ORGANISATIONAL FACTORS INFLUENCING MICROFINANCE INSTITUTION TRANSFORMATION STRATEGY TO FORMAL BANKING: A SURVEY OF MICROFINANCE INSTITUTIONS IN KENYA

BY

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DECLARATION
This research project is my original work and has not been presented for award of a degree in any other University.

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DEDICATION

This work is dedicated to God who is my all in this life. I owe Him everything for my academic achievement. I also dedicate it to my family, my parents, my husband and children.
ACKNOWLEDGEMENTS

This study has been a long and taxing journey and I feel indebted to those who participated in their own ways to make it a success.

I thank our almighty God for his special grace and protection over the research period and entire, enabling me to complete the proposal within the stipulated study time.

Special appreciation goes to my supervisor Mr. Robert Nzulwa for his dedication, sincere guidance, suggestions, criticisms, understanding and support throughout the research project writing. Without his support I would not have made it in time.
ABSTRACT

Microfinance transformation generally refers to institutional process whereby microfinance creates or converts into a share-capital company and becomes a regulated financial institution to carry out banking business or just become a credit institution. In this study, the definition of microfinance transformation is “a process of a credit-focused MFI creating or becoming a bank” will be adopted. The study was guided by four objectives which include: to find out the influence of regulatory framework on MFI transformation strategy to formal banking in Kenya, to determine the effect of efficient Management Information Systems on MFI transformation strategy to formal banking in Kenya, to establish the influence of ownership and governance on MFI transformation strategy to formal banking in Kenya and to investigate the role of capital requirements in influencing MFI transformation strategy to formal banking in Kenya. This study adopted a descriptive design. It is descriptive because the bulk of the study tries to explain what the situation is and why the situation is as it is. The target population comprised of employees from Faulu Kenya and Kenya Women Finance Trust (KWFT). A sample of 223 employees, representing 30% of the population was used. Data analysis for this research was largely quantitative. SPSS statistics version 19.0 was used for descriptive statistics such as creating frequency tables, cross-tabulation, means and standard deviations, correlations, regression and nonparametric tests.

Based on the study results, majority of the sampled employees of KWFT and Faulu bank responded in the affirmative as evidenced by a mean of 4.11 and a standard deviation of 0.82. According to the analysis of the study results, it was revealed that efficient management information system plays an important role in MFI transformation to formal banking as supported by the sampled employees with a mean of 4.02 and a standard deviation of 1.15. From the analysis of the study results, it was further established that Ownership and governance affects MFI transformation strategy to formal banking given the high rating with a mean of 4.26. From the findings, the respondents attested to the fact that MFI’s transformation to formal banking is indeed influenced by capital requirements as embedded in the regulations with a mean of 4.30 and a standard deviation of 1.004. Drawing on Faulu and KWFT experiences, the study makes the following recommendations for successful transformation in Kenya.
It is preferable to undertake a progressive transformation, in several phases, leaving time for adjustment at each phase, transformations are very costly in terms of time, finances and human resources. The process is often long and full of obstacles. Before considering a transformation, it is important to plan adequately and commit the required resources. These include a full-time transformation manager who has a good understanding of the institutional culture, and preferably several good external consultants with a track record in banking and microfinance and that a successful transformation will need the development of new expertise within the organization, especially in the area of deposit-taking.
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ABBREVIATIONS AND ACRONYMS

AMFI-Association of Microfinance Institution

CBK-Central Bank of Kenya

CGAP-Consultative Group to Assist the Poor

DTM-Deposit Taking Microfinance

FSD-Foundation for Sustainable Development

KWFT-Kenya Women Finance Trust

MFI- Microfinance Institution

NBFI-Non-Bank Financial Institutions

TQM-Total Quality Management
CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

In the recent past, microfinance has gained prominence among poor and developing countries of Asia, Latin America, Eastern Europe and Africa. It has been prompted by the search for solutions to poverty alleviation. At first, the term microfinance was used interchangeably with microcredit and was easily understood as a credit methodology that 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). However, 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, Morduch & Hashemi, 2003). Over the years, institutions offering microfinance services have grown both in outreach and asset base raising safety concerns on such microfinance operations. Many countries have opted to regulate these operations at varying degrees (CGAP, 2008).

The Consultative Group to Assist the Poor (CGAP) (2003c) defines regulation as binding rules governing the conduct of legal entities and individuals, whether they are adopted by a legislative body (laws) or an executive body (regulations). 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. Institutions opting to operate under prudential regulation 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. 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. 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). Access to local savings has been the main motivation for microfinance institutions to lobby for regulation.

This research study aims to explain the motivation for transformation, establish organizational factors affecting the transformation process and explain those factors that are relevant to the Kenyan case. Establishing these factors would help the policy makers and practitioners to improve the implementation process.

1.1.1 Financial sector in Kenya

Kenya has a relatively well-developed and widely-structured financial sector in comparison to other African states (FSD, 2007). The sector includes banks, micro-finance institutions, savings and credit cooperatives (SACCOs), short-term and long-term insurers, non-bank financial institutions (NBFI) like mortgage finance houses and building societies and postal service offering savings products (FSD, 2007). There are also many other informal institutions like the rotating/accumulating savings and credit associations (ROSCAs or ASCAs) and financial
services associations (FSAs). In 2008 microfinance institutions and SACCOs served a combined clientele of 7.7 million. Over 55 per cent of people accessing formal financial services in Kenya are clients of SACCOs and MFIs (CBK, 2008b). About 48 per cent of all bank accounts as at December 2008 were held by one bank largely operating microfinance business (CBK, 2008b). This indicates the crucial role microfinance activities play in the Kenyan economy. Interestingly, many clients of SACCOs and MFIs are also customers of the commercial banks.

1.1.2 Microfinance Transformation

Microfinance institution (MFI) is used to refer to a formal organization whose primary activity is microfinance business (Christen et al., 2003). The range of institutions referred to as MFIs is wide and vary from country to country. There is emerging consensus that these institutions include commercial banks, state-owned development banks, financial non-governmental organizations (NGOs), financial cooperatives, and a variety of other licensed and unlicensed non-bank financial institutions (NBFI s) that focus on serving the poor (Christen et al., 2003). Microfinance transformation generally refers to 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). In this study, the definition of microfinance transformation given by Ledgerwood and White (2006) as “a process of a credit-focused MFI creating or becoming a regulated deposit-taking financial intermediary” will be adopted.

The 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). In most cases, these transformations are driven by legislative changes or the desire to provide new services (Lauer, 2008). An example of microfinance transformation driven by legislative changes is that of Faulu DTM (Faulu Kenya, 2009) and another driven by desire to provide new services is Equity bank (2006).

A number of MFIs have sought transformation to regulated institutions due to associated benefits, such as an ability to mobilize public deposits, access to wider sources of capital, improvement in governance and transparency that would enable them to reach significant scale of operation and financial sustainability (Hishigursen, 2006). More specifically, Lauer (2008) points out that NGOs transform for various reasons such as to offer financial services beyond lending, to access capital, to comply with new legislation, to gain legitimacy or to enable employees, clients, and other stakeholders to become owners.

1.1.3 Microfinance regulation in Kenya

The push for regulation in Kenya has come from two fronts. On the one hand, microfinance institutions have been lobbying for the regulation for the last ten years under their umbrella body, the Association of Microfinance Institution (AMFI), to gain access to local deposits. Access to savings is regarded as a cheap source of a bank’s funds for on-lending (Rosengard, Rai, Dondo & Oketch, 2001). With dwindling availability of donor grants and expensive commercial loans, MFIs have found themselves constrained in their expansion plans. On the other hand, government has been concerned about the need to protect the poor against losses that could be occasioned by unscrupulous operators. The poor have limited shock absorbers and are more vulnerable to slip into extreme poverty than the rich. In a span of two years, between 2005 and
2007, Kenya experienced two financial scandals targeting the poor under the pretext of being a microfinance and savings scheme. This has prompted the central bank to restrict use of the word ‘finance’ business names to those that are regulated by it. Two crucial bills have been passed into law: the Microfinance Act (GOK, 2006) for microfinance institutions and SACCO Act (GOK, 2008c) for savings and credit cooperatives societies operating front office services (CBK, 2008). The regulation of microfinance in Kenya has adopted a three-tier approach: (i) Prudential regulation and supervision for deposit-taking institutions by central bank, (ii) non-prudential regulation for credit only by ministry of finance and (iii) no regulation for ROSCAs and ASCAs.

