Causes of Loan Default within Micro Finance Institutions in Kenya

Dr. Walter Okibo Bichanga
(Ph.D., MBA, Bcom., Dip. Computer Science, Dip. Personnel Management)
Senior Lecturer - Jomo Kenyatta University of Agriculture and Technology
P.O. Box 52255 – 00100, Nairobi, Kenya,

Mrs. Lilian Aseyo
(MBA- Strategic Management, Bachelor of Education English Literature)
Micro Credit Officer – Kenya Commercial Bank – Kitale,
P.O. Box 1974 - 30200, Kitale,

Abstract

Many rural credit schemes have sustained heavy losses because of poor loan collection. And yet a lot more have been dependent on government subsidy to financially cover the losses they faced through loan default. The main objective of the research was to find out the causes of loan default within micro finance institutions in Trans Nzoia County. Specific objectives were to investigate how non- Supervision of borrowers influences the loan repayment financed by MFIs in Trans-Nzoia county; to find out the effects of shrinking economic growth experienced by borrowers on loan repayment and to establish how diversion of loan funds by borrowers leads to default in loan repayment. The target population comprised a total of 400 loan borrowers and 200 MFIs out of which a sample of 150 was picked using simple random sampling for each stratum, which enable every member of the population have an equal and independent chance of being selected as respondents and also simplest, most convenient and bias free selection method. The data was collected by use of structured and semi-structured questionnaire. The data was analyzed from questionnaires using both quantitative and qualitative techniques and tabulated by use of frequency tables. The study found out that loan repayment default was as result of non supervision of borrowers by the MFIs, and also as a result of inadequate training of borrowers on utilization of loan funds before they received loans. The findings also revealed that most borrowers did not spend the loan amount on intended and agreed projects.

Keywords: *Loan Default, Causes and Micro Finance Institutions*

List of Abbreviations: KWFT – Kenya Women Finance Trust, MFIs – Micro Finance Institutions, NGOs- Non Governmental Organisations, ROSCAS – Rotating Credit and Savings Associations, SACCOS – Savings Co-operative and Credit Society

1. Background to the study

International organizations are coming to the realization that MFIs are veritable and effective channels to ensure programme implementation effectiveness, particularly in poverty alleviation projects and firsthand knowledge of the needs and interest of the poor (Okumadewa, 1998). According to Chossudovsky (1998), the World Bank Sustainable Banking with the Poor project (SBP) in mid-1996 estimated that there were more than 1,000 microfinance institutions in over 100 countries, each having a minimum of 1,000 members and with 3 years of experience. In a survey of 2006 of such institutions, 73 per cent were NGOs, 13.6per cent credit unions, 7.8 per cent banks and the rest savings unions. An overwhelming majority of the world’s poor live in the third world countries. Various approaches have been employed in alleviating poverty of which provision of credit that targets the poor is one. Many are now of the opinion that allowing the poor to have command over resources through credit can contribute towards poverty alleviation. Kiteme(1992) argues that the best way to do something about poverty is to let the people do their own thing. Nobody will have more motivation to change his situation than the sufferer himself/herself.

According to Rosenberg (1999), Micro Finance Institutions (MFIs) are increasingly a central source of credit for the poor in many countries. Weekly collection of repayment installments by bank personnel is one of the key features of micro-finance that is believed to reduce default risk in the absence of collateral and make lending to the poor viable. Some of the factors that lead to loan default include; inadequate or non-monitoring of micro and small enterprises by banks, leading to defaults, delays by banks in processing and disbursement of loans, diversion of funds, over-concentration of decision making, where all loans are required by some banks to be sanctioned by Area/Head Offices.

2. Statement of the problem

It is generally accepted that credit, which is put to productive use, results in good returns. But credit provision is such a risky business that, in addition to other reasons of varied nature, it may involve fraudulent and opportunistic behavior. MFIs should rather depend on loan recovery to have a sustainable financial position in this regard, so that they can meet their objective of alleviating poverty. Whether default is random and influenced by erratic behavior or whether it is influenced by certain factors in a specific situation, therefore, needs an empirical investigation so that the findings can be used by micro financing institutions to manipulate their credit programs for the better(Buvinic, 1997).

