtained from the five selected Microfinance institutions operating in Kampala city and Makindye Division.

From these, individuals were randomly selected for inclusion in the survey. Members of different groups were treated as independent individuals so as to highlight the impact of the credit at household level especially given the poverty alleviation objective of micro financing.

Small and medium scale enterprises were treated as projects for given individuals and hence households regardless of their legal status. A total target sample of 60 SMEs was used for the purpose of this research paper.

Out of the total of 60 SMEs, 75% had received credit at least once whilst the rest had not. The latter (25%) served as a control group.

400 respondents were targeted from the SMEs and 20 from the MFIs.

This was to enable the sample with reasonable accuracy, to reflect the thinking, opinions, and attitudes and behavior of the entire population.

The sample size enabled the researcher to integrate and critically examine theory and practice.

3.3. Data Collection Methods

Secondary data was collected from existing literature from libraries, formal financial institutions, Association of Microfinance Institutions of Uganda (AMFIU), individual institutions, non-governmental organizations directly or indirectly involved the Internet and mass media.

The literature review provided the basis for the hypotheses and a framework for analysis of the situation on the ground. Secondary data was used because of its availability as well as the fact that it is already synthesized and processed.

The points noted above made the approach very cost effective.

It was however noted that the data and/or information was in some instances over simplified, biased, lacking the necessary relevance in terms of timing and distribution of the target group. These shortcomings were addressed through verification of data by using different sources as well as primary data collection.

Primary data collection techniques revolved around interviews and questionnaires. In addition primary sources of information such as own experience through observations, fieldwork, discussion, thinking and reflection were used.

The interviews ranged from fairly informal exchanges to very structured, ordered sets of questions. In some cases, a combination of the two was used. This depended on the subject under discussion, the kind of information needed and the characteristics of the respondents.

For the five targeted MFIs, both structured and unstructured interviews were carried out as well as the use of a self-administered questionnaire. The questionnaire was either e-mailed to the respondents or dropped for later collection.

For the SMEs and the poor, a face-to-face encounter was considered appropriate. Representative groups of the poor and the SMEs were invited to a guided discussion to further verify and justify the data that will have been collected through the other methods. Existing structures such as the Hawkers' Associations and Rural Associations were targeted.

It has been argued that group discussions have an added advantage in that they empower the target group by boosting their confidence, Gordon and Cheghorn, (1999). This is essential for fruitful future interactions with the Micro Finance Institutions and other financiers.

As much as it was possible, the researcher strived for objective observations of given situations to pick those salient but fundamental issues influencing the noted behavior of the target population.

3.4. Data Analysis

The data collected was first sorted out for meaningful analysis according to whether it was for the rural or urban samples and whether the respondent had received credit or not. All the data was checked for completeness as well as internal consistency. The responses were then checked for relevancy and flow of logic.

Access to credit was measured in terms of turnover / growth on the output of SMEs or accumulation of business assets. For the poor, the impact was measured in terms of changes in their standards of living. The standards of living were based on their disposable income and subsequent access to goods and services.

The measure is easy to apply in monetary terms hence applicable universally. It is however noted that it was difficult to define this variable for the very poor who live from hand to mouth.

CHAPTER FOUR:
DATA PRESENTATION, ANALYSIS AND INTERPRETATION

4.0 Research Findings

This chapter of this study is concerned with presentation, analysis and interpretation of the results. The study was carried out along three research objectives from which three research hypotheses were derived.

Data collected under the three objectives is presented in two sections where section one presents information on the background characteristics of the microfinance institutions, their performance in terms of operational efficiency, outreach and portfolio quality, while section two seeks to assess the qualitative measure of the industry's performance as viewed by the credit consumers and thus presents results on the SMEs in terms of the population mostly accessed, their level of education, sources of credit and the conditions for accessing the credit.

4.1 Findings on MFIs

The selected MFIs were established between the period 1992 and 2000. Three of them were registered under Uganda's enacted laws while two were registered under the Company Acts law.

The reasons for being dually registered were mainly to reap the benefits of both sets and ensure that the other covers the shortfalls of one statute. By so doing, there is recognition that there are shortfalls within both Acts.

Two of the MFIs were business credit providers while three were purely consumer credit financiers. As to the reasons why MFIs chose to belong to different categories, the determining factors encompassed the mission, goals and objectives of the founding members.

The underlying objectives for the selected MFIs revolved around poverty eradication and facilitation of empowerment of vulnerable groups such as women and the disabled. It all boils down to a desire to manage poverty on sustainable bases through the creation of wealth in whatever entrepreneurial way.

The selected MFIs had financial policies that govern their operations. However the formulation of such policies in some cases was donor driven to an extent that it is increasingly becoming almost impossible to implement them. Among other things such financial policies provide for critical issues such as credit risk management, portfolio management, profitability, interest rate issues and capital contributions.

The major customers of the selected MFIs are mainly women (75%). The bulk of them are into service provision and vending of different wares. Other activities include light manufacturing, handicrafts and cross border activities.

The lending criteria of the surveyed MFIs revolve around group lending methodologies. The only visible difference among them was the issue of collateral security. On one hand, some insisted on saving deposits of up to 20% of the loan while on the other, some accepted guarantees by gainfully employed friends and relatives. These relatives however could not be spouses or parents as it was felt that misfortunes befalling one would affect the other.

According to the MFIs, clients are generally happy with the lending conditions because of the ever-increasing demand for repeat loans.

However, they also acknowledged that some clients were discontent about high interest rates, administrative costs and loss of savings in the event of default. The other issues of concern relate to lack of adequate follow up on clients by the MFIs and their failure to follow laid down procedures especially on repeat loans and on defaulters. These were considered genuine issues that the industry needs to revisit and polish up on.

The respondents noted that there were a number of factors that enhanced the provision of credit to the SMEs and the poor in Makindye Division. This included donor financial support in the form of grants and soft loans for on- lending as well as capacity building in the sector.

The other factor was the increased networking amongst the MFIs in Kampala as well as other interested parties nationally. This was said to promote information and experience sharing for the betterment of all concerned. It allowed players to tap on each other's expertise as well as making use of their comparative advantages.

While there were positive factors on one hand, the main factors cited to be inhibiting the provision of credit to the SMEs on the other hand, included lack of cooperation and support from the government. This was evidenced by the failure by the Government to give the industry all the necessary resources and infrastructural support such as relevant information and clear enforcement provisions in the event of default.

