

**STRATEGIC RESPONSES BY MICROFINANCE BANKS TO  
THE DYNAMISM OF THE ECONOMIC ENVIRONMENT:  
CAPPING OF INTEREST RATES BY CENTRAL BANK OF  
KENYA**

**BY**

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**A RESEARCH PROJECT SUBMITTED IN PARTIAL  
FULFILLMENT OF THE REQUIREMENT FOR THE AWARD OF  
THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION,  
SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI**

**DECEMBER 2017**

## DECLARATION

I declare that this project is my original work and has not been presented for award of any degree in any university.

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### **Supervisor Approval**

This project has been submitted for examination with my approval as the university supervisor.

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## ACKNOWLEDGEMENTS

Glory to the Almighty God for His indescribable love and gift of life without which I would not achieve academic success.

Much appreciation to my project supervisor, **Prof. Zachary B. Awino** for his commitment, guidance and availability throughout the project period. He has been patient and provided positive criticism to enrich this work. I am also grateful to my project moderator, Prof. K'Obonyo for the checks on my work.

I thank all the respondents from microfinance banks for their feedback upon which success of this research has materialized. Special thanks to my house-help Millicent for her great support in taking care of my children while away from home for longer hours.

Lastly, thanks to my family, friends, classmates and colleagues at work for their encouragement and psyche to pursue and finish this work.

## **DEDICATION**

To my dear husband Collins and our children Jesse and Abigail for their love and inspiration and to my parents George and Rebecca Imbahale for the support bestowed to me in pursuit of my academic endeavors.

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## **ABBREVIATIONS AND ACRONYMS**

**AMFIK:** Association of Microfinance Institutions in Kenya

**CBK:** Central bank of Kenya

**CBR:** Central Bank Rate

**CRBs:** Credit Reference Bureaus

**DTM:** Deposit Taking Microfinance Institutions

**GDP:** Gross Domestic Product

**GOK:** Government of Kenya

**IFRS:** International Financial Reporting Standards

**IMS:** Information Management System

**KBRR:** Kenya Banks' Reference Rate

**MFBS:** Microfinance Banks

**MFRC:** Microfinance Regulatory Council

**MFIs:** Microfinance Institutions

**MPC:** Monetary Policy Committee

**MRPs:** Money Remittance Providers

**OMO:** Open Market Operations

## ABSTRACT

The business environment is highly dynamic posing various opportunities and threats to organizations. Strategic realignments are therefore inevitable in the current business environment. Organizations are tasked to continuously scan and assess the internal and external environment and develop appropriate strategies to survive and remain competitive amidst the changes in the environment. The banking sector has undergone a paradigm because of many changes in the economic environment affecting their performance. The microfinance banks meant to support the SMEs have faced the ripple effect of capped interest rates by the Central Bank of Kenya. This research sought to determine the strategic responses by microfinance banks to the dynamism in the economic environment with specific focus on the capping of interest rates by the CBK. The research also sought to determine the impact of capping of interest rates on performance of MFBs. The resources and dynamic capabilities that influence strategic responses were also established. A cross-sectional survey of all the thirteen licensed microfinance banks as at the end of 30<sup>th</sup> June, 2016 was undertaken. A semi-structured questionnaire was administered to the heads of strategy and equivalents at the headquarters of the microfinance banks using drop and pick technique. Data analysis was undertaken using descriptive statistics to address the objectives of the study. Findings of the study indicated increase in loan applications and reduction in number of successful loan applications as the main ways in which performance of MFBs was affected. In addition, MFBs experienced a flight of high-end customers to commercial banks. Technological innovations and exemplary customer service were the main capabilities that spearheaded strategic orientation towards the capping of interest rates by CBK. The strategies pursued as revealed by this research included secure lending, innovation, diversification, focus and investment into new markets. Microfinance banks need to expand on market intelligence to cover the untapped markets and increase market share given the opportunities in the economic environment. Full implementation of secure lending will seemingly reduce financial inclusion of SMEs. This would open windows for illegal lending which poses tough times for low-income earners. There is need for policy reviews to remedy such outcome. Microfinance banks need to continue to invest in dynamic capabilities and continuously assess the economic environment as a competitive advantage. In addition, successful strategic responses will require commitment of available resources and capabilities.

# CHAPTER ONE: INTRODUCTION

## 1.1 Background of the study

Organizations operate as open systems that constantly interact with the external environment for strategic success (Barney, 2001). The external environment experiences dynamism that requires organizations' responsiveness through alignment of their strategic decisions with the change (Ansoff & Sullivan, 1993). Economic dynamism triggers organizations to actively scan and respond to changes within the environment (Ansoff & McDonnel, 1990). The capping of interest rates by the CBK after liberalization of interest rates in 1991 is a game changer to the incumbent banking sector. Players in this sector such as microfinance banks need to position themselves to the paradigm shift that propagates economic repression.

Theories that supported this study encompassed resource-based theory, open systems theory and dynamic capability theory. Resource based theory describes the use of internal capabilities to create sustainable competitive advantage (Wernerfelt, 1984). Open systems theory delineates the relationship of organizations with the external environment (Barney, 2001). Dynamic capability theory defines an organization's capability to build, realign and integrate core competencies to address environmental turbulence (Pisano, Shuen, & Teece, 1997).

Financial institutions have been charging exorbitant interest rates on loan facilities while offering low returns on deposits. In August 2016, the legislature amended the Banking Act to introduce interest rate caps on loans and savings facilities provided by commercial banks (Kenya Gazette, 2016). This regulation was necessary to protect consumers from arbitrary interest rate variations (Kinya, 2013).

In addition, the government of Kenya had committed to reduce interest rates on credit facilities to deliver Economic Pillar of the Vision 2030 (GOK, 2007). Capping of interest rates by the CBK has introduced economic shocks in the banking sector. In response, commercial banks are launching various business models to curb effects of interest rate caps. The interest rates charged by MFBs have not been capped hence vulnerability to the economic shocks. This dynamism in the economic environment subjects MFBs to adopt survival strategies in the banking sector culminating to the motivation of this study.

According to CBK, the lending rates in Kenya increased from 15.5% in February 2015 to 17.9% in February 2016. The World Bank attributed this interest rate spreads to lack of competitiveness and high cost of financial intermediation in the banking sector (Deloitte, 2016). Interest income form more than fifty percent of total income for microfinance banks since lending is their main activity (CBK, 2016). Therefore, the impact of interest rates capping to strategic industries such as MFBs in extending affordable credit is huge (Omondi, 2016). Capping of interest rates by CBK require MFBs to adjust their strategies for competitive advantage in the banking sector.

### **1.1.1 Strategic Response**

Strategic response defines the business approaches deployed by organizations to increase market share, compete favorably and achieve targeted business performance. Ansoff and Sullivan (1993) viewed strategic response as responsiveness of organizations to changes in the environment. Strategic response also refers to the behaviour adopted by organizations to counter turbulence in the external environment (Ansoff & McDonnel, 1990).

Strategic actions are critical for all organizations to stay viable amidst the dynamism in the external environment. Organizations need to actively assess the level of environmental dynamism to enable informed strategy development. Uncertainties induced by this dynamism can be managed through strategic planning and strategic architecture (Ansoff & McDonnell, 1990); (Hamel & Prahalad, 1990).

Managing dynamism in the external environment requires organizations to modify either the type of activity performed or the mode of doing the activity for competitiveness (Porter, 1985). This requires organizations to create a pool of resources upon which competitive advantage is derived. Managing turbulence also takes commitment of resources which include key stakeholders.

### **1.1.2 Dynamism of Economic Environment**

Environmental dynamism refers to the rate of change in customer and product preferences of organizations over time (Wijbenga & Witteloostuijn, 2007). Dynamism in the economic environment involves variations in interest rates, exchange rates and inflation rates. Organizations need to continuously monitor and assess the environment for opportunities and threats and adopt suitable strategies to adjust to the changes accordingly (Ansoff & Sullivan, 1993).

The global economy has experienced various trends such as the economic meltdown in 2008 and Chinese stock market turbulence in 2016. Kenya's economy is vulnerable to unforeseen dynamism in macroeconomic indicators such as balance of payments, inflation, public finances, monetary indicators and investment, savings and income. Financial institutions need to understand how these changes unfold and actively look for opportunities to exploit their strategic abilities (John & Thompson, 1997).

The banking sector has been operating in an oligopolistic market where credit pricing is not reflective of the market ground rules (Njoroge, 2016). The reduction of inflation rates and stability of the shilling steered the lowering of CBR from 11.5% to 10.5%. In response, the MPC revised the Kenya Banks' Reference Rate (KBRR) that led to a lower cost of debt in June 2016 (Deloitte, 2016). In August 2016, maximum interest rate on credit facilities by commercial banks was adjusted to 4% above CBR and a minimum interest on deposits at 70% of the CBR (Kenya Gazette, 2016). Microfinance banks still lend at high interest rates despite the action by the regulator to cap the rates charged by commercial banks.

### **1.1.3 Strategic Response to the Dynamic Economic Environment**

Strategic response to dynamic circumstances needs translation, adaptation and sustainability of strategic actions (Dunlop, Firth, & Lurie, 2013). Dynamism in the economic environment exposes organizations to macroeconomic shocks. Organizations susceptible to these shocks need to reconfigure their internal capabilities to suit their corporate and business needs (Teece, 2007). The degree of dynamism in the economic environment and resources possessed by organizations vary. This underpins strategic responses to remain fluid, unique and specific to individual organizations.

Ansoff and Sullivan (1993) advocated for real time strategic management in diagnosing weak and strong signals in the external environment. In a highly dynamic economic environment, intensive real time environmental assessment and control mechanisms are inevitable. MFBs need to realign their strategies to leverage on the emergent opportunities and threats derived from capping of interest rates by CBK.

Strategic response is incomplete without industry analysis, which informs on the competitive forces affecting performance of an organization. Porter (1980) identified five forces affecting industry attractiveness as threat of entry, threat of substitution, bargaining power of buyers, bargaining power of suppliers and rivalry among current competitors. The analysis is pivotal in development of strategic architecture that sustains core competencies. Therefore, managers need to build a portfolio of core competencies to manage incumbent and future dynamism in the economic environment (Hamel & Prahalad, 1990).

#### **1.1.4 Interest Rate Capping**

Interest rate capping refers to set limits of interest rates chargeable on credit facilities and deposits from customers. Gallegos and Maimbo (2014) identified components of interest rate capping to include cost of funds, overheads, and non-performing loans and profit. Empirical studies indicate success of interest rate caps on loans in Korea for thirty-eight years (Gallegos & Maimbo, 2014).

Elsewhere, high interest rates charged by banks have had adverse economic impacts. The adverse impacts ease through monetary stability and government supervision of banks (Balassa, 1989). According to the World Bank report, the financial crisis in 2008 reopened a debate on introduction of interest rate controls to protect consumers.

Interest rate ceilings have had various effects in different countries. For instance, the threat of interest rate ceilings in Kenya made the Cooperative bank to avoid its plans to expand to microfinance market. Ceiling of 27% by the Central Bank of West Africa made MFIs to exit the market for the poor and remote areas, invest in urban markets and increase loan sizes for more returns. In Columbia, interest rate ceilings inhibited development of microfinance.



