EFFECTS OF MICROFINANCE SERVICES ON THE FINANCIAL PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES IN MOGADISHU, SOMALIA

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ABSTRACT: In this study titled the effect of microfinance services on the financial performance of small and medium enterprises, a case study of microfinance institutions in Mogadishu, Somalia. Most of the small and medium enterprises in Somalia fail in their premature state, because of lack of insufficient capital, lack of risk awareness and the absence of financial literacy. The major objective of this study was to measure the relationship between these above variables, the independent and dependent respectively. The specific objectives for this study include ascertaining how financial sustainability affects financial performance in small and medium enterprises in Mogadishu. The findings about this study stated that financial sustainability, financial literacy and risk diversification have moderate positive relationship with financial performance of microfinance institutions in Mogadishu. The target population for this study consisted of four microfinance institutions Salam Somali Bank, Dahabshiil, Trust African bank and Kaah microfinance enterprise. Sample of 82 respondents was taken. The sample was chosen by using Slovene's formula. Sampling technique for this study was non-random sampling particularly purposive sampling. Descriptive research design was employed. Structured questionnaire have been designed to facilitate the acquisition of relevant data which was used for analysis. Descriptive statistics which involves simple tables and illustrations was tactically applied in data presentations and analysis. Regression model was used to measure the kind of relationship that exists between the independent and the dependent variable**.** The results of the study showed that moderate positive relationship exists between financial sustainability, financial literacy, risk diversification and financial performance of microfinance institutions in Mogadishu, Somalia. The researcher would like to recommend for the microfinance institutions to expand their services to other parts of the country to distribute the opportunities that can be benefited by the poor citizens in entire the country.

INTRODUCTION

Background

Microfinance institutions have evolved since the late 1990s as an economic development tool intended to benefit low-income people. Microfinance plays a major role in the economies of many developing countries. Microfinance was developed to provide the poor with access to financial services and to support the development of small and micro-businesses. Ledger wood (2000) points out that the goals of microfinance institutions as development organizations are to service the financial needs of underserved markets as a means of meeting development objectives such as to create employment, reduce poverty, help existing business grow or diversify their activities, empower women or other disadvantaged population groups, and encourage the development of new business. In short, microfinance institutions have been expected to reduce poverty, which is considered as the most important development objective (World Bank, 2000).

In the world, Professor Muhammad Yunus addressed the banking problem faced by the poor through a program of action-research. With his graduate students in Chittagong University in 1976, he designed an experimental credit program to serve them. It spread rapidly to hundreds of villages. Through a special relationship with rural banks, he disbursed and recovered thousands of loans, but the bankers refused to take over the project at the end of the pilot phase. They feared it was too expensive and risky in spite of his success. Eventually, through the support of donors, the Grameen Bank was founded in 1983 and now serves more than 4 million borrowers.

In Africa, the microfinance industry is as diverse as the continent itself and geographically dispersed. An array of approaches has been used ranging from traditional group based- systems to specialized lending by banks, non-governmental organizations (NGOs), non-bank financial institutions, cooperatives, rural banks, savings and postal financial institutions and increasing number of banks. The Community-Based approach in MFI development that is commonly followed in African countries has been to rely on local communities to support the development of MFIs, outside the formal banking sector. As MFIs operating outside the formal banking sector had to find their own source of funds, the development of innovative saving vehicles was important and supported by participatory efforts in local communities to form cooperatives it has been proven that microfinance programs have a great contribution in reducing poverty. More importantly; it has been proven that Microfinance can be viewed as a development strategy tool by enabling poor entrepreneurs to initiate their own business, teaching them how to protect the capital they have, to deal with risk, and to expand the circle of their economic activities. Availability of a microcredit schemes increases the number of small enterprises, which in turn creates employment opportunities for the poorest and stimulates therefore economic development and social inclusion.

In Somalia, Sa'id foundation began micro-credit programs in 1993.Said received its capital injection from Oxfam America (Sa'id foundation report, 2005).Salam Somali bank launched microfinance program to help the poor and small business in 2010 (Salam Somali Bank, 2011).

