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Factors affecting institutional transformation for regulated MFIs

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ABSTRACT

Purpose - Regulating microfinance activities has been an important policy concern in improving financial inclusion and extending financial services to all. However, introducing a regulatory framework of any kind pushes targeted institutions to change. In this case, microfinance regulatory framework in Kenya that came to effect in 2008 has created three tiers of microfinance institutions: prudentially regulated deposit-taking institutions, credit only and unregulated informal groups. Those undertaking deposit-taking business were required by this regulation to transform their operations to comply with the requirements. Though many institutions wanted to be allowed to mobilise public deposits, only six institutions had managed to obtain a license in four years after the regulation became operational. The purpose of this research was to establish the factors affecting this microfinance transformation process.

Design/methodology/approach – The research was carried out by collecting empirical evidence from microfinance institutions target by regulation in Kenya to establish these factors contributing to the slow phase of transformation. The possibility that the challenges could be affecting both the regulator and institutions being regulated was explored.

Findings – This study identifies several important factors affecting the transformation process of microfinance institutions in Kenya. These include the ability to meet capital requirements, restructuring existing ownership and getting new shareholders, ability to raise funds for transformation, acquiring suitable information systems, motivation to be regulated, governance issues and managerial inertia. These factors explain why certain institutions have moved faster than others in the transformation process and why some have opted to remain credit only.

Research limitations – The availability of reliable database of microfinance institutions that were a target for this study was a challenge affecting sampling and reach. In addition, data collected was limited to one point of contact yet some factors could relate to operational process.

Originality/value – The study broadens research to transformation process of regulated microfinance institutions, factors affecting them and regulatory framework.

Key words:

Microfinance

Microfinance Regulation

Transformation challenges

Kenya

Deposit taking

1 INTRODUCTION

Poverty has continued to be a concern and attracts attention both in the developed world and developing world. Unfortunately, in many poor countries the gap between the poor and the rich is big and growing (Littlefield, Morduch & Hashemi, 2003). In most instances, the poor are denied access to many essential services including financial, education and medical services, because they cannot afford them.

There has been a close association between economic development and financial access. Demirguc-Kunt (2006) argues that, although there is no consensus on the nature of the association between the two, some scholars are of the view that financial systems are a catalyst in alleviating market restrictions and hence influencing savings rates, investment decisions, technological innovations and therefore long-run growth rates. Demirguc-Kunt (2006) also points out that financial systems help mobilise and pool savings, provide payment

services that facilitate the exchange of goods and services, produce and process information about investors and investment projects. These facilitate business transactions, both big and small.

Since there is evidence that links the provision of financial services to economic growth as well as both increase and distribution of income, the concern has shifted to who has access to these services (Littlefield *et al.*, 2003). Of interest is the extent to which the poor have access to financial services. Smaller enterprises and poor households face much greater obstacles in their ability to access finance all around the world hence isolating them from development (Demirguc-Kunt, 2006; Honohan & Beck, 2007). Microfinance has been accepted as a viable approach to reaching the poor with financial services. It has also been linked with growth of micro and small businesses (Littlefield *et al.*, 2003; Omino, 2005). Microfinance has evolved over time and is now accepted to be the provision of a full range of financial services to low-income earners (Littlefield *et al.*, 2003). It employs effective collateral substitutes to deliver and recover short-term, working-capital loans to existing (or potential) micro-entrepreneurs (Yunus, 2007; Sengupta & Aubuchon, 2008: 9).

Integrating microfinance into the national financial system has gained a great deal of momentum and is seen as a way of increasing financial access for all and bringing the poor into the centre of development (CGAP, 2005a*;* Coetzee, 2005; Demirguc-Kunt, 2006; Honohan & Beck, 2007). Integrating microfinance into a financial system involves more than just recognising that it exists. It requires instituting the necessary reforms in the sector to create an enabling environment. Such reforms include regulation and supervision of the activities of microfinance institutions (Christen, Lyman & Rosenberg, 2003). Institutions opting to be regulated are, in most cases, required to transform institutionally to comply with set requirements. Sometimes this transformation may involve change of legal status ownership, organizational structures and systems, and probably their delivery systems. This

change creates challenges for transforming institutions and some institutions may fail to transform.

The push for regulation in Kenya has come from two fronts; on the one hand by microfinance institutions have been lobbying for the regulation to gain access to local deposits for on-lending (Rosengard, Rai, Dondo & Oketch, 2001; Ndambu, 2011) while government has been concerned about the need to protect the poor against losses that could be occasioned by unscrupulous operators. The CBK report for 2009 indicates that 33 microfinance institutions had sought for name approval as the first step into becoming becoming a deposit-taking microfinance (DTM) but only two had at least acquired a provisional license as at December, 20 months after the regulations became effective (CBK, 2009). By December 2011, only six institutions had received DTM license, three of them have transformed and the other three were newly formed.

This research, therefore, aims to investigate factors affecting the transformation process of microfinance institutions in compliance with the regulatory framework in Kenya. It seeks to explain the motivation for regulation and establish factors affecting the transformation process. Establishing these factors would help the policy makers and practitioners to improve the implementation process.

2 THEORY AND LITERATURE

2.1 Microfinance operations

The origin and evolution in microfinance are closely related to developments in micro and small enterprises (MSEs) and implementation of poverty alleviation strategies. The typical microfinance clients are low-income persons who do not have access to formal financial institutions. These are basically small-scale entrepreneurs and farmers, low-salary earners, and all other categories that have low and irregular incomes. These could be found in urban

low-income residential areas and rural areas. They are often faced with limited access to financial services and other related problems like poor sanitation, poor nutrition, lack of education and insecurity (Holtz & Klose, 2000).