### **1.1.5 Interest Rate Capping by the Central Bank of Kenya**

Interest rates capping in Kenya started in 1906 until 1992. During this period, banks made reasonable profits and prospered. Kenya followed a policy of low interest rates like other developing countries through adjustment for inflation rate to maintain positive real rates (Kabubo & Ngugi, 1998). The first oil crisis made interest rates very high but the government reviewed the interest rate policy to encourage savings.

The first review of interest rates in Kenya was in 1974 with the aim of making interest rates responsive to changes in international markets. Ceilings on savings rose in 1989 and interest rates were liberalized in 1991. Deregulation of interest rates in 1993 resulted to high lending rates. The Donde Bill 2000 was tabled in Parliament in 2001 to stabilize the financial sector. This bill failed due to hostile response from banks. Consequently, the Finance Bill 2011 that proposed pegging of interest rate against the Treasury bill or at a maximum of four percent above the CBK lending rate also failed (Finance Bill, 2011).

Kenya joined more than twenty countries in Sub-Saharan Africa with interest rate controls. The capping of interest rates was necessary since financial institutions in Kenya could not regulate themselves (ICPAK, 2016). The law came into effect in August 2016 through signing of the Banking (Amendment) Act No. 25 of 2016 into law with inclusion of section 33. The Act asserts the maximum lending rate of four percent above CBR and a minimum rate of 70% of the CBR on deposits held (Citi Bank, 2016). Implementation commenced on 14<sup>th</sup> September 2016 as per the CBK guidelines.

### **1.1.6 The Banking Sector in Kenya**

Development of the banking sector in Kenya dates back the Indian moneylenders in Zanzibar in the 18<sup>th</sup> Century. The spread in Kenya was effective when National Bank of India opened a branch in Mombasa in 1896 and another in Nairobi in 1904 (CBK, 2017). The Cooperative bank became the first locally owned commercial bank in Kenya with its roots as a co-operative society. The rest of the banks were established after independence in Kenya.

The banking sector began to serve the needs of farmers from pre-colonial period. The banking sector in Kenya comprises of CBK as the regulator, 43 banking institutions, 13 MFBs, 3 CRBs, 77 forex bureaus, 17 MRPs and 8 representatives of foreign banks (CBK, 2016). Microfinance banks were among the institutions in the banking sector that were initially privately owned.

The banking sector serves wide range of needs to various customers. Activities pursued by all the banks are regulated by the Central bank of Kenya. This ensures that the sector is guarded and conducts all business in line with policy provisions. Microfinance banks serve the needs of most informal businesses, SMEs and individuals not catered for by commercial banks.

### **1.1.7 Microfinance Banks in Kenya**

A microfinance bank refers to a company licensed to carry out microfinance bank business and includes all branch networks, marketing units and outlets licensed by the CBK (Kenya Gazette, 2013). Deposit taking microfinance institutions changed name to microfinance banks through the Microfinance (Amendment) Bill 2013. MFBs form the first tier of the MFIs in Kenya with minimum capital of 60M Kenyan Shillings.

There are thirteen licensed microfinance banks in Kenya as at 30<sup>th</sup> June 2016 include Caritas, Century, Choice, Daraja, Faulu, Kenya Women Trust Fund, Rafiki, Remu, SMEP, Sumac, U&I, Uwezo and Maisha Microfinance bank limited(CBK, 2016).MFBs provide loan facilities to consumers not catered for by the conventional banking industry.

Categories of these banks include large, medium and small. The Banking Act Sec. 25 guides the operations of MFBs. Microfinance banks experienced decline in profits in 2016 attributed to increased borrowing expenses (CBK, 2016). Interest on customer deposits decreased by 25% due to reduced customer deposits. Appropriate strategic orientation is necessary to manage effects of interest rate capping.

## **1.2 Research Problem**

Organizations are open systems that closely interact with the external environment for strategic success (Kahn & Katz, 1978; Bastedo, 2004). Strategic responses are not static in a dynamic external environment. This calls for continuous scanning of the external environment for suitable strategic fit. Monetary policy changes such as interest rate capping by CBK present various signals to players in the banking sector. This change has triggered MFBs to realign their strategies for sustainable competitive advantage in the banking business. Appropriate strategic responses are therefore critical in addressing dynamism in the economic environment (Ansoff & Sullivan, 1993). This research explored this matter and identified the strategic responses to capping of interest rates by CBK.

There are several local studies on strategic responses by organizations to changes in the external environment. Machuki, Murerwa, and Ndung'u (2014) carried out a descriptive survey of 43 commercial banks to determine their response strategies to economic changes in Kenya. Mutuku (2014) examined strategic responses by Old Mutual Kenya to the dynamic business environment in Kenya. Murungi (2013) surveyed all the 55 oil marketing companies in Kenya to identify their strategic response to the dynamic economic environment.

Macharia (2015) carried out a case study for Tausi Assurance Company Limited to establish its strategic responses to changes in the dynamic business environment. Afande and Maina (2015) undertook a descriptive survey of 17MFIs in Kenya to establish their response to turbulent business environment. In another study, Nderitu (2012) carried out a descriptive survey of six DTMs to examine their strategic responses to environmental changes in Kenya. These studies cut across many sectors and those within the banking sector focused on strategic responses to changes in the economic and general business environment. It is on this breath this research explored the strategic responses by MFBs to capping of interest rates by CBK as dynamism in the economic environment.

International studies have focused on MFIs, interest rate ceilings and their impact. A case study on Excel Crop Care in India was done to establish its strategic shift to cope with turbulent environment (Narula & Upadhyay, 2010). A census survey of countries with interest rate caps around the world was conducted (Gallegos & Maimbo, 2014). Another study focused on the impact of interest rate ceilings on Microfinance that deployed census survey of MFIs in Zambia (Alshebami & Khandare, 2015).

In addition, a census survey of MFIs to establish effects of interest rate ceilings on the Micro lending market in South Africa (Coetzee, Grant, & Mohane, 2002). These studies did not present the current scenario locally of the major shift in Kenya's monetary policy of interest rate capping by CBK affecting the banking sector as addressed by this research.

Various studies have deployed different methodologies such as descriptive surveys (Afande & Maina, 2015; Nderitu, 2012). Case studies include Old Mutual Kenya Limited (Mutuku, 2014) and Tausi Assurance company Limited (Macharia, 2015). This research sought to depart from the previous methodologies and deploy cross sectional survey design to study the variables.

Previous studies informed on different concepts linked to strategy, diverse contexts and methodologies. This study confirmed that individual MFBs devised strategies based on their resources and capabilities as evidenced by the cross-sectional survey of the population. The main research question that addressed the knowledge gaps was; what strategies have MFBs adopted in response to capping of interest rates by CBK.

### **1.3 Research Objective**

The overall objective of this research was to establish the strategic responses by microfinance banks to capping of interest rates by the Central Bank of Kenya.

#### **Specific Research Objectives**

Specific research objectives were, to:

- i. Determine the impact of capping of interest rates on the performance of MFBs.
- ii. Determine the resources and capabilities that have enabled MFBs to respond to changes occasioned by the capping of interest rates by the CBK.

## **1.4 Value of the Study**

Findings of this study will enable policy makers to assess the effects of interest rate capping by CBK to performance of MFBs. This will also inform decisions on formulation and passing of amendments to the DTM Bill. Future decisions on interest rate controls will borrow from conclusions of this research.

This study adds to the body of knowledge of strategy. Findings provoke further research on strategy for MFBs. Strategic responses based on organization's capabilities stressed applicability of Resource Based Theory. Prominence of open systems theory and dynamic capability theory received elevation through core competencies embraced by MFBs in response to capping of interest rates by CBK. Open systems' theory requires MFBs to focus more on assessment of the economic environment for competitive edge in the banking industry. Building up on core competencies of these institutions will facilitate future counter-actions on external forces.

This study is a motivation to the management of MFBs to align their strategic objectives with dynamism in economic environment. Findings of the study have emphasized the importance of market intelligence to the banking business. MFBs need to leverage on the available pool of resources to operate profitably despite the uncertain prevailing economic conditions.

In summary, this chapter has introduced the concepts, context, research problem and value of the study. The research problem sought to identify conceptual, contextual, and methodological research gaps. The findings of the study fulfilled the gaps identified in the research problem. Strategies such as secure lending, innovation and diversification are necessary to reduce the adverse impacts of capping of interest rates by CBK on performance of MFBs.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This section contains review of various researches relevant to this study. The review comprised of theoretical foundation, dynamism of the economic environment and strategic responses. Related studies have also been reviewed and knowledge gaps ascertained.

The theoretical foundation explained the theories upon which the concepts of the study are anchored. This theories include open systems theory, resource based theory and dynamic capability theory. Strategic response as a concept has undergone analysis to understand its originality as depicted by various authors and varying applicability.

Dynamism of the economic environment has been explored to build up on the research concept. Review of empirical studies has been done to support the researchable gap. These studies have been reviewed and findings indicated for critical judgment in the proceeding sections.

### **2.2 Theoretical Foundation**

The theoretical framework detailed theories deployed to explain the concepts underlying the study. The theories include open systems theory, resource based theory and dynamic capability theory. These theories supported the study extensively.

The open systems theory related the activities of the microfinance banks with the external environment. Organizations do not operate in vacuum and hence assessment of the external environment is key (Kahn & Katz, 1978).The environment is a source of competitive advantage by unveiling the opportunities for growth and expansion.

The resource based theory and dynamic capability theory support strategic decisions. Organizations optimize on the available resources in order to deliver strategic actions (Wernerfelt, 1984). Dynamic capabilities are configured to suit changing market needs. Successful organizations have organized pool of core competencies from which they derive competitive edge (Pisano et al. 1997).

### **2.2.1 Open Systems Theory**

The works of Bertalanfly (1956) form the origin of open systems theory. Organizations are open systems due to the influence of the external environment on their performance (Bastedo, 2004). Organizations are also dynamic, organic and complex in nature (Kahn & Katz, 1978). The interactions of organizations with the environment are similar to integration of organized subsystems to attain a common goal.

The external environment is the source of competitive advantage to firms (Johnson & Scholes, 2002). The open systems' concept maps the cycle for input, throughput, output and feedback from the environment (Kahn& Katz, 1978). Strategy therefore provides a link between organizations and the external environment. This interaction of firms with the external environment forms the basis of strategy formulation and implementation.

According to the open systems model, the existing internal structure, strategy and success of an organization are heavily inclined to the environment in which it operates, interacts and competes (Pfeffer & Salancik, 2003). Microfinance banks interact with the dynamic economic environment that involves CBK as its regulator. Capping of interest rates by CBK would have significant impacts on their performance hence need for realignment of the banks' strategies to the change.



### **2.2.2 Resource Based Theory**

Resource based theory views strategy development as the use of internal capabilities to create sustainable competitive advantage (Wernerfelt, 1984). These capabilities are either distinctive capabilities or reproducible capabilities. A match between opportunities and a firm's capabilities will lead to sustainable competitive advantage. Organizations need to develop existing resources while creating new ones to exploit and manage changes in the external environment. The theory emphasizes identifying firms' resources; assessing their potential and developing a strategy that will enable derive maximum value from environmental dynamism in a sustainable way (Grant, 1991).

