PERSPECTIVES ON THE TRANSFORMATION OF MICROFINANCE INSTITUTIONS IN KENY A INTO REGULATED STATUS UNDER THE MICROFINANCE ACT, 2006

By

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A Thesis Submitted in Partial Fulfilment of the Requirement For
Master of Commerce

STRATHMORE UNIVERSITY

SCHOOL OF GRADUATE STUDIES

2009

DECLARATION

This research thesis is my original work and has not been presented for a degree in any other university.

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This thesis has been submitted for examination with my approval as a university supervisor.

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ABSTRACT

The Kenya Government's move to regulate Microfinance Institutions (MFls) was primarily to create an enabling environment for MFls to maximize outreach on a sustainable basis so as to increase financial access by poor households, thus reducing the population without access to financial services in Kenya. The *Microfinance Act, 2006* will allow qualifying microfinance institutions to transform into deposit -taking institutions. The Act lays the legal and regulatory framework for the licensing and supervision of microfinance institutions. The primary objective of this thesis was to assess the prevailing institutional capacity and preparedness of the existing microfinance institutions to transform into deposit taking MFls. Secondly, was to establish the perception of micro finance practitioners on the appropriateness of the legislation and regulations for the microfinance industry in Kenya.

The study employed survey methodology to explore issues such as institutional capacity and preparedness of Microfinance Institutions. A researcher constructed questionnaire was administered to elicit responses from the microfinance institutions that are members of the Association of Microfinance Institutions (AMFI). Face-to-face interviews with executives of microfinance institutions were conducted to supplement the questionnaire and also for an in-depth understanding and analysis of certain key aspects of the research.

Findings of the study suggest that there are considerable challenges to the transition from informal to formal financial institutions. The institutions expressed concerns with respect to certain regulatory requirements in the microfinance legislation and regulations that make the costs of implementation quite high. The requirements that were considered to be most difficult and by extension considered inappropriate for the microfinance industry were the requirements for business premises, loan loss provisioning and disclosure and reporting requirements. The branch infrastructure and overall cost of transformation, in particular modernisation of Management Information Systems (MIS) are considered quite significant, especially for smaller or rural MFIs which will have to incur additional costs of upgrading their MIS.

ACKNOWLEDGEMENT

This study would not have been possible without the support of a number of individuals who dedicated their time and resources to guide, assist as well as critique this study.

I am deeply indebted to my principal supervisor Dr. Ruth Kiraka and Mr. David Wang'ombe, for their guidance and assistance in the undertaking of this study.

I would also like to extend a special thanks to the incredible team of lecturers at Strathmore University who contributed in one way or another in my success throughout this course - I am most grateful. Special thanks are extended to Dr. Jim McFie, for his guidance to the pioneer class of Forensic Accounting option.

My heartfelt gratitude goes to my loving wife for her patience and support as I struggled to put this script together, and for going through my work and proofreading it.

The inspiration to research on micro finance came from my interaction with the industry and was motivated by what I saw as the passion to transform and be regulated. To all the Chief Executive Officers of Microfinance Institutions that responded to my questionnaire as well as the executives who were interviewed in the course of this study for their time, support and their willingness to share information with me. I appreciate their valuable assistance without which the final output of this research paper would have been in vain.

Last but not least is to my colleagues at the Central Bank of Kenya Dr. D. G. Barako and Evelyn Kilonzo for their constructive comments and suggestions in different stages of this research paper.

DEDICATION

This is dedicated to the Almighty God for enabling me to complete this research and to my family for their encouragement and patience.

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background to the Study

The transformation of microfinance non-governmental organizations (NGOs) into regulated financial institutions is a model that has been evolving over time. The transformation of K-REP Bank from an NGO to a commercial bank was the first in Kenya in the year 1999. However, with the enactment of the Microfinance Act 2006, transformation in this thesis will refer to the establishment of a regulated financial institution (RFI) by a nongovernmental organization (NGO) or a group of NGOs by transferring its loan portfolio to the **RFI** completely or partially (Fernando, 2004).

The transformation of microfinance NGOs into regulated financial institutions (RFI) is embraced as one of the most effective strategies for achieving a significant scale by offering a wider range of services, accessing commercial sources of capital and improving operational efficiency through enhanced systems, controls and transparency in reporting that would result from links to regulators and other banking expertise (Campion and White, 1999) and financial sustainability of MFIs.

Indeed improving access to financial services and products for many more Kenyans remains a great challenge. By December 2006, there were only 3.3 million bank accounts, for a population of about 34 million Kenyans. The percentage of Kenyans holding bank accounts still remains low by international standards (World Bank, 2008).

The World Bank (2008) argues that financial access is lacking not only for the poor, but for large segments of the non-poor. Improving access and building inclusive financial systems is a goal that is relevant to economies at all levels of development. According to Kenya Vision 2030, the challenge of better access means making financial services available to all, thereby spreading equality of opportunity and tapping the full potential in an economy.

According to Robinson (2001) increased access to finance is important for two reasons. First, it provides the financial services that the active poor need to expand and diversify their economic activities to increase their income and to improve their lives. The economically active poor who are able to expand their economic activities often create jobs for others; among those who gain employment in this way are some of the extremely poor. Secondly, it is a powerful tool for building the self confidence of the poor. By lending to the poor, microfinance institutions demonstrate confidence that poor households are worthy of trust. Because financial services help the poor expand their economic activities and increase their income and assets, their self confidence grows simultaneously.

In short, therefore, financial exclusion can impose significant costs on individuals, families and society as a whole. Thus, the statistics below on the population without bank accounts raises serious concern for the Government.

Table 1.1: Percentage of Population without Bank accounts

	Country	Percentage (%)
1.	South Africa	30
2.	Ghana	38
3.	Madagascar	40
4.	Cameroun	55
5.	Swaziland	60
6.	Kenya	80
7.	Sierra Leone	85
8.	Uganda	90
9.	Malawi	92

Source: World Bank (2008)

As shown in Table 1.1 above, 80 per cent of the Kenyan population do not operate bank accounts, despite a robust banking industry (World Bank, 2008). The World Bank Policy Research Report (2008) identifies some key barriers to maintaining bank accounts as complex documentation, and paperwork procedures and unaffordable interest rates, fees and minimum balances. It is evident from Table 1.1 that Kenya compares unfavourably with South Africa and Ghana. Madagascar has 40 per cent of its population unable to open bank accounts (World Bank, 2008).

Appropriate access to banking services serves as a crucial stepping stone to full financial inclusion. Those with bank accounts find it easier to use other financial services and grow more used to handling their own personal finances. A reduction in the proportion of individuals and households without access to bank accounts is not only an important goal in itself; such a reduction also makes a crucial contribution to wider success in tackling financial exclusion (Government of Kenya, 2007b).

With the focus on the financially excluded, and as part of the needed reforms in the financial sector, the government enacted the *Microfinance Act, 2006.* The enactment of the Act was a major milestone as it was in recognition of the fact that this sector is unique with several features that distinguish it from banks (Meagher, 2002). It therefore requires separate legislation from that of the mainstream commercial banks. Microfinance institutions are recognized as legitimate providers of financial services. In addition, the sector has long been identified as a key sector to harnessing economic development for entrepreneurs and low income families, especially in rural Kenya (Government of Kenya, 1992). The principal objective of the *Microfinance Act; 2006* is to make provision for the licensing, regulation and supervision of microfinance business in Kenya and ultimately expand access to financial services by creating an alternative pathway for institutions to be licensed as regulated business entities separate and distinct from commercial banks (Central Bank of Kenya, 2006).

The Microfinance Act will allow qualifying Microfinance Institutions (MFls) to mobilise savings from the public, providing the appropriate financial impetus to improve on the current practice characterised by limited micro credit product ranges 'collateralised' by forced savings. In essence, governments and donor funds can supply only a tiny fraction of microfinance demand and hence financial intermediation by self sufficient institutions is the only way that financial services can be supplied to lower-income people (Robinson, 2001 and Schmidt and Zeitinger, 2003).

Nonetheless, the regulation and supervision of micro finance institutions has its own challenges both from the point of practitioners as well as regulators. Carmen and Marconi (2004) established that there was more instability in the regulated microfinance sector in Bolivia. Christen and Rosenberg (1999) argue that regulating and supervising microfinance can have unintended consequences. However, the two argue strongly for the regulation of microfinance, as it is the only setting that would permit massive, sustainable delivery of financial services to the poor. Their overall message was a cautionary one that there were problems in regulating microfinance that needed to be dealt with realistically.

1.2 The Financial Landscape of Kenya

The financial sector in Kenya cornpnses the formal banking institutions, the microfinance institutions, savings and credit cooperatives societies (SACCOs), and the informal financial services providers such as Rotating and Savings Credit Associations (ROSCAs) and Accumulating and Savings Credit Associations (AS CAs) - with the level of formality defined by the degree ofregulation (Central Bank, 2006). This financial landscape can be depicted diagrammatically as follows:

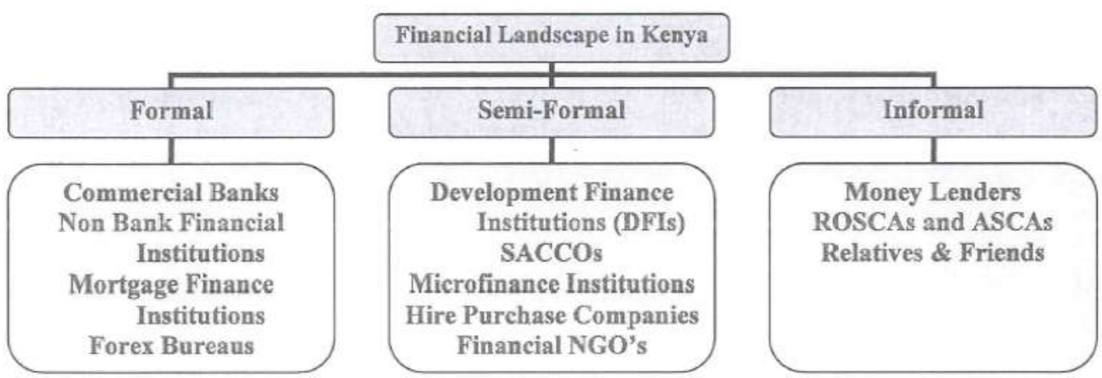

Figure 1.1 : Financial Landscape of Kenya
Source: Central Bank of Kenya, 2006.

According to the *FinAccess study 2007*, the formal sector serves about 19% of the Kenyan population while 8% and 35% of the populace are served by the semi formal and informal financial services respectively. The findings of the FinAccess Report are discussed in greater detail in chapter 2.

The formal financial system is regulated and supervised by the Central Bank of Kenya. It is well organised and provides financial services mainly to the middle and upper income earners as well as the working elites in urban areas. It comprises of banks, mortgage finance companies and the foreign exchange bureaus. At the end of December 2006, there were 45 formal financial institutions of which 42 were commercial banks; two mortgage finance companies and one a non-bank financial institution. Four banks, that is Co-operative, K-REP, Equity and Family banks, offer specialised microfinance products and services. The Foreign Exchange Bureaus totalled 96 (Central Bank of Kenya, 2006).

The semi formal non deposit taking microfinance institutions operating in Kenya have largely been donor supported NGOs. The key umbrella organisation, the Association of Microfinance Institutions (AMFI) had a diversified membership that consisted of 34 microfinance institutions, by the end of 2007. Twenty five out of the 34 AMFI member institutions are retail lending microfinance institutions, two are wholesalers while four are commercial banks, two development finance institutions and one is an insurance company (AMFI Directory, 2008).

Table 1.2: Composition of Association of Microfinance Institutions (AMFI)

Institution		**Number**
1	Retail Lenders	25
2	Wholesale Lenders	2
3	Commercial Banks	4
4	Development Institutions	2
5	Insurance Companies	1
	TOTAL	34

(AMFI Directory, 2008)

The non deposit-taking MFls have been providing micro-credit services to a clientele that is poorer and more vulnerable than that of traditional banks. However, the activities and programs of these institutions have been severely hampered by limited resources. With the enactment of the Microfinance Act 2006, the Central Bank has been empowered to regulate deposit-taking microfinance institutions. The entities that will be licensed by the Central Bank will be allowed to take deposits. It is envisaged that allowing these institutions to access deposits from the public, will avail the MFIs with a cheaper source of funds to leverage their capital bases (Omino, 2005).

Microfinance has received increasing public acclaim as an effective strategy to alleviate poverty by providing financial services to the poor who have little or no access to capital and formal financial services (Robinson, 2001). In Kenya, microfinance institutions are fundamentally essential in providing credit for the micro and small-scale enterprise (MSE) sector (Central Bureau of Statistics, 1999). The micro finance sector is also important for employment generation, wealth creation and welfare improvement (Government of Kenya, 1997). The objective for financial services as outlined in *Kenya Vision 2030* is that the country will 'decrease the share of population without access to finance from 85% to below 70% through reforms in the banking industry and the streamlining of microfinance institutions.' The Government envisages the building of a vibrant and globally competitive financial sector that drives high levels of savings and finances the country's investment needs. To this end, the microfinance industry is being elevated as an integral part of the financial system in Kenya, expected to playa pivotal role in deepening financial markets to expand access of affordable financial services and products to the majority of Kenyans, particularly the poor, low-income households and micro and small scale enterprises (Government of Kenya, 2007b).

1.3 Statement of the Problem:

In Kenya where 80% of the population do not operate bank accounts, the Government initiated policy reforms in the financial sector. One of these reforms was the enactment of a Microfinance Act. The Microfinance Act, enacted in 2006, laid the legal and regulatory framework for the licensing and supervision of deposit taking microfinance institutions. Traditional non-deposit-taking MFls are expected to transform into regulated deposit-taking financial institutions. This transformation is considered critical in facilitating the strengthening of these institutions to enhance their capacity to serve many more Kenyans at the lower end of the financial pyramid.

However, existing microfinance institutions could give a wide berth to transforming under the Microfinance Act, 2006 by opting to remain as credit only institutions in their current institutional structures. This could arise if there are considerable challenges to their transformation. These considerable challenges for the existing institutions to transform could arise from two sources. First, it could be that the legislative framework developed is inadequate or not conducive to the growth and development of the microfinance sector as was the case in Bolivia (Velasco and Marconi, 2004) or as established in a study by Christen and Rosenberg (1998). Second, it could be the lack of capacity by institutions to transform. This would be due to the absence of strong mature MFIs to transform, as was the case of Tanzania (Bikki, 2005). The presence of these two challenges could derail the realisation of strong and sustainable microfinance institutions to increase access to financial services to the majority of Kenyans. This ultimately would hamper the government's efforts towards meeting the millennium development goals, to reduce poverty by halfby the year 2015.

The aim of this research is therefore two fold. First, the researcher will assess the appropriateness of the microfinance regulatory framework from the perspective of practitioners. Second, the researcher recognises the importance of well functioning institutions. Therefore, this research will explore the institutional preparedness and capacity of the non-deposit taking MFIs to transform into deposit taking regulated entities.

1.4 The Objectives of the Study:

Specific Objectives

Specifically, the study aimed at:

i) Establishing the prevailing institutional capacity and preparedness of the existing microfinance institutions, to transform into regulated deposit taking micro finance institution.

ii) Establishing the perceptions of practitioners on the appropriateness of the legislation and regulations for the microfinance industry.

1.5 Research Questions

j) What is the institutional capacity of the non-deposit taking microfinance institution to transform itself into a deposit taking MFI?

ii) What preparations have been put in place by non deposit taking MFIs towards transforming into a regulated status?

iii) What is the perception of the practitioners on the appropriateness of the legislation and regulations for the microfinance industry?

1.6 Significance of the Study

This study is expected to be of importance to: -

a) Government policy makers, in particular the Kenya Vision 2030 Steering Committee. One of the key objectives of *Kenya Vision 2030* is the broadening of financial access. This study aims at gauging the ability of the unregulated microfinance institutions to transform and by extension broaden financial access by penetrating into the rural areas and supporting small scale business.

b) The Central Bank of Kenya as the country's financial regulator. The study will explore some of the challenges that the transforming microfinance institutions will face in meeting the laid requirements. This will provide insights to the regulator, with a view to provide workable strategies and intervention mechanisms to enhance capabilities in their oversight role.

c) Academic researchers by adding to the existing body of knowledge in the microfinance industry. The study presents empirical evidence on perceptions of microfinance practitioners in Kenya on their transformation to regulated status.

d) Microfinance institutions' executives can learn from the findings of this study. They can benefit from the lessons of others to assist them in strategising to adequately plan and roll out their transformation program

e) Business executives and the General Public will increase their knowledge on microfinance industry from this study.