Diverse delivery methodologies have been employed all over the world and have evolved over time. These methodologies have revolved around addressing the challenges of the poor people who cannot afford to provide collateral or are in need of small quantities of financial services whose administrative costs outweigh the income (Hermes & Lensink, 2007). According to Hermes and Lensink (2007: 1) many MFIs have employed varied degrees of joint-liability group lending to reduce these administrative costs. Some of the most common methodologies include: group methodology (Grameen model)[1], solidarity group model, village banking, financial service associations (FSAs) and individual lending (Wendt & Eichfeld, 2006; Delfiner, Pailhé & Perón, 2006).

Microfinance as a business has proved to be profitable and sustainable (Gross & Silva, 2003; Wendt & Eichfeld, 2006). In some countries in Latin America, Asia and Africa some microfinance institutions have grown big and transformed into deposit-taking businesses specially regulated or within the conventional banking laws (Hishigsuren, 2006). In other cases commercial banks have expanded their services to serve the poor and small businesses through subsidiaries or establishing fully pledged business units. Analysis in the MIX market report of June 2009 shows that deposit-taking microfinance institutions performed better (Gonzalez & Meyer, 2009) and access to local savings helps such institutions scale up their operations (Wright & Kaplan, 2001; Arun & Murinde, 2011). Access to local savings has been the main motivation for microfinance institutions to lobby for regulation.

2.2 Challenges in microfinance delivery

[1] Grameen model uses group guarantee mechanism to provide alternate collateral by the poor as experimented by Dr Muhamad Yunus in 1976, initially implemented through Grameen bank in Bangladesh and later replicated worldwide.

Various studies on the impact of microfinance have been carried out in different parts of the world, but researchers have differed on their conclusions. Though Professor David Hulme (2000) argues that microfinance institutions have achieved less than what is hyped by donors and the poor have benefitted less, Professor Jonathan Morduch blames faulty results from weak methods of measurement employed (Goldberg, 2005). Evidence from a cross-national study on the impact of microfinance in India, Peru, and Zimbabwe by Nathanael Goldberg in 2005 strongly suggests that access to financial services at the household, enterprise and individual levels is associated with improvements of social and economic welfare of low-income households (Goldberg, 2005; Zaman 2000). He concludes that impacts of microfinance services differ from one institution to another, client to client and depend on a variety of other reasons than access (Goldberg, 2005: 46). A recent study by Rosenberg (2010: 1-8) indicates that there is no clear-cut conclusion on whether microfinance achieves its objectives all the time. Therefore, microfinance on its own may not deliver the expected results and some intervention is indeed necessary.

Sustainability of MFIs is essential for growth in outreach, quality and reliability of provision of financial services (CGAP, 2004b). Sustainable MFIs are able to increase their capital through retained earnings and hence increased capacity to reach more loan customers. According to Littlefield and Rosenberg (2004: 1) microfinance works and is sustainable; several institutions have proved that financial services for poor people can cover their full costs, through adequate interest spreads, relentless focus on efficiency, and aggressive enforcement of repayment.

Many MFIs find themselves unable to scale up their operations due to limited access to funds. Some of the reasons preventing them from accessing external funding are related to their weak organisational structures (especially not-for-profit), shortage of management skills and

lack of profitability (Avgouleas, 2007). They are unable to attract the interest of outside investors.

Another inhibiting factor has been the lack of a flexible regulatory framework. Where legal systems are weak, there are uncertainties regarding enforceability of commercial contracts and property rights and low-level mechanisms of gathering reliable information (Avgouleas, 2007: 32-33). As a result there are agency problems and even group monitoring of alternative collateral becomes difficult.

2.3 Microfinance regulation and supervision

2.3.1 Rationale for regulation

Historically microfinance was initiated, sponsored and implemented largely by welfare-based, non-governmental organizations (NGOs) whose orientation was different and certainly not for profit (Lauer, 2008). With growth in outreach and loan portfolio as well as the need to mobilize savings, certain risks started to emerge at both the institutional level and macro level (Littlefield & Rosenberg, 2004). These risks were credit risk, liquidity and interest risk, fiduciary, ownership and governance risk. Credit risk emanated from the process of assessment and the form of collateral available from the poor. Liquidity and interest risk resulted from the type of funding the MFIs received (Hannig & Katimbo-Mugwanya, 1999). In addition, management risk resulted from the fact that most of the senior staff of the MFIs lack banking backgrounds, while ownership and governance risk was a result of no real stake existing for board members of such institutions and their internal systems were generally weak (Hannig & Katimbo-Mugwanya, 1999: 8-10, Staschen, 1999: 9-12).

There is consensus that regulating microfinance operations is necessary for the growth of the sub-sector and stability of the wider financial sector (Hannig & Katimbo-Mugwanya, 1999: 8-10, Christen *et al.*, 2003: 8, Cull, Demirguc-Kunt & Morduch, 2009; Sarma, 2011). In some

countries like Kenya, Uganda and Ghana, institutions offering microfinance have grown to such a level that if not regulated, the safety of the national financial system is at risk (CGAP, 2008; Arun & Murinde, 2011). The Consultative Group to Assist the Poor (CGAP) (2003c) defines regulation as binding rules governing the conduct of legal entities and individuals, whether a legislative body (laws) or an executive body (regulations) adopts them. Two forms of regulation exist, namely prudential and non-prudential. Institutions that mobilise deposits threaten the security of the financial sector and pose a risk to depositors hence require prudential regulation (CGAP, 2003c). Institutions that meet the prudential regulation are then issued with an operating license to carry out the financial service delivery as per the set rules.