The study was guided by agency and resource based theories. The first author used this theory is said to be Ross. The agency theory argued that there was conflicting goals of microfinance institutions and small business owners that are based loan repayment default. The agency theory is concerned with how agency affect the form of the contract and the way they are minimized, particularly, when contracting parties are asymmetrically informed. Asymmetric information refers to situations in which one party to a transaction has more information about the transaction than the other. This situation could cause markets to deviate from the conventional behavior patterns and lead to moral hazards and adverse selections (Ferguson & Peters, 2000) The resource based view (RBV) suggests that lack of financial, human, organizational resources and capabilities reduce the firm innovation activities (Hewitt-Dundas, 2006) The inaccessibility of financial resources is a major challenge to the development of SMEs, particularly because it prevents them from acquiring the new technology that would make them more productive and more competitive.

According to (Robinson, 2006) He defined it as: “Microfinance refers to small-scale financial services for both credits and deposits that are provided to people who farm or fish or herd; operate small or micro enterprises where goods are produced, recycled, repaired, or traded; provide services; work for wages or commissions; gain income from renting out small amounts of land, vehicles, animals or machinery and tools; and to other individuals and local group in developing countries, in both rural and urban areas.”

Gungen, 2002 described the features of microfinance based on the type of client, lending technology, loan portfolio, organizational ideology and institutional structure. On the client type for micro finance, Gungen noted that clients are characterized by low income, employment in the informal sector, low wage bracket, lack of physical collateral, closely interlinked business activities. The lending technology for microfinance is that of Prompt approval and disbursement of micro loans, lack of extensive loan records ,Collateral substitutes; group-based guarantees, conditional access to further micro-credits, information-intensive character-based lending linked to cash flow analysis and group-based borrower selection. Loan portfolio is highly volatile and is heavily dependent on portfolio management skills. Organizational ideology is remote and non-dependent on government with cost recovery objective and profit maximization. Institutional structure for microfinance is decentralized with insufficient external control and Regulation. Capital base is quasi equity, mainly inform of soft loans and grants (Anan, 2006).

Hiratsuka (2005) also defined microfinance as the provision of small scale financial services to low income people. Microfinance is an effective tool to fight poverty by providing financial services to those who do not have access to or are neglected by the commercial banks and other financial institutions (Janda, 2010). However, for sustainable poverty alleviation, the MFIs themselves should be sustainable since unsustainable MFIs will not help the poor in the future because the MFIs will be gone (Schreiner, 2000).

Statement of the problem

Microfinance institutions (MFIs) supply financial services to micro-enterprises and low income families. MFIs pursue the double bottom lines of social development and financial returns, and their funding is supplied by a range of sources, from donations to commercial investments. Microfinance is thus an arena in which donors meet professional investors. MFIs can be incorporated as banks, non-bank financial institutions, non-governmental organizations, cooperatives/credit unions, and state banks (Strøm, 2008).

Microfinance instititutions were very important to a country like Somalia, where most people live below the poverty line ,althought there was no accurate statistics that showing the poverty state that exists in the country.

However, most of the small and medium enterprises in Somalia fail in their premature state, because of lack of insufficient capital, lack of risk awareness and the absence of financial literacy.

