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## THE TRANSITION FROM MICRO-FINANCING INTO FORMAL BANKING AMONG THE MICRO FINANCE INSTITUTIONS IN KENYA

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### **Abstract**

*The main objective of the study was to establish the factors influencing in the transformation from micro financing to formal banking in Kenya. The research used a survey strategy, simple random sampling in finding the number of schools, and simple stratified sampling in finding the respondents. Questionnaire and interviews were used to collect data from the respondents and out of the fifty managers (50) who were sampled, fourthly nine (49) of them responded, giving a response rate of ninety eight (98) percent. Firstly, it was found that a number of measures can be taken in order to transform from micro financing to formal banking. Secondly, there are many measures that can be undertaken in order to transform from micro financing to formal banking. The key factors are: increasing customer base; improving the quality of service; changing the IT in the organization; improving the turn around a round in loan application; customer segmentation and change of measures in giving loans. Thirdly, the factors to a very great extent that have facilitated the MFI's (which are now on the formal banking business) in the transformation efforts to formal banking include: a sound customer care desk; the MFI's ability to optimize business volume; understanding organizations exposure to customers; operating through efficient systems and processes; minimizing losses when loans go bad; and lastly, effective balancing of high and low risk business. Lastly, the serious challenges facing/ inhibiting factors MFIs facing the transformation from micro financing to formal banking are: strict rules from the Central Bank; high costs of operation; no proper government policy on MFIs; unscrupulous MFI's spoiling the reputation of the industry; and the inability to deliver services to poor or remote populations. Further analysis using factor analysis broke the factors into five components: inadequate regulatory and loan management systems, rivalry and competition in the industry, poor customer care, high operation cost to central banks cost levies and unscrupulous nature of MFI's.*

**Keywords:** *Transition, Micro-Financing, Formal banking, Micro Financial Institutions*

### **1. Introduction**

#### **1.1 General Background**

Financial services have witnessed a significant change in their market in the 21<sup>st</sup> century especially following deregulation of their operation; they diversified in to new areas such as estate agency and unsecured lending. It has long been accepted that the development of a healthy national financial system is an important goal and catalyst for the broader goal of national economic development. In Nations with lower population densities meeting the operating costs of retail branch by serving nearby customers have proven considerably more challenging. Although much progress has

been made, the problem has not been solved yet yet, and the overwhelming majority of people who earn less than SI a day, especially in the rural areas, continue to have no practical access to formal sector finance. Microfinance has been growing rapidly with S25B currently at work in micro finance loans (Deutsche Bank, 2007).

Theoretically, microfinance may encompass any efforts to increase access to, or improve the quality of, financial services poor people currently use or could benefit from using. For example, poor people borrow from informal moneylenders and save with informal collectors. They receive loans and grants from charities. They buy

insurance from state-owned companies. They receive funds transfers through remittance networks.

Traditionally, banks have not provided financial services to clients with little or no cash income. Banks must incur substantial costs to manage a client account, regardless of how small the sums of money involved. But the fixed cost of processing loans of any size is considerable: assessment of potential borrowers, their repayment prospects and security; administration of outstanding loans, collecting from delinquent borrowers and so on. There is a break-even point in providing loans or deposits below which banks lose money on each transaction they make. In addition, most poor people have few assets that can be secured by a bank as collateral (Hernando de Soto, 1989). It has been suggested that in service industries of this type, where competition can move very quickly and new players can enter easily, there is a constant need to think strategically about what is going on (Schmenner, 1995).

The microcredit era that began in the 1970s has lost its momentum, to be replaced by a 'financial systems' approach. While microcredit achieved a great deal, especially in urban and near-urban areas and with entrepreneurial families, its progress in delivering financial services in less densely populated rural areas has been slow. The new financial systems approach pragmatically acknowledges the richness of centuries of microfinance history and the immense diversity of institutions serving poor people in developing world today. It is also rooted in an increasing awareness of diversity of the financial service needs of the world's poorest people, and the diverse settings in which they live and work. Brigit (2006) in her book 'Access for All: Building Inclusive Financial Systems', distinguishes between four general categories of microfinance providers, and argues for a pro-active strategy of engagement with all of them to help them achieve the goals of the microfinance movement.

**Informal financial service providers:** These include moneylenders, pawnbrokers, savings collectors, money-guards, ROSCAs, ASCAs and input supply shops. Because they know each other well and live in the same community, they understand each other's financial circumstances and can offer very flexible, convenient and fast services. These services can also be costly and the choice of financial products limited and very short-term. Informal services that involve savings are also risky; many people lose their money.

These include self-help groups, credit unions, and a variety of hybrid organizations like 'financial service associations' and CVECAs. Like their informal cousins, they are generally small and local, which means they have access to good knowledge about each others' financial circumstances and can offer convenience and flexibility. Since they are managed by poor people, their costs of operation are low. However, these providers may have little financial skill and can run into trouble when the economy turns down or their operations become too complex. Unless they are effectively regulated and supervised, they can be 'captured' by one or two influential leaders, and the members can lose their money.

**NGOs:** The Microcredit Summit Campaign counted 3,316 of these MFIs and NGOs lending to about 133 million clients by the end of 2006 (Deutsche Bank research, 2007). Led by Grameen Bank and BRAC in Bangladesh, Prodem in Bolivia, and FINCA International, headquartered in Washington, DC, these NGOs have spread around the developing world in the past three decades; others, like the Gamelan Council, address larger regions. They have proven very innovative, pioneering banking techniques like solidarity lending, village banking and mobile banking that have overcome barriers to serving poor populations. However, with boards that don't necessarily represent either their capital or their customers, their governance structures can be fragile, and they can become overly dependent on external donors.