1.2 Problem Statement

There is consensus among stakeholders that regulation of the process of microfinance transformation is necessary (CGAP, 2003c; CGAP, 2008; Lauer, 2008). The main challenge of unregulated MFls is limited access to financial resources. The major benefit MFls derive from transformation is to gain permission to mobilise deposits from the public and the opportunity to offer a wider range of financial services to their clients. MFls mobilise savings from their loan clients as collateral and such funds are usually held by commercial banks. With a license to operate as a bank, such institutions will be allowed to access their clients’ savings. With regulation in place, it is expected that MFls will move faster to transform and comply with the requirements. However, the CBK report for 2009 indicates that only one institution had transformed to DTM as at December, 20 months after the regulations became effective (CBK, 2009). This brings to question the process of transformation. Could there be a problem with the regulatory framework? The process which the transforming institutions are put through, points to some possible difficulties.
The CBK report for 2009 indicates that most institutions have sought approval of a business name but have not started the process of application. Could this be signaling a possibility that the transformation process is way beyond the reach of most MFIs that would wish to transform? If the purpose of regulating microfinance was to create an enabling environment, does this indicate that this is not the case? This research, therefore, aims to answer the following question: Which organizational factors influence MFI transformation strategy to formal banking?

1.3 Objectives

The main objective of the study was to investigate the organizational factors influencing microfinance institution transformation strategy to formal banking using a case study of MFI’s in Kenya.

1.3.1 Specific Objectives

The study sought to achieve the following specific objectives:

i) To find out the influence of regulatory framework on MFI transformation strategy to formal banking in Kenya

ii) To determine the effect of efficient Management Information Systems on MFI transformation strategy to formal banking in Kenya

iii) To investigate the role of capital requirements in influencing MFI transformation strategy to formal banking in Kenya

iv) To establish the influence of ownership and governance on MFI transformation strategy to formal banking in Kenya
1.4 Research Questions

i) What is the influence of regulatory framework on MFI transformation strategy to formal banking in Kenya?

ii) How do efficient Management Information Systems influence MFI transformation strategy to formal banking in Kenya?

iii) Does capital requirement play a role in influencing MFI transformation strategy to formal banking in Kenya?

iv) What is the influence of ownership and governance on MFI transformation strategy to formal banking in Kenya?

1.5 Significance of the Study

The experiences of transformation of microfinance institutions into formal banking across the world indicate a number of challenges that face target institutions and regulators (Sinha & Sagar, 2007; Sinha, 2007). It is hoped that the study will add value in the following areas:

• It will broaden the knowledge on the transformation process that microfinance institutions are subjected to by regulating their operating activities.

• It will help provide policy makers with detailed and classified information about the effects of regulating microfinance in Kenya.

• It will help highlight some of the experiences that could help policy makers to improve on the transformation process through regulation.

• It will create curiosity among researchers and prompt them to do more research in this field in Kenya and in other countries.
1.6 Scope of the Study

The study was limited to organizational factors influencing microfinance institution transformation strategy to formal banking. The study sampled MFI’s in Kenya and therefore drew the respondents from selected institutions.

1.7 Limitations of the Study

This study was limited to the organizational factors influencing microfinance institution transformation strategy to formal banking using a case study of MFI’s in Kenya. The study focused on the transformation process occasioned by the regulation; what the affected institutions have done or are doing to comply, challenges being faced by affected institutions and how transformation into formal banking business is likely to affect the subsector. The study did not attempt to make impact assessments because this would require longitudinal data and a longer period of observation. Though SACCOs and other cooperatives play a pivotal role and are important a player in the microfinance, their inclusion in this study was limited.
CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter looks at the issues related to organisational factors influencing microfinance institution transformation strategy to formal banking. The chapter develops a conceptual framework to guide the study discussion and data methodology, a theoretical framework to justify the need for the current study and the empirical review on factors influencing microfinance institution transformation strategy to formal banking. The chapter also looks at the research gaps.

2.1.1 Global and Regional Context of Transformation

The first transformation to take place is still regarded as one of the most successful to date. The Bolivian NGO PRODEM took the initiative to transform into the commercial bank BancoSol in 1989. At the time, no one could have imagined that it would set an example for other NGOs around the globe (among them K-Rep in Kenya, ADEMI and ADOPEM in Dominican Republic). A little over a decade later, PRODEM launched a second transformation, to become a regulated Private Financial Fund, taking advantage of the developments in the regulatory framework.

In both cases, PRODEM’s aim was to mobilize more funding through deposits, diversify its products and increase its outreach. Taking the steps towards transformation was not easy for PRODEM. As a pioneer, it had to educate the banking sector and the supervisory and regulatory bodies about microfinance: there were concerns that microfinance clients were too risky to be
served by a formal financial institution, especially a bank. However, with the experience of both transformations, PRODEM was able to demonstrate that it is possible to succeed as a regulated entity with competitive market prices for financial products and services, in urban as well as rural areas.

One of the best known and well documented regional experiences is the transformation of Uganda Microfinance Union (UMU) into Uganda Microfinance Limited (UML). The developments in the regulatory framework, marked by the Microfinance Deposit-Taking Institution (MDI) Act of 2003, precipitated the decision to transform from an NGO to an MDI. The aim was to widen the scope of their activities and attract funding from international investors. The transformation of UMU into UML took approximately three years to complete and was nearly derailed by issues of ownership between the founding members and the investors. This drew attention to the importance of ownership and good governance. Indeed, most NGOs which transform experience difficulty in finding strategic investors who share their long-term vision and objectives.

2.1.2 Transformation Experiences in Kenya

Both regional and international experience of transformation has demonstrated the importance of having a clear national strategy for microfinance, aimed at enhancing the legal and regulatory frameworks as well as the policy environment. Not only does this make it easier for existing and potential players in the market to position themselves, it also encourages the international donors to invest in the development of the country. This is achieved through capacity building, equity and the provision of funds for on-lending. It is therefore no surprise that the majority of the 40 or so transformations recorded since PRODEM are in Latin America, where the regulatory framework is the most advanced. The African region has the least number of transformations,
with many countries still struggling to supervise commercial banks, let alone MFIs (CGAP, 2000).

As the first NGO in Kenya to transform into a regulated institution (bank in the 1990s), K-Rep had to educate the banking sector and the Central Bank of Kenya (CBK) about its proposed activities. K-Rep suffered from the lack of an appropriate microfinance regulatory framework in its request for a license from CBK. The decision to transform came at a time when the banking sector was going through a crisis characterized by a high level of non-performing loans. The licensing of an NGO was not seen as a priority. Complicating things still further, K-Rep wished to transform its existing microcredit programme into two complementary institutions under the umbrella of K-Rep Holding Limited (AMFI Kenya, 2010). These included K-Rep Bank, a for-profit organization, and K-Rep Development Agency, a capacity building organization for financial services.

Anyango (2010) observed that in addition to the challenges posed by the CBK, K-Rep faced more from its own Board members, who were sceptical of the added-value of the transformation. They feared that they would no longer have control over the institution should they open the company to new shareholders. They also worried that an increase in operations would cause K-Rep to drift from its core mission of poverty reduction and capacity building. Nevertheless, five years after it had written the concept paper outlining its strategy, K-Rep finally received its banking license in 1999. It became the first commercial bank in Kenya to serve only low income clients, and the first NGO in Africa to transform into a regulated financial institution. In 2006, Faulu decided to establish itself as a full financial intermediary in order to provide a broad range of financial services. In the same year, with support from FSD Kenya, Planet Finance supported Faulu in a strategic planning exercise which entailed exploring the options available for
transformation and making an institutional assessment. Based on this preparation, the Board of Directors decided to go ahead and transform into a DTM. As part of this decision, Faulu was to retain its grassroots oriented microfinance operation. A strategic transformation plan (2007-2011) was prepared by the management of Faulu that heavily leaned on the Planet Finance report. As part of this pre-transformation planning exercise and still with FSD support, MicroSave helped Faulu conduct a market survey. The aim was to help Faulu understand its clients’ perception regarding the transformation, and identify the need for new credit and savings products (Awan, 2010).