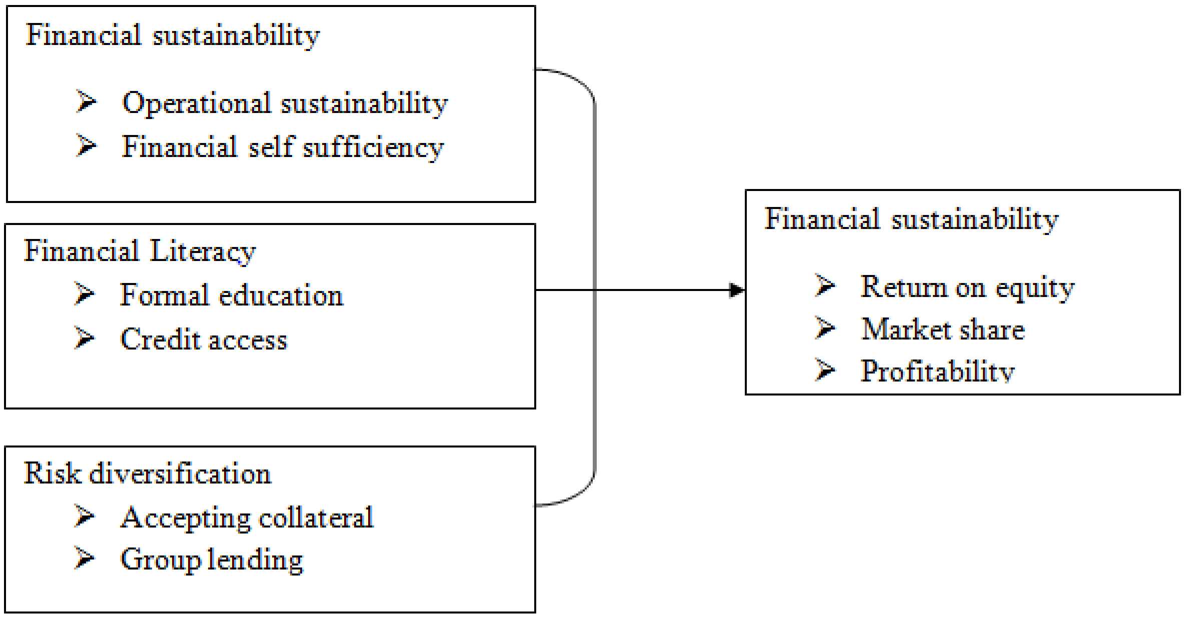
Low economic activity in low income communities is primarily due to lack of financial resources. In developing countries, people from low income communities like shopkeepers or household products manufacturers have innovative ideas for their business but they do not have any financial resources to implement them. This phenomenon leads them to more poverty and poor standard of life. MFIs generally provide financial services covering savings and credit activities which according to (Ledgerwood, 2006) also provide insurance and payment services to their clients.

However, in our best awareness there is no evidence that microfinance services have effect on the performance of small businesses. Therefore, this study we are going to examine the relationship between the Microfinance institutions and the performance of Small and medium enterprises in Mogadishu.

Specific objectives

1. To ascertain how financial sustainability affects financial performance of small and medium enterprises in Somalia.
2. To determine whether risk diversification affects financial performance of small and medium enterprises in Somalia.
3. To assess the effects of financial literacy on financial performance of small and medium enterprises in Somalia.

Conceptual framework



Independent variable **Dependent variable**

Figure 2.1 Conceptual Framework

Financial sustainability

Financial sustainability can be measured in two stages namely operational sustainability and financial self-sufficiency. According to Meyer (2002) operational sustainability refers to the ability of the MFI to cover its operational costs from its operating income regardless of whether it is subsidized or not. On the other hand, MFIs are financially self- sufficient when they are able to cover from their own generated income, both operating and financing costs and other form of subsidy valued at market prices. Financial Self-Sufficiency indicates whether or not enough revenue has been earned to cover both, direct costs - including financing costs, provisions for loan losses, and operating expenses - and indirect costs, including the adjusted cost of capital. Financial Self-Sufficiency is an important measure of sustainability of the lending operations (Reed 2011).

Financial Sustainability is the long term continuation of the Microfinance programs after the project activities have been discontinued. It entails that appropriate systems and processes have been put in place that will enable the Microfinance services to be available on a continuous basis and the clients continue to benefit from these services in a routine manner. This also would mean that the program would meet the needs of the members through resources raised on their own strength, either from among themselves or from external sources (Reed 2011).

