

Impact of CBK Prudential Guidelines on MFI Operations in Kenya

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Abstract: Microfinance institutions in Kenya are currently registered under eight different Acts of Parliament; The Non Governmental Organizations (NGO) Co-ordination Act, the Building Societies Act, the Trustee Act, the Societies Act, the Co-operative Societies Act, The Companies Act , the Banking Act and the Kenya Post Office Savings Bank (KPOSB) Act. Some of these forms or registrations do not address issues regarding ownership, governance, and accountability. They have also contributed to a large extent to the poor performance and eventual demise of many MFIs because of a lack of appropriate regulatory oversight. This paper aims to identify whether the absence of a regulatory framework has had any effect on the outreach and sustainability of microfinance in Kenya. This paper concludes that that the major challenge hindering outreach and sustainability of micro finance institutions in Kenya is lack of specific legislation and set of regulation to guide the operation of microfinance subsector. Also, the paper creates a platform where further insight can be provided through empirical research.

Keywords: MFI, MFI Regulations, Prudential guidelines, CBK, Guidelines, Microfinance.

I. INTRODUCTION

According to Goodhart et al. (1998) The objectives of financial regulation cited in the literature are four-fold, viz.: (1) to protect consumers or investors; (2) to ensure the solvency and financial soundness of financial institutions; (3) to promote fairness, efficiency and transparency in the securities markets; and (4) to promote a stable financial system. The important role played by the financial system dictates that financial institutions need to be regulated for three main reasons, viz: consumer protection, stability of the financial system, and maximizing efficiency

Micro finance constitutes a wide range of practitioners, practices and body of knowledge. Hospes, Musinga and Ong'ayo (2002), observed that two approaches are generally used to categorize the different providers of micro finance services in Kenya. Firstly, they are categorized on the basis of formality where providers are categorized as formal, semi-formal or informal depending of the extent to which the provider is registered and regulated under formal law and transactions are governed under the various statutes of the law of contract or rather by self-regulation or group-based rules. The second categorization is based on the customer/provider relationship in the management and ownership of the financial service-providing entity. Under this categorization, micro finance providers could be dichotomized into client-based micro finance agencies (CMFAs) and member-based microfinance agencies (MMFAs).

Kenya with a projected population of 51.3 Million by 2025 and a per capita income of US \$1240 is categorized by the World Bank to be among the poorest countries in the world (WorldBank, 2009). Muhota (2008) argues that Kenya's development challenge remains in finding sustainable poverty eradication strategies. Micro and small enterprises have been seen as one of the strategies that can bring faster development. Micro finance institutions therefore play a big role in financing the micro and small enterprises for faster development. Micro and finance enterprises are also highly rated for employment creation. They are therefore important in Kenya where unemployment and underemployment are estimated at between 25% and 35% respectively. On this basis, micro finance has played a leading role in Kenya in poverty alleviation. On the other hand, lack of operation regulations in Kenyan micro-finance has resulted to a messy environment with much uncertainty and change (Fisher and Sriram, 2002). Through such disorder, several pyramid schemes have cropped up operating under the banner of MFIs and try to offer financial services to meet the poor population

The regulation and supervision of MFIs however, is a double-edged sword. On the one hand, there are limitations in the ability of public regulatory authorities to provide adequate oversight over MFIs. Innovative players in the industry such as Equity bank that has since transformed into a bank could not have occurred by placing premature and costly regulations on MFI activity. On the other hand, the lack of a regulatory and a supervisory framework can place the microfinance sector in a vulnerable situation. Absence of such a system weakens their credibility as institutions offering deposit protection with the same standards of prudence as other formal financial intermediaries, and could also hamper their ability to raise other forms of capital such as bank borrowings and equity offerings. An appropriate regulatory and supervisory framework would not only overcome reputational challenges MFIs would generally face, it would also strengthen their institutional capacity (Sharif, I et al, 2001)