By 2007 when it was preparing for transformation, Faulu was one of the three largest microfinance institutions in Kenya. It had a network of 19 branches, 48 offices and a client base of about 76,000. Faulu’s main competitors were other large MFIs that served the same market segment. Kenya Women Financial Trust was its most direct competitor, although it dealt only with women. The increasing profitability of MFIs serving the lower income market encouraged microfinance oriented banks such as Equity Bank, Family Bank and Cooperative Bank to take greater interest in the same segment. This led to a more competitive environment for Faulu (Awan, 2010).

Faulu realized that the ability of the microfinance oriented banks to provide a larger scale of products, including credit and savings, was key to their success. Its decision to transform was therefore based on three main reasons: increased competition, increased demand for a wider range of services, and the need to lower the cost of funds in order to serve the clients better. By deciding to transform Faulu also hoped to contribute to the development the microfinance sector by being a pioneer - the first MFI to transform into a DTM in Kenya Central Bank of Kenya (CBK, 2009).
2.2 Theoretical Framework

This study was guided by institutional theory of organization. Institutional theory of organization provides a rich, complex view of organizations. In these theories, organizations are influenced by normative pressures, sometimes arising from external sources such as the state, other times arising from within the organization itself. Under some conditions, these pressures lead the organization to be guided by legitimated elements, from standard operating procedures to professional certification and state requirement, which often have the effect of directing attention away from task performance (FSD, 2007). Adoption of these legitimated elements, leading to isomorphism with the institutional environment, increases the probability of survival. Institutional theories of organization have spread rapidly, a testimony to the power of the imaginative ideas developed in theoretical and empirical work. As rigor increases, with better specification of indicators and models, it is likely to attract the attention of an even larger number of organizational researchers.

Institutional theory is inherently difficult to explicate, because it taps taken-for-granted assumptions at the core of social action. The main goal of this review, then, is to make institutional theory more accessible. The review begins with a brief summary of the two current theoretical approaches to institutionalization in organizations, moves to identification of indicators of central concepts, and then progresses to a review of empirical research. It concludes with two short sections, one on points of intersection with other theories of organization, the other on the "new institutionalism" in economics and political science (Gallardo, 2001).

Institutional theory is a modern theory of the firm which states that the goals and activities of a firm are the results of its organizational structure. The theory calls for the understanding of the organization characteristic, which include structure, membership, leadership committee,
members' qualification, style of decision-making process applied and how the organization ensures members commitment to the organization. Always the organization structure is designed to ensure the purpose of the organization. Also, organization is a continuous process, where it refers to identification and classification of required activities, and grouping of activities necessary to achieve some objectives. The question raised here is how these housing MFIs are organized and to supervise sustainably their loan delivery programme? Since the organizational structure is designed to ensure the purpose of the organization, then it is very important to observe if the organization structure suits the purpose of the housing MFI. Also, since organization is a continuous process, then re-organization is expected when necessary so as to improve the managerial performance of the institution.

2.3 Empirical Review

2.3.1 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). The regulator is expected to understand the industry which the regulation targets.
A fundamental guideline into regulating microfinance is that the regulator first conducts a survey on the microfinance practice (Kirkpatrick & Maimbo, 2002: 303; 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), innovation and unduly increases transaction costs. 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) emphasized the need to fashion differentiated licensing regimes for MFIs depending on their structure and services they offer. Gallardo, Ouattara, Randhawa and Steel (2005) in their comparative review of microfinance regulatory regimes in Benin, Ghana and Tanzania found that recognizing 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.

The lower tiers of institutions serving the lower end of the market can enable non-bank micro-lenders to seek greater formalization without actual licensing from a central bank (Gallardo et al., 2005). The upper end of microfinance institutions could apply for licensing to mobilize savings and other commercial instruments. The other options could be licensing of rural and community banks that could also facilitate the emergence of new types of MFIs serving specific markets (Gallardo et al., 2005). Financial cooperatives (also called SACCOs) are another viable category and should be prudentially supervised by a specialized financial authority (Gallardo et al., 2005, Steel & Andah, 2004, Christen et al., 2003).
It is important to note that the process of developing a regulatory framework and the conditions set for licensing can also stifle microfinance operations. Rigidities in licensing rules on capital adequacy requirements (especially on minimum or maximum), limited degrees of funding structures, too heavy, bureaucratic regulations and supervision as well as very strict accounting requirements can be obstacles to MFIs transformation (Avgouleas, 2007: 38-39). If prudential regulation does not provide a balance between the objectives of regulation and the need to promote microfinance operations, scarce supervisory resources can be wasted, institutions can be saddled with unnecessary compliance.

2.3.2 Management Information System

The requirement for MFIs to provide detailed documentation for loans that are typically small and many does have profound implications on their management information systems (MIS). This loan documentation required from borrowers is designed to ensure the reliability of the collateral and the financial stability of the borrower. In prudential banking practice documentation forms a significant component (Delfiner et al., 2006). The major challenge lies in acquiring software that can perform the banking operational functions and keep the detailed database for microloans. The cost of such software could be enormous (Christen et al., 2003) and funds to acquire such systems are not easy to get. Regulations come with reporting and disclosure requirements that contain a certain amount of content and with set frequency of reporting. This will add substantially to the administrative costs to an MFI since most of the transactions are very small. Though such reporting requirements should be simpler for microfinance institutions than for normal commercial bank operations, they are definitely add-ons to original activities (Christen et al., 2003). Changing the MFIs’ orientation from a donor mentality to a performance-based management could pose a challenge (Valdemar et al., 2007: 4).
According to the reporting requirements, as outlined in the Microfinance Act (GOK, 2006) and Regulations (GOK, 2008a), MFIs would require good MIS and stable software applications for this purpose. There are up to 22 different reports with varied frequency of reporting ranging from daily to annual. The penalties for non-compliance or late submission are huge. The reports cover, among other things, asset and liability management, capital adequacy, liquidity, financial statements, disclosure on large loans, performance, returns on directors and management. These reports are meant to ensure that acceptable performance standards are upheld, and to ensure compliance with accounting standards, accountability and transparency and depositor protection (Mwatela, 2008).

2.3.3 Capital requirement

High minimum capital requirements are entry barriers for smaller MFIs and tend to favour a few larger ones (Christen et al., 2003). Raising the required minimum capital may take time to achieve. It is hard for smaller MFIs to be transformed into regulated institutions because soliciting for investors requires going through a due diligence process. This a common tool used to weed off smaller MFIs as was used in Ghana (Gallardo et al., 2005). In Kenya, the regulation offers three options: national DTM, community DTM or remain as credit-only MFI. Those MFIs applying for nationwide DTM are required to raise Kshs 60 million (equivalent to USD 7.5 million) and for community-based DTM the minimum capital is Kshs 20 million (USD 4 million) (Ndung’u, 2010a).

Nationwide DTM institutions are allowed to roll out their operations across the country, while community-based DTMs have their operations restricted to a defined geographical area. MFIs may have a challenge in meeting capital adequacy requirements. The difficulties in meeting loan loss-provision standards set for MFIs by most regulators. There is controversy as to whether the
capital adequacy requirements for specialised MFIs should be tighter than the requirements applied to diversified commercial banks (Christen et al., 2003; Handy et al., 2002). Well-managed MFIs maintain excellent repayment performance, with delinquency typically lower than in commercial banks (Ramírez, 2004), but in some countries, the banking laws consider loans provided to micro-entrepreneurs risky. In this perception, microloans are supposed to be classified as risky assets fundamentally due to lack of collateral and diversity, and be heavily provided for (Delfiner et al., 2006).

The guidelines for provisioning of bad and doubtful debts for DTMs are more stringent than commercial banks in Kenya and Uganda (BOU, 2010). This could easily wipe out the entire loan portfolio and lead to weak capital adequacy.

2.3.4 Ownership and Governance

Banking regulations will always specify ownership suitability and diversification requirements. Typical ownership and governance structures of MFIs tend to reflect their origins and initial sources of capital (Christen et al., 2003). Many NGO MFIs are forced to transform from ownerless to owned (Lauer, 2008). Such regulations stipulate minimum number of shareholders and a maximum percentage of ownership for any shareholder. These conditions raise a big challenge to meet especially for those MFIs that are still small and not profitable (Lauer, 2008). The problem is getting willing investors that share the same aspirations and are willing to continue with the organization’s mission. The consideration is therefore not only who has money but who shares a similar vision and aspirations (Ledgerwood & White, 2006).

