THE DETERMINANTS OF TRANSFORMATION OF MICROFINANCE INSTITUTIONS INTO DEPOSIT TAKING MFIs IN KENYA

BY:

LUCY WAMAITHA NDEERI

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DECLARATION

This research project is my original work and has not been presented for a degree in any university

Lucy Wamaitha Ndeeri; Reg. No. D61/P/8383/2004

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Signature Date

This research project has been submitted for moderation with my approval as University Supervisor

.... 9/11/20 ....

Signature Date

Mirie Mwangi, Lecturer, Department of Finance and Accounting

First and most importantly, I wish to thank God, the Almighty the Lord of the Universe for bringing me this far. I pride in his name because he means well for me all the times. Secondly, I wish to acknowledge my sincere appreciation to the following people without whom this research work would not have been successful. It may not be possible to mention all by name but the following were singled out for their exceptional contributions.

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DEDICATION

I dedicate this project to my family. Without their encouragement, understanding, support and love, completion of this study could not have been possible.

ABSTRACT

The purpose of this study was to determine the determinants of transformation of non-deposit taking Micro Finance Institutions in Kenya into deposit taking microfinance institutions. The study specifically sought to find out the effect of commercialization, self-sustainability and automation of customer products and services on the transformation process.

The research design used was descriptive survey study. A census of 46 MFIs in Kenya, excluding banks and insurance institutions were surveyed from the target population and 36 of them responded. The researcher used primary data which was obtained through self-administered questionnaires with closed and open-ended questions. SPSS was used to perform the analysis as it aided in organizing and summarizing the data. The analyzed data was presented in tables, charts and graphs including frequency percentages.

The study established that the three determinants; commercialization, self-sustainability and automation of customer products and services have a significant effect on the transformation of MFIs, with self-sustainability as the strongest determinant of transformation of MFIs. The study recommended that there should be adequate motivation for Micro Finance Institutions to operate at most convenient environment for them and to promote their transformation.

TABLE OF CONTENT

LIST OF TABLES

LIST OF FIGURES

ABBREVIATIONS

AMFI	-	Association of Micro finance Institutions of Kenya
ANOVA	-	Analysis of Variance
AKRSP	-	Aga Khan Rural Support Programme
ASCA	-	Accumulating Savings and Credit Associations
ATM	-	Automated Teller Machine
BRI	-	Bank Rakyat Indonesia
CBK	-	Central Bank of Kenya
CGAP	-	Consultative Group to Assist the Poor
DTM	-	Deposit Taking Microfinance
FSD	-	Financial Sector Deepening
ICT	-	Information and Communication Technology
IFS	-	Institutional Financial Self-Sufficiency
K-REP	-	Kenya Rural Enterprise Program
KPOSB	-	Kenya Post Office Savings Bank
MFI	-	Micro Finance Institution
MIS	-	Management Information System
MIX	-	Microfinance Information Exchange
MMSE	-	Micro, Small and Medium Enterprise Sector
NGO	-	Non- Governmental Organization
ROSCA	-	Rotating Savings and Credit Associations
RFI	-	Regulated Financial Institutions

SACCO	-	Savings and Credit Cooperative
SME	-	Small Micro Enterprises
SPSS	-	Statistical Package for Social Sciences
UML	-	Uganda Microfinance Limited
UMU	-	Uganda Microfinance Union
USAID	-	United States Agency for International Development

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The financial sector of many developing countries is comprised of the formal and informal financial services sectors. The formal sector is made up by the Central Bank, commercial banks, development banks, agricultural banks, microfinance institutions and money markets. The informal sector is made up of moneylenders, pawnbrokers, savings collectors, money-guards, Rotating Savings and Credit Associations (ROSCAs), Accumulating Savings and Credit Associations (ASCAs) and input supply shops (FSD, 2012).

Lack of access to credit is generally seen as one of the main reasons why people in developing countries remain poor. The poor usually have no access to loans from the banking system, because they cannot put up acceptable collateral or because the costs for banks of screening and monitoring the activities of the poor are too high to make lending to this group profitable. Since the late 1970s, however, the poor in developing economies have increasingly gained access to small loans with the help of microfinance programs (Hermes & Lensink, 2007).