Regulation enhances sustainability of MFIs in various ways. It requires formal ownership and governance structures, that are vital for continued sustainability and transparency, to be defined (Mersland, 2008). The management of MFIs are constantly monitored and put under pressure through regular reporting and disclosures. Prudential regulations specify performance indicators to be adhered to, hence the public builds trust on regulated institutions and are willing to save with them (Christen *et al.*, 2003). Thus regulation helps MFIs to increase their chances to attract external funding or investors (Avgouleas, 2007). The benefits of a well-crafted and implemented regulation regime are great as it usually levels the playing ground for financial institutions and receives public acceptance.

The generally-agreed objectives of prudential regulation include (Christen *et al.*, 2003; Hannig & Katimbo-Mugwanya, 1999; Staschen, 1999; Lauer, 2008; Shankar, 2009: 2-3; Arun & Murinde, 2011):

i) Protecting the country’s financial system by preventing the failure of one institution from leading to the failure of others;

ii) Protecting small depositors, who are not well positioned to monitor the institution’s financial soundness themselves;

iii) Ensuring that there is no unwarranted run on a financial institution; and

iv) Effectively limiting the danger of opportunistic behaviour.

There is concern to protect consumers from excessive risk taking behaviours of some players in the financial market for selfish gains (Avgouleas, 2007; Arun & Murinde, 2011). On the other hand, the main motivation for regulatory change is to encourage formation of new MFIs and/or improve performance of existing institutions (Christen *et al.*, 2003). Regulating microfinance is believed to have the effect of increasing the volume of financial services delivered and the number of clients served through increased safety of deposits and confidence in the regulated institutions.

2.3.2 Regulatory framework

Regulators have a challenge in determining who, what, how and when to regulate. At initial stages regulators can choose to have no regulation, self-regulation, use existing banking regulation or set special regulations (Staschen, 1999; Kirkpatrick & Maimbo, 2002; WSBI, 2008). Where the choice is to use existing banking laws, the framework should be structured to provide MFIs with a clear view of attaining institutional development and transformation (Gallardo, 2001). In addition, these laws should enable the MFIs to operate sustainably in a market-based financial system and be able to offer a wide range of financial services like savings, insurance and transfer facilities (Gallardo, 2001; Lauer, 2008). The focus of regulation should be on the microfinance activities rather than on the institutions (WSBI, 2008: 6).

Regulation of microfinance activities and MFIs may take three main forms: (a) simple registration as a legal entity; (b) non-prudential regulations that provide standards of business operations and oversight, such as operating and financial reports to be submitted, to protect the interests of clients or members; and (c) full prudential supervision (Gallardo *et al.*, 2005).

There seem to be a consensus that prudential regulation should be used primarily with respect to deposit-taking institutions to protect depositor safety and the soundness of the financial sector as a whole (CGAP, 2008; Sinha & Sagar, 2007). Non-prudential regulation, often more appropriate for the regulation for credit-only microfinance institutions, tends to be easier to enforce and less costly (Chiumya, 2006; Christen *et al.*, 2003). Experiences in Ghana, Benin, Tanzania, India, Nepal, Uganda and Zambia show that the approach to microfinance regulations are different and have resulted in varied degrees of success (Gallardo, Ouattara, Randhawa & Steel, 2005; Sinha & Sagar, 2007: 7; Sinha, 2007:12; Okumu, 2007; Chiumya, 2006: 226-228).

The approach to regulation may differ from country to country. Some countries such as Bolivia and Peru in Latin America, and Ghana, Uganda, Kenya and Zambia in Africa, have opted for a tiered financial and regulatory structure (Gallardo, 2001; Okumu, 2007; Chiumya, 2006). Avgouleas (2007) emphasised the need to fashion differentiated licensing regimes for MFIs depending on their structure and services they offer. in their comparative review of microfinance regulatory regimes in Benin, Ghana and Tanzania found that recognising different tiers of both regulated and unregulated institutions in a financial structure facilitates financial deepening and outreach to otherwise underserved groups in urban and rural areas with flexibility in supervision mechanisms (Gallardo, Ouattara, Randhawa & Steel, 2005; Steel & Andah, 2004, Christen *et al.*, 2003). Kenya has also adopted a tiered approach. In addition, the World Savings Banks Institute (WSBI) (2008) suggests that a good regulatory framework should have triple objectives to: (i) support growth in financial access; (ii) guarantee a level playing field for all involved; and (iii) protect all consumers (WSBI, 2008: 7-9). Savita Shankar (2009) suggests that regulators should avoid over regulation that hampers innovation and unduly increases transaction costs.

2.3.3 Institutional transformation resulting from regulation

Venkateswaran (2007) defines institutional or organizational transformation as "an act, process or an instance of changing organization's context, principles or business processes that radically orients it to a new direction and takes it to a different level of effectiveness" (Venkateswaran, 2007). The need for transformation could be triggered by change in governing laws, change in business environment or enactment of a new law that alters the way the business is conducted.

Microfinance transformation generally refers to the institutional process whereby an NGO microfinance (or other) provider creates or converts into a share-capital company and becomes a regulated financial institution to carry out deposit-taking business or just become a credit institution (Ledgerwood & White, 2006; Dreihann-Holenia, 2009). Types of microfinance transformation represent a continuum. The simplest and most common type of microfinance transformation occurs when an existing MFI operation is transferred to the local office of an international NGO as a new, locally-formed NGO (Lauer, 2008). On the other end is a legal transformation that involves the creation of a commercial company by an NGO, to which the NGO contributes its existing portfolio in exchange for shares in the new company (CGAP, 2003c).