**Formal financial institutions:** In addition to commercial banks, these include state banks, agricultural development banks, savings banks, rural banks and non-bank financial institutions. They are regulated and supervised, offer a wider range of financial services, and control a branch network that can extend across the country and internationally. However, they have proved reluctant to adopt social missions, and due to their high costs of operation, often can't deliver services to poor or remote populations. The increasing use of alternative data in credit scoring, such as trade credit is increasing commercial banks' interest in microfinance (Robert, Richard & Veena, 2007).

Banks act as payment agents by conducting checking or current accounts for customers, paying cheques drawn by customers on the bank, and collecting cheques deposited to customers' current accounts. Banks also enable customer payments via other payment methods such as telegraphic transfer, EFTPOS, and ATM. Banks borrow money by accepting funds deposited on current accounts, by accepting term deposits, and by issuing debt securities such as banknotes and bonds. Banks lend money by making advances to customers on current accounts, by making installment loans, and by investing in marketable debt securities and other forms of money lending.

Banks provide almost all payment services, and a bank account is considered indispensable by most businesses, individuals and governments. Non-banks that provide payment services such as remittance companies are not

normally considered an adequate substitute for having a bank account. Banks borrow most funds from households and non-financial businesses, and lend most funds to households and non-financial businesses, but non-bank lenders provide a significant and in many cases adequate substitute for bank loans, and money market funds, cash management trusts and other non-bank financial institutions in many cases provide an adequate substitute to banks for lending savings to.

With appropriate regulation and supervision, each of these institutional types can bring leverage to solving the microfinance problem. For example, efforts are being made to link self-help groups to commercial banks, to network member-owned organizations together to achieve economies of scale and scope, and to support efforts by commercial banks to 'down-scale' by integrating mobile banking and e-payment technologies into their extensive branch networks.

### 1.2 The Concept of Micro Financing

Modern micro finance emerged in late 1970s with a strong orientation towards private-sector solutions. This resulted from evidence that state-owned agricultural development banks in the developing countries had been a monumental failure, actually undermining the development goals they were intended to serve (Adams et al., 1984). Nevertheless public officials in many countries hold a different view, and continue to intervene in microfinance markets.

Micro finance refers to the provision of financial services to low-income clients, including consumers and the self-employed. (Ledgerwood, 2000) The term also refers to the practice of sustainably delivering those services. Microcredit (or loans to poor microenterprises) should not be confused with microfinance, which addresses a full range of banking needs for poor people (Ledgerwood, 2000).

More broadly, it refers to a movement that envisions "a world in which as many poor and near poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance, and fund transfers." (Robert, Richard and Jayadeva, 2004). Those who promote microfinance generally believe that such access will help poor people out of poverty. Microfinance can also be distinguished from charity. It is better to provide grants to families who are destitute, or so poor they are unlikely to be able to generate the cash flow required to repay a loan. This situation can occur, in a war zone or after a natural disaster.

Some principles that summarise a century and a half of development practice were encapsulated in 2004 by Consultative Group to Assist the Poor (CGAP) and endorsed by the Group of Eight leaders at the G8 Summit on June 10, 2004 (Helms, 2006): Poor people need not just loans but also savings, insurance and money transfer services. Microfinance must be useful to poor households: helping them raise income, build up assets and/or cushion themselves against external shocks. "Microfinance can pay for itself." (Ledgerwood, 2000) Subsidies from donors and government are scarce and uncertain, and so to reach large numbers of poor people, microfinance must pay for itself

Micro finance means building permanent local institutions. Micro finance also means integrating the financial needs of poor people into a country's mainstream financial system. "The job of government is to enable financial services, not to provide them." "Donor funds should complement private capital, not compete with it." "The key bottleneck is the shortage of strong institutions and managers." (Ledgerwood, 2000). Donors should focus on capacity building. Interest rate ceilings hurt poor people by preventing micro finance institutions from covering their costs, which chokes off the supply of credit. Micro finance institutions should measure and disclose their performance, both financially and socially.

No systematic effort to map the distribution of microfinance has yet been undertaken. A useful recent benchmark was established by an analysis of 'alternative financial institutions' in the developing world in 2004 (Robert, Richard & Veena, 2004). The authors counted approximately 665 million client accounts at over 3,000 institutions that are serving people who are poorer than those served by the commercial banks. Of these accounts, 120 million were with institutions normally understood to practice microfinance. Reflecting the diverse historical roots of the movement, however, they also included postal savings banks (318 million accounts), state agricultural and development banks (172 million accounts), financial cooperatives and credit unions (35 million accounts) and specialized rural banks (19 million accounts).

Wright (2000) and others contend that, as MFIs seek their own self-sustainability, they are focusing on existing small- and medium-scale businesses and are increasingly excluding the key constituents they ought to be reaching, namely, severely undercapitalized businesses, new and start-up businesses, businesses with slow and/or irregular turnover, fragmented societies, and risk-averse poor people who are skeptical of debt. They argue that the traditional 'Grameen-style' MFIs need to move away from the 'microenterprise era' and enter the 'micro financial services era', where emphasis is put not simply on providing credit on inflexible terms but rather on providing savings as well as insurance facilities. Microfinance practitioners must embrace the need to supply the poor with a variety of financial services and not fear the perceived 'complexity' of providing a mix of financial services for the poorest.

### 1.2.1 The Concept of Formal Banking

A bank is a financial institution licensed by a government. Its primary activities include borrowing and lending money. Many other financial activities were allowed over time. For example banks are important players in financial markets and offer financial services such as investment funds. In some countries such as Germany, banks have historically owned major stakes in industrial corporations while in other countries such as the United States banks are prohibited from owning non-financial companies. In Japan, banks are usually the nexus of a cross-share holding entity known as the zaibatsu. In France, bank assurance is prevalent, as most banks offer insurance services (and now real estate services) to their clients (George, 2000).

