# FACTORS CONSIDERED IN THE RATINGS OF MICRO FINANCE INSTITUTIONS AND THE APPLICABILITY OF THESE RATINGS IN TANZANIA.

## A CASE OF MWANZA REGION

**By**

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## CERTIFICATION

We, the undersigned, certify that we have read and hereby recommend for acceptance by the Mzumbe University, a dissertation/thesis entitled **Factors considered in the ratings of Micro Finance Institutions and the applicability of these ratings in Tanzania: A case of Mwanza region,** in partial/fulfilment of the requirements for award of the degree of Master of Science in Accounting and Finance of Mzumbe University.

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# DEDICATION

I dedicate this research to my family: my mother Mrs. Asteria Kishamba, my brother Albert K. Kishamba, my sisters Judith Kishamba, Julieth H. Kishamba and Janeth H. Kishamba and my aunt Ms. Doroth H. Sylvester.

## ABBREVIATIONS AND ACRONYMS

| | |
|---|---|
| ACB | Akiba Commercial Bank Ltd. |
| ADB | African Development Bank |
| ALPB | Average loan balance per borrower |
| ASCAs | Accumulated Savings Credit Associations |
| ATM | Automated Teller Machine |
| BLUE | Best Linear Unbiased Estimator |
| BoT | Bank of Tanzania |
| BPS | Borrowers per staff member |
| CGAP | Consultative Group to Assist the Poorest |
| CIDA | Canadian International Development Agency |
| COASCO | Cooperatives Audit and Supervision Corporation |
| CPB | Cost per borrower |
| CRDB | CRDB Bank Plc formally, Community and Rural Development Bank |
| FICO | Financial Cooperative |
| FINCA | Foundation for International Community Assistance |
| FSDT | Financial Sector Deepening Trust |
| GLP | Gross Loan Portfolio |
| GOT | Government of Tanzania |
| IADB | Inter-American Development Bank |
| IFAD | International Fund for Agricultural Development |
| IFC | International Finance Corporation |
| IMF | International Monetary Fund |
| KFCB | Kagera Farmers Cooperative Bank |
| LHS | Left-Hand Side |
| ln | Natural logarithm |
| MFC | Microfinance Company |
| MFI | Microfinance Institution |
| MIX | Microfinance Information eXchange |

| | |
|---|---|
| MKUKUTA | Mkakati wa Kukuza Uchumi na Kupunguza Umaskini |
| MLC | Maximum Liability Certificate |
| NAB | Number of active borrowers |
| NBC | National Bank of Commerce Ltd |
| NGO | Non-governmental Organisation |
| NMB | National Microfinance Bank Ltd. |
| OLS | Ordinary Least Square |
| OSS | Operational self-sufficiency |
| P | Personnel |
| PAR | Portfolio at risk for more than 30 days |
| PRIDE | Promotion of Rural Initiatives and Development Enterprises |
| RFSP | Rural Financial Services Support Project |
| ROSCAs | Rotating savings and credit Associations |
| SACCO(s) | Savings and Credit Cooperative Society (ies) |
| SCCULT | Savings and Credit Cooperative Union League of Tanzania Ltd |
| SEDA | Small Enterprise Development Agency |
| SELFINA | Sero Lease and Finance Limited |
| SIDO | Small Industries Development Organization |
| SMEs | Small and Micro Enterprises |
| TA | Total Assets |
| TAMFI | Tanzania Association of Microfinance Institutions |
| TANZALEP | Tanzania Leasing Project |
| Tshs | Tanzanian Shillings |
| TWB | Total women borrowers |
| VICOBA | Village Community Banks |
| WB | World Bank |
| WOCCU | World Council of Credit Unions |
| YOSEFO | Youth Self Employed Foundation |

## ABSTRACT

The major problem faced by microfinance institutions has largely been lack of self sustainability which calls for borrowing externally. These difficulties faced by Microfinance institutions (MFIs) have triggered a great deal of researches on ways through which these problems can actually be addressed. Concern form the financial providers has always been whether the money that they provide will be repaid together with the interest thereon. Addressing this concern, several agencies have been established to help rate the MFIs according to their credit worthiness. This research therefore had the main objective of assessing the factors considered in the ratings of the MFIs and the applicability of these ratings in Tanzania.

With specific objectives of seeking to assess the contribution of social factors in ratings, assessing the applicability of the ratings in the Tanzanian context and assessment of procedures followed in ratings, the study deployed secondary as well as primary data.

The research deployed the qualitative research approach and borrowing some quantitative measures by applying the ordinal/ordered logit model for the analysis of secondary data while the primary data were mainly analyzed using the percentage.

The study found that only the financial factors are considered when rating the MFIs and that social factors have got no bearing at all in the rating that an MFI assigned. The researcher also found out that the rating system can be put into use in the MFI industry in Tanzania and therefore recommends that an agency is established that will help rating the Tanzanian MFIs and therefore getting rid of the current system of issuing the maximum liability certificate.

## TABLE OF CONTENTS

# CHAPTER ONE

# INTRODUCTION

## 1.0.Introduction

The microfinance institutions, which are understood to be institutions that provide financial services to micro entrepreneurs and businesses, are largely known for advancing the microcredit facility to their members. To do so, they need enough funds to finance their operations while accomplishing the purpose of their existence. They have largely been faced with the problem of lack of self sustainability, Gutiérrez-Nieto and Serrano-Cinca (2010). This means the funds that they are able to raise from their own operations is not sufficient to cover for operating cost and for microcredit services hence a need for external borrowings. However, there also have been some difficulties when asking for funds from external due to concerns that are being raised by the funds providers.

Concerns from the finance providers have always been whether the money that they provide will be repaid in full together with the interest thereon promptly. These difficulties faced by MFIs have triggered a great deal of researches on ways through which these problems can actually be addressed. Addressing these concerns also, several agencies have been established to help rank the MFIs according to their credit worthiness. Several researchers however have assessed how the financial performance affects the ratings but none has been able to identify the social performance effect on these ratings, Beisland and Mersland(2012). This research therefore sought to assess the factors, including the social performance ones, which affect the ratings of the MFIs and the applicability of these ratings in Tanzania.

## 1.1. Background

Rating of microfinance institutions is the process of assigning the values that determine the probability of the MFI to pay its debts in full together with the interest thereon, to the fund providers. These rating values are used by finance providers in assessing the credit worthiness of the MFIs that seeks to secure funds from them.

A good rating for an institution increases the chances that it will secure enough funds at cheap cost compared to the other MFI with poor rating. The MFIs will utilize these funds in investing in some businesses including providing the microcredit services to its members so as to make profits for the survival and development of the institutions themselves as well as for paying back to the capital providers. For them to do this, they need an efficient operation system that ensures profits are continuously made and the financial management system that ensures these collected profits are economically utilized for the betterment of the MFI in general.

These operating systems and financial management systems will generally determine the level of riskiness the financial institutions will be in default with respect to the borrowed funds and interest thereon.

In a research conducted by Beisland and Mersland(2012) it was suggested that these ratings are mainly driven by size, profitability, and risk. Another study by Gutiérrez-Nieto and Serrano-Cinca (2010) also came up with similar suggestion that “As expected, the larger, the more profitable, the more productive, and the less risky, achieved the better rating”. All these studies failed to spot the impact of the social performance on the rating of the MFIs as none of the factors they named to have effect on the ratings is actually connected with the social performance the MFIs. This study therefore was built on this foundation trying to highlight the impact of the social performance on these ratings of the MFIs particularly the member based MFIs.

### 1.1.1. MFI industry in Tanzania

There are three main categories of microfinance institution (MFI) in Tanzania, the first being non-governmental organizations (NGOs). The most prominent NGOs include PRIDE, FINCA, SEDA and PTF. Banking institutions also offer a range of microcredit products. The largest banks are the National Microfinance Bank (NMB), CRDB bank and Akiba Commercial Bank (ACB). There are a few regional and community banks, namely Dar es Salaam Community Bank, Mwanga Community Bank, Mufindi Community bank, Kilimanjaro Cooperative Bank, Mbinga Community Bank and Kagera Cooperative Bank. Lastly, cooperative based institutions (SACCOS and SACCAS), which are not regulated by the Bank of Tanzania. They provide financial services that are predominately savings based.

## 1.2. Statement of the problem

Donors and providers of funds to the microfinance institutions have had concerns about whether the funds they are providing are actually used effectively and efficiently in attaining the desired objectives and whether the MFIs will be able to repay back the amounts that the investors have provided together with the interest on them.

As a consequence of these concerns, different agencies have been formed that work on the assessment of the MFIs to establish the ratings that will be used as assessment tool for creditworthiness of the MFIs. The ratings are basically expected to reveal the extent of financial as well as the social performance of the MFIs. Bala and Garibian (2009) believe that the establishment of a common framework and consistent, accepted standards for evaluating the credit profile of MFIs will enhance transparency, providing clear information and disclosure benchmarks.

To achieve this objective, various models has been developed that will be used in assessing the performance of the MFIs in financial as well as in social terms. Then therefore, this study aimed at assessing the factors behind the rating of the MFIs.

Nonetheless, the research will further examine the current system of assessing the credit worthiness of the MFIs in Tanzania in which the Registrar of Cooperatives, through Regional Cooperative Departments, sets the maximum amount that an MFI can borrow. Wangwe and Lwakatare (2004) suggested that this system is inefficient in that “these Departments have very low capacity to undertake such tasks, part of the problem being that they are very much under-funded, and lack adequate facilitation to implement their functions satisfactorily". The two went on suggesting that the system has resulted into poor supervision, including weak accounting and monitoring. Hence the research assessed the possibility of implementing the rating system in Tanzanian microfinance industry.

### 1.3. Objectives

The main (general) objective of this research was to determine the factors that affect the rating of the MFIs on the order of their credit worthiness. However the research also sought to assess the applicability of these ratings in Tanzania. As part of the use of the findings, the study has established and formulated some of the ways that could help the MFIs improve their operations and hence secure stable sources of funds.

### 1.4. Specific objectives

On its way to attain the main objective, the study was guided by the following specific objectives:

i. To identify the reasons behind the rating of the MFIs
ii. To assess the procedures used for rating the MFIs
iii. To assess the social performance factors contribution in the ratings
iv. To assess the applicability of these ratings in Tanzania

### 1.5. Research question(s)

With main objective being to enquire the factors behind the ratings of the MFIs then the study was set up to respond to the main question that "what are the factors behind the rating of the MFIs?" The specific objectives however were to address the following specific questions which both aimed towards achieving the main objective of the research:

i. Why is it important to assess the performance of the MFIs and rate them accordingly?
ii. What procedures are used (followed) when rating the MFI?

iii. Does the social performance of the MFI have effect on its level of rating?
iv. How different is this system of MFIs rating different from that prevailing in Tanzania?
v. Can this rating system be applied in Tanzania?

### 1.6. Scope

This research intended to cover the member based part of the microfinance industry. It was basically looking on those factors considered in the ratings of the MFI's worldwide. However, it further went on assessing the applicability of these ratings in the Tanzanian context with Nyamagana and Ilemela districts of Mwanza region taken as a case area.

### 1.7. Significance

The findings from this research most importantly contribute toward the knowledge currently available about the MFIs but also can found helpful in other different ways the following inclusive:

i. To the funds providers, these findings can be helpful for them in assessing the credit worthiness of the borrowing MFIs with easiness and reduce the rate of defaulted payments.
ii. To the MFIs, the research findings might help them in knowing what is required of them so that they can secure funds from lenders and as a result smoothening their operations
iii. To the researcher, this research forms one of the major requirements that are expected of him before being awarded the masters degree in accounting and finance and in doing so it does help him consolidating his knowledge on the microfinance field.
iv. The findings might also be helpful for the government policy makers in helping the private sector reducing the unemployment in the country.
v. The research also lays the foundation for further researches to be conducted on the issues concerning the MFI in future.