Microfinance has empowered millions of people the world over, to work their way out of poverty. Microfinance Institutions (MFI's) in Sub-Saharan Africa had 6.5 million borrowers and 16.5 million depositors by the end of 2008 (CBK, 2012). Microfinance plays a crucial role in enhancing inclusion of the low-income in the financial sector and has therefore promoted economic development.

1.1.1 Microfinance Institutions

Microfinance refers to the provision of financial services to poor and low-income clients, both the employed and self-employed. It refers to a movement that envisions a world in which low-income households have permanent access to a range of high quality and affordable financial services offered by a range of retail providers to finance income-producing activities, build assets, stabilize consumption and protect against risks. Microfinance should not be confused with microcredit, which refers to very small loans for unsalaried borrowers with little or no collateral, provided by legally registered institutions (Microfinance gateway, 2012).

The precedence for microfinance lies in the many traditional and informal systems of credit that has existed in developing economies for centuries. Many of the current practices are derived from community-based mutual credit transactions that were based on trust, peer-based, non-collateral, borrowing and repayment. Transactional, mutual or personal credit suppliers, such as money lenders, rotating savings and credit associations, or friends and neighbours have always lent to the poor, providing the right quality and quantity of credit, at the right time and place, to low-income households (Hassan, 2002).

Microfinance Institutions comprise a wide range of providers that vary in their legal structure, mission, and methodology. However, all share the common characteristic of providing financial services to clients who are poorer and more vulnerable than traditional bank clients .The services offered by the microfinance institutions are of a financial and non-financial nature. The financial services provided include savings, provision of credit, insurance and transfer payments. The non-financial services offered include health services, business development, development of self-confidence and training in financial literacy (Microfinance gateway, 2012).

1.1.2 Concept of Transformation

Transformation of Microfinance Institutions (MFI's) and Non-Governmental Organizations (NGOs) to formal or Deposit Taking Microfinance Institutions primarily refers to the change from non-profit, socially motivated and donor dependent institutions to for-profit, self- reliant and regulated financial institution (Hishigsuren, 2006).

According to Hishigsuren (2006), an institutional transformation of microfinance NGOs into Regulated Financial Institutions (RFIs) is embraced as one of the most effective strategies for achieving a significant scale by offering a wider range of services, accessing commercial sources of capital and improving operational efficiency through enhanced systems, controls and transparency in reporting that would result from links to regulators and other banking expertise and financial sustainability of MFI's.

The microfinance industry is undergoing significant change worldwide. The Microfinance Institutions (MFI's) have grown substantially in scale and have had major changes in their mode of operation. Traditional microfinance has largely been an operation of Non-Governmental Organizations (NGOs) and government sponsored programs. The changes to the sector have been evolving over the last three decades. This change has been mainly through transformation of NGOs into regulated microfinance institutions. The first transformation to take place is regarded as one of the most successful to date. The Bolivian NGO PRODEM, took the initiative to transform into the commercial bank BancoSol in 1989. Regionally, one of the best known and well documented experiences is the transformation of Uganda Microfinance Union (UMU) into Uganda Microfinance Limited (UML). In Kenya, the first NGO to transform into a regulated institution was K-Rep. This was in the 1990s, during a time when the banking sector was going through a crisis and there was also lack of an adequate regulatory framework for micro-finance institutions. K-Rep received its banking license in 1999. It became the first commercial bank in Kenya to serve only the low income clients, and the first NGO in Africa to transform into a regulated financial institution (FSD, 2012).

Worldwide, transformation has taken four different forms; Microfinance NGO transformation to a regulated commercial entity; traditional regulated financial institutions penetrating the microfinance market; creation of commercial microfinance institutions and merger between a commercial bank and a microfinance institution, or a merger between two or more microfinance institutions (Hishigsuren, 2006). For the purposes of this paper, transformation shall be assumed to take the form of traditional MFI's transforming into a regulated commercial deposit-taking entity.