The level of government regulation of the banking industry varies widely, with countries such as Iceland, the United Kingdom and the United States having relatively light regulation of the banking sector, and countries such as China having relatively heavier regulation (including stricter regulations regarding the level of reserves) Banks borrow most funds from households and non-financial businesses, and lend most funds to households and non-financial businesses, but non-bank lenders provide a significant and in many cases adequate substitute for bank loans, and money market funds, cash management trusts and other non-bank financial institutions in many cases provide an adequate substitute to banks for lending savings to (Matyszak, 2007).

### 1.2.1 Factors That Influence the Transition from Micro Financing To Formal Banking

Most of the factors are regulatory and policy implications in the microfinance operations in a country. The evolving microfinance agenda has significant implications for regulatory and supervisory policy with respect to licensing requirements, monitoring for unsafe and unsound practices and the orderly existence of financially distressed MFIs. During the government-led subsidised agricultural credit era, the majority of institutions were created through parliamentary legislation that was independent of financial sector legislation. Their entry into the financial sector was determined by political decisions and, once in operation, they were subject to little or no supervision.

During the microenterprise era of 1980-96, the institutions providing the poor with financial services were primarily registered as non-governmental organisations and again not subject to financial regulation or supervision

by the central bank or other competent organisation. Moreover, with the financial crises of the 1980s and early 1990s, the limited regulatory resources available to most developing economies were directed towards reforms in the banking and financial sectors. However, with the emergence of the micro financial services era when the provision of deposit-taking facilities was seen as key to achieving self-sustainability, microfinance began to attract regulatory concern. Towards the end of the 1990s, a plethora of microfinance regulation literature followed (Berenbach and Churchill, 1997; Rock and Otero, 1997; McGuire et al., 1998; Greuning et al., 1999).

To this end, there is no proper demonstration on the enabling and inhibiting factors in the rapid transition and development from micro financing to formal banking among micro finance institutions.

### 1.3 The Structure of the Kenya Microfinance Industry and Institutions

According Omino (2005) microfinance is the provisions of financial services to the low-income households and micro and small enterprises (MSEs) provide an enormous potential to support the economic activities of the poor and thus contribute to poverty alleviation. Widespread experiences and research have shown the importance of savings and credit facilities for the poor and MSHs. This puts emphasis on the sound development of microfinance institutions as vital ingredients for investment, employment and economic growth. The potential of using institutional credit and other financial services for poverty alleviation in Kenya is quite significant. . Despite this important contribution, only 10.4% of the MSEs receive credit and other financial services.

In spite of the importance of this sector, the provision and delivery of credit and other financial services to the sector by formal financial institutions, such as commercial banks has been below expectation. This means that it is difficult for the poor to climb out of poverty due to lack of finance for their productive activities. Therefore, new, innovative, and pro-poor modes of financing low-income households based on sound operating "principles have been developed. About 8 million people, or 60% of the population, are poor and mostly out of the scope of formal banking services. The formal banking sector in Kenya over the years has regarded the informal sector as risky and not commercially viable (Omino, 2005).

In the past, microfinance institutions (MFIs) established using either an NGO or a savings and credit co-operative societies framework have been important sources of credit for a large number of low income households and MSEs in the rural and urban areas of Kenya. The MFIs have, however, operated without an appropriate policy and legal framework. There is therefore need to focus more on these institutions to enhance their effectiveness in the provision of savings, credit and other financial services to the poor and MFIs (Omino, 2005).

Over 100 organizations, including about 50 NGOs, practice some form of micro finance business in Kenya.

About 20 of the NGOs practice pure micro financing, while the rest practice micro financing alongside social welfare activities. Major players in the sector include Faulu Kenya, Kenya Women Finance Trust (KWFT), Pride Ltd. Wedco Ltd, Small and Medium Enterprise Programme (SMEP). Kenya Small Traders and Entrepreneurs Society (KSTES), Ecumenical Loans Fund (ECLOF) and Vintage Management (Jitegeme Trust). The Kenya Post Office Savings Bank (KPSOB) is also a major player in the sector but only to the extent of providing savings and money transfer facilities. Many microfinance NGOs have successfully replicated the Grameen Bank method of delivering financial services to the low-income households and MSEs,

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. Therefore, an appropriate policy, legal and regulatory framework to promote a viable and sustainable system of microfinance in the country has been developed via the Deposit Taking Micro Finance which has since been enacted. In enacting the Bill into law, the Government had 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 ([www.treasury.go.ke/](http://www.treasury.go.ke/)). This bill has seen some microfinance institutions transform to formal banking, for example Equity bank and Family Finance Bank while others have tried to make a move in vain.

#### 1.4 Statement of the Problem

Micro finance, defined as efforts to improve poor people's access to loans and savings services – may be the fastest growing and most widely recognized anti-poverty tool. The theme of wider implications of micro finance institutions' interventions is a relatively uncharted territory, though the term is alluded to quite frequently. The interest in this theme has emerged out of a number of motivations, the most important among them being a view that the total impact of micro finance intervention is being underestimated through conventional impact studies, which do not take into account the possible positive externalities on spheres beyond households and the subsequent feedback effects on both participant

and non-participant households (Sajjad and Imran, 2004).

The micro finance sector in Kenya has faced a number of constraints that need to be addressed to enable them to improve outreach and sustainability. The major impediment to the development of micro finance business in Kenya is lack of specific legislation and set of regulations to guide the operations of the micro finance sub-sector. Micro finance institutions in Kenya are registered under eight different Acts of Parliament namely: The Non Governmental Organizations 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 (KPSOB) 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 ([www.treasury.go.ke](http://www.treasury.go.ke)).