II. STATEMENT OF THE PROBLEM

Omino (2005), argues that the major challenge hindering outreach and sustainability of microfinance institutions in Kenya has been lack of specific legislation and set of regulations to guide the operations of the microfinance sub-sector (Omino, 2005). Currently, the Deposit-Taking Microfinance bill in Kenya was enacted in parliament. A task force that was established in 2003 had proposed a three-tier framework for the regulation and supervision of MFIs. The first tier would comprise formally constituted MFIs that intend to take intermediate deposits from the general public. The prudential guidelines was meant to empower the Central Bank through the Microfinance Bill to license, regulate, and supervise these institutions in the first tier. The second tier are to comprise formally constituted microfinance organizations that do not take deposits from the general public but accept collateral tied to loan contracts. It is proposed that an umbrella body such as the Association of Microfinance Institutions (AMFI) regulate them. Tier three is to comprise Rotating Savings and Credit Associations (ROSCAs), club pools, and financial service associations regulated by an external agency.

Though efforts have been made by the government, AMFI as well as other players in the industry to prepare MFI institutions for the enactment of the law, there seems to be lack of preparedness by the MFIs in the implementation of the prudential guidelines. Since limited studies have been done to assess whether lack of regulatory framework has been a major hindrance to outreach and sustainability of MFIs as well as studies on preparedness of MFIs to on deposit taking MFIs on the implementation of CBK prudential guidelines, this paper attempted to shade more light in this line. The purpose of this research was to identify whether the absence of a regulatory framework has had any effect on the outreach and sustainability of microfinance in Kenya.

III. THEORETICAL REVIEW

There are limited theories in financial regulations. Studies of regulation, whether theoretical or empirical, normally fall into three areas: price and entry regulation in industries with competitive market structures, price and entry regulation in monopolistic industries, and (for want of a better term) "qualitative" regulation, which attempts to cope with various kinds of market-failure problems that are only indirectly linked to prices, profits, and market structure.

IV. EMPIRICAL LITERATURE

A. Outreach Challenges and Sustainability

Gaama (2006) observes that the sustainability of over two thirds of MFIs in Africa are far from reach with reason brought forth as having revenues on average as low as 30-40 percent of the actual operating expenses, with transaction costs inflated by high administrative costs and expatriate expenses draining program funds. For lending to be effective, microfinance must reach a wider coverage since majority of the Kenya's poor populace reside in the rural areas. Kathuri (2006), on the other hand noted that the CBK is expected to prudentially regulate the microfinance institutions so that sustainability can be achieved as microfinance institutions will be allowed to widen their sources of funding to include mobilization of savings from the public at a cost that is relatively lower than the prevailing lending rates in the market and be run efficiently

Since outreach is an ultimate goal for micro-finance operations, three approaches can be used to achieve this goal. The first measure for outreach can be through the expansion of the geographical coverage and range of services and/or products offered which could lead to an increase in number of clients and/or members served though more human, physical and financial resources would be required. Secondly, advocacy and partnership with other organizations working for the same cause can be adopted which is a strategy that does not require an organization to increase its human, financial and physical resources, as it will be leveraging the resources already available in other organizations. Thirdly,

microfinance operations may be restructured, such as through merger & acquisition, franchising, linkage with or downscaling of mainstream financial institutions or transformation from NGO to regulated financial institution (Gaama, 2006).

Available data suggest that outreach to micro- and small enterprises (MSEs) has been likewise very limited: the national survey of MSEs in Kenya held by the Central Bureau for Statistics estimated that only 10.4% of the total number of about 1.3 million MSE proprietors have ever received credit from any source (CBS/ICEG/K-REP 1999). Though not specifying what is meant with “important”, the baseline survey qualifies NGOs as the most important source of credit for MSEs: the 130 NGOs with credit programmes, together have reached 2.8% (or about 36,000) of the MSEs with their credit services. Given the outreach scores of other types of providers, this is not bad but still very low in absolute terms. Instead of using the qualification “most important”, it would be better to speak of the best of the poor performers in this connection. Having said this, the next “popular” source according to the CBS baselines survey, are ROSCAs that have reached 2.5% of the MSEs. The outreach of cooperatives is estimated at a low 1.2%, which is less than half of the outreach of the group of NGOs or ROSCAs, but might be explained by the bias in service provision of cooperatives towards cash-crop farmers. Commercial banks and family and friends take an in-between position, each having reached 1.5% of the MSEs (Hospes et. Al,2002).