The most pertinent issue raised was with respect to the unfavorable macroeconomic conditions prevailing in the country, characterized by increasing unemployment (68%), economic growth (real growth rate 5%) and unstable inflation (7%) ultimately shoving the majority of people (56%) below the poverty datum line.

This was said to be rendering most MFIs non-viable as economic agents because people's levels of income are not able to keep up with the pace of inflation thereby resulting in increased levels of poverty.

Some loan officers (65%) complained about the poor working conditions. Moreover, the negative stigma attached to the SME sector in Makindye Division and Kampala City also spills over to the MFIs employees. They are always looked down upon especially when compared to the formal financial sector employees.

From the MFIs' perspective, the government has to facilitate the work of the MFIs by coming up with a clear policy and supportive framework for the industry and their clients, the SMEs and the poor.

Moreover, the government apex unit through the Social Dimensions Fund should be more visible in providing loans to the industry to improve their liquidity.
The table below highlights the performance indicators for the surveyed MFIs and the comments are given.

Table 4.1: Performance Indicators for the Surveyed MFIs (2007).

Performance Indicator	MFIs > 3 years AMFIU (standard)	MFIs > 3 years (Sample Average)	Comments
Operational Efficiency			
Cost Per Unit of Lent Money	40% and declining	154%	Very poor, it is too costly
Number of loans per Officer	>300	172	Poor and below average
Outreach			
Number of Clients	12000	2397	Very low
Number of Women Clients	>70%	75%	Good but can be improved
Portfolio Quality			
Portfolio at Risk	10%	N/A	No records
Loan Loss Ratio	5%	N/A	No records
Portfolio in Arrears	5%	N/A	No records
Reserve Ratio	5%	27%	Too high

Source: Primary data

In light of this, one would expect the MFIs to have ceased their operations, but this is not the case and the only possible explanation one could offer is that they are getting some operational funds from somewhere else.

In this instance it is the presence of subsidy from donors that is making it possible for them to continue operating despite the losses. The very high operating cost of 154% further highlights the gravity of the problem.
For every UGx 1 invested in assets, on average MFIs incur costs to the tune of UGx 1.54 compared to UGx 0.20 in the AMFIU standard.

The computed ratios for operating and financial self-sufficiency are falling within the standard, which under normal circumstances will be good and commendable.

Further probing however suggests that, operating expenses figure could have been distorted. This figure, according to the formula, is an aggregation of loan losses, administration and depreciation expenses. The exclusion of any one of these costs will result in an incorrect operating expenses figure that will affect the ultimate results. This seems to be the position in this case.

Surprisingly most MFIs managed to provide the aggregated figure for operating expenses but could not do the same for the loan losses figure. One then wonders how they could have calculated their aggregated operating expenses figure without it. This further confirms the doubts on the accuracy of the figures provided. The research findings also indicate that interest rate setting by MFIs is rather arbitrary ranging from a desire to exploit to an attempt to conceal the full cost of funds to the borrower.

The rates charged were given as ranging from the stipulated 35% to 72% per annum. Almost all of the respondents charged some form of administrative fees as application, processing or just administrative charges. The high interest rates could be contributing to the high financial and operational self-sufficiency ratios. Overall there is no logical connection between the sufficiency ratios and the rest of the ratios.

4.1.1 Operational Efficiency

The survey showed that the industry's operational efficiency is extremely low.
The computed average cost per unit of money (shillings) lent was 154%, meaning that it cost UGx 1.54 to lend out UGx 1. This is further explained by the number of loans per loan officer that is just over half of the minimum AMFIU standard of 300. This means that the officers are under employed.
This questions the appropriateness of their mobilization of clients assuming that funds for disbursement are available.

The fact that operational efficiency is low yet the MFIs continue operating further reinforces the point that these MFIs are heavily subsidized. There was however one MFI whose cost averaged UGx 0.20. The micro finance institution in question is the oldest in the country having been formed in 1983.

It could be argued that it has reached a different level of micro finance development, which among other things includes well-defined management and governance structures as well as a sound accounting system.
However, more research needs to be done to ascertain whether this institution is indeed efficient and profitable.

4.1.2. Outreach

On a positive note, the MFIs are gender sensitive as evidenced by the large figure (75%) of women participating in the micro credit programs. While the figure of women clients is impressive, unfortunately the average outreach for the MFIs is very low (34% of target), even for an industry that is still in its infancy. The chart below shows the outreach of MFIs in terms of gender.

There is an urgent need for co-coordinated education, training and capacity building in the industry to improve outreach. This should include training of loan officers who in turn should train their clients.
The main areas identified are project proposal writing and appraisal, business management as well as marketing of products. Individuals and institutions that have adequate capacity and competence such as Business Development Services providers should provide the training.

The issues of qualification and motivation of MFIs staff highlighted earlier, can never be down played given their impact on the administration of the MFIs, the quality of service delivery to their client and hence outreach.

4.1.3 Portfolio Quality

The Portfolio Quality indicators appear not to be given the weight they deserve by the MFIs. The information available was highly scanty and again off the mark. 60% of the selected MFIs had Provisions for Bad and Doubtful debts (loss reserve) although two had over provided with 44% and 53% respectively compared to the standard of 5%. The findings cast some doubt on the accuracy and objectiveness of such a provision policy.

Information relating to portfolio at risk, loan loss ratio and portfolio in arrears was not available for most of the MFIs. This suggests inadequacy of the loan tracking mechanism.

The MFIs appear to overlook the importance of appropriate/ good selection criteria and their enforcement. Such a development is a recipe for high delinquency in the long-term rendering self-sufficiency impossible.
The other view is that the omission of such important information could have been deliberate so as to obscure the poor loan quality by some unscrupulous MFIs.

The MFIs' indifference to portfolio management is only possible with access to cheap money obtained from donors either freely or at minimal interest rates. The provisions for bad and doubtful debts (loan reserves) would be invested with formal institution thus defeating the whole purpose of micro credit.
A further analysis of the MFIs credit recipients' show that most of them had borrowed for at least twice 68% and 18% of them had accessed their fourth loans.

Interviews with the MFIs representative revealed that repeat loans were only available to those clients who would have paid off the initial advances. This applied to both individual and group loans, meaning that no member of a group could access an additional loan if a co-member had an outstanding debt. This high frequency of borrowing might be a good thing if it is to facilitate the expansion of enterprises and/or diversification of product.