This has had a bearing on a number of other constraints faced by the industry, namely: diversity in institutional form, inadequate governance and management capacity, limited outreach, unhealthy competition, limited access to funds, unfavorable image and lack of performance standard. The lack of oversight, however, has enabled them to innovate and develop different techniques of providing micro finance services ([www.treasury.go.ke](http://www.treasury.go.ke)).

Therefore, to stimulate the development of the sector, some appropriate laws, regulations and supervision framework have been put in place, especially the enactment of a micro finance legislation that clearly defines the roles to be played by the Government, the Central Bank of Kenya, and the micro finance practitioners, which is now the Deposit Taking Micro Finance Bill ([www.treasury.go.ke](http://www.treasury.go.ke)). This is expected to lead to quality growth, broaden the funding base to MFIs eligible to mobilize and administer deposits, credit facilities, other financial services, and initiate the process of integrating these institutions into the formal financial system. Deposit taking involves a potential risk of loss depending on how the deposits are employed. There are also a number of techniques and sensitivities associated with deposit taking that would justify external regulation and supervision. These include convenience to depositors in terms of location and premises and provision of qualitative and physical security of deposits including insurance of deposits. Others include adequate liquidity, as depositors should be able to withdraw without subjecting the MFIs to solvency risks: attainment of acceptable rates of returns since MFIs expect good returns.

The Deposit Taking Micro Finance Bill aimed at ensuring that licensed MFIs contribute to poverty alleviation and at the same time comply with the requirements of financial sector safety and soundness. The MFIs to be regulated under this Bill shall provide savings, credit, and other financial services to MSEs and to low-income households in both rural and urban areas. To date, several micro finance institutions have made it

successfully to formal banking, while majority are still in micro financing. Interesting cases include new entrants into micro financing like Equity Bank and KPSOB moving to formal banking, leaving the veterans in microfinance like Faulu stagnating in micro finance. It was against this background that the study intends to document enabling and inhibiting factors in the rapid transition and development from micro financing to formal banking among micro finance institutions in Kenya.

A number of studies have been done on microfinance institutions, have been carried out by Coleman (1999), Hulme and Mosley (1996), Khandker (1998), and Morduch (1998). The study of Hulme and Mosley (1996) is significant in part because of its sheer magnitude: it comprehensively analyses eight microfinance institutions on three continents, generally finding a strong and significant impact on borrowers with access to microfinance relative to control groups who do not. Interestingly, Hulme and Mosley find borrower impact to be stronger for institutions with greater levels of self-sufficiency. In contrast, however, Coleman (1999), using a carefully designed survey technique that controls for selection bias, finds little significant impact of credit access based on data obtained in Northern Thailand.

This study therefore sought to document enabling and inhibiting factors in the rapid transition and development from micro financing to formal banking among micro finance institutions in Kenya.

## 2.0 Research Strategy

This study was a descriptive survey study on the factors that influence the transition and development from micro-financing to formal banking, particularly the micro finance institutions in Kenya. This enabled the researcher to document the enabling and inhibiting factors in the rapid transition and development from micro financing to formal banking among micro finance institutions in Kenya.

The study covered only microfinance institutions in Kenya, and not any other finance agency or Bank in Kenya. Consequently, this research adopted an interpretive methodology (Russell, 1996) in an iterative fashion (Hoque et al., 2004), where the researcher conducts both a reflective analysis (Bryman, 2001) with an initial problem focus and then observes what other issues duly emerge. This enabled the researcher build up interpretations from the direct experience, perceptions, and beliefs of participants.

The researcher entered the field to study microfinance in action by focusing on chief executive officers in banks and operation/finance managers as its key practitioners. A total of fifty-one (51) currently operating in Kenya were focused on (See Appendix II). The field study will be based on intensive qualitative research, complemented by the researcher's "indigenous knowledge", and extensive prior local field experience. However, the researcher did not guarantee open access at both corporate and branch level, as even the introductory letter to the branch managers from the Head office in most cases request that, while they should facilitate the research programme, "normal" operations must not be disrupted.

The study was comprised of a total of 40 managers from the microfinance institutions and 4 from those banks that were initially operating as micro finance institutions. A total sample size of 50 micro financial institutions was taken from the population. Rosco (1975) proposes a rule of the thumb for determining a sample size and says that a size of 30 to 500 is appropriate for most researches. This sample is considered large enough to provide a general view of the entire population and serve as a good basis for valid and reliable conclusions. Simple random sampling will be used to select the organizations/individuals to participate in the study.

This study relied on both primary and secondary data. Primary data focused on the enabling and inhibiting factors in the rapid transition and development from micro financing to formal banking. Primary data was collected using questionnaires (See Appendix D). The questionnaire contains structured and semi-structured questions. Secondary data will be on the progress made by micro finance institutions toward formal banking operations. Comparative data was also be collected in the following four key areas: lending success levels; debt figures; efficiency/cost figures. The questionnaires are divided into the following sections: Section A: Respondent's profile; Section B: enabling factors in the rapid transition and development from micro financing to formal banking; Section C: inhibiting factors in the rapid transition and development from micro financing to formal banking. All respondents are to answer part A - C. The questionnaires was administered on a drop and pick later basis.

The process of data analysis involved several stages. Completed questionnaires were edited for completeness and consistency. The data was then be coded and checked for any errors and omissions (Kothari, 1990). The responses from the open-ended questions were listed to obtain proportions appropriately; descriptive analysis, that is, the descriptive mean and standard deviation will be used for likert-scale responses. The closed questions, a comparative analysis using distribution tables, quantiles (percentiles) and graphical analysis has been done to improve the presentation of the analyzed results for ease of interpretation. The data was analyzed using procedures within Statistical Package for Social Sciences (SPSS) and Factor analysis technique.