In addition, transformation often means getting an entirely new set of investors with different interests. In this case managing these divergent interests of both social and commercial investors is not easy (Ledgerwood & White, 2006) and at times may lead to mission drift (Christen, 2000).
It is therefore, essential to link the search for new investors with the strategic direction the transformed MFI would like to take. As early as possible some strategic choices and tradeoffs must be made on whether to go for strategic or financial investors, local or foreign, microfinance or formal financial experience, and majority or minority shareholding (Ledgerwood & White, 2006). Another challenge is restructuring existing ownership and their capital contributions to comply with the new regulations (Christen et al., 2003). The majority of microfinance institutions were NGO formed, operated and funded by foreign organizations. This becomes more complicated where there are foreign ownership restrictions or vetting of institutions taking up stake. The owners of the transformed MFI have to be vetted. Where minimum share contribution has been set, like in Kenya, larger MFIs will have a challenge of raising matching capital from diversified shareholders (Ledgerwood & White, 2006).

Corporate governance in most microfinance institutions is weak and the structure often represents ownership. In NGO governance, the board members do not represent ownership or have profit motivation but a social consideration (Lauer, 2008). Regulation, on the other hand, specifies how institutions’ board and management should be structured thereby bringing a challenge. This would imply that a new caliber of board members have to be appointed. Opening up governance of family-owned rural banks, cooperatives and NGOs to bring in board members that have banking expertise and improve quality in their boards was identified as a challenge in the Philippines (Valdemar et al., 2007: 4). Another difficult aspect would be the selection criteria to be adopted for the board and senior management for the transformed MFI (Lauer, 2008). The process takes time and is prone to controversy and conflict of interest.
2.4 Conceptual Framework

The study was guided by the following conceptual framework. The conceptual framework shows the relationship between variables that influence organizational transformation strategy to formal banking.

**Figure 2.1 Conceptual Framework**

- **Regulatory framework**
  - Legal process of creation
  - Legal status

- **Management Information Systems**
  - Documentation
  - MIS requirements by regulator

- **Capital requirements**
  - Minimum capital
  - Capital Adequacy
  - Meeting loan provisions

- **Ownership and governance**
  - Managing conflicting investors’
  - Restructuring existing ownership

**Independent variables**

**MFI TRANSFORMATION STRATEGY TO FORMAL BANKING**

- Operational transformation
- Organizational structure
- Structural transformation
- CT/MIS

**Dependent variable**

Source (Mwatela, 2008)
2.5 Research Gap

Scholarly interest in microfinance has lagged behind industry development, but it too is now growing rapidly. Before 1997, academic journals published only an occasional article on microfinance, but since that time, academic journals have published hundreds of peer-reviewed articles on the topic. Nonetheless, microfinance has yet to break into finance journals. This despite the term finance in microfinance and the fact that the basic products offered by microfinance institutions (MFIs)—namely investing (savings), lending (credit services), and insurance (risk management)—are all well-established topics of mainstream finance research. The purpose of this paper, therefore, is to introduce microfinance to the academic finance community and to provide an outline for future research.

Issues surrounding MFI transformation, and the implications/tradeoffs implied therein seem well-suited for finance researchers. Few rigorous studies have been conducted in a financial institutions framework to develop and test theory pertaining to MFI transformation. Some evidence does exist however, that MFIs have historically been very resilient and sustainable. Empirical evidence suggests that majority of studies have looked at how organizational factors, singly influences transformation of MFI’s to formal banking. This study therefore intends to look at how the four selected variables collectively influence the transformation process. Vast studies on institutional transformation have also been undertaken in developed countries neglecting developing countries. This study hence seeks to fill the existing gap in literature by undertaking the research in Kenya. Toward these goals, the study sought to investigate the organizational factors influencing transformation of MFI’s to formal banking.
CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The subsequent sections discusses the choice of research design, the unit of analysis and sampling, methodology used, questionnaire design, actual data collection and data analysis.

3.2 Research Design

This study adopted a descriptive design. It was descriptive because the bulk of the study tried to explain what the situation is and why the situation is as it is (Saunders et al., 2009: 139-140). Descriptive research also allows the researcher to identify and describe the variability in different phenomena. The research also renders itself to explanatory research when trying to link the phase of transformation and factors influencing the process. Transformation implies change and therefore a process. Examining factors affecting this process require a bit of exploration. The need emanates from the fact that the phenomenon being studied must be understood. So this exploratory study at the beginning of the analysis helps to establish the situation on progress of microfinance transformation. This exploratory information is essential to provide background, explanations to actions, decisions and state of affairs of each case.

3.3 Population

According to Kombo & Tromp (2010), a population is a well-defined group / set of people, or items that are being investigated/studied. The target population of the study comprised of employees of Faulu Kenya and KWFT. Therefore the unit of analysis was identified as the Faulu bank and KWFT branches in Nairobi region.
3.4 Sampling Frame

A sampling frame is a complete list of all the members of the population that we wish to study (Kothari, 2004). The sampling frame for this study was the list of employees of Faulu Kenya and KWFT in Nairobi region.

Table 3.1: Sampling frame

<table>
<thead>
<tr>
<th>MFI</th>
<th>Population</th>
<th>Sample</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Faulu Kenya</td>
<td>402</td>
<td>120</td>
<td>30</td>
</tr>
<tr>
<td>KWFT</td>
<td>376</td>
<td>113</td>
<td>30</td>
</tr>
<tr>
<td>Total</td>
<td>778</td>
<td>233</td>
<td>30</td>
</tr>
</tbody>
</table>

Source, HRM Faulu Kenya and KWFT (2013)

3.5 Sample and Sampling Method

Stratified random sampling was employed in carrying out the study. Kothari (2004) notes that stratified random sampling is a process of selecting respondents using well defined strata. In this study, the departments formed the strata. Simple random sampling was used to select individuals from the strata. Mugenda and Mugenda (2003) defines simple random sampling as a process of selecting respondents without any particular sequence where all subjects in the study population have an equal chance of being selected. According to Kombo and Tromp (2010), an effective sample should possess diversity, representativeness, reliability, accessibility and knowledge. This process was applied in this study because the study population was large (778 employees). Mugenda and Mugenda (2003) advises that 10% of the accessible population would suffice for descriptive study if the population units are more than 30. Thus, a sample of 233 employees, representing 30% of the population, was used which satisfies the above conditions as shown in table 3.1 above.
3.6 Data Collection Procedure

Data collection is the process of acquiring subjects and gathering information needed for a study; methods of collection varied depending on the study design, (Kothari, 2004). Primary data was collected for this study. Primary data was collected by administering a semi-structured questionnaire. This type of questionnaire had both closed and open-ended questions. Closed questions had predetermined answers and usually collect quantitative data while open-ended questions gave the respondents freedom to express their views and usually collect qualitative data. The use of questionnaire ensures collection of data from many respondents within a short time and respondents are free to express their views give relevant information because they are assured of their anonymity (Mugenda and Mugenda, 2003). Secondary data on the other hand was collected through review of both empirical and theoretical data from books, journals, dissertations, magazines and the internet.