The total number of clients reached by MFIs as well as NGO in 1999 was not really impressive, when considering the total population of nearly 30 million people of Kenya and the estimated total of 1.3 million micro and small enterprises. Some argued that this was to do with the limited sources for on-lending to micro finance NGOs from donors. On the other hand, distribution of these MFIs and NGOs is skewed in favor of urban areas, wealthier rural areas and busy rural markets (like Nyeri in central Kenya) connected to main roads, thus leaving a whole spectrum of poor people living in marginal areas with no access to their credit and other financial services(Hospes et. Al, 2002).

Many development NGOs have gained further power by expanding the scope of their financial transactions and taking over various profit-making economic enterprises. Bangladesh is one of the success stories in micro finance lending, key factor being the partnership with foreign aids and donors. To begin with, large Bangladesh NGOS such as Grameen Bank, BRAC, ASA, and Proshika have received significant financial assistance from the World Bank, the Asian Development Bank, the European Commission, UN International Fund for Agricultural Development, UN Capital Development Fund, UNDP, Unicef, and Unesco (ASA, 2001). In addition, Grameen Bank and BRAC have received funds from the above mentioned bilateral agencies and various private foundations like the Ford, the Rockefeller, and the McArthur (GBSG, 2000).

Additionally, for MFI to achieve high profitability levels requires attention to four key elements: client demand, efficient operations, high portfolio quality and yield on portfolio (USAID, 1999). USAID report continues to add that, Successful microfinance institutions should keep loan losses to about 1.2 to 1.4 percent of ongoing expenses; this must be covered by interest rates. Maintaining a high portfolio quality requires a lot of effort, with immediate follow-up on delinquencies and the ability to track them instantly. An effective management information system (MIS) can be essential. Oji (2005) also found out that if MFIs acquire the necessary technologies, equipment and machinery for their operations they will enhance their productivity; increase their rate of output, competitiveness, and profitability. Consequently, they will repay their loans, expand their operations, employ more resources (including labor) and thereby request for bigger loans.

Most Successful Microfinance have changed their organization culture and gone extra mile in marketing themselves. Kamal (2000) talks of Large NGOs in Bangladesh such as Proshika and BRAC having engaged in directly advocating and lobbying for their respective objectives and policy agendas with the government. The poorer sections of society also use NGOs as an articulate lobby in pursuing their welfare interests. The direct work experience of development NGOs with the poor gives them additional leverage over the government to shape public opinion in favor of their espoused objectives and policies.

Micro finance in Bangladesh have gone an extra mile and played strategic alliances with the government in the strategic plans implementations. Evident of this is the growing recognition of NGOs in the two national development plans, including the Second Five Year Plan (1980-85) and the Third Five Year Plan (1985-90). Many NGOS were increasingly considered as collaborative partners of the government to implement programs undertaken in both the Fourth Five Year Plan (1990-95) during the BNP rule under Khaleda (1991-96) and the Fifth Five Year Plan (1995-2000) during the Awami League government under Sheikh Hasina (Kabir, 2000).

Credits are the dominant products for most MFIs. Moussa(2007) found out that the major impediment to outreach is the legal requirement for NGOs to have all cheques for loan disbursements signed by the chairman of the board (or a delegate thereof) and the treasurer. As NGOs continue to expand, the volume of transactions will increase significantly, and unless more appropriate procedures are instituted, delays in processing loans will become inordinate. To address this issue, the MFIs asked for a revision of the Executive Regulations of the NGO law to also give an MFI's Executive Director or the Microfinance Activity Manager authority to endorse checks in order to speed the process of loan disbursement.