1. 7 Delimitation:

The study involved carrying out interviews and filling out of questionnaires by executives of micro finance institutions that are members of AMFI. The study was limited in scope to cover only institutions that are registered as MFr, and has excluded the informal ones. Other alternative financial services providers not members of AMFI have been excluded because they are considered less organised and therefore, it is difficult to obtain information from them.

CHAPTER TWO

2.0 REVIEW OF RELATED LITERATURE

2.1 Overview of the Chapter

Literature review provides important experiences from all over the world. This chapter is intended to provide a summary compilation of background information and international experiences on microfinance regulation, access to financial services and the role of microfinance as a tool for increasing access to financial services and for fighting poverty. The review also maps related studies and research as well as emerging paradigms that are relevant to this study, while at the same time drawing on an annotated bibliography of over 30 articles and research studies from development agencies, academics and practitioners.

The chapter is divided into five sections and provides summarized conclusions and findings from previous studies and research findings. Section one presents literature on the transformation of MFls to regulated status, and the motivating factors for transforming into deposit-taking institutions. The second section reviews other research findings on access to financial services and, more generally, some linkages between microfinance and financial access from various research institutes, think-tanks, academics and practitioners. Section three summarises the major concerns for deposit-taking institutions that necessitate tight regulation of these institutions. The fourth section is divided into two subsections: challenges of regulating microfinance from the perspective of the regulators and that from the MFI. This section also highlights the importance of perceptions in intluencing human behaviour. Finally, Section five introduces the conceptual framework and discusses the research gaps in the field and emerging paradigms/ themes that seem to be potentially important issues to consider in the near future. But first, we look at the theoretical framework for this thesis.

2.2 Theoretical Background

From the outset, we would like to indicate the basic premises upon which this thesis is founded. This thesis follows four theories that have been advanced by various researchers namely Legitimacy, Institutional, Economic and Capitalism Theories.

2.2.1 Legitimacy Theory

Legitimacy theory asserts that organisations continually seek to ensure that they are perceived as operating within the bounds and norms of their respective societies. This is seen as a social contract between the organisation and the pubic at large. That is to say that the institutions attempt to ensure that their activities are perceived by outside parties as being 'legitimate' (Deegan and Unerman, 2006).

The theory alludes to the fact that organisations will be penalised if they do not operate in a manner consistent with community expectations. Failure to comply with societal expectations may lead to sanctions being imposed by society for example in the form of legal restrictions imposed on an organisations operations, limited resources and or reduced demand for its products and services. Legitimacy (from society's perspective) and the right to operate go hand in hand (Mathews, 1993).

Transformation into regulated status can therefore be viewed as a process of maintaining the congruence between the public's expectations and the perceptions by the organisation to be seen to be conforming to that expectation in order to be considered as legitimate. After all, the objective of enacting the Microfinance Act was to provide a regulatory framework for the micro finance sector. Therefore, to be seen as being relevant (legitimate) the microfinance institutions will be under pressure to transform under the Microfinance Act.

However, the concept of legitimacy is dynamic in that the public continuously evaluates organisations against an ever evolving expectation. If society's expectations change, then an organisation will need to show that what it is doing is also changing or explicitly communicate and justify why its operations have not changed (Lindblom, 1994). This is therefore, to say that the MFIs that chose not to transform will seek to change external expectations, for example by demonstrating that specific regulatory requirements are unreasonable, with a view to ensure that their operations are perceived to be legitimate.

2.2.2 Institutional Theory

Institutional theory attends to the deeper and more resilient aspects of organisational structure. It considers the processes by which structures including rules, norms, and routines, become established as authoritative guidelines (Scott, 2004). Scott asserts that institutions are social structures that have attained a high degree of resilience. They are composed of cultural-cognitive, normative, and regulative elements that, together with associated activities and resources, provide stability and meaning to social life.

There are two dimensions to institutional theory namely *isomorphism* and *decoupling.* Dillard, Rigsby and Goodman (2004, p.509) explain that 'isomorphism refers to the adaptation of an institutional practice by an organisation' .

According to DiMaggio and Powell (1983) isomorphism can either be coercive or mimetic. Coercive isomorphism is where organisations only change their organisational practices because of pressure. On the other hand mimetic isomorphism involves institutions seeking to emulate institutional practices of other organisations for competitive advantage.

The dimension of decoupling implies that for organisations to be seen to be adopting certain institutional practices, will even institute formal processes aimed at implementing these practices. Thus the actual practices can be decoupled from those institutionalised (apparent) practices. In terms of MFIs, this decoupling can be linked to some of the insights from legitimacy theory whereby the operational procedures and practices can be used to construct an organisational image very different from actual organisational practices. Thus regulatory requirements are incorporated into the organisations formal practices because they maintain appearances and thus confer legitimacy irrespective of whether the entity has transformed or not.

Institutional theory provides an explanation of mechanisms through which organisations seek to align perceptions of their practices and characteristics with social and cultural values. Such mechanisms in the case of an MFI could include those stipulated under microfinance regulatory framework that prescribes the road map for the transformation from informal to formal financial institutions.

The transformation of financial NGOs into formal financial institutions may help solve MFls funding constraints and increase their ability to provide additional financial services to the target market. Accompanying this change of perspective is a better understanding of the implications of institutional structure for achieving the ends of greater service, scale and sustainability (Ledgerwood, 1998).

According to Ledgerwood (1998) a good microfinance institution has three attributes. The first attribute is that it provides services to the relevant target group. Secondly, the activities and offered services should have identifiable positive impact on the lives of the customers. Thirdly, the institution should be strong, financially sound and stable. An MFI must be able to make visible progress toward financial self-sufficiency. The current literature and actual practice tells us that the government and donor funds can supply only a tiny fraction of global microfinance demand and hence financial intermediation by self sufficient institutions is the only way that financial services can be supplied to lower-income people worldwide (Robinson, 1998). Only an MFI that is able to cover its cost (on a medium term basis) can continue its operation in a sustainable way and also generate benefits to its clients.

Therefore, creating a formal financial institution also implies additional costs and restrictions as the MFI becomes regulated and supervised. MFls must develop institutional capacity to manage a number of different products, and services as well as mobilize resources, and enhance management information systems to adhere to regulatory reporting requirements and manage additional products (Robinson, 1998).

2.2.3 Economic Theory and Theory of Capitalism

Microfinance theoreticians have also advanced Economic Theory and Theory of Capitalism. The two theories emphasize that, given an enabling macroeconomic, political, legal, regulatory and demographic condition; MFls can be developed to provide financial intermediation for the economically active poor. These institutions can deliver services at the local level profitably, sustainably, without subsidy and with wide coverage.

According to Remenyi (2000), the gist of the economic argument is that success in any business venture, including MFls, is determined by the entrepreneurs' ability to deliver appropriate services and profitably.

Economic theory treats microfinance institutions as infant industries. This theory sterns from the fact that the international donor community and governments had devoted substantial financial and non-financial investments in developing and providing subsidized financial services for the poor on the premise that they have limited access to the formal mainstream financial institutions. However, instead of seeking subsidized financial services for their life time, the MFls, should transform into self-sustainability through cost control, efficient operations, and adopting modem commercial practices. Economic theory builds on the institutional theory of self sustainability advocating the case for the development of strong viable microfinance institutions.

Capitalism theory is based on the assumption that continued prosperity (sustainability) critically depends upon the progressive creation of private wealth. In Smith's view, the prime mover behind the creation of private wealth is human self-interest. This maxim is best summarized in Smith's own words. In his classic *'An Inquiry into the Nature and Causes of the Wealth of Nation'*, published in 1776, Smith states: "It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their self-interests; we address ourselves not to their humanity but to their self-love and never talk to them of our own necessities but of their advantages" (Smith, 1939, pp. 26-27).

The new thinking in microfinance adds a new chapter in the theory of capitalism. As noted above, this thinking is founded upon economic ideas. The economic idea is the orthodox infant industry argument that justifies protectionist measures within the framework of the classical theory of free trade. Yunus (1998) is one of the ardent advocates of this theory, in which he argues that it is possible to attain a balance in a capitalist society in which enterprises that maximize private profits do so having in mind fair interest of their customers. The overriding principle is that these enterprises are not exploitative, as consider interests of their customers.

2.2.5 Past Research Using the Theories

A number of studies in the past have drawn parallels with these theories. One study was a case study based on the Aga Khan Rural Support Programme (AKRSP), which is one of the prominent microfinance institutions in Pakistan. The study examined the process of transformation of the subject as it changed from a donor based institution to a sustainable, commercial institution.

The study drew parallels between two theoretical frameworks, namely the theories of Laughlin's (1991) Model of Organizational Change and Institutional Theory (DiMaggio and Powel, 1983). The study provides insights into the successful adaptation of the AKRSP in which it had to tailor all of its tangible and intangible organizational elements in response to the changed external conditions to ensure its survival and sustainability.

Some scholars argue that in the case of emergmg organizational forms, institutional concerns do not form a "unified system" pushing organizations to follow a predefined design, (Sewell, 1992; Greenwood and Hinnings, 1996; Seo and Creed, 2002). Instead they form a sort of "toolkit" (Swidler, 1986) from which actors can select different pieces for constructing organizational designs. Founders then do not blindly follow pre-existing designs. Instead they negotiate the creation of organizational forms which they perceive as adequate for the new venture by combining pre-existing elements from this institutional toolkit. Their designs depend on their previous organizational background (Baron, Hannan, and Burton, 1999) and network of relations. They also depend on their political talents to engender collective support for their novel combinations (Fligstein, 1997).

Available empirical evidence indicates that a lot of studies have delved into the issues surrounding possible mission drift on transformation to a commercial institution from an NGO - that is, to deviate from advancing social issues like fighting poverty in communities in which they operate but increasingly operating as profit maximisers. However, the studies of some scholars have found weak evidence to support social mission drift by transforming organisations (Christen, Rosenberg, and Veena, J. 2004).

Christen's (2004) study of selected commercial microfinance organizations in Latin America, Asia, and one in Africa illustrated increased access to resources.

Most of the Latin American organizations multiplied their equity and all but two of the Asian organizations doubled their equity.

A study by Stephen 2005 indicated that transformed MFIs had increased their access to resources by using savings and borrowing in larger numbers than their NGO counterparts to finance their loan portfolio. The study undertaken by Stephen using 2003 data was based on 230 microfinance organizations (Stephen 2005).

Further, the study by Stephen found that the transformed institutions had become more transparent and hence more accountable to external stakeholders. Stephens studies revealed that the transformed entities had strengthened their organizational capabilities to function as commercial institution. In addition, the transformed institutions had brought in experienced bankers and accounting personnel for specialized functions such as asset and liability management, treasury management and internal controls.

Other studies found that the new people brought in did not necessarily share in the initial mission and practices of the organization. A particularly painful example was experienced in BancoSol as workers coming from the NGO and those newly hired with a banking background developed an "oil and water" relationship (Dorado, 2005).

From the foregoing, it is notable that the theories have been used by a number of scholars. This thesis contributes to these theories by exploring the reaction of microfinance practitioners on the enacted microfinance legislation in Kenya. Kenya has enacted a law to supervise the microfinance sector. This is in recognition of the inappropriateness of banking legislation for the regulation of specialized activities of microfinance and the diversity of the institutions engaged in the sector. Further, this thesis is based on the beliefthat the microfinance sector could reach full potential in a regulated situation. In order to attain full potential, the microfinance industry must enter the arena of licensed, prudentially supervised financial intermediaries, and regulations crafted should allow effective and efficient development of the MFls (Christen etal, 2003).

Nonetheless, the most important consideration after protecting depositors is that the regulatory framework fosters innovation, competition, stability and growth for MFls (Ledgerwood, 2006). Therefore, this thesis tries to shed light on how the regulatory and supervisory framework for MFIs in Kenya will impact on the institutions' decision to transform or to retain the status quo. In addition, the thesis documents the current status of microfinance institutions in terms of capacity and resources to comply with the new law. With these objectives, the relevant literature IS briefly reviewed below, beginning with the literature on transformation of MFls, for this form the foundation towards strong and viable institutions.

2.3 Transformation of MFls into Regulated Status

According to Hishigsuren (2006), there are several factors that motivate microfinance NGOs to transform into a regulated institution. The first critical factor is to access commercial sources of funding. NGOs feel unable to meet the large and growing demand for microcredit because their sources of funds are limited to donations, income from lending and subsidized loans. Microfinance practitioners have realized that the donor grants and soft loans are limited (both in terms of amount and terms attached) and does not support the portfolio growth need to ensure long-term sustainability for the institution. As NGOs, they do not have access to commercial sources of funds. Transformation is sought to access other sources of capital more rapidly and to increase leverage.

The need to provide a wider range of financial services is another critical factor that drives NGO microfinance institutions to transform. As NGOs, most microfinance institutions are not allowed to provide clients with financial services other than credit. By transforming into a regulated financial institution, they can provide a wider range of financial services, including savings. This will allow them not only to access this relatively stable source of local resources, but also to expand their outreach by attracting a larger pool of clients.

Another motivation for NGO MFls to transform is their need to attain selfsustainability and profitability. For some NGOs, transformation into a commercial entity is seen as the only means to attain self-sustainability and profitability. The combination of access to a larger pool of funds and the ability to provide savings services among other financial services should enable them to expand their outreach and support the growth of the institution.

The attainment of diversifying ownership and cultivating private sector ownership also provides the necessary impetus for transformation. The involvement of private investors, with their own capital at risk, is expected to enhance the internal control and governance of MFls. Currently, the lack of a defined ownership structure leaves NGOs susceptible to instability in their governance.

The need to attain higher efficiency and improve financial performance is also one of the key motivations for transformation. To survive in an increasingly competitive marketplace, microfinance institutions need to cut down on costly transactions and increase their efficiency. This is expected to improve their overal I financial performance.

Other reasons to transform include: to improve customer service. Having the status of regulated financial institutions, microfinance institutions are able to offer a range of services and products to meet the various needs of their clients. Also, as markets become more competitive, microfinance institutions must pay more attention to their customers' needs and desires to retain their market. Otherwise, they will risk losing customers to the competition; and to improve financial transparency and accountability. Regulation of financial institutions typically involves greater reporting requirements. This is expected to improve the financial transparency and accountability of the institution (Hishigsuren 2006).

The *Microfinance Act* 2006 will allow regulated microfinance institutions to mobilize savings from the public. Since lack of access to depositors' funds/ savings has constrained the growth of MFls in Kenya and particularly in their ability to serve the poor, low-income households and MSEs, (Omino, 2005) it is expected that several institutions will be transforming from their current institutional form into regulated status, in order to offer a broader range of services, gain access to capital to fund growth as well as to unlock the unrealized potential of the un-banked population.

2.4 Access to Financial Services

In Kenya, there is a general consensus that there is constrained access to financial services and products, particularly to the poor, low income households and Micro and Small Enterprises, both in the rural and urban areas (Government of Kenya, 1992). This is highlighted from the findings of the *National Financial Access Study, 2007.* The study was an initiative of the joint public-private sector Financial Access Partnership (F AP), a collaboration of approximately 20 microfinance institutions. The partnership oversaw the commissioning of a study, named *"Fin/iccess: Understanding Kenya's Financial Landscape n,* to establish the level of access to financial services in Kenya. A total of 4,420 households were interviewed and the top line findings of this study were officially launched on 25th January 2007.

The findings of the study established that only 19% of Kenyans have access to formal financial services through commercial banks and Postbank (But this contrasts with the World Bank report which gives the percentage as 20%). An additional 8% of Kenyans are served by Savings and Credit Cooperatives Societies (SACCOs) and Microfinance Institutions (MFls), while 35% of the people depend primarily on informal financial services such as Rotating Savings and Credit Associations (ROSCAs) and Accumulating and Savings Credit Associations (ASCAs). Hence, approximately, 62% of the population accesses financial services and products from formal, semi-formal and informal financial service providers; while 38% of Kenyans have no access to financial services and products, and are classified as "financially excluded".

