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Social intermediation and financial services access in Uganda's microfinance industry

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Abstract

Purpose – The purpose of this paper is to examine the extent to which social intermediation influences access to financial services in Uganda's microfinance industry.

Design/methodology/approach – The paper adopts analysis of moment structures (AMOS), a form of structural equation modeling (SEM) to test hypotheses.

Findings – It was established that social intermediation together with antecedents of social capital and managerial competence, account for 32 percent of the variance in access to financial services in the microfinance industry.

Research limitations/implications – Only a single research methodological approach was employed and future research through interviews could be undertaken to triangulate. Furthermore, the findings from the present study are cross-sectional, future research should be undertaken to examine the social intermediation and its effects on access to financial services across time.

Practical implications – In order to boost the wealth of the active poor and microfinance institutions in Uganda, Uganda should always endeavor to build the human and institutional capacities through social intermediation so as to encourage the marginalized people to fully participate in formal financial intermediation in the microfinance industry.

Originality/value – This is the first study that focuses on testing the influence of social intermediation on access to financial services in Uganda's microfinance industry.

Keywords Social intermediation, Microfinance industry, Access to financial services, Uganda, Finance

Paper type Research paper

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Introduction

The escalating limited access to financial services by marginalized communities in most developing countries has generated endless debates, which hardly yield solutions to the pandemic (MDG Report, 2010). In spite of the substantial un-bankable population of 68 percent (Nuwagaba, 2011) in Uganda, earlier studies have not actually tackled the real issues that inhibit access to financial services in the microfinance industry. Though a number of studies have predicted access to financial services using information asymmetry, institutional capacities and funding levels (Dusuki, 2008; Claressens, 2005), they have yielded inadequate and mixed results in the microfinance domain.

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However, Ledgerwood (1999) believes that a sustainable solution to the above challenges lies in the building of more efficient and strong client and institutional capacities before either party participates in financial intermediation process. The process entails the development of competences of both parties, which Dusuki (2008) refers to as social intermediation.

At a glance, Lynn (1996) and Goldberg (1998) conceptualize social intermediation as a process which entails building up of both human resources and institutional capital so as to increase self-reliance of marginalized groups and to prepare them for engaging in formal financial intermediation. Promotion of social intermediation in the microfinance industry is capable of creating new attitudes and self-perceptions as well as new systems and institutions, which in turn, can promote self-reliance, confidence, trust and empowerment amongst the clients (Goldberg, 1998).

The desire for social intermediation by the people in the microfinance industry is critical because of the high levels of financially illiterate community that can hardly participate in formal financial intermediation (Baguma, 2010). Giving credit to people, who do not have the capacity to generate income from the loans, puts them at risk of becoming more indebted and, hence more destitute. In any case, credit without business knowledge is nothing but charity, a constraint to financial intermediation (Ledgerwood, 1999). Hence, providing social intermediation services (social ties empowerment, confidence building, and financial literacy and management capabilities enhancement, etc.) among members of a group (Kalyango, 2009) boosts a financially literate client base. Social intermediation will in turn, promote the community's participation in financial intermediation, and increased access to financial services.

Social intermediation achieves this by creating social capital, which compensates for the lack of material assets. It is this investment in social capital that creates creditworthy borrowers, strong networks within the group, peer monitoring and guarantee mechanism, better flow of information between lenders and borrowers, and hence, less adverse selection and moral hazard in the credit market (Bhatt and Tang, 1998; Collier, 1998). The foregoing discussion pre-supposes that investment in social intermediation gives rise to social capital and managerial competences, which in turn, influence financial access in the microfinance industry.

In a related case, Pischke (1991) argues that financial intermediation, and thus, credit access, depends upon trust between the borrower and the lender that contracts will be honored. In this case, trust, which results from social capital will play a paramount role in the formation of group lending success, particularly in the absence of collateral, as in the case of the microfinance industry. Pischke's argument agrees with Baguma's (2010) observation that social collarateral, instead of material assets, acts as security for credit access in the microfinance industry. It is therefore believed that social intermediation should precede financial intermediation if access to financial services in the microfinance industry is to be increased. Despite the foregoing theoretical assertions, there is not enough empirical evidence to confirm the connection between the two antecedents (Hishingsuren, 2004; Meyer, 2002). It is this knowledge gap that motivated an investigation on the extent to which social intermediation influences access to financial services in the microfinance industry. Consequently, this study is expected to benefit stakeholders as follows:

- The study will help microfinance institutions to identify where more emphasis is required as far as social intermediation, social capital and managerial competences

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are concerned. This body of knowledge will be used by nations to stimulate further research in order to promote the expansion of the microfinance industry.