Many development NGOs have gained further power by expanding the scope of their financial transactions and taking over various profit-making economic enterprises. Bangladesh NGOs are now involved in such business contracts and profit making enterprises. For example, BRAC ventured into printing presses, cold storage, garment manufacturing, retail outlets, and milk products (Daily Star, 1999). Similarly, Grameen Bank and Proshika are now into businesses such as banking, garments, shopping complexes, telephone systems, transport services, cold storage, fisheries projects, fertilizers, deep-tubewells, and biotechnology (GBSG, 2000). Such extensive business ventures undertaken by these NGOs not only make them financially independent of the government, but also enable them to influence government policies in the relevant economic sectors (Islam, 1999)

B. Policies and Regulation

USAID (1999) proceedings found out that, creating an enabling environment for microfinance includes a regulatory framework that allows banks and MFIs to charge interest rates that cover costs. In Uganda, interest rates were liberalized in 1994 and as a result, the microfinance industry has bloomed in recent years. In South Africa, however, the Usury Act has established an interest rate ceiling that has hampered the indigenous microfinance industry. The Usury Act was enacted in South Africa in 1968 with the claimed objective of protecting the poor from being exploited. By capping interest rates, however, the Act had limited credit access for the poor by making it practically impossible for lenders to recover the costs of making micro loans. As a result, the poor have been forced into the informal financial market or into commercial credit where the retailer can be compensated for real costs, and where the consumers will pay a higher price for credit.

A significant step in the development of the microfinance industry in Kenya was the enactment of the Microfinance Act in December 2006. The introduction was meant to enhance the performance of this sector by putting in place the necessary laws and regulatory framework for the establishment, licensing and supervision of deposit-taking microfinance institutions, focused on providing services and products to low income households and enterprises. The overriding rationale for microfinance regulation and supervision was to create an enabling environment that will promote the performance and sustainability of deposit taking microfinance institutions, while at the same time protecting depositor's interests. The Act envisages two tiers of microfinance institutions, i.e. nationwide microfinance institutions whose minimum core capital is prescribed at Ksh 60 million, and community microfinance institutions with a minimum core capital of Ksh 20 million (CBK, 2007).

Rhynne (2002) in a study in a number of institutions involved were overwhelmingly pleased to be regulated. All report that the benefits of being regulated outweigh the costs. None would even begin to contemplate reverting to their NGO status. This message is highly significant. It means that even when debates over specifics of regulation become heated, the underlying fundamentals are there. The process of becoming regulated has brought microfinance institutions the benefits of; greater access to sources of funds for both equity and debt, especially commercial sources, ability to achieve growth and quantitative outreach goals to serve more people, improved and more professional operations through meeting higher standards of control and reporting, greater ability to offer products beyond microcredit, especially savings and transfers as well as enhanced legitimacy in the financial sector and with clients

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

Microfinance today seems to find itself in the midst of a rush to regulate. There is no shortage of people willing to offer views on when and how to do it. But all of them, including the research authors, suffer from the same handicap: experimentation with microfinance supervision whereas the subject is so recent that we can't rely much on its historical results to guide us. The problems of bank supervisors in poor countries may not sound like a "visionary" place to start. The most carefully conceived regulations will be useless, or worse, if they can't be enforced by effective supervision. If a

bank supervisor displays resistance to adding MFIs—mostly small, mostly new, mostly weak on profitability—to her basket of responsibilities, we should recognize that her reasons may be nobler than narrow-mindedness or lack of concern for the poor (Christen and Richard Rosenberg, 1999). In Kenya, like in many other countries, approaches to the regulation of MFIs are complicated by the fact that many institutions are involved in providing microfinance services under different legal structures. This presents a challenge in identifying an appropriate regulatory approach, which is conducive to the development of the sector while providing adequate flexibility to microfinance activities (Omino, 2005).

C. Knowledge and Understanding

The Government of Kenya recognizes that greater access to, and sustainable flow of financial services, particularly credit, to the low-income households and MSEs is critical to poverty alleviation. An appropriate policy, legal and regulatory framework to promote a viable and sustainable system of microfinance in Kenya has been developed via the proposed Deposit Taking Micro Finance Bill. In drafting the Bill, the Government consulted with stakeholders to get their views on the best way to create the required enabling environment for the microfinance sub-sector. In addition, full-fledged microfinance units have been established in the Ministry of Finance (the Treasury) and the Central Bank of Kenya to formulate policies and procedures to address the challenges facing microfinance institutions, especially in the rural areas, and to build a database to facilitate better regulation and monitoring of their operations (Omino, G. 2005)