Kenya's financial sector was liberalised in 1991, with the relaxation of foreign exchange controls and the dismantling of the administered interest rate regime. The liberalisation of the banking sector, has not delivered the expected benefits. The banking sector is still characterised by low competition and low outreach, with the majority of the population excluded from the financial system (DFID, 2001). The main reasons cited by the *National Financial Access study* (2007) for low usage of formal financial services in Kenya included: low incomes, where it was revealed that about 50% of the Kenyan population was poor and had no income worth banking; the high cost of financial services and stringent conditions that formal financial institutions had imposed, such as high opening and minimum balances, which made it difficult for a segment of the population to meet; and the availability of cheaper informal financial alternatives such as interest and commission-free credit, savings, insurance and remittance services provided by suppliers like shopkeepers, friends or family members and matatus or buses. The study also established that the unavailability of the financial services, for example in North Eastern Province, due to lack of infrastructure to support the establishment of financial institutions also played a role in limiting the access to financial services.

Access to financial services by the majority of Kenyans was further constrained by the closure of unprofitable rural branches by commercial banks, the raising of minimum account balances and the introduction of bank charges, as well as the failure of a number of indigenous financial institutions specifically set up to address the needs of Kenyans and, more so, the rural population (Central Bank of Kenya, 2006). These developments have led to a financial system that focuses on meeting the needs of the corporate sector and the working elite, while excluding the poor and the low income earners.

To fill the gap and to serve the financially *excluded*, a number of NonGovernmental Organisations (NGOs), *largely* donor-supported, were set up. Their main aim was to serve the poor and low" income hOLlseholds. These noble initiatives however have been hampered by inadequate funding as the donors increasingly have been unable to provide adequate funding to meet the global demand 10r finance.

A number of studies have shown that l11icrofinance has a positive impact on households that have access to it. A large number of impact studies made on Grameen Bank have demonstrated significant impact on the population across a wide range of economic and social indicators, including increased income, improved nutrition, better consumption on clothing, better housing, lower *child* mortality, lower birth rate, higher adoption of family-planning practices, better health care, better access to education for children, empowernlent of women and participation in social and political activities (Yunus, 2003).

According to Grameen Bank's own internal survey, 42% of its borrower families had crossed the poverty *line* between 1995 and 2001. This was judged on the basis of ten indicators such as the size of the lean, the amount of savings, housiog condition, and furniture in the house, provision of warm clothing and education of the children (Yunus, 2003). These indicators have been set by Grameen Bank to track the impact of its program on the poor families that it serves.

The poor in developing countries have been 011 the margins of their national economies. Though the poor know what hard work is, they have no collateral, no official business history and no bankable worth. They are therefore denied access to resources, which might enable them to expand, increase efficiency, or diversify their sources of income. By delivering credit and savings services tailored to the needs of micro and small entrepreneurs, microfinance institutions send a tangible message to the poor that they do count, they are important, and that their hard work can payoff (Ledgerwood and White, 2(06).

Although MFls are attempting to address and meet the demand for credit, the gap between credit demand and supply remains phenomenal. According to the World Bank's *World Development Report 1999/2000*, over 1.2 billion people lived on less than a $1 /day. Further, the report states that 80% of the world's 4.5 billion people living in low and lower middle income economies do not have access to formal financial services (World Bank, 2(08). The demand for financial services by the world's poor remains largely un-met.

In 1998, the United Nations General Assembly proclaimed 2005 the International Year of Micro Credit to recognize micro credit's contribution to poverty alleviation. **In** December 2003, the UN Member States approved the Secretary General's Draft Programme of Action *[A/581179]* and invited the United Nations Capital Development Fund (UNCDF) and the United Nations Department of Economic and Social Affairs (UNDESA) to become joint coordinators for the Year.

The resolution *[A/58/488]* expanded the mandate for the Year by "stressing that people living in poverty in rural and urban areas need access to micro credit and microfinance that enhance their ability to increase income, build assets and mitigate vulnerability in times of hardship". The resolution further stated that "Member States, relevant organizations of the United Nations system, nongovernmental organizations, the private sector and civil society should collaborate in the preparation and observance of the Year and raise public awareness and knowledge about micro credit and microfinance" (United Nations, 2003, p. 98).

The declaration of the International Year of Micro Credit provided an opportunity for the international community to raise awareness about the importance of microfinance in eradicating poverty, and to enhance 'existing programmes that support sustainable, inclusive financial sectors worldwide. Efforts to extend the provision of financial services to poor and low income people will help achieve the Millennium Development Goals - in particular the goal of cutting in half the number of people living in extreme poverty by 2015 (Workshop on Micro credit & Microfinance, 2004).

The limited resources of microfinance institutions have hampered their ability to serve MSEs. The lack of access to credit is a major impediment to the growth and expansion of small businesses in Kenya. According to the National MSE Baseline Survey of *1999/2000,* nearly 89.6 percent of MSE requirements for credit and other financial services had not been met (see Table below).

Table 2.1: Sources of Credit to MSEs in Kenya - *1999/2000*

	Source	**% Credit Need Served**
A.	**Formal Institutions**	
– –	Co-operatives	1.2
	NGOs	2.8
	Commercial Banks	1.5
	Government	0.2
	Sub-total	5.7
B.	Informal Institutions	
	ROSCAs	2.5
	Family and Friends	1.5
	Money Lenders	0.1
	Trade Credit Suppliers	0.6
	Sub-total	4.7
C.	**Served credit Needs(a+b)**	**10.4**
	Unserved Credit Needs	**89.6**
		100

Source: National MSE Baseline Survey 1999 (CBS)

The majority of Micro and Small Enterprises (MSEs) depend on credit mostly from Rotating Savings and Credit Associations (ROSCAs), friends and relatives. The importance of this sector cannot be over-emphasised. According to the 1999 Baseline Survey, 15% of the total employment **in** the country and 36.4% of total non-agricultural employment work **in** the MSE sector.

In recognition of the importance of MSEs to the local economy and their contribution to national Gross Domestic Product (GOP), attempts should be made to Improve funding sources with a VIew to create business relationships that would facilitate growth. The average productivity of these businesses could be increased substantially with access to appropriate institutional savings and credit services (Omino, 2005).

The proposed regulation and supervision of the microfinance industry to allow qualifying institutions accept deposits from the public is expected to primarily assist the MFls with a new and cheaper source of funds. By accessing public savings, the MFls will be better able to leverage their capital and this is expected to greatly increase their capacity to reach many MSEs, as well and poor and low income households, in many parts of the country. Profitable microfinance institutions can provide financial services at a moderate cost to far more of the economically active poor than any alternative provider (Robinson, 2001, p. 31).

According to Vogel (1997), the attraction of deposits as a source of funding has three main origins. Firstly, deposit mobilization appears to leave funding decisions in the hands of the microfinance institution; secondly, deposits appear to be a cheaper source of funds than bank loans (but this is empirically controversial and depends on the effectiveness and efficiency of the deposit mobilization efforts) and thirdly, there may be economies of scope between lending and deposit mobilization (however, this depends largely on the extent to which the borrowing and depositing clienteles overlap).

The Government of Kenya's Sessional Paper Number 2 of 1992 and the *199912000, 2000/2001* and *200112002* budget speeches recognized microfinance business as one of the most important tools of poverty alleviation. Furthermore poverty alleviation has now received greater national attention under the poverty reduction strategy paper (PRSP) of 200 1.

The Government's policy under *the Economic Recovery Strategy for Wealth and Employment Creation* (ERSWEC), 2003 - 2007, sets out clear priorities for the financial sector reforms based on three pillars; namely Stability, Efficiency and Access. The Government has also developed a new development blueprint, better known as Vision 2030 that commences after ERSWEC. Vision 2030 envisages the streamlining of alternative financial service providers including microfinance institutions (MFls), Savings and Credit Co-operative societies (SACCOs) and Rotating and Accumulating Savings and Credit Associations (ROSCAs and ASCAs), to contribute to savings mobilization.

2.5 Structure of Legal and Regulatory Framework for Microfinance in Kenya

The *Microfinance Act, 2006* defines the legal framework for microfinance and the role of all stakeholders. The Act was enacted by parliament in December 2006. Since then, *the Regulations, 2008* that govern the operation of deposit-taking microfinance institutions have been gazetted by the Central Bank. Accordingly, some NGOs that have been running micro credit programs will be transformed in to regulated institutions by fulfilling the requirements.

The Regulations consist of a comprehensive package of rules for licensing, regulating and supervising MFIs. An exposition of the salient features of the microfinance regulatory framework in Kenya in relation to this study is as follows:

2.5.1 Entry Requirements

The *Microfinance Act* section 5(2) and regulation 3 defines entry requirements that have to be fulfilled by those who are interested in engaging in deposit taking microfinance business. The most important entry requirements include minimum capital requirement, institutional form, ownership restrictions, feasibility study, due diligence reports and conditions to be fulfilled by Board of Directors and officers of microfinance institutions. Below are discussions on three key entry requirements.

a) Minimum Capital Requirement

The microfinance institutions have been categorised into two categories, namely community and nationwide MFls. Community MFls are restricted to operating within a district. Community MFls minimum capital requirement for their establishment is Kenya shillings twenty million, which is approximately equivalent to US$250,000. The low capital requirement for MFls range worldwide from US$25,000 to US$250,000 (Fiebig, 2001). Lower capital requirement at the initial stage was made to encourage investors, community based organisations and others to be engaged in micro finance business.

The nationwide MFls have initial rmmrnum capital requirement of Kenya shillings sixty million, equivalent to 750,000 US Dollars. The objective of the higher capital requirements for the nationwide MFls is to enable applicants to establish strong MFls that have the capacity to withstand adverse external conditions and unfavourable market situations.

b) **Institutional Form and Ownership Restrictions**

The regulatory framework requires microfinance institutions to be formed as limited liability companies with 25% minimum share capital shareholding restrictions, aimed at improving governance in these institutions. There are no restrictions on foreign nationals investing in the financial sector, including in micro finance businesses.

The Microfinance Act has a provision for the transforming MFls, allowing them a four year period for divestiture by shareholders to comply with the ownership restrictions for those who own more than 25 % of the total capital of the MFIs. This was made to ease the transformation burden and to encourage transformation for those interested to be engaged in deposit taking microfinance.

c) Feasibility studies and other Licensing Requirements

Regulation 3 stipulates detailed licensing requirements. Applicants are required to submit a memorandum and articles of association, audited accounts for the previous three years for transforming institutions, due diligence reports, business plans (including major financial services to be offered, delivery channels to be used, overview of economic conditions in the country, MFI competitiveness, SWOT analysis, cash flow and income statement and balance sheet projections) for three years of operation.

Curriculum vitae and 'fit and proper forms' for vetting of members of the board of directors and chief executive officers must be submitted. However, the Regulations have not defined the minimum qualifications required. In Ethiopia, the Board of directors are required to hold at least completion of high school education with the ability to read and grasp reports, especially financial statements (Gobezie, 2005).

2.5.2 Ongoing Regulatory Requirements

The micro finance regulatory framework has put in place a set of ongoing requirements that a regulated MFI should comply with on an ongoing basis as it conducts the deposit taking microfinance business. Two of these on-going requirements are discussed below.

a) Liquidity Requirement

The rmrumum liquidity ratio prescribed for microfinance institutions is 20% which is the same as that prescribed for commercial banks. This limit is set for both community and nationwide MFIs. The main objective of the liquidity requirement is to ensure that MFls maintain an adequate level of liquidity to meet all known and unexpected obligations. This promotes public confidence.

b) **Provisioning Requirement**

According to the Regulations, non-performing loans are defined as outstanding loan and advances of a microfinance institution that are past due for more than 31 days. MFls are required to hold provision of 25%, 75% and 100% for loans classified as substandard, doubtful and loss. These loans are considered as nonperforming as are no longer generating income as have gone bad. The categorisation is based on the number of days the loan is past due.

Table 2.2: Provision Requirement for MFIs in Kenya

Category	No of days Past due	Minimum Required Provisions
Normal	Current	1 % of the outstanding balance
Watch	1 - 30 days	5% of the outstanding balance
Substandard	31 - 60 days	25% of the outstanding balance less security held
Doubtful	91 - 180 days	75% " 11 11 " "
Loss	Over 181 days	100% 11

Source: Government of Kenya, 2008

The provisioning requirement are designed to ensure that the financial statements (that is balance sheets and income statements) of MFls reflect the real financial position. The provisioning requirements requires MFls to consider the impact of portfolio at risk and provide for any past due exposures as per the minimum provisioning criteria outlined above.

The regulation issued by Bank of Uganda (Central Bank) in 2004 indicates that Uganda follows similar provisioning requirements for MFIs to those of Kenya. However, the Kenyan provisioning requirements are stricter requiring a higher provisioning for the doubtful category. MFls in Uganda are required to hold a provision starting from a loan which is unpaid for 30 days and to set aside provision of 100% for loans which are unpaid for greater than 90 days. The Uganda provisioning requirements are shown as follows:

Table 2.3: Uganda Deposit Taking MFIs Provisioning Requirement

No.	**Type** of Loan	No. of days **un Paid**	**Minimum Requirement**
I	Sub- standard	30 - 60 days	25%
2	Doubtful	61 - 90 "	50%
3	Loss	> 90 days	100%

Source: Extracted from Deposit Taking MDls Law of Uganda (2004)

Tanzania follows an even more conservative approach of provisionmg requirement for MFls than that of Uganda and Kenya. It follows a different loan classification mechanism of Micro credit to be paid on a monthly basis and micro credit with instalments less than one month. This may enable to accommodate MFls that follow different repayment schedules (monthly or biweekly or weekly) to meet the specific needs of their clients.

Table 2.4: Tanzania Provisioning Requirement for MFIs

No.	For Micro credit with instalment less than one month	For micro credit with instalment greater than one month	Classification	provision percentage
I	Current	Current	Current	2%
2	up to 15 days	up to 30 days	Special mention	2%
3	16 to 30 days	31 to 60 days	Substandard	50%
4	31 to 45 days	61 to 90days	Doubtful	75%
5	more than 45 days	more than 90days	Loss	100%

Source: Government of Tanzania (2004).

Loan provisioning should be commensurate with loan maturities, risk weighting that consider the quality of security and standard methods that can easily be and consistently replicated (Christen etal, 2004).

d) Branch Premises Requirements

The openmg of a branch by a deposit taking MFI is subject to review and approval by the Central Bank in Kenya. Regulations 10 to 15 describe the procedures to be followed in opening, closing or relocating a branch. Further, the Regulations require that every branch premises be inspected and the facilities reviewed against the stated requirements. Some of the requirements include alarm system installation, clear cash loading areas, adequate banking halls, vaults with dual locking system and insurance policies for the premises.

Further, MFls are also required to include information such as the full physical address of a proposed branch, expected date of commencement of operation, and to provide feasibility reports on the viability of the branch. This requirement is put in place to ensure that branch opening is carried out on a prudent basis by conducting market analysis and feasibility study.

e) Frequency of Reporting

Deposit taking MFls are required to submit quarterly reports such as income statements, balance sheets, report on loans, savings and disclose the status of impaired loans and loan provisioning on returns (report form) prescribed by the Central Bank of Kenya. In addition, MFIs are required to submit twice a month, on the fifteenth and the last day of each month, liquidity information to the Central Bank. Further, the return is to be submitted within five working days of the reporting date.

The Kenyan reporting frequency compares unfavourably with that of Ethiopia. Ethiopia has followed a more lenient approach due to wider branch network of MFls in rural areas which makes more frequent reporting difficult because of infrastructure problems. However, the Kenyan reporting requirement is more lenient than that of Ghana. Ghana requires MFls to submit liquidity reports on weekly basis and the rest of the reports (such as financial statements, capital adequacy ratio and others) on monthly basis.

f) Setting up of subsidiary MFIs by commercial banks

The provisions of section four of the Microfinance Act allow a commercial bank to set up a microfinance institution as a subsidiary. Further, a bank can hold 100% shareholding in such a subsidiary.