3. Objectives of the study

The general objective of the study was to find out the causes of loan default within micro finance institutions. A case study in Trans Nzoia County.

Specific Objectives

The following were research objectives;

i) To investigate the how non-Supervision of borrowers influences the loan repayment financed by MFIs in Trans-Nzoia county.

ii) To find out the effects of shrinking economic growth experienced byborrowers on loan repayment to MFIs in Trans-Nzoiacounty.

iii) To establish how diversion of loan funds by borrowers leads to default in loan repayment to MFIs in Trans-NzoiaCounty.

4. Significance of the study

The study sought to determine and analyze the socio-economic factors that affect loan repayment in Trans-Nzoia County to fill the knowledge gap by providing useful current-state insights into the factors that influence loan repayment and the performance of Micro Finance Organizations performance particularly in the district. It will also assist private and public sector to develop policies which support the development of Micro Finance Organizations development.

5. Scope of the Study

The study was limited to potential and existing clients accessing and beneficiaries of loans from the microfinance institutions existing in the Trans-Nzoia County. The county was chosen because of its rural set-up and the socio-cultural practices undermining loan access and development.

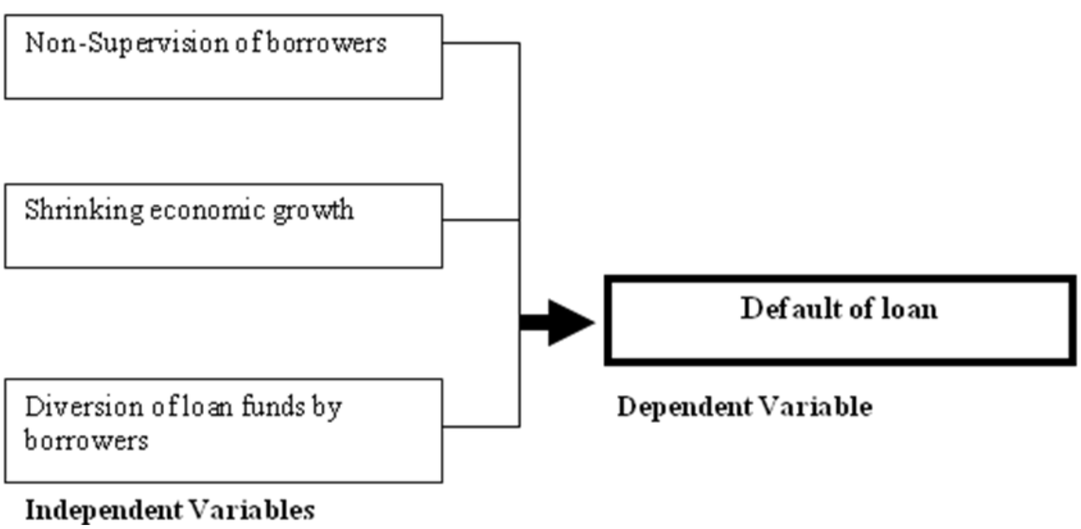
Literature Review

Literature review covers relevant literature with the aim of gaining insight into the factors that cause loans default within micro finance institutions in Trans Nzoia County. It covers: conceptual frame work, Chirwa's theoretical framework, and empirical studies which shed light on causes of loan default within micro finance institutions.

6. Conceptual Framework

The diagrammatic representation of conceptual framework shows how the variables are related. Non – Supervision of borrowers, shrinking economic growth experienced by borrowers and diversion of loan funds by borrowers are independent variables but default of loan repayment is a dependent variable, which depends on the occurrences of the said independent variables.

Figure 1 Conceptual Framework



Chirwa'sTheoretical Framework for the study

Chirwa (1997), specified a probity model to assess the determinants of the probability of credit repayment among smallholders in Malawi. The model allows for analysis of borrowers as being defaulters or non-defaulters. Various specifications of the X-vector were explored by step-wise elimination. The explanatory power of the model is plausible with the log likelihood statistically significant at 1- percent. Four independent variables – gender, amount of loan, club experience and household size were not statistically significant in various specifications.