3 METHODOLOGY AND DATA

The target population for this study was formal financial service providers to low-income earners operating as microfinance institutions. Therefore the unit of analysis was identified as the microfinance institution targeted by the Microfinance Act of 2006. Emphasis in this study was put on MFIs since their regulation has been effective for two years up to the time of this research. The population of the MFIs whose contacts were available was small and a survey method was applied with questionnaires being sent to all the 63 institutions.

This is an empirical study largely using primary data (Mouton, 2008: 158) since such data was not available from secondary sources. It applied a mixed methods approach that uses qualitative and quantitative data collection techniques and analysis procedures. The study made use of a standardised questionnaire that was sent to the respondents via email, dropped or administered by the researcher. Semi-structured and unstructured interviews were organised with representatives from treasury, the chief executive officer (CEO) of AMFI and three CEOs of MFIs.

Data collection was based on variables that were identified in the literature review where the dependent variable was the pace of change measured by the progression through the stages of transformation to become a deposit-taking microfinance institution. Independent variables are ownership and governance, size of MFI and capital structure and the MFI's readiness for change. Ownership and governance were measured by the diversity of ownership prior to transformation, board size and structure and organisational form prior to transformation. Size of the MFI was measured by the value of assets, loan portfolio and client base. The MFI's readiness to change was measured by size and quality of management, ability to raise funds, prior training on transformation and preliminary work done like a feasibility study.

Use of advanced statistical analysis like ANOVA and regression in this research was limited since most of the data was either ordinal or nominal. However, relationships between variables were established for categorical (nominal) data through cross-tabulation. To test the significance of the relationship between categorical variables used in this research, Pearson Chi-square was used. The technique is used because one can compute expected frequencies in a two-way table (Statsoft, 2010).

4 RESULTS AND DISCUSSION

4.1 Status of microfinance regulation

The findings points out that many institutions wanted to be regulated but few seem to be making it. Though 33 institutions sought approval of name by December 2009, only 10 (30%) had made it beyond first step and three were at the final stage. In fact, the process may even be harder because the one-year window that was accompanied by some substantial waivers elapsed before many of these MFIs moving to the application stage to take advantage. Figure 1 below shows the stages at which the MFIs were at time of this survey.

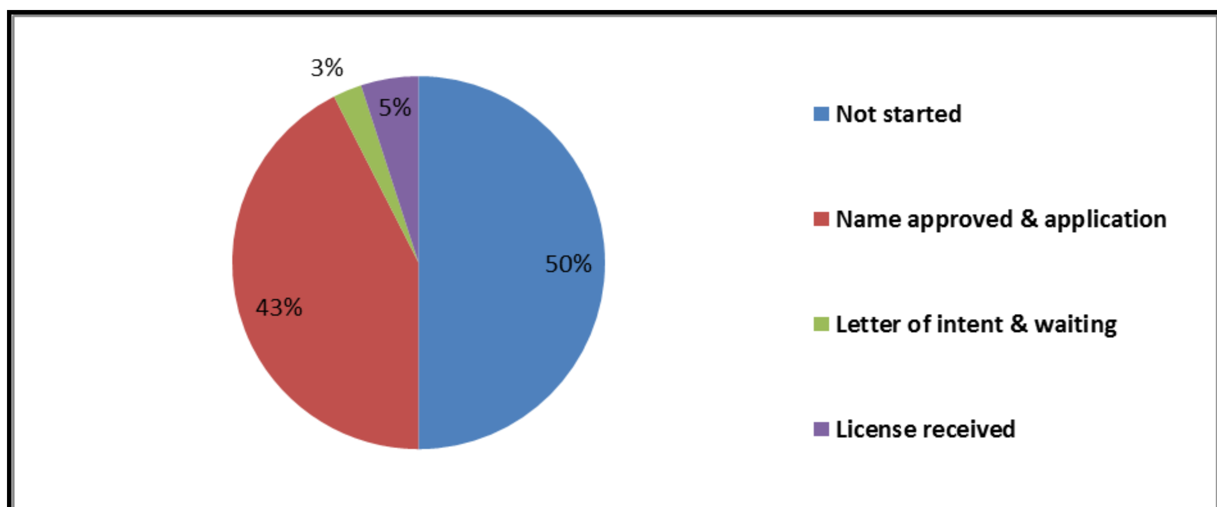

Figure 1: Stage in transformation

Source: Research data, 2010.

There is evidence in this research that some big MFIs that exist as shown by asset base, number of borrowers and branch network spread throughout the country. 25 per cent of the institutions had total assets greater than Kshs 500 million (equivalent to USD 6.5 million) and 25 per cent had over 10 branches countrywide. Going by these measures of size, some MFIs are bigger than some commercial banks supervised by CBK and mobilize huge amounts of deposits.

The data collected revealed that the largest three MFIs (with over 90,000 borrowers) either have received the license or are in the final stage. Two of these institutions have received the license and the other opted to acquire an existing commercial bank and is waiting to receive

the operating license. The trio had engaged consultants or had experience of transformation through affiliated institutions elsewhere and therefore they had an advantage to move faster in their quest for transformation. In addition, 73 per cent of the respondents had chosen to become deposit taking and out of these majority (55%) want to operate nationwide DTM. This proportion is as high as 86 per cent among the MFIs category.

Another key finding was that many institutions (40%) were ownerless, that is, were either NGOs or companies limited by guarantee. All these institutions were MFIs and their capital was largely donated or had one owner, a holding company or trust. In addition, 50 per cent of the institutions had their board elected by shareholders while the other 50 per cent had their boards are appointed by the donor or sponsor (40%), CEO (5%) or community (5%).