According to the MFI prudential regulations, Micro-Finance Institutions (MFIs) will always be required to maintain a liquidity ratio of 20 per cent of all their liabilities. On the other hand, MFIs with offices throughout the country will be required to have a capital base of KE60 million while those confined to a community will have KE20 million (Central Bank of Kenya, 2007). On the sale shares owned by the deposit-taking MFI, not more than 10 per cent of the shares will be allowed unless with approval of CBK. One aspect which that is also critical from in proposed regulations is the provision for external auditing of the deposit-taking MFIs. The auditors will be required to communicate any evidence of any noted irregularities or illegal acts by any officer of the institution. On share acquisition, the proposal go forward by proposing that deposit-taking micro-finance are expected to seek the approval of the Finance minister for any acquisition of more than 25 per cent of their shares(CBK,2007)

Additionally, under the guidelines, deposit-taking MFIs from time to time will be required to make disclosures like those currently provided to banks. Loans will be classified as normal, under watch, sub-standard doubtful and loss depending on the anticipated level of default. The provisions for bad debts attached to the five categories are one per cent, five per cent, twenty five per cent, fifty percent, seventy five percent and one hundred percent. The regulations also forbid MFIs from offering certain financial services such as issuing of third party cheques, operating current accounts, foreign exchange trading, investing in enterprise capital, wholesale or retail trade, underwriting or placement of shares as well as acquisition of land and building except as is necessary for carrying out business.

It is worth noting that staff involved in MFI regulation just like in any other discipline should have professional understanding and experience in microfinance. The set of skills required of staff will change as NGOs transform into regulated financial institutions. Whether the organization chooses to hire additional bankers, re-train its existing staff, or to apply a combination of the two, MFIs need to be aware of the significant amount of time and money required (Campion and White 1999)

Wa Kimotho (2007) argues that full knowledge and understanding of operations and regulation of microfinance banks that fall under central banks, is not a core competence of the Central Bank in any country. Acquiring and gaining such knowledge and understanding is a slow process, takes much effort and it often has a steep learning curve. Therefore, systematic, strategic, well co-ordinated and focused capacity building programmes must be put in place, at the earliest time, to close any skill gaps noted and the efforts continue to be maintained to ensure measurable results. Coordinated donor support, understanding and goodwill are essential and key to the success of these programmes. Such programmes would enable all the institutions engaged in microfinance activities, to achieve wide outreach within a minimum period and without sacrificing the portfolio quality. These programmes would, also, enable the CBK staff to regulate and supervise these new institutions with efficiency and confidence.

Microfinance institutions are likely to continue to have owners and managers who do not fit standard expectations. They do not, however, automatically fail the “fit and proper” test, as many bring compensating factors to the table, in terms of specialized knowledge, deep long-term commitment, reputation risk, etc. This is an area where flexibility is appropriate, and as regulators become more familiar with the microfinance sector, they are likely to become more comfortable making judgments about the suitability of individual players (Rhyne, 2002).

V. FINDINGS

The research utilized descriptive design where a population of micro-finance institutions was asked the same questions in order to eliminate the biasness that could arise from the characteristics of the elements under study. The total sample population comprised 60 micro finance institutions distributed all over Kenya, with most of them having their head offices in Nairobi. Questionnaires were distributed to 33 institutions under the umbrella institution of Association of Micro Finance Institutions (AMFI). 25 respondents were received. The questionnaires were analyzed using descriptive tools and presented using tables and charts.

The study revealed that majority of respondents accounting to 60% of the respondent institutions had been in existence for more 15 years thus should have a higher outreach by now, the research found out that; only 12% of the respondents had a branch distribution in all the 8 provinces, majority accounting to 52% of the respondent institutions had a low clientele level of between 20,001-50,000 clients. While majority of the respondents institutions accounting to 32% had a main goal to alleviate poverty they were still charging higher interest rates and thus were raising funds through transaction fees and interest on loans. Limited financial support plays a role in making most MFI unable to meet their objectives.