(Onyuma 2005) pointed out that financial sustainability is the ability of an institution to generate sufficient funds to sustain the costs of the programs. Microfinance institution is said to have reached sustainability when the operating income from the loan is sufficient to cover all the operating costs (Jolis, 2003)

Experience has shown that sustainability is critical to the longevity and further growth of any microfinance institution (MFI). Sustainability, or financial health, becomes more critical as the sector continues growing; unfortunately, the potential market continues to grow as well. Growth, among its other ramifications and side effects, both positive and negative, has the ability to drag the focus away from sustainability.

According to Meyer (2002) the poor need to have access to financial service on long-term basis rather than just a onetime financial support, he argues that, any short-term loan would worsen the welfare of the poor. Financial sustainability has been one of the indicators of performance in most Microfinance institutions.

financial literacy

Financial illiteracy has long been recognized as a major problem in poor households and communities. Microfinance institutions have discovered that simply providing financial services to individuals can have limited impact if those individuals don't understand the basics of money management. This is the result not only of inadequate access to, or inferior standards of, formal education, but also of insufficient access to information (Piprek 2007).Therefore, as the industry has evolved, some microfinance institutions have incorporated a financial literacy component into their program. These financial literacy programs can provide varying degrees of education and include topics such as; managing cash flow, basic banking instruction, and the importance of savings. Companies are providing small shareholders with information they do not read. Small shareholders may not read this because they lack the financial skills to understand what is presented or they may feel that this information is not relevant to their decision-making.

Microfinance institutions in most developing countries are trying to make training workshops for their customers particularly self-employed clients. The self-employed poor rarely have any Formal training in business skills. However, a growing number of microfinance organizations are attempting to build the human capital of micro-entrepreneurs in order to improve the livelihood of their clients and help further their mission of poverty alleviation. In addition to impact on the clients´ businesses and households, the training could impact important outcomes for the institution. If clients' businesses improve, they are able to repay their loans (Karlan 2010). The training also may engender goodwill and sentiments of reciprocity, also leading to higher repayment rates.

According to (Mason 2012) financial literacy is Defined an individual's ability to obtain, understand and evaluate the relevant information necessary to make decisions with an awareness of the likely financial consequences. There is clearly a similarity here between information literacy and financial literacy. This is not surprising since information that has financial implications is still information. The difference between the two terms arises because the outcomes are different. The definition attempts to recognize that information relevant to decision-making may not necessarily be financial information in its strictest sense. For example, a school may face a reduced intake of pupils. This in itself is not financial information yet there are financial implications where a school's funding is determined by the number of pupils. The ability to recognize these financial implications is fundamental to financial literacy. Financial literacy for this study will be used saving and credit access.

Risk diversification

Risk diversification, defined as the offering of other products aside from loans and/or savings, on the different aspects of performance. Group lending refers specifically to arrangements by individuals without collateral who get together and form groups with the aim of obtaining loans from a lender. The special feature is that the loans are made available individually to group members, but all in the group face consequences if any member runs into serious repayment difficulties (Morduch, 2005).

Microfinance is associated with group lending. When borrowers form groups and are held liable for each other, lending to the poor can be profitable even if borrowers do not possess any collateral and lack of credit history. However, large group of microfinance institutions do not offer group lending but individual.Another important strategy in microfinance business is the demand of commensurate collateral to back lending to clients.

The loan portfolio is an MFI's largest asset and therefore the quality of this type of asset, the risk attached to it may be difficult to measure. For microfinance institutions, the quality of the loan portfolio is very crucial as loans are not typically backed up by collateral. In the microfinance industry, Portfolio at Risk (Par) is the most widely used measure of portfolio quality. It measures the portion of the loan portfolio "contaminated" by arrears as a percentage of the total portfolio. A loan is considered to be at risk if a payment on it is more than 30 days late. This day-limit is stricter than what is practiced among commercial banks given the lack of collateral to back up the borrowed loans. To measure risk, we use three measures of portfolio quality aside from Portfolio at Risk – the loan loss reserve ratio, risk coverage ratio and write-off ratio. The loan loss reserve ratio gives an indication of the expense occurred by the institution to anticipate future loan losses. Risk coverage ratio meanwhile shows how prepared an institution is for a worst-case scenario. Lastly, the write-off ratio represents the loans that the institution has removed from its books because of fear that they will not be recovered.