4.2 Challenges in microfinance transformation

In collecting data on challenges facing MFIs in transformation process, an adjusted Likert Scale of 1 – 10 was used. During data analyzing additional categories were created summarizing these scales to three; low (1 to 3) medium (4 to 7) and high (8 to 10) and assigned scales of one to three in that order. The mean score is derived from computing a weighted average of low, medium and high. Table 1 shows a ranking of the challenges using the mean score for MFIs.

MFIs seem to face several challenges in trying to transform to regulated institutions. These challenges vary in degree of severity among the MFIs and from one challenge to another. The main challenges for all institutions transforming to prudential regulation were acquiring suitable software, setting branches that meet requirements and raising fund for transformation. Using ranking by mean score, the challenge on meeting branch set requirements was the most serious challenge closely followed by fund raising for

transformation, acquiring suitable software and developing suitable MIS. Board and management issues were relatively lesser significant challenges for MFIs.

Table 1: Descriptive summary for major challenges

	N	Scores in percentage			Mean score	Std. Deviation
		Low (1)	Medium (2)	High (3)		
Meeting branch set-up requirements	33	15	85	0	2.85	0.364
Raising funds for transformation	33	3	24	73	2.7	0.529
Acquiring suitable software	33	6	27	67	2.61	0.609
Developing suitable MIS	33	3	64	33	2.3	0.529
Soliciting for willing investors	33	27	18	55	2.27	0.876
Organising financial & other documents for application	33	6	67	27	2.21	0.545
Restructuring ownership	33	33	18	49	2.15	0.906
Setting up board structures & systems	33	15	58	27	2.12	0.65
Lengthy transformation process	33	9	73	18	2.09	0.522
Raising minimum capital	33	30	40	30	2	0.791
Registering foreign stake	33	33	37	30	1.97	0.81
Recruiting management	33	6	91	3	1.97	0.305
Undertaking feasibility study	33	18	70	12	1.94	0.556
Meeting capital adequacy	33	18	76	6	1.88	0.485
Completing "Fit and Proper forms"	33	18	76	6	1.88	0.485
Preparing business plan	33	33	61	6	1.73	0.574
Compiling directors profiles	33	33	64	3	1.7	0.529
Compiling profiles of shareholders	33	36	64	0	1.64	0.489
Setting management structures and systems	33	49	51	0	1.52	0.508

Source: Research data, 2010.

4.3 Purpose of transforming to regulated institution

The new microfinance law (GOK, 2006) requires institutions offering microfinance services to make a choice on whether to take deposit or remain credit only. Each option has its own set regulations.

As per the analysis of those that were involved in this research study, a large proportion (68%) indicated that they would want to become deposit taking. The main motivation for this is to access public deposits to fund their lending activities and growth (Avgouleas, 2007). 64 per cent of the respondents were already holding deposits for customers. Though one of the objectives of being regulated is for MFIs to access equity and deposits for growth (Avgouleas, 2007), but this ambition may be beyond the reach of many. The results indicated that the majority of the institutions (43% of total respondents and 86% of those that have started the process) are still stuck at application stage, they are unable to meet the requirements for licensing such as ownership, management structures, software and MIS, branch requirements, business plan and feasibility study report and so on. In addition to this AMFI CEO, Benjamin Nkungi (2010) stated that legal requirements for capital and shareholding are hard to meet especially those institutions that are owned by one or several welfare organizations. This explains why most of them are stuck in stage two and are not likely to move beyond that stage.

4.4 Factors affecting microfinance transformation

In Table 1 in section 4.2, various challenges facing the microfinance regulation and eventual transformation have been identified. These challenges formed the basis of seeking to know the factors that affect the transformation process by either slowing down the process or preventing some MFIs transforming to regulated institutions. Evidence collected had strong

score in some of the factors while in others it was not very clear and would require further research to confirm or disapprove them. These are discussed below.

4.4.1 Soliciting for shareholders

Many MFIs, and more specifically the small MFIs, are unable to attract willing shareholders, fundraise for transformation and meet other basic requirements. The research data indicated that 72 per cent and 20 per cent of the respondents rated severity of the challenge of soliciting for new shareholders as high and medium respectively. This implies that the majority of the MFIs find it difficult to get investors into their institutions. Ezra Anyango (2010), microfinance expert at the Treasury agrees that it is not easy to solicit for new shareholder since this would require performing due diligence. According to Joanna Ledgerwood and Victoria White (2006), fundraising for share capital requires an institution to prepare a prospectus and conduct due diligence of willing shareholders that could be both expensive and time consuming. It also means moving away from traditional financiers to commercial-like investors. Among other things, these investors are interested at the bottom line to see if there is profit (Ledgerwood & White, 2006). This is a tall order for small and non-profitable MFIs (Lauer, 2008).

The search for investors is complicated by the fact that the MFI wants to maintain its mission and core values while available commercial investors may not have the same interests (Ledgerwood & White, 2006). The process of reaching consensus may take time or at times may lead to compromise. Many transformed MFIs have suffered from a mission drift (Rosenberg, 2010). The regulator also has to approve the would-be investors. According to empirical evidence, 80 per cent of the respondents indicated that providing profiles for shareholders presented a moderate challenge. This is complicated by the fact that there might not be enough willing local individual or corporate investors. The law limits forms of entities

that can own a stake in transformed MFIs. NGOs, community-based organizations and church organizations are among the entities that cannot own stakes in transformed MFIs.

4.4.2 Restructuring ownership

The issue of restructuring ownership is complicated and has a number of facets. The first issue has to do with opening up ownership from one to many; ceding control to a broader group of stakeholders (Awan, 2010). About 25 per cent of the institutions interviewed had less than five shareholders.