### 3.0 Data Analysis, Findings and Discussions

#### 3.1 Background Information

This section covers data analysis and findings of the research. The respondents to this study were the managers of microfinance institutions and out of the fifty managers (50) who were sampled, forty nine (49) of them responded, giving a response rate of ninety eight (98) percent. Micro Finance Institutions can be owned by locals, foreigners, or both. This is because some of them act like NGOs. From the research data, majority of the institutions are locally owned, that is the ones that are predominantly local (51% or more) and the ones that balance between foreign and local (50/50). This is an implication that the institutions are out to support local entrepreneurs hence a good enabling environment for transformation from micro financing to formal banking.

The number of years in operation can influence an institutions experience in business operations and growth strategy. The branch network can also be motivated by the customer base and performance of the micro finance institution towards formal banking. The respondents were asked to indicate the lengthy of time they have been in operation, number of branches they have been in Kenya and the customer base by ticking the appropriate categories. From the research data, most micro finance 57% have been operation for 10-20 years, a clear indication that the microfinance organizations that participated have enough experience in business transformation from micro financing to formal banking. It also indicates that the respondents understood the issues under research. Also, most micro finance institutions 71% have a branch network of above 20, while the rest is of 14% has between 5-10, as well as a branch network of between 11 - 20. This is a clear indication that they have been performing well, either financially or with customer base and have high chances of transforming to formal banking.

Although the micro finance institutions have operated in Kenya for a good number of years and an established branch network, from the responses, majority up to 86% have a customer base of more than ten thousands. This might be due to the switching nature of Kenyan customers and the highest rate of people who do not bank they proceeds.

There are many measures that can be undertaken in order to transform from micro financing to formal banking. The respondents

The microfinance institutions can target different clienteles. The different clienteles behave differently in their ability to take loans and their ability to pay back. The respondents were asked to indicate the market segment served by their institutions. It was found that majority of micro finance institutions; 86 % are serving both business and personal/individual clientele. This is an indication that they have a high potential of transforming from micro financing to formal banking. Hence there is need to establish the factors influencing in the transformation from micro financing to formal banking in Kenya as in the next subsection.

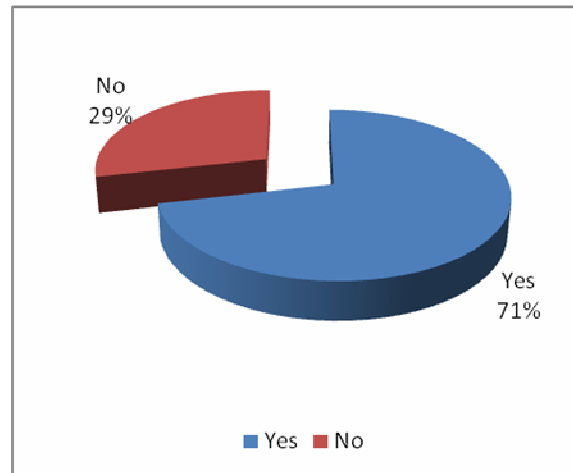
#### 3.2 The Factors Influencing In the Transformation from Micro Financing To Formal Banking in Kenya

The transformation from micro financing to formal banking can be influenced by an umber of factors. Some factors can be seen as measures taken in order to facilitate quick transformation as others are seen as inhibitors. Below is the discussion on the factors:

##### 3.2.1 Measures Taken To Transform From Micro Financing To Formal Banking

A number of measures can be taken in order to transform from micro financing to formal banking. The respondents were first asked to indicate whether their institutions have invested time and effort in order to transform from micro financing to formal banking in Kenya, and the results are as in Figure 3.1 below.

Figure 3.1: Time and Effort to Transformation



Source: Research Data

From the results in figure 3.1, 71% of the institutions sampled have invested time and effort in order to transform from micro financing to formal banking in Kenya. This means that the microfinance institutions are very conscious time and effort in order to transform from micro financing to formal banking in Kenya.

we asked to indicate some the measures as in table 3.1 below.

**Table 3:1 Measures Are Being Undertaken To Transform To Formal Banking**

Measures	Descriptive	
	Mean	Std. Deviation
Increasing customer base	1.0000	.00000
Improving the quality of service	1.0000	.00000
Changing the IT in the organization	1.0000	.00000
Improving the turn around around in loan application	1.0000	.00000
Customer segmentation	1.5000	.51887
Change of measures in giving loans	1.5000	.51887

Source: Research Data

From the research data on table 3.1, the key factors that to a very great extent (Mean 1) have been undertaken in order to transform from micro financing to formal banking are: increasing customer base; improving the quality of service; changing the IT in the organization; improving the turn around a round in loan application; customer segmentation and change of measures in giving loans. This is an indication that all the key measures surrounding the transform from micro financing to formal banking are covered and put into consideration by micro finance institutions.

The respondents were asked to indicate factors that have facilitated the MFI's which are now on the formal banking business in the transformation efforts to formal banking. This was on a scale of 1-5, in which; 1- To a very large extent; 2- To a large extent; 3- To some Extent; 4- To a small extent; and 5- To no extent. The results are as in table 3.2 below:

**Table 3:2 Factors Facilitating MFI's Efforts in the Transformation**

Factors	Descriptive	
	Mean	Std. Deviation
A sound customer care desk	1.0000	.00000
The MFI's ability to optimize business volume	1.6000	.49705
Understanding organizations exposure to customers	1.6000	1.21752
Operating through efficient systems and processes	1.8000	.75926
Minimizing losses	2.0000	1.57181

when loans go bad		
Effective balancing of high and low risk business	2.6000	1.37627

Source: Research Data

From the research data in table 4.7 above, the factors to a very great extent (Mean 1) that have facilitated the MFI's (which are now on the formal banking business) in the transformation efforts to formal banking include: a sound customer care desk; the MFI's ability to optimize business volume; understanding organizations exposure to customers; operating through efficient systems and processes; minimizing losses when loans go bad; and lastly, effective balancing of high and low risk business.