Financial performance of Small and medium enterprises

In the real world, there have been various definitions of SMEs to serve a specific purpose for the respective scholars and establishments. In developed countries such as the United States and the United Kingdom, both quantitative and qualitative criteria have been used to define a SME. A literature review indicated that the number of employees working in one enterprise or establishment tends to be one of the main criteria used in size-categorization of SMEs.

Measuring business performance in today's economic environment is a critical issue for academic scholars and practicing managers. In general, business performance is defined as "the operational ability to satisfy the desires of the company's major shareholders" (Smith& Reece, 1999).

According to Stoner (2003), financial performance in financial institutions refers to the ability to operate efficiently, profitability, survive grow and react to their environmental opportunities and threats to sustain long period of time. Low performance from poorly performing assets is often related to strategic errors made in the acquisition process. According to Dixon et al (1990), appropriate performance measures should which enable organizations to direct their actions towards achieving their strategic objectives. Kotey &Meredith (1997) contends that, performance is measured by either subjective or objective criteria, arguments for subjective measures include difficulties with collecting qualitative performance data from small firms and with reliability of such data arising from differences in accounting methods used by firms. Kent (1994) found out that, objective performance measures include indicators such as profit growth, revenue growth, return on capital employed. Hitt.et al., 2001) mention accounting- based performance using three indicators: return on assets, return on equity, and return on sales.

According to (Kotler, 2000) strong performer firms are those that can stay in business for a good number of years. Dwivedi (2002) also found out that, the ability of a firm to survive in business in an indicator of good financial performance. Uganda, about 90% of Ugandan SMEs collapse within 3 years Kaunda (2005). This is therefore an indicator of poor financial performance. Financial performance in this study will be conceptualized in terms of profitability, Return on equity and market share.

Empirical review

However, a lot of researches were made from the current topic by different authors from different countries below are some of those:

According to Irene Rotech, Charles and kagai 2015 investigated Effects of microfinance services on the performance of small and medium enterprises using questionnaires the result indicated that access to credit, Mobilization and training in micro enterprises investment was on average satisfactory to the micro entrepreneurs.

Impact of microfinance services on the financial performance of small and medium scale enterprises in kakamega, Kenya by Njeri Ngunjiri 2012 by using questionnaire the result states that microfinance services have positive effect on the performance of small and medium enterprises.

Nicholas (2004) used case study to investigate the impact of microfinance on the lives of poor people in the rural of china and found that the participation of poor in microfinance programs had led positive impact on their life.

Mochona (2006) studied the impact of microfinance in Ethiopia. He assessed the impact of microfinance in Women owned enterprises. The study declared that on small number of women clients reported increased income from their micro enterprise activities.

Research Gap

The literature reviewed shows that the debate on microfinance services was inadequate on the impact of microfinance on poverty reduction as the study portray. This study attempts to empirically ascertain the effect of MFIs on SMEs. The study confirms the positive contributions of MFIs loans towards promoting SMEs market share, production efficiencies and competitiveness. It should be noted that the varying conclusions in the text may be accounted for by differences in the methodology used to measure the impact, among other biases. Conducting such a study is justified by the increased rate of microfinance service institutions in Somalia. Since the study being criticized lacks very important variables that are to be valued from the microfinance institutions. It is against this background that the researchers find it necessary to make a study on the effects of MFIs services on financial performance.

METHODOLOGY

The research design was descriptive research design. The purpose of using descriptive research design was to find the relationship between Microfinance services and performance of small and medium enterprises. A descriptive study is one in which information is collected without changing the environment. Sometimes these are referred to as correlational or observational studies (Kahn, 2007). In this study the researcher used quantitative approach. Quantitative research is a data collection technique such as questionnaire and graphs for data representation that generates or uses numerical data,

This study was conducted among of microfinance institutions. Population is defined as all the items under consideration in any field of inquiry constitute (Sivasubramaniyan, 2012).However, the researcher selected number of organizations such as Salaam Somali Bank, Kaah microfinance enterprise, Trust African bank and Dahabshil Bank of Somalia, the main reason for selection of these organizations because they were the main institutions that provided micro financing programs in Mogadishu. The sampling frame for this study was Microfinance departments within the major commercial banks in Mogadishu.