Secondly, shifting ownership or creating ownership from an ownerless situation where donors and founders have no legal monetary stake but have helped create the MFI (Lauer, 2008) is a challenge. About 40 per cent of the institutions were relying on donated funds from different sources. This revelation is in agreement with comments from the CBK Governor Professor Njunguna Ndung'u (2010b) that many NGO microfinance institutions are finding it hard to convert to a limited company.

The third aspect is that of foreign ownership. Some MFIs were founded by international NGOs and wholly owned by such while the law limits ownership by foreign entities (Lauer, 2008). The process of ascertaining the suitability of such foreign institutions is lengthy. 88 per cent of the MFIs had indicated that the severity of challenge on registering foreign stake is either high (40%) or medium (48%).

4.4.3 Software and MIS issues

Managing deposits is more challenging and sensitive than loans. The public is very sensitive on deposits and any misinformation could send a serious signal of panic to the public that could cripple the entire financial sector. CBK is very keen on this matter and has set out conditions and functionalities of the MIS and application software that should be met before a

license could be issued. An inspection of such systems has to precede the issuance of the license. There is no waiver on this matter.

In addition, the cost of acquiring suitable software application with banking functionalities is high (Christen *et al.*, 2003). The situation is worsened by requirements for the detailed documentation of customers and loan transaction to help achieve the goal of 'know your customer' as specified in Section 37(1) of the Microfinance regulations 2008. In addition to software cost, the hardware cost to support such systems is high. This explains why the severity of the challenge to set up MIS and reporting systems and acquisition of suitable software was rated as high or medium by 80 per cent and 78 per cent respectively. The reporting deadlines of the 22 reports to be sent to CBK as outlined in the regulations could be a real challenge (GOK, 2008a). This poses a danger of redirecting MFIs' resources to just producing reports to CBK instead of doing the core business (Nkungi, 2010; Anyango, 2010).

When the asset base variable was cross-tabulated with the challenge of acquiring software, a relationship was established. The *p* value (0.028) for Pearson Chi-Square is less than the significance level of $\alpha=0.05$. This implies that there is enough evidence to conclude that the size of the MFI as measured by asset size is related to the challenge of acquisition of suitable software. The software challenge is more severe with larger MFIs.

4.4.4 Branch set up

The requirements of a fully-pledged branch for DTM are expensive to establish. An estimate given by a treasury expert is USD 50 000 (Anyango, 2010). About 85 percent of respondents rated the severity of the challenge of setting up a branch as high or medium. Obviously, the cost involved in setting up a branch is a major constraint. This situation is worsened by the fact that MFIs are increasingly finding it hard to raise funds from donors. As noted by

Shankar (2009), if regulation requirements increase the cost of operation they become a constraint.

Further analysis on correlation between resource base (total assets) and challenge on branch set-up does show some relationship. The resulting *p* value for Spearman's Correlation is 0.637 for two-tailed test and is greater than the significance level of $\alpha=0.05$. This implies that the challenge on branch set-up was not related to the asset base of institutions. Thus, the challenge was significant for both small and big institutions. In addition, the correlation between number of branches currently held and the challenge of setting up new branches is not significant. The *p* value for Spearman's correlation is 0.285 (2-tailed test) suggesting that the challenge for setting up new branches is independent of the existing branch network. New branches cannot operate in the same set up as the current office without spending substantial amounts of money to refurbish them to comply with the CBK standards.

4.4.5 Ability to raise funds for transformation

A lot of resources are required for transformation. Setting up a branch, acquiring microfinance software, developing business plan and feasibility study and writing the required manuals are expensive and sometimes the process requires use of external consultants. According to Phyllis Mbui (2010) and Francis Kihiko (2010), raising funds for these activities could be a challenge. About, 60 per cent of the respondents rated the severity of this challenge as high and another 20 per cent as medium. The challenge is therefore a major hindrance to transformation. There are few donors that are willing to fund transformational activities (Ledgerwood & White, 2006).

The situation may be complicated by the fact that future profits of the transformed MFIs may not be forthcoming. Available data indicated that 63 per cent of the respondents were either not sure whether the profitability will increase or predicted that it will not increase much.

With this forecast, transforming MFIs may not wish to take up the risk of borrowing from commercial sources to meet transformation expenses.

Cross-tabulation between the size of MFI (given by asset base) and stage in transformation shows that bigger institutions were able to move faster in transformation. The results of Pearson Correlation indicate a *p* value of 0.003. Even at significance level of $\alpha=0.01$ there is sufficient evidence to conclude that resource base contributes to the pace of transformation. Bigger institutions that have their own resources did not entirely depend on external sources to fund all their transformation activities. Though at a slower pace, these larger institutions could get started with setting up their own systems. Faulu and KWFT, the two MFIs that were able to transform by 2009, received sizeable funding for transformation from both donors and commercial sources (Faulu Kenya, 2009).

4.4.6 Institutional readiness for transformation

Analysis on readiness to transform indicated that there are issues related to management experience in transformation, engaging expert advice on the process or training their teams on transformation. About 93 per cent of the institutions did not have management experience in transformation and another 78 per cent did not engage services of a consultant to advise them on transformation. In addition, about 53 per cent did not have formal training on transformation process and challenges. These observations point out that all three the institutions that made it had utilized two of the above transformation enhancement activities. All three the institutions had engaged consultants to advise them on the transformation process.

The driver of change is the human component in an organization. According to Awan (2010), NRSP in Pakistan was able to transform faster because staff were involved, trained, informed of everything that was happening and their concerns were addressed. When employees are

aware of what is happening and that the transforming institution accommodates their concern, they are willing to support the process. When employees are not involved in institutional change, there is much resistance due to fear of the unknown and the transformation boat is rocked from within (Nkungi, 2010).