- By emphasizing social intermediation, self-help groups that provide a new type of organization through which the poor can relate to others in society will be formed. Through such social groups, members are expected to develop a substitute for the collateral they lack. That substitute, the peer guarantee mechanism, will introduce shared liability and pressure from social groups as a replacement for security and business appraisals. With the formation of such groups, members will be able to use the "social collateral" to access the necessary financial services from microfinance institutions.

This paper is organized into five sections. The first section is the brief overview of the research and contribution of the study. It is followed by literature review and hypotheses in the second section to discuss the theoretical background of the research and previous studies on social intermediation. The third section discusses research methodology and framework. The fourth section concentrates on interpretation of the findings and discussion. Finally, the fifth section concludes and makes recommendation for future research.

Literature review

While earlier scholars may not agree on the precise definition of social intermediation, there is broad consensus that it is a process in which investment is made in the building up of both human resources and institutional capital, with the aim of increasing the self-reliance of marginalized groups, and preparing them to engage in formal financial intermediation (Lynn, 1996; Goldberg, 1998). Other scholars such as Edgcomb and Burton (1998), conceptualize social intermediation as financial intermediation with a capacity-building component, aimed at those sectors that lack access to credit and savings facilities. Dusuki (2008) observes that social intermediation is different from other common types of social welfare services because it offers mechanism enabling beneficiaries to become clients who should then be ready to enter into a contract involving reciprocal obligations. This aspect of social intermediation should eventually prepare individuals to enter into solid business relationship with formal institutions. The process normally involves training members on basic accounting and financial management as well as business strategy to ensure viability and sustainability of financial services offered.

By playing the role of social intermediation, financial institutions are able to build self-reliant groups of poor people in rural areas with related skills that could foster long-term business relationship. More so, social intermediation helps financial institutions to exploit cost advantage of informal monitoring and enforcement systems which are crucial for a more efficient and effective financial intermediation system.

Social intermediation involves building of social capital in the form of groups that can generate an "information asset" (an information asset is organized information that is valuable and easily accessible to those who need it) for their members, allowing financial organizations to develop confidence in establishing a lending relationship. It also leads to the establishment of systems and structures in which one or more institutional players create a sustainable process that successfully links poor borrowers to sources of capital and financial services, both credit and savings (Edgcomb and Burton (1998).

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Ledgerwood (1999) observes that social ties and information asset created are capable of increasing awareness of financial services, and social collateral (network connections between individuals are used as assets to secure loans), which are determinants of access to financial services in the microfinance industry.

Despite the relevance of the extant literature, the implication or significance of social intermediation to financial services access, specifically in microfinance institutions, remains unclear. As pointed out by CGAP (2002), more empirical research is needed to investigate the extent to which social intermediation influences financial access in the microfinance industry. In this context, the challenge is to investigate the significance of social intermediation on financial services access in the microfinance industry in Uganda. Thus, there is a need to test the following hypothesis:

H_1. Social intermediation positively influences financial services access in the microfinance industry in Uganda.

Social intermediation and social capital

Investment in social intermediation gives rise to social capital. Social capital refers to the willingness of individuals to cooperate with other individuals and with institutions for a common purpose (Berenbach and Guzman, 1992). According to the World Bank social capital initiative, social capital is the internal social and cultural coherence of society, the norms and values that exist among people and the institutions in which they are embedded. Social capital is, thus, known as a foundation of group lending model because it creates social collateral which compensates for lack of material assets in group lending arrangement.

Increasingly, the created social capital will lead to creation of creditworthy borrowers, strong networks within the group, trust, peer monitoring and guarantee mechanism, better flow of information between lenders and borrowers and hence, less adverse selection and moral hazard in the credit market. Pischke (1991) argues that financial intermediation depends upon trust between the borrower and the lender that contracts will be honored. In this case, trust, which results from social capital plays a paramount role in the formation of group lending success, particularly in the absence of collateral. It is worth noting that the main theme of social capital is the level of mutual trust, respect and friendship that arises out of close interactions between internal and external partners (Kale *et al.*, 2000).