However, this could also suggest loan dependency and possible debt trap for the clients. This defeats the objective of eradicating poverty.
It is with the forgoing discussion that we revisit the research question on the impact of the industry on the target group. Have MFIs increased access of the SMEs to finance or not?

The findings above show a low standard performance of the industry. This should however not be taken to mean that their contribution is insignificant.
The next section seeks to assess the qualitative measure of the industry's performance as viewed by the credit consumers.

4.2. Findings on the SMEs from Kampala City and Makindye Division

The research study revealed that SMEs were not a topical issue before the introduction of economic reforms in Kampala City and Makindye Division because:

They were not officially recognized by the government and as such were looked down upon by the public. In towns and cities there was a general discouragement of informal trading.

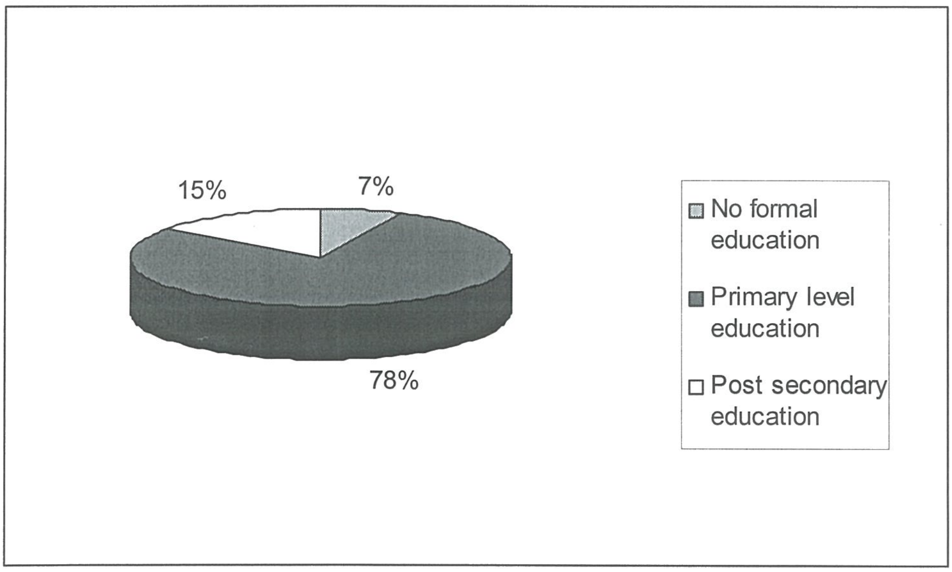
The poor who engaged in informal trading carried out such activities in the periphery and were not as organized as they are today after the introduction of reforms.

Many people seemed to be involved mainly in subsistence farming (82%), others were working as laborers (5%) in the industries within the urban and peri-urban areas. The rest, (13%) were engaged in a variety of odd activities that were housed under sponsored cooperatives of that era. Thus their economy largely was barter trade driven.

4.2.1 Profiles for SMEs

The majority of the respondents were women, to be precise 85% of them. Most of the people who owned SMEs were within the ages of 31-40. Out of the total respondents, the SMEs employed 35%. The level of education attained by SME owners varied (as shown in the chart below) and the majority had obtained primary level education.

Chart 4.1: Level of Education of SME owners.



7% of the respondents had no formal education at all, at least 78% obtained primary level qualifications and 15% of the respondents had post secondary education qualification and some were skilled in various areas. In terms of operations, 66% of the respondents were urban based whilst 34% were rural based.

The ownership structures of the SMEs revolve around sole proprietors, family businesses, partnerships and private companies. Most of the SMEs (80%) were established between 1995 and 2003. The reason for this is that this is the time when the economic reforms gained momentum. Moreover, until 1997, the Ugandan economy was doing fairly well.

Table 3 below shows a breakdown of surveyed SMEs according to size.

Table 4.2: Distribution of SMEs according to Project Values

Value of Project	Rural	% Rural	Urban	% Urban	Cumulative %
Up to UGx 100,000	160	83.7%	103	53.6%	68.65%
100,001 – 500,000	18	9.4%	40	20.8%	83.75%
500,001 – 1,000,000	10	5.2%	28	14.5%	93.6%
1,000,000 and above	2	1%	21	10.9%	100%

Source: Primary data

As shown in the table above, the value of the businesses for 83.7% of the rural based respondents were below UGx 100,000 as compared to 53.6% for their urban counterparts. The monthly profits were put at UGx 130,000 and below for rural based respondents 45% and 97% for their urban counterparts.

Further probing revealed that the profits excluded the household expenses and food purchases for the trading period. This suggests that for most of the SMEs the actual profit could be higher than stated. A few however paid themselves some salaries or allowances in both the rural and urban settings.

Just fewer than 3% of the urban SMEs had monthly profits averaging above UGx 500,000 per month. These were mainly recipients of MFI's credit who were also exporting some of their products to neighboring countries.

Most of the SMEs (73%) employed between 4 and 10 people, the majority of whom were family members, friends or relatives. Most of the employees possessed minimal skills (60%) such as carving, carpentry, and garment making. The survey revealed that all MFIs provided credit to SMEs for day to day operations and expansion purposes rather than as start up capital. This is because MFIs insist that the project should have been in operation for at least 6 months before it can be considered for funding.

Most of the SMEs had initially used either personal (76% and 55%) or family savings (7% and 35%) for urban and rural based respondents respectively.
The balance had used other sources of funding that included grants and donations.

It is worthy noting that the family interdependency is still dominant in the rural setting where some individual ownership of assets is still rare. Some respondents had actually inherited the plots from parents and as such inputs were jointly sourced.

Seventy-eight (78%) of the SMEs had borrowed at least once from the different sources. Table 4 below shows the distribution of the credit recipients.

Table 4.3: Distribution of Respondents According to Sources of Credit

Type of respondent	Formal Banks	MFIs	Other sources
Rural Respondents	24	158	18
Urban Respondents	35	163	2
Total	59	321	20
Percentages	14.75% ≈ 15%	80.25% ≈ 80%	5%

Source: Primary data

From the total sample of 400, only 15% had accessed formal bank loans. If the 17 respondents who had accessed housing loans are factored out; the percentage falls to barely 10%. This is to be contrasted with the 74% of the same respondents who operate one form of a formal bank account or another.
The majority of the respondents (80%) had accessed microfinance loans and the remaining 5%had accessed loans from other sources.