It could be deduced that the slow pace of transformation arises from lack of institutional preparedness to change. A test run for this relationship for MFIs showed that there is a strong correlation between stage in transformation and training on transformation or consultancy support for transformation. In both cases the p value is 0.001 and therefore at significant level of $\alpha=0.05$. There is thus overwhelming evidence that lack of training or technical assistance (consultancy) is slowing down the process of transformation.

4.4.7 Raising minimum capital

Meeting minimum capital requirement is a big challenge especially for small MFIs. Those choosing to operate nationwide DTM are required to have minimum capital of Kshs 60 million and community- based DTM to have Kshs 20 million (GOK, 2008a; GOK, 2008b). Though the overall rating of the challenge of raising minimum capital was 58 per cent, 80 per cent of the MFI respondents rated the severity of meeting minimum capital as either medium or high.

4.4.8 Maintaining adequacy

Evidence from empirical data indicates that about 68 per cent of the respondents noted meeting capital adequacy as a challenge. Probably this explains why 32 per cent of the institutions have chosen to remain credit only or not yet decided. This is so because the conditions for capital adequacy for DTMs are tougher than for commercial banks. As per the confession of Philip Ochola (2010), the condition provisions for bad and doubtful debts are more stringent for DTMs than for commercial banks. This erodes the value for adjusted

assets and eventual reduction of capital adequacy ratio (Anyango, 2010). Most regulators consider microloans that normally have no tangible collateral as very risky and hence award a higher provision (Delfiner *et al.*, 2006; Christen *et al.*, 2003; Handy, Holden & Prokopenko, 2002). Though the quality of MFIs' loan portfolio is much better than that of commercial banks, many regulators lack the tools to gauge this (Ramírez, 2004).

4.4.9 Governance issues

The results of this research support earlier findings in the literature that quality governance could be a factor affecting transformation or challenge for transforming institutions (Lauer, 2008). The fact that most of the board members (77%) of MFIs are appointed by the donor/sponsor, CEO or community is also supported by the rating of transformation challenges. The results on governance issues indicate that the severity of the challenge of profiling directors was rated by 55 per cent of respondents as both high and medium. Similarly the challenge in setting up governance structures and systems as well as preparing profiles for directors were rated high and medium by 70 per cent of the respondents. Replacing current board members with ones that meet the criteria set by the CBK may not be that easy (Lauer, 2008). The situation is worse where some of the board members and the CEO were the founders of the MFI. They would be reluctant to effect changes that would affect them negatively. This could be a possible reason why many MFIs have adopted a 'wait-and–see' attitude (Ndung'u, 2010a) and are not pushing management to effect changes.

4.4.10 Management Structures and systems

The empirical evidence shows this as a medium challenge. Ezra Anyango (2010) and Benjamin Nkungi (2010) point out that the challenge with microfinance law is that many CEOs of the MFIs do not pass the test of occupying such positions in the transformed and regulated institution. Pursuing transformation was viewed like pushing for their retrenchment.

Recruiting senior managers was rated by 91 per cent of respondents as a medium challenge and another three percent as high. Getting persons that have both banking and MFI experience is hard. Many managers working in the microfinance industry lack banking expertise. Setting up management structures was also rated as a challenge by 51 per cent of the respondents.

In addition, the regulator is very strict on the recruitment of senior managers for DTM. There are minimum requirements for each position that has to be filled and the names must be approved beforehand. For example, the CEO of the DTM should have among other things five years of banking experience, economics, microfinance or law (CBK, 2008). Treasury and operations managers must have banking experience. Going by the experience of the two transformed MFIs, there has been a change of guard at the top. The CEOs have been replaced together with other changes in senior positions. This has created uncertainty among the founders of these MFIs who had become CEOs as it appears going for DTM would mean they pave the way for other persons. In a separate occasion, the governor has complained that the CEOs of the MFIs are not keen to transform, as they have even adopted a 'wait-and-see' attitude on their part too (Ndung'u, 2010a).

4.4.11 Motivation to improve public image

An emerging factor from the empirical evidence is a strategic move by the MFIs to remain in business. Out of the 30 institutions that chose to become DTMs or bank, 25 institutions (representing 83%) predict that competition will increase and this could be interpreted to mean a threat to their business. Those taking deposit will be in a better position to offer variety of services to their customers and stand to retain them as well as attract others. DTMs will have a competitive advantage over their counterparts that remain credit only. In this case moving to become DTM is a strategic decision for survival.

In addition, there is a close relation between institutions that chose to become DTMs and those that predicted increase in financial stability. 75 per cent of respondents whose institutions (30 cases) chose to become DTMs predicted that financial stability will improve either significantly or to a greater extent. Again, it can be interpreted that institutions chose to become DTMs to improve their image.

Financial discipline was another aspect that appears to have an influence on the decision taken. 52 per cent of the respondents indicated that their institutions chose DTM because they predicted that financial discipline will improve either significantly or to a greater extent. This observation could be interpreted to mean that institutions choosing to become DTMs would want to be disciplined and be seen to play within the law. Similarly this is another image issue. Thus becoming regulated was a major motivation.

4.4.12 Application process and documentation

The transformation process is viewed as lengthy and cumbersome. 75 per cent of the respondents felt that the transformation process is lengthy and thus discouraging. Choice of names was not a challenge, supported by 70 per cent and this explains why 50 per cent of the institutions have had a name reserved for them. Choice of names was only applicable for MFIs transforming to deposit taking.