Trust, according to Morgan and Hunt (1994), exists when one party has confidence in an exchange partner's reliability and integrity. It is, therefore, embedded in a particular exchange relation, and becomes a fundamental basis of long-term relationships between partners. Besides, the extant literature defends the relationships with stakeholders as the necessary condition for building, maintaining and renewing resources, structures and processes over time. Through external relationships, firms can access critical and complementary resources and capabilities that may otherwise not be available (Vainio, 2005). Drawing from the Social Capital Theory by Nahapiet and Ghoshal (1998), networks of relationships constitute a valuable resource for the conduct of social affairs and much of this capital is embedded within networks of mutual acquaintance. Consistent with the social capital theory, Bontis (1998) argues that it is this social relationship that increases the efficiency of action, and aids co-operative behavior. However, Bontis (2002) argues that network of relationships can only yield tangible results if the parties involved are capable and willing to do so.

Microfinance institutions that have embraced social capital, and well built strong ties with its clients, have been able to take advantage of low cost marketing, knowledge diffusion, low operational costs, and the like. This has consequently enabled them to enjoy the economies of scale in the industry. In a related case, the created social capital normally results into "information asset" for the active poor. The created "information asset" acts as the collective endorsement of character that each member of the group provides the other, that will easily be accepted by the financial intermediary in lieu of other assets. "Information asset" reduces information asymmetry; a barrier to financial intermediation (Dusuki, 2008). Besides, the increased level of awareness and transparency, enable the communities to make viable financial decisions, and selection of legitimate suppliers of financial services which is key in hedging against commercial risk.

Notwithstanding the above assertions, interaction within microfinance institution groups creates cooperation and trust that not only facilitate microfinance activities, but also contribute benefits beyond loan accesses itself. Such benefit may include a greater sense of community, trust and reliance on the group in time of crisis, sharing of valuable social and market information and more positive social practices. The networks and norms created by groups are thereby said to be a positive form of social capital, which in turn, can lay building blocks for other social capital development in a community.

In rural context, social capital can lead to group formation and group dynamics, which in turn, can lead to the creation of support systems that build confidence of the poor, thus empowering them to be more active in the community, improve their family situation, and gain access to education (Dusuki, 2008).

Unfortunately, little has been done so far to empirically establish the level of association between social capital and social intermediation in the microfinance industry. Insufficient literature in this area is, therefore, a matter of great concern in this study. This study, therefore, will address the following underlying hypothesis:

H_2. Social capital positively relates to social intermediation in the microfinance industry.

Social capital promotes social interaction, information sharing and trust which are the cornerstones of group lending methodology. Through their groups, the poor are able to share valuable information about events in and around the community; they are able to build solidarity relationships and rely on each other for accessing credit from financial institutions. For example, strong social links among borrowers may increase their ability to participate in credit transactions characterized by uncertainty about compliance (Lynn, 1996). In particular, social capital could lead to a better flow of information between lenders and borrowers and hence less adverse selection and moral hazard in the credit market. Besides, social capital potentially expands the range of enforcement mechanisms for default on obligations in environments in which recourse to the legal system is costly or impossible (Zeller and Sharma, 1998).

Furthermore, trust (output of social capital) plays a paramount role in the formation of group lending success, particularly in the absence of collarateral. In this case, trust harnesses "social collarateral" constituting a powerful incentive device to yield higher repayment rates than individual lending (Besley and Coate, 1993). The self-selected group members share a common interest in gaining access to credit and savings services, and possess enough low-cost information to adequately screen each other and supply sanctions to those who do not comply with the rules. In this way, beneficiaries will

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be transformed into clients through the development and enforcement of contracts between lender and borrower, and through the support for ownership and control over resources by the poorest. This, therefore, leads to the establishment of systems, and structures in which one or more institutional players create a sustainable process that successfully links the poor borrowers to sources of capital and financial services, both credit and savings.

Though there is general consensus that social capital influences access to financial services, Firer and Williams (2003), and Otero (2005) observe that the effect of social capital on financial services access cannot be generalized because of varied industries. The position of social capital and how it influences financial services access in the Ugandan microfinance industry is elusive. This, therefore, caused the need for a scientific investigation which links social capital and financial services access in Uganda's microfinance industry. This necessitated the study to test the following hypothesis:

*H*3. Social capital is positively related to access to financial services in Uganda's microfinance industry.