1.1.3 Factors Determining the Transformation of MFIs

There are several factors that motivate the transformation of Microfinance Institutions (MFI's) into Deposit Taking Microfinance Institutions (DTM). These are:

commercialization; self-Sustainability and automation of customer products and services (Hishigsuren, 2006).

1.1.3.1 Commercialization

Commercialization of microfinance generally refers to the application of market-based principles and to the movement out of the heavily donor-dependent arena of subsidized operations into one in which microfinance institutions manage on a business basis as part of the regulated financial system. In commercialization lies the potential for truly exponential growth and ultimately, vastly improved financial services to the poor (Ledgerwood & White, 2006).The terms commercialization and transformation are frequently used interchangeably; however, transformation is only one of the ways an MFI can commercialize (Lauer, 2008).

1.1.3.2 Self-sustainability

According to the CGAP (1997), all microfinance institutions have to depict two kinds of self-sustainability before claiming to be self-sustainable. One is the operational self-sufficiency where all MFI's are required to depict full coverage of all their operational and administrative costs, including losses from bad loans, from their revenues from operations. The other is financial self-sustainability, whereby MFI's have to prove that they are meeting all their financial requirements through funds generated from internal operations and other commercial sources.

Savings are a pillar of sustainability. A sustainable institution is one which is viable and does not depend on donors but its own resources. A viable institution is able to cover its costs and perhaps make a profit from its own business operations (Seibel, 1999). In the effort to achieve self-sustainability, many MFI's have become commercial institutions. If successful at this change, MFI's will no longer be reliant on government grants or below market-rate loans (Crabb & Keller, 2006).

1.1.3.3 Automation of Customer Products and Services

Another external factor which has come into play in recent times is the advent and development of Information and Communications Technology (ICT) (Ndulu, 2010). Growth in ICT has made the MFI's automate most of their processes and this in turn contributes to their transformation.

1.1.4 MFIs in Kenya

The Kenyan financial sector is comprised of the banking sector, microfinance institutions (MFI's), Savings and Credit Cooperatives (SACCOs). Money transfer services and the informal financial services sector. The regulator is the Central Bank of Kenya (CBK) (FSD, 2010).

There is still limited access to financial services for the majority of Kenyans, even though there has been improvement over the years. According to FinAccess Survey (2009), 22.6% of the adult population now has access to formal financial services through banks, compared with 18.9% in 2006. A further 17.9% are served by other formal financial institutions (MFI's and SACCOs) compared with only 7.5% in 2006. The proportion of adult Kenyans that depend primarily on informal financial service providers has declined from 35.2% in 2006 to 26.8% in 2009. Overall, the proportion of adult Kenyans that are excluded from accessing financial services and products shrank from 38.4% in 2006 to 32.7% in 2009 (FSD, 2010).

The microfinance sector in Kenya was until recently, regulated under eight different acts of parliament namely; The Non -Governmental Organizations Co-ordination Act; The Building Societies Act; The Trustee Act; The Societies Act; The Co-operative Societies Act; The Companies Act; The Banking Act and The Kenya Post Office Savings Bank (KPOSB) Act (Omino, 2005). These forms of registration did not address issues on ownership, governance and accountability.

The Microfinance Act, 2006 came into force on 2nd May 2008 after the Microfinance (Deposit-Taking Microfinance Institutions) Regulations, 2008 were formulated by the Central Bank. This was seen as a fresh start for the industry in terms of legal, regulatory and supervisory framework. The Act covers Deposit Taking Microfinance Institutions (DTMs) as well as non-deposit taking MFI's. It also provides for banks to establish fully owned subsidiaries to undertake DTM business (FSD, 2010).

The Microfinance Act of 2006 has provided a much more comprehensive and consistent regulatory environment for MFI's. It has been designed to promote the performance and sustainability of deposit taking MFI's (DTMs) while, simultaneously, protecting depositors' interests better. The Act also enables MFI's to provide more complete financial services to the Micro, Small and Medium Enterprise (MMSE) Sector (FSD, 2010).