3.7 Pilot Study

A pilot study is a small scale preliminary study conducted before the main research in order to measure the validity and reliability of the data collection instrument (Burns & Grove, 2007). Pilot study was conducted to measure the validity and reliability. According Kombo& Tromp (2010), validity is the ability of an instrument to measure what it is expected to measure while reliability is the ability of the instrument to give consisted results. This pilot study included multiple Likert’s measurement scales. A sample size of five was chosen, using triangulation, to form the pilot study. Cronbach’s α measure of internal consistency was employed in analyzing the results of the pilot study after which some items from the Likert scales might be edited.
3.8 Data Analysis and Presentation

Data analysis for this research was largely quantitative. Though this is so, most of the data was categorical (nominal) limiting modes of analysis. In addition, the nature of the study rendered analysis techniques to employ descriptive statistics. The results of the analysis were presented in frequency tables, charts and graphs to show the general phenomenon of variables being measured. Use of advanced statistical analysis like ANOVA and regression in this research was limited since most of the data is either ordinal or nominal. In addition to limited interval data, the main focus of analysis was not to analyze differences between groups or make inferences about the population. However, relationships between variables was established for categorical (nominal) data through cross-tabulation. This cross-tabulation allows for examination of frequencies of observations that belong to specific categories on more than one variable and helps in identification of relations between cross-tabulated variables. Qualitative data was analyzed through comparing recorded statements and observations, noting similarities and sifting through the data. It involved sorting pieces of data, grouping them to solve a puzzle that would explain a phenomenon observed in the quantitative analysis. These explanations were fitted to the quantitative analysis to provide a fuller picture of the occurrence. SPSS statistics version 19.0 was used for descriptive statistics such as creating frequency tables, cross-tabulation, means and standard deviations. A limited use of Microsoft Office Excel was made especially in creating charts.
CHAPTER FOUR

DATA ANALYSIS, INTERPRETATION AND PRESENTATION

4.1 Introduction

This chapter presents data analysis, interpretations and discussions. Information in this chapter is divided into two sections. The chapter deals with analysis of data on each of the four objectives based on descriptive and inferential statistics.

4.2 Response Rate

The sample of the study comprised of 233 respondents. The research instruments were administered to the respondents who later on returned all duly filled instruments. Out of 233 questionnaires that were administered, 164 were duly filled and returned. This was a response rate of 70.39% as displayed in table 4.1.

According to Mugenda and Mugenda (2003) a 50% response rate is adequate, 60% good and above 70% rated very good. This also concurs with Kothari (2004) assertion that a response rate of 50% is adequate, while a response rate greater than 70% is very good. This implies that based on this assertions; the response rate in this case of 70.39% is very good. This high response rate may be attributed to the fact that the researcher employed various data collection techniques including mail interviews which facilitated immediate feedback while ensuring that many respondents were accessible. Telephone interviews were used and this was possible since most employees in the Company were accessible via mobile phone. This enabled the interviewer to reach those who were not present during face to face interviews. This method saved on transport costs of going back to reach those absent or on leave and yet they were in the sample.
Table 4.1: Response Rate

<table>
<thead>
<tr>
<th>MFI</th>
<th>Questionnaires administered</th>
<th>Questionnaires filled &amp; returned</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Faulu Kenya</td>
<td>120</td>
<td>84</td>
<td>70.00</td>
</tr>
<tr>
<td>KWFT</td>
<td>113</td>
<td>80</td>
<td>70.79</td>
</tr>
<tr>
<td>Total</td>
<td>233</td>
<td>164</td>
<td>70.39</td>
</tr>
</tbody>
</table>

4.3 Pilot Test Results

The research instruments were given to experts in measurement and research to vet. Two experts were selected who evaluated the relevance of each item in the instrument in relation to the objectives. The questionnaire used had likert scale items that were to be responded to. For reliability analysis Cronbach’s alpha was calculated by application of SPSS. The value of the alpha coefficient ranges from 0 to 1 and may be used to describe the reliability of factors extracted from dichotomous (that is, questions with two possible answers) and/or multi-point formatted questionnaires or scales (i.e., rating scale: 1 = poor, 5 = excellent). A higher value shows a more reliable generated scale. Cooper & Schindler (2008) indicated 0.7 to be an acceptable reliability coefficient. Since, the alpha coefficients were all greater than 0.7, a conclusion was drawn that the instruments had an acceptable reliability coefficient and hence were appropriate for the study.

Table 4.2: Reliability Results

<table>
<thead>
<tr>
<th>Variable</th>
<th>Cronbach’s Alpha</th>
<th>Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory framework</td>
<td>.79</td>
<td>9</td>
</tr>
<tr>
<td>Management Information Systems</td>
<td>.82</td>
<td>6</td>
</tr>
<tr>
<td>capital requirements</td>
<td>.78</td>
<td>6</td>
</tr>
</tbody>
</table>
4.4 Organizational Factors Influencing Transformation

The study sought to find out the factors affecting transformation of microfinance institution to formal banking. According to the analysis of the findings, lengthy transformation process emerged as one of the factors affecting transformation as indicated with a mean of 4.50 and a standard deviation of 1.098. Further findings revealed that restructuring ownership (mean= 4.22 and standard deviation= 1.054), meeting capital adequacy requirement (mean= 4.13 and standard deviation= 1.29), preparing a business plan (mean= 4.22 and standard deviation= 1.01), developing operations manual (mean= 4.24 and standard deviation= 0.865), organizing for financial and other supporting reports as required by act (mean= 4.28 and standard deviation= 1.003), setting up premises for branch operation as per set standards (mean= 4.05 and standard deviation= 0.550), setting of management structures and systems (mean= 3.90 and standard deviation= 0.561), developing a suitable MIS and reporting system (mean= 4.01 and standard deviation= 0.811), setting up risk management and internal control policies and systems (mean= 4.26 and standard deviation= 0.995), developing marketing and savings mobilization plans (mean= 3.46 and standard deviation= 1.008) and registering stake owned by foreigners or a subsidiary of foreign company (mean= 3.56 and standard deviation= 0.712). The other findings of the study are displayed in table 4.3.

Table 4.3 Organizational Factors Influencing Transformation

<table>
<thead>
<tr>
<th>Statement</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Search for a name that fits CBK requirements</td>
<td>4.02</td>
<td>0.954</td>
</tr>
<tr>
<td>Task</td>
<td>Time</td>
<td>Cost</td>
</tr>
<tr>
<td>----------------------------------------------------------------------</td>
<td>------</td>
<td>------</td>
</tr>
<tr>
<td>Lengthy transformation process</td>
<td>4.50</td>
<td>1.098</td>
</tr>
<tr>
<td>Searching/Soliciting for willing investors</td>
<td>4.00</td>
<td>1.142</td>
</tr>
<tr>
<td>Restructuring ownership (contributions by donors, management)</td>
<td>4.22</td>
<td>1.054</td>
</tr>
<tr>
<td>Meeting capital adequacy requirement</td>
<td>4.13</td>
<td>1.29</td>
</tr>
<tr>
<td>Raising funds for transformation activities (branch set-up, MIS, etc)</td>
<td>3.99</td>
<td>1.02</td>
</tr>
<tr>
<td>Preparing feasibility study report</td>
<td>3.55</td>
<td>0.91</td>
</tr>
<tr>
<td>Preparing a business plan</td>
<td>4.22</td>
<td>1.01</td>
</tr>
<tr>
<td>Completing the ‘Fit and Proper Forms’ for directors and shareholders</td>
<td>3.19</td>
<td>0.99</td>
</tr>
<tr>
<td>Organizing for financial and other supporting reports as required by Act (statements, due diligence report, Board/AGM resolution, etc)</td>
<td>4.28</td>
<td>1.003</td>
</tr>
<tr>
<td>Registering stake owned by foreigners or a subsidiary of foreign company</td>
<td>3.56</td>
<td>0.712</td>
</tr>
<tr>
<td>Setting up premises for branch operation as per set standards</td>
<td>4.05</td>
<td>0.550</td>
</tr>
<tr>
<td>Recruiting qualified management team that meets CBK requirements</td>
<td>3.84</td>
<td>0.667</td>
</tr>
<tr>
<td>Setting up board structures and systems</td>
<td>3.76</td>
<td>0.584</td>
</tr>
<tr>
<td>Setting of management structures and systems</td>
<td>3.90</td>
<td>0.561</td>
</tr>
<tr>
<td>Finding a suitable software that meets CBK requirements</td>
<td>3.65</td>
<td>1.065</td>
</tr>
<tr>
<td>Developing a suitable MIS and reporting system</td>
<td>4.01</td>
<td>0.811</td>
</tr>
<tr>
<td>Developing marketing and savings mobilization plans</td>
<td>3.46</td>
<td>1.008</td>
</tr>
<tr>
<td>Developing operations manuals (lending, MIS, HR, etc)</td>
<td>4.24</td>
<td>0.865</td>
</tr>
<tr>
<td>Setting up risk management and internal control policies and systems</td>
<td>4.26</td>
<td>0.995</td>
</tr>
</tbody>
</table>
The desire to grow, expand outreach and improve the quality of financial services to its target clients is a legitimate and fundamental goal for any financial institution. Growth allows financial intermediaries to enjoy economies of scale and paves the way for sustainability. A clear strategy to reduce funding costs is critical to achieve this objective. Based on Microfinance Act 2006, the related regulations aimed at regulating deposit taking microfinance institutions, came into effect in May 2008. This opened a window of opportunity for institutions such as Faulu Kenya and Kenya Women Finance Trust to become deposit-takers.