Social intermediation and managerial competences

Naturally, social intermediation aims at improving the skills of deprived communities. The exercise involves training of members in basic accounting and financial management as well as business strategy to ensure viability and sustainability of financial services offered (Dusuki, 2008). Ledgerwood (1999) observes that the skills acquired by the communities enable them to understand fully the business environment and take viable decisions that add value to their day to day activities. Social intermediation strengthens the firm's human capital base which represents the human factor in the organization, the combined intelligence, skills and expertise that gives the organization its distinctive character. At the individual level, human capital development gives rise to increased confidence, skill building and attitude about life and business (Bontis *et al.*, 2009).

Investment in social intermediation is therefore, necessary to increase the capacity of the poor to access and productively use microfinance services. Such investment assists the poor people to "remove" some of the barriers posed by financial illiteracy, and lack of a positive mentality or business capacities (Bennet and Cuevas, 1996). It is in this sense that the capacities and confidence of low-income people have to be developed. By emphasizing social intermediation, microfinance institution is not only building self-reliant groups of poor people in rural areas with related skills that could foster long-term business relationships, but is also exploiting cost advantage of informal monitoring and enforcement systems in the long-run, which is inevitably important for a more efficient and effective role of financial intermediation (Bhatt and Tang, 1998).

Increasingly, investment in social intermediation in the microfinance industry has become inevitable, given the competitive and technological forces that are sweeping the twenty-first century. A contemporary company changes so rapidly, that every thing is dependent on its competences, the dedication of its people, the quality of stock of knowledge and the strength of networks with its stakeholders. Through social intermediation, microfinance institutions will be in position to build the capacities of the communities to match the dynamic business environment. Whether social intermediation has a direct or indirect effect on managerial competence or not, is a matter that is limited in literature on the microfinance industry. In this context, the challenge is to investigate the

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extent to which social intermediation influences managerial competences in the microfinance industry in Uganda. Thus, the following hypothesis:

H4. Social intermediation is positively related to managerial competences in the microfinance industry.

Landeiro (2003) observes that managerial competences can influence firm performance if the system in place can promote knowledge generation and transfer, which are sources of the firm's sustainable competitive advantage. Furthermore, Evans and Jukes (2000) argue that knowledge-sharing is an important factor that is associated with organizational value alignment. In this case, when the values of employees are aligned with those of their organization, they tend to be more open with one another, exchange ideas, transfer information, and share their knowledge. Consistent with the transactive memory theory by Wenger (1998), members are able to benefit from each other's knowledge and expertise if they develop a good shared understanding of who knows what in the group or unit. Ruzevicius (2006) supports the same view and acknowledges that the sharing of knowledge should become one of the essential values within any setup. Business managers should, therefore regard employee training and passing knowledge on to others as one of the most important priorities of the organization. The professional capacities belonging to human capital can, therefore, be seen as an element of interaction among individual attributes and performance requirements in a particular context (Marr and Schium, 2001). Thus, the interactive behavior of the individuals and their willingness to generate and share knowledge in the firm influence the competence base, which is a source of firm value and better performance (Bontis *et al.*, 2009). However, Kulvisaechana (2005) argues that the accumulation of exceptionally-talented individuals is not enough for the organization; there must be a desire on the part of individuals to invest their skills and expertise in the organization.

Increasingly, business knowledge increases the level of awareness of different possible opportunities and threats. This state of affair is hoped to reduce information asymmetry, a major hindrance to the access of financial services. Business knowledge is, therefore, vital in increasing the borrowers' participation in the formal financial intermediation (Yunus, 1998). Lynn (1996) and Goldberg (1998) observe that this direction builds confidence of marginalized groups in handling financial matters. In this case, business skills will enhance the assimilation of poor communities into formal financial markets; a direction that boosts productivity of the communities (Yunus, 1998). Henceforth, managerial competence is perceived as an answer to limited access to credit facilities, high poverty levels and information asymmetry.

Though there are many studies carried out in this area, there is still inadequate literature that links managerial competences and access to financial services in the microfinance industry. Limited literature on the effect of managerial competences on access to financial services in the microfinance industry motivated this investigation. The researcher therefore, hypothesizes as follows:

H5. Managerial competences and access to financial services are positively related in the microfinance industry.

Study design and methodology

This study used cross-sectional and quantitative research designs to address the hypotheses covered in this research.