### 1.8. Limitations to the study

This research required a great deal of relevant information in order to come up with a valid conclusion on the subject. However, the following was considered to be setbacks towards attainment of that goal.

i. Lack of sufficient time for data collection and data analysis. This problem rendered the use of sample imperative. Using sample is in most of the time associated with sampling error and probably the use of none representative sample. To avoid this setback, a careful and much well designed sampling technique was used.

ii. Finances posed another threat. For the researcher to gain access to the required information, funds were needed in sufficiency and timely available. Since resources are often scarce compared to their requirement then a well designed budget was planned to ensure that no part of the available funds was put into unnecessary use and priorities were observed.

iii. Reluctance of the some people to provide the required information. Some people were reluctant to provide information when called upon due to fear of being implicated on some of the issues or simply the lack of transparency policy of some of the institutions. This problem was to some extent addressed through putting no requirement for disclosure of any person's identity in responding to any questions from the researcher when giving any information considered fit.

# CHAPTER TWO

# LITERATURE REVIEW

## 2.0. Introduction

This study attempts to analyze and present facts on the factors that determine the level of ratings for MFIs and assess whether the rating system can be applied in Tanzania. The researcher used contributions from different authors and disciplines to accomplish this task. The approach used by the researcher was to review existing theories and empirical evidence on the subjects of interest with a view of identifying knowledge gap and hence establish a study that will be beneficial to the Tanzania public and the academic community at large. This chapter therefore will shade light on various literatures that the researcher reviewed while doing this research study.

## 2.1. Microfinance and Microfinance Institutions

Microfinance is usually understood to entail the provision of financial services to micro-entrepreneurs and small businesses, which lack access to banking and related services due to the high transaction costs associated with serving these client categories. Banks need to at least recover the amount spent in serving its client let alone the margins for profits. Now if a bank is to break even it needs to cut short its costs by for example through maintaining few accounts of their well-off clients. By doing so the bank might be able to charge low rates for any finances extended by the bank to its clients. Unlike serving poor clients, the bank will need to maintain many customers accounts each with little amount of funds extended. This makes the costs of maintaining clients' accounts ridiculously increasing hence a need to charge higher rates (www.wikipedia.com).

This calls for specialized institutions to come into place to help poor people with financial services and therefore the MFIs. MFIs are, therefore, organizations which seek to serve the financial needs of the micro-entrepreneurs and small businesses. These institutions are always setup to bring financial services to the class of people who have got no access to financial services from commercial banks and other investment banks.

Microfinance Institutions (MFIs) are not a rarity any more, but are now becoming important members of financial and banking systems, at least in developing countries. Their growth parameters are outstanding, both in the number of entities and in the number of clients. According to Daley-Harris (2005), as of December 2004, 3,164 microcredit institutions were reported to have reached 92.3 million clients. There was also a growth rate of 21.6% per annum in terms of poorest clients served as the number of poorest clients increased from 54.8 million clients at the end of 2003 to 66.6 million clients at the end of 2004.

The focus of MFIs in social matters appears to be their main attraction. Many of their borrowers are socially excluded, and they lack access to conventional credit systems due to the lack of real assets to use as collateral for loans and they often rely on relatives for financial assistances.

The MFIs offer a wide range of services to their clients the most notable one being micro credict. Microcredit is the credit facility extended by MFIs to low income clients.

Historically the concept of MFI dates several years back but in early 1970s it gained popularity after the work of Muhammad Yunus (the Nobel Peace Prize winner himself) for his work at the Grameen Bank of Bangladesh. The bank was formed to provide loans to poor people were considered risky in India.

### 2.2. The Ratings of Microfinance Institutions

With its popularity however, MFIs have been faced with several problems particularly the issue of securing funds to finance its operation and to serve its clients. In an effort to overcome that problem different agencies have tried to rate the MFIs as they attempt to present the MFI’s performances when it comes to the evaluation of their performance for getting funds from financial providers. These Rating assessments of microfinance institutions (MFIs) are claimed to measure a combination of creditworthiness, trustworthiness, and excellence in microfinance, Beisland and Mersland(2012). Now the question is “what are the factors are considered when determining the level of ratings for these MFIs?”

Although MFIs can obtain funds from financial markets, funds from donors or socially responsible investors are widespread. These providers of funds not only aim at economic return but also at social return. Donors and investors want to know how well their money is being managed. This has stirred the recent development of MFI rating agencies. MFIs have to submit themselves to performance assessments taking into account their dual nature: financial and social. Is it possible to aim at so different goals like being profitable and lending to the poor?
What aspects matter to develop a MFI rating? This paper will analyze the rating assessments received by MFIs.

Industrial corporate bonds rating exist since the early 1900s, Levich et al (2002). Nowadays it is a blooming industry, led by some of the longest existing rating firms, such as Standard & Poor’s, Moody’s, and Fitch. By contrast, MFI ratings are fairly new, since first evaluations were made in 1996, Gutiérrez-Nieto and Serrano-Cinca (2010). There are two kinds of institutions that perform this task: conventional rating firms and specialized microfinance rating companies and according to Jansson (2003), the conventional rating firms are starting to work with microfinance while and the specialized microfinance rating lack popularity among investors.

The CGAP (Consultative Group to Assist the Poorest), and the IADB (Inter-American Development Bank), created in 2001 the Microfinance Rating and Assessment Fund (Rating Fund). Rating Fund is a marketplace for rating agencies and MFIs. The providers of rating services carry out credit ratings or global risk assessments. According to Rating Fund, a credit rating is “an opinion of the ability and willingness to pay a specific debt obligation on time; it measures creditworthiness and always has a grade”. Regarding MFIs credit ratings, there are a number of anecdotes; the pioneer local issue was launched in 2002 by Compartamos, a Mexican MFI, Gutiérrez-Nieto and Serrano-Cinca (2010).

## 2.3. Institutionists vs Welfarists

Global risk assessments are defined by Rating Fund as "an opinion of the ability to deliver according to objectives", Gutiérrez-Nieto and Serrano-Cinca (2010). While expectations might be different between donors or investors, the assessment obtained from rating agencies is a matter of interest for both funding sources. It seems that investors prefer sustainability to outreach. Donors in the other hand prefer social impact to sustainability. Thus, investors would generally prefer a financial strength based rating assessment and donors a social centered one. The debate about this issue of rating assessment have led to the development of a strata of schools of thought; one called the institutionists the others known as welfarists, Yaron (1994), Conning (1999), Woller et al. (1999).

Institutionists prefer financial self-sufficiency and sustainability. Their argument is that a sustainable MFI will survive with its own revenues, without the help of external donors; Adams and Von Pischke (1992). Welfarists say that MFIs role is to help the poor; and that sustainability should be a secondary issue; Hulme and Mosley (1996). For some eclectics, both visions can co-exist; Morduch (2000).

## 2.4. Study Variables

The variables employed in this study are those for measuring the financial performance and those for social performance. Each of them is well elaborated in the following section together with how they will be operationalized in the study.

### 2.4.1. Financial Performance

To get an insight into the financial performance, it is necessary to analyze the measures of financial performance into measures of Size, Profitability, Riskness and Efficiency. Each of these measures will further be analyzed into more observable variables as follows:

#### 2.4.1.1. Size

The assumption is that as the size of the MFI increases its respective rating is likely to increase as well. Pioneer studies, such as Ederington (1985) included variables measuring size like assets, number of employees, or turnover. Gutiérrez-Nieto, B. and Serrano-Cinca (2007) also suggested that "size can be measured in a number of ways. As a first indicator, we selected Total Assets (TA). As a second measure, we chose the Gross Loan Portfolio (GLP) because MFIs are financial institutions. So with the given data, we will use total assets (TA), gross loan portfolio (GLP) and personnel (P) as the appropriate variable to measure the size of the MFI".

#### 2.4.1.2. Profitability

Rationally, the rating of the MFI improves with its profitability. As Beisland and Mersland(2012) put it, "The more profitable the MFI, the higher the rating". Companies with better returns will have more capacity to meet their financial obligations, and therefore, get a good rating, Gutiérrez-Nieto and Serrano-Cinca (2010). Therefore it is logical to expect the MFI which is highly profitable to have a better rating. In this study, the profitability of an MFI will be represented by Return on assets (ROA), Return on equity (ROE) and Operational self-sufficiency (OSS) which considers the extent to which interest and other financial revenue covers financial expenses, loan impairment charges and operating expenses, Hamilton S M. et al (2008).

#### 2.4.1.3. Riskiness

This is the measure of the chances that the MFI will default the payments of the interest on funds borrowed as well as the repayment of the principal. It is one of the major concerns of the investors when deciding on provision of capital to the MFIs. Gutiérrez-Nieto and Serrano-Cinca (2010) applied portfolio at risk and the written off portfolio as the measure of riskiness of the MFI therefore in this study the Portfolio at risk for more than 30 days (PAR) will be used as the measure of riskiness.

#### 2.4.1.4. Efficiency

Efficiency is a crucial aspect of every financial institution, which implies the rational use of inputs and outputs, Gutiérrez-Nieto and Serrano-Cinca (2010). Impliedly then, as the efficiency of an MFI improves it is logical to presume that the respective rating of the MFI improves as well. To represent efficiency in this study the variables Cost per borrower (CPB) and Borrowers per staff member (BPS) will be used as Beisland and Mersland (2012) did in their study.

### 2.4.2. Social performance

As with the logical thinking, it is very hard for a company to attain the better performance socially while keeping the level of profitability as high. This is due to the fact that better performance socially entails provision of financial assistance to low income groups, which are often considered risks, at low rates while profitability requires charging considerably higher rates and in the mean time keeping the operating costs as minimum as possible. Beisland and Mersland (2012) say that, it is now being asked whether microfinance institutions (MFIs) actually help bring poor people out of poverty, charge overly high lending rates, and practice collection methods that are too heavy handed. They do this so that they could improve their financial performances like profitability and others. This suggests that the social performances have negative correlation with the financial ones. Having noted that, intuitively from the institutionists' perpective, the rating of an MFI can be said to be negatively influenced by the level of social performance that the MFI attains.

Literatures however suggest that there is no relationship that exists between the level of social performance attained by the MFI and its respective rating. As Gutiérrez-Nieto and Serrano-Cinca (2007) said there is no observed relationship between social performance and rating. This study therefore will seek to establish direction of the effects of social performance of the MFI on its rating if indeed such relation exists.

Now the issue will be how the social performance will be measured.

To represent the measures of social performance the following variables will be used

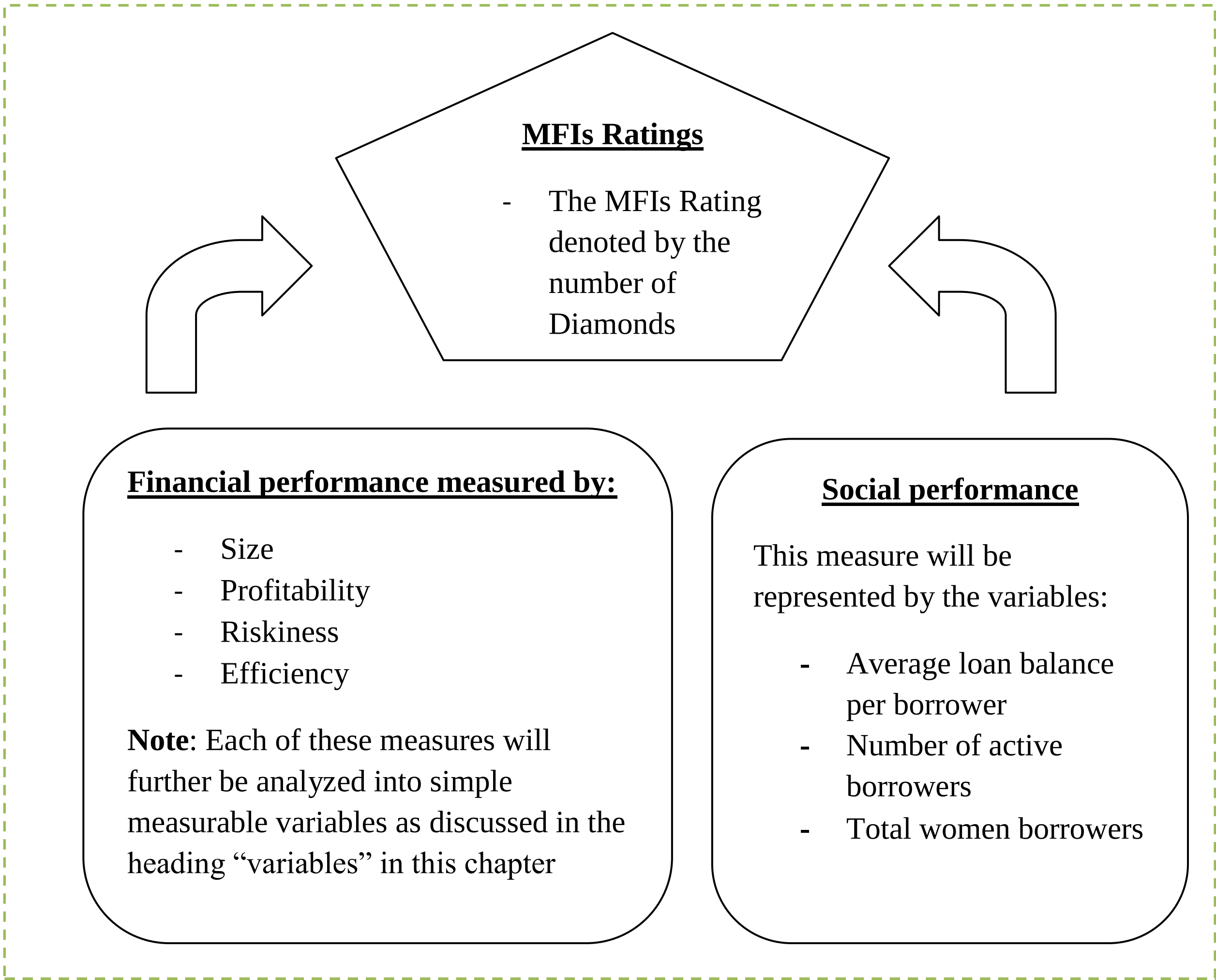
**i.** Average loan balance per borrower (ALPB); assuming that with the average loan balance per borrower decreasing, the number of borrowers will be increasing meaning the MFI does reach scores of people.