4.2.2. Conditions for Accessing Credit

MFIs require an applicant to have been in business for at least six months and is a member of a group or can find a formally employed guarantor.

The interviewed SMEs felt that the MFIs conditions are the best as they present them with alternatives for group or individual guarantors. The interest charged by some players was deemed to be too high by the SMEs.
Interviews with the MFIs indicated that the rates charged ranged between 35% and 75% per annum. Informal discussions however indicated that the actual rates could be higher than the stipulated ones especially for consumer loans.
In addition to that the respondents were concerned about the administrative charges levied per transaction over and above the interest rates.

Thirty-two (53%) of the SMEs were concerned about the lending methodology used by the industry. While group guarantees are helpful especially for those without collateral, they can potentially be counterproductive.

For instance in the event of default by one member, the entire group becomes liable. Depending on how the group was initially formed, members may not be in a position to enforce payment from the defaulter. Moreover, with the HIV/AIDS pandemic spreading, the industry has not been spared.

The other issues related to unfavorable climatic conditions especially for the rural respondents and lack of foreign currency for the cross border traders. The majority of the respondents felt that the central government should play a crucial role in normalizing the economic conditions. This they felt could help them stabilize their operations.

CHAPTER FIVE:
DISCUSSIONS, CONCLUSIONS AND RECOMMENDATIONS

This chapter is concerned with discussion, conclusion and recommendations of the researcher. The discussion part comprises of two parts; the first part dwells on recent developments in microfinance institutions and the challenges faced while the second part brings out issues of the models for microfinance institutions. This is followed by the conclusion part and recommendations pertaining the research and the areas for further research, in that order.

5.0. Institutionist and Welfarist Approaches

Thinking about the rift between the institutionist and welfarist camps, we are reminded of the quote by George Bernard Shaw that Great Britain and the United States are "two nations divided by a common language." Although the two camps share a common commitment to microfinance services and a common rhetoric of concern for the poor, many in the industry mistake this unity for a unity of purpose.

The stated ultimate goal of both camps is poverty reduction. Yet the practical objectives each camp has set for itself diverge. Each has defined "poor" differently, and each has articulated different visions of how the poor can be helped by increased access to microfinance services.

The practical implications of these differences between the two camps are at least threefold:

(1) Differences in the population segments served (the not-so-poor true entrepreneurs vs. those who struggle on the margins of survival);

(2) Differences in the designs (and the reasons for the designs) for service delivery to these populations (lending to individuals vs. small solidarity groups vs. large village banks); and

(3) Differences in the institutional structures and financing to support these services (social service NGOs vs. community-based credit unions and community banks vs. commercial banks and finance companies).

These differences are legitimate, if and only if the objectives from which they derive are considered equally legitimate. But they are not considered equally legitimate by many persons in each camp. Heightening the potential for conflict is the apparent unity of purpose in the microfinance community, which has fostered a mentality of "one way" for microfinance. Donors have become confused by the veil of unity and the argument that a common set of standards is needed to advance the apparently common agenda. There has developed in the 1990s a struggle to define that "one way" for both microfinance practitioners and donors.

5.1. Microfinance Institutions

The recent developments in the microfinance sector raise a number of challenges to microfinance as an instrument for poverty alleviation.

With the enactment of the MDI ACT 2003, MFIs have been compelled to re-think their strategies from quasi social economic development and humanitarian focus towards stricter commercial orientation and profit making.

The MFIs have embarked on strategies to improve and stabilize their respective capital asset bases to enable them to maintain full financial institutional self-sustainability; towards attaining competitiveness and market share within the industry. The developments also demand that micro finance players develop standards and professional ethics to guide service delivery.

To be competitive and gain market share, micro finance institutions are now more focused on the principles of profit making. The new profit orientation of the MFIs has motivated them to clearly define their market niche. While the PEAP policy document assumes that the poor who do not have access to formal financial services will be targeted by the MFIs MFPED, (2001) the MFIs are targeting only a small proportion of the poor whom they have code named —the economically active poor".

The MFIs definition of the economically active poor is those that have businesses and the capacity to repay back the loans. From the poverty spectrum, the economically active poor are the richest of the poor just close to the poverty line. This has serious policy implications for the poor of the poor (the core poor).
The new focus on sustainability as demanded by the MDI Act (2003) might have the effect of motivating MFIs moving more towards the non-poor clientele who will have more capacity to repay the loans.

Key informant interviews with some of the Executives of MFIs revealed a number of interesting issues;
First, their argument is that they are now running microfinance as a business and in business the determining factor is profits. In the microfinance business one of the key factors that influence profitability is the portfolio quality, basically because the higher the loan default the higher will be the write-off of bad loans which lowers the profits. So one of the ways of minimizing the loan default is through careful analysis of the repayment capacity of the potential clients.

From their experience of repayment capacity analysis, the MFIs have come up with a categorization of the poor into economically active poor and the core poor. The economically active poor have the repayment capacity and therefore can qualify to get credit from the MFIs, but the core poor do not have the repayment capacity and so are not eligible to get MFIs credit. To them the poorest of the poor need grants which should be taken care of by the state.

One MFIs Executive said — "If you are doing business and you lend to people whom you can see can not be able to pay back, are you a good or a bad business man? Who will take care of your operational losses now that grant funding is increasingly becoming a story of the past?"

The other issue that came to the forefront was the return to investment to attract investors in the MFIs.
The MFIs argued that they are required to be sufficiently capitalized under the new shareholding arrangement by MDI Act (2003), thus the need to attract private sector investors to the industry. Their argument is those private sectors investors will mainly be motivated by the expected return on their investment; hence the importance of screening out the core poor that will spoil the portfolio quality and profitability. It therefore follows that targeting all the poor, including the core poor who have no repayment capacity, would be a bad investment decision.

The third issue that arises in connection with their operational policies to identify the poor. While mention of the poor is mentioned in most of MFIs mission statements as the target group, they do not have any operational parameters to identify the poor. Since the driving factor is the repayment capacity and profitability, it may not be surprising that some of the clients of the MFIs are the non-poor.