The theory is relevant to this study in that the loan repayment by the borrower is dependent on various aspects such as the MFIs monitoring financial and business performance of the borrower, the state of the country's economy and diversion of the loan funds by the borrowers to other purposes not agreed upon.

7. Repayment frequency and default in microfinance

The typical repayment schedule offered by an MFI consists of weekly repayment starting one to two weeks after loan disbursement. Weekly collection of repayment installments by bank personnel is one of the key features of micro-finance that is believed to reduce default risk in the absence of collateral and make lending to the poor viable - Vogelgesang (2003). In addition, frequent meetings with a loan officer may improve client trust in loan officers and their willingness to stay on track with repayments.

8. Rural area credit provision Challenges

The literature reviewed presents a comprehensive list of challenges affecting rural finance institutions and also offers interesting and innovative ideas to address them. Some challenges faced by rural institutions are similar to those facing any microfinance organisation while others are specific to rural institutions offering loans for farm-based activities.

Some factors unique to rural and agricultural markets that constrain both the supply and demand for finance in those areas include;

1. High transaction costs for both borrowers and lenders
2. high risks faced by potential borrowers and depositors due to the variability of incomes, exogenous economic shocks and limited tools to manage risk
3. Seasonality – heavy concentration on agriculture and agriculture related activities exposes clients and institutions to multiple risks
4. Lack of reliable information about borrowers and lack of market information and/or market access
5. Weak institutional capacity – including poor governance and operating systems

9. The Case of Kenya Microfinance

Kenya's local self-help development efforts are predicated on the spirit of Harambee - a Swahili word that connotes community efforts for a common goal. Some women in Kenya already demonstrate competence through the use of "informal networks" frequently known as "'women's self-help groups." Their actions also complement efforts of various agencies to reduce poverty and improve the lives of rural people (Snow & Buss, 2001). Modern women’s groups' objectives now focus more on income-generating projects rather than solely welfare activities. They are multi-purpose and combine mutual financial assistance in the form of rotating credit associations to provide the means to pursue social, educational, and economic activities (Mbugua-Murithi, 1997).

Knowledge Gap

There have been attempts in the past to study Micro financing and Micro lending but much focus has been on the impact of MFIs in poverty alleviation, especially in Kenya. Not much has been done to find out causes of loan default in MFIs institutions in Trans Nzoia County, therefore this research addresses that gap.

Research Methodology

10. Research Design

The study adopted a descriptive survey method because it is efficient in collecting large amounts of information within a short time. Also, this research design does not permit manipulation of the variables as Sproul (1995) observes that descriptive survey is the only means through which views, opinions, attitudes and suggestions for improvements regarding of the phenomenon under study. Furthermore Cohen and Manion (1980) state that the intention of survey research is to gather data at a particular point in time and use it to describe the nature of existing conditions. The descriptive survey design was adopted in this study because the effect, i.e. the independent variable (factors affecting loan repayment) was studied after it has exerted the effect on the dependent variable (loan defaulting).

11. Area of Study

The study was carried out in Trans-Nzoia County. Trans-Nzoia town MFIs were chosen as a research site because of evidence of the increasing number of loan borrowers and also because of high growth rate. Therefore the results from Trans-Nzoia can be generalized to other areas in Kenya.

12. Population Size

The study population consisted of a total of 100 MFIs loan borrowers and 50 MFIs official loan borrowers mainly drawn from the owners of small scale farming activities.

13. Sample Size and Technique

The study made use of simple random sampling because it is considered the simplest, most convenient and bias free selection method. It enables every member of the population to have an equal and independent chance of being selected as respondents.The study adopted 25% sample size of the target population chosen from each of the strata whereby the target population was divided into strata, and samples of 50% of each stratum that was selected, this ensured that all the strata within the study area were included in the study.

Table 1 Sample Population

Respondents	Target population	Sample 25%
MFIs staff	200	50
Loan borrowers	400	100
Total	**600**	**150**

14. Instrument for data collection

The main data collection instruments employed in this study were questionnaires. The design included multiple-choice questions, fill in questions and questions that required ranking of answers. The questions were clearly simplified and structured in a manner void of any ambiguity and technical details. The questionnaire was drawn to elicit information/data on general management, research and development and general information on the MFIs on study.