**ii.** Number of active borrowers (NAB); as with the ALPB, the MFI is perceived to have performed better socially if it reaches a great deal of people in the community. So rating will be positively influenced with number of active borrowers.

**iii.** Total women borrowers (TWB); the level of women involvement in social developmental project suggests a level of social contribution of such a project. So for the purpose of this study number of women borrowers will be used as one of the indicators of the level of social performance of an MFI.

## 2.5. Conceptual Framework

**Figure 2.1 Conceptual Framework**




Source: Researcher's Construction

Figure 2.1 explains roughly the determinant of the level of rating for an MFI. The diagram shows that, the level of ratings is generally dependent on the social performance as well as the financial performance of an MFI. However, the direction of the relationship existing between each of the explanatory variables and the dependent variable can better be explained using the following set of hypotheses:

i. MFI ratings with financial performance

- *Rating of the MFI is positively dependent on the size of the MFI*
- *Rating of the MFI is positively affected by the IMF's level of profitability*
- *Riskiness level affects the rating of the MFI negatively.*
- *Rating improves with improvement in the efficiency of the MFI*

ii. MFI ratings with social performance

- *Ratings is negatively dependent on the average loan balance per borrower*
- *Rating will be positively influenced with number of active borrowers*
- *Rating of the MFI will be positively dependent on the number of women borrowers.*

These hypotheses will be subjected to the quantitative analysis technique to ascertain whether there is any significant relationship between the dependent and the independent variables as discussed in the next chapter (methodology).

## 2.6. MFI Industry in Tanzania, an Overview

The microfinance industry in Tanzania is relatively young and limited in scale. The World Bank estimates that less than 20% of Tanzania's working population – approximately 13 million people – has access to mainstream banking service. In an attempt to address this, many banks have recently begun targeting the poor by extending collateral-free and low interest microcredit and loans. Due to lack of skills and experience within the market these efforts are not widespread and mostly favor borrowers in urban areas, leaving the rural areas largely underserved. Of the estimated 800 institutions providing financial services to low-income borrowers in Tanzania, most are reluctant to move into rural areas due to the poor national infrastructure, perceptions of high risk and due to the higher expense of operating costs, Triodos-Facet (2007).

Since 2003, there have been positive developments in Tanzania's microfinance industry as numerous banks and financial institutions have provided increased funding either directly to beneficiaries or through intermediary institutions. Despite this progress, it is estimated that microfinance service providers have a combined outreach of approximately 500,000 clients, which is only about 5% of the estimated total demand, Bank of Tanzania, (2011).

Over the past fifteen years, the financial sector as a whole has undergone major changes from the originally state-owned and -controlled system to a liberalized financial sector, Triodos-Facet (2007). Principal elements of reform included liberalization of interest rates, restructuring of state-owned financial institutions, strengthening the BoT's role in regulating and supervising financial institutions, and allowing entry of local and private banks into the market.

By December 2006, total bank assets stood at Tshs. 6.6 Trillion, total customer deposits amounted to Tshs. 5.3 Trillion, with Tshs. 2.4 Trillion outstanding in loans and advances. In all three aspects, there has been over 200% growth compared to 2002. The sector counted 294 bank branches and 176 ATMs, and employed 6,400 Tanzanians, Bank of Tanzania, (2011).

### 2.7. National MFI Policies

Over the past 5-10 years the enabling environment for microfinance in Tanzania has improved significantly. The GOT has come out strongly in support of the development of the industry.

The *National Microfinance Policy*, approved by Cabinet in May 2000, articulates a clear vision for the development of a sustainable microfinance industry, specifying the respective roles of the key stakeholders. According to the policy, the private sector is to be the key provider of financial services; the Government is not to engage actively in the delivery of microfinance. Providers of microfinance are expected to apply sound financial principles in delivery of their services, particularly with respect to pricing, loan delinquency control, financial reporting, appropriate techniques and products, gender equity and governance.

The microfinance policy is part of the wider policy framework for Tanzania. Other national policies and strategies with relevance to microfinance include:

- *The National Strategy for Growth and Reduction of Poverty* (known as MKUKUTA, 2005 – 2010) contains Tanzania's overall development strategy. The MKUKUTA addresses three clusters of outcomes: i) growth, and the reduction of income poverty; ii) improving the quality of life and social well-being; and iii) strengthening governance and accountability.
- *Small and Medium Enterprises Development Policy*, Ministry of Industry and Trade, 2002;
- *National Land Policy*, 1995

The Government of Tanzania has also come out strongly in support of the revival and strengthening of SACCOs. The cooperative history in Tanzania is a tainted one: in the past, the system was highly politicized, resulting in mismanagement, poor governance and in many cases collapse, all at the expense of poor (rural) producers and their savings.

In 2001, the Tanzania mainland Department of Cooperatives within the Agricultural Ministry was upgraded to the Ministry of Cooperatives and Marketing. In 2002, a new National Cooperative Development Policy was approved, in line with the 1995 International Cooperative Alliance (ICA) Statement of Cooperative Identity and Principles.

In 2006, the Government introduced the National Economic Empowerment and Job Creation Programme. The programme encourages the establishment of SACCOs at Ward level and offers to lend them a total of Tshs. 21 Billion (Tsh. 1 Billion per region, therefore popularly known as the 'JK Billions'). So far, the Government has approved NMB and CRDB as its agents to channel the funds to individuals and SACCOs. Financial institutions are expected to triple the amount guaranteed by the Government. By end of March 2007, NMB had received over 50,000 applications and stopped accepting more. In the near future, MFIs, SCCULT and SELF are expected to channel part of the funds.

The Government and BoT, with support from FSDT, aim to develop a Rural Finance Services Strategy in 2008.

Tanzania has a tiered structure of licensed and prudentially regulated and supervised financial institutions through different entry requirements in terms of required minimum core capitalization, for commercial banks, non-bank financial institutions, Micro-Finance Companies (MFCs) and Financial Cooperatives (FICOs) as indicated in Table 2.1.

**Table 2.1**

| **Minimum Capital Requirements** | **Tshs** |
|---|---|
| Commercial Bank | 5 Billion |
| Regional Unit Commercial Bank | 200 Million – 50 Million |
| Non-Bank Financial Institution | 100 Million – 50 Million |
| Micro Finance Company (MFC) | 800 Million (national) |
| | 200 Million (1 unit) |
| Financial Cooperative (FICO) | 800 Million in savings and deposits |

**Source: Triodos-Facet 2007**

The regulatory and supervisory framework includes the following Acts:

- *The Banking and Financial Institutions Act (2006)*;
- *The Bank of Tanzania Act (2006);*
- *The Companies Ordinance (Cap 212).*

In addition, a number of Regulations are relevant for microfinance activities:

- *The Microfinance Companies and Microcredit Activities Regulations (2005)*. This allows for the establishment of MFCs, able to take deposits from the public, subject to supervision of BoT.
  The minimum core capital requirement for MFCs has been set at Tshs. 800 Million for a nationwide network and Tshs. 200 Million for a one unit entity. So far, no MFC has yet been licensed.
- *Banking and Financial Institutions Regulations (1997)* prescribe conditions of entry or exit into the banking industry in Tanzania (licensing requirements).
- *Capital Adequacy Regulations (2001)* provide for capital adequacy requirements for various forms of banking institutions in Tanzania.

Other regulations for the MFI industry include:

- National Microfinance Policy
- The cooperative Development Policy, 2002
- The cooperative Societies Act, 2003
- The cooperative Societies Regulations, 2004

- Microfinance Regulations, 2005

The microfinance Regulations were approved by the Government on 25th March, 2005 comprising regulations for internal control and Internal Audit; Microfinance Companies, Micro credit Activities and Financial Cooperatives. .As of to date, the implementation of the Microfinance Companies and Financial Cooperatives Societies has not created positive results. NGOs MFIs and SACCOS have not transformed to Microfinance Companies or FICCOS respectively. Therefore, Commercial Banks and Community Banks remain to be regulated institutions providing microfinance services in Tanzania. SACCOS receive some limited supervisory services governed by the Cooperative Act.

According to the Microfinance Policy, Government should not interfere on MFIs operations such as pricing, product development, loan terms, etc. Ministry of Finance has the responsibility of ensuring that microfinance programs are consistent with the policy. However, the Government still plays a direct role in lending through JK Funds (JK Millions), Local Authorities Funds for Youth and Women and SELF Project. The main concern for the microfinance industry is that some of the Government funds offer subsidized interest for example JK Funds which in turn distort the market.

Entities applying for a license from the BoT as a commercial bank, non-bank financial institution or MFC have to be legally registered with the Registrar of Companies (the Business Registration and Licensing Agency, BRELA) as companies limited by shares under the Companies Ordinance (Cap 212).

### 2.8. National Microfinance Networks

Networks are the principal private sector advocacy groups for the microfinance industry and serve as a unifying force for the development and expansion of a range of institutions providing financial services to the low segment of the population. The role of the networks is, therefore, of working together to create self-regulatory mechanisms, define standards and help organizations improve their operations to meet set standards.

### 2.8.1. *Tanzanian Association of Microfinance Institutions (TAMFI)*

Comprised of 41 member groups including 2 commercial banks, 3 community banks and 36 NGOs, TAMFI is the umbrella organization for microfinance institutions operating in Tanzania. TAMFI is an open forum devoted to strengthening the microfinance sector by promoting cooperation and collaboration among its members. Through lobbying and advocacy, TAMFI aims to create and maintain a strong regulatory framework for Tanzania's microfinance industry. TAMFI also carries out research relevant for MFI development in Tanzania and provides viable suggestions to member organizations. Membership is voluntary and open to all institutions involved in microfinance activities, including commercial banks and financial institutions, community banks, NGOs and SACCOs.

### 2.8.2. *Tanzania Federation of Cooperatives (TFC)*

Tanzania Federation of Cooperatives is the national umbrella organization for cooperative-based institutions. It promotes and coordinates the development of all cooperative-based institutions. Founded in 1994, TFC is an autonomous, non-governmental and non-partisan body that is member owned and managed. The founding members consist of five National Cooperative apexes from tobacco, cotton, coffee, cashew and cereal and other produce industries; two specialized Unions (Savings and Credit Cooperative Union of Tanzania – SCCULT, and Tanzania Industrial Co-operative Union) and six Cooperative Unions. TFC replaced the then Cooperative union of Tanzania (CUT) following the enactment of the new Cooperative Act in 1991, which rescinded the political association of the current ruling party. The Cooperative Act of 1991 stressed the importance of an autonomous cooperative body with member empowerment, resulting in the formation of the TFC. Currently, the cooperative movement comprises of about 6,000 Cooperative Societies having about 700,000 members.