What is also evident in the MFIs lending operations was the increasing level of collateralization even among the group lending methodology. Apart from the group guarantee, most MFIs require the members to pledge some form of collateral either in the form of household chattels, land. Of course the collaterals pledged by MFIs clients are not of the same quality as those required by formal banks but is still of significance to the poor.

The increased collateralization is argued to give more incentive to the borrowers to repay. The challenge therefore is that if the microfinance services are not accessible to the core poor, how will their welfare be improved?

Additionally, given the persuasive economic arguments of having private sector led provision of microfinance services and the distortions that are generated by grants and / or subsidized government credit schemes, the core poor stand the risk of being the forgotten lot in the development process.

The MDI Act 2003 classifies players in the micro finance industry into those to be regulated under the MDI Act (2003) and those not to be regulated under a tiered arrangement. The Act recognizes four different tiers: Tier 1 are the formal commercial banks and Tier 2 are the Financial Institutions registered under the Financial Institutions Statute of 1993. Tier 3 will constitute of Deposit-taking MFIs that will be licensed and supervised by the Central Bank.

The Tier 3 MFIs will be allowed to take deposits and intermediate them. The Tier 4 MFIs will not be regulated by the Central Bank and will not be allowed to take and intermediate deposits. These will be the credit only MFIs such that even if they take compulsory savings as part of their methodology, they are not allowed to intermediate those savings. The opportunities raised by tiered classification are that all institutions in tiers 1 to 3 are legally allowed to engage in microfinance business.
This explains why some commercial banks like Centenary Rural Development Bank (CERUDEB) is actively engaged in the microfinance sector.

The other opportunity is that it allows the Tier 3 institutions to take on deposits for intermediation which is a cheaper source of capital, hence having the potential effect of raising their profitability and sustainability. However the greatest challenge raised by the MDI (2003) Act relates to security requirement by informal sector to the Tier 4 institutions that are non-regulated which by law may collect compulsory savings from clients but cannot intermediate them.

The challenge relates to the number of MFIs that are likely to meet the licensing requirements and qualify to be in Tier 3. Ledgerwood et al (2002) estimated that very few MFIs (less than 5) are likely to meet the licensing requirements in the short run and most of them will remain in Tier 4.

This raises specific challenges relating to access of savings services and sustainability of Tier4 institutions, all of which have policy implications for poverty alleviation. As a result of financial sector reforms (which included the divestiture of Uganda Commercial Bank), most of the non-profitable rural branches were closed thereby creating a vacuum of financial service delivery to the poor.

However due to the legitimate concerns of the safety of public savings, the Tier 4 institutions will not be allowed to take deposits. But if in the short-term only very few MFIs will qualify to be in Tier 3, then the poor will not have access to savings products.

It is argued in the development literature that the poor can save but all they lack is access to flexible savings products. Savings are key products of micro finance activity and both MFIs and clients value savings as important complements to the financial management, institution /client relationships and to the livelihoods of the low income population.

The other challenge relates to the terms of credit to the poor especially interest rates. Profitability and sustainability is a key indicator of success that is used to judge whether the MFIs will qualify to move to Tier 3 or not. From the MFIs institutional side, the sustainability equation relates the revenue side and the expenditure side. The revenue side can improve by either increasing interest rates and commissions or portfolio volumes.

It is probable that inefficient MFIs especially in Tier 4 which are the majority may try to improve their sustainability levels by raising the interest rates and commissions. Though it is argued in the literature that demand for credit by the poor is interest inelastic, it can be counter argued that high interest rates that are due to inefficiencies are counter productive to the poor.
Currently the interest rates charged by the microfinance institutions range between 2.5% - 4% per month, before factoring in the other commissions and fees which vary across MFIs. It is also true that under the liberalized environment, interest rates can not be controlled.

However it can be argued that competition in the microfinance sector can be enhanced if there is perfect information flow about interest rates charged by the different players, a role that the government can do without necessarily fixing interest rates.

On the expenditure side, the MFIs can improve their financial sustainability by minimizing their operational costs which is consistent with the microfinance best practices. However this has implications on the location of the MFIs office and definition of the operational area which in turn has implications for access to microfinance services by the rural poor.

As observed by Wamatsembe (2001), MFIs that follow the microfinance best practices prefer to operate only in urban and peri-urban areas (usually within a radius of 5 kilometers for town centers). Clearly the motivation for this is to minimize the heavy transaction costs that are associated with rural credit operations, thereby denying the rural poor with access.

The policy implication is that big MFIs will definitely need some incentives to increase their rural outreach. The policy incentive structure as outlined by the

Microfinance Outreach Plan (MOP) in their document entitled —Matching Grant Facility for Capacity Building (MCAP) Design is a step in the right direction.

Basically the MCAP is a fund initiated by Government and supported by key donors and other stakeholders in the microfinance sector with the overall aim of providing a coordinated donor-funding mechanism for microfinance capacity building, based on agreed Best Practice principles and cost sharing basis, in ways that would enhance impact, market responsiveness and sustainability.

The proposed incentive structure is such that good performing MFIs (thus those abiding by Microfinance Best Practices) that will be willing to expand their outreach into remote rural areas will have their operational losses for first year for the specific rural branch opened under this arrangement (and possibly at most second year losses) refunded.

However existing rural branch losses incurred before the signing of the Memorandum Of Understanding (MOU) between the MFIs and MCAP/MOP are not covered by this policy. The additional incentive is that part of the new rural branch set up costs will also be refunded from this fund, which amount depends on the extent of remoteness of the branch.

This proposed incentive mechanism is expected to lure the urban based MFIs to the rural areas, thus making the services more accessible to the rural poor.
Design of appropriate financial products for the Poor: The poor are not a homogeneous lot of people, hence the challenge of designing appropriate financial products that meet their diverse needs. Currently the MFIs are mainly providing generic products with standardized features. The current product features of most MFIs are characterized by short loan periods (on average 4 - 12months), no grace periods, weekly repayments and small loan amounts.

These product features may not be suitable especially for agriculture related investments, from which the rural poor mainly derive their livelihoods.
While MFPED (2000) under the Plan for modernization of agriculture (PMA) clearly identified the poor farmers' priority as access to credit and financial services so as to improve agricultural production, the MFIs financial products are not tailored to agricultural production.

However the MFIs argue that these product features are consistent with microfinance best practices as the small loans which are progressively increased over time provide dynamic incentives to the clients to repay the loans in anticipation of getting bigger loans.