The sampling technique adapted to this research was non-probability sampling particularly purposive or judgmental because the researcher selected the respondents that can give accurate information about the problem at hand. Kumar (2005) stated that judgmental sampling is a way of sampling where the researcher selected using his/her judgment to select the population members who are good at information related to the study. To select sample from population the researcher used Slovan's formula 82 respondents from the microfinance institutions selected. Where n is the sample size, N is the population size, and e is the level of precision. When this formula is the result below will come out.

$$n = \frac{N}{1+Ne2} = \frac{104}{1+104(.25)2 =} = 82$$

DATA ANALYSIS AND RESULTS PRESENTATION

This chapter deals with the analysis of data. The data analysis is in line with the specific objectives where patterns were investigated, interpreted and inferences drawn from them.

Table 4.1 Response Rate

Response	Total	Percent
Non Responses	14	17
Responses	68	83
Total	**82**	**100**

Reliability Results

The reliability and validity measurement of the data instrument helps the researcher to gauge the wellbeing of variable measurements. (Sekaran and Bougie, 2010). Reliability was measured using Cronbach's Alpha coefficient which is used to measure the internal consistency of the variable measures. Factor Analysis was also used to determine the underlying dimensions of variables and to determine the key factors from a large number of variables.

Table 4.2 Reliability

Variables	Cronbach's Alpha	Comments
Financial sustainability	0.728	Accepted
Financial literacy	0.713	Accepted
Risk diversification	0.721	Accepted

Cronbach's Alpha

Reliability was measured using Cronbach's Alpha coefficient which was used to measure the internal consistency of the study measures. The Cronbach's alpha coefficient ranges between 0 and 1 and alpha coefficients of a minimum of 0.70 are considered appropriate. The overall Cronbach's alpha coefficients for all the constructs in the study were 0.713. The study measures were found to be highly reliable in that they all had alpha coefficient greater than the minimum accepted Cronbach's alpha coefficient of 0.70 (Hair *et al.*, 2010). Financial sustainability had Cronbach's alpha coefficient of 0.728 while financial literacy had 0.713. Risk diversification had 0.721.

Regression Analysis

In this study, a multiple regression analysis was conducted to test the effect of Micro finance services on the financial performance on Small and medium enterprises in Mogadishu, Somalia. The research used statistical package for social sciences (SPSS V 20) to code, enter and compute the measurements of the multiple regressions.

Regression Models

Table: 4.12 Models Summary

Model	R	R^2 Square	Adjusted R Square	Std. Error of the Estimate
1	0.645^a	0.416	0.278	.27806

Adjusted R^2 squared is coefficient of determination which tells us the variation in the dependent variables due to change in the independent variables. From the findings in the above table the value of adjusted R squared is 0.278 and indicates that there was variation of 27.8% on financial performance of microfinance institutions in Mogadishu due to changes in financial sustainability, financial literacy and Risk diversification at 95%

confidence interval. This shows the significant that 2.78% of the variations in the financial performance of microfinance institutions with in major commercial banks in Mogadishu are accounted for by the variations in the independent variables and the remaining 72.2% are accounted by other factors contained in the standard error.

R is the correlation coefficient which shows the relationship between the study variables. From the findings shown in the table above there was a moderate positive relationship between the study variables as shown by 0.645.