Respondents indicated that some of the documents that have to be prepared and lodged at various stages pose a challenge. Assembling all the documents to accompany the application was rated as a medium to high challenge by 78 per cent of the respondents. Feasibility study and business plan preparation was seen as a challenge by 73 per cent and 55 per cent of respondents respectively. Preparation of these documents are particular a challenge for small MFIs that have lean management and lack people with adequate skills. With limited resources, they are constrained to outsource the service.

The CBK governor (Ndung'u, 2010b) acknowledged regulators' dilemma in developing regulatory framework as there is a trade-off between flexibility and risk control. The regulator has "no appetite for risk" (Ndung'u, 2010b). All the above paperwork is geared towards gathering as much information as possible to gauge risk per each applicant for licensing. This confirms the argument that many regulators do not understand the operations of microfinance (Dreihann-Holenia, 2009) and they cover themselves with more controls.

5 SUMMARY AND CONCLUSION

5.1 Factors affecting transformation

This research identified factors that affect the transformation as arising from the process in which the institution implement it, challenges they are facing and perception of the future of microfinance business. In summary following factors have been identified as to be affecting that the pace of the transformation process of MFIs to regulated institutions in Kenya and these should be of interest to policy makers.

a) *Ability to raise funds for transformation*. Transformation is expensive and requires substantial amount of money to acquire software, set up systems, develop business plan and feasibility study, set up branches and pay for consultancy services on various aspects.

b) *Raising minimum share capital*. The regulator sets minimum capital that institutions seeking prudential regulation must raise and contribution limit by a single investor. Raising this capital internally may take time for small MFIs.

c) *Ability to acquire and implement suitable information systems*. Acquiring banking software that has capabilities of addressing MFIs information needs is expensive. The information requirements for DTM are enormous and the regulator is clear on this matter that information systems must be in place before a license is issued.

d) *Meeting capital adequacy requirements*. The conditions of capital adequacy are tougher for prudentially regulated MFIs than those of commercial banks for example provisions for loans. Some MFIs feared that complying with this provision may have adverse repercussions on their performance.

e) *Restructuring ownership*. Institutions that were originally NGOs, limited companies by guarantee or owned by few shareholders find it challenges in creating ownership and restructuring that ownership to meet the requirements.

f) *Soliciting for suitable shareholders*. Social investors are rare to find and commercial investors would insist to see the business viability. Investors have variety of interests in business and getting investors that share same mission may be hard.

g) *Resource base and size of the institution*. The larger MFIs have been able ability to raise their own resource to fund part of the transformation processes. They stand better position to fund raise from both commercial and donor sources since they can produce attractive financial statements.

h) *Motivational level for transformation*. Becoming a regulated institution was identified as a motivator and institutions viewing regulation as improving public image, stability and discipline were positive about business prospects in transformation tended to put extra effort to attain the license.

i) *Institutional readiness to transform*. Preparatory work such as training board members, management and staff is helpful in creating awareness and buy-in. Those MFIs that made use of experts on various transformational tasks had an advantage.

j) *Management inertia*. The regulator specifies the calibre of personnel that are supposed to run the regulated DTMs. Pushing for transformation is seen as CEOs and top management team calling for their retrenchment hence conflict of interest.

k) *Application process and documentation required*. The process of getting a license to operate microfinance deposit-taking business is lengthy, cumbersome a lot of vetting at various stages, many documents and reports required, and strict deadlines for submission of such.

l) *Governance issues*. Issues include determining board selection criteria, lack of motivation for boards to push for transformation, profiling directors and setting up board systems.

m) *'Wait – and – see' attitude*. After applying for name approval, many MFI's seem to have adopted a 'wait and see' attitude to learn from the experience of those that have been regulated.

5.2 Conclusion

The literature and empirical evidence in this research point out the importance of regulation microfinance operations. The role of regulation in bringing sanity and stability in the financial sector cannot be underscored. As MFIs grow both in outreach and asset base, public interest on security of their resources also increases. Financial scandals in the name of microfinance has twice happened in Kenya could cause panic and loss of public confidence in the entire financial sector. Regulation is therefore necessary.

The empirical evidence confirms that MFIs targeted for prudential regulation have to undergo a process of transformation. Other institutions targeted by non-prudential regulation will largely make minor adjustments to their operations to comply with the low. The transformation process is not a bed of roses. Many of them, as supported by the analysis in the preceding chapters, were dogged with huge challenges that slowed their process of transformation. The factors that influenced the process of transformation varied from institution to institution.

The regulatory framework for microfinance should provide room for various players in the sector and thus the tiered approach to regulation is appropriate. There should be adequate motivation for institutions to operate at most convenient environment for them. A considerable effort should be made by the regulator to understand the sector it is trying to regulate. This could be improved by setting up a working committee comprising of members from the regulator, practitioners and consultants among others during initial stages in developing regulatory framework. This framework has worked well in Pakistan (Ahmed & Shah, 2007). The regulatory process should be based on shared experience.

This research identifies certain areas that could be of interest for further research. One of such areas would to find out the impact of such regulation and whether the benefits justify the effort. There is need to research on the emerging issues of mission drift caused by regulation and whether this is beneficial to the society. The tendency of regulated institutions to move up market is a threat to exclusion of the poor and works against the spirit of deepening financial inclusion. This creates a research opportunity.

5.3 Limitations

Information about all MFI operation in Kenya was not readily available limiting sampling techniques to apply. Data from Central Bank of Kenya on institutions that sought name approval and their contacts was not available. This led to use of less powerful sampling technique for statistical purposes. However that data collected included key players in the sector and those that are targeted by the regulation.

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