The weekly repayment schedules are also preferred by MFIs on account easing their cash flow problems and also enhancing high repayment rates. The MFIs rationale is that regular repayment keeps clients on their toes rather wait up for longer periods to receive the installment. If the poor farmers took the MFIs loans to purchase production inputs say like high yielding seeds, the first weekly installment repayment will be due even before they plant the seeds or before the seeds even germinate which raises the issues of sources of funds for loan repayment.

Such restrictive MFIs credit products will constraint the uptake of new, more productive and high-yielding technologies by poor farmers which would have a profound impact on household income and poverty alleviation.
Ahmed (1999) also argued that payment of small period installments may not be a good method of collecting loans from poor people experiencing persistent negative shocks, despite being accepted as a best practice. Ahmed (1999) further argues that for MFIs to meet the needs of the poor, they need to understand the vulnerabilities that the poor operate in and design flexible products that cater for the income vulnerabilities of the poor.

Anecdotal evidence suggests that these generic features of MFIs products have made the clients to develop the culture of multiple borrowing from MFIs so as to get commensurate loan amounts and subsequently raised their vulnerability to the debt burden. However an empirical investigation is required to assess the extent to which this could be affecting poverty levels at the household levels so as to appropriately inform policy. In addition credit from the informal sector was also utilized for heath and consumption purposes.

The other consumption purposes included purchase of durable assets, ceremonies etc. Interestingly 16%% and 31% of all the loans from money lenders / commercial firms is utilized for heath care and consumption respectively.
This underscores the productivity of consumption credit in enhancing household welfare irrespective of the interest rates. What all this points to is that there is a demand for consumption credit which the MFIs need to take on board in the design of products.

5.1.1 Models for Microfinance Institutions

While donor-dependent MFIs might improve social welfare, large-scale, financially sustainable MFIs, owing to their greater breadth and depth of outreach and their long-term permanence, can improve social welfare more. (Again, the a priori assumptions that only financially self-sufficient MFIs are sustainable and can achieve significant scale).

Suffice it to say that this argument is based on a number of questionable assertions as well as questionable "findings" from a small handful of "successful" MFIs. It also ignores important counter examples of proven sustainable, social welfare (or poverty) focused MFIs that have achieved significant scale and depth of outreach, high portfolio quality, institutional efficiency, while using "subsidies" to catalyze and nurture their operations.

Another issue is that while arguing that financial self-sufficiency is sufficient for social worthwhileness may be true in a strict sense, it ignores the crucial question of who is or who is not being served. The general goal is improved social welfare, but for many MFIs it matters very much precisely whose welfare is being improved.

For these MFIs, improved social welfare among the very poor is weighed more heavily than improved social welfare among the marginally poor or the non-poor (a point on which there exist general agreement between the Institutionist and the welfarist). If it is the case that "subsidized" programs possess a comparative advantage in reaching the very poor, as the researcher suggests here, then they may increase social welfare relative to other programs by improving depth of outreach, even if the researcher assumes they do so at some cost in breadth of outreach.

The researcher would propose the industry to consider the implications of this overarching emphasis on financial self-sufficiency. What is most important?

Is it to build social enterprises that can last long enough to bring about major improvement in the lives of very large numbers of people? Or is to become certified as totally subsidy-free.

I do not pretend to speak for all practitioners, but for many MFIs, the goal is not to become totally subsidy-free. That is neither necessary nor sufficient to achieve their priority objectives.

The reality is that social investment is available. There is a market for social investment for traditional social services. It is called philanthropy or charity. NGOs have more or less thrived on this market for decades now. And now there is a developing social investment market for MFIs-for start-up capital, for technical assistance, and for loans at concessional rates. Should not MFIs tap that market for one-time or occasional infusions of social investment? Social entrepreneurs should lose their business licenses if they did not!

Institutionist writers portray a dichotomous view of microfinance. In this view, MFIs are both financially self-sufficient and large, or "the alternative to viable organizations are expensive, unviable quasi-fiscal programs that reach only a select few beneficiaries" Gonzalez-Vega, (1994).

Many Welfarists also fall into the dichotomy trap, in which they envision a single "correct" approach for microfinance. As such, the discussion has gone the way of too many other discussions in development-it has polarized, and it has produced a fruitless debate about who is more truly concerned for the welfare of the poor.

Rather than continue with this nonproductive dichotomous view of microfinance, it would be more helpful to characterize the diversity of microfinance practitioners as lying somewhere along a continuum from traditional business (a purely financial bottom line) at one end to traditional social service (a purely social bottom line) at the other end. In the middle is the emerging phenomenon of the "social enterprise," which manages toward a double bottom line in a search to achieve a productive balance between selfish and social returns.

The emergence of social enterprise can be seen in many sectors, but it may be best developed in the microfinance world. Among the institutionist MFIs, some operate as traditional businesses, while others include "best practices" and financial self-sustainability among their core values. For these institutions, any social objectives they may have either are assumed by-products of their financial and institutional objectives, or they are relegated to subordinate or roughly equivalent status as their institutional objectives. Such institutions tend not measure success by social impact or by depth of outreach.

There is nothing wrong with this approach, as long as practitioners in such institutions are up front about their objectives, and they do not try to attract social investors who explicitly want to pursue social objectives.

Institutionist MFIs appear to address significant market failure to serve the borrowing needs of marginally poor and not-so-poor. In many cases, however, it is only incidentally that they serve the very poor. Moreover, serving the very poor frequently is not their "priority objective." For those MFIs to whom this applies, it would be helpful to donors and practitioners alike for them to say so.
Likewise, it would be helpful for traditional social service providers to admit that sustainable institution building is not their objective. They and their donors would do well to acknowledge that fact by making plans for leaving a legacy to be proud of when their microfinance projects phase out, sooner or later.

They can provide loans at or below market rates to the poor needing special consideration (e.g., refugees and disaster victims) and still do a good job of loan recovery and managing their costs. Again, there is nothing wrong with this approach, as long as social service MFIs develop good strategies for eventually handing off their clients to more sustainable service institutions.

In fact, traditional social service providers can at times serve certain market niches better than sustainability-oriented MFIs. They can do a great deal of good during the "life of the project," provided they do not compete for clients, who can better benefit from long-term microfinance services, put the meager assets of the poor at risk, or use their social mission as an excuse operating inefficient and low impact programs.