In addition, organizations leverage on their internal capabilities to develop strategies appropriate to changes in the external environment (Barney, 2001). The theory assumes heterogeneity and immobility of resources hence companies cannot copy rivals' resources and strategy. Organizations' resources include all assets, capabilities, processes, attributes, information and knowledge controlled by the organization to conceive and implement strategies (Barney, 2001). MFBs would consider their internal assets in developing strategic responses to the interest rate capping by CBK.

Competitive advantage materializes on optimal allocation of resources by organizations to maximize productivity. Possession of resources in isolation without deployment into productive work does not guarantee competitive edge of microfinance banks. Leveraging on opportunities require strategic analysis of environmental factors (Johnson & Scholes, 2002). Therefore, MFBs need to identify valuable resources and their potential to influence strategic decisions with focus on controlled interest rates.

### **2.2.3 Dynamic Capability Theory**

Dynamic capability theory describes how organizations build, integrate and reconfigure their core competencies to match environmental dynamism (Pisano et al. 1997). Firms that take advantage of their core competencies have a higher chance of strategic success than those that do not. Dynamic capabilities demonstrate organizations' ability to innovate ways of achieving their competitive advantage (Teece, 2007). For instance, MFBs use their IMS to redefine their credit policies and markets.

This theory borrows from the works of Hamel and Prahalad (1990) in building a portfolio for core competencies. Dynamic capabilities are developed within individual functionalities and integrated in the entire value chain. Strategic responses are viable when they result to distinctive competencies that drive competitive advantage. This theory is relevant in empowering microfinance banks to develop appropriate mechanisms to position themselves in aligning to the changes in the economic environment.

Strong dynamic capabilities enable organizations to compete and survive in rapidly changing environments (Teece, 2007). These capabilities enable firms' to demonstrate and practice entrepreneurial abilities in response to dynamic business environment. Microfinance banks need to leverage on their dynamic capabilities to navigate through the turbulent economic environment. Managers must influence the creation and evolution of capabilities for them to be considered as strategic variables (Figgie & Pisano, 2016).

### **2.3 Dynamism of Economic Environment**

Environmental dynamism refers to the rate of change in customer and product preferences of organizations over time (Wijbenga & Witteloostuijn, 2007). The level of instability of environmental factors anchors the concept of dynamism (Li & Simerly, 1998). The uncertain nature of the economic environment tasks organizations to upscale their strategic analysis for long-term competitiveness and survival.

Teece (2007) emphasizes the importance of dynamism of the environment in building strategic capabilities. Organizations constantly interact with the external environment from which they derive value (Johnson & Scholes, 2002). Poor alignment to the economic dynamism such as industry, monetary policy and fiscal policy changes can jeopardize operations of microfinance banks. MFBs should understand how these changes unfold and actively look for opportunities to exploit their strategic abilities (John & Thompson, 1997).

Economic dynamism also manifests itself through CBK's OMO that involves trade of government securities to regulate money supply and credit conditions in the economy. The purchase of securities in open market increases commercial banks' reserves facilitating loan supply while increasing money supply (CBK, 2017). Interest rate capping is an expansionary monetary policy meant to stimulate economic growth through increased money supply hence increased liquidity and access to cheap credit triggering growth in savings and investments. MFBs need to fast track such changes to remain profitable.

## **2.4 Strategic Response**

Strategic response refers to pro-active action undertaken by an organization to counter environmental turbulence (Chandler, 1963). Ansoff and McDonnell (1990) define strategic response as change of strategic behaviour to meet demands of the external environment. Strategic scanning of the external environment facilitates informed strategy development to mitigate unforeseen uncertainties (Adebisi & Babatunde, 2012). Effective strategic responses need optimal organization and allocation of resources (Mintzberg & Quinn, 1998) as well as development and modification of core competencies (Pisano et al. 1997).

Ansoff and Sullivan (1993) argued that strategic responses vary with levels of environmental turbulence. He further advocates for real time strategic management, vertical and horizontal integration to counter environmental dynamism. Machuki et al. (2014) established that commercial banks in Kenya use ambidextrous strategies, investment strategies and retrenchment strategies in responding to changes in their environment.

Porter (1985) recognized cost leadership, differentiation and focus strategies as strategic indicators. Ansoff (1965) identified four growth strategies for organizations in a turbulent environment market penetration, market development, product development and diversification. Miles and Snow (1978) defined the scope of strategic responses to include analyzers who protect current markets while exploring new opportunities, defenders who protect and grow current markets, and reactors who respond to signals in the environment and prospectus who leverage on innovation for new opportunities and markets.

## **2.5 Empirical Studies and Knowledge Gaps**

Afande and Maina (2015) carried out a descriptive survey of 17 MFIs in Nairobi registered under AMFIK in 2013 to find out their responses to challenges in dynamic business environment. Primary data was collected through drop and pick questionnaires. Findings confirmed that changes in the environment compromise on MFIs operations, profitability and long-term viability. Liberalization of interest rates affected 88% of MFIs while most of the MFIs complied with government regulations. Capping of interest rates by CBK is contrary to liberalization of interest rates.

Nderitu (2012) carried a descriptive survey of six licensed DTMs in Kenya for strategic responses to environmental changes. Primary data collected and analyzed using descriptive statistics. Findings showed that customer service has significant impact on MFIs' competitiveness while economic factors affect the DTMs largely. The study was limited to strategic responses by DTMs to the general environment. This research focused on capping of interest rates as a variable of the economic environment.

Machuki et al. (2014) carried out a cross-sectional descriptive survey of 43 commercial banks in Kenya to establish their response strategies to economic changes. Primary data was collected from managers in charge of strategy through semistructured questionnaires administered by drop and pick technique. Data collected was analysed using descriptive statistics and qualitative data analysis. Ambidextrous strategies, investment strategies and retrenchment strategies counter changes in their environment. Economic factors studied excluded monetary policy while the context was limited to commercial banks. This study focused on capping of interest rates by CBK and the context is microfinance banks.

Murungi (2013) did a census survey of all 55 oil marketing companies in Kenya to determine their strategic response to the dynamic economic environment. Data collected from CEOs and equivalents using drop and pick questionnaire was analyzed by descriptive statistics. The context of study was oil-marketing companies, which differs from the banking sector context.

Coetzee et al. (2002) conducted a census survey on all the formal lenders registered by MFRC in South Africa. The research sought to establish the effects of interest rate ceilings on the Micro lending market in South Africa. The study revealed administrative costs as the biggest cost component of the microlending institutions. Microlenders would not be induced by interest rate ceilings to innovate ways of reducing these costs. Recommended strategy was to encourage competition which would spur innovation to reduce risks associated with lending. The current scenario in Kenya is where MFBs interest rates have not been capped yet they operate in the same banking industry with commercial banks. This research unveiled the effects of capping of interest rates on performance of MFBs in Kenya.

Gallegos and Maimbo (2014) did census survey of all the countries in the world that were using interest caps. Findings indicated that 76 countries have interest rate caps which has led focus markets and additional charges on loans among financial institutions. The paper suggested better ways of reducing interest rates which included intergration of micro-credit products, credit bureaus, financial literacy and product innovation. The study focused on financial institutions in totality and did not present the scenario in Kenya hence justifying this replicate study on MFBs in Kenya.

Alshebami and Khandare (2015) carried out survey on MFIs in Zambia to establish the impact of interest rate ceilings and alternatives of the control. They collected secondary data from various sources and found out that imposing interest ceilings to MFIs would result to reduction of operations, closing down or relocating to urban areas. The context was general to the microfinance industry and the concept limited to interest rate ceilings. This study explored the strategic responses by MFBs to dynamism in the economic environment with specific focus on capping of interest rates in Kenya.

A case study on Excel Crop Care in India was done to establish the company's strategic shift to cope with turbulent environment (Narula & Upadhyay, 2010). Secondary data from 1995 to 2005 was collected from the company's website, annual reports and business articles. Findings indicated that the company leveraged on its strengths such as huge manufacturing capacity to explore opportunities on its markets emerging from the competitive turbulence. Strategies deployed included integration, related diversification, entry to international markets and market concentration. The context was limited to Excel crop hence the need for similar studies in the banking sector.

The literature on organizations' exposure to the dynamic economic environment and the strategic responses adopted has been reviewed. The theoretical foundation elucidates MFBs as open systems interacting with the dynamic economic environment which has various signals such as capping of interest rates by CBK. This exposure demands MFBs to leverage on available pool of resources and dynamic capabilities for appropriate strategic response. Strategic response to interest rate capping has not been addressed in Kenyan context leading to a researchable gap.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Introduction**

This chapter entails the research design, population, data collection and data analysis method used in this study. The research design sought to determine the impact, resources and capabilities as well as the strategic responses. Cross-sectional survey was adopted to capture the objectives of the study.

The population of the study comprised of all licensed microfinance banks in Kenya. Selection of this population was based on its susceptibility to the effects of capping of interest rates by CBK. MFBs are a vulnerable sector because of the target market they serve. Their strategic orientation to dynamism in the economic environment was the quest for this study.

The study relied on primary data as it was viewed to represent the current state. The data was categorized, analyzed and output presented as summaries in form of tables, pie charts and graphs of the results. Data was analyzed using descriptive statistics to ascertain the frequencies, percentages and measures of central tendency. Analysis and interpretation of the findings was made easier through summaries in terms of tables, bar charts and pie charts.

### **3.2 Research Design**

A research design is a framework for data collection and analysis (Bell & Bryman, 2007). The research design for this study was a cross-sectional survey of all the licensed microfinance banks in Kenya as at 30<sup>th</sup> June, 2016. Cross-sectional survey was the preferred research design as opposed to sampling since the population of the study was small.



The researcher considered the population of the study to establish strategies deployed to respond to the dynamic economic environment in Kenya with specific focus on changes brought about by capping of interest rates by CBK. The census survey enabled diverse insights that affirmed the objectives of the study. The research design increased generalization and credibility of the findings and recommendations.

Different strategies adopted by individual MFBs were informed by the research design. This is despite exposure to the same economic environment. Consequently, this minimized biasness of strategic responses that are tailor-made to suit individual MFBs. Reasons for varying responses were highlighted at the end of the study.

### **3.3 Population of the Study**

Population refers to the total of the objects considered in seeking to address the objectives of a study. The population of this study comprised of all the thirteen microfinance banks licensed by the CBK as at 30<sup>th</sup> June 2016(CBK, 2016). This population is current and a representative of the licensed microfinance banks as at the end of December 2016. Microfinance banks are the immediate competitors of commercial banks although they lend to a riskier market. This population provided a platform to get diverse insights on strategic responses as necessitated by possession of various resources and dynamic capabilities at different capacities.

Choice of this population was driven by the vulnerability of MFBs to the shocks in the macroeconomic environment. MFBs charge high interest rates and operate in a banking business where the CBK capped the rates charged by commercial banks. It was vital to understand the impact by this change and strategies deployed by MFBs to remain competitive. The reasons for varied strategic responses were based on the level of resource deployment as indicted by the findings of the study.

The headquarters of all the microfinance banks are located in Nairobi and its environs. The location of the population necessitated the ease of access for data collection. The researcher focused on the headquarters of the microfinance banks. The headquarters have affair view of the general strategic alignments and positioning of the entire branch networks. The population also represents the economic vibrancy of the banking industry in Kenya with focus on SMEs. SMEs rely on microfinance banks for credit facilities as well as the deposit facilities.