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The population of the study included clients of microfinance institutions in Uganda. On the basis of Ntoumanis (2001) and Field (2006) guidelines, this study covered a minimum of five clients per microfinance institution. Since clients' sampling frame could not easily be established, snowball sampling technique was used. From 78 ((The) Association of Microfinance Institutions of Uganda, 2010) microfinance institutions, a total of 390 clients constituted a sample size (i.e. 5 per firm × 78 firms). However, out of 390 clients, 275 responded, giving a response rate of 70.5 percent.

All items were anchored on a five-point Likert – type scale ranging from 5 (strongly agree) to 1 (strongly disagree). Questionnaire was validated through expert interviews and a panel of practitioners. The reliability of the instrument (using internal consistency approach) to find out whether it consistently measured the study variables on the scales used (Nunnally, 1978) was tested. The computed Cronbach α coefficient results were all above 0.6.

Common method bias was addressed in this study by collecting data from at least five clients of each MFI, and potential effects of response pattern biases were reduced by incorporating negatively worded items on the questionnaire (Hinken, 1995; Idaszak and Drasgow, 1987). The logic is that negatively worded items are like cognitive "speed bumps" that require respondents to engage in a more controlled, as opposed to automatically cognitive processing (Hinken, 1995).

Data were screened to establish the distribution of data and assess whether the assumptions of parametric data are tenable. Specific assumptions tested included normality of the distribution of the data, homogeneity of variance, linearity of the data independence of errors and multi-collineality. Multi-collinearity was tested by running the variance inflation factor (VIF) and the tolerance levels. Standard cut-off points suggested by Scott (2003) and Yu (2008) were observed.

Data were analyzed using multiple regressions and analysis of moment structures (AMOS).

Results

Sample characteristics

Response rate of 70.5 percent was registered; female and males represented 37 and 63 percent, respectively. Of these, 42 percent were from central, 22 percent western, 15 percent northern and 21 percent eastern regions of Uganda. The bigger percentage (86 percent) of the clients has been getting financial services from MFIs for more than ten years. The mean scores of variables studied ranged between 3.01 and 4.21 and standard deviations in the ranges of 0.57 to 0.71. Since the standard deviations are small compared to mean values, it is true the computed means highly represent the observed data. In effect, the calculated averages are a good replica of reality (Field, 2006; Saunders *et al.*, 2007).

Correlation and regression analyses

Correlation results presented in Table I indicate that social intermediation, managerial competence and social capital have a substantive and significant relationship to financial services access ($r = 0.332, p < 0.01, r = 0.345, p < 0.01, r = 0.180, p < 0.01$), respectively. The results signify that increased levels of social intermediation, social capital and managerial competences are highly associated with increased access to financial services in the microfinance industry. Although a positive and significant

relationship was established between social intermediation and social capital ($r = 0.151$, $p < 0.05$), there was not significant relationship between social intermediation and managerial competence. This implies that increased social intermediation is associated with increased levels of social capital in the microfinance industry (Table II).

Relating to Table I and path diagram on Figure 1, the regression results indicate that social intermediation together with social capital and managerial competence account for 32 percent of variance in access to financial services in Uganda's microfinance industry. This finding supports *H1*.

Relationships between social intermediation and access to financial services in the microfinance industry

Results have indicated that positive and significant relationship exists between social intermediation, social capital, managerial competence and access to financial services in the microfinance industry. This signifies that an improvement in social intermediation is highly associated with high levels of access to financial services in the same industry. These findings are consistent with conclusions made by Ledgerwood (1999) who observes that social ties and information asset created are capable of increasing

Table I.
Regression results

			Estimate	SE	CR	p	Estimate β-values
FINSERVICES	←	MANCOMPETENCE	0.433	0.075	5.777	*	0.350
FINSERVICES	←	SOCINTERMEDIATION	0.694	0.125	5.553	*	0.330
FINSERVICES	←	SOCPITAL	0.223	0.075	2.981	0.003	0.180
Financial services			Estimated R^2 0.318				

Table II.
Correlation between the independent variables

			Estimate	SE	CR	p
MANCOMPETENCE	↔	SOCPITAL	0.165	0.081	2.041	0.041
SOCINTERMEDIATION	↔	MANCOMPETENCE	0.059	0.048	1.240	0.215
SOCINTERMEDIATION	↔	SOCPITAL	0.102	0.049	2.091	0.037