4.4.1 Influence Regulatory Framework
One of the objectives of the study sought to document the influence of regulatory framework on transformation of MFI to banking. Based on the study results, majority of the sampled employees of KWFT and Faulu bank responded in the affirmative as evidenced by a mean of 4.11 and a standard deviation of 0.82. Table 4.4 illustrates the summary of the findings.

<table>
<thead>
<tr>
<th>Statements</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory framework influences MFI transformation strategy to formal banking</td>
<td>4.11</td>
<td>0.82</td>
</tr>
</tbody>
</table>

The findings of the study corroborate Goldberg (2005) who observed that a well defined regulatory framework, a clear national vision, legal and policy environment are all pre-requisites to a successful transformation. In most countries, a tiered financial and regulatory approach has proved the most effective for enabling transformation, offering clear categorization of the institutions and providing a good basis for a roadmap. The tiered approach is also suited to the increasing demand for diversified microfinance products, as the industry changes from a
primarily social development tool to a recognized economic development tool. A broader range of strong financial intermediation institutions is therefore needed.

4.4.2 Influence of Efficient Management Information Systems
According to the analysis of the study results, it was revealed that efficient management information system plays an important role in MFI transformation to formal banking as supported by the sampled employees with a mean of 4.02 and a standard deviation of 1.15 indicating that the responses revolved around the same rating without differing to a large extent.

During the transformation process of Faulu bank, PriceWaterhouseCoopers provided support in the selection of the Information and Communication Technology (ICT) system.

Before transformation, Faulu had been using the FAO/GTZ (Food and Agriculture Organization/Gesellschaft fuer Technische Zusammenarbeit) developed Microbanker system for loan tracking. This clearly needed upgrading. A Board committee was established to supervise this process. With FSD Kenya’s support, Faulu identified and engaged PriceWaterhouseCoopers to support them in selecting and configuring a suitable management and information/core banking system.

KWFT had a centralized ICT system before the transformation process, and the main task was to upgrade the system in order to fulfil the regulatory requirements. KWFT was already using the ICT system Temenos (T24) but needed an upgrade to be able to cope with the necessary changes in procedure. They also needed to equip the deposit-taking branches with new software and expanded capacity. The upgrade and transition into use of the new system posed a number of challenges. The ICT system became unreliable for a number of months due to problems in the database and the system upgrade. When the system went live, a number of bugs were detected.

The finding of the study is summarized in table 4.5.
4.4.3 Influence of Ownership and Governance on MFI Transformation Strategy

The challenge with ownership is complicated by the fact that contribution to the existence and success of MFIs has both financial and non-financial dimensions. The founders of the MFI spent a great deal of their time and energy to get the institution to where it is. These founders treat the MFI as their baby. Their contribution has not been factored in the financial statements and hence poses a challenge when deciding how much to allocate to each stakeholder.

From the analysis of the study results, it was further established that Ownership and governance affects MFI transformation strategy to formal banking given the high rating with a mean of 4.26 and a standard deviation of 1.021. It is worth noting that when MFI transforms, the ownership changes as well as governance due to the requirements by the regulator. As far as KWFT is concerned, as an internal requirement, two-thirds of Board members must be women. Furthermore, to impede mission drift, powers have been split between the Board and shareholders. There are currently nine Board members, five of whom were already in KWFT before its transformation. The other four have been appointed to manage the expanded and new responsibilities, especially in the banking operations, and to meet CBK’s requirements regarding the required skill set.

KWH currently owns 100% of the for-profit KWFT DTM. As per the microfinance regulations, CBK gave KWFT DTM (like any licensed DTM) four years to make the transition to a maximum of 25% shareholding by each shareholder. KWH intends to own 25% of the

---

Table 4.5: Influence of Efficient Management Information Systems

<table>
<thead>
<tr>
<th>Statements</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Efficient Management Information Systems plays an important role in MFI</td>
<td>4.02</td>
<td>1.15</td>
</tr>
<tr>
<td>transformation to formal banking</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
organization within the required time. It will do so by diluting its shareholding through inviting other shareholders instead of divesting. The organization is seeking social, long-term, responsible investors, not speculators. These investors are expected to bring not just funds, but ideas for future growth and commitment to the organization’s mission and values.

Faulu established itself as a company limited by share capital in 1999 in order to obtain debt funds from the market. In 2004 the institution decided to go a step further and become a public limited company, issuing a bond to raise additional funds for operations. Once this was accomplished, the main challenge was to identify new, like-minded shareholders/investors. Ideally, incoming shareholders would not only share Faulu’s social objectives, but also the Christian faith of its current investors. The new Microfinance Act limits individual shareholding to 25% of the total share capital. Table 4.6 displays the findings.

Table 4.6: Influence of Ownership and Governance

<table>
<thead>
<tr>
<th>Statements</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ownership and governance affects MFI transformation strategy to formal banking</td>
<td>4.26</td>
<td>1.021</td>
</tr>
</tbody>
</table>

4.4.4 Influence of Capital Requirements
The respondents were further required to rate on a five point likert scale the influence of capital requirements on MFI transformation. The Acts have specified the minimum capital to be held by a deposit-taking institution. The minimum capital to be raised by MFIs is Kshs 60 million (USD 7.5 million) and Kshs 20 million (USD 2.5 million) for nationwide and community DTMs respectively. From the findings, the respondents attested to the fact that MFI’s transformation to
formal banking is indeed influenced by capital requirements as embedded in the regulations with a mean of 4.30 and a standard deviation of 1.004.

The DTM regulations have defined the following prudential ratios: (1) capital adequacy ratios including a core capital of 10% of total risk adjusted assets plus risk adjusted off balance sheet items, core capital of 8% of total deposit liabilities, total capital of 12% of total risk adjusted assets plus risk adjusted off balance sheet items; (2) a minimum liquidity ratio of 20%; (3) a limit on insider loans which should not exceed 2% of core capital and should be contained on aggregate within a ceiling of 20% of core capital.

Faulu's initial estimate of the total costs of the first phase of the transformation was slightly over KShs 300 million. Half of this budget went to the acquisition of a new core banking system. FSD Kenya provided KShs 75 million, representing 22% of the total. In addition, Faulu used KShs 100 million of retained earnings and covered the other costs with loans obtained from the Overseas Private Investment Corporation (OPIC) and the Deutsche Bank.

KWFT DTM has enjoyed strong growth throughout the transformation process: business has grown by about 100% every year since 2007. In readiness for the transformation, the organization created a reserve. It relied on loans to fund the microfinance activities, putting aside profits for investment in the transformation. The debt load is considered to be sustainable as all the costs are capital investments, and are expected to yield returns over time.

Capital adequacy is a challenge affected by asset valuation and more specifically the provisioning for bad and doubtful debts. The regulator classifies most of the MFI loans as risky because they do not have good collateral other than joint liability of group members, hence stricter loan provisions. The severity of the challenge of meeting capital adequacy requirement was rated high.
Table 4.7: Influence Capital requirements

<table>
<thead>
<tr>
<th>Statements</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital requirements affects MFI transformation strategy to formal banking</td>
<td>4.30</td>
<td>1.004</td>
</tr>
</tbody>
</table>

4.5 Views on Microfinance and Sacco Acts

The respondents were asked to present their views on the current current laws which include microfinance and Sacco Acts. According to the findings, the respondents agreed that the existence of the laws would lead to stability of the financial sector with a mean of 3.12 and a standard deviation of 0.765. Following the enactment of the laws, the discipline of the financial sector will increase as supported by respondents with a mean of 3.51 and standard deviation of 0.861. With a mean of 3.05 and a standard deviation of 1.061, the respondents were of the view that with regulation the challenges of providing microfinance services will decrease. The other effect of the microfinance and Sacco Act include: the level of competition will increase (mean=3.09 standard deviation=0.736), access to financial services by the poor and disadvantaged will improve (mean=3.14 standard deviation=0.849), the amount deposits/savings mobilized nationally will increase (mean=3.02 standard deviation=1.003), MFIs that transform to deposit-taking business are likely to increase their profits (mean=3.80 standard deviation=1.801).