15. Techniques for Data Analysis

The raw data was classified and tabulated after ensuring that it was carefully checked for completeness and consistency of information collated. This was followed by analysis and interpretation of findings. The analysis was based on the 150 questionnaires administered and returned. Analysis was done using descriptive techniques and presented in frequency tables.

DATA ANALYSIS AND PRESENTATION OF RESULTS

This research presents the findings of the study, analysis of data and presentations of major findings. For the purpose of demonstrating the relationship among the various variables, the data is presented in the form of tables, frequencies and percentages where applicable.

16. Age of Respondents

The study sought to establish the ages of MFI loan borrowers. Findinds are given in table below

Table 2 Age of Respondents

Age	Frequency	Percent
Below 30 years	20	20.0
30-40 years	54	54.0
Above 40 years	26	26.0
Total	100	100.0

The findings revealed that 20 % of the respondents are below 30 years, while the majority (54%) of MFI borrowers is aged between 30 – 40 years and 26 % of them are aged above 40 years. This implies that those aged between 30-40 years are the ones take up loans with MFI more. It is assumed that at that age bracket people are active in terms of business and other economic activities therefore in need of financial support.

17. Number of children

It was important for the study to establish the number of children the borrower has. The findins are summarized in the table below

Table 3 Number of Children

No of children	Frequency	Percent
None	15	15.0
1-2	20	20.0
3-5	34	34.0
Above 5	31	31.0
Total	100	100.0

From the findings, 15% of the respondents have no children, 20% have 1-2 children while the majority, with 3-4 children are 34% of all borrowers and 31% of the respondents had more than 5 children. The number of children is higher among the majority of respondents to this question, which means that family commitments lead to higher uptake of MFI loans.

18. Level of education

The researchers thought it was significant to find out about the level of education of the borrowers since it would be vital during training on loan utilization.

Table 4 Level of Education

Level	Frequency	Percent
Secondary certificate	59	59.0
Diploma	26	26.0
Bachelor's degree	10	10.0
Masters	3	3.0
Doctorate	1	1.0
Total	100	100.0

Findings point out that 59% of MFIs have secondary certificate, 26% of the respondents have diploma level of education, and 10% have bachelor's degree, 3% with masters and only 1% with Doctorate level of education. The findings mean that people with lower levels of education use MFIs loan facilities more than those who have higher levels of education.

Loan repayment trends of loan borrowers

The researchers sought to find out loan repayment trends of borrowers that lead to default loan in repayments and the findinds are summarised htrough answers to the following questions.

19. Is repayment period suitable?

Table 5 Repayment Period

Responses	Frequency	Percent
Yes	34	34.0
No	66	66.0
Total	100	100.0

The findings show that 66% of the respondents feel that the repayment period set by MFIs was not suitable, while 34 % thought the period was adequate, of which they recommended the period should be long enough.

20. What is the Status of the Loan?

Table 6 Loan Status

Status	Frequency	Percent
Fully repaid	34	34.0
Repayment on Schedule	27	27.0
Repayment in arrears	39	39.0
Total	100	100.0

It was found that 34% of borrowers had fully repaid their recent loans, 27% had repayment on schedule, while 39% had their repayments in arrears. The findings therefore indicate that the majority of borrowers were in arrears as far as loan repayment was concerned.

21. Why Loans are in Arrears

Table 7 Loans Arrears

Reason	Frequency	Percent
Business not profitable	23	23.0
Loan used for household expenses	12	12.0
Sold on credit	18	18.0
Loss of asset	3	3.0
Not in arrears	44	44.0
Total	100	100.0

Responses from Some 23% of the borrowers in arrears, the reason why their loan repayment was in arrears was because business was not profitable, while 12% said they used the loan for household expenses hence unable to repay the loan on schedule. Further, 18% of borrowers sold on credit and were not able to make repayments on time, 3% lost their assets and 44% of the respondents indicated they were not in arrears.