Traditional business and traditional social service approaches are familiar polar opposites, the two ends of the microfinance spectrum. What is new and interesting in the microfinance movement is the broad middle ground occupied by the emergent social enterprises specializing in microfinance and related services.

This is where the debate over "best practices" for combined impact and sustainability is most productively focused. The debate will improve as the different objectives are articulated and regarded as legitimate by all involved in the debate. Social enterprises have to be explicit in both their social and financial-institutional objectives. Through appropriate staff incentives for managers and service staff, they need to commit to managing and measuring progress toward both.

To date, social enterprises in microfinance have had serious difficulties defining, targeting, and reaching the core poor households, and they have done a very poor job of developing social impact measurement systems, much less actually measuring social impact. All are hard to do, but they have to be done, and MFIs better get started on it in earnest if they are to remain credible as social enterprises. Donors also need to clarify their own objectives and make sure these match up with the objectives of the traditional businesses, social enterprises, and traditional social services in which they invest.

If I had to guess, it would be that the future of microfinance will be characterized by a relatively small number of traditional business (or institutionist) MFIs with significant breadth of outreach but limited depth of outreach and a relatively large number of social enterprise MFIs of widely varying sizes, institutional designs, and levels of financial self-sufficiency offering a wide variety of products and services targeted to the more poor. There is no need to make a once-and-for-all choice between competing approaches-a variety of approaches are needed, now and in the future.

I would thus agree with Nitin Bhatt (1999), who writes that "no one model of microfinance can solve the diverse developmental needs of the poor throughout the world. There is room for different kinds of programs, both subsidized and non-subsidized, that caters to various segments of low-income communities. Given the need for a diversity of microfinance institutions, institutional plurality is key to prudent microfinance policy."

Finally, for everyone involved in microfinance today, we must know ourselves and be true to ourselves. We need to be more open and honest with each other about our real objectives and our commitment to reach them.

5.2. Conclusions

The harsh laws of demand and supply apply to each individual micro entrepreneur. He or she must realize that with micro enterprise, fishing in the wake of a giant trawler using only a fishing pole, may very well be the reality in one's hope of achieving success through self employment and micro credit.
There is no doubt that MFIs and SMEs have a role to play in the alleviation of poverty despite all the challenges facing both sectors. It is generally agreed that the two need to form a partnership so as to improve the standards of living for the majority poor (Mosley, 1998; Balkenhol, 2001 and Hulme, 1991).

On average, MFIs in Kampala are currently neither profitable nor efficient as evidenced by the unrealistic and extremely high costs rendering a weak linkage between MFIs and SMEs.

The Government realizes the need for more rapid growth in opportunities for productive employment and overall economic empowerment. In line with the principles that govern market economies. The Government has improved conditions by enabling new firms to enter all sectors of the main stream economy through the removal of existing barriers and through provision of targeted incentives. This has ushered in a social class of “working poor” to run the new firms.

The continued existence and operations of many MFIs despite posting losses can only be explained by the presence of heavy subsidies from the donors and/or government who jointly fund 90% of their operations. For some programs, on going subsidization can be an important means through which social objectives are achieved (Morduch, 2000). Subsidization is not all that bad provided funds are utilized in a profitable and efficient manner, although donors as sources of funds for MFIs at times bring insecurity and uncertainty. The majority of donors are foreign and MFIs have no control over them. They always live in fear of the donor contracts coming to an end since the majority of them are usual short-term.

Most donors that fund micro- finance programs are advocates for “best practices” that turn out to be more complicated (Morduch, 2000) than originally bargained for. Many MFIs are really frustrated by replication of standard models especially in situations where they realize that they are not working. There exists a dilemma of fulfilling donor requirements (institutionist approach) as opposed to fulfilling the MFI objective of wealth creation (welfarists approach). Until a time when MFIs will have diverse and secure sources of funds, fulfilling their objectives remains a very difficult task. Off-course accessing finance by MFIs does not solve all their problems. There are numerous factors that contribute to this poor performance and some of the main ones are: the prevailing macro-economic instability, capacity and legal constraints.

While all the MFIs included in the sample had financial statements prepared in a professional manner, the accuracy of the presented information was questionable. Moreover, most had no portfolio quality tracking systems. Standard financial statements per se have limited relevance in developing appropriate policy responses for loan recovery, staffing, and payments in arrears, outstanding balances of loans and average portfolio.

This information is fundamental in the computation of indicators concerning portfolio quality, efficiency and sustainability. MFIs need to have sound management information systems because accurate information will facilitate them make informed decisions.

Although the industry is still young, outreach is very low and if not improved long term sustainability may not be attained.

Average loan sizes of MFIs are too small to allow for the economies of scale that are required to deliver financial sustainability.

There is a general feeling from MFIs that government is not doing enough to support them.

Qualitatively, the industry despite its challenges is making a difference for the Poor and the SMEs. This may only be at a small scale but for the few beneficiaries, life will never be the same. MFIs have an edge over their formal counterparts because of their value added lending. They capacitate the SMEs and the poor by imparting knowledge and skills. Capacity building of both the MFIs and SMEs remains a challenge and there is so much to be done in this area. Government and organizations such as AMFIU need to pool the scarce resources and collectively embark on such an important programme.
MFIs show that it is important to have a well-defined objective and a target group to facilitate measurement of impact in the long run. It does not matter whether the MFI is financial or social focused.

Ascertaining the extent to which access to financial services by SMEs and the poor improves their well being, proved very difficult and beyond the scope of this paper, but certainly a potential research theme.

5.3. Recommendations

The micro finance industry in Kampala has a lot of potential linking up SMEs to sources of credit in an effective and profitable manner. There are however a number of issues and challenges that need to be highlighted and revisited. The following recommendations could help improve the performance of the MFIs.

To motivate sustainable MFIs to extend their services (savings and credit) to remote rural areas where the poorest of the poor are, the incentive mechanism in the design document of MOP be immediately implemented. The incentive mechanisms, which must be time bound, could include refund of genuine first year branch operational losses after which the rural branch would be expected to break-even. This tie well with the liberalization policy which requires that operations must be market based with no continuous subsidization.