In Kenya microfinance transformation has mostly taken the form of a Not-for-Profit organization converting into a regulated commercial entity and this shall be the focus of this paper. The Kenyan microfinance sector is one of the most vibrant in Sub-Saharan Africa. Its diverse nature and large network have enabled it to serve the rural and urban poor. Microfinance activities in Kenya have been regulated since 2006, when the Microfinance Act came into play. The sector has since grown immensely and more so after the Deposit Taking Microfinance regulations were effected in 2008 (FSD, 2012).

1.2 Statement of the Problem

Microfinance has proven to be an effective measure in poverty alleviation, enabling those without access to traditional lending institutions to borrow. The idea behind microfinance is to provide a vehicle that would enable very poor people to become self-employed so that they can generate their own income, thereby allowing them to take care of themselves and their families. The aspect of microfinance that has contributed to its success is its integration with other developmental activities such as development of community organizations, leadership and skills training, entrepreneur management and financial management. The success and sustainability of microfinance programs has depended upon its ability to integrate these aspects (Hassan, 2002). Innovative forms of microfinance and progressive government policies have helped to make Kenya's microfinance sector one of the most developed in Sub-Saharan Africa. Leading contributors to this dynamic are introduction of mobile banking, the passing of the Finance Act of 2010. allowing for agent banking, and the development of effective credit bureaus throughout the country.

A number of studies on Microfinance Institutions (MFI) have been done. Of attention are those carried out by Hishigsuren (2006), Mokoro (2009) and Ndulu (2010).The study of Hishigsuren (2006) looked at the key issues and challenges faced by microfinance institutions before, during and after transformation. He looked at three institutions in Latin America, Africa and Asia and stated that only of the internal and external environments are favorable, will an MFI decide to convert.

Ndulu (2010) looked at the transformation of Microfinance Institutions (MFI's) into Deposit Taking Microfinance Institutions (DTMs) in Kenya specifically from the point of view of legislation. He concluded that regulation is key in microfinance operations as it brings stability to the financial sector and protects investors from losses arising from financial scandals. Mokoro (2009) looked at the enabling and inhibiting factors in the transition from micro-financing into formal banking in Kenya.

This study seeks to build on the past research carried out on the transformation of the microfinance sector, in light of the change in legislation brought about by the Microfinance Act (2006) that came into force on 2nd May 2008 after the Microfinance (Deposit-Taking Microfinance Institutions) Regulations, 2008 were formulated by the Central Bank that were then not looked at by Ndulu. While Mokoro (2010) looked at the transition from micro-financing into formal banking among the microfinance institutions in Kenya, Ndulu (2010) looked at the factors affecting institutional transformation, with a focus on the regulatory framework. However, none of these studies looked at the factors affecting transformation in the context of DTMs and Non- DTMs. They looked at the MFIs in general without any categorization into DTMs and Non-DTMs. This study therefore sought to fill that gap by looking at the factors that have motivated the non-deposit taking MFI's in Kenya to convert into DTMs and the challenges of transformation, in light of the current world of Information and Communication Technology (ICT) development.

This research therefore aims to answer the following question: What are the determinants of transformation of Microfinance Institutions into Deposit Taking MFIs in Kenya?

1.3 Objective of the Study

To establish the determinants of the transformation of Microfinance Institutions into Deposit Taking MFI's in Kenya.

1.4 Value of the Study

Microfinance Institutions form a significant part of the Kenyan financial sector, with many individuals and Small Micro Enterprises (SME) benefitting immensely from the services provided by them. The recent changes in the industry have brought about major change and growth in this sector. This study aims to analyze the factors that affect the transformation process of these institutions into Deposit Taking Microfinance (DTMs). The findings of this study will therefore be of interest to:

The results will provide additional insight to the management of MFIs into the factors that affect their transformation. This will help them in their decision making and also to guide the upcoming MFIs that wish to transform.

The study will assist government in any further amendments of the Deposit Taking Microfinance Bill as they will see the impact that the bill has had so far on the transformation process.