22. Aspects Forcing Borrowers to Repay Loan in Time

Table 8 Aspects forcing borrowers to repay loan in time

	Frequency	Percent
Claim against personal wealth	17	17.0
Claim against Guarantors	24	24.0
Social sanctions (loss of status)	18	18.0
Fear of losing future loan	5	5.0
No reason	36	36.0
Total	100	100.0

From the findings, 17% of the respondents said the most important aspect forcing them to repay the loan in time was the claim staked against their personal wealth, while 24% was due to claim staked against guarantors. 18% were forced to repay because social sanctions especially fear of loss of status and 5% were repaying on time because of fear of losing future loan from the MFIs. 36 % did not have any particular reason which is good as this can only be perceived to mean that the highest number of respondents felt the obligation to repay loans in time.

23. Supervision, Advisory Visits and Training

This study sought to investigate how supervision/non-supervision of borrowers influences the loan repayment financed by MFIs in Trans-Nzoia district. To that effect, the researchers asked respondents if they had ever been supervised by MFIs staff regarding loan utilization and repayment, whether they considered the supervision being important for the loan repayments, if they had received any training before the getting loans and about record keeping.

24. Supervision on Loan Utilization

Table 9 Supervision on Loan Utilization

Ever been supervised?	Frequency	Percent
Yes	53	53.0
No	47	47.0

The findings indicate that 53% of borrowers had been supervised by MFIs staff on loan utilization while 47% had not been supervised over the same. Non supervision of borrowers on loan utilization by MFI is a pointer that rates default could be higher since no obligation pressure will be on the borrowers.

25. Supervision on Loan Repayment

Table 10 Supervision on Loan Repayment

Ever been supervised?	Frequency	Percent
Yes	73	73.0
No	27	27.0
Total	100	100.0

On loan repayment, 73% of the respondents indicated that they had been supervised by MFIs staff on loan repayments, while some 27% of the respondents indicated that they had only been supervised on repayments. The findings show that MFIs put more emphasis on supervision of loan repayments as opposed to supervision of utilization of the loans.

The research also revealed that most MFIs carried out loans repayment supervision on a quaterly basis and a few on a monthly basis.

26. Training before receiving loans

Respondents were asked if they had received any training before receiving the loan and if they thought the training had helped them increase their income. The findings are summarized in the following tables.

Table 11 - If Respondents Received Training Before Receiving Loan

Did you get any training?	Frequency	Percent
Yes	65	65.0
No	35	35.0
Total	100	100.0

Majority of the respondents (65%) indicated that they had received some kind of training before receiving loans, while 35 % reported that they had not received any training before receiving loans. Training is important in that it empowers borrowers with knowledge on utilization of loan fund, which in turn would translate to lower default rate.

Table 12 – If Training has Helped Increase Income

Has training helped increase income	Frequency	Percent
Yes	87	87.0
No	13	13.0
Total	100	100.0

The findings show that 87% of the respondents reported that training helped increase their income, while 13% said that training before receiving the loan did not help them increase their income.

27. Effects of shrinking economic growth on loan repayment

One of the objectives of this study was to find out the effects of shrinking economic growth experienced by borrowers on loan repayment to MFIs. To this effect the researchers asked respondents about their source of income, consumption and living conditions and if their living conditions had improved due to their participation in the credit scheme.

28. Source of income

Respondents were asked if they had a source of income for their household before joining the loan programme and the estimated value of their assets currently.

Table 13 Source of Income

Did you have source of income before joining loan programme?	Frequency	Percent
Yes	74	74.0
No	26	26.0
Total	100	100.0

The findings revealed that 74% of the respondents had a source of income before joining the loan programme while 26% did not have any source. The large number of respondents who had a source of income before joining the loan programme is an indicator that they have experience handling funds hence are able to meet repayment schedule.

29. Household consumption

Table 14 Household Consumption

Household consumption	Frequency	Percent
Below Ksh 1000	9	9.0
Between Ksh 1001-3000	2	2.0
Between Ksh 3001-5000	3	3.0
Between Ksh5001-7000	15	15.0
Between Ksh 7001-10000	10	10.0
Above 10000	61	61.0
Total	100	100.0

It was evident that 61% of respondents had a household consumption of above Ksh.10,000, some 15% of them had an expenditure of between Ksh. 5001-7000, while 10% of them spent between Ksh. 7001-10000. The remaining percentages of respondents spent lower amounts on their household. The results indicate that the majority of the borrowers were having a high household consumption, yet 39% of them had indicated their repayments were in arrears and 12% said they used the loan for household expenses. Therefore diversion of loans to household expenses is likey to lead to default in loan repayment.