### **3.4 Data Collection**

Collection of data involved gathering the relevant facts to address the objectives of research. The research relied on primary data to understand various issues arising from the capping of interest rates by the CBK to address the research objectives. Data collected was both qualitative and quantitative in nature. A semi- structured questionnaire was the instrument used to collect the data from respondents. A semi-structured questionnaire enabled the research to capture responses that were left out when providing for options for choice and rating.

The respondents to the research questionnaires were heads of strategy and equivalents at the headquarters of the microfinance banks. The technique used to administer the questionnaires was drop and pick. This gave respondents more time to engage with the questionnaire and give comprehensive feedback credible for decision-making. The researcher collected the filled questionnaires after agreed timelines with the respondents.

The research questionnaire consisted of three sections as indicated in Appendix I: organizational demographics, dynamism in the economic environment and strategic responses. The questionnaire comprised of these questions, open-ended questions, closed-ended questions and Likert scale questions. Open-ended questions facilitated the arousal of the urge for respondents to give more information that improved the general understanding of the subject matter. Likert scale questions addressed the extent to which various variables influenced strategic responses.

### **3.5 Data Analysis**

Data collected was edited to check for errors and completeness. The edited data was then coded for categorization for ease of generating frequencies. Data analysis was carried out using descriptive statistics to show the characteristics and patterns in the data. The patterns informed on the impact, strategy and effectiveness of strategies adopted by microfinance banks in response to capping of interest rates by the Central Bank of Kenya.

Descriptive statistics was the preferred mode of data analysis for the data sought in achieving the research objectives from different views of respondents. The impacts and strategies adopted by MFBs in response to capping of interest rates by CBK were not predetermined and hence the approach to analyze the data. The output of the data analysis included tables, graphs, percentages and measures of central tendency.

In summary, the research methodology for this study employed cross sectional survey as the research design. This was the preferred design to understand and address the objectives of this study. The study considered the whole population of licensed microfinance banks to get the diverse insight on addressing the objectives. The researcher deployed descriptive statistics to analyze the data collected.

## **CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION**

### **4.1 Introduction**

This chapter entailed data analysis and discussions of the research findings. Data collected was analyzed using descriptive statistics to determine the impact of capping of interest rates by CBK on performance of microfinance banks. The information also depicted the strategies pursued by respondents to this dynamism in the economic environment. The resources and dynamic capabilities relied upon by respondents in responding to capping of interest rates were established.

The data collected was analyzed to establish frequencies upon which calculation of percentages was based. The means of responses were calculated. The results of the data analysis were summarized in form of tables, graphs and pie charts. Pie charts informed on the level at which some sectors dominated in deploying various strategies. The bar graphs provided ease of interpretation and synthesis of the information displayed. Tables displayed the percentages and means of various variables. The findings on likert scale questions were summarized in table format.

The results were discussed to establish whether they support previous studies or depart from previous findings. The discussions supported the findings of the study in regards to dynamism of the economic environment and strategic responses. The main objective and specific objectives were discussed in line with the findings. Majority of the findings were in line with the empirical studies as earlier reviewed. Findings on secure lending departed from findings of Coetzee et al. (2002).

## 4.2 Demographic Information

Demographic information describes the general background information about respondents. Microfinance banks in Kenya were the target respondents for the study. The researcher sought to identify the main target market for their products and services. All the respondents identified SMEs as their main target market. The respondents also noted that the banking facilities provided target both individuals and groups not catered for by commercial banks.

Products offered by respondents range from deposit accounts, savings accounts, investment products and micro insurance products. Respondents serve more than one million Kenyans across the country. Respondents were requested to indicate the year of establishment as part of the demographic information. Table 4.1 shows operational period after licensing of respondents.

**Table 4.1: Years of operation**

| Years of Operation | Frequency | Percentage |
|--------------------|-----------|------------|
| Less than 2 years  | 3         | 30%        |
| 3-5 years          | 2         | 20%        |
| More than 5 years  | 5         | 50%        |
| Total              | 10        | 100%       |

Source: Research data, (2017)

Feedback from respondents was analyzed to determine the number of years of operation. Findings on the data showed that 50% of the respondents have been in the banking sector for more than five years. Thirty percent of the respondents have been in operation for less than two years while 20% of the respondents have been in operation between three to five years.

### **4.3 Dynamism of the Economic Environment**

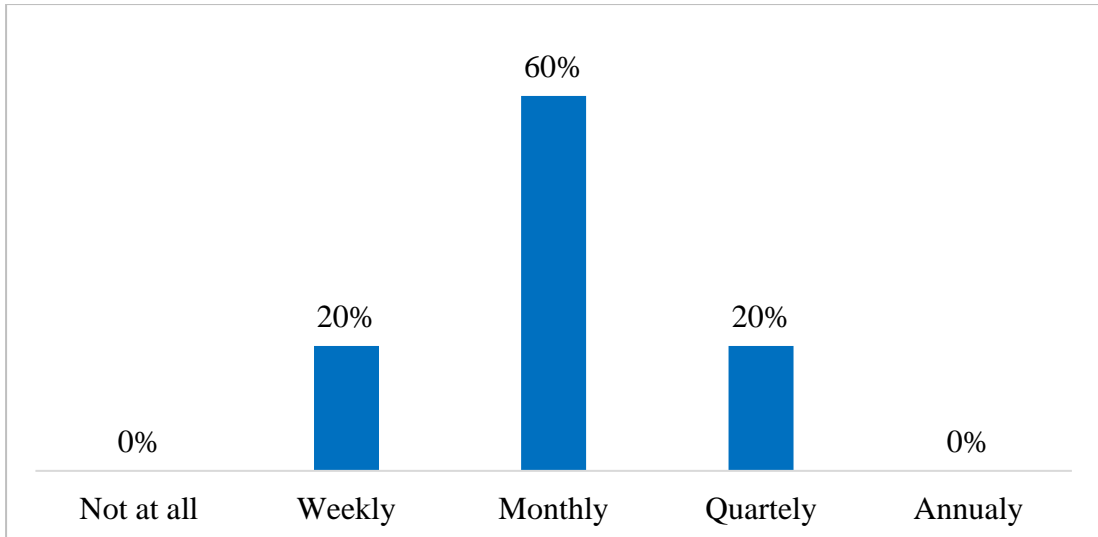
The business environment experiences immense changes with the emergent shift in factors such as customer needs, market needs, monetary policy, taxation and competition. Analysis of the events and activities in the business environment is critical in supporting organizations' strategic success. Respondents were asked to rate the impact of these factors on a 5 point likert scale.

The general outlook of respondents on the dynamism of the economic environment was evaluated using open-ended questions. In addition, the influence of economic environment on strategy and various activities done by respondents in responding to capping of interest rates by CBK was evaluated. The researcher also sought to understand the frequency at which respondents assess the economic environment.

The extent to which economic changes influence the strategies adopted by respondents was sought from respondents. The respondents were also asked to identify how their performance was affected by capping of interest rates by CBK. The researcher also enquired on the investments and activities carried out by respondents in adapting to changes in the economic environment.

#### **4.3.1 Assessment of the Economic Environment**

The researcher investigated on the frequency at which respondents monitor changes in the economic environment. Findings indicated that 60% of the respondents compile their environmental assessments on monthly basis. Twenty percent assess the environment on weekly basis and 20% assess the environment on quarterly basis as shown in Figure 4.1.



Source: Research data, (2017)

**Figure 4. 1: Frequency at which MFBs scan Economic Environment**

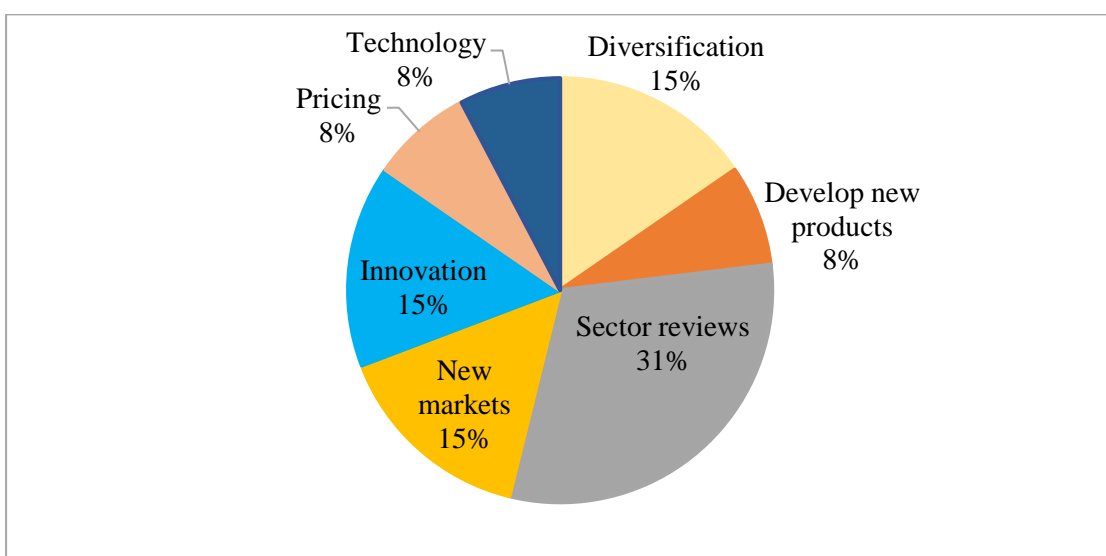
Assessment of the external environment for threats and opportunities is a source of information for respondents to determine the kind of investments and internal capabilities to pursue in order to outlive competition. Organizations have failed to cope up with dynamism in the external environment. This emanates from failure to detect changes upfront and hence delays in developing survival mechanisms. Respondents continue to embrace scanning of the external environment ahead of uncertainties.

The time respondents have been in the market is one of the contributing factor to how well and frequent marketing intelligence is done. Environmental scanning does not need to be narrow-minded that only direct factors are tracked. Indirect impacts such as capping of interest rates have great influence on performance of MFBs. It is for this reason that environmental assessment is necessary and from all perspectives of the business operations. Respondents do not have to wait until a major shift in the external environment has occurred for them to embark on environmental analysis. Twenty percent of the respondents do assess the environment on a quarterly basis, which is quite a long time to trace the stages of changes that are likely to be very significant to the wellbeing of the business.

### 4.3.2 Approach to Dynamism in Economic Environment

Respondents were asked to explain how they deal with economic changes affecting their performance. Findings on approach to dynamism in the economic environment are summarized in Figure 4.2. Results depicted that 8% of the respondents appreciate technology to ensure that they keep abreast with the demands in the economic environment. This is in light of the mobile applications that enable them to increase accessibility to customer needs and increase market share.

Thirty one percent of the respondents carry out sector reviews to adjust to changes in the economic environment. This includes constant review of products by either downgrading or upgrading the less performing sectors to ensure customer expectations are met and exceeded. Fifteen percent of the respondents redesign the way they carry out their business and tailor make products to suit various customer needs. Another 15% of the respondents rely on diversification and entry in new markets. Lastly, 8% of the respondents develop new products and adjust prices for competitive edge amidst economic dynamism.