### 2.8.3. *Savings and Credit Cooperatives Union League of Tanzania (SCCULT)*

SCCULT is National Association of SACCOs in mainland Tanzania and was formed in 1992. It was registered on 19th October 1992. SCCULT is governed by an elected nine member Management Board. Currently SCCULT has 671 members SACCO affiliates. The role of SCCULT is to promote, develop and strengthen SACCOs in Tanzania by providing diverse financial services in a competitive environment. The goal of these efforts is to assist individuals in alleviating poverty, commanding respect and dignity, and promoting equity and justice.

### 2.8.4. *The Community Banks Association (CBA)*

The Community Banks Association was founded by Tanzania Gatsby Trust (TGT) in liaison with all community banks in Tanzania in the year 2005. The Association was registered under the Societies Ordinance of 1954 (rule 5) with Registration issued on 1st day of February 2006. The association is an instrument for Delivering Financial and Non-Financial Services to Community Banks which serves the micro, small and medium sized enterprises, considered to be the true engines of economic growth. The CBA's Mission *is ''to mobilize resources so as to maximize value and economically empower community banks in Tanzania by offering financial and non-financial resources efficiently and effectively for mutual benefit of all parties''*

## 2.9. Savings and Credit Cooperatives (SACCOs)

Savings and Credit Cooperatives were first established in Tanzania in the 1920s and have since played a vital role in the country's economic and social development. The principle behind cooperatives is that they are owned and controlled by their own members in the community. Figures from 2006 showed that there were 1,507 registered SACCOs with 217,418 individual members in Tanzania, although only 761 were listed as active SACCOs. The cooperatives serve an estimated 130,000 clients, most of whom are savers. There are nearly twice as many SACCOs based in urban areas than rural. SACCOs are formally registered by the Ministry of Cooperatives and Marketing. The Cooperatives Audit and Supervision Corporation (COASCO) is mandated to conduct an annual external audit of all SACCOs. In practice, supervision by the Ministry of Cooperatives and Marketing (through the Registrar of Cooperatives) is weak. Partly this is due to lack of adequate technical staff and resources. However, there also seems to be lack of willingness (and/or political room) to take restrictive actions against SACCOs that do not abide by the laws.

Tanzanian cooperatives provide a valuable service to low-income borrowers, offering a safe place to make savings and access loans. In 2006, almost 700 SACCOs were affiliated with SCCULT, accounting for 92,687 individual members. However, the SACCOs in Tanzania have been accused of being "*unable to cope with modern realities*", their image having been tarnished by poor administration, poor leadership, unreliable business practices, and corruption.

Tanzanian cooperatives need to undergo a comprehensive transformation and refocus attention on their founding principles in order to survive. To be successful, cooperatives must be sustainable, viable business enterprises that maintain the trust of their communities. A number of significant steps have been taken in the last ten years to help revive this sector, including the 2000 Special Presidential Committee on reviving cooperatives and the new cooperative legislation of 2004. These efforts culminated in the writing of a key strategic document, The Cooperative Reform and Modernization Program 2005-2015.

This is a home grown initiative and was produced with the direct involvement of Tanzanian cooperatives, rather than by external consultants. A number of important issues were identified. These included concerns about poor management, inappropriate cooperative structures, a lack of working capital, a lack of cooperative democracy and education, weak supporting institutions, and some instances of corruption and embezzlement. The Program is now working towards establishing economically strong cooperative societies that are capable of facing competitive challenges, and an empowered membership with good governance and accountability. The aim is to develop a network of cooperatives that has an efficient and cost effective structure, and is able to respond easily to the needs of its members.

The program is a part of a larger effort on behalf of the Tanzanian government to promote economic development, including MKUKUTA – the National Strategy for Growth and Reduction of Poverty adopted in June 2005. In October 2010, Tanzania also invited the World Council of Credit Unions (WOCCU) to develop a stronger regulatory framework for the credit union sector. Additionally, WOCCU hopes to address the scarce liquidity and long waiting periods to obtain a loan with SACCOS. Many of these organizations are volunteer-run and despite efforts taken by the Bank of Tanzania, regulation and supervision have been virtually non-existent in rural areas of the country. This is particularly important as the number of financial cooperatives in Tanzania has exploded in recent years, increasing over 50% in only three years. Despite the proliferation of SACCOS, no single entity provides centralized financial or statistical information on the institutions. As the SACCOS sector continues to grow, it faces an increasing need for central oversight to ensure appropriate the financial discipline needed to protect member savings

The Cooperative Societies Act, 2003 creates four cooperative tiers: primary cooperative societies; secondary cooperative societies; apex cooperative societies and federation, Bank of Tanzania, (2011). The allocation of powers between the different levels, however, is not clearly indicated in the law. In addition, the Cooperative Rules 2004 were formulated, containing amongst others prudential guidelines for SACCOs.
In 2005, the Financial Cooperative Societies Regulations were approved. These regulations specify that Savings and Credit Cooperatives engaged in accepting savings and deposits from their members for an amount totaling or greater than Tshs. 800 Million will be licensed as a Financial Cooperative (FICO), supervised by the BoT. So far, no FICO has yet been licensed.

## 2.10. Funders and Donors

The international donor agencies provide not only substantial financial resources to serve as loan and investment capital for microfinance NGOs but they also technical assistance for staff capacity building and technology transfer of best practice in microfinance. In this context they comprise a significant and influential stakeholder group in Tanzanian microfinance. The list of recipients include Bank of Tanzania, the High Court and Commercial Court, The Ministry of Cooperatives and Marketing, the second tier and third tier organizations for cooperative societies as well as the primary SACCOs, the commercial banks, the regional and rural unit banks providing microfinance services such as Kilimanjaro Cooperative Bank, Mufindi Community Bank and Mwanza Rural Community Bank, as well as the numerous microfinance NGOs including the newly established NGO network organization – Tanzania Association of Microfinance Institutions.

An important item that needs to be properly recognized by the Tanzanian microfinance industry is that continued reliance and dependence on donor funds and assistance is not viable, and that this particular resource will at some point be exhausted. Microfinance under private initiative is a relatively new development in Tanzania when compared to other countries, and the industries stakeholders have been encouraged towards placing microfinance development on a sustainable path. External advisers and consultants can assist in the construction and crafting of a legal and regulatory framework for the sector but the primary responsibility for incorporating these into the design of the framework must belong to local stakeholders. Establishing effective coordination will be beneficial, not only for the international donors but for the microfinance institutions themselves. Without coordinated efforts, there will continue to be instances of NGOs changing and shifting their focus so as to fit donors' goals, and of the scarce resources becoming less productive.

## 2.11. Demand for Financial Services

There is a huge unsatisfied demand for financial services both in rural and urban areas of Tanzania. Approximately 70% of the population lives in rural areas and has limited or no access to financial services, Bank of Tanzania, (2011). In 2006, FSDT commissioned a national survey of the demand for, and barriers to, accessing financial services. With close to 5,000 interviews conducted, the *FinScope Survey* represents the national population of 16 years and over, on the mainland and Zanzibar (21 Million people).
Initial analysis was done by FSDT early 2007 and presented and discussed in a series of workshops (for commercial banks, SACCOs, MFIs, mobile phone companies, researchers). Main findings from FinScope include (all figures and statistics are according to Triodos-Facet (2007):

***Population profile***: confirms that the population of Tanzania is relatively young: 57% of the adult population is less than 34 years, and mainly rural-based (72%). In addition, there are approximately 14 Million people under 16 years of age, which fall outside the scope of this survey.

***Exclusion***: A large segment (54% overall; 45% of urban, 57% of rural) of the adult population has *no access at all* to financial services, either formal or informal (overall, 9% has a formal bank account (11% men, 5% women, 16% urban, 4% rural), 2% has access to semi-formal finance (NGOs, SACCOs) and 35% has access to informal finance like ROSCAs/ASCAs and moneylenders – these categories are mutually exclusive). Only 20% of the population has access to formal bank within 1 hour walking distance.

***Financial literacy***: is generally low, and lower still for women and for people living in rural areas (92% of the population has heard of loans, but 84% do not understand how interest rates work, or collateral, guarantors, opening an account etc.; 27% has never heard of a savings account). Beyond loans and savings, financial literacy is close to nil (e.g. on insurance, ATMs). Nevertheless, 82% of the total population indicated that they would like to know how to open an account in a financial institution. This indicates a huge need for better and more communication on financial services with the larger population, in the right language.

***Sources of income***: Only 4% of the population is employed in the formal sector. Most people make a living from agriculture, either by selling food crops (36%), cash crops (12%), cattle/livestock produce (9%), or livestock (11%). Others run an informal small business (28%), not (directly) related to agriculture. A large majority of people (61%) goes without cash income at times. Many (28%) depend on getting money from family and friends.

***Use of credit and loan facilities***: of those that borrow, most (38%) turn to family and friends. An additional 33% has a loan from a kiosk, 23% borrows in-kind (e.g. livestock). Only 4% said that they have a loan from a bank (5% of men, 1% of women). SACCOs and MFIs serve only a small percent of all borrowers; 9% and 6% respectively.

***Use of savings facilities***: most people with money do not save it with a bank or financial institution. Of those who save, four out of ten favour saving in-kind (even more so in rural areas) and three out of ten say they keep money in a secret hiding place (similar for urban and rural).
Another interesting aspect is that of the people with a bank account (9%), many also save with or borrow from informal providers (48%), SACCOs (26%) or MFIs (15%).

***Non-monetary financial services***: Out of the 54% that has no access at all, 20% uses nonmonetary products and transactions (e.g. barter, savings-in-kind). In-kind transactions are especially popular in the rural areas (used by 84% of the rural population, 16% of urban population). Similarly, 80% of the rural population has savings in-kind, compared to 20% of the urban population. Savings in-kind are primarily in livestock (goats, cows), but also to a lesser extent in agricultural produce, food, entertainment items (e.g. radio), means of transport (e.g. bicycle), household items (e.g. salt), agricultural inputs and clothing.

***Transferring money***: 90% of all remittances are within Tanzania. When people want to transfer money around the country, they are seven times more likely to use a personal contact, and three times more likely to use a courier (usually a bus), than any kind of financial institution. Women use any method slightly less often than men.

***Technology****:* the internet and mobile phone technology is expanding the potential for financial service customers more rapidly than anything else. Although the number of people who use internet is very low (9% overall, 23% in urban and 4% in rural), nearly half the population already has access to a mobile phone. Internet access is expected to increase in the medium term when connectivity speed increases and cost goes down (e.g. through EASSy project – connecting Tanzania to international glass fibre network in 2-3 years time).

### 2.12. Financial Products and Services

There are various financial services demanded by the wider public. The services provided by the microfinance institutions in Tanzania include the following, Triodos-Facet (2007):

**Agriculture**: Agricultural finance is yet in its infancy – even though the sector provides the mainstay for the large majority of the (especially rural) population. Some of the initiatives include:

- *CRDB* has always been involved in agricultural lending to some extent, with varying degrees of success. *Barclays Bank* recently introduced a new scheme to support commercial farming (provide farm inputs and equipment straight from the supplier). Overall, commercial banks still shun away from lending to agricultural small holders, as do NGO-MFIs. Rural SACCOs are usually involved in agricultural lending, but not necessarily in a sustainable manner.
- Some interesting pilots in the area of warehouse receipt schemes, e.g. by *FBME Bank* (to be combined with insurance cover for stock in warehouses) and soon by *NMB Bank*. The World Bank is also involved in this.

- A weather insurance product has been developed, yet to be piloted further after initial pilot phase. World Bank, Technoserve, MEDA and local insurance companies will be involved.
- *USAWA* SACCOs, the network supported by FERT in Kilimanjaro, have developed certain innovations for agricultural lending;
- The *Agricultural Input Trust Fund* (AGTIF) was established by the GoT in 1994. Loans can be accessed (for inputs and tractors) through various banks and SCCULT. Dunduliza also borrowed funds from AGTIF in 2006, for on-lending to its SACCOs.
- *Tanzania Fertilizer Partnership* (involving IFAD, Ministry of Agriculture, others) aims to upgrade the agricultural supply chain, including fertilizer input.