Table 4.13 Analysis of Variations

Model		Sum Squares	df	Mean Square	F	Sig.
1	Regression	2.224	3	.784	9.586	.000[a]
	Residual	4.984	64	.770		
Total		7.224	**67**			

From the ANOVA statistics shown in table, the processed data, which is the population parameters, had a significance level of 0.5% which shows that the data is ideal for making a conclusion on the population's parameter as the value of significance (p-value) is less than 5%. The F critical at 5% level of significance was 2.72. Since F calculated (9.586) is greater than the F critical (2.72), this shows that the overall model was significant and that financial sustainability, financial literacy and Risk diversification significantly affect the financial performance of Small and medium enterprises in Mogadishu- Somalia.

Regression Coefficients

Model	Un standardized Coefficients		Standardized Coefficient		
	B	**Std. Error**	**Beta**	**T**	**Sig.**
1. (Constant)	.880.	366	2.400		.019
Financial sustainability	.289	.115	.277	2 .513	.014
Financial literacy.	.188	.081	.248	2.323	.023
Risk diversification	.218	.086	.276	2.530	.014

From the data in the above table the established regression equation was;

$Y= \beta 0+\beta 1X1+\beta 2X2+ \beta 3X3 + \beta 4X4 + \varepsilon$ *and* the multiple regression equation became $= 0.880 + 0.289X1 + 0.188X2 + 0.218X3+ \varepsilon$ From the above regression equation it was revealed that financial sustainability, financial literacy and risk diversification are to a constant zero, financial performance of microfinance institutions in Mogadishu would be at 0.880. A unit increases in Financial sustainability would lead to increase in the financial performance of micro finance enterprises in Mogadishu by a factor of 0.289. A unit increases in Financial literacy would lead to increase in the financial performance of micro finance institution with in major commercial banks in Mogadishu by a factor of 0.188 and a unit change in risk diversification would lead to increase in the financial performance of MFIs in Mogadishu by a factor of 0.218.

The regression results presented in above table indicate that financial sustainability, financial literacy and risk diversification were significant at 5 percent level. The coefficient of financial sustainability showed 0.2772 with a p-value 0.014, which is less than 5%, the coefficient of financial literacy was .248 which is less than 0.05, with a p-value of 0.023. And the coefficient of risk diversification was 0.276, with a p-value of 0.014 which is less than 0.05 so that indicates there was statistically strong positive relationship between financial sustainability, financial literacy, risk diversification and financial performance of microfinance institutions with in the major commercial banks in Mogadishu. All of the variables were found to be significantly affect financial performance of microfinance institutions because they less than ($p<0.05$).

Conclusions

Financial performance has moderate positive and highly significance relationship with financial sustainability, financial literacy and risk diversification. The study found that sustainability is critical in the long-term existence of the institution.so that they have to expand their services to the entire country to ensure the enough number of customers. The second objective for this study was assess the financial literacy of microfinance customers, the result showed that the majority of customers of micro financing services are literate are able to understand these services.

The third objective for the study was to show how risk diversification affects financial performance, and it showed that microfinance institutions to diversify the risk invested other business apart from the micro financing and also give services to groups rather than individual that can lead them to be safe from default. The study used operationalized variables to get the intended responses from microfinance institutions and are structured as questionnaires these were operational sustainability, financial self-sufficient, formal education, credit access, group lending and taken collateral the operational variables made possible that information is gotten from the respondents.

The results reveal that financial sustainability, financial literacy and risk diversification have significant and positive effects on financial performance for microfinance services in Mogadishu, Somalia.

Recommendations

1. Only financing services can help SMEs attain growth and development. Most of clients of microfinance institutions meet challenges when seeking or applying loans. Therefore, it is recommended, that before granting loans to clients, they should first train them on how to account for the finance. The MFIs should also plan for seminars and workshops to train them on financial management.

2. The researcher would like to recommend for the microfinance institutions to expand their services to other parts of the country to distribute the opportunities that can be benefited by the poor citizens in entire the country.

3. The government should set up regulations for micro financing services to ensure that micro financing activities are creating opportunities for the poor people and also to take part the programme by contributing funds to it.

4. The micro financing institutions should come up with clear policies that show all the people who fill all the required conditions to get the right to benefit from the wide micro financing services.

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