2.6 The Need for Regulation of Deposit-Taking Institutions

Deposit-taking involves a potential risk of loss depending on how the funds are employed. As such, institutions intending to take deposits must be regulated and supervised by an external authority to ensure that deposits are prudently employed and cushioned by adequate capitalization. The principal objective of supervising the financial sector is for maintaining a sound financial system (Central Bank of Kenya, 2006).

Information asymmetry can result in the exploitation of information advantages by agents to the detriment of principals. Moral hazard and adverse selection as a result of information asymmetries can undermine the functioning and credibility of the financial markets. This scenario warrants the setting up of an independent overseer of the financial system to maintain confidence in deposit safety and to ensure that the financial intermediation does not threaten the stability of the overall financial system. In order to maintain confidence in deposit safety, the regulator sets requirements to ensure that the institutions are sound, with enough capital and earnings to cover risks and operational costs and enough liquidity to meet client withdrawal demands (Hannig and Omar 1999). Bank problems can be easily transferred from one institution to another, regardless of soundness and hence the need to protect the whole financial system is an objective of regulation and supervision (Gallardo, 2001).

A sound banking system is important because of the key roles it plays in the economy: intermediation, maturity transformation, facilitating payment flows, credit allocation and maintaining financial discipline among borrowers. Banks provide important positive externalities as gatherers of savings, allocaters of resources and providers of liquidity and payments services. Financial regulatory policy generally focuses on the soundness and sustainable growth in a financial sector run primarily on commercial grounds. Financial institutions will strive for efficiency by providing well-priced and well-customised products which benefits clients while getting savings and loans. This practice helps in building a stable financial system (Fiebig, 2001).

According to the *Banking Act, 2005* Chapter 488 section 16 (2) an item is considered a deposit if it has been placed by a member of the public, repayable on demand or at the expiry of a fixed period or after notice and employed by lending, investing or in any other manner for the account and at the risk of the person employing the money. Under section 16 (1), no person, other than a licensed institution which holds a valid license, shall invite or accept deposits in the course of carrying on deposit-taking business. Every institution intending to transact deposit-taking business must obtain a licence from the Central Bank of Kenya.

The financial system has to be regulated to ensure stability and safety of the depositors' funds and thus maintain public confidence in the entire system. Any erosion of this confidence would dislocate the process of mobilizing deposits and lending and thus destabilize the entire system to the detriment of the country's economic activity. In the same thinking, the regulation and supervision of deposittaking in the microfinance industry sector is expected to create an enabling environment that will lead to quality growth, broaden the funding base, build confidence and stability, encourage fair competition and efficiency and initiate the process of integrating these institutions into the formal financial system (Omino, 2005).

2.7 Challenges of Regulating Microfinance

It has been demonstrated in the preceding section, that regulation is desired to mitigate the potentially negative outcomes of un-checked market processes in the financial sector.

However, micro finance has evolved largely outside regulation. As a result the impending regulation presents challenges both from the point of the MFls to be regulated and from the regulators. Financial regulatory policy generally focuses on soundness and sustainable growth in a financial sector run primarily on commercial grounds. The microfinance policy inevitably will require careful thinking taking cognisance of the uniqueness of this sector. Further, the most carefully conceived regulations could end up being useless, or worse, if they cannot be enforced by effective supervision (Christen and Rosenberg, 1999).

2.7.1 Challenges of Regulation from the Perspective of the MFI

A significant policy change in the operational focus of a firm ultimately means changes in governance as well as management/staff roles and responsibilities. This transformation has at its core to change the management process (Laurie, 2005). The transforming entities have to factor in the regulation aspect, which will effectively touch on the board of directors and their responsibilities as well as those of senior management and all the staff in general. Governance issues will also affect the overall responsibilities of all stakeholders, e.g. government, shareholders and auditors.

According to Meagher (2002), Microfinance has several features that distinguish it from other kinds of financial services - commercial banking in particular - and that need to be taken into account in the design of regulatory systems. These features include: the aim of serving micro enterprises and poor households; high unit costs of lending; the effort to bring physical access to banking services to underserved clients; frequently undiversified portfolios; the start-up pattern of many MFls as NGOs with a social mission; differences in cost structures and fund sources among for-profit, cooperative, and NGO MFls; the relatively low value of MFI portfolios in relation to that of national financial sectors as a whole; and the market risk to the microfinance sector when MFls are not properly managed and monitored.

A study by Velasco and Marconi (2004) established that there was more instability in the regulated microfinance sector than the unregulated in Bolivia. They state' At the onset of the global financial crisis which hit Latin America in 1999 there was a dual structure of microfinance in Bolivia in which some financial institutions had come under the purview of the regulator and others remained unregulated. Two unexpected paradoxes emerged. First, the locus of financial instability was in the regulated and not in the unregulated sector. Secondly, the gender balance was almost the same as between the regulated and the unregulated with about 40 percent male and 60 percent female.'

A report of the World Bank, 2006, *Making Finance Workfor Africa* cautions that undue restrictions on the scope of bank operations can weaken rather than strengthen institutions by limiting their profit opportunities. The report cites the case of provisioning requirements as set out in the regulations by the regulators. In some countries financial institutions are obliged to fully provision large uncollateralized loans even if they are performing. For instance, Tanzanian regulations required 125 per cent collateral for any individual loans larger than 5 per cent of the bank's capital. This means, in effect, that such uncollateralized lending must be fully financed out of the bank's capital and not at all out of deposits. This cannot fail to place a brake on what might otherwise be sound lending backed by a credible projection of cash flow. Defenders of high collateral requirements point to the cost and difficulty of recovering even on apparently over-collateralized loans. However valid this consideration may be, it also points to the complementary importance of considerations other than collateral in loan appraisal.

The World Bank report goes on to argue that African banking regulators need to act with restraint, therefore, in fulfilling their mandate to keep banking systems safe and sound. Aggressive measures that are likely to constrain the ability of banks to take reasonable and prudent credit risks should be avoided. This is not really a question of accepting materially higher risks of failure; rather it is the avoidance of unnecessarily restrictive precautions. The overriding principle therefore in guiding regulatory design in regard to MFr, is that regulation should not choke-off initiative and outreach especially in remote areas.

2.7.2 **Challenges** of Regulation **from the Perspective** of the **Regulator**

Microfinance regulation presents the regulator with additional challenges and costs as demonstrated by the cases that follow. Hannig and Omar (1999) identify three challenges of regulating microfinance. The first is a lack of in-depth knowledge of microfinance by the regulators. Secondly, resource constraints on the part of the supervisory authority and thirdly, the problem of turnover and loss of highly qualified supervisory staff to the banking industry.

In the case of the Philippines, the central bank supervises the small banks known as 'rural banks'. These rural banks have been integrated into the payments system and their operations include credit and deposit services for relatively poor clients. As of September, 1997, 824 of these rural banks had only about 2 percent of the banking system's assets and deposits, but they made up 83 percent of the institutions the central bank had to supervise (Christen and Rosenberg 1999).

Supervising the rural banks severely stretched the resources of the Philippine central bank's supervision department, tying up as much as one half of its total staff and budgetary resources. In the early nineties, one out of every five rural banks had to be shut down, and many others had to be merged or otherwise restructured. A 1996 report estimated that 200 inspectors were assigned to the rural banks. Each field visit consumed up to three person-weeks or more. Christen and Rosenberg (1999) conclude that there are practical problems faced by supervisors and that the costs of regulating and supervising MFls can have unintended consequences. Despite these problems in regulating MFls, the authors believed strongly that the future of microfinance lies in a regulated setting, as it is the only setting that would permit massive, sustainable delivery of financial services to the poor. Their overall message was a cautionary one that there were problems in regulating microfinance that needed to be dealt with realistically.

In India, the role of the regulator was to integrate into the overall financial infrastructure, which required a degree of promotional support in the early stages of the industry's development. Applying a cost effective method to regulate and supervise MFIs is a major challenge for the regulators. Due to the special characteristics of microfinance, a range of legal and regulatory norms may challenge the sector to scale up and professionalize, or may simply stifle its development. Christen and Rosenberg (1999) advocated for the regulators to make some attempt to tailor financial licenses, prudential norms, supervision systems, and other rules affecting microfinance operations **-** in order to ensure orderly growth.

2.7.3 Importance of Perceptions in influencing human behaviour

This study utilises perceptions of the microfinance practitioners. Use of perceptions has been widely used and most recently for its firm-level variation by Beck, Demirguc-Kunt, and Maksimovic (2005). It has also been widely used by Transparency International in computing its Corruption Perceptions Index since year 2002. Integrating perceptions serves a pragmatic end as it is often perceptions that dictate what is and what IS not possible and hence actual outcomes.

According to Vernon 1955 the perceiver has certain expectations and focuses attention on particular aspects of the information. He or she knows how to classify, understand and name selected information and what inferences to draw from it. Vernon found that a number of variables, or factors, influence perception. These factors include expectations, emotions, motivation and culture.

Similarly, the World Business Environment Survey (WBES), a project of the World Bank's Investment Climate and Institute Units, surveyed business perceptions of more than 10,000 firms in 80 countries in late 1999 and early 2000. This survey focused on firm owners and managers on their perception of the business environment in the country. The survey used questions on judiciary, corruption, regulation, taxation, competition, and access to financing. Questions in the survey focused on the quality of the investment climate as shaped by domestic economic policy; governance; regulatory, infrastructure, and financial impediments; and assessments of the quality of public services.

Beck and Levine (2002) showed that perceived differences in legal and financial systems affect the availability of external finance and the growth of different industries in the manufacturing sector. We expect these differences to matter as much or more when we look across at the microfinance sector. Hence, we examine how the microfinance practitioners perceive the microfinance legislative framework and how it impacts on their transformation to deposit taking microfinance institutions.

This thesis explores the perceptions of microfinance practitioners on the appropriateness of the microfinance law. Microfinance institutions in Kenya are at a critical juncture. While their activities are widely perceived to contribute to poverty alleviation, their future viability is clouded by donor requirements that they become financially self-sufficient. At the same time, the government has put in place a microfinance law. The choice now is to choose the path to take between transforming under the law or to maintain the status quo.

2.8 Conceptual Framework

From the literature reviewed, the key players with regard to transformation of the MFIs are the government (regulator) and the MFIs themselves. The two players have key roles that they must play to ensure the successful transformation of MFI.

Successful transformation of MFls is important as the regulated entity will be allowed to accept deposits, to leverage the institution's funding base.

On the government's side, its main responsibility is to create an enabling environment. The government has enacted the Microfinance Act, 2006 and a regulatory framework has been put in place for the development of a vibrant microfinance industry. However, the perceptions of MFI practitioners on the appropriateness of the micro finance regulatory framework are important as it will determine the actions of those involved in the sector. It is critical that the regulatory framework be responsive enough to the unique nature of the sector in order to enhance orderly growth.

On the side of the MFls, there are considerable challenges to transformation which are likely to interfere with the ability of MFls to transform. By transforming into a deposit taking institution, the MFls will change fundamentally. The MFls key responsibilities are to build core capacity within their organisations with a view to strengthen the institutional capacity to facilitate a smooth transition into a deposit taking institution. The institutions will need to invest in technology, diversify their product ranges and develop appropriate and innovative delivery channels. Similarly, developing and rolling out, in an effective and efficient way, new products such as savings is expensive and complex. These require funds, appropriate risk management tools and highly skilled staff with a thorough understanding of the clients' needs and socio-economic conditions. It is critical that MFls have access to appropriate high quality business services to meet the requirements of the regulatory framework.

Figure 2.1 below summarises this transformation process from an unregulated MFI to that of a regulated MFI in a conceptual framework.

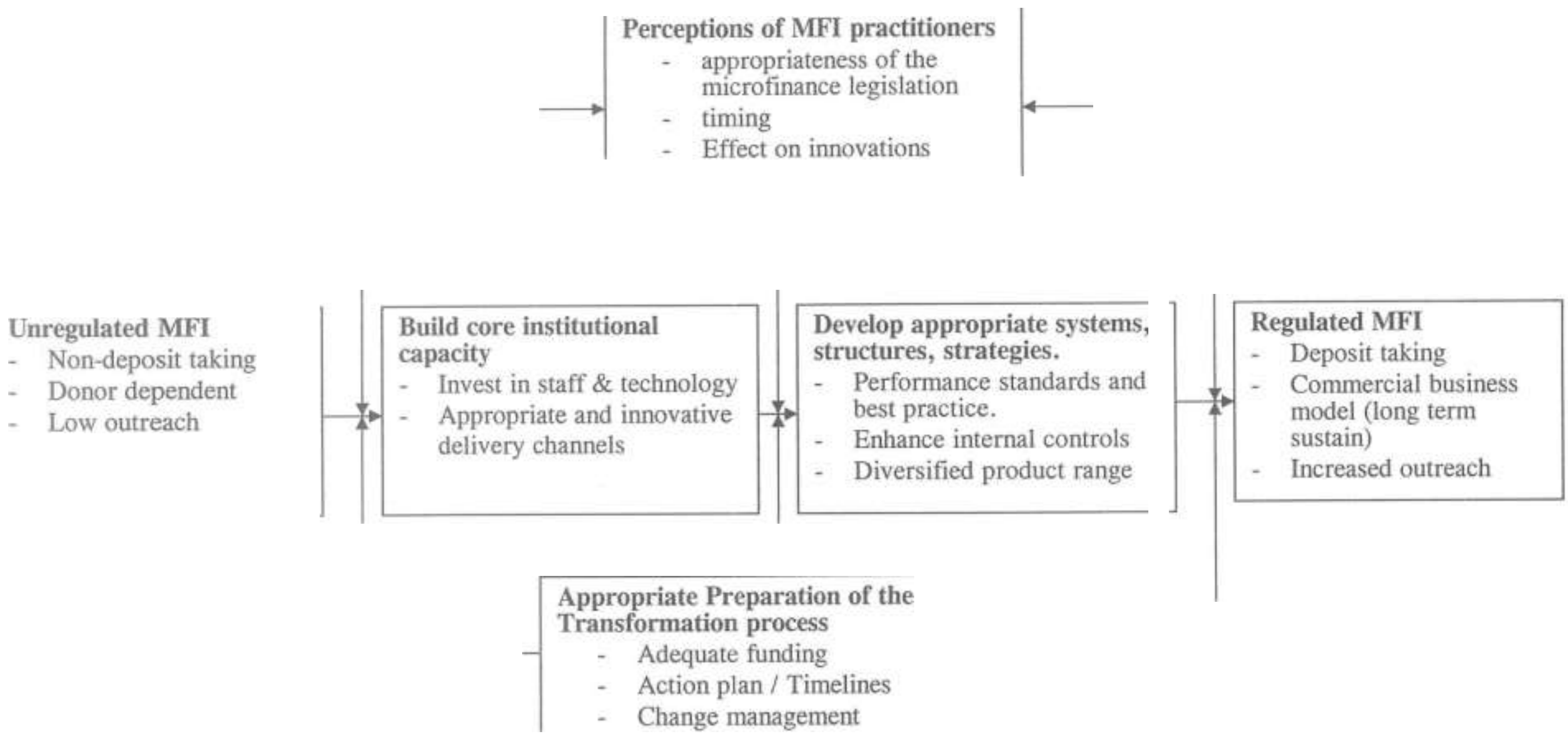

Figure 2.1 - Conceptual Model: Transformation to a regulated MFI
Source: Author, 2009

From the framework, it is important that unregulated MFls aspiring to transform into regulated deposit taking MFI be prepared to go the long haul to strengthen their institutional capacity to handle the deposit taking microfinance business. It is anticipated that increased financial outreach will be achieved through stronger and successfully transformed MFls. The enactment of *the Microfinance Act, 2006* was therefore a major milestone for the microfinance industry. However, it remains to be seen how appropriate it is for this unique industry.

2.9 Research Gap

Some evidence from literature has shown that regulation does enhance the stability of financial institutions and accessibility to financial services (Robinson 2001). Hishiguren (2006) has outlined several factors that motivate non deposit taking MFls to transform into regulated deposit taking MFls. Christen and Rosenberg (1999) underscore the importance of regulating microfinance stating that it is fundamental to sustainable delivery of financial services to the poor.