**SME Lending**: The 'missing middle' is only recently being addressed and SME finance is still in the developmental stages. SMEs contribute over 30% of Tanzania's GDP, but lack business skills, track record and/or collateral to meet existing lending criteria from banks. Various banks have started to develop more appropriate products for SMEs:

- *Akiba Commercial Bank* is traditionally focused on SMEs and developed various products.
- *Exim Bank* received $ 6 Million from NorFund for long-term foreign currency lending to SMEs, through its 10 branches.
- *CRDB* has introduced an SME product, and trained over 700 SMEs, as have *NBC* (so far 300 SMEs attended workshops) and *Barclays Bank*.
- *BOA Bank* (former EurAfrican) has a $40 Million fund 'Aspire Tanzania' (in partnership with GroFin and Shell Foundation) which focuses on SMEs in renewable energy.
- *Tanzania Investment Bank* is being transformed by the GOT into a development bank, to become a major long-term financier to productive sectors. A recapitalization effort is underway, involving the GOT and NORSAD.

- The Government introduced a *Credit Guarantee Scheme* for SMEs. By January 2007, loans valued Tshs. 2.2 Billion had been approved under this facility, and guarantees of Tshs. 1.1 Billion had been issued. Various banks participate.
- *Equity for Africa* provides equity to SMEs, with focus on agricultural and food processing and manufacturing sectors, initially in northern Tanzania (28 investments so far, total over £ 100,000). FSDT plans to conduct an SME survey to assess the demand for financial services from SMEs in 2007/2008.

**Housing Finance**: has been introduced recently by a few banks (e.g. United Bank of Africa), but legal and regulatory issues impede growth.

- As part of the *Second Generation Financial Sector Reforms* that the Tanzanian authorities are in the process of implementing, the project will develop an integrated strategy and an action plan for mortgage finance development. This will include implementing recommendations on regulatory changes, liquidity mechanism and credit enhancement schemes and will particularly include recommendations on options for enhancing mortgage finance provision to lower income groups. The strategy will distinguish between actions needed to support development of the primary mortgage market and extra actions eventually needed to address the needs of low income households.
- *Low-cost housing finance*: *Women Advancement Trust (WAT) SACCO* in DSM (largest SACCO in Dunduliza network) is introducing low-cost housing finance. Possibly with support from UN Habitat. *FINCA Tanzania* is also experimenting with housing loans.

**Leasing Finance**: Leasing finance is in the early development stages.

- *Tanzania Leasing Project (TANZALEP)* is an IFC/SECO supported project to develop and support the growth of financial leasing. The initial focus is on developing an enabling tax, legal and regulatory framework, as an essential prerequisite for leasing development. A Leasing Act has been developed, but is yet to be approved. In addition, TANZALEP provides leasing product and business development support and training to banks, prospective leasing companies, equipment supply companies, institutional investors, micro leasing companies and various GOT departments. Tanzalep is also working on a strategy that will enable it to work closely with MFIs, to develop micro leasing for micro enterprises. Furthermore, the establishment of a national leasing association (TALA) is underway.

- Some of the current providers include *SELFINA. FINCA Tanzania* offers leasing finance for solar home systems, in partnership with Umeme Jua Limited. *Tunakopesha Limited* offers (salary-based) hire-purchase services for domestic appliances, since 1993. It has 18 branches and over 20,000 clients. The *USAWA*, the network of SACCOs in Kilimanjaro have also successfully introduced leasing loans.

**Micro-insurance**: Micro-insurance is yet in its infancy. There are no specialized providers of micro-insurance. The main existing insurance companies do not provide appropriate products or services for the rural and low-income segments. PharmAccess is preparing the piloting of a micro health insurance product, together with a local insurance firm.

**Remittances**: As highlighted by FinScope, the large majority of remittances is done through personal transfer. Only a minor part is handled by the formal financial system. For example through Western Union Money Transfer, offered by Tanzania Postal Bank, DSM Community Bank (linked with MUCOBA) and Kilimanjaro Cooperative Bank.

**HIV/AIDS**: there are a few developments and partnerships in the field of HIV/AIDS and microfinance in Tanzania.

- *PRIDE Tanzania* is associated with the Tunajali Programme (2007 – 2011, with $ 56 Million funding from USAID), which aims to provide care and (anti retro-viral) treatment to individuals through 38 participating hospitals and health centres.

- *MEDA Tanzania* was involved in research on microfinance and HIV-AIDS in 2005 (focus risk mitigation strategies related to MFI clients as well as staff), followed by a workshop.

**Technological Innovation:**

- *Umoja Switch* provides a shared card payment switching infrastructure and ATM network for a consortium of six local banks (Azania, Akiba, BOA Bank (formerly EurAfrican), Dar Es Salaam Community Bank, Twiga Bancorp and Tanzania Investment Bank). The six banks had a total of 17 branches as in 2008.
- *Debit Cards*: CRDB introduced the Tembo card, and Tanzania Postal bank offers its TanPay system. Both have a limited network of Point of Sale (POS) devices. As in 2008 there were about 200,000 Tembo-card holders. CRDB has also started to offer its Tembo cards to SACCOs. Active use of debit cards is still limited; most clients use it for ATM withdrawals.
- *Credit Cards*: Exim bank introduced Mastercard in July 2006 as the first (and only) bank but now most banks, with exception of few, offer mastercard facility to any customer in need.
- *SMS banking*: various banks have started introduction of SMS-banking, e.g. CRDB and NMB. This involves requesting and receiving information by SMS, e.g. on account balance, or alert message when salary has been deposited, transfer of funds from one's account and getting notification when they receive funds.
- *Internet banking*: various banks have introduced internet banking, e.g. NBC. However, with only 9% of the population having access to internet, this is not likely to be a driver for access to financial services for those currently excluded.
- *Mobile phone banking*: Mobile phone banking is expected to be a major driver that will create access for large amounts of people – given that already over 50% of Tanzanians has access to a mobile phone. So far, one entrant into this market has been licensed by the BOT (June 2007): *E-Felusi Africa Limited*, a local company. They are currently piloting their system (mobipawa) with FMBE

Bank. Other entrants are expected, notably *Vodacom*, which is planning to roll out its successful M-PESA from Kenya to Tanzania in 2007/2008. Other mobile phone operations may follow. There are regulatory issues yet to be addressed in the process of developing mobile banking.

### 2.13. Challenges Facing the Tanzanian MFI Industry

The microfinance industry of Tanzania faces several significant challenges in its development. These include the endeavors to become financially sustainable, the development of suitable products, and the various capacity building and technical assistance needs. Similar to other developing countries in Africa, economic activities in Tanzania are usually conducted in the informal sector. Tanzania is beginning to take steps to create a regulatory environment that makes it easier to voluntarily register a business and formalize business activities, hoping to clear some of the impediments caused by unclear regulation and discretionary enforcement

Microfinance in Tanzania also faces negative coverage in the local media. In July 2010, Tanzanian MFIs came under attack by the Daily News for charging deceptive interest rates to borrowers. The tendency for microfinance companies to advertise very low interest rates, sometimes as little as one or two percent, was labeled as a "*calculated gimmick*", often causing clients more harm than good. The Assistant Commissioner of the Policy Section in the Ministry of Finance and Economic Affairs responded to these attacks by outlining basic conditions underlying the problem, including insufficient regulation and lack of financial literacy. According to Mr. Mwakipesile, "*the majority of microfinance companies take advantage of the existing vacuum as there is no specific body to regulate their operations. Borrowers are undoubtedly lured by money lenders who talk sweetly to them, setting low interest rates of between two and five per cent. No one remembers that five per cent a month is equivalent to 60 per cent annually*." Several internationally recognized initiatives, such as MF*Transparency*, are working to help the sector address these issues and to promote a more responsible form of microfinance in Tanzania.

## 2.14. MFI Ratings and Reporting

Ratings by external rating agencies are still comparatively rare in Tanzania's relatively young microfinance industry. The Bank of Tanzania has approved 13 auditors to supervise the country's financial institutions. Non-regulated institutions may choose any auditor, while SACCOs must undergo an annual audit formally conducted by COASCO. However, these audits are often late and many times do not occur at all due to the auditor's limited knowledge and experience with the microfinance industry. In 2004 a Credit Information Bureau was established for the commercial banking sector with the Tanzania Bankers Association. However its implementation is still in process and its development has been hampered by the lack of a national ID-system.

Thirteen Tanzanian microfinance institutions had reported their data to the MIX by 2010, and fourteen institutions reported their pricing data to MF*Transparency's Pricing Initiative* in 2011. Many of these institutions have also undergone thorough ratings checks of their financial and operational performance. All three of the major rating agencies in the microfinance industry have worked in the Tanzanian microfinance market. Several MFIs have also undergone social performance ratings. Table 2.2 lists the MFIs with their respective rating score.

**Table 2.2. Rated MFIs**

| MFI | Rating Agency | Rating | Report Date (most recent) |
|---|---|---|---|
| **Financial & Operational Ratings** | | | |
| SEDA Tanzania | MicroRate | Y+ | 2007 |
| Presidential Trust Fund | MicroRate | Y+ | 2006 |
| FINCA Tanzania | MicroRate | β- | 2005 |
| Tujijenge Tanzania | Planet Rating | C- | 2010 |
| Belita | MicroFinanza Rating | | 2009 |
| ECLOF-Tanzania MicroFinanza Rating | MicroFinanza Rating | | 2011 |
| Mbinga Community Bank | MicroFinanza Rating | CCC- | 2010 |
| MuCoBA | MicroFinanza Rating | B | 2011 |
| Pride Tanzania | MicroFinanza Rating | | 2009 |

| | | | |
|---|---|---|---|
| Wedac | MicroFinanza Rating | B- | 2008 |
| YOSEFO | MicroFinanza Rating | | 2009 |
| **Social Ratings** | | | |
| Tujijenge Tanzania | Planet Rating | 1+ | 2010 |
| YOSEFO | Planet Rating | 2 | 2010 |

Source: MF*Transparency*, December 2011

# CHAPTER THREE

# RESEARCH METHODOLOGY

## 3.0. Introduction

This chapter seeks to present the methodology followed in analyzing the data collected in order to reach the conclusion about the findings of this research. This chapter describes the research design, study area, study population, sample size, data collection techniques and data analysis procedures.

## 3.1. Research Design

The study sought to establish the factors behind the rating of the MFIs. It can apparently be regarded as the qualitative design though some quantitative data analysis approach had to be borrowed so as to establish the cause and effect relationship existing between the factors adjudged to have effect on the rating and the level of rating attained by an MFI.

Since the study aimed at establishing the factors that determine the ratings of the MFIs, then it was appropriate to consider it descriptive due to the factor that there have already been some earlier studies that also tried to explore the same subject and this research built on them trying to extend the knowledge so far available on the ratings. The study further went on assessing the applicability of the ratings in Tanzania. So this study can be regarded descriptive with some elements of an exploratory study seeking to describe those factors influencing the ratings of the MFIs as well as exploring the applicability of these ratings in Tanzania.

## 3.2. Study Area

Basically the study was about the MFIs and to be more specific their respective financial units.  However, putting all the MFIs understudy was almost next to impossible. So the study was narrowed to incorporate only those member-based MFIs in Mwanza region from which sample was drawn randomly for the sake of the study.

## 3.3. Study Population

The study was conducted in Mwanza region. However not all the MFIs were studied but rather a sample was selected basing on which the conclusion about the research study were made. The study population included all the Banks offices available in the two concerned districts, the other finance providers available such as Pride and Finca, and the member-based MFIs available in concerned districts. As at March 2013 the two districts of Ilemela and Nyamagana had a total of 59 member-based MFIs distributed as 25 MFIs in Ilemela and 34 in Nyamagana.

## 3.4. Sampling Techniques

Sampling involves the selection of a group of individuals or element from a population. That group or sample can then stand for the whole. Anderson (1987) says that the purpose of taking a sample is to use the information in the sample to generalize about the population as a whole.