Loans management is a key measure in its own that can influence the growth of micro finance institution. If well managed, the transformation becomes very easy. There are many measures which can be used by MFI to minimize losses when loans go bad. The respondents were asked to indicate the extent to which their micro finance institutions use some measures to minimize losses when loans go bad using a scale of 1-5, in which; 1- To a very large extent; 2- To a large extent; 3- To some Extent; 4- To a small extent; and 5- To no extent. The results are as in table 4.8 below:

**Table3:3 Measures by MFI to Minimize Losses When Loans Go Bad**

Measures	Descriptive	
	Mean	Std. Deviation
By insurance	1.1667	.37720
Proper vetting of customers	1.3333	.47712
Reputation of the company where loans are advanced	1.6667	.75439

Source: Research Data

From the research data on table 3.3, the key measures to a very great extent (Mean 1) which can be used by MFI to minimize losses when loans go bad were found to be: by insurance; proper vetting of customers; and reputation of the company where loans are advanced.

This is indeed the case since the money that is not repaid back for any institution influences the quality of the returns on equity, returns on assets, returns on investments, and the total operating expenses per unit of output, but not necessarily the monetary output per staff, hence no transformation or growth.

**3.2.2 The Inhibiting Factors Facing the Transformation from Micro Financing to Formal Banking**

In a bid to transform form micro financing to formal banking, it is now evident that a successful past for Kenyan micro finance institutions is no guarantee for transformation. It is only three microfinance institutions out of forty four that have fully transformed to formal



banking. The respondents were asked to indicate the extent to which they agreed with some statements concerning the challenges facing their institution's operations in Kenya using a scale of 1-4, (in which: 1 = Strongly Agree, 2 = Agree, 3 = Disagree, 4 = Strongly Disagree) and the responses are seen as in table 3.4 a & b below.

**Table 3.3a The Inhibiting Factors Facing the Transformation from Micro Financing to Formal Banking**

Factors	Descriptive	
	Mean	Std. Dev
Strict rules from the Central Bank	1.2857	.45644
High costs of operation	1.5714	.73598
No proper government policy on MFI's	1.7143	1.04083
Unscrupulous MFI's spoiling the reputation of the industry	1.8571	.64550
Inability to deliver services to poor or remote populations	1.8571	.84163
Stiff competition from other financial institutions	2.1429	1.13652
The regulatory and supervisory policy with respect to orderly existence of financially distress	2.2857	1.17260
Reluctance to adopt social missions	2.2857	1.50000
Poor lending methodologies	2.4286	1.19024
The entry into the financial sector is determined by political decisions	2.4286	1.06066
Inability to operate using ATMs	2.4286	1.06066
The regulatory and supervisory policy with respect to monitoring for unsafe and unsound practices	2.4286	.91287
The regulatory and supervisory policy with respect to licensing requirements	2.4286	1.06066
Difficulty in loan recovery	2.5714	1.19024
Inability to conduct checking or current accounts for customers	2.5714	1.30703
Inability to use telegraphic funds transfer	2.7143	1.04083

Source: Research Data

From the research responses in table 3.3a above, the serious challenges (Mean 1) facing/ inhibiting factors MFIs facing the transformation from micro financing to formal banking are: strict rules from the Central Bank; high costs of operation; no proper government policy on MFI's; unscrupulous MFI's spoiling the reputation of the industry; and the inability to deliver services to poor or remote populations.

The moderate challenges (Mean 2) facing/ inhibiting facing MFIs facing the transformation from micro financing to formal banking are: stiff competition from other financial institutions; the regulatory and supervisory policy with respect to orderly existence of financially distress; reluctance to adopt social missions; poor lending methodologies; the entry into the financial sector is determined by political decisions; inability to operate using ATMs; the regulatory and supervisory policy with respect to monitoring for unsafe and unsound practices; the regulatory and supervisory policy with respect to licensing requirements; difficulty in loan recovery; inability to checking or current accounts for customers; and lastly inability to use telegraphic funds transfer.

The above factors are far too many. Further analysis using factor analysis using Principal Component Analysis to extract the inhibiting factors MFIs facing the transformation from micro financing to formal banking required Varimax with Kaiser Normalization gave a rotation that converged in 16 iterations. The results are as in table 3.3b.

**Table 3.3b: Factors that Influence Adoption of Strategic Human Resource Management Practices (Factor Analysis)**

	Rotated Component Matrix				
	1	2	3	4	5
The regulatory and supervisory policy with respect to monitoring for unsafe and unsound practices	<b>.894</b>	.040	-.204	-.017	-.309
Inability to deliver services to poor or remote populations	<b>.810</b>	-.009	-.567	-.142	.035
No proper government policy on MFI's	<b>.808</b>	.184	-.085	.542	-.083
Difficulty in loan recovery	<b>.801</b>	-.491	-.042	.098	.266
Inability to operate using ATMs	<b>.715</b>	.306	-.125	-.415	.451

The entry into the financial sector is determined by political decisions	.697	.465	-.155	-.516	-.020
Poor lending methodologies	.590	-.316	.639	.374	-.008
The regulatory and supervisory policy with respect to orderly existence of financially distress	.544	.259	.748	-.226	.059
The regulatory and supervisory policy with respect to licensing requirements	.531	.010	-.364	.640	.420
Stiff competition from other financial institutions	.276	.898	.074	.105	.274
Inability to use telegraphic funds transfer	.275	.514	.783	-.141	-.142
Inability to conduct checking or current accounts for customers	-.116	-.672	.092	-.477	.538
Reluctance to adopt social missions	-.284	-.560	.557	.212	.345
High costs of operation	-.291	.874	.112	.217	.241
Strict rules from the Central Bank	-.700	.628	.138	.104	.218
Unscrupulous MFI's spoiling the reputation of the industry	-.753	.290	-.547	.023	.147

Extraction Method: Principal Component Analysis.

a 5 components extracted.

