ABSTRACT

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers and insurance to the poor and low-income households and their micro enterprises. The sector reaches out to 832,794 active borrowers with a loan book amounting to Kshs.28.6 billion and reporting 26.4 % annual growth in Kenya. However, owing to the fact that there is limited literature on the determinants of financial performance, various studies conducted indicate divergent views on the effect of financial indicators on financial performance. For this reasons it is not clear whether or not financial indicators affect financial performance of microfinance institutions (MFIs) in Kenya. The study focused on three plausible financial indicators namely debt to equity ratio, portfolio to assets ratio and operating expense ratio. The main objective of the study was to investigate the effect of financial indicators on financial performance of MFIs in Kenya. The specific objectives were to; find out the effect of debt to equity ratio on financial performance, examine effect of portfolio to assets ratio on financial performance and examine effect of operating expense ratio on the financial performance of MFIs in Kenya. The study was modeled on the Arbitrage Pricing Theory and correlation research design adopted. Target population comprised 12 registered MFIs. Sample size consisted a panel data set of 12 MFIs selected using purposing sampling method for the period from 2009 to 2013 and secondary data was collected. Fixed effect model was the preferred model based on the Hausman specification but the study used random effect model since fixed effect model gave insignificant results. Breusch pagan LM test of heteroscedasticity in random effects was conducted to test if the variance of the residual term will be constant over different values of the explanatory variables. Random effect model results revealed that debt to equity ratio had a negative but insignificant relationship with return on assets ratio. Portfolio to assets ratio had a positive relationship with financial performance but the relationship was not significant. Operating expense ratio had negative and significant relationship with return to assets ratio. The coefficient for lagged return to assets ratio was 0.4733, debt to equity ratio was -0.0026, portfolio to assets ratio was 0.0090 and coefficient for operating expense ratio was -0.1857. P-values for DER was 0.878, PAR, 0.686 and OER, 0.000. The results for lagged ROA the coefficient was positive and was statistically significant. Autoregressive distributed lag model on debt to equity ratio preferred model random effect model findings postulated that debt to equity ratio had positive and significant relationship with return to assets ratio. Lagged DER had positive and significant relationship with return to assets ratio. ARDL model on portfolio to assets ratio preferred model random effect model findings revealed that PAR had positive and insignificant relationship with return to assets ratio. Lagged PAR had positive and significant relationship with return to assets ratio. ARDL model on operating expense ratio and preferred model fixed effect model showed that OER had negative and significant relationship with return to assets ratio. The lagged OER had positive and insignificant relationship with return to assets ratio. The study concluded that negative and significant effect of operating expense ratio on financial performance shows that an increase in expenses decreases the performance of the MFIs industry in Kenya and negative coefficient of OER implies that there is lack of efficiency in expense management of the MFIs industry in Kenya. The study recommends that AMFI should conduct audit to ensure that all MFIs maintain a proper balance between debt and equity, MFIs in Kenya should aim at formulating and implementing strategies that are likely to enhance rate of returns from their investment portfolios and MFIs should lower their interest rate to a level that would cover its operating expenses. The study would be significant in the provision of MFIs with proper decision making as well as provide the contextual information to researchers and scholars.