In this research the entire population was split into two strata. This means the stratified random sampling technique was employed. The first group was made up of the member-based MFIs available while the other was be made up of finance providers.

From the MFIs stratum, a sample was randomly selected making sure that the drawn sample is the true representative of the rest. Randomness in random sampling entails that chance alone should operate to select the elements from population so as to be included in the sample. The same was done when drawing sample from the list of the finance providers to these MFIs.

The advantage of using the stratified sampling for this study was that at least some members of the total sample will come from each stratum. It also reduced sampling error because each stratum was assured representation in the sample and because the strata restrict the spread of values contained within them. Consequently, the elements within each stratum are more like one another. The fewer different properties that have to be represented, the less likely the occurrence of error (if all elements in the population were exactly alike, no sampling error would occur).

### 3.5. Sample Size

According to Wikipedia, sample size determination is the act of choosing the number of observations or replicates to include in a statistical sample. In practice, the sample size used in a study is determined based on experience of data collection and the need to have sufficient statistical power which according to Wikipedia is the probability that the test will reject the null hypothesis when the null hypothesis is false (the probability of not committing a type II error or simply making a false negative decision/false negative rate)

Lenth (2011), says the sample must be big enough that an effect of such magnitude as to be of scientific significance will also be statistically significant. Large sample sizes generally lead to increased precision when estimating unknown parameters. However, Lenth goes on suggesting that the study must not be too big where an effect of little scientific importance is nevertheless statistically detectable an idea supported by Sekaran (2003).

Sekaran suggests that the “problem of sample size is governed by the extent of precision and confidence interval. Unless the sample size is adequate for the desired level of precision and confidence, no sampling design, however sophisticated, can be useful to the researcher in meeting the objective of the study”.

Roscoe (1975) put forward the following rule of thumb for determining the sample size:

1. Sample sizes large than 30 and less than 500 are appropriate for most researches
2. Where samples are to be broken into subsamples (male/female, junior/senior etc) a minimum sample size of 30 for each category is necessary.

3. In multivariate research (including multiple regression analyses) the sample size should be several times (preferably 10 times or more) as large as the number of variables in study.
4. For simple experimental research with tight experimental controls (matched pairs, etc), successful research is possible with samples as small as 10 to 20 in size.

Now for the purpose of this research, the sample, being made up of the finance providers and MFIs in Mwanza, it included all the possible finance provider organizations available that provide finances in form of loan to the member-based MFIs in Mwanza region and at least 50 MFIs in the region. This is due to the fact that there are relatively less institutions that provide funds to these institutions and the study therefore tried to capture the entire population of these institutions to its best possible.

However with such a mushrooming number of MFIs it was impossible to survey every single institution hence therefore it became practically wise to select just a few of the available MFIs to represent them all as shown in table 3.1.

**Table 3.1**

| **District** | **Number of MFIs available** | **Number of MFIs selected in the sample** | **Percentage in the sample** |
|---|---|---|---|
| Nyamagana | 25 | 10 | 38.5 |
| Ilemela | 34 | 16 | 61.5 |
| Total | 59 | 26 | 100 |

Source: Research data (2013)

### 3.6. Types and Sources of Data

The study used both primary, for purpose of assessing the applicability of th ratings in Tanzania, and secondary data so as to obtain the quality information that had the required integrity in assessing the trending of the ratings for different micro finances worldwide.

Ghauri and Gronhaug (2005) suggested that information collected by other organizations such as Bureau of Statistics offer more neutral information and includes not only the positive information but also the negative. They went on saying that secondary data are useful not only to find the information to solve our research problem but also to better understand and explain our research problem.

The secondary data are generally expected to be of high quality and reliability as they are collected and compiled by experts using rigorous methods.

However in reaching at the final conclusion on the applicability of the ratings in Tanzania, the study sought primary data from the lenders to these MFIs and also from the MFIs themselves.

According to www.microfinancegateway.org, an increasing number of MFIs report their performance to international databases each year. The MIX Market is the primary source for this information, containing financial and other performance data from almost 2,000 MFIs collected and processed by the Microfinance Information eXchange (MIX). Data for participating MFIs, including client outreach measures, simplified financial statements, and a number of standard financial performance indicators, is publicly available on their website.

The MIX also publishes MIX Microfinance World, featuring country, regional and global analyses based on the MIX Market database, such as benchmarking reports; and the MicroBanking Bulletin, a periodic publication covering a variety of topics including financial reporting, social performance, transparency, policy & regulation, and investment.

The Microcredit Summit Campaign collects outreach data annually from hundreds of MFIs around the world. Summary information is published annually and the State of the Campaign reports can be found on their website. Therefore the secondary data was gathered from this website (that is www.mixmarket.org) for the purpose of analyzing the factors behind the rating of the MFIs.

### 3.7. Data Collection Methods

The secondary data for this study were obtained directly from www.mixmarket.org albeit with some slight editing for easy use on stata program.

For the collection of primary data, questionnaires were used as the main tool but at times some more verbal explanations was provided to the respondents in clarification of the questions contained in the questionnaires when need arose.

Questionnaire, which can be defined as pre-formulated written set of questions to which respondents record their answers usually within rather closely defined alternatives and may be with some little room for extended opinions, was adopted for data collection. This is due to the reason that, questionnaires have an advantage of enabling the researcher to collect all the completed responses within a short period of time and can be administered to a large group of individuals at the same time without requiring much skill to conduct, Sekaran (2003).

Any doubt that the respondents had on any questions was rectified on the spot so that an appropriate response was recorded. The researcher was also afforded an opportunity to introduce the research topic and motivate the respondents to offer their frank answers.

Kothari (2004) backed the use of questionnaire saying that "it is free from the bias of the person administering it and that the answers are in respondents own words. Respondents have adequate time to give well thought out answers and that large samples can be made use of and thus results can be made more dependable and reliable".

### 3.8. Data Analysis Methods

Myoung (2010) said that When a dependent variable is categorical, the ordinary least squares (OLS) method can no longer produce the best linear unbiased estimator (BLUE); that is, OLS is biased and inefficient. That being the case, some other methods had then to be employed to test the relationship existing between the dependent and the independent variables.

In categorical dependent variable models, the left-hand side (LHS) variable or dependent variable is neither interval nor ratio, but rather categorical. The level of measurement of a dependent variable determines a proper model for data analysis. Binary responses (0 or 1) are modeled with binary logit and probit regressions, ordinal responses (1st, 2nd, 3rd, …) are formulated into (generalized) ordinal logit/probit regressions, and nominal responses are analyzed by the multinomial logit(probit), conditional logit, or nested logit model depending on specific circumstances.

The dependent variable, labeled ‘diamonds’, in the first part of this study is an ordinal variable and therefore the ordinal logit regression model was considered fit for the analysis of this kind of data. The second part, which was concerned with assessing whether the ratings are actually or could be applied in Tanzania, had nominal responses specifically the ‘NO or YES’ responses and therefore simple statistical central tendency measure, Mode and the percentage measurement served the purpose. The binary logit model could have been used instead. Stata, a statistical package was employed for this purpose.

# CHAPTER FOUR

# PRESENTATION OF FINDINGS

## 4.0. Introduction

In this chapter, the study gives an account of the findings from the field work. After collecting the data and analyzing them as described in chapter three, the research uses this part to shade light on what really was found in the course of this research. The information in this chapter is mainly the views and opinions of respondents and not researcher's. The findings are presented in line with the research specific objectives.

## 4.1. Reasons Behind the Rating of the MFIs

Regarding the question of what are the reasons behind the credit rating of MFIs, the researcher used two separate questions in order to get responses from the respondents. The questions asked where if the respondents had ever heard of credit ratings of MFI and whether in their opinion, it was important that the MFIs in Tanzania are credit rated and reasons behind their responses.

However, before going deep in the study, the research wanted to know if the respondents had any experience in borrowing externally together with the reasons of doing so. The response was overwhelmingly identical. That is they are doing so due to lack of self-sufficiency.

It was indicated that MFIs lack self sufficiency in that they cannot generate funds from their own sources enough to support their funds needs. That is to say, the members' contributions plus the returns from different investments seems to be incompatible with the funds requirement for extending microcredits to members and financing the daily as well as periodic cash needing activities.

This always resorts to the external borrowing from large financial institutions that extend loans to MFIs. Data indicates that every MFI has at least once its survival gone for external borrowing to cover for some internal cash needs.

With regard to question of whether the respondents had ever heard of credit ratings, the responses were as presented in Table 4.1.

**Table 4.1**

| | **Frequency** | **Percentage** |
|---|---|---|
| YES | 6 | 23.07 |
| NO | 20 | 76.93 |
| **TOTAL** | **26** | **100** |

Source: Research data (2013)

The issue of MFI ratings doesn't seem to be a new idea altogether though the issue of credit rating of the MFIs seems to be a relatively new idea. Of the respondents to have given their responses to the question of whether they had come across the issue of credit ratings, only the 23.07% said yes and the 76.92% had never heard of it.

Asked whether they thought it was important that the MFIs are credit rated, the respondents unanimously replied yes to the idea, see Figure 4.2. This, however, required more elaboration on what credit entails since majority of respondents had no idea about the issue of credit rating as indicated on table 4.1

**Table 4.2**

| | **Frequency** | **Percentage** |
|---|---|---|
| YES | 26 | 100 |
| NO | 0 | 0 |
| **TOTAL** | **26** | **100** |

Source: Research data (2013)

The question however was an open one going further to ask the respondents to give their opinion on why they thought it was important that the MFIs are credit rated. This question produced different responses from different respondents as presented in Table 4.3:

**Table 4.3**

| S/N | Reason for rating | Frequency | Percentage |
|---|---|---|---|
| 1. | The ratings would help MFIs self assess themselves even before going for loans from external lenders. | 15 | 57.7 |
| 2. | Attraction of funding from external funds providers if the MFI is to get a better rating. | 11 | 42.3 |
| 3. | By knowing their ratings, MFIs would strive to improve their ratings so that they can be able to negotiate better terms for loans from external lenders. | 9 | 34.6 |
| 4. | The ratings would enable the MFIs to compare their performance with others within the MFI industry. | 5 | 19.2 |
| 5. | It will also help the MFIs in complying with the standard rating requirements of the regulatory authorities. | 5 | 19.2 |
| 6. | Ratings will help improving MFI industry by bringing uniformity in assessing the worthiness of MFIs. | 2 | 7.7 |
| 7. | Having the MFIs to submit their financial reports for rating will enhance transparency in financial reporting. | 1 | 3.8 |
| 8. | Reducing the bureaucracy in loan systems since there will be no need for independent assessments from loan providers | 1 | 3.8 |
| 9. | Rating system will help the government in assessing the growth and development of the MFI industry. | 1 | 3.8 |
| 10 | The ratings will help potential investors in identifying the better performing MFIs in which to join. | 1 | 3.8 |
| 11 | Ratings will help taking power off corrupt official who demands money for a higher value in MLC system | 1 | 3.8 |

Source: research data (2013)

### 4.2.Procedures Used for Rating the MFIs

Different rating agency used different approach in rating but mainly they would want the MFIs to submit their audited financial statements. They will then use these financial reports to assess the level of performance attained by the MFI.

MicroRate's credit rating for example, includes a pre-visit desk analysis, on-site evaluation, and final report. The entire process from the desk analysis to final report delivery is about 6-8 weeks (www.microrate.com).