Source: Research Data (2009)

From the research data, factors can be broken into five components. The components factors are: inadequate regulatory and loan management systems, rivalry and competition in the industry, poor customer care, high operation cost to central banks cost levies and unscrupulous nature of MFI's.

<b>Loadings</b>	<b>Factors</b>
-----------------	----------------

The regulatory and supervisory policy with respect to monitoring for unsafe and unsound practices	Rivalry And Competition Inadequate In The Systems Industry
Inability to deliver services to poor or remote populations	
No proper government policy on MFI's	
Difficulty in loan recovery	
Inability to operate using ATMs	
The entry into the financial sector is determined by political decisions	
Poor lending methodologies	
The regulatory and supervisory policy with respect to orderly existence of financially distress	
The regulatory and supervisory policy with respect to licensing requirements	
Stiff competition from other financial institutions	
Inability to use telegraphic funds transfer	Poor Customer Care
Inability to conduct checking or current accounts for customers	
Reluctance to adopt social missions	High Operation Cost To Central Banks Cost Levies
High costs of operation	
Strict rules from the Central Bank	Unscrupulous Nature of MFI's.
Unscrupulous MFI's spoiling the reputation of the industry	

#### 4.0 Conclusions and Recommendations

##### 4.1 Conclusions

The conclusions of the study are based on the research questions leading to the main purpose of the study. One can safely conclude the following

Firstly, it was found that a number of measures can be taken in order to transform from micro financing to formal banking. It was noted that 71% of the institutions sampled have invested time and effort in order to transform from micro financing to formal banking in Kenya.

Secondly, there are many measures that can be undertaken in order to transform from micro financing to formal banking. The key factors that to a very great extent have been undertaken in order to transform from micro financing to formal banking are: increasing customer base; improving the quality of service;

changing the IT in the organization; improving the turn around a round in loan application; customer segmentation and change of measures in giving loans.

Thirdly, the factors to a very great extent that have facilitated the MFI's (which are now on the formal banking business) in the transformation efforts to formal banking include: a sound customer care desk; the MFI's ability to optimize business volume; understanding organizations exposure to customers; operating through efficient systems and processes; minimizing losses when loans go bad; and lastly, effective balancing of high and low risk business.

Fourthly, loans management is a key measure in its own that can influence the growth of micro finance institution. If well managed, the transformation becomes very easy. There are many measures which can be used by MFI to minimize losses when loans go bad. The key measures to a very great extent which can be used by MFI to minimize losses when loans go bad were found to be: by insurance; proper vetting of customers; and reputation of the company where loans are advanced.

Fifthly, in a bid to transform form micro financing to formal banking, it is now evident that a successful past for Kenyan micro finance institutions is no guarantee for transformation. It is only three microfinance institutions out of forty four that have fully transformed to formal banking. The serious challenges facing/inhibiting factors MFIs facing the transformation from micro financing to formal banking are: strict rules from the Central Bank; high costs of operation; no proper government policy on MFI's; unscrupulous MFI's spoiling the reputation of the industry; and the inability to deliver services to poor or remote populations. Further analysis using factor analysis using Principal Component Analysis to extract the inhibiting factors MFIs facing the transformation from micro financing to formal banking factors can be broken into five components. The components factors are: inadequate regulatory and loan management systems, rivalry and competition in the industry, poor customer care, high operation cost to central banks cost levies and unscrupulous nature of MFI's.

#### 4.2 Recommendations for Improvement

The Kenyan micro finance institutions should get ways of responding to the challenges facing them, that is, inadequate regulatory and loan management systems, rivalry and competition in the industry, poor customer care, high

operation cost to central banks cost levies and unscrupulous nature of MFI's. The ministry should take responsibility over the Micro finance institutions by offering materials and sponsoring managers to undergo short courses under the Ministry and in relevant areas of microfinance management which will assist in proper transformation from micro financing to formal banking.

#### 4.3 Suggestion for Further Research

Areas of further research that were identified include a similar study to be carried out on other countries to examine to establish the factors influencing in the transformation from micro financing to formal banking in Kenya. Crucially further research is should be done to determine how to reverse the challenges.