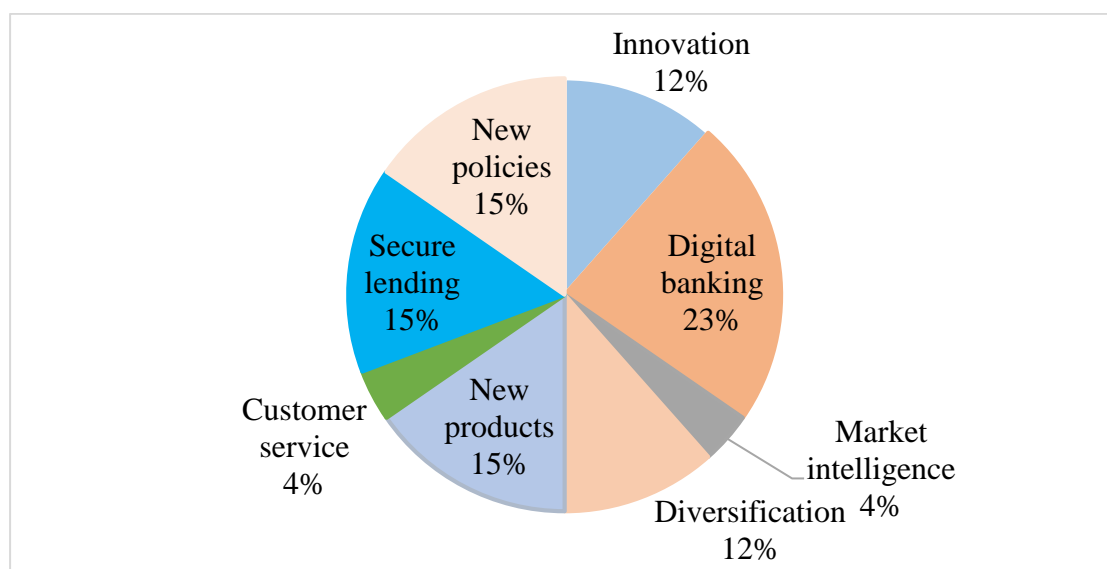
Source: Research data, (2017)

**Figure 4. 2: Approaches to dynamism in the Economic Environment**



Respondents seem to embrace varied ways of dealing with economic changes based on the available resources and core competencies. Respondents need to invest in dynamic capabilities by either outsourcing or collaborating with established businesses for successful strategic actions. Some of the investments undertaken by respondents to address changes in the economic environment are shown in Figure 4.3.

Respondents capitalized on available resource levels and worked within the constraints of their limited capabilities to improve on their bottom line and market share. This is despite the anomalies introduced in the economic environment by various economic factors. Digital banking is a dominant investment at 23% due to the reduction in the economic space brought about by technological advancements. The world is a global village because of the technology advantage experienced by all sectors in the economy. Microfinance banks continue to optimize their available technical infrastructure to build on the digital and mobile platforms in promoting their product packages.



Source: Research data, (2017)

**Figure 4. 3: Investments and activities done by MFBs to Adapt to Changes in the Economic Environment**

### 4.3.3 Influence of Economic Changes on Strategy

Sixty three percent of respondents noted that, changing market needs ranks highest in influencing their strategic decisions to a very large extent. Changing market needs, evolving customer needs and competition influence strategies adopted by respondents to a large extent. Monetary policy changes affect strategic responses to a moderate extent while taxation policy does to a small extent as displayed in Table 4.2.

**Table 4. 2: Extent to which Economic Changes influence Strategies by MFBs**

| Economic changes        | Not at all | Small extent | Moderate | Large extent | Very large extent | Mean  |
|-------------------------|------------|--------------|----------|--------------|-------------------|-------|
| Changing market needs   | 0%         | 0%           | 25%      | 13%          | 63%               | 4.375 |
| Evolving customer needs | 0%         | 0%           | 25%      | 38%          | 38%               | 4.125 |
| Monetary policy changes | 0%         | 14%          | 14%      | 43%          | 29%               | 3.125 |
| Taxation policy         | 13%        | 25%          | 25%      | 25%          | 13%               | 2.375 |
| Competition             | 13%        | 0%           | 13%      | 50%          | 25%               | 3.625 |

Source: Research data, (2017)

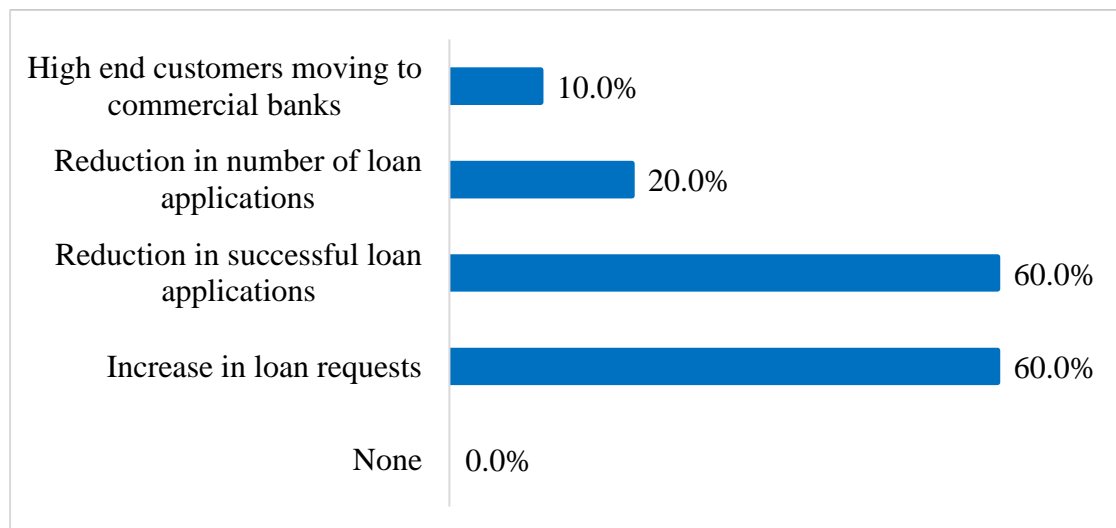
Economic factors play a major role in determining the profitability of any business. Inability to be keen on the changes from economic environment could result to losses. Customers have become more aware of their needs and preferences. This departs from the past when digitization and information availability was limited. Respondents seem to be affected at different degrees by various attributes of the economic environment. This in turn determined the types of strategies deployed.

Strategies used to combat changes in the economic environment need clear alignment. Successful strategy implementation is dependent on how well the influencers of change have been established. A limited approach to strategic response is achieved in case of inadequate environmental scanning. Therefore, organizations need to invest more in market intelligence and industry analysis for appropriate strategy development.

#### 4.3.4 Impact of Capping of Interest Rates by CBK on Performance of Microfinance Banks

Respondents were asked to select an option that reveals how their performance has been affected by capping of interest rates by CBK. Findings revealed that 60% of the respondents have seen an increase in loan requests. Sixty percent of the respondents confirmed a reduction in the number of successful loan applications because of intensive screening of loan applicants and requirement of collateral for credit facilities sought.

In addition, 10% of the respondents lost high-end customers who moved to commercial banks for credit facilities at lower interest rates. Twenty percent of the respondents experienced a reduction in the number of loan applications. This was partially attributed to retreat of some customers to loan sharks given the tight credit prequalification criteria pursued by banks. Summary of the findings is displayed in Figure 4.4.



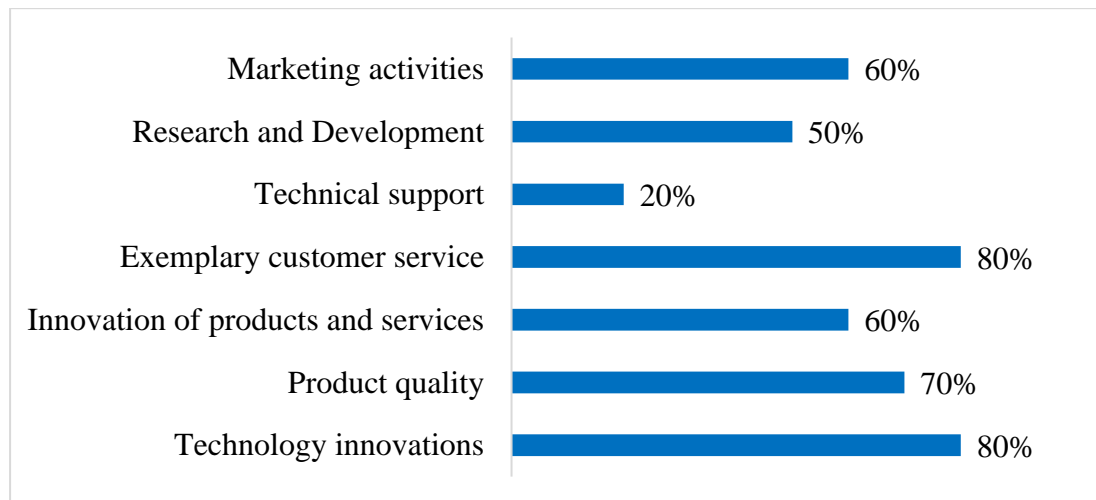
Source: Research data, (2017)

**Figure 4. 4: Effects of Capping of Interest Rates by CBK on Performance of Microfinance banks**

The changes have only taken effect for a period of one year only. The respondents would know more in future. Therefore, the study findings may not fully address future needs on the impacts of capping of interest rates on performance of microfinance banks. Respondents have to keep an eye on this economic shift and address emerging issues as soon as possible. However, reduction in the number and size of loans is significant. SMEs might resort to other credit sources in pursuit of their financial inclusion goals.

#### 4.4 Factors influencing Strategic Responses by Microfinance Banks

In a dynamic economic environment, organizations realign the available resources and optimize on their core competencies to achieve competitive advantage. Respondents were asked to identify factors that influence their response to market changes caused by capping of interest rates by the CBK. Figure 4.5 indicates their feedback in light of the factors upon which successful strategic responses are anchored.



Source: Research data, (2017)

**Figure 4. 5: Factors influencing Strategic Responses by MFBS**

Research findings showed that, 80% of the respondents invested in exemplary customer service in order to remain competitive amidst the market changes attributed to capping of interest rates by CBK. Respondents have put in place mechanisms such as feedback systems and suggestion boxes in order to serve customers better.

Some respondents conduct market surveys to understand how well their products and services serve different markets. Complaints from customers are captured, investigated and proper action plan put in place for improvement. Respondents have also invested in competent staff conversant with changing customer needs.

Technology innovation is a source of competitive advantage among 80% of the respondents in delivering customer value and competing favorably in the banking business. Banking activities such as loan processing, mobile loans and opening of accounts have been transformed and are accessible via mobile and internet platforms. Amidst loss of high-end customers to the commercial banks on capping of interest rates, respondents deployed technology in the areas of deposit taking and credit processing time.