With regard to the unsuccessful GOU Entandikwa scheme, there is need for efforts to recover the outstanding loans as writing them off will not only have negative effects on the entire private sector micro finance industry, but will also result in increased and willful defaulting. One option for the GOU is to hand over the portfolio to court bailiffs, lawyers and/or the Non Performing Assets Recovery Trust (NPART) which will continue recovery of the loans. Another option is to sale the loan portfolio to financial institutions, which will provide additional financial services to the clients subsequent to full recovery of the outstanding Entandikwa loans.

Other challenges facing the micro finance industry in Kampala include building good corporate governance especially for the Tier-4 MFIs and providing medium and long-term finance for small and medium enterprises. With regard to corporate governance, a code of conduct could be put place by the AMFIU for the Tier 4 MFIs. With regard to medium and long term finance it is important to establish other financial products like equity facilities, venture capital, long-term bonds, higher purchase schemes and leasing facilities. In this regard, it is noted that plans are underway to review the legal and institutional arrangements for the development of equity funds to pave the way for the provision of long-term investment finance for the small and medium scale enterprises. And recently government introduced a three- year bond. Moreover, for many of the programs aimed at supporting the micro finance industry to be effective, there is need for continued economic stability, government commitment to develop the industry, improvements in mechanisms to monitor the implementation of the programs and further efforts to rebuild the capacity at local governments.

Research findings indicate that MFIs have been largely foreign donor funded. The donor community has contributed significantly and is commended for its efforts. However, with global policy shifts, such funding is very unpredictable therefore risky. It is recommended that Government prioritize MFIs and SMEs in her poverty eradication policies and strategies. Government can provide well spelt out user-friendly operational guidelines that will foster transparency and accountability. In addition, government can guarantee those MFIs that are performing well to enable them access commercial finance from the wider capital markets.

The MFIs industry should lobby for a regulatory instrument that will enable it to use savings collected for prudential on lending, as well as for more user- friendly operational provisions. A national credit bureau, similar in nature to the one serving formal financial institutions- Financial Clearing Bureau (FCB), should be formed. The same can be done for other relevant shared databases to facilitate ease vetting of clients.

Catastrophes such as the HIV/AIDS pandemic, recurrent droughts and recently floods have had adverse impact on marginal societies. The findings indicate that the target SMEs and the poor in Makindye Division and Kampala city were not spared. It is imperative that disaster preparedness, response and management be incorporated into micro enterprise development and capacity building programmes. In addition, MFIs should consider introducing affordable and tailor-made insurance products to cushion both themselves and their clients.

MFIs need to be innovative and experimental drawing appropriate lessons from both the mistakes of the past and the success of the present and create new financial services, develop simple management structures and accounting systems that reduce costs substantially without imposing excessively high costs on clients.

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APPENDIX I: Questionnaire for MFIs

CONFIDENTIAL RESEARCH QUESTIONNAIRE FOR MFIs

A. **Respondent Profile**
A.1 Name and Title of Respondent (optional)..
A.2 Name and Address of Organization
....
A.3 When was your organization /institution established
....
A.4 Under what act/ acts are you registered and why?
....

B. Subject Matter
B.1 What were the major reasons for your establishment?
....
B.2 Where did you source funds to establish such an institution?...................................
B.3 What are your current sources of funds, in order of importance
i) ....
ii) ....
iii) ....
B.4 i) What major products were you offering in

a) 2000-2003	**b) 2004-2006**
1.	
2.	

ii) Are there any significant changes in your product range during a) and b) periods?
Explain your answer..

B.5 i) Do you have any financial policies Yes . { } No . { }
ii) Who formulated these policies ....
iii) Briefly, what are the major highlights of these policies

....
....

B.6 Who are your major customers..

B.7 I) What is your lending criteria?...
ii) What percentage of loan value must be backed by col!ateral, if any?
....

B.8 Are clients happy with the conditions that exist for one to access credit? Explain your answer
……………………………………………………………………

B.9 What are the most common purposes for and average sizes of loans that clients apply for?

i) ………………………Average …………….
ii) …………………….. Average …………….
iii) ……………………. Average …………….

B.10 What is the institution policy on:

i) Delinquent clients…………………………………………………..
ii) Follow up of clients ………………………………………………
iii) Repeat loans……………………………………………………….

B.11 What is the institution's bad debt provision and loan write off policy
……………………..

B.12 How is interest rate set in your organization?
……………………………………………

B.13 What is your current annual rate of interest on loans?
……………………………………..

B.14 In your view, what factors have inhibited or enhanced the provision of credit to your clients

Inhibitors	**Enhancing Factors**

B.15 How best can you describe your relationship with the formal financial institutions, if any? Explain your answer.
…………………………………………………………………………………

B.16 In your view, what should be done by the Government to facilitate MFIs' role in serving the SMEs and the Poor?
…………………………………………………………………………

B.17. Are you a member of any association or network organization?

[ ] Yes, which one and since when ……………………………………….
[ ]No, and why? …………………………………………………………

B.18 What benefits do you derive from such association or network?
……………………………………………………………………………

C. **Performance Indicators.**
Kindly provide copies of the following documents for the years your organization has been in operation:

(1) Balance sheets
(2)Income Statements
(3) Portfolio Outreach reports/ Executive Summaries.

Alternatively, please complete the following table

Kindly provide copies of the following documents for the year your institution has been in operation 1) Income Statement. 2) Portfolio Outreach Reports / Executive Summaries. 3) Balance Sheets. Alternatively, please complete the following table.

	Raw Data	Source	YEARS			
1.	Operating Income	Income Statement				
2.	Total Number of Active Borrowers	POR				
3.	Number of Loans Disbursed	POR				
4.	Total Amount Disbursed	POR				
5.	Value of Outstanding Loans	Balance Sheet				
6.	Average Loan Outstanding	POR				
7.	Loans in Arrears	POR				
8.	Amount Written Off	Income Statement				
9.	Average Portfolio Outstanding	POR				
10.	Number of Loan Officers	POR				
11.	Salaries and Wages	Income Statement				
12.	Balance of Loan in Arrears	POR				
13.	Loan Loss Reserve	Balance Sheet				
14.	Operating Costs	Income Statement				
15.	Financial Expenses	Income Statement				
16.	Bad Debt Provision	I/E Statement				
17.	Number of Female Borrowers	POR				
18.	Value of Loans to Women					

The information so extracted will be treated in confidence and the name of the organization will not be included in the publication of the findings. Contact Details: +256774003559 or +254725590682 (Andrew N. Kamatu)