### 4.3. The contribution of Social Performance Factors on the Ratings

The research sought to assess the effect of social performance factors on the level of rating that an MFI is assigned. To attain this objective, the researcher used the secondary data. Table 4.4 shows the result of the analysis of the data obtained from www.mixmarket.org:

**Table 4.4**

```
. ologit diamonds returnonassets returnonequity lnTA lnGLP lnALPB lnCPB lnBPS lnPAR lnP lnNAB lnTWB lnOSS,or

Iteration 0:   log likelihood = -4405.2989
Iteration 1:   log likelihood = -3862.2031
Iteration 2:   log likelihood = -3853.1619
Iteration 3:   log likelihood = -3853.1449
Iteration 4:   log likelihood = -3853.1449

Ordered logistic regression                       Number of obs   =       4089
                                                  LR chi2(12)     =    1104.31
                                                  Prob > chi2     =     0.0000
Log likelihood = -3853.1449                       Pseudo R2       =     0.1253
```

| diamonds | Odds Ratio | Std. Err. | z | P>\|z\| | [95% Conf. | Interval] |
|---|---|---|---|---|---|---|
| returnonas~s | 5.186438 | 1.752931 | 4.87 | 0.000 | 2.674097 | 10.05915 |
| returnoneq~y | .9906176 | .0115238 | -0.81 | 0.418 | .9682869 | 1.013463 |
| lnTA | .4404583 | .0510449 | -7.08 | 0.000 | .3509609 | .5527781 |
| lnGLP | .0877388 | .580503 | -0.37 | 0.713 | 2.05e-07 | 37580.77 |
| lnALPB | 26.78636 | 177.1362 | 0.50 | 0.619 | .0000629 | 1.14e+07 |
| lnCPB | 2.090437 | .1325496 | 11.63 | 0.000 | 1.84614 | 2.367063 |
| lnBPS | .8842941 | 2.994968 | -0.04 | 0.971 | .001158 | 675.283 |
| lnPAR | .8040545 | .0179037 | -9.79 | 0.000 | .7697186 | .8399221 |
| lnP | .5855993 | 1.981209 | -0.16 | 0.874 | .0007723 | 444.0168 |
| lnNAB | 64.56448 | 484.9743 | 0.55 | 0.579 | .0000261 | 1.60e+08 |
| lnTWB | 1.043133 | .0615532 | 0.72 | 0.474 | .9292062 | 1.171029 |
| lnOSS | .7936659 | .084174 | -2.18 | 0.029 | .644706 | .9770431 |
| /cut1 | .5654302 | 1.082259 | | | -1.555759 | 2.68662 |
| /cut2 | 2.52987 | .5593309 | | | 1.433601 | 3.626138 |
| /cut3 | 8.076538 | .4294295 | | | 7.234872 | 8.918204 |
| /cut4 | 10.01874 | .4403519 | | | 9.155668 | 10.88182 |

Source: Research data (2013)

Data analysis output Table 4.4, as extracted from stata, shows that only the financial factors are really important when it comes to rating the MFIs. The social factors bear not significance in evaluating the credit worthiness of the MFIs. Looking at table 4.4, we can come up with the following:

### 4.3.1. Social Performance

The data analysis output seems to pose questions on whether the MFIs really help getting people out of poverty. As widely known that the primary goal of MFI is to bring financial services to the poor and needy but none of the indicators of social performance show impact on the level of rating an MFI is to be assigned.

The measure of social performance in this case the number of women borrowers (lnTWB), average loan balance per borrower (lnALPB) and the number of active borrowers (lnNAB) both had a p-value that is statistically insignificant enough to warrant the rejection of null hypothesis that the coefficients of these variables in the designed model are non zero.

lnTWB according to the table 4.4, at 95% confidence level, has a p-value of 0.474 which is regarded as insignificant and hence warrant the rejection of null hypothesis that "the level of rating improves as the total number of women borrower increases". The same can be said of lnALPB and lnNAB that, their p-values of 0.619 and 0.579 respectively are statistically insignificant at 95% confidence level hence their respective hypotheses that, "the level of rating will improve as the average loan per borrower decreases" and "the level of rating improves as the number of active borrowers increases" can be rejected.

### 4.3.2. Financial Performance Factors

Most of the variables that has been used to measure financial performance in the designed model have proved to have impact on the level of rating that an MFI is assigned.

#### 4.3.2.1. Size

The size of MFI as measured by its total assets (lnTA) under its possession, gross loan portfolio (lnGLP) and its personnel (lnP), shows to have an impact on the level of ratings an MFI is assigned. The test statistic and the p-value (having a statistically significant value of less than 0.05 at 95% confidence interval) warrants the authority of not to reject the null hypothesis that the coefficients are non zero and hence size is an important determinant of the MFI's rating.

By the look at the odds ratio (using the proportional odds model), for a one unit increase in the log value total assets as expressed in monetary units, the odds of getting a high rating versus a lower one is 0.44 times greater given the other variables are held constant.

#### 4.3.2.2. Profitability

Profitability, which is another measure of financial performance, indicated much larger impact in the ratings. As measured by the return on assets (returnonas-s), return on equity (returnoneq-y) and operational self sufficiency (lnoss), the profitability has a statistically significant p-value for both ROA and OSS. Studying the odds ratios it can be seen that for a unit increase in the ROA, the odds of high rating against lower one are 5.19 times higher keeping the other variables constant while the odds are 0.79 higher for log value of OSS.

#### 4.3.2.3. Riskiness

As measured by the value of portfolio at risk (lnPAR), riskiness which is also another measure of financial performance has an impact on the ratings an MFI is to be assigned. Again by looking at the p-value which is statistically significant at 95% confidence interval, it is statistically rational not to reject the null hypothesis in this that the coefficient of PAR in the designed model is non zero. Stata output indicates that for every one percentage increase in PAR, the odds of an MFI being assigned a better rating are 0.80 lower than a poor one keeping other variables constant.

#### 4.3.2.4. Efficiency

Efficiency is another crucial aspect of every financial institution, which implies the rational use of inputs and outputs. Operationalized by cost per borrower (lnCPB) and borrowers per staff member (lnBPS), efficiency is also regarded as another factor that determines the level of rating an MFI is assigned. Evidenced by the p-value which is statistically significant at 95% confidence interval, efficiency has a positive impact on the ratings.

The odds ratio shows that the odds of getting a better rating are 2.09 lower than getting a worse one if the CPB is to increase by one percent. If CPB increases then efficiency declines and hence poor rating is to be expected.

## 4.4.The Applicability of these Ratings in Tanzania

With this objective in mind, the researcher sought to establish whether the rating system can be successfully applied in Tanzania. The researcher started by seeking to establish the difference between the current system of issuing MLC and the rating system. He then went further to assess whether respondents were ready to let go of the old MLC system and welcome this new system of rating.

### 4.4.1. Procedures followed by MFIs under MLC system

The researcher posed the question "What procedures are being followed by the MFIs when they are to know the maximum amount of loan they can borrow?" to the regional registrar of cooperative. The response to this question was a series of explanation which are summarized below.

The current system involves a process whereby an MFI is to be issued with a certificate called "Maximum Liability Certificate". Under this system, the MFIs are required by the law to submit their annual budget for the proceeding year as well as the audited financial reports of the preceding one. The regional registrar of cooperative unions will then issue them with an MLC stating the limit of the amount that an MFI can raise by way of loans from external lenders.

The research revealed that, before the issue of the MLC, there are some procedures that need to be followed by MFI. First of all, the MFI is required to prepare the estimates of its income and expenses for the proceeding financial year. These estimates will then require the approval of the general meeting of the respective MFI before being sent to the registrar. Upon receiving these documents, the registrar will then conduct the valuation of fixed and current assets under the possession of the MFI as at the date of the reports. On submitting the projections, the MFI will have to apply for the MLC which will be prepared by the registrar of the cooperative unions.

To gain more understanding on the MLC system, the researcher asked the question about the factors that are being looked at when setting the maximum amount that an MFI can borrow and whether this maximum amount can be negotiated between the MFI and the registrar of cooperative. The response was as follows:

The maximum amount the MFI can borrow is set by the registrar of cooperatives and is expressly written on the MLC. In determining the maximum amount the registrar looks at several factors that may be used to assess the effectiveness of the concerned MFI in the use and repayment of the funds to be borrowed. The main factors that looked at include the following:

i. The value of the assets under the possession of the MFI
ii. The list of current creditors to whom the MFI is owed
iii. The list of assets currently used to secure loans from lenders
iv. Members contributions and participations in the MFI activities

The MFI can however negotiate the amount assigned to it under MLC but the amount assigned by the registrar is limited to as much as three times the capital of the MFI. Whenever the MFI feels dissatisfied by the assigned amount, the law gives right for the MFI to appeal for some amends or rectifications. The law also gives right for the MFI to apply for MLC for an amount greater than the statute limit of three times the capital.

However, for this purpose the application should rather be filled to the Minister of Agriculture, Food Security and Cooperatives.

### 4.4.2. Factors Considered when extending Loans to the MFIs

It has been found out that there are almost identical criteria for evaluating the MFIs by the funds providers. Some funds providers, in this case the banks (NBC, NMB, ACB), have a centralized system for loans provision to the MFIs. In this system, the MFI through the bank branch near its vicinity will have to apply for the loan to the headquarters of that bank. For some others (CRDB), the loan process isn't as complicated due to the fact that the bank branches have got autonomy to provide loans to their MFI clients without the consultation of their respective head offices.

Despite that little but significant difference, these institutions do have a set of criteria that they consider before extending loans to the MFIs which, to a large extent, is identical from one institution to another. They do consider the following factors as revealed by the data collected from them:

i. The MFIs capital by way of share or savings
ii. The value of assets under possession of the MFI
iii. List of assets that have already been used to secure loans that are still outstanding
iv. The amount of debt outstanding from the loans extended to its members
v. The internal debts repayment policy and collection efficiency as measured by the late repayments and defaults
vi. The financial record keeping procedures and the reports from the auditors of their financial reports
vii. The outstanding external debts and loans and repayment records
viii. The MLC figure for maximum loan as assigned by the registrar
ix. Growth rate of the MFIs in terms of members share, savings and portfolio
x. Quality of the MFI's management team in terms of their qualification to the job and decision making

xi. Members participation in decision making and in taking loans from the MFI

### 4.4.3. Comparison of the MLC System and the Ratings System

To some extent the two systems looks alike but their differences is somewhat very significant. According to the MLC system it has been revealed from the outset that there are some procedures the MFI needs to follow before being given the certificate. The rating system only demands that the MFI submits it financial reports to the rating agency. The rating agency will then, depending on the information on the reports, rate the MFI accordingly.

There is room for negotiation for the amount assigned under MLC while the rate given by the rating agency is not negotiable. Furthermore, the figure for the maximum liability under MLC system is dependent on the discretion of the registrar. The funds providers upon receiving this certificate, they conduct their own assessment to decide whether or not to extend the loan the MFI has applied for.

Two systems look alike in terms of the factors considered to be important in deciding the credit worthiness of the MFI. As the study reveals, they are solely concerned with the financial performance of the MFI and lays no particular attention on the social aspect of the MFI performance.

### 4.4.4. Establishment of Rating Agency in Tanzania

Having established an understanding of MLC system and how it compares to rating system and knowing that the respondents regard ratings as an important move (see table 4.1.2), the researcher wanted to know whether the respondents would support the idea of establishing an agency that would help rating the MFIs in Tanzania. The respondents almost unanimously supported the initiative of having an agency in Tanzania that will help rate the MFIs. Data indicates that 92.3% said yes to the idea with only 7.7% saying no as per table 4.5.

**Table 4.5**

| | Frequency | Percentage |
|---|---|---|
| YES | 24 | 92.3% |
| NO | 2 | 7.7% |
| **TOTAL** | **26** | **100%** |

Source: Research data (2013)

However, they were concerned about the credibility of this agency saying that it might end up favoring those known institutions while undermining the others. There were suggestions that the agency should be formulated under the special law to be enacted by the parliament for this purpose and that the officials from this agency should be responsible for whatever comes from the agency and they should be punishable by law for any misconduct or negligence.

In addition, the government should make sure to employ people with a much needed knowledge of microfinance. People to be employed in this agency should be those with understanding on the microfinance issues and most particularly the issues of credits.

### 4.4.5. Publicizing the MFI Ratings

Asked whether the respondents were ready to accept the ratings system by making their ratings go public, the respondents had some split decisions. Some indicating that they would ready while others won't. Table 4.6 indicates the frequency distribution of the responses:

**Table 4.6**

| | Frequency | Percentage |
|---|---|---|
| YES | 21 | 80.8% |
| NO | 5 | 19.2% |
| **TOTAL** | **26** | **100%** |

Source: Research data (2013)

The result indicates that 80.8% would allow their rating to be made public while 19.2% were to the opinion that these ratings should not be made public mean that only the concerned MFI should be notified of the rating level assigned.