However, many questions remain unanswered such as the appropriateness of the regulatory and supervisory framework? Chavez and Gonzalez Vega (1994) argue that a regulatory framework that is not specific to the unique situation of the microfinance institutions may hinder the effectiveness of these institutions to carry out their activities. Does regulation always result in the stability of institutions? The Bol ivia example (Velasco and Marconi 2004) suggests not. Also, does the presence of regulation always mean that institutions will transform and therefore be regulated? The Ugandan experience (Kalyango, 2005) suggests not necessarily. Similarly are there MFls in Kenya, mature enough to transform to deposit taking or are the majority still in the early development stage? Will subjecting the MFIs to the regulatory oversight of the CBK hinder the innovati veness of these MFIs?

Are the regulatory requirements quite burdensome to the extent of contributing significantly to (a) higher costs of funds and therefore loans, and (b) reducing access to credit services as a result of higher costs? Does the regulatory framework discourage unregulated microfinance institutions from becoming regulated so that they can mobilize deposits and expand their outreach?

The reason for conducting this study was to attempt to answer some of these questions. This study explores the challenges of regulating microfinance institutions in Kenya as well as the transformational challenges that the MFls will face. In addition the study has examined the perceptions of microfinance practitioners on the legislative framework for the microfinance industry.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

This chapter describes the research methodology, design, population, data collection, and analysis and presentation techniques that were used in this study.

Methodology refers to a systematic way of solving a research problem. A research methodology should spell out what the study is about, why the study is being done, where the study is to be carried out, the type of data required, sources of required data, the period of time the study will include, the sampling method, the data collection techniques and data analyses techniques (Cooper and Schindler, 2007). The two define research methodology as the framework within which facts are placed so that meaning can be extracted from them. It gives direction that a researcher must follow in order to get answers to issues he or she is concerned with.

3.1 Research Design

The research design constitutes the blue print for the collection, measurement and analysis of data. It aids. the researcher in the allocation of limited resources by posing crucial choices in methodology. It also includes an outline of what the investigator will do from writing hypotheses and their operational implications to the final analysis of data (Cooper and Schindler, 2007).

The research design that was employed for the purposes of this study was descriptive design. Descriptive design was chosen because there exists a great deal of information on the microfinance sector. The legislative framework is already in place and the aim of the research was to find out the preparedness of MFls to transform, as well as the perceptions of practitioners on the appropriateness of the microfinance regulatory framework. Perceptions of those interviewed are important not because they help to portray reality, but especially because perceptions of reality determine the actions of those involved in the financial system.

The research has been undertaken in two levels. Level one entailed completion of a questionnaire by microfinance institutions that are members of AMFI. Level two was the interviews with the executives of MFIs.

3.2 Population and Sampling

The Population is the total collection of elements about which we wish to make some inferences (Cooper and Schindler, 2007). The target population of interest for this research comprised the unregulated / non-deposit taking micro finance institutions, who are members of the Association of Microfinance Institutions (AMFI). The Association of Microfinance Institutions of Kenya is a member institution that was registered in 1999 under the Societies Act by the leading microfinance institutions in Kenya with a view to build capacity of the microfinance industry in Kenya. AMFI presently has 34 member institutions including four banks and an insurance company. This research excluded the four banking institutions and the insurance company as these institutions were outside the scope of the study. A questionnaire was sent to each of the 29 institutions for completion by the CEO or the transformation managers. The researcher considered them to be the most appropriate respondents to give information regarding this study.

On the basis of the responses to the questionnaire, the researcher selected a sample of five MFls for the interviews. The purpose of the interviews was to conduct an in-depth study on the issues raised with a view to add qualitative value to the questionnaires. Interviews help confirm and clarify some items and also allow interaction with interviewees in order to make an observation. The interviews corroborated the information gathered through the questionnaire. Further, through the visit to the sampled institutions the researcher was able to observe and assess the institutional preparedness of these institutions.

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3.3 Data Collection:

Primary data coIlection was used in the collection of both quantitative and qualitative data. The research was undertaken in two steps, the questionnaire stage and the interviews. The first stage entailed completion of the Questionnaires administered to the 29 unregulated microfinance institutions that are members of AMFI. The questionnaire had close-ended questions. The questionnaires were hand delivered for Nairobi based MFls. However, for rural based MFls, the questionnaire was sent through registered mail. A period of three weeks was all owed for responses, and a reminder sent for non- response within the three weeks. These reminder questionnaires allowed another three weeks. Any questionnaire response not received within one and a half months was treated as non-respondent.

The questionnaire that was used consisted of three sections (appendix 2). Section A had questions that sought information on general operations of the **MFI** and strategic direction. Section B had questions that examined perceptions on the legal and regulatory environment. The institutions assessed their own ability to fully comply and incorporate the legal, regulatory and supervisory regime to their businesses. Section C was used to get information on the institutional capacity and preparations towards transformation into regulated institutions as expressed by the strength of the human resource systems and structures to deliver varied financial services and products. Further, the section gathered information on preparations towards transformation in the form of planned acquisition of infrastructure and recruitment of key staff.

The qualitative data was obtained after the responses from the questionnaires through interviews with executives of five microfinance institutions. The five institutions were selected on the basis of level of transformation as captured in the questionnaire response, with one rural based, two urban based while two were large MFls. Semi-structured interview guide notes were used to enhance the comparability of findings across respondents and data analysis. The interview stage also allowed the researcher to observe in the MFI the physical infrastructure, information systems in place, customer care for the current customer base, and the existing human resources for the institution. Perceptions of the interviewees helped to portray the reality on the ground that will determine the actions of those involved in the microfinance industry.

The researcher arranged for appointments with the executives of the five sampled institutions for a face to face interview. The interviews were conducted with the Chief Executive Officer or the transformation managers. However, two institutions in the sample were outside Nairobi. Telephone interview was used for institutions based outside Nairobi.

The officers were asked the following questions:

1) Involvement: Have you been involved in the development of the framework for the regulation of microfinance in Kenya?
2) In your opinion how will the regulatory framework influence the ability of your MFI to transform?
3) In your opinion how appropriate IS the regulatory framework for the microfinance sector? Does the regulatory framework require excessive initial capital, excessive reporting, inappropriate liquidity ratio or excessive provisioning?

4) What suggestions would you make to improve the microfinance regulatory framework? Which areas?
5) How prepared is your MFI for the transformation?
6) What other challenges are you likely to face in expanding access to financial services in Kenya?

3.4 Data Analysis Procedure:

The data that was collected in the study was both quantitative and qualitative. The quantitative data obtained from research questionnaires was coded and keyed into Statistical Package for the Social Sciences (SPSS). The data was analysed in the form of frequency tables and percentages. The mean was also used in data analysis. An explanation of problems was obtained at the interview stage which was also used to corroborate information from the questionnaire.

Content analysis was used to analyse the qualitative data which was then presented in the form of a table. The responses from each of the microfinance executives were captured in bullet point style in the table matrix for easy analysis.

The data analysis was in the following manner: -

1) Understanding by the institutions of the requirements of the microfinance legislative framework and institutional strategic direction.
2) Preparations in place towards transformation of the non-deposit taking NGO microfinance institution into regulated deposit taking microfinance institution.
3) The perceived challenges and problems In complying with the Microfinance Act 2006.

4) Institutional capacity and planning to meet the regulatory requirements.

The results of the survey were presented in tables and charts. This was then followed by an analysis of the qualitative data and the observations made during the interviews.

3.5 Limitations:

The non-response by the small MFls was a big setback. Therefore, this was a challenge as to whether these findings can be generalised to the small MFls. Data could therefore, be skewed as it leaves data from the small ones. The response could have had a greater impact if all the MFls including the small ones had responded.

Another limitation was the need to protect the confidentiality of the respondents. As a result the presentation of data was not as explicit as the researcher would have liked. For example the profiles of the MFls could not be disclosed as this would have compromised the confidentiality of the responders.

Despite these limitations the findings and discussions have provided useful information on transformation and have adequately addressed the research questions.

CHAPTER FOUR

4.0 FINDINGS AND ANALYSIS

4.1 Introduction

This study used Statistical Package for the Social Sciences (SPSS) for quantitative data analysis. The qualitative data has been analysed in a table. This chapter presents the analysis and findings from the data collected from the field based on the responses to the research questionnaire administered on the microfinance institutions and the information gathered through the interviews. The major purpose of this chapter was to analyze and interpret the findings from both the field survey as well as the interviews.

4.2 Quantitative Data Analysis & Results

This section presents the analysis of the questionnaire, and is divided into three sections. Section **one** presents an analysis of general information of the MFI and strategic direction. Section **two** presents the examined perceptions on the legal and regulatory environment, while the **third** section presents information on the institutional capacity and preparations towards transformation into regulated institutions as expressed by the strength of the human resource systems and structures to deliver varied financial services and products. Further, the section presents information on preparations towards transformation in the form of planned acquisition of infrastructure and recruitment of key staff.

4.2.1 Response rate

From the study population target of 29 respondents, 20 questionnaires were collected representing a response rate of 68.9%. This response affords a reasonable level of confidence that the included sample is representative of the Microfinance Community in Kenya.

$$\text{Response rate} = \frac{\text{Actual number of responses}}{\text{Planned number of responses}} \times 100$$

4.2.2 Products/Services Offered By Unregulated Microfinance Institutions

The researcher sought to find out the products and services that the unregulated microfinance institutions were offering to their clientele in order to determine the available products and services.

Table 4.1: Products/Services Offered By Unregulated Microfinance Institutions

Product/ Service	Yes (%)	No(%)
Savings	3 (15)	17 (85)
Credit facilities-Retail	18 (90)	2 (10)
Payment transfers	1 (5)	19 (95)
Leasing	5 (25)	15 (75)
Micro- insurance	5 (25)	15 (75)
Others	5 (25)	15 (75)

The study findings as shown in table 4.1 above indicate that a majority of the non deposit-taking microfinance institutions offer credit facilities to retail customers as shown by 90% of the respondents responding in the affirmative. The institutions that offer savings services were 15%, while only a small proportion of respondents, 5%, reported that their institution offered payment transfers.

4.2.3 The Expected Time Period to Transform. by institutions

The researcher also requested the respondents to indicate the expected time period to transform if their organization planned to transform.

Table 4.2: The Expected Time Period to Transform

Duration	Frequency	Percent
In less than a year	9	45.0
Between 1 and 2 years	7	35.0
Between 2-5 years	4	20.0
Total	**20**	**100.0**

From table 4.2 above, the findings indicate that 45% of the respondents would transform within a year. 35% of the responding institutions indicated that their institution was planning to transform in between 1 and 2 years, while 20% of the respondents said that their institution was planning to transform between 2-5 years.

4.2.4 Importance of transforming into a regulated micro finance institution

The respondents were also asked to indicate how important they thought it was to transform into a regulated microfinance institution.

Table 4.3: Importance of transforming into a regulated microfinanee **institution**

Importance	Frequency	Percent
Not important	1	5.0
Important	2	10.0
Very important	17	85.0
Total	**20**	**100.0**

From the findings in table 4.3 above, the study revealed that transforming into a regulated microfinance institution was very important as shown by the majority of respondents indicated by 85%. 10% of the respondents felt that it was important, while 5% of the respondents were of the view that it was not important.

4.2.5 Reasons of the Institutions Consideration to Transform Into a Regulated Deposit Taking MFI

The researcher sought to investigate the reasons why the institutions considered transforming into a regulated deposit taking MFI under the newly enacted Microfinance Act, 2006.

Table 4.4: Reasons of the Institutions Consideration to Transform Into a Regulated Deposit Taking MFI

	Reasons	Not important (%)	A little important (%)	Moderately important (%)	Important (%)	Very important (%)	mean
1	Expanded outreach	5 (25)	0	3 (15)	2 (10)	10 (50)	3.6
2	Experiment as you are ready to take risks	10 (50)	4 (20)	6 (30)	0	0	1.8
3	Requirements by law	7 (35)	0	3 (15)	5 (25)	5 (25)	3.1
4	Pressure from the donor/financiers	11 (55)	0	3 (15)	4 (20)	2 (10)	2.3
5	Improved institutional governance, professional standards and accountability	1 (5)	0	3 (15)	5 (25)	11 (55)	4.3
6	Access to deposits as a source of funds	1 (5)	4 (20)	0	3 (15)	12 (60)	4.1
7	Other reasons	• To be allowed to offer a greater range of products and services, • for deposit protection, • Image building and improved public confidence.					

Table 4.4 above shows the findings on the reasons for transformation. These findings were then presented using mean scores for easier interpretation. The greater the mean score, the higher the importance attached to the reason for transformation, of which the highest possible score was a 5.

From the findings, the most important reason of the institutions considering to transform into regulated deposit taking MFI was to improve institutional governance, enhance professional standards and accountability as it had the highest mean score of 4.3, followed closely by access to deposits as a source of funds as shown by a mean score of 4.1. The third important reason was expanded outreach as shown by a mean score of3.6.

The reason that was found to be of little importance was to experiment whether they were ready to take risks as shown by a mean score of 1.8.

Four institutions also included other reasons that were being considered for transformation. These were protection of deposits by the Deposit Protection Fund, diversification of product ranges, raising of the institution's image and public confidence in the sector.

4.3 Rating the appropriateness of the microfinance legislation and regulations for efficient operations of the institution

The study also sought the perception of the microfinance practitioners on their opinion on the appropriateness of the microfinance legislation and regulations, for efficient operations of the institutions.

4.3.1 Ability of the Institutions to Meet the Requirements of the Existing Regulatory Framework for the Institution

The researcher requested respondents to rate the ability of their institutions to meet the requirements of the existing regulatory framework for their institution with regard to a number of regulatory requirements as discussed in table 4.5 below.

Table 4.5: Ability of the Institutions to Meet the Requirements of the Existing Regulatory Framework

	Requirement	Very low (%)	Low (%)	Moderate (%)	High (%)	Very high (%	Mean
1.	Change in the legal form of organization to a limited liability company	0	0	7 (35)	0	13 (65)	4.3
2.	Ownership restri cti ons (25% per person)	0	3 (15)	7 (35)	10 (50)	0	3.6
3.	Minimum capital requirements	0	0	0	0	20 (100)	5
4.	Business plan and feasibility reports	0	0	2 (10)	6 (30)	12 (60)	4.5
5.	Fit and proper tests for directors and senior managers	0	0	2 (10)	5 (25)	13 (65)	4.6
6.	Liquidity requirements	0	0	2 (10)	9 (45)	9 (45)	4.4
7.	Loan loss provisioning, write-off	0	2 (10)	8 (40)	5 (25)	5 (25)	3.7
8.	Disclosure and reporting requirements	0	2 (10)	8 (40)	5 (25)	5 (25)	3.7
9.	S pecificati ons for business premises (place of business/branch specifications)	0	2 (10)	8 (40)	8 (40)	2 (10)	3.5

Table 4.5 above presents the findings on the rating on ability to meet the regulatory requirements. The findings were also presented using mean score for easier interpretations.

The findings of the study revealed that all the institutions had a very high ability to meet the minimum capital requirements as shown by the highest mean score of 5. The most challenging requirement to meet in the opinion of the practitioners was the specifications for business premises (place of business/branch specifications) as shown by a mean score of 3.5, followed by the ownership restrictions (25% maximum shareholding per shareholder) shown by a mean score of3.6.

The majority of the institutions also felt that they have a very high ability to meet the 'fit and proper tests' for directors and senior managers as shown by a mean score of 4.6 and also to prepare a business plan and feasibility reports shown by a mean score of 4.5. Ability to meet the liquidity requirements had a mean score of 4.4, change in the legal form of organization to a limited liability company mean score of 4.3, loan loss provisioning, write-off and disclosure and reporting requirements shown by a mean score of3.7 each.

4.4 Institutional capacity of the unregulated institution

The study also sought to investigate the extent to which the institutions felt they were prepared with regard to the requirements for transforming into regulated institutions. This was intended to gauge the extent to which the MFls could be considered to have matured from the informal entities in readiness to transform to formal financial institution. The existing institutional capacity was used as a pointer to the existence (or lack) of a ready pool of unregulated MFls to transform under the Microfinance Act.