The study indicates that most respondent institutions accounting to 56% are registered limited companies by guarantee. This finding indicates that most microfinance institutions have not enough funding to enable sustainability and have a wider outreach as expected. It is worth noting that the registration outlined above has played a substantial role in the MFI operation. In terms of ownership, 48% of the respondents believed that the registration had a moderate impact on the operation of MFI. When asked about the role of AMFI and government in regard to the institutions supporting MFI on policy and regulation, most respondents indicated that the two institutions had done a fair work. On the respondents that indicated that the government and AMFI had done a "good" support, 48% indicated AMFI and 12% indicated government.

Global bodies have done a magnificent role in helping MFI institutions acquire knowledge and skills on current prudential guidelines. This accounted to 48% of the respondents. It is unfortunate to note that universities, seminars and research bodies have played a minimal or no role in supporting MFI institutions to acquire knowledge and skills in the prudential guidelines. There is need therefore for the research institutions and universities to work hand in hand to support MFIs understand the prudential guidelines. MFIs have also done constructive efforts to ensure the knowledge and skills acquired are utilized to produce quality results. 64% of respondents indicated that continuous assessment was an effective tool to impart and assess the acquired knowledge and skills in prudential guidelines. It is inopportune to note that professional exam, internal examination and external audit which could play a bigger role in assessing the quality of knowledge and skills had actually nil respondents.

When asked about the areas the prudential guidelines address the current challenges faced by MFI, all the areas had a high response of "NO" by the respondents. Most respondents believed that the areas outlined on licensing, corporate governance, internal audits, prohibited business, capital adequacy, liquidity management etc were not satisfactorily addressing their challenges. It is also unfortunate to note that some respondents actually indicated "I don't know" on various aspects such as; licensing, capital adequacy, liquidity management and appointment of directors. With such a background, it clearly indicates that some MFI have not taken the guidelines as a critical tool for their sustainability and outreach.

VI. CONCLUSION

The purpose of this research was to identify whether the absence of a regulatory framework has had any effect on the outreach and sustainability of microfinance in Kenya. The following are the major conclusions based on the findings and discussions.

From the study, it can be concluded that, lack of a regulatory framework has been a major hindrance to outreach and sustainability of MFIs in Kenya. Other factors that have played a bigger role in making MFIs not able to attain sustainability are lack of product diversification, poor customer service and organizational culture. Another factor that was found critical is absence of donor funds and soft loans. Such challenges have made MFIs only be able to concentrate on major cities rather than concentrate in rural areas where a majority of the local communities live. Additionally, Microfinance institutions in Kenya are currently registered under different Acts of Parliament, it worth noting that this diverse legislation has had minimal impact on the operation of MFIs. Issues of governance, ownership, MFI image and accountability are still a challenge to many MFIs. It therefore calls for a standardized regulatory that will apply across all the micro finance institutions in order to streamline the already messy environment.

Most MFIs aren't conversant with the contents of the CBK prudential guidelines. The current tools that are in place to disseminate information on prudential guidelines are not effective. Research bodies and universities which are key in knowledge exploration and imparting have played rear stand on contributing and supporting this crucial sector of the economy. There should be collaboration between MFI management, Universities, Research institutions, AMFI and the government to ensure that the MFIs are taught the need as well as the various aspects of the prudential guidelines.

Through capacity building, MFI should develop collaborations through AMFI which they can relook at their current policy and regulatory environment. They should understand that since the current regulatory environment has played an insignificant role in enhancing their operations, there is need to look at the loopholes in the current regulations and try to harmonize with the prudential on deposit-taking MFI prudential CBK guidelines. There is need also to develop and implement an integrated regulatory environment that will encompass both deposit-taking and non-deposit taking MFI. This was noted especially on non-deposit taking MFI and only a few of the ones interviewed have made progress by accepting deposits. Clear policies should be put in place to cater for both deposit and non-deposit taking MFIs to enable them acquire a competitive edge as well as curb against collapse of such institutions. MFI should increase their client base to ensure outreach and sustainability. Such measures should include use of innovative measures through application of technology to be able to reach the rural areas, improve customer services and aggressively put in place measures that ensure customer retention

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