The results provided by the study are expected to be of great value to researchers and academicians as it would add to the pool of knowledge the factors that affect the transformation of Microfinance Institutions in Kenya; from the limitation of this study, future researchers can identify areas for further research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews the theories on microfinance which represent the different approaches that scholars have taken regarding the best way to help the poor through access to financial services specifically: the institutionist and welfarist theories. It also discusses the microfinance lending theories that are important to the success of the MFIs namely: the individual lending model; the group lending model and the village banking model. Empirical studies on the factors that bring about the growth and transformation of microfinance have also been reviewed. These studies have been carried out in Asia, Latin America, Africa and locally, in Kenya.

Transformation in the microfinance industry refers to the institutional process whereby a non-for-profit microfinance provider creates or converts into a share-capital company and becomes licensed as a regulated financial institution. Microfinance is believed to be growing annually between 15 and 30 percent, translating into a demand of between $2.5 and $5.0 billion for portfolio capital, and requiring $300 to $ 400 million in additional equity each year (Ledgerwood & White, 2006). The sheer magnitude of the capacity of the industry has generated a lot of interest worldwide and this is evidenced by the number of studies that have been and continue to be carried out on this subject.

2.2 Theoretical Review

Many studies have been done across the world in regard to the transformation of non-profit microfinance institutions into deposit taking microfinance institutions.

2.2.1 Microfinance Approaches

The microfinance industry is characterized by a "schism," or debate, between two camps that represent broadly different approaches to microfinance: the institutionists and the welfarists. The institutionist approach, with its emphasis on financial self-sufficiency and institutional scale, appears to have gained ascendancy over the welfarist approach, with its emphasis on direct poverty alleviation among the very poor. Morduch (1998) refers to this division as the microfinance schism. The irony is that while the worldviews of each camp are not inherently incompatible, and in fact there are numerous MFIs that appear in practice to embrace them both, there nonetheless exists a large rift between the two camps that makes communication between them difficult.

2.2.1.1 The Institutionist Approach

Institutionists such as Robinson (2001), argue that the success of microfinance institutions both in terms of making a real dent on poverty through reaching a maximum number of poor households and ensuring their own long term survival and sustainability, depend on their ability to adopt principles of commercialization in all their operations. They want MFI's to ensure their own long-term survival and sustainability through controlling costs and improving profitability instead of always expecting subsidized financial resources from the donor community for ensuring their long-term survival (Khan, 2008).

The institutionist approach focuses on creating financial institutions to serve clients who either are not served or are underserved by the formal financial system. Emphasis lies on achieving financial self-sufficiency; breadth of outreach (meaning numbers of clients) takes precedence over depth of outreach (meaning the levels of poverty reached); and positive client impacts are assumed. The center of attention is the institution, and institutional success is generally gauged by the institution's progress toward achieving financial self-sufficiency. The best-known examples of the institutionist approach are Bank Rakyat Indonesia (BRI) and Banco Solidario (BancoSol) in Bolivia. Institutionists argue that a primary objective of microfinance is financial deepening, the creation of a separate system of "sustainable" financial intermediation for the poor. Theirs is a "financial systems" approach to microfinance, in which the future of microfinance is dominated by numerous large-scale, profit-seeking financial institutions that provide high quality financial services to large numbers of poor clients. Because of their insistence on financial self-sufficiency, institutionists avoid subsidies of any kind. The institutionist position is articulated in virtually all the literature coming out of the Ohio State University Rural Finance Program, the World Bank and the Consultative Group to Assist the Poorest (CGAP) in the World Bank, and USAID. Most published literature in the field of microfinance agrees with the institutionist view (Woller, et.al 1999).

2.2.1.2 The Welfarist Approach

Welfarists argue that the primary purpose of microfinance should be to help reduce poverty through subsidized credit. The idea they advocate is to ensure the inflow of subsidized financial resources to the sector on a continuing basis (Murdoch, 1998). Welfarists emphasize depth of outreach. Welfarists are quite explicit in their focus on immediately improving the well-being of participants. They are less interested in banking per se than in using financial services as a means to alleviate directly the worst effects of deep poverty among participants and communities, even if some of these services require subsidies. Their objective tends to be self-employment of the poorer of the economically active poor, especially women, whose control of modest increases of income and savings is assumed to empower them to improve the conditions of life for themselves and their children. The center of attention is the "family." Like the institutionists, welfarists have assumed more impact than they actually have been able to document. The most prominent examples of welfarist institutions are the Grameen Bank in Bangladesh and its replicates elsewhere, and finca-style village banking programs in Latin America and, more recently, in Africa and Asia (Woller et.al, 1999).