4.4.1 Extent of preparedness

Table 4.6: Rating of Organization's Preparedness based on existing infrastructure

		very low	Low	Moderate	High	Very high	Mean
1	Management information systems (lCT)	0	0	12 (60)	5 (25)	3 (15)	3.5
2	Operational manuals	0	5 (25)	8 (40)	7 (35)	0	3.1
3	Business plan and feasibility reports	0	" .J (15)	0	14 (70)	3 (15)	3.9
4	Business premises (place of business/branch specifications)	4 (20)	7 (35)	6 (30)	3 (15)	0	2.4

The business premises (place of businesslbranch specifications) were reported as the least prepared area by the institutions recording a low mean score of 2.4. A majority of the respondents reported that the organizations were prepared with a business plan and feasibility reports as shown by a high mean score of 3.9 and were also prepared with management information systems (lCT) to a high extent. The majority of the respondents were found to be prepared with operational manuals to a moderate extent as shown by a mean score of 3.1

4.4.2 Transformation planning by the Organization

The study sought to know the importance the institutions attached to having an action plan/timeline for the transformation process of the organization. The respondents were required to indicate the level of importance attached to having clear timelines on transformation.

The findings indicate that a majority of the respondents considered it as highly important as shown by 65% of the respondents, and 35% considered it important.

4.4.3 Internal skills versus hiring of consultants to guide the transformation

The researcher sought to know whether the institutions were hiring the services of consultants to assist in the transformation process or were relying on internal skills. The internal skills refer to having a transformation manager and or a steering committee to champion transformation.

Table 4.7: Institutional Transformation Process

	Transformation champion	Yes (%)	No(%)
1	The organization has hired the services of consultants to help with the transformation process	11 (55)	9 (45)
2	A steering committee IS charged with the responsibility of the transformation process	13 (65)	7 (35)
3	A transformation manager has been appointed by management to champion transformation	5 (25)	15 (75)
4	Either transformation manager or a steering committee but no external consultants	10 (50)	10 (50)
5	All three	5 (25)	15 (75)

The research established that 55% of the responding institutions had engaged the services of consultants to guide them in the transformation. A majority (65%) of the institutions had set up steering committees charged with the responsibility of the transformation process, while only 25% had appointed a transformation manager to champion transformation,

4.4.4 Human Resources

The study also sought to find out the capacity of the staff in terms of the skills available in the organizations.

From the findings, 55% of the respondents reported that the staff skills in place and the number of existing members of staff were considered not adequate to transform and to undertake the business of a transformed MFr, while 45% of the respondents said that they were adequate.

4.4.5 Action being taken where staff skills were considered inadequate

The respondents who reported that their staff capacity in terms of the skills and number was a little adequate were asked whether their institution was planning to recruit or retrain staff to specialise in providing savmgs and other financial services.

The findings indicate that 63.6% of the respondents responded that their institutions were planning to recruit staff to specialise in providing savings and other financial services. On the other hand 36.4% said they were not.

4.4.6 Resource mobilisation Costs Incurred (Or Expected to Be Incurred) In Preparation for Transformation to A Deposit Taking MFI

The respondents were also requested to rate the cost elements with regard to preparations towards transformation to a deposit taking MFIs. These ratings were then presented using mean score for ease of interpretation. The highest possible mean score was a 5 and the lower the mean score, the greater the costs to be incurred.

Table 4.8: Rating the Cost Elements Incurred (Or Expected To Be Incurred) In Preparation for Transformation to A Deposit Taking MFI

		Very high (%)	High (%)	Moderate (%	Low (%)	Very low (%)	mean
1	Hiring/recruiting staff	7 (35)	9 (45)	3 (15)	0	1 (5)	1.9
2	Training staff	12 (60)	7 (35)	0	0	1 (5)	1.6
3	Modifying or replacing MIS	17 (85)	2 (10)	0	0	1 (5)	1.3
4	Administrative bureaucracy due to requirements such as board and corporate governance requirements	5 (25)	9 (45)	2 (10)	3 (15)	1 (5)	2.3
5	Preparing prermses to specified standards	19 (95)	0	0	0	1 (5)	1.2

From the findings in the above table, the costs that were rated as highly incurred or expected to be incurred were on preparing premises to specified standards as shown by the lowest mean score of 1.2, and modifying or replacing MIS as shown by a mean score of 1.3. The costs associated with training staff was shown by a mean score of 1.6, while that for hiring/recruiting staff was shown by a mean score of 1.9. Administrative bureaucracy due to requirements such as board and corporate governance requirements was rated low as shown by a mean score of 2.3.

It is important to note that all the mean scores are less than *2.5*. This means that the costs of transformation to be incurred are all high. Therefore, costs of transformation to meet the regulatory requirements were a major concern by the respondents.

4.5 Qualitative Analysis & Results

This section analyses the findings of the interviews with senior executives of five institutions for in depth understanding of the sector and as a follow up of issues raised in the questionnaire by the respondents. The longest interview took an hour while the shortest took twenty five minutes. The interviews expanded the information furnished on the questionnaire on the subject of transformation to regulated status by non deposit taking institutions.

Qualitative data from the interviews was analysed for content (content analysis). This entailed reading and re-reading the recorded interview transcripts looking for similarities and differences in order to find themes and to develop categories (Cooper D & Schindler 2007). To maintain confidentiality, the five MFIs interviewed have been labelled as A, B, C, D and E, for the purpose of reporting findings in the discussions.

Appropriateness of the Microfmance Legislation to the sector

The question on the appropriateness of the microfinance regulatory framework to the sector created heated debates during the interviews. It was an obvious matter of great concern to the microfinance practitioners. The Microfinance practitioners made a passionate request to the regulatory authority to treat Microfinance Institutions as "Microfinance institutions" and not as downgraded banks or banks that had failed to grow. One MFI Executive captured this:

"We recognise the importance of the Microfinance Legislation. However, it will be difficult to conform word to word with the Act, as the central focus of microfinance will be lost / compromised. .... our institution is appealing to the regulators to continually ensure that the Regulations remain friendly and conducive. There is need to take into consideration the unique nature of microfinance to ensure that the regulation do not hamper growth of the sector' ,

The microfinance practitioners were categorical that legislation was important as it would help in many areas including weeding out bad institutions and raising public confidence in the sector. The five institutions interviewed argued strongly that the regulation of the industry was long overdue. However, there was sceptism on the understanding of micro finance business on the part of the regulators and policy makers in Kenya. Further, institutions A and C were of the opinion that the Central Bank of Kenya should establish a department dedicated to the microfinance sector, rather than the current situation where issues to deal with the sector were being handled in a unit within the Bank Supervision Department. An executive from institution C aptly put it as follows:

to this kind of business you need to be regulated by an appropriate regulator, who has the know-how of your kind of operations. Collaboration will be necessary to build the capacity of the regulators."

Indeed it was confirmed by the Association of Microfinance Institutions (AMFI) that the Regulator had taken a keen interest on the sector. A number of staff members had been seconded to three large MFIs for exposure on the operations of the sector. A number of initiatives to strengthen the capacity of the Regulator had also been undertaken, through the support of development partners.

However, there seemed to be some concerns that certain statutory provisions were suited for banks and were not made in cognisance of the dynamic nature of microfinance, and, that although the regulator had indicated willingness to be accommodative with some of the provisions, that this would not be as effective as having the provisions expressly catered for in the legislation. An executive from an institution with a large network stated:

> *"We are concerned with branch infrastructure requirements... with a large branch network are we expected to have all of them meet the regulatory requirements for branch premises at one go? We would really love to contribute more to broaden outreach as this is critcal to MFJ operations, but we cannot transform them to comply with requirements all at once. If that was the case, the costs of transformation would be prohibitively huge. Emphasis should be not to kill the institution but to help it grow and develop.* "

However, two institutions that in their own opinion indicated that they had made good progress praised the intervention role of two development partners. The two institutions had received financial support to help them defray transformation costs of hiring consultants to guide in the transformation process and for upgrading information systems.

The following table summarises the interview responses.

Table 4.9: Responses by the five MFIs interviewed

	Issue	Response of the interviewees
1.	Involvement of the MFIs in the development of the framework for the regulation of microfinance in Kenya?	All the 5 MFIs in the interview indicated that they had been involved in the development of the regulatory framework. However, there was indication that some of the recommendations by the industry did not appear in the final version, and were the main areas of concern. Provisioning and liquidity requirements were cited by institution A as examples.
2.	General opinion regarding the appropriateness of the regulatory framework in place to regulate deposit taking microfinance business and in particular the transformation of institutions to regulated status?	There was varied response with two institutions stating that they considered it too tough for the MFIs and that if not handled well could destabilise the sector. Further, it was considered expensive to meet all the requirements.
3.	Difficulties encountered in the regulatory framework by the transforming entities.	• The 25% maximum shareholding limit was a great challenge to 4 MFIs due to the problem of being able to identify like-minded partners. MFIs expressed the fear that getting new shareholders would lead to mission drift. Further the requirement for dilution of shareholding could lead to the institution being bought by foreigners. • Liquidity requirements of 20% was considered too high as the strength of an MFI was in its ability to lend to viable business ideas and not keeping idle cash to meet regulatory requirements. Further, financial reporting, especially liquidity reporting that is expected on a fortnightly basis was considered to be quite burdensome. • The risk classification and provisioning guidelines for the loan portfolio are considered too harsh for the industry since the clients pay on a weekly basis, hence four defaults of instalments would be considered as loss category. The reporting requirements are considered as not feasible with this industry as

		would require installing expensive robust information system to help in the reporting. • The specifications for the branch premises layout were considered as too expensive. One institution felt that it would require about Kshs. 15m putting in the required specifications which is too high for an MFI. • Lack of standardization of the content of the due diligence report required by CBK.
4.	Suggestions by the MFIs on how the difficulties above could be addressed / tackled	• Local investors should be allowed to own 100% to be able to retain focus on the social mission. Bringing other shareholders could lead to losing the mission. Further, the law should be changed to restrict foreign shareholders. • The MFIs were of the opinion that commercial banks should not be allowed to set up subsidiary companies to run microfinance, but should be allowed to offer microfinance within the set up of the bank. • Recommend gradual compliance for the offices to avoid too high initial cost of putting in the required physical infrastructure for branch premises layout. • Were also of the opinion that a specialised unit with understanding of microfinance be set up by the regulator to specifically handle microfinance.

4.5.1 Observations made

In the course of the interviews the researcher observed that the transforming entities have to invest in infrastructure to be able to handle the new expectations. The following section records the observations that were made in the course of the interviews.

4.5.1.1 Management information systems

Two institutions were conducting their transactions on manual systems. Three out of the five institutions visited were found to be engaging in a lot of manual intervention to the installed computer packages, as existing systems were not robust. The MIS was not robust enough to allow the integration of the loan processing system to that handling accounting information. In the five MFIs, the current systems was found to be strong on credi t management and group reporting and would require to be upgraded to meet deposit mobilisation needs. In addition, the researcher observed that the institutions had too much paper trail; due to the fact that the client accounts were held in separate multiple databases as the existing system could not handle the numerous transactions in one database. The existing management Information Systems in three institutions were found to be lacking in capacity to handle transactions to the expected reporting standards. However, the institutions were planning to upgrade or to install completely new packages.

4.5.1.2 Accounting practices

Whilst the laid down regulations require the MFls to comply with International Financial Reporting Standards (IFRS), it was observed that in two institutions the cash based system of accounting was still in use. The two institutions were grappling with the challenge of migrating to the accrual basis of accounting.

Though the institutions were committed to serving the economically active poor clients, three institutions were found to be largely inefficient, and there was lack of clear and transparent accounting records. Two institutions did not provide audited accounts while one had not been audited in the last three years. From the audited accounts provided, institutions A and B had huge borrowed funds from commercial banks to support the lending to the clients. Debt financing was cited as being very expensive for the microfinance institutions. However, one institution indicated that they were having problems accessing loans or credit facilities from the commercial banks, due to, in the opinion of the MFI, a lack of trust as the banks do not understand their business operations. Further, institution

D indicated that they had encountered a number of frauds mainly perpetrated by dishonest staff indicating weak internal control systems.

4.5.1.3 **Branch premises** physical lay **out**

The researcher observed that the premises being used to conduct the business were largely information processing centres for their credit customers. Since the institutions utilise the banking services of the commercial banks, the institutions branch premises layout were simple offices without the adequate banking halls to securely handle customer service such as cash and deposit services. The institutions will require enhancing the outlets to the required physical security standards such as installing dual locking doors and window grills. Further, the outlets will require to provide adequate banking halls for customers and to install strong and secure cash vaults all as per the prescribed regulatory standards.

CHAPTER FIVE

5.0 DISCUSSION OF FINDINGS

5.1 Introduction

This study was conducted with the aim of achieving the following two objectives:

i) To establish the prevailing institutional capacity and preparedness of the transforming microfinance institutions.

ii) To establish the perception of practitioners on the appropriateness of the legislation and regulations for the microfinance industry in Kenya.

To achieve the above objectives, the researcher administered a questionnaire to the microfinance institutions that are members of the Association of Microfinance Institutions (AMFI). The information gathered through the questionnaire was supplemented with interviews with executives of microfinance institutions. The responses to the questionnaire and those from the interviews were analysed and below is a discussion of the findings.

5.2 Discussion of the Findings

5.2.1 Reasons for the Institutions Consideration to Transform Into a Regulated Deposit Taking MFI

According to Hishigsuren (2006) the motivation to transform to a regulated MFI is driven primarily by the desire to access additional commercial sources of capital, provide a wider range of services, self sustainability and higher financial performance.

This study found that:

The transforming MFls In Kenya are primarily driven by the fact that transformation will yield to greater accountability and transparent institutions with enhanced corporate governance practices. The prescribed microfinance regulations require formation of formal limited liability companies with clear reporting lines and performance standards. Further, the ownership of these institutions has a 25% limitation on the maximum shareholding per investor, a clear departure from the prevailing NGO situation lacking clear owners. The ownership structure where shareholders exert influence for better governance and management is seen as key to enhancing corporate governance practices in these institutions. This will ensure transparency with regard to the ownership structure of MFls and improve their governance by limiting the amount of control vested in a single individual. These were particularly important as MFls serve one of the most vulnerable segments of the population and these provisions would minimize the likelihood of exploitation and abuse of MFls clients.

Secondly, access to deposits as a source of funding was cited as a key factor motivating the drive to be regulated. The credit only microfinance institutions have largely faced limitations on their funding base. This has led to slow outreach of these institutions. The institutions are keen on being regulated as they cite regulations as enhancing their credibility in the market place which further enhances their ability to raise commercial funds.

Consequently, the institutions cited the fact that with increased funding, they will be able to reach out to many. Transformation will lead to institutions that are considered sustainable in the long run. The potential of the market and the willingness to improve the availability and the quality of financial services are primary motivators for transformation.

These factors make it worthwhile for the institutions' desire to transition from an informal environment largely undisturbed by regulators to a formal regulated financial institution.

5.2.2 Institutional capacity of the transforming institutions

The study sought to gauge the institutional capacity of the transforming institutions in terms of staff capacity and necessary infrastructure to deliver varied financial services and products. The study revealed that there are challenges in both staff capacity and infrastructure requirements.

The institutions cited the fact that the existing staff have core competences in credit practices and would require to be retrained to handle deposit taking and savings mobilisation. Further, institutions will require training their staff on financial intermediation practices in particular liquidity risk management, developing new policies and procedures for savings collection, teller functions, investment and so on.

The study also revealed that the transforming entities have to invest in infrastructure to be able to handle the new expectations. The existing management Information Systems lack the capacity to handle transactions to the expected standards by the regulator. The institutions have largely been conducting their transactions on manual systems. Even for institutions that have computer packages, a lot of manual intervention was observed.

Another key area that the institutions lacked in terms of infrastructure was the branch premises' physical layout requirements. The prevailing office outlets were largely used as information processing centres for credit customers lacking the necessary secure physical infrastructure to handle cash and deposit services. One institution explained that they estimated that it would cost them about Kshs. 15 million (which translates to 25% of the required minimum capital for a nationwide MFI) to upgrade a single branch to the required standard.

Clearly, this study has revealed the need for institutions to build sufficient internal capacity so that licensing will not impose significant additional compliance related costs.

