MACHAKOS UNIVERSITY

University Examinations for 2018/2019 Academic Year

SCHOOL OF BUSINESS AND ECONOMICS

DEPARTMENT OF ECONOMICS

THIRD YEAR SUPPLEMENTARY EXAMINATION FOR

BACHELOR OF ECONOMICS & FINANCE

BACHELOR OF ECONOMICS & STATISTICS

EAE 302: ECONOMICS OF MICROFINANCE

DATE: **TIME:**

INSTRUCTIONS:

(i) Answer question one (Compulsory) and any other two questions

(ii) Do not write on the question paper

(iii) Show your workings clearly

QUESTION ONE (COMPULSORY) (30 MARKS)

a) Explain five (5) main components of the cost structure used by microfinance institutions to determine marginal costs and the interest rate on loans. (5 marks)

b) . Use the principle of marginal returns to capital to explain the economic theory proposition that small firms should be able to generate higher returns to investment than larger firms. (6 marks)

c) Assume a money market with two borrowers: one safe and the other risky. The bank that is ready to lend money does not know who is safe and who is risky. However experience has led the bank to know that 25% of the borrowers are safe. Suppose that the banks marginal costs are 30% for every KES20, 000. Suppose again that each borrower has a one month investment project which requires KES20, 000. If the borrowers choose not to invest they have the option of earning a wage of Kshs. 6000 per month. Given that the gross revenues from the projects are KES28, 000 and KES38, 000 for the safe and risky borrower respectively and that the risky borrower has a 5% chance of not succeeding.

Find:

i) The average probability of succeeding in this money market. (3 marks)

ii) The interest rate that the bank must charge to break even (4 marks)

iii) Who should invest in their project and why? (4 marks)

d) Micro-finance institutions provide subsidized interest rates, subsidized services and face higher transactional costs. How do they manage to be profitable? (8 marks)

QUESTION TWO (20 MARKS)

a) Financial institutions in Kenya encounter agency problem. Briefly describe using a relevant example the three stages in which agency problem manifests itself in relation to lending. (6 marks)

b) Most MFI's lend to low-income clients who do not have the normal collateral used by formal banks. Discuss four innovative and alternatives forms of collateral that are used instead. (8 marks)

c) Dynamic incentives refer to the practice of promising larger and larger loans for groups and individuals in good standings with regard to loan repayment. Explain any three forms of dynamic incentives used by microfinance institutions in Kenya. (6 marks)

QUESTION THREE (20 MARKS)

a) Why has there been a need for the emergence of microfinance when ROSCAs have been in existence for a long time and are wide spread all over the globe? (10 marks)

b) Absence of formal financial institutions in village or informal sector is often attributed to *agency problems.* Enumerate the main reasons why formal banks face agency problems. (4 marks)

c) Explain three advantages and three disadvantages under the the Grameen Bank's Group lending methodology (6 marks)

QUESTION FOUR (20 MARKS)

a) Rotating savings and credit associations (ROSCAs) hinge on the assumption that participation for members who acquire money earlier is enforced. Discuss strategies (incentives) used by ROSCAs to enforce this assumption. (8 marks)

b) Explain the factors responsible for the emergence of modern microfinance banks (4 marks)

c) Explain four main reasons for the global growth of microfinance (8 marks)

QUESTION FIVE (20 MARKS)

a) If you have two money lenders:

One money lender in the Gikomba market of Nairobi, whose clients are reliable with nil default rate, charges 10% interest rate per annum.

The second money lender in the rural area of Bungoma County, expects half his clients to default. At what interest rate will the Bungoma money lender charge his clients in order to cover his projected losses due to defaulters and make a rate of return equivalent to that of Gikomba market? (4 marks)

Give and explain three reasons which account for differences in interest rates charged by the two money lenders in (d) above (3 marks)

b) Economic theory suggests that most profitable businesses will encounter greater competition. Give reasons why money lenders do not face this kind of competition. (5 marks)

c) Name and briefly explain five (5) risk factors a regulator of microfinance institutions looks out for to keep the microfinance institutions afloat. (8 marks)