**Table 4. 3: Dynamic capabilities**

| <b>Statement</b>  | <b>Not at all</b> | <b>Small Extent</b> | <b>Moderate</b> | <b>Large Extent</b> | <b>Very large extent</b> | <b>Mean</b> |
|---|-------------------|---------------------|-----------------|---------------------|--------------------------|-------------|
| The bank has established mechanisms of dealing with credit banking destructors.   | 10%               | 10%                 | 10%             | 60%                 | 10%                      | 3.500       |
| The bank has a portfolio of resources that gives it a competitive edge over the other banks in the industry               | 0%                | 0%                  | 0%              | 70%                 | 30%                      | 4.300       |
| The bank has leveraged on technology innovations to deliver customer value and compete favorably in the banking business. | 0%                | 0%                  | 20%             | 20%                 | 60%                      | 4.400       |

Source: Research data, (2017)

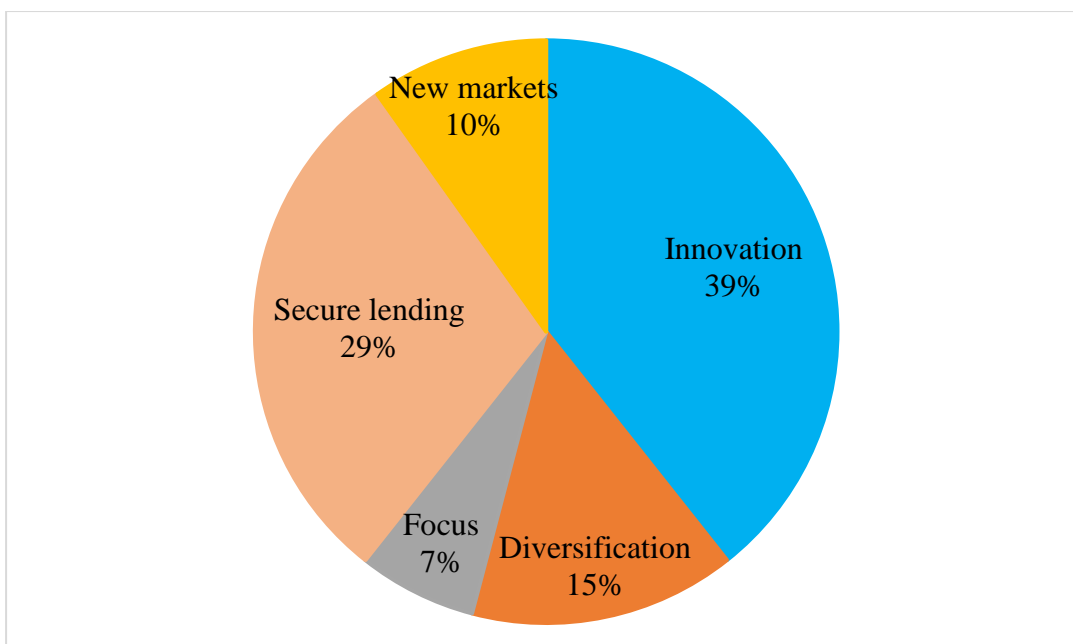
Respondents were requested to rate the level of agreement of statements describing their dynamic capabilities. The research identified that 70% of the respondents have to a large extent a portfolio of resources upon which they derive competitive edge in the banking sector. Findings indicated that respondents have to a large extent leveraged on technology innovations to compete favorably and deliver customer value concerning banking activities. Findings on dynamic capabilities and the extent to which they are applicable is as indicated in Table 4.3.

#### **4.5 Strategic Responses by MFBs to Capping of Interest Rates**

Respondents were asked to select strategies they have put in place in response to capping of interest rates by CBK. Findings were grouped to include development of new markets, secure lending, innovation, focus and diversification strategy. Popularity of innovation strategy stands at 39% among the respondents followed by secure lending at 29%. Focus on specific markets is considered to an extent of 7% across respondents.

Fifteen percent of the respondents are diversifying into non-lending income streams in response to capping of interest rates by CBK. Ten percent of the respondents have chosen to invest in new markets in aligning to this paradigm in the economic environment. Deployment of these strategies by various respondents is as displayed in Figure 4.6.

Majority of the respondents relied on secure lending as the best strategy in coping up with effects emanating from capping of interest rates by CBK. This continues to reduce on the loans advanced. The consequent effect of reduction of interest income due to reduce levels of borrowing is diversifying in income streams such as government bonds and treasury bills. Respondents are moving away from credit business to investment business.



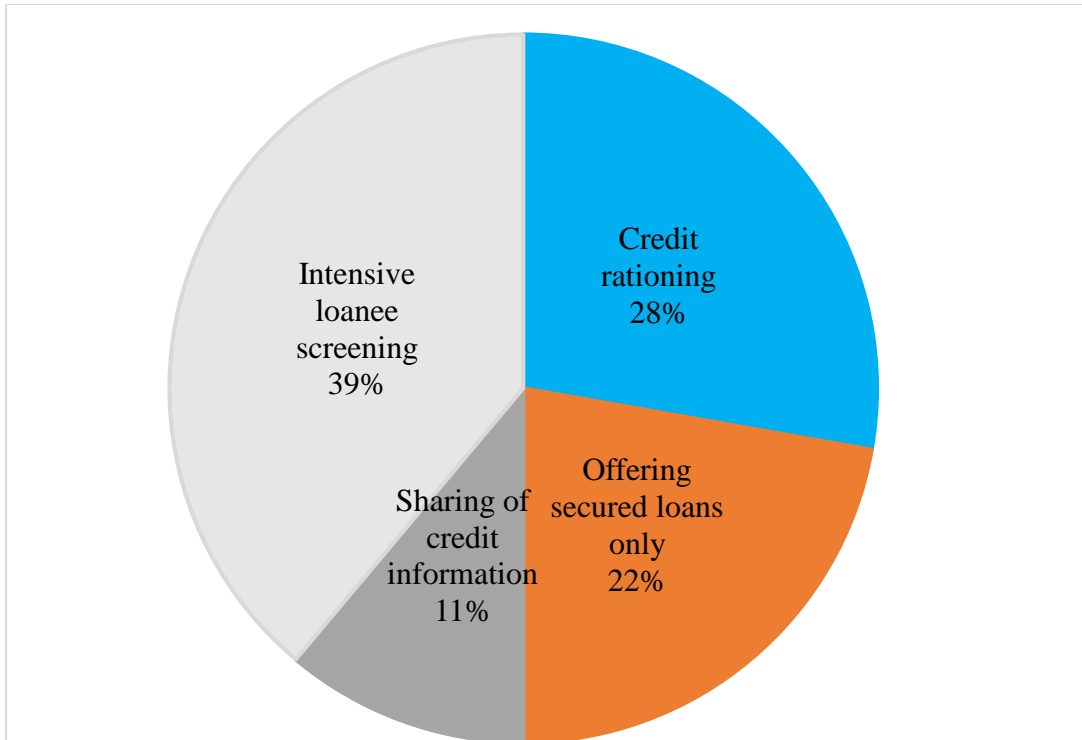
Source: Research data, (2017)

**Figure 4. 6: Strategic Responses by Microfinance Banks to Capping of Interest Rates by CBK**

#### **4.5.1. Secure Lending**

Secure lending comprise of responses in relation to intensive screening of loan applicants, sharing of credit information, offering of secured loans only and credit rationing. Twenty nine percent of the respondents considered secure lending due to default risk and moral hazard risk amongst their target customers. Applicability of various secure lending techniques among respondents is shown in Figure 4.7.

Thirty nine percent of the respondents undertake intensive screening of loan applicants to manage credit risk. Credit rationing is carried out among 28% of the respondents. Twenty two percent of respondents prefer providing credit facilities on collateral basis only. Sharing of customers' credit information is considered as a strategic response among 11% of the respondents. However, this is seen as a hygiene factor among the established respondents.



Source: Research data, (2017)

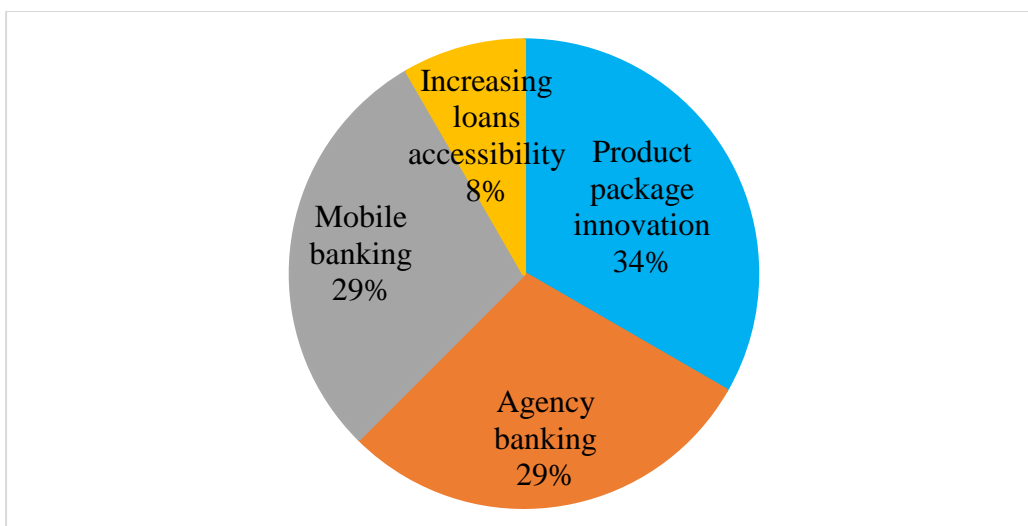
**Figure 4. 7: Secure Lending**

Secured loans will limit the amount of loans advanced to SMEs. This could affect the investment capacities of SMEs and loss of customers. In lieu of this, microfinance banks need to continue innovating ways to attract more customers and broaden the scope of products and services. This will in effect reduce the adversity of secure lending challenges.

#### **4.5.2. Innovation**

Respondents leverage on technology to deliver customer satisfaction and ease transactions. This is in order to retain the market share despite the low interest rates charged by credit facilities provided by commercial banks. Use of the digital platforms to ensure provision of more efficient services to customers is a step to enable quick loan disbursements to SMEs.





Source: Research data, (2017)

**Figure 4. 8: Innovation Strategy**

According to the research findings, innovation strategy is a combination of product package innovation, agency banking, mobile banking and increasing accessibility to credit facilities. Findings indicate that 34% of respondents using innovation strategy engage product package innovation, 29% rely on agency banking, and 29% rely on mobile banking and 8% leverage on increasing loans accessibility.

Innovation attributed to technological advancements continues to introduce competitive advantage to market participants' more so concerning the banking industry. Respondents have come up with business models to necessitate banking activities. Devising new ways of doing microfinance banking activities will ensure long-term survival of the business.

#### **4.6 Effectiveness of Strategic Responses by Microfinance Banks**

Respondents were required to rate the effectiveness of their strategic responses to capping of interest rates by the CBK. Findings indicated effectiveness of secure lending, innovation, diversification, new markets and focus strategy. Expanding product portfolio is a very effective strategy as indicated in Table 4.4 below.