Table 15 Have living conditions improved due to credit scheme?

Responses	Frequency	Percent
Yes	98	98.0
No	2	2.0
Total	100	100.0

98% of respondents indicated that their living conditions improved in general because of their participation in the credit scheme while only 2% of them indicated that there was no improvement. This means that with improved living conditions loan defaulting will be minimal since the participants would like to benefit in future.

30. Defaulting due to economy

The study asked MFIs staff if they thought defaulting of loan repayments were as result of the situation of the economy. Responses are summarized in the following table

Table 16 Is defaulting due to economy?

Responses	Frequency	Percent
Yes	35	70.0
No	15	30.0
Total	50	100.0

When asked if they thought loan repayment defaulting by borrowers was as a result of the prevailing economic situation, 70% of MFIs staff thought defaulting was due to the economy but 30% of them did not think defaulting in loan repayment was due to the economy.

31. How loan diversion leads to default in loan repayment

The study sought to establish how diversion of loan funds by borrowers leads to default in loan repayment to MFIs. Questions were posed to MFI officials to find out if loans given to borrowers were utilized for the intended purpose, the purpose of the loan diversion and the rate of diversion among borrowers.

Table 17 Are loans used for intended purposes?

Responses	Frequency	Percent
Yes	18	36.0
No	32	64.0
Total	50	100.0

When the researchers sought to know from MFIs if they thought loans given to borrowers were used for the intended purposes 36% agreed but 64% said that loans given to borrowers were not used for the intended use. The rate of loan default is likely to be high because of the large proportion of borrowers who do not use the loans for intended purposes hence prone to misusing the funds.

Conclusions on Supervision of borrowers

The result of this study concluded that inadequate supervision of borrowers by the MFIs staff on loan utilization and loan repayment lead to default of repayments. Supervision is an important aspect since it compels borrowers to be committed; a fact expressed by borrowers who said they considered supervision important in loan repayment.

On training of borrowers before receiving of loans from MFIs, it was concluded that training is important in giving borrowers skills in business management, savings and in book keeping. At the same time the study concluded that borrowers who did not receive any training before receiving loans from MFIs defaulted in repayments since they were unable to increase their earnings

Recommendations on Supervision of borrowers

The study felt that in order to minimize the rate of loan repayments, MFIs need to have mandatory supervision borrowers on loan utilization and repayment, which should be done quarterly. Such supervision will enable the MFIs monitor the performance of borrowers closely done. Also training of borrowers before and after receiving loans should be done focusing on areas such as business management, book keeping and savings. Such measures will bring down the rate of defaulters.

Conclusions on effects of shrinking economic

The study concluded that default in loan repayments was as a result of borrowers having inadequate asset value, which led them to spend more on household consumption than on loan repayments. Further, poor repayments were compounded by the fact that those who were supposed to repay the loans to MFIs were the greatest bearers of household expenditure. Some 70% of MFIs staff thought defaulting was due to the economy acknowledging that the prevailing economic situation was to blame for defaulting in loan repayments to MFIs.

Recommendations on effects of shrinking economic

In order to minimize default in repayments, MFIs should ensure that whoever they are lending to meets a minimum threshold in asset value before loans are accessed. Also, the MFIs should educate the borrowers on the need to spend less on household consumption so as to reduce on default as well as borrowers being able to save their money in the face of the shrinking economy.

Conclusions on diversion of loan funds by borrowers

The study concluded that a good number of the borrowers did not use the loans they received from the MFIs for the intended and agreed purposes. Such diversions were the reason why they were unable to keep up to date in their repayments.

Recommendations on diversion of loan funds by borrowers

The study recommends that in order for MFIs to reduce default in loan repayments, they should monitor the borrowers regularly so as to ensure that they use the loans they received for the agreed and intended. This can they can do through getting regular account statements from borrowers as well as physically visiting the borrowers to monitor and evaluate the progress of their loan projects.

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