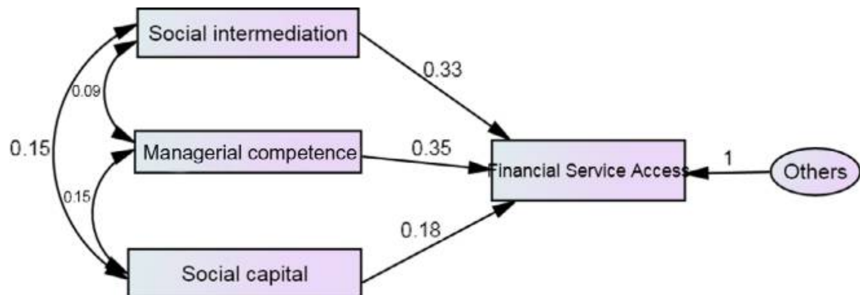

Figure 1.
Path diagram

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awareness of financial services, and social collateral, which are determinants of access to financial services in the microfinance industry. Pischke (1991) observes that the finding above is possible because the created social capital will lead to creation of creditworthy borrowers, strong networks within the group, trust, peer monitoring and guarantee mechanism, better flow of information between lenders and borrowers, and hence less adverse selection and moral hazard in the credit market; which in turn, boost access to financial services. In this case, there is sufficient evidence to prove that social intermediation and access to financial services are highly connected in the microfinance industry; thereby providing support for *H1*.

More so, a positive and significant relationship was established between social intermediation and social capital. In addition, a strong significant relationship was established between social capital and access to financial services in the microfinance industry. These findings are consistent with Tang's (1998) and Collier's (1998) observations. They observed that investment in social intermediation gives rise to social capital, which is, a major factor in promoting financial intermediation in the financial sector. These findings hence lend support to *H2* and *H3*.

Likewise, tests on relationships between managerial competence and access to financial services indicated a strong and positive association between the two, thus supporting *H5*. This finding is consistent with conclusions by Yunus (1998) who argues that managerial skills give potential borrower ability to access and use the available funds at his disposal. This is further collaborated by the works of Lynn (1996) and Goldberg (1998) who argue that increased investment in human resources promotes self-reliance and confidence of marginalized groups, and prepare them to participate in formal financial intermediation.

Nonetheless, insignificant relationship was registered between social intermediation and managerial competence, thus, rejecting *H4*. This contradicts the findings of Wenger (1998) who observes that members are able to benefit from each other's knowledge and expertise if they develop a good shared understanding of who knows what in the group or unit. The inconsistence is also seen in the works of Ruzevicius (2006) who argues that providing and sharing of knowledge build competences of people who in turn, become independent when making informed decisions. Following the above results, *H4* is therefore rejected.

The foregoing mixed results could be explained by the target group of people in the communities. Traditionally, majority of microfinance clients are illiterate (CGAP, 2002; Kalyango, 2009), incapable of mastering the skills quickly. Furthermore, because of diversity of industries as observed by PekChen (2005), conflicting results are expected. The truth is that these industries are completely different in structure and intent. Bandura's (1986) observations further support Penchen's conclusions. Through his social cognitive theory, Bandura (1986) posits that different environments influence different responses and results. Thus, studies by Wenger (1998) and Ruzevicius (2006) which observed positive relationship between social intermediation and managerial competence were carried out in more advanced institutions (i.e. commercial banks) as opposed to the microfinance industry. Microfinance industry is still at infancy stage, with different goals compared to commercial banks. Thus, conflicting results obtained in this case, could be attributed to different environments and study groups.

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Conclusion

Social intermediation is an important factor which must not be ignored by government and financial service providers. The fact that it influences the social capital, and therefore, access to financial services in the microfinance industry, is sufficient enough to emphasize its implementation. More so, with the exception of managerial competence whose association with social intermediation is insignificant, all the rest of the constructs exhibited a positive and significant relationship in the microfinance industry. The probable explanation for the insignificant association between managerial competence and social intermediation may be attributed to the high level of illiteracy in the microfinance industry.

Recommendations to management and researchers

As reviewed in this paper, microfinance requires innovative approach beyond the traditional financial intermediately. Government and other stakeholders in the industry should embark seriously on building human capacity of clients through social intermediation and create opportunities that promote social capital among the groups. Social capital in this case, will increase coordination and information symmetry which are proven to be one of the effective means to increase access to financial services.

It is also recommended that client screening process should go beyond applicants' ability to pay, other attributes like social competences, client motivation and leadership abilities of clients have to be considered. Welbourne (2008) observes that it is not the quality of the clients you serve that will promote business success, but the ability of the people you serve to network well with stakeholders and their agility in pointing out sensitive matters to the firm.

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