On the question of whether the loan providers would rely on the ratings provided by the agency to be established, it was seen that only 20. 4% percent would place their reliance on these ratings while 33.7% wouldn't. The remainder 45.9% would simply wait for directives from their officials from head offices. The main reason for this as per the respondents is lack trust on the objectivity and integrity of the agency to be established.

# CHAPTER FIVE

# CONCLUSIONS AND RECOMMENDATION

## 5.0. Introduction

This research report is on the factors considered in the rating of MFI and the applicability of these ratings in Tanzania. This chapter presents the summary and conclusions researched by the researcher on the topic while giving some of the recommendations on the subject. The chapter begins by giving summary on the factors that, the data collected by the researcher, suggest to have an effect on the level of rating that MFI is assigned. Then it will go further explaining on how the ratings system can be applied in Tanzania. Lastly, the chapter will conclude by giving some recommendations for ways to improve the MFI industry in Tanzania and proposing some areas for further research regarding the MFI industry.

## 5.1. Summary

In summary, the following can be drawn out this report indicating the attainment of the research objective as hinted in chapter one:

### 5.1.1. Reasons behind the Rating of the MFIs

It is to the researcher’s belief that ratings will help improving MFI industry by bringing uniformity in assessing the worthiness of MFIs. Having a single agency to rate all the MFIs will help bring objectivity and hence fairness in the loans provision.

Furthermore having the MFIs submitting their financial reports for assessments will enhance transparency. Transparency in the sense that every all the operations of the MFIs will be put into scrutiny hence there won’t be an easy chance for the MFIs official to squander the available resources under their stewardship.

Moreover, having an agency available to rate the MFIs will further reduce the bureaucracy in loan systems since there will be no need for individual assessment from loan providers if an MFI applying for the loan is rated. In the process it will also reduce the serving costs for these providers.

As for the government, the rating system will help assessing the growth and development of the MFI industry. The Government will able to know the profile of every registered MFI and will be able to provide aid when it thinks fit after establishing some slacks in growth.

The general public on the other hand will able to identify those MFIs with better performance and possibly join or invest in them.

Better than anything else, the rating system will eliminate the chances for any cooperative officials to make themselves some illegal money when bargaining with the MFIs the maximum amount that an MFI will be assigned as per the system of MLC.

### 5.1.2. Procedures used for Rating the MFIs

The system of ratings requires only the MFI to submit its audited financial reports with the rating agency. After submitting the reports then the agency through it criteria of rating and for some after pre-visit desk survey, will assign the number of diamonds that an MFI deserves considering it financial performance as indicated by the financial reports. Then the agency will file a final report to the MFI stating the level of rating it has been assigned and possibly making the rating available for public use.

### 5.1.3. Factors determining the Ratings of MFIs

It has been seen from the research findings that the only important factors that are considered when rating the MFIs are the financial factors. Social factors on the other hand have got no part to play in the rating that an MFI is assigned. In a nutshell, size, profitability, efficiency and riskiness which all measure financial performance have been see to affect the ratings.

Total number of women borrowers, average loan per borrower and the number of active borrowers which were all used as the measure of social performance have got not impact on the level of rating that an MFI is assigned.

### 5.1.4. Applicability of the Ratings in Tanzania

Considering the issue of applicability of the rating system in Tanzania, the findings suggest that if logistics are well in place and that proper knowledge of the financial issues is given to people involved in the microfinance industry in Tanzania, then the rating system could be a success. Suggestions were made that an independent agency that will be concerned with rating of the MFIs, is established under the special law that will supervise the total operations of the agency.

## 5.2. Conclusion and Policy Implication

This research just like the one previously conducted by Gutiérrez-Nieto and Serrano-Cinca (2010) has come to reveal that only the financial factors do have impact on the level of rating an MFI is to be assigned. From the selected variables of financial performance, that is the size of MFI, its profitability, riskiness and efficiency both shows that the level of rating is dependent on the financial performance and not social performance.

The social performance as revealed earlier has got no impact on the rating which is in conformity with institutionists and against the welfarists. Hence questions can be asked about contribution of the MFIs to the social development of the community.

On the other hand, being a new idea to many, the credit ratings of MFIs in Tanzania will first need to be properly introduced to players in the MFIs industry. They will need to know what really do the credit ratings entail and what is needed to be done for the MFI to earn itself a better rating. Then, an agency specialized in ratings of MFIs will need to be established.

This new specialized agency will need to be established under the law so as to have a mandate. It should be clearly stated in the statute that the ratings given by the agency are to be respected and that the institutions that lend funds to the MFIs are to use them and that any further assessment of the MFI's credit worthiness that is conducted individually by the funds providers should only compliment the rating level already assigned by the rating agency.

However, the reliability of the agency will be enhanced by employing people with a great deal of knowledge and experience on MFI industry. It will be to the benefit of everyone involved if the agency's management board is to be made up of representatives from different institutions that provide funds to MFIs. The main reason for this is that these people know what really is required of the MFI when deciding on their credit worthiness. It is also rational to believe that these people having helped recruiting employees for their respective institutions will be in a better position to appoint and employ the right personnel to run the agency.

### 5.3. Recommendations

Opportunities for supporting microfinance initiatives in Tanzania are enormous. It is one of the world's poorest countries, but politically stable and enjoying continued economic growth. This economic growth is driving increasing demand for access to financial services. At the same time, still large masses of Tanzanians have no access at all to financial services, be they formal or informal.

Due to structural reforms, there is continued financial market deepening and even development of capital markets. However, there still are a lot of setbacks in financial growth. These include limited market capacity (in terms of human resources and effective and efficient organizations), low levels of financial literacy to the Tanzanian public, as well as limited business skills to invest money effectively, and recent politicization of SACCOs and the MFI industry at large.

It is to researcher’s opinion that an agency should be established that will help with rating the MFIs. This agency should be an independent organization that is to be specifically brought into existence for this purpose. To help empowering and maintain its reliability and credibility it is advised that this agency is established under the law giving it the legal power to enforce its decisions.

The research on the other hand, has revealed that the finance performance factors are solely responsible for rating level. This being the case the MFIs should seek to improve these factors for them to be better rated. That is to say they should seek to increase worthiness of the assets under their possession, increasing the gross loan portfolio and the personnel employed.

Improving the efficiency with which they run their operations should also be another concern. The MFIs should be looking to reduce the cost per borrowers while increasing the number of borrowers per staff member.

### 5.4. Areas for further Research

This study might raise a lot more questions than possibly the answers it has provided. It is however to the best interest of knowledge base that more questions are raised that will warrant further more research on the subject. This will not only enhance the knowledge base but also the improvement in the area that are seen as demanding improvements since research is mainly the best way forward for finding solutions for problems and improvement in almost every aspect of life.

Further research areas that could provide valuable information include the extension of this research to determine how the set up for the new ratings agency should look like that will bring the benefit ratings to the MFI industry in Tanzania.

Also areas such as efficiency in utilisation of funds borrowed, efficiency in operations such as serving the members and servicing the loans.

As an area that definitely calls for much more research, the contribution of the MFIs in helping the community fight against poverty should be a priority. Questions have been asked if they really help improve the living standard of people in the community or they simply are concerned with investing for the purpose of making profits. This research has identified that only the financial factors are behind the level of rating an MFI is assigned. None of the financial factor has been deemed to have impact on the level of rating. Therefore it will be very interesting to see if the MFIs really help reducing the level of poverty in the country.

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## APPENDIX 1

**THE QUESTIONNAIRE**

St. Augustine University of
Tanzania,
P.O BOX 373,
**Mwanza**

15th Dec 2012

**Dear respondent,**

My name is Ansbert Kishamba, a student at Mzumbe University, MU pursuing Masters Degree of Science in Accounting and Finance. I am conducting the research on the **Factors considered in the ratings of Micro Finance Institutions and the applicability of these ratings in Tanzania: A case of Mwanza region**.

I kindly request your cooperation in responding to the questions incorporated in this questionnaire as a way of helping me in the process of data collection for my proposed research topic

I assure you that the information to be obtained from you will be treated with utmost confidentiality in the whole process of writing my research report.

Thanks in advance

Sincerely yours

……………………..

Kishamba Ansbert

Questionnaire for the finance directors in MFIs

Please respond accordingly.

1. Does your institution borrow funds from external lenders (investors)?
   YES { }
   NO
2. What do you think are the factors that the financial providers consider when deciding the amount of funds to be provided for the MFIs?
   ……………………………………………………………………………………
   ……………………………………………………………………………………
   ……………………………………………………………………………………
   ……………………………………………………………………………………
   …………………………………………
3. Have you ever heard of credit ratings of MFIs in the context of MFIs industry in Tanzania?
   YES { }
   NO
4. In your opinion do you think it is important that the MFIs in Tanzania are credit rated?
   YES { }
   NO
   Why do you think so?
   ……………………………………………………………………………………
   ……………………………………………………………………………………
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   ……………………………………………………………………………………
   …………………………………………

5. If there was a call for establishment of an independent agency that will help assessing the creditworthiness of the MFIs and hence rate the institutions accordingly, would you have supported the idea?

   YES { }

   NO

6. What do you think will be the important factors to be looked at when rating the MFIs?

   ……………………………………………………………………………………
   ……………………………………………………………………………………
   ……………………………………………………………………………………
   ……………………………………………………………………………………
   …………………………………………

7. What are the chances that you will be ready to submit the financial and well as the social performance reports of your institution to this agency if it was up to you to decide?

   A. HIGH
   B. MODERATE { }
   C. LOW

   ……………………………………………………………………………………
   ……………………………………………………………………………………
   ……………………………………………………………………………………
   ……………………………………………………………………………………
   …………………………………………

8. Would it appease you if these ratings were to be made publicly available?

   YES { }

   NO

9. What things need to be done to improve the MFIs industry in Tanzania?

   …………………………………………………………………………………….

Questionnaire for the loan officers in lending institutions:

1. Does your institution lend funds to any MFIs?

   YES { }

   NO

   If Yes, how many times since your MFI were registered? ................................................
2. What factors do you consider before extending a loan to any MFIs?

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   ……………………………………………………………………
3. Have you ever heard of credit ratings of MFIs in the context of MFIs industry in Tanzania?

   YES { }

   NO
4. In your opinion do you think it is important that the MFIs in Tanzania are credit rated?

   YES { }

   NO

   Why do you think so?

   ………………………………………………………………………………………
   ………………………………………………………………………………………
   ………………………………………………………………………………………
   ………………………………………………………………………………………
   …………………………………………

5. If there was a call for establishment of an independent agency that will help assessing the creditworthiness of the MFIs and hence rate the institutions accordingly, would you have supported the idea?

   YES { }

   NO

6. What do you think will be the important factors to be looked at when rating the MFIs?

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7. Would you rely on the rates from this agency to assess the credit worthiness of the MFIs when deciding to extent loans to them?

   YES { }

   NO

8. What do you think will need to be done to improve the reliability of the assessment of the MFIs from this agency?

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10. What things need to be done to improve the MFIs industry in Tanzania?

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Questionnaire to the registrar:

1. What procedures are being followed by the MFIs when they are to know the maximum amount of loan they can borrow?

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   ……………………………………………
2. What are the factors that are used to determine the maximum amount the MFIs can borrow from the lenders?

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   …………………………………………………………………………………
   …………………………………………………………………………………
   ……………………………………………
3. Can the MFIs negotiate the maximum amount that they can borrow?

   YES { }

   NO
4. Have you ever heard of credit ratings of MFIs in the context of MFIs industry?

   YES { }

   NO
5. In your opinion do you think this system of rating the MFIs can be applicable successfully in Tanzania?

   YES { }

   NO

   Why do you think so?

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…………………………………………

6. If there was a call for establishment of an independent agency that will help assessing the creditworthiness of the MFIs and hence rate the institutions accordingly, would you have supported the idea?

   YES { }

   NO

7. What do you think will be the important factors to be looked at when rating the MFIs?

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8. What do you think will important thing to do for this agency to gain the faith and trust of the public hence place their reliance on the ratings from this institution?

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   …………………………………………

9. Would it be appropriate if these ratings were to be made public (available for every one use)?

   YES { }

   NO

   Why is it so?

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