It is also worth noting that the respondents disagreed that with the current laws, many MFIs will merge or be bought by commercial banks and that the Central Bank will reduce some of the requirements to accommodate more MFIs transforming to banks with means of 2.51 and 2.44 respectively. There has been some lobbying and negotiations on the possible changes of some clauses in the microfinance Act. As indicated by some interviewees, the microfinance law is
more stringent on some matters than the banking law and players in the sector have been asking for considerations. The findings of the study are summarized in table 4.8.

Table 4.8: Views on Microfinance and Sacco Acts

<table>
<thead>
<tr>
<th>Statement</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The stability of the financial sector will be enhanced</td>
<td>3.12</td>
<td>0.765</td>
</tr>
<tr>
<td>The discipline in the financial sector will increase</td>
<td>3.51</td>
<td>0.861</td>
</tr>
<tr>
<td>With regulation, the challenges of providing microfinance services will decrease</td>
<td>3.05</td>
<td>1.061</td>
</tr>
<tr>
<td>The level of competition will increase</td>
<td>3.09</td>
<td>0.736</td>
</tr>
<tr>
<td>Access to financial services by the poor and disadvantaged will improve</td>
<td>3.14</td>
<td>0.849</td>
</tr>
<tr>
<td>The amount deposits/savings mobilized nationally will increase</td>
<td>3.02</td>
<td>1.003</td>
</tr>
<tr>
<td>Many MFIs will merge or be bought by commercial banks</td>
<td>2.51</td>
<td>0.912</td>
</tr>
<tr>
<td>MFIs that transform to deposit-taking business are likely to increase their profits</td>
<td>3.80</td>
<td>1.801</td>
</tr>
<tr>
<td>The Central Bank will reduce some of the requirements to accommodate more MFIs transforming to banks.</td>
<td>2.44</td>
<td>0.879</td>
</tr>
</tbody>
</table>

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. 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. In addition to this AMFI CEO, Benjamin Nkungí (2010) stated that Legal requirements for capital and shareholding are hard to meet especially those institutions that are owned by one or several welfare organisations. This explains why most of them are stuck in stage two and are not likely to move beyond that stage.
4.6 Organizational Transformation Experiences

According to the analysis of the study results, the respondents agreed that the transformation manager should have a thorough knowledge and understanding of the organization. They further agreed that commitment of the management and the Board of Directors is crucial to ensure a successful transformation. With a mean of 3.784 and a standard deviation of 0.377, the respondents were of the view that human Resource and communication with staff and clients is extremely important to reduce tensions. The study also established that rebranding is an important tool to show the public, clients and staff that the institution has indeed changed as supported with a mean of 3.726 and a standard deviation of 1.442 and that change in organizational structure becomes inevitable as the institution starts the deposit-taking business (mean=3.930 standard deviation=1.362).

The respondents also agreed that: the choice of new investors must be made carefully and introduced gradually (mean=3.242 standard deviation=1.402), setting up a “bank” branch has proven to be time consuming and very costly (mean=2.746 standard deviation=1.331), the set-up of a branch network is therefore extremely expensive (mean= 3.309 standard deviation=1.312), in reality, implementing branchless banking seems to be more challenging than had been envisaged (mean=4.168 standard deviation=0.065), a detailed analysis of the available solutions is advised before investing in ICT/MIS (mean=0.312 standard deviation=1.011), Strong project management is a key component of an ICT/MIS deployment and this should be assured at the start (mean=2.687 standard deviation=0.908). Table 4.9 displays the findings.
<table>
<thead>
<tr>
<th>Statement</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>The transformation manager should have a thorough knowledge and understanding of the organization.</td>
<td>3.792</td>
<td>1.401</td>
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<tr>
<td>Commitment of the management and the Board of Directors is crucial to ensure a successful transformation.</td>
<td>3.808</td>
<td>1.1452</td>
</tr>
<tr>
<td>Human Resource and communication with staff and clients is extremely important to reduce tensions.</td>
<td>3.784</td>
<td>0.377</td>
</tr>
<tr>
<td>Rebranding is an important tool to show the public, clients and staff that the institution has indeed changed.</td>
<td>3.726</td>
<td>1.442</td>
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<tr>
<td>Change in organizational structure becomes inevitable as the institution starts the deposit-taking business.</td>
<td>3.930</td>
<td>1.362</td>
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<td>3.242</td>
<td>1.402</td>
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<tr>
<td>Setting up a “bank” branch has proven to be time consuming and very costly.</td>
<td>2.746</td>
<td>1.331</td>
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<tr>
<td>The set-up of a branch network is therefore extremely expensive.</td>
<td>3.309</td>
<td>1.312</td>
</tr>
<tr>
<td>In reality, implementing branchless banking seems to be more challenging than had been envisaged.</td>
<td>4.168</td>
<td>0.065</td>
</tr>
<tr>
<td>A detailed analysis of the available solutions is advised before investing in ICT/MIS.</td>
<td>3.312</td>
<td>1.011</td>
</tr>
<tr>
<td>Strong project management is a key component of an ICT/MIS deployment and this should be assured at the start.</td>
<td>2.687</td>
<td>0.908</td>
</tr>
</tbody>
</table>

Both regional and international experience of transformation has demonstrated the importance of having a clear national strategy for microfinance, aimed at enhancing the legal and regulatory
frameworks as well as the policy environment. Not only does this make it easier for existing and potential players in the market to position themselves, it also encourages the international donors to invest in the development of the country. This is achieved through capacity building, equity and the provision of funds for on-lending. It is therefore no surprise that the majority of the 40 or so transformations recorded since PRODEM are in Latin America, where the regulatory framework is the most advanced. The African region has the least number of transformations, with many countries still struggling to supervise commercial banks, let alone MFIs.
CHAPTER FIVE
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction
This chapter summarizes the study and makes conclusion based on the findings. The recommendations of the study and areas for further research are also presented. This section presents the findings from the study in comparison to what other scholars have said as noted under literature review.

5.2 Summary of Findings
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 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). 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 challenges of transformation include they inability 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.

5.2.1 Influence of Regulatory Framework
One of the objectives of the study sought to document the influence of regulatory framework on transformation of MFI to banking. Based on the study results, majority of the sampled employees
of KWFT and Faulu bank responded in the affirmative. The revelation in the results agrees with literature and findings of previous studies on the purpose of regulation and challenges that face institutions transforming to prudential regulation. It was clear that some of the challenges were indeed the contributing factors for delay in the transformation process. Given that the Acts are very clear on certain requirements as pre-requisite to licensing, many MFIs that do not meet these conditions may not proceed with their transformation process.

5.2.2 Influence of Efficient Management Information Systems
According to the analysis of the study results, it was revealed that efficient management information system plays an important role in MFI transformation to formal banking as supported by the sampled employees. Acquiring banking software that has capabilities of addressing MFIs information needs is expensive. Having MIS that can produce the required daily, weekly, monthly and quarterly reports is equally challenging to set up. 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. Small MFIs are struggling to get these systems and may take some time to attain.

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.
5.2.3 Influence of Ownership and Governance
From the analysis of the study results, it was further established that Ownership and governance affects MFI transformation strategy to formal banking given the high rating. 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). 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. 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.

5.2.4 Influence of Capital Requirements
The respondents were further required to rate on a five point likert scale the influence of capital requirements on MFI transformation. From the findings, the respondents attested to the fact that MFI’s transformation to formal banking is indeed influenced by capital requirements as embedded in the regulations.

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.

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 et al., 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).

5.3 Conclusions

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 law. The transformation process is not a bed of roses. KWFT and Faulu bank 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 research identifies a
worrying prediction on the future of microfinance. The high levels of uncertainty on profitability,
addressing challenges of providing financial services to the disadvantaged and unlikely
substantial increase in deposits are areas of concern. This casts doubts on whether regulation of
microfinance institutions increases deposit mobilisation and its overall benefits to institutions
and society. Transformations are very costly, both in terms of financial and operational
resources. The process itself can be a long one and is often full of obstacles. Before considering a
transformation, it is therefore important to have a history of strong growth good prospects of
sustaining it throughout the process.
Transforming into a deposit taking institution is a huge task. Organisations which believe it is their future must have a solid past. They need to start from strong foundations, continue to be well organized and flexible enough to keep aspirations focused when difficulties arise. They will also need determined leadership, dedication, excellent communication and a great deal of patience. For those that have all these requirements, the risks and rewards still need to be carefully weighed up. Investing in staff training throughout the organisation, particularly in the use of new MIS, mobilising and managing deposits, and developing and marketing new products is crucial.