2.2.2 Models on Lending

According to Crabb & Keller (2006), there are three microfinance lending models employed throughout the world. Despite the different approaches, all of the institutions work toward the same goal: the reduction of poverty and the promotion of economic growth. Institutions have placed very heavy importance on the lending methodologies in the success of the MFI. It therefore follows that the success of the MFI and its sustainability are likely determined by the extent to which the group lending methodologies are employed.

2.2.2.1 Individual Lending Model

This is the provision of credit to individuals who are not members of a group that is jointly responsible for loan repayment (Ledgerwood, 2000). Each loan is specifically tailored to the individual and business involved. This approach tends to work best when used with larger urban businesses or small rural farmers, since collateral is generally required. Also, the personal nature of the relationship between the bank and the borrower often results in repeated transactions over a long period of time.

2.2.2.2 Group Lending Model

This strategy was initially developed by the Grameen Bank of Bangladesh. It was designed to serve rural and landless women who wish to finance income-generating activities. The general approach is as follows: small groups of four to seven unrelated individuals are formed. Before receiving any loans, each member is required to contribute savings for 1-2 months and continue saving throughout the duration of the loan. Additional requirements for loans include prompt repayment, mandatory weekly meetings and pre-credit orientation and assistance. After these conditions are satisfied, the credit officer loans money to two individuals. No further lending occurs until the initial loans are repaid. The same process occurs for the remaining members of the group.

2.2.2.3 The Village Banking Model

Village banks are community-managed credit and savings associations established to provide access to financial services in rural areas, build a community self-help group and help members accumulate savings (Ledgerwood, 2000). The bank is financed in two ways: by the mobilization of members' funds and by loans from microfinance institutions.

2.3 The determinants of Transformation of MFIs

Sriram & Upadhyayula (2002) studied the transformation experience in the Indian microfinance sector. They identified five issues that trigger the movement of microfinance operations to move away from an NGO format to the mainstream format, namely; size, diversity of services, financial sustainability, focus and taxation. They concluded that there should be regulatory changes that allow smaller microfinance institutions to get into more complex forms as they grow. They argue that the MFI's should be allowed to invest in equity as a source of financing.

According to Mokoro et al (2010), most of the factors influencing the transition from micro-financing to formal banking are regulatory and policy related. The evolving microfinance agenda has significant implications for regulatory and supervisory policy with respect to licensing requirements, monitoring for unsafe and unsound practices and the orderly existence of financially distressed MFI's. During the government-led subsidized agricultural credit era, the majority of institutions were created through parliamentary legislation that was independent of financial sector legislation. Their entry into the financial sector was determined by political decisions and once in operation, they were subject to little or no supervision.

This study will look at three main factors that determine whether a non-deposit taking micro-finance institution will convert into a deposit taking microfinance institution.

2.3.1 Commercialization

The terms commercialization and transformation are frequently used interchangeably; however, transformation is only one of the ways an MFI can commercialize. According to Christen (2000), there are three key principles of what constitutes a commercial approach to microfinance; profitability; competition and regulation. Commercialization of microfinance results in strong financial performance, as they become more profitable. Once microfinance institutions are committed to managing business on a commercial basis, competition quickly becomes the norm of the environment in which they operate. In many countries, reaching sustainability is a precondition for obtaining a license to become deposit taking. Thus it can be assumed that licensed, regulated microfinance institutions have already adopted a commercial approach.

The ability to source capital is a fundamental component for an institution to grow. An MFI must be able to meet continual demand for loans by new and existing clients. Relying on donor funding to meet capital needs is not sustainable as donors are not willing to permanently fund the needs for loan capital. As donor funding is becoming less available and reliable and clients are demanding new products and improved customer service, MFI's are forced to plan for long-term sustainability and client retention, thus the importance of obtaining capital (Ledgerwood & White, 2006).