5.2.3 Preparations in place towards transformation and costs

The study sought information on the preparations towards transformation in the form of planned acquisition of infrastructure and recruitment of key staff. The findings indicate that the institutions preparation to modify or replace the existing management information system was rated as very expensive. The same observation was noted with regard to upgrading the premises to meet the laid down regulatory standards. These findings can be explained by the nature of the non deposit taking institutions in which their operations were largely limited. Transformation is expected to fundamentally change these institutions and therefore, adequate investment in infrastructure by the institutions is considered crucial to their success. It is therefore, important that adequate resources be allocated for the transformation. In this regard, financial support of development partners is highly important to help defray some of the transformation costs.

The study found that 65% of the responding institutions considered it highly important to have an action plan/timeline for the transformation process. The institutions also had a steering committee which was charged with the responsibility of the transformation. Further, these institutions had also hired the services of consultants to help with the transformation process. This was an indication that transformation though considered a complex exercise was being taken seriously leading to hiring of consultants to guide the process.

There were also cost elements incurred (or expected to be incurred) in preparation for transformation to deposit taking MFIs which included preparation of premises to specified standards, modifying or replacing MIS, costs of training staff and hiring/recruiting staff. There are costs, in terms of time, effort and resources, associated with meeting the reporting requirements of publication and prudential reports. These will be substantial (in some cases the cost is estimated to far outweigh the mimmum statutory capital requirements), especially for smaller MFIs and those located in rural areas which may have to upgrade and improve their management information systems (MIS).

One glaring finding was the fact that though some institutions recognised their inadequacies in staffing, they were unwilling to hire skilled staff from other financial institutions. The argument by these entities was that recruiting staff from established financial institutions was considered untenable as the recruited staff would not have the requisite culture and would lead to a drift in the culture of these institutions. This perception requires clear evaluation by the microfinance institutions as failure to address it comprehensively could derail efficient operation of the transformed MFIs.

5.2.4 Perceptions about the Legal and regulatory environment

This section discusses the reactions by MFls to the legal and regulatory framework for microfinance in Kenya.

5.2.4.1 The perceptions of MFls to the Appropriateness of the Entry Requirements / licensing process

Microfinance institutions were asked to provide their OpInIOn on the appropriateness of entry requirements and the licensing process. The study revealed that the licensing process was not considered a difficult aspect of being regulated. However, MFls indicated that the contents of the due diligence report to be submitted to the Central Bank were not clearly specified. As a result of lack of standardization of the contents of the due diligence report required by CBK, the MFls argued that this could lead to difficulties in reaching an agreement at the review process.

Besides, an ownership restriction of 25% shareholding was reported as one of the challenges faced by MFls during the transformation process. This is mainly due to the fact that identifying like-minded partners was a big challenge. One MFI expressed fears that the ownership restriction could lead to the entry of investors (foreign or local) whose interest is profit maximisation. This could lead to eventual erosion of the social mission ofMFIs in the long run.

It was also possible to understand from the responses collected from all the responding MFIs that the minimum capital is not difficult to meet. The study revealed that 100% of the responding institutions to the questionnaire had a high ability to meet the minimum capital requirements as prescribed by the Microfinance Act. One possible explanation for this is the fact that the existing MFls that are members of AMFI have relatively, strong balance sheet positions and are therefore, good candidates for transformation to regulated status under the Microfinance Act, 2006. This implies that the low minimum capital requirement would facilitate easy entry to deposit taking microfinance business. But the challenge is getting resources to defray the high cost of transformation, to create strong MFls with diversified ownership structure and commitment to control and monitor the MFls performance.

5.2.4.2 Ongoing Regulatory Requirements

The microfinance regulatory framework has put in place a set of ongomg requirements that a regulated MFI should comply with on an ongoing basis as it conducts the deposit taking microfinance business. The reactions by the practitioners on the on-going requirements are discussed below.

a) Liquidity Requirement

The main objective of the liquidity requirement is to ensure that MFIs maintain an adequate level of liquidity to meet all known and unexpected obligations. This promotes public confidence. However, from the responses collected through the questionnaire, 10% of the MFls have expressed that there is some level of difficulty in meeting the liquidity requirement. The minimum liquidity ratio prescribed for microfinance institutions is 20% which is the same as that prescribed for commercial banks. This limit is set for both community and nationwide MFls.

The MFls interviewed criticised the liquidity ratio as high arguing that this would lead to MFls maintaining high level of cash and other liquid assets, considered to be idle rather than being utilised for lending. However, it is important to note that the liquidity requirement in Kenya is 5 percentage points less than that of Uganda. This indicates that a more conservative approach is followed by Kenya. Further, the MFIs were critical of the reporting requirements (required to report the liquidity ratio on a bi-weekly basis) arguing that this would be difficult for outlets that are in remote places. The documentation necessary would make it time consuming and would require them to install expensive MIS packages.

b) **Provisioning Requirement**

MFIs expressed their VIew about the appropriateness of the provisionmg requirement. They noted that most of the credit facilities of MFls in Kenya comprise numerous small repeat loans, with quick repayment (weekly and biweekly payments) and that the loans are granted based on collateral substitutes (solidarity / group lending). They felt that the provisioning guideline is too harsh for them. The MFls were particularly critical of the requirement that a loan that is overdue by a day be downgraded from Normal to Watch category.

The microfinance practitioners were also sceptical that the loan classification and provisioning methodology would lead the regulator to classify the microfinance loans as problematic and require provisions against them, thereby reducing shareholders' earmngs and capital. In addition, the MFIs complained that the classification would be difficult to implement as the nature oftheir business is that a client may fail to pay by a day but turn up with the payments the following week. This would require constant classification and subsequent reclassification for such facilities, and this would make it cumbersome to operate.

However, it is important to note that once micro credit loans fall delinquent they have less probability of repayment and the fact that they are unsecured and have short (weekly, bi-weekly or in rare cases monthly) maturity periods justifies requiring them to be provisioned more aggressively than conventionally collateralized portfolio (Christen et al , 2003).

c) Branch Premises Requirements

Branch opening by deposit taking MFls is subject to review and approval by the Central Bank. Regulations 10 to 15 describe the procedures to follow in opening, closing or relocating a branch. Further, the Regulations require that every branch premises be inspected and the facilities reviewed against the stated requirements. Some of the requirements include alarm system installation, clear cash loading areas, adequate banking halls, vaults with dual locking system and insurance policies for the premises.

Microfinance institution A was of the opinion that to comply with the regulatory requirements on premises of a branch would require an institution to spend about Kshs 15m, considered to be very expensive. 50% of the institutions that responded to the questionnaire stated that branch premises compliance would be high The MFIs also felt that the definition of branch as defined in the Regulations does not take cognisance of the uniqueness of the microfinance industry. The existing MFIs were operating in leased premises and the requirement that MFIs seek approval for these premises was imposing added costs. Considering the wide areas of operation of MFls in rural areas, allowing MFls to open new branches with flexibility on the approval process would seem appropriate.

Further, MFls are also required to include information such as the full physical address of a proposed branch, expected date of commencement of operation, and to provide feasibility reports on the viability of the branch. This requirement is put in place to ensure that branch opening is carried out on prudent basis by doing market analysis and a feasibility study.

d) Frequency of Reporting

Deposit taking MFls are required to submit quarterly reports for their income statements, balance sheets, report on loans and savings and status of impaired loans and loan provisioning on returns (report form) prescribed by Central Bank of Kenya. Besides, MFls are required to submit twice a month, at the fifteenth and the last day of each month, liquidity information to the Central Bank. Further, the return is to be submitted within five working days of the reporting date.

The response (on the reporting requirement) of MFIs indicated that some MFIs due to inadequate MIS and wider branch networks in rural areas, found it difficult to comply with the existing reporting requirement prescribed by the Regulations. The reaction was that the required documentation (e.g., audited financial statements, liquidity reporting, portfolio reports etc) would be time consuming. The MFIs were calling for extension of the time limit prescribed for submitting in particular the liquidity return, and the report on classification and provisioning of assets.

e) Other Concern on the Law

One other issue that raised concern of the MFls was the lack of explicit restrictions for banks to set up subsidiaries to carry out micro finance business.

The Microfinance Act allows commercial banks to set up microfinance institutions and allows banks to own these subsidiaries 100%.

The MFls were of the opinion that this would be counterproductive as it could lead to further complications in the sector. This is an issue that could complicate the role of the regulator as it could lead to regulatory arbitrages by the commercial banks. Further, it does not make sense to give an institution two set of licenses from the same regulator, one for commercial banking and another for microfinance operations.

5.3 Relationship of Findings to Previous Research:

Previous studies on microfinance have shown lots of similarities with the findings of this study based on the Kenyan microfinance industry. Christen and Rosenberg (1999) and World Bank (2006) report found out that regulating and supervising microfinance can have unintended consequences. The two studies cite the case of provisioning requirements as set out in the regulations by the regulators in Tanzania as being unrealistic for the sector. Hishigsuren (2006) found out that regulation of financial institutions typically involves greater reporting requirements. This led to improvements in financial transparency and accountability of the institution (Hishigsuren, 2006). Hannig and Omar (1999) identify a number of challenges of regulating microfinance. These findings relate well with the findings of this thesis on the Kenyan experience.

Further, the World Bank (2006) report advocates the avoidance of excessive regulatory measures that are likely to constrain the ability of institutions to take reasonable and prudent credit risks. The overriding principle therefore in guiding regulatory design in regard to MFls, is that regulation should not choke-off initiative and outreach especially in remote areas. It is therefore imperative that the Regulator in Kenya would need to reconsider the stringent requirements for branch premises in particular for the rural branches.

However, despite the numerous challenges Christen and Rosenberg (1999) argue strongly for the regulation of microfinance, as it is the only setting that would permit massive, sustainable delivery of financial services to the poor. Their overall message was a cautionary one that there were problems in regulating microfinance that needed to be dealt with realistically. Christen and Rosenberg (1999), and Barth, Caprio, and Levine (2006) recommended for the regulators to make some attempt to tailor financial licenses, prudential norms, supervision systems, and other rules affecting microfinance operations, in order to ensure orderly growth. Chavez and Gonzalez- Vega (1994) found out that the role of the regulator in India required a degree of promotional support in the early stages of the industry's development.

5.4 Conceptual Framework Revisited:

In this section, we revisit the conceptual framework in light of the research findings. The unregulated MFIs are exposed to several challenges including weak information systems; weak corporate governance and management capacity; weak internal controls; a narrow range of products and services on offer; reduced access to funds, and lack of performance standards and accountability. These challenges have adversely constrained the MFls' growth and development, product range diversification, stability and soundness as well as their prudent management.

The Microfinance Act sets out various regulatory and supervisory requirements for deposit taking MFls including but not limited to Corporate Governance requirements; performance and regulatory standards; accountability and transparency; deposit protection; dissolution mechanisms and supervision by the Central Bank. It is expected that transformation into regulated status under the Microfinance Act will enhance governance, accountability and transparency, performance standards, deposit protection and ultimately promote competition to enhance efficiency. With increased access to savings and other cheaper sources of funds, the transformation of MFls into regulated institutions helps them to increase market penetration, open new branches, and increase their loan portfolio (Robinson, 2001).

Microfinance institutions will be transforming to regulated status under the Act in order to gain increased access to additional sources of funds to support growth, profitability and sustainability; offer a wider range of financial services and products including savings/ deposit mobilization, lending, money transfer and micro-insurance to meet the various needs of their clients; and unlock the unrealized potential of the un-banked and underserved segments of the population. Further, transformation will lead to increased private sector ownership that will ultimately enhance internal controls and corporate governance resulting in institutions that are highly transparent and accountable.

During the transformation process from non-regulated status to regulated, micro finance institutions are expected to face some constraints and challenges including managing the stakeholders through the transformation process especially with regard to concerns relating to institutional cultural shift and mission drift. MFls are institutions with dual missions or responsibilities inter-alia social and financial provision services to the lower income population. The extent to which microfinance institutions seek to maintain the dual focus on financial sufficiency and reaching poor clients is directly shaped by the strategic policies as directed by the ownership and the management objectives.

Further institutions will require raising adequate funding resources to upgrade, develop and/or acquire infrastructural facilities, processes and procedures, management information systems and capacity building. In addition the institutions will require allocating sufficient funding to meet the full cost of the transformation process in terms of information technology and processes and risk management tools and highly skilled staff with a thorough understanding of the clients' needs and socio-economic conditions.

These challenges notwithstanding, the transforming institutions will also have to deal with the perceived weaknesses of the regulatory system. Figure 5.l below summarises these relationships between the unregulated and the regulated MFI and the intervening parameters.

Figure 5.1 - Conceptual Model Revisited: Transformation of MFIs in Kenya
Source: Author, 2009

Figure 5.1 - Conceptual Model Revisited: Transformation of MFIs in Kenya
Source: Author, 2009

CHAPTER SIX

6.0 CONCLUSIONS AND RECOMMENDATIONS

6.1 Conclusions

This study on the transformation of informal financial institutions to regulated status has revealed that a majority of the unregulated institutions consider transformation as very important. Transformation will be challenging, but beneficial to the sector. On the one hand, there will be benefits, specifically, increased confidence in the sector through improved credibility derived from being a licensed institution and the vetting of entrants; increased transparency and accountability through the disclosure of information; and increased funding base which are likely to foster financial system stability. Further, there will be increased outreach.

On the other hand, the institutions expressed concerns with respect to certain regulatory requirements in the microfinance legislation and regulations that make the costs of implementation quite high. Compliance costs with regard to meeting reporting requirements, business premises requirements, and other operational requirements like loan loss provisioning are quite significant, especially for smaller or rural MFls which will have to incur additional costs of upgrading their MIS. All transforming institutions will in one way or the other incur increased costs.

The study concluded that the informal microfinance institutions were gearing up to transform in the sense that a majority had a steering committee which was charged with the responsibility of the transformation and they had also hired the services of consultants to help with the transformation process. In the literature review, it was found that for the institutions to be prepared for the transformation process, they had to have adequate funding, action plan/timeliness and change management. From the study, these organizations are prepared to incur costs in preparation for transformation to a deposit taking MFIs which included preparation of premises to specified standards, modifying or replacing MIS and costs of training staff, hiring and or recruiting staff.

6.2 Recommendations

These study findings indicate that the nurturing of sustainable institutions from the transforming institutions requires long term commitment to invest in these entities. Transformation is expensive and requires use of resources. Microfinance institutions will need support in areas such as accounting and control systems, financial management, product development and human resource development. It is critical that MFls have access to appropriate high quality business services to meet the requirements of the new regulatory framework. Further, this study recommends continued support by development partners to MFls preparing to transform into deposit taking MFls.

Secondly, the study reveals areas in the microfinance legislation that may require further streamlining to make them friendlier to the microfinance industry. These requirements that were considered to be most difficult and by extension considered inappropriate for the microfinance industry were the requirements for business premises, disclosure and reporting requirements and loan loss provisioning. It is important to strengthen dialogue between the regulatory body and practitioners to enhance the understanding of the regulatory framework.

Thirdly, it does not make sense to give an institution, two set of licenses, one for commercial banking and another for microfinance. This is an issue that could complicate the role of the regulator as it could lead to regulatory arbitrages by the commercial banks. The law should be amended to explicitly disallow banks from setting up subsidiary companies to carry out microfinance business. The banks should be encouraged to carry out microfinance business as a segment of the operations of the commercial banks to prevent malpractices like regulatory arbitrage.

Fourthly, there are few opportunities to learn about current microfinance operations and innovations in Kenya leading to a shortage of trained personnel. The lack of qualified personnel and training resources will have a continuing negative effect on the ability of the microfinance institutions to extend and improve their' operations in an efficient and effective manner in the years to come. This study therefore, recommends development of a microfinance training curriculum that could assist in preparing qualified personnel for work in microfinance institutions. This curriculum should encompass the foundations of microfinance as well as awareness of current innovations and "Best Practice" thinking.

Across the country, microfinance institutions serve the lower segment of the citizenry whose plight warrants an intervention strategy from the policy perspectives of the government. Effective regulation and supervision of microfinance institutions safeguard the stability of the sector and protect the savings deposits of the depositors. Microfinance supervision ensures that the sector may not negatively affect the integrity of the Financial Sector and hence contributing to safeguarding of the whole economy. Supervision in Kenya will include determining risks faced by MFls and also ensuring regulatory compliance by MFTs. Although the assets of MFTs may be low by comparison to that of commercial banks, microfinance institutions have the capacity to serve larger numbers of small depositors and as such should be regulated and supervised. The supervision of MFls is being handled by a division within the bank supervision department. However, this study recommends that the regulatory authority should supervise microfinance institutions through a specialised unit trained in their nature, risks and methodologies.