Both Faulu Kenya Ltd and Kenya Women Finance Trust have transformed successfully. Although their journey was often difficult and protracted, they have eventually arrived at a place in which they believe they can thrive. Our review of the Microfinance Act and the supportive DTMs regulations concludes that the current legislation is very stringent, both in licensing procedures and branch infrastructure establishment. Credit-only MFIs seeking a DTM licence should therefore prepare a detailed and prudent strategy, dedicating sufficient human and financial resources to the transformation process. At the same time, they must concentrate on continued business growth in order to make the profits needed to help finance part of the process. Transformation is extremely expensive and a detailed strategy to manage the finances throughout the process will be essential.

In the two cases under review in this study, the transformation process took longer than expected and cost far more than initial estimates. Their experiences show that transformations are long and complicated processes which call for ownership from all stakeholders. They also highlight the importance of a clear communication strategy to ensure that the interests and incentives of all parties are aligned. Those contemplating transformation have a great advantage: they can be
better prepared as a result of the pioneering experiences of Faulu Kenya Ltd and the Kenya Women Finance Trust.

5.4 Recommendations

Drawing on Faulu and KWFT experiences, the study makes the following recommendations for successful transformation in Kenya.

i) A progressive transformation approach: it is preferable to undertake a progressive transformation, in several phases, leaving time for adjustment at each phase.

ii) Prudent planning: transformations are very costly in terms of time, finances and human resources. The process is often long and full of obstacles. Before considering a transformation, it is important to plan adequately and commit the required resources. These include a full-time transformation manager who has a good understanding of the institutional culture, and preferably several good external consultants with a track record in banking and microfinance.

iii) Readiness to develop new areas of expertise: a successful transformation will need the development of new expertise within the organization, especially in the area of deposit-taking. The experience of Faulu and KWFT demonstrates the importance of training existing staff and recruiting new employees within a short timeframe. There is need to identify capacity gaps and draw for a clear plan on how these are to be filled. Proper implementation of the training and integration plan is essential to ensure that both existing and new staff can work together in harmony.

iv) Governance: a very strong commitment towards good governance is essential for a successful and transparent transformation. Once complete, the organisation will be
subject to even greater supervision of Central Bank of Kenya (CBK). This would become cumbersome and unproductive if the Board and management lacked commitment to strong governance principles.

v) A good communication strategy: change is always associated with risk and it is important to have a good communication strategy before, during and after the transformation. Both the members of the organisation and the public need to be informed and reassured throughout the process that their interests are being protected.

vi) Ownership from all stakeholders: the transformation should be embraced by all members of the organization (staff, management, and the Board of Directors). All must be aware of and agree on the objectives that the institution plans to achieve throughout the transformation. They must also be clear about the expected benefits and the investment required transforming successfully. The top management and the staff must be committed, to ensure that they will not back out at the first sign of difficulty. NGOs considering transformation must draft clear terms of reference (ToR) and know in advance the type of investor they would like to attract - strategic or financial. The ToR should include a clear exit strategy for financial partners, who may not envisage a long term commitment.

vii) Mission Drift: there must be a clear strategy detailing how the institution will maintain its mission of serving the target group following transformation. This should be shared with all the stakeholders (shareholders, partners, members of staff and clients).
5.5 Areas of Further Research

This research identifies certain areas that could be of interest for further research. One of such areas would be to find out the impact of MFI regulation and whether the benefits justify the effort. There is a 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.
REFERENCES


Hishigsuren, G.L (2006). Transformation of microfinance operations from NGO to regulated MFI. IDEAS, USA.


APPENDIX I: QUESTIONNAIRE

SECTION I: ORGANIZATIONAL FACTORS INFLUENCING TRANSFORMATION

1. The statements below are concerned with organizational factors influencing MFI transformation strategy to formal banking. Please tick the one that best describes your opinion. Use the following scale.

5-strongly agree, 4-agree, 3-neutral, 2-disagree and 1-strongly disagree.

<table>
<thead>
<tr>
<th>Statement</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Search for a name that fits CBK requirements</td>
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<tr>
<td>Lengthy transformation process</td>
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<tr>
<td>Searching/Soliciting for willing investors</td>
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<tr>
<td>Restructuring ownership (contributions by donors, management</td>
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<tr>
<td>Meeting capital adequacy requirement</td>
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<tr>
<td>Raising funds for transformation activities (branch set-up, MIS, etc)</td>
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<td>Preparing feasibility study report</td>
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<td>Preparing a business plan</td>
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<tr>
<td>Completing the ‘Fit and Proper Forms’ for directors and shareholders</td>
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<td>Organizing for financial and other supporting reports as required by Act (statements, due diligence report, Board/AGM resolution, etc)</td>
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<td>Registering stake owned by foreigners or a subsidiary of foreign company</td>
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<tr>
<td>Setting up premises for branch operation as per set standards</td>
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<tr>
<td>Recruiting qualified management team that meets CBK requirements</td>
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<tr>
<td>Setting up board structures and systems</td>
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</tbody>
</table>
Setting of management structures and systems
Finding a suitable software that meets CBK requirements
Developing a suitable MIS and reporting system
Developing marketing and savings mobilization plans
Developing operations manuals (lending, MIS, HR, etc)
Setting up risk management and internal control policies and systems

2. State the extent to which you agree with the following statements. Use the following scale


<table>
<thead>
<tr>
<th>Statements</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulatory framework influences MFI transformation strategy to formal banking</td>
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<tr>
<td>Efficient Management Information Systems plays an important role in MFI transformation to formal banking</td>
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<tr>
<td>Ownership and governance affects MFI transformation strategy to formal banking</td>
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<tr>
<td>Regulatory framework contributes to MFI transformation strategy to formal banking</td>
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<tr>
<td>(Others) please specify</td>
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</table>

SECTION II: VIEWS ON THE CURRENT LAW (MICROFINANCE & SACCO ACTS)

3. Please indicate the extent to which you agree with the following statements regarding the possible trends Microfinance Sector as a result of regulation. Please tick the one that best describes your opinion. Use the following scale.
5- Significantly, 4- To a greater extent, 3- to some extent, 2- not much and 1- not sure.

<table>
<thead>
<tr>
<th>Statement</th>
<th>1</th>
<th>2</th>
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<tr>
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<td>Many MFIs will merge or be bought by commercial banks</td>
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<td>Some MFIs will opt to remain as they are and be regulated by ministry or the SACCO regulatory authority</td>
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<tr>
<td>MFIs that transform to deposit-taking business are likely to increase their profits</td>
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<td>The Central Bank will reduce some of the requirements to accommodate more MFIs transforming to banks.</td>
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SECTION III: ORGANIZATIONAL TRANSFORMATION EXPERIENCES

4. The statements below are concerned with transformation experiences. Kindly tick the one that represents your opinion. Use the following scale.

5- strongly agree, 4- agree, 3- neutral, 2-disagree and 1- strongly disagree.

<table>
<thead>
<tr>
<th>Statement</th>
<th>1</th>
<th>2</th>
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<tr>
<td>Change in organizational structure becomes inevitable as the institution starts the deposit-taking business.</td>
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<td>Setting up a “bank” branch has proven to be time consuming and very costly.</td>
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<td>The set-up of a branch network is therefore extremely expensive.</td>
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<td>In reality, implementing branchless banking seems to be more challenging than had been envisaged.</td>
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</tr>
<tr>
<td>A detailed analysis of the available solutions is advised before investing in ICT/MIS.</td>
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<td>Strong project management is a key component of an ICT/MIS deployment and this should be assured at the start.</td>
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APPENDIX II: TIME FRAME
This is the estimated time plan of the study. It is essential in that it enables the researcher to assess the feasibility of conducting the research within the scheduled time frame. It will also enable the researcher to stay on schedule as the research progresses.

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**Grand Total** 50,000.00