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## Appendices

### Appendix I: Questionnaire for Micro-Finance Institutions

#### Section A: General Information

1. Name \_\_\_\_\_ of MFI/Bank \_\_\_\_\_

2. Please state your position in the Organization \_\_\_\_\_

3. Please indicate the ownership of the institution using the categories below (please tick one)

a) Predominantly local (51% or more)

[ ]

b) Predominantly foreign (51% or more)

[ ]

c) Balanced between foreign and local (50/50)

[ ]

4. Using the categories below please indicate how long your MFI has been in operation.

Below 10 years [ ]

10-20 Years [ ]

21-30 Years [ ]

31-40 Years [ ]

41 and above years [ ]

5. Using the categories below, please indicate the number of branches you have in Kenya

Less than 5 [ ]

Between 5-10 [ ]

Between 11-20 [ ]

Above 20 [ ]

6. Please indicate your customer base by ticking any of the categories below.

Less than 10,000 [ ]

- Between 10,001 and 50,000 [ ]
- Between 50,001 and 100,000 [ ]
- More than 100,001 [ ]
- 7. Which market segment does your bank serve? Please tick as is appropriate.
- Business [ ]
- Personal [ ]
- Both Business and Personal [ ]

**Section B: Factors Influencing In The Transformation From Micro Financing To Formal Banking In Kenya**

8. Has your MFI invested time and effort in order to transform from micro financing to formal banking in Kenya? Yes[ ] No[ ]
- If “Yes”, indicate what measures are being undertaken to achieve this from the ones given,
- a) Increasing customer base
  - b) Improving the quality of service
  - c) Changing the IT in the organization
  - d) Improving the turn around around in loan application
  - e) Customer segmentation
  - f) Change of measures in giving loans
  - g) Increasing the repayment period of loans
  - h) Any other suggestion\_\_\_\_\_

9. In your opinion, to what extent have following FACTORS facilitated your MFI's efforts in the transformation from micro financing to formal banking in Kenya. State the extent using a scale of 1-5 below, in which; 1- To a very large extent; 2- To a large extent; 3- To some Extent; 4- To a small extent; and 5- To no extent.

- a) Effective balancing of high and low risk business [1][2 ][3] 4][5]
- b) A sound customer care desk [1][2 ][3] 4][5]
- c) The MFI's ability to optimize business volume [1][2 ][3] 4][5]
- d) Operating through efficient systems and processes[1][2 ][3] 4][5]
- e) Understanding organizations exposure to customers[1][2 ][3] 4][5]
- f) Minimizing losses when loans go bad [1][2 ][3] 4][5]

10. How does your MFI minimize losses when loans go bad from the choices below?

- a) By insurance?
- b) Proper vetting of customers?
- c) Attaching collateral to loans offered?
- d) Reputation of the company where loans are advanced?
- e) Any other suggestion\_\_\_\_\_

11. Indicate to what extent to which the following challenges have inhibited your MFI in an attempt to transform to formal banking in Kenya using a scale of 1-4 below, in which; 1-

Strongly Agree; 2- Agree; 3- Disagree; 4- Strongly Disagree.

Stiff competition from other financial institutions[1][2 ][3] 4][5]

No proper government policy on MFI's [1][2 ][3] 4][5]

Difficulty in loan recovery[1][2 ][3] 4][5]

Strict rules from the Central Bank [1][2 ][3] 4][5]

Unscrupulous MFI's spoiling the reputation of the industry[1][2 ][3] 4][5]

Reluctance to adopt social missions[1][2 ][3] 4][5]

High costs of operation [1][2 ][3] 4][5]

Inability to deliver services to poor or remote populations [1][2 ][3] 4][5]

Inability to conduct checking or current accounts for customers[1][2 ][3] 4][5]

Inability to use telegraphic funds transfer [1][2 ][3] 4][5]

Inability to operate using ATMs [1][2 ][3] 4][5]

Poor lending methodologies[1][2 ][3] 4][5]

The regulatory and supervisory policy with respect to licensing requirements [1][2 ][3] 4][5]

The regulatory and supervisory policy with respect to monitoring for unsafe and unsound practices [1][2 ][3] 4][5]

The regulatory and supervisory policy with respect to orderly existence of financially distress[1][2 ][3] 4][5]

The entry into the financial sector is determined by political decisions [1][2 ][3] 4][5]

The regulatory and supervisory policy with respect to provision of deposit-taking facilities[1][2 ][3] 4][5]

The regulatory and supervisory policy with respect to self-sustainability[1][2 ][3] 4][5]

Any other challenges that your institution is facing?  
\_\_\_\_\_  
\_\_\_\_\_

**Appendix II: List of Micro-Finance Institutions (CBK 2006)**

1.	AAR Credit Service
2.	Action Aid
3.	ADRA Kenya
4.	AgaKhan Foundation Micro Credit Programme
5.	Archdioceses of Nairobi
6.	AREP
7.	BIMAS
8.	Care International
9.	Christian Health Association of Kenya
10.	Crossbridge Credit Ltd
11.	Daraja Trust
12.	Ecumenical Church Loan Fund (ECLOF)
13.	Elite Microfinance
14.	Equity Building Society
15.	Family Finance
16.	Faulu Kenya
17.	Ghetto Child Programme
18.	Hope Africa

19. Jamii Bora
20. Jaru Micro Credit Africa Ltd
21. Jitegemee Trust
22. KADET (Kenya Agency to Development of Enterprise and Technology)
23. Kenya Commercial Bank-Special Loan Unit
24. Kenya Gatsby Trust
25. Kenya Post Office Savings Bank
26. Kenya Small Traders and Enterprise Society
27. Kenya Women Finance Trust
28. K-Rep Bank Ltd.
29. K-Rep Development Agency
30. Micro Kenya Ltd
31. Millenia Multipurpose Credit Society
32. OIKO Credit
33. Pride Africa
34. Private Sector Development Unit
35. SISDO
36. Skills Across Kenya
37. Small and Micro-Enterprise Programme (SMEP)
38. Small Enterprise Credit Association
39. Smallholder Irrigation Scheme Development Organisation
40. Sunlink Micro Finance Partners
41. Undugu Society of Kenya
42. United Disabled Persons of Kenya (UDPK)
43. Vintage Management Consultants
44. WEEC (Women Economic Empowerment Consort)
45. WEDCO
46. Widows and Orphans Welfare
47. Window Development Fund
48. World Vision
49. Yehu Enterprise Support Services