**Table 4. 4: Effectiveness of Strategic Responses by MFBs to capping of Interest Rates by CBK**

| Strategy  | Not Effective | Less Effective | Mode rate | Effective | Very Effective | Mean  |
|---|---------------|----------------|-----------|-----------|----------------|-------|
| Product package innovation                            | 0%            | 0%             | 13%       | 38%       | 50%            | 4.375 |
| Agency banking  | 25%           | 0%             | 0%        | 0%        | 75%            | 4.000 |
| Mobile banking  | 0%            | 0%             | 0%        | 0%        | 100%           | 5.000 |
| Credit rationing                                      | 0%            | 0%             | 40%       | 20%       | 40%            | 4.000 |
| Intensive loanee screening                            | 0%            | 0%             | 14%       | 43%       | 43%            | 4.286 |
| Offering secured loans only                           | 0%            | 0%             | 25%       | 50%       | 25%            | 4.000 |
| Sharing of credit information                         | 0%            | 0%             | 60%       | 20%       | 20%            | 3.600 |
| Investing in new markets                              | 0%            | 40%            | 20%       | 20%       | 20%            | 3.200 |
| Focusing on specific markets                          | 0%            | 0%             | 0%        | 50%       | 50%            | 4.500 |
| Other businesses other than banking                   | 0%            | 0%             | 75%       | 25%       | 0%             | 3.250 |
| Expanding portfolio of products and services provided | 0%            | 0%             | 0%        | 43%       | 57%            | 4.571 |
| Increasing loan accessibility                         | 0%            | 0%             | 0%        | 100%      | 0%             | 4.000 |

Source: Research data, (2017)

Findings on the effectiveness of strategic responses confirmed that, expansion of product portfolio was the most effective strategy adopted by respondents in responding to effects of capping of interest rates by CBK. Interest income may not be the main source of income in the mere future. The current scenario of capped interest rates on loans advanced by commercial banks is the contributing factor. Respondents continue to invest in non- credit business streams to reduce on the credit risk.

Further, respondents that adopted increasing the accessibility to loan facilities have been effective. This is attributed to the available digital platforms that necessitate ease of transactions including loan facilities at a glimpse of an eye. Product package innovation is effective among those who use it. Incorporation of technology to diverse ways to improve way of business will propagate development of new products to suit changing customer needs.

Secure lending is deemed effective among respondents who deploy it. Al though this strategy will limit the credit business, it has effectively reduced on the moral hazard risk as well as the default risk. Investing in new markets seem to be less effective among 40% of respondents who pursued this strategy in coping with changes attributed to capping of interest rates by CBK. New market development requires intensive market intelligence and other key resources committed to deliver to customer satisfaction. The constrained resource and capability capacity is the main inhibitor to success of this strategy.

#### **4.7 Discussion of Research Findings**

Demographic information of an organization influences its strategic decisions. Fifty percent of the respondents were licensed less than five years ago. It is important to note that their level of strategic alignment may vary due the number of customers they serve, their markets, product portfolio and technical infrastructure. All the headquarters of respondents are located within Nairobi. This is a representative of the country's economic state for SMEs being the economic epicenter of the country and banking sector to be specific. The resources possessed vary and hence influence their strategic responses (Hamel & Prahalad, 1990).

Respondents serve the SMEs in Kenya at large, which represents a sector touted as the largest employer and platform for economic development as envisioned by the Vision 2030. Low-income earners are interested in banking with the microfinance banks to achieve their empowerment goals as some are excluded from the mainstream banking sector.

Economic environment is the source of competitive advantage for businesses. The environment provides the inputs for the respondents such as deposits from customers who receive loan facilities as outputs from the MFBs. This relationship with the economic environment is vital for organizations' success as it forms the basis for strategic analysis (Kahn & Katz, 1978).

Respondents are open systems and hence any change in the economic environment regardless of magnitude has a great impact on performance. Industry analysis is critical in influencing strategic decisions (Porter, 1980). Frequency at which environmental scanning is conducted determines on how fast and when changes in the environment can be addressed. Timely response to changes in the economic environment is critical for respondents to avoid adverse effects from environmental uncertainty (Ansoff & Sullivan, 1993).

Strategic response requires assessment of the business environment for threats and opportunities (Adebisi & Babatunde, 2012). Environmental scanning includes collecting information within the environment in which the business operates. The results from scanning the environment then inform on the way and provide a cue to tailor make available resources and capabilities to address the changes. Respondents assess the economic environment on various frequencies and compile reports for discussion of strategic actions.

Strategic alignments in the economic environment are mainly driven by changes in market, evolving customer needs and competition. Changes in taxation and monetary policies also contribute to strategic adaptation of MFBs. The market needs are continuously changing due to the globalization, technology and more customer awareness. Successful respondents are those that will be able to meet customer and market needs in the end. Customers lose confidence in seasonal product package providers.

The impact of capping of interest rates by CBK on performance of respondents is huge. Respondents have seen an increase in loan applications leading them to revert to secure lending to mitigate the moral hazard and adverse selection risk. This strategy has led to reduction of successful loan applications because of increased screening with a cautionary orientation to reduce default risk. Indeed changes in the economic environment can jeopardize performance of organizations in diverse ways. These findings are in tandem with those of Afande and Maina (2015) who found out that the external environment affects profitability and long-term viability of MFIs in Kenya.

The resources and dynamic capabilities by the respondents support strategic responses identified. This is in line with findings of Narula and Upadhyay (2010) on strategic responses of Excel Company that leveraged on its strengths such as huge manufacturing capacity to move to international markets and diversify. Actions for strategic responses require modification and adjustment of the available resources and capabilities to suit the change (Pisano et al, 1997). Respondents leverage on technology and market intelligence to drive innovations and satisfy customer needs to a large extent. Technology appreciation is an enabler for upgrading productive sectors and downgrading the sectors unable to sustain effects of capped interest rates by CBK.

During strategic responses, it is not mandatory that the available systems be disrupted to curb the turbulence, rather be amended through monitoring and evaluation. Majority of respondents were prospectus who leverage on innovation for new opportunities and markets (Miles & Snow, 1978). Innovation continue to gain prominence in introducing new ways of running business by improving the available capabilities to deliver services with better quality, efficiency and speed.

Respondents considered secure lending and innovation strategy as the main strategies for addressing capping of interest rates by CBK. These findings depart from earlier findings that secure lending reduces financial inclusion of SMEs (Coetzee et al. 2002). Respondents need to spot opportunities amidst environmental turbulence and take advantage of them (Bessant & Pavitt, 2005). Findings on strategic responses are in support of adaptive diversification achieved through modification of core competencies and optimizing technology to deliver customer value (Pisano et al. 1997).

More findings confirmed that, available pool of resources and dynamic capabilities determine how well a strategic response will be effected. Constrained resources reduce the effectiveness of strategic responses as highlited by the findings in Table 4.4. This findings are in tandem with conclusions of resource based theory (Grant, 1991). In Summary, the findings seem to support previous findings and all the objectives of the study have been met.

## **CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS**

### **5.1 Introduction**

The research findings are summarized in this chapter. Recommendations, conclusion and areas for further study are discussed in this chapter. The chapter is a recap of the research findings undertaken to establish the strategic responses by MFBs to the dynamism in the economic environment with specific focus on the capping of interest rates by the Central Bank of Kenya.

Findings of the study addressed the research objectives. Specific objectives included to find out the impact of capping of interest rates on the performance of microfinance banks. The findings indicated a reduction in the number of successful loan applications and an increase in the number of loan requests. This has improved the quality of the loan book held by the MFBs through thorough screening of loan applications to mitigate credit risk. Findings also indicated a reduction in the number of deposits. This has raised concern among the respondents due to its effect on the health of the balance sheet. It is evident that capping of interest rates by the CBK has affected the performance of microfinance banks in on areas of significance on the bottom line.

Determination of the resources and dynamic capabilities that spur strategic responses was also done to address the second objective of this research. Findings indicate that technology innovations and exemplary customer services were the main drivers of strategic responses. It was also noted that, more than 70% of the respondents had to a large extent a portfolio of resources that gives them a competitive edge over the other participants in the industry.

## **5.2 Summary of Research Findings**

The study sought to determine the strategic responses by microfinance banks to dynamism in the economic environment with specific focus on capping of interest rates by CBK. The economic environment presents scenarios that if not strategically addressed could be detrimental to the banking business. Findings drew the attention of secure lending, innovation, diversification, new markets and focus strategies as the strategic responses.

The specific objectives that sought to determine the impact of capping of interest rates on performance of MFBs as well as the resources and dynamic capabilities in possession of MFB to ensure appropriate strategic responses were also met. Findings indicate that the capping of interest rates led to increase in loan requests and reduction in successful loan applications. In addition, MFBs experienced a shift of high-end customers to the commercial banks where they got credit facilities at lower interest rates. However, some of the customers are coming back to the MFBs but the reasons for the shift are still under investigation. The resources and dynamic capabilities necessary to influence adopted strategic responses include technology innovations and exemplary customer service.

Organizations are open systems that respond positively to the changes in the economic environment (Kahn & Katz, 1978). All respondents assess the economic environment and develop various mechanisms to adjust to the changes. Fifty percent of the respondents discuss the changes on a monthly basis after compiling them on weekly basis. Diversification has been deployed due to the innovation spearheaded by technology applications. Sector reviews are done based on various market intelligence.



This has contributed to increase in product range offered by MFBs hence reducing the risk of compromising with the bottom line as a result of depressed revenue streams. Product package innovation is the main strategy that MFBs are using to broaden the revenue sources. Technology improvement has triggered numerous advancements by respondents in delivering exemplary customer service. Respondents have reduced turnaround time of loan processing. Markets such as churches are some of the new frontiers pursued by respondents. Mobile banking, agency banking and sharing of credit information are seemingly hygiene factors though some respondents consider them as strategies.

### **5.3 Conclusion**

Microfinance banks are open systems operating in a dynamic business environment. The impact of economic dynamism cannot be ignored regardless of whether it is direct or indirect. The capping of interest rates by the CBK directly affected the lending and deposit interest rates charged by commercial banks. MFBs have felt the ripple effect of this monetary policy change intended for economic repression.

Investment on market intelligence and product innovation is critical in enabling MFBs to realize long-term sustainable competitive advantage amidst the dynamic environment (Pisano et al. 1997). This will embrace assessment of the economic environment and development of suitable and flexible strategies for competitive advantage. Technology coupled with acts of innovation can drive reputable and immense performance improvement among MFBs.

Failure to combine resources optimally can be detrimental given the level of engagement required. Strategic agility is therefore inevitable for MFBs. Search for new markets and increasing the accessibility of the products in terms of convenience has great impact rather than price. Some respondents noted that Kenyans are ready to pay heavily for credit facilities that are of convenient access. Secure lending and innovation are the main strategies adopted by MFBs in response to changes occasioned by capping of interest rates by CBK.

#### **5.4 Recommendations**

MFBs need to broaden the scope of their market intelligence to continuously scan the external environment and respond to the changes on time. Embracing technology and innovation is critical in delivering customer satisfaction and market needs of SMEs. Accessibility of the products offered by MFBs is also wanting. Microfinance banks need to leverage on available capacities to increase financial inclusion of SMEs.

Microfinance banks need to understand why the customers who moved to commercial banks are coming back as earlier indicated by some respondents. There is a likelihood of customer shift to shylocks due to ease of access to funds. MFBs can leverage on the mobile applications as some have already done in order to serve dynamic customer needs.

The secure lending strategies are likely to limit credit facilities to the low-income sectors and hence open a window for alternative financing including illegal lending. There is need for policy amendments on the Microfinance Act to increase financial inclusion among SMEs. This will lock out loan sharks and instead encourage competition (Coetzee et al, 2002). Growth potential by respondents is immense and requires continuous actions of innovations to reach untapped markets.

## **5.5 Limitations of the Study**

The study was carried out one year after the capping of interest rates. The findings may not be conclusive in the long-term hence need for future studies. The research was constrained of data collection time. The respondents had to create time to complete the questionnaires alongside their normal work routines.