Microfinance is estimated to have an annual growth of between 15 and 30 percent, which translates into a demand of between $2.5 to $5.0 billion for portfolio capital and requiring $300 to $400 million in additional equity each year. Non- commercial investors, including donors, bilateral and multilateral financial institutions, disburse approximately $400 million annually to the sector. This clearly cannot sustain the demands of the industry for capital funds, since much of their support goes to regulatory change, information services, sector associations and other development initiatives. One of the driving factors for an MFI to convert is to offer savings services not only as an additional service to clients, but also to fund a larger volume of loans and access a stable and potentially cheaper local source of funds. Access to capital, therefore, includes accessing client deposits, commercial or concessional debt, as well as equity sources. MFI's that have transformed have been able to access a significantly wider range of financing sources, thus greatly improving their ability to rapidly scale up operations by growing, deepening and leveraging their equity bases (Ledgerwood & White, 2006).

2.3.2 Self-Sustainability

According to the CGAP (1997), all microfinance institutions have to depict two kinds of self-sustainability before claiming to be self-sustainable. One is the operational self-sufficiency where all MFI's are required to depict full coverage of all their operational and administrative costs, including losses from bad loans, from their revenues from operations. The other is financial self-sustainability, whereby MFI's have to prove that they are meeting all their financial requirements through funds generated from internal operations and other commercial sources.

Institutional Financial Self-Sufficiency (IFS) is necessary for a Microfinance Institution (MFI) in order to obtain the large amount of funds required to reach and benefit truly large numbers of the poor and poorest households.

2.3.3 Automation of Customer Products and Services

Since the early 1990s, a major emphasis within the microfinance sector has been on institutionalization of microfinance activities, including building the quality and capacity of the governance and management of MFI's and the development of computerized Management Information Systems (MIS). It is necessary for the MFI's to develop their information system for a number of reasons: so as to meet prudential requirements for deposit taking; so as to manage growth in client outreach and so as to attract capital investment from commercial or external sources. Over the last few decades, the continuous and growing penetration and implication of Information and Communication Technologies (ICT) into the financial services industry has been immense. In the micro-finance industry, ICT has generated new processes or products such as: back office management information systems; mobile computing; branch office franchise model; credit card , electronic transfers and ATM services and lastly, internet banking. The ICT innovation has so far been limited to use by medium or large MFI's. The challenges that arise from this development are: the view that ICT services tend to de-personalize the services of the micro-finance institutions, thereby conflicting with the group-based concept of these institutions. Secondly, there may be financial sector regulations that restrict innovation (Rai, 2012).

2.4 Empirical Review

Transformation has been given different descriptions by researchers such as transformation, liberalization and growth. Studies on the factors affecting the development of microfinance institutions have varied in methods and results.

In his 1998 study of the Pakistan microfinance sector, Khan looked at the impact of the paradigm shift in microfinance to the sector. He did a case study on Aga Khan Rural Support Programme (AKRSP), a large and well performing MFI, which has been actively involved in providing microfinance services in the country through its Microfinance Division. He studied the MFI before, during and after the environmental changes facing the microfinance sector. He focused on the adaptation and reorientation of AKRSP in response to two environmental disturbances; the first being the donor's changed approach and thinking about the sustainability of the microfinance institutions and second, the resulting competition among the MFI's.

According to Hassan (2002), the motivation behind microfinance is simple. Financial institutions can extend loans to the poor while, at the same time, making a reasonable profit. By charging high interest rates, microfinance institutions can afford the high transaction costs of processing large volumes of loans as small as a few dollars. He did a study of the Grameen bank in Bangladesh, which is infamous for its success in transforming the microfinance industry and has been studied worldwide by countries interested in growing their microfinance sector. His emphasis was on the sustainability of microfinance institutions and defined it as the ability of the MFI to achieve its goals in the short term without harming its ability to meet long term goals. He concluded that to prevent their future demise, it is crucial that MFI's establish procedures that will assist them