The study has revealed that a majority (85% of the responding unregulated institutions) consider transformation as very important. This study, therefore, recommends that in order to increase the access to financial services, as many of the traditional non-deposit taking MFls should transform into regulated deposit taking financial institutions. The challenge, however, is to make the dream of transforming MFls a reality that will make millions of poor men and women currently un-served access financial services.

6.3 Areas for Further Studies

This study has addressed the perceptions of the executives of microfinance institutions on their transformation to regulated status. The researcher also focused on institutional readiness for transforming into regulated microfinance institutions directed only to Microfinance Institutions (MFls) considering transforming into deposit taking institutions, under the newly enacted Microfinance Act, 2006.

The researcher recommends a similar research to be undertaken in two years' time to conduct a first assessment of the early effects of the microfinance law on various aspects such as ownership, governance, management, reporting, performance indicators, MIS, and product development. This study should also assess the level of transition by the microfinance institutions and the vivid impact to financial access by the transformed entities.

Further research on the possible impact of the commercial banks in microfinance should be undertaken. With the setting up of microfinance subsidiaries by the traditional commercial banks, research could be conducted on the impact this development is likely to have on the MF sector.

This research also recommends that research be undertaken to find out whether subjecting the microfinance institutions to the regulatory oversight of the Central Bank will hinder the innovativeness of this sector.

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APPENDICES

Appendix 1: LETTER OF INTRODUCTION

Dear ....,

RE: A STUDY OF MICROFINANCE INSTITUTIONS IN KENYA

With the enactment of Microfinance Act 2006, microfinance institutions (MFIs) are gearing up to transform into deposit-taking institutions. However, this transformation is likely to present several challenges to MFIs. To broaden the debate and discussions on how some of these challenges can be addressed, Mr. Peter Gikang'a, a Masters student at Strathmore University is conducting a study titled:

The Perceptions of *Microfinance* ***Practitioners' on the Transformation into Regulated Entities under the Microfinance Act, 2006***

The study is a requirement towards partial fulfilment of the Masters degree.

The objectives of this study are to:

- Establish the views of the MFls on the appropriateness of the current regulatory and supervisory framework for MFls in Kenya;
- Establish the institutional capacity of the non-deposit taking microfinance institutions to facilitate transformation into deposit taking MFIs;
- Determine the preparations that have been put in place by the non-deposit taking MFls towards transforming into a regulated status.

It is to this end that we believe your input to this research is crucial.

Please note that the study will be conducted for academic purposes and the information provided will be treated in strict confidence. Strict ethical principles will be observed to ensure confidentiality. The questionnaire has an identification number for mailing purposes only. The responses you provide in this questionnaire are completely confidential. The study outcomes and report will not include reference to any individuals or organizations.

In order to ensure a comprehensive analysis of the findings, it is important that each questionnaire be completed and returned. We also request that the questionnaire be completed by a senior level management member of staff in your organisation.

As a sign of our appreciation for your participation, a generic overview of the findings will be made available to you.

To facilitate the completion of the study we kindly request you to take about 15 minutes to complete the attached questionnaire which will be collected from your office on or before **12th June 2008.**

In case of any questions, please do not hesitate to contact the undersigned or Mr. Gikang'a on telephone number (020)2863062, 0722 XXXXXX or email at gikangapeter@yahoo.com.

Thank you very much for your invaluable contribution.

Yours Faithfully,

Dr. Ruth Kiraka
Principal Supervisor
Faculty of Commerce

Appendix 2: RESEARCH QUESTIONNAIRE

A: General Information

1. Name of Institution:..

2. Year of Registration:

3. Postal address:

4. Contact Information (Telephone, and e-mail address):

5. Products/ Services (*tick where applicable):*

• Savings	• Credit facilities	• Payment transfers	• Leasing	• Micro insurance

Others, please specify ____ _

B: Perceptions about the Legal and Regulatory environment

6. If you plan to transform, what is the expected time period to transform? (please circle one)

    In less than a year 1

    Between one and two years 2

    Between 2- 5 years 3

    More than 5 years. 4

7. How important do you think it IS to transform into a regulated microfinance institution? (please circle one)

    Very Important 3

    Important 2

    Not Important 1

8. Please rate on a scale of 1 to 5 where 1 = Not important, 2= A little important, 3= moderately important, 4= Important and 5= most important, the reason why your institution is considering to transform into a regulated deposit taking MFI? (Tick as appropriate).

	~g **Reason**	**Not Important**	**A little Important**	**Moderately Important**	**Important**	**Very Important**
5.	Expanded outreach					
6.	Experiment as you are ready to take risks					
7.	Requirements by Law					
8.	Pressure from the donor / financiers					
9.	Improved i nstituti onal governance, professional standards and accountability					
10.	Access to deposit as a source of funds					
11.	Other, please specify					

9. How would you generally rate the appropriateness of the Microfinance Legislation and Regulations for efficient operations of your institution? (Please circle one).

Excellent 3

Appropriate 2

Moderately appropriate 1

Totally Inappropriate 0

10. Please rate the **ability of your institution** to meet the requirements of the existing regulatory framework for your institution with regard to the following areas in the table below (please tick as appropriate):

	~ **Legal Requirement**	**Very Low**	**Low**	**Moderate**	**High**	**Very High**
1.	Change in the legal form of organisation to a limited liability company					
2.	Ownership Restrictions (25% per person)					
3.	Minimum capital requirements					
4.	Business plan and feasibility reports					
5.	Fit and Proper tests for Directors and Senior managers					
6.	Liquidity requirements					
7.	Loan loss provisioning, write-off					
8.	Disclosure and Reporting requirements					
9.	Specifications for Business Premises (Place of business / branch specifications)					

11. How would you rate the understanding of the regulators and policy makers in Kenya about microfinance? (Please circle one)

Excellent 3

Average 2 Below

average 1

Do not Know 0

C: Institutional Capacity & Preparedness

12. To what extent does your organisation consider it important to have an action planltimeline for the transformation process of your organisation? (Please circle one)

Highly Important	1
Important	2
Not Important	") .)
Not Important	4

13. Please circle against the statement(s) that you agree with

a) The organisation has hired the services of consultants to help with the transformation process.
b) A steering committee is charged with the responsibility of the transformation process
c) A transformation manager has been appointed by management to champion transformation

14. How would you describe the staff capacity both in terms of the skills and numbers for your organisation? (please circle one) Highly adequate

Adequate	2
A Little Adequate	3
Not Adequate	4

15. If your answer to above question is either a little adequate or not adequate, is your institution planning to recruit or retrain staff to specialise in providing savings and other financial services? (please circle one)

Yes	
No	2

16. To what extent do you think your organisation is prepared with regard to the following? (please tick as appropriate)

	▪ ▪ Requirements	Very Low	Low	Moderate	High	Very High
1.	Management Information Systems (reT)					
2.	Operational manuals					
3.	Business plan and Feasibility reports					
4.	Business Premises (Place of business / branch specifications)					

17. How would **you rate** the following cost elements incurred (or expected to be incurred) in preparation for transformation to a deposit taking MFI? (please tick as appropriate)

	~g **Cost Element**	Very High	High	Moderate	Low	Very Low
l.	Hiring / Recruiting staff					
2.	Training staff					
3.	Modifying or replacing **MIS**					
4.	Administrative bureaucracy due to requirements such as board and corporate governance requirements.					
5.	Preparing premises to specified standards					

Thank you very much for taking the time to respond to this questionnaire. Your invaluable contribution is highly appreciated.

Appendix 3: INTERVIEW GUIDE

Introduction

I thank you for taking time to respond to my research questionnaire. This interview is a follow up of issues raised in the questionnaire on institutional preparedness on transformation to regulated status.

It is designed to corroborate / expand the information you furnished on the questionnaire for my thesis on the subject of transformation to regulated status by non deposit taking institutions. Please cooperate and respond to the questions to the best of your ability.

Confidentiality Note:

Neither your name nor that of your organisation will be disclosed or used. All descriptive information will be pooled into a summary, so that no individual confidentiality will be violated. (The researcher will avail a copy of the final report for your information should you so wish.)

Interviewee information:

1.Your name (Optional) __________________________________ _

2. Job Title -------
3. Name of the Microfinance Institution

4.How long have you worked for this organization / job? _________________________ _

Institution Information:

1. Briefly describe your institution history and CUITent operations . ./ Vision

./ Mission Statement

./ Products and services ./

Branch operations

./ Outreach

2. In your opinion is the regulatory framework in place to regulate deposit taking microfinance business appropriate for the transformation of institutions to regulated status? If no, in which areas?

3. Would you please suggest how the difficulties that you mentioned on question number 2 can be addressed / tackled

4. **In** your opinion how will the regulatory framework influence the ability of your **MFI** to transform?

5. What adaptations or changes or additions do you think are required on the current regulatory framework?

6. Have you been involved in the development of the framework for the regulation of micro finance in Kenya? ___________________________ _

7. What are the key lessons you are learning from the transformation process?

8. What recommendations would you make to other MFls as they seek to transform?

r,

Appendix 4: DIRECTORY LIST OF MICROFINANCE INSTITUTIONS

	Name	Contact Person	Address	Location
MFIs (AMFI Members)				
1.	AAR Credit Services	John Kariuki MD	P.O Box 41766 GPO Nairobi Tel: 2715319 Fax: 2715328 i kkari uki (m,aar. co .ke	Williamson House, 4th N gong A venue Nairobi
2.	Adok Timo	Sam Deya CEO	P.O.Box 3650-40100 Tel: 057-2025570 adoktirnorritvahoo. com	Sifa House, Ground Floor, Mission Road Off Kibuye Market, Kisumu
3.	Agakhan Foundation Microcredit Programme	Azim Dawood Programme Manager	P.O. Box 13149-00100, Nairobi Tel: *4451346/7/8* Fax: 4451349 azim.dawood@fmfa.or.ke	3rd Floor Mpaka Plaza, Next Caltex Plaza, Parklands Nairobi
4.	BIMAS	Nduati Mwangi Managing Director	P.O Box 2299 Embu Tel: 068-31645 Fax: 068-31573 info(c-t)'bimaskenya.org	BIMAS Complex Opposite Shell Petrol Station Embu.
5.	Crossbridge Credit Ltd	Managing Director Fred Obwora	P.O Box 10208 Nairobi Tel: *318882/241226* fobwora@crossbridgegro up.co.ke	Rehani House 8 til Floor Kenyatta Avenue
6.	Elite Microfinance	Mr. OJ Kebatta CEO	P. O Box 2111 Mombasa Tel: 041-5486771 Cell: 0720735514 Fax: 5486767 elitemicrofimmce@swift mombasa.com	Mombasa
7.	Faulu Kenya	Lydia Koros, CEO	P.O Box 60240-00200 Nairobi *Tel:3877290/387218414* Fax:3867 *504/3874857* lydiak@faulukenya.com	Ngong Lane, Off Ngong Road

	Name	Contact Person	Address	Location
8.	Jamii Bora	Ingrid S. Munro	P.O Box 2704-00202 Nairobi Tel: 3875327 Fax: 3868470 imunro@jamiibora.org	Funzi Road, Industrial Area
9.	Jitegemea Credit Scheme	Francis Kihiko CEO	P.O Box 46514, Nairobi Tel: *535866/552169* j itegemea@wananchi.co m	KCB Plaza Jogoo Road
10.	Jitegemee Trust	Anne W. Mutahi CEO Newton Njagi Credit Manager	P.O Box 21768-00505 Nairobi Tel: *3874693/3872998* Fax: 561120 amutahi@jitegemeetrust.c o.ke	Lenana Road Roshan Maer Place
11	· KADET	David Ruchiu, MD	P.O Box 1676-00200 Nairobi Tel: *2731954/87* Fax: 2731955 david ruchiu@wvi.org	Capital Hill Towers
12	· Kenya ECLOF	Mrs Rose Wanjohi	P.O Box 34889 Nairobi Tel:3745055 Cell: 0721-344699 Fax:37441430 keclof(m,kenyaweb.com rwanjohi(cv,eclof- kenya.org	First Insurance Plaza Muthithi Road.
13	· Kenya Gatsby Trust	Mr. Constantine Kandie	P.O Box 44817-00100 Nairobi Tel: *2720711/03/2720571* Fax: 2721707 *0722201233/0735337661*	ACK Garden Hse 6th Floor, Wing D
14.	Kenya Women Finance Trust	Dr Jennifer Riria, CEO	P.O Box 55919 Nairobi Tel *2712903/2712823* Fax 2723303 riria@kwft.org joan(mkwft.org	Muchai Drive Off Ngong Road

	Name	Contact Person	Address	Location
15.	K-rep Development Agency	Mr Aleke Dondo, CEO	P.O Box 39312 Nairobi Tel *4343495/4343493* kda@k-rep.co.ke adondo@,k-rep.co.ke	Next to Kileleshwa Police station
16.	Micro Africa Ltd	Tim Carson CEO	P.O Box 52926 Nairobi Tel: *27273731* Fax: 2721745 tim(a)microkenya.co.ke	Off Lenana Road
17.	Micro Enterprises Support Programme Trust (MESPT)	Mr. JeffK. Njagi CEO	P.O Box 187-00606 Nairobi Tel:3 *746354/3 746764* jnj agi(a)mespt.org	2nd Floor, First Assurance Plaza, Muthithi Road, Westlands
18.	Millennia Multipurpose Credit Society	Fred Omaiyo	P. O Box 12056, Nakuru Tel: 051-2214943 milleniampcs(QJ,yahoo.co m	Nakuru
19.	*OTKO* Credit	Kathure Mwenda Judy Ngarachu	P.O Box 67181 Nairobi Tel: *4445845/4441442* Fax: 4445318 oikocreditrclafricaonline.c o.ke	AACC Building 4th Floor Waiyaki Way.
20.1	Plan International	Else Kragholm Kenneth Marangu	P. O. Box 3870420 Nairobi Tel: *3870216/4987/3862593* Dorothy. wandabwa@plan - international. org	North Star Building Lenana Road
21.	Pride Limited	Mr Joseph Kariuki 0721819370	P.O Box 63486 Nairobi Tel: 4453216 pridel td@yahoo.com mdkerre@yahoo.com	KCB Building 2[1la] Floor Jogoo Road.
22.	Smallholder Irrigation Schemes Development Organization (SISDO)	Antony Githinji Managing Director	P.O Box 76622-00508 Nairobi Tcl : *3870280/3864901* Cell: 0722-200083 Fax: 3871531 sisdo@sisdo.org, info(a)si sdo .org	N ext to Adams Arcade

	Name	Contact Person	Address	Location
23.	Small and Micro Enterprise Program (SMEP)	Phyllis Mbungu, CEO	P.O Box 64063 Nairobi Tel:3870162/3861927 Fax:3870191 smcp@afl·icaonline.co.ke	Kirichwa Road Off Argwings Kodhek Road
24.	Sunlink	Costa Malai CEO	P.O Box 13874-00800 Nairobi Tel:44507501l Fax: 4450752 malai@mpl.co.ke	3ra Floor Woodvale Place, W oodvale Groove
25.	WEDCO	Mano Kamaleson	P.O Box 6711-40103 Kisumu Tel: 057-202 I 2 I *112034849* Fax: 057-2 I 680 0722-205 I 7 I / 0733609996 info@wedcoJtd.com	Oginga Odinga Street Opposite Swan Centre
26.	WEEC	CEO	P. O Box 486 Kiserian Tel: 045-25226 weec@swiftkenya.com	Kiserian Off Magadi Road.
27.	Fusion Capital Ltd	Luke Kinoti	Tel: *2475381218223* Fax: 219738 Email: info@fusioncapita1.co.ke	View Park Towers io" Floor
28.	YEHU Enterprises Support Services	Dr. Rita Lugogo	P.O Box 82120 Nairobi Tel: 041-224406 choice@africaonline.co.k ~	K wale District, Mombasa
29.	PAWDEP	Mr. Julius Chege Muiruri	Kiambu Town	Kiambu