The response rate was 84.6% and one out of the eleven questionnaires was invalid and not considered for analysis. Two of the respondents did not respond to the questionnaires administered to them. The organizational policies for some of the respondents in seeking information require more time for prior arrangements to collect data.

The respondents were limited to managers in charge of strategy and equivalents. There is need to access responses from other employees in lower ranks. In addition, research was conducted at a time when the country was involved in heightened political situation. This limited access to some of the respondents who did not want to respond to the questionnaires. At such point in time, respondents were not at ease to release any organizational information.

## **5.6 Areas for Further Studies**

This study focused on capped rates on the credit facilities offered. There is need to understand the effect of capping of interest rates on deposit performance. Further studies can reveal the impact of the strategies used by the microfinance banks to capping of interest rates on their performance. Customer perception on the capping of interest rates is also an opportunity for research.

Research to establish customer behavior on the policy reviews undertaken by the microfinance banks after the capping of interest rates by the CBK is another area of study. The banking sector is again facing change in credit supply implicated by the requirements of IFRS 9 to anticipate future losses for loans issued and provide for them on the life of the loan. This is dynamism in the economic environment facing banks after the capping of interest rates by the CBK. There is an opportunity to unravel the impact on the loan performance of microfinance banks and the entire banking sector on the effect of this change in financial reporting standard.

Research to be carried out in other sectors of the financial sector to investigate further spillover effect of interest rate capping to strategy. Some of these institutions include insurance, stock market, investment and real estate sectors. Further research need to be undertaken to investigate the impact of other legislative controls to the banking sector in Kenya. Successful implementation of the strategic responses by microfinance banks to capping of interest rates by CBK is a necessary study area. Other researches can be done on the impact of interest rate capping in other African countries in the recent past.

In summary, this chapter has concluded on the research findings and recommendations of the study. The economic environment is highly dynamic and firms need to keep abreast of these changes. Spotting opportunities and threats and exploiting them using the available resources and dynamic capabilities will lead to creation of competitive edge and successful strategic responses.

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## APPENDICES

### Appendix I: Research Questionnaire

#### STRATEGIC RESPONSES BY MICROFINANCE BANKS IN KENYA TO CAPPING OF INTEREST RATE BY THE CBK

The questionnaire was administered to investigate the strategic responses by microfinance banks to capping of interest rate by the Central Bank of Kenya. The questionnaire is comprised of three sections: Section one, two and three to capture organizational demographics, dynamism of the economic environment and strategic responses to interest rate capping by the Central Bank of Kenya respectively. Data collected will be strictly for academic purpose hence confidential.

#### SECTION ONE: ORGANIZATIONAL DEMOGRAPHICS

1. Please indicate the name of the microfinance bank .....
2. Which year was bank established? .....
3. What products and services does the bank offer? .....
4. What is the target market of the products and services provided by the bank...?
5. How many customers does the bank serve?

Less than 100   101-1,000   1,001-10,000   More than 10,000

#### SECTION TWO: DYNAMISM OF THE ECONOMIC ENVIRONMENT

1. At what frequency does the bank monitor changes in the economic environment?Not at all    Weekly    Monthly   Quarterly   Annually
2. How does the bank deal with economic changes affecting its performance?  
.....

3. Please indicate the extent to which the following economic changes influence strategies developed and used by the bank on a 1-5 point scale ;1-not at all 2-small extent, 3-moderate 4-large extent and 5-very large extent

| Economic changes        | Frequency |   |   |   |   |
|-------------------------|-----------|---|---|---|---|
|                         | 1         | 2 | 3 | 4 | 5 |
| Changing market needs   |           |   |   |   |   |
| Evolving customer needs |           |   |   |   |   |
| Monetary policy changes |           |   |   |   |   |
| Taxation policy         |           |   |   |   |   |
| Competition             |           |   |   |   |   |

4. Indicate using a tick (√) ways in which the bank's performance has been affected by the capping of interest rates by the Central Bank of Kenya.

- None
 Increase in loan requests  
Reduction in the number of successful loan applications
 Reduced number of loan applications  
Other

5. Highlight 3 main investments or activities done by the bank to adapt to changes in the economic environment.

- a) .....  
 b) .....  
 c) .....

### **SECTION THREE: STRATEGIC RESPONSES TO CAPPING OF INTEREST RATES BY THE CENTRAL BANK OF KENYA**

1. Please select with a tick (√) the factors that influence how the bank is responding to market changes brought about by capping of interest rate by the CBK.

- Technology innovations
 Technical support  
Product quality
 Research and Development  
Renovation of products and services
 Marketing activities  
Exemplary customer service
 Other (Specify.....)

2. Please show with a tick(√) on a scale of 1-5, the level at which you agree with the following statements about the bank where: 1-Strongly disagree, 2-Disagree, 3-Somehow agree, 4-Agree, 5-Strongly agree

| Statement   | Rating status |   |   |   |   |
|---|---------------|---|---|---|---|
|   | 1             | 2 | 3 | 4 | 5 |
| The bank has established mechanisms of dealing with credit banking destructors.   |               |   |   |   |   |
| The bank has a portfolio of resources that gives it a competitive edge over the other banks in the industry               |               |   |   |   |   |
| The bank has leveraged on technology innovations to deliver customer value and compete favorably in the banking business. |               |   |   |   |   |

3. Please select by applying a tick (√) on strategies pursued by the bank in response to capping of interest rates by the Central Bank of Kenya?

|   |  |
|---|--|
| <input type="checkbox"/> Product package innovation                 | <input type="checkbox"/> Credit rationing  |
| <input type="checkbox"/> Lowering lending interest rates            | <input type="checkbox"/> Intensive loanee screening                                |
| <input type="checkbox"/> Mobile banking                             | <input type="checkbox"/> Offering secured loans only                               |
| <input type="checkbox"/> Agency banking                             | <input type="checkbox"/> Investing in other businesses other than banking          |
| <input type="checkbox"/> Focusing on specific markets and customers | <input type="checkbox"/> Sharing of credit information                             |
| <input type="checkbox"/> Investing in new markets                   | <input type="checkbox"/> Expanding the portfolio of products and services provided |

Other (Specify).....

4. Please rate with a tick (√) on a scale of 1-5, the effectiveness of the strategies used by the bank in response to capping of interest rates by the Central Bank of Kenya with 1 as the least effective strategy and 5 for the most effective strategy.

| Strategic response  | Rating scale of impact of strategic responses |   |   |   |   |
|---|---|---|---|---|---|
|   | 1   | 2 | 3 | 4 | 5 |
| Product package innovation                                |   |   |   |   |   |
| Lowering lending interest rates                           |   |   |   |   |   |
| Investing in new markets                                  |   |   |   |   |   |
| Focusing on specific markets and customers                |   |   |   |   |   |
| Credit rationing  |   |   |   |   |   |
| Intensive loanee screening                                |   |   |   |   |   |
| Investing in other businesses other than banking          |   |   |   |   |   |
| Agency banking  |   |   |   |   |   |
| Mobile banking  |   |   |   |   |   |
| Offering secured loans only                               |   |   |   |   |   |
| Sharing of credit information                             |   |   |   |   |   |
| Expanding the portfolio of products and services provided |   |   |   |   |   |
| Other (Specify).....                                      |   |   |   |   |   |

## Appendix II: Letter of Introduction



### UNIVERSITY OF NAIROBI SCHOOL OF BUSINESS

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P.O. Box 30197  
Nairobi, Kenya

DATE 28/09/2017

#### TO WHOM IT MAY CONCERN

The bearer of this letter WINNIE AFANDI

Registration No. D61/79158/2015

is a bona fide continuing student in the Master of Business Administration (MBA) degree program in this University.

He/she is required to submit as part of his/her coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would, therefore, appreciate your assistance to enable him/her collect data in your organization.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you.

  
**PATRICK NYABUTO**  
SENIOR ADMINISTRATIVE ASSISTANT  
SCHOOL OF BUSINESS



### **Appendix III: List of Licensed Microfinance Banks in Kenya**

|   |
|---|
| <p style="text-align: center;"><b>1. Choice Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 18263-00100, Nairobi<br/>Physical Address: Siron Place, Magadi Road, OngataRongai<br/>Date licensed: 13th May, 2013      Branches: 1</p>                  |
| <p style="text-align: center;"><b>2. Faulu Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 60240-00200, Nairobi<br/>Physical Address: Faulu Kenya House,Ngong Lane off Ngong Road<br/>Date licensed: 21st May, 2009      Branches: 32</p>             |
| <p style="text-align: center;"><b>3. Kenya Women Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 471900506, Nairobi<br/>Physical Address: Akira House, Kiambere Road, Upper Hill<br/>Date licensed: 31st March, 2010      Branches: 29</p>            |
| <p style="text-align: center;"><b>4. SMEP Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 6406300620, Nairobi<br/>Physical Address: SMEP building, Kirichwa Road, Off ArgwingsKodhek Road<br/>Date licensed: 14th December, 2010      Branches: 7</p> |
| <p style="text-align: center;"><b>5. Remu Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 20833-00100, Nairobi<br/>Physical Address: Finance House, 14th Floor, Loita Street<br/>Date licensed: 31st December, 2010      Branches: 3</p>              |
| <p style="text-align: center;"><b>6. Rafiki Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 12755-00400, Nairobi<br/>Physical Address: Rafiki House, Biashara Street<br/>Date licensed: 14th June, 2011      Branches: 17</p>                         |
| <p style="text-align: center;"><b>7. Uwezo Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 1654-00100, Nairobi<br/>Physical Address: Rehani House, 11th floor, Koinange Street<br/>Date licensed: 8th November, 2010      Branches: 2</p>             |



|   |
|---|
| <p style="text-align: center;"><b>8. Century Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 38319-00623, Nairobi</p> <p>Physical Address: KK Plaza 1st Floor, New Pumwani Road, Gikomba</p> <p>Date licensed: 17th September, 2012      Branches: 1</p>  |
| <p style="text-align: center;"><b>9. Sumac Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 11687-00100, Nairobi</p> <p>Physical Address: Consolidated Bank House 2nd floor, Koinange Street</p> <p>Date licensed: 29th October, 2012      Branches: 3</p> |
| <p style="text-align: center;"><b>10. U&amp;I Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 15825-00100, Nairobi</p> <p>Physical Address: Asili Complex Building 1st Floor, River Road</p> <p>Date licensed: 8th April, 2013      Branches: 2</p>       |
| <p style="text-align: center;"><b>11. Daraja Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 100854-00100, Jamia, Nairobi</p> <p>Physical Address: Karandini Road, off Naivasha Road</p> <p>Date Licensed: 12th January, 2015      Branches: 1</p>        |
| <p style="text-align: center;"><b>12. Caritas Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 15352-00100, Nairobi</p> <p>Physical Address: Cardinal Maurice Otunga Plaza, Kaunda Street</p> <p>Date Licensed: 2nd June, 2015      Branches: 1</p>        |
| <p style="text-align: center;"><b>13. Maisha Microfinance Bank Limited</b></p> <p>Postal Address: P.O. Box 49316-00100, Nairobi</p> <p>Physical Address: 2nd Floor, Chester House Commercial Wing,</p> <p>Date Licensed: 21st May, 2016      Branches: 1</p>            |

Source: [www.centralbank.go.ke](http://www.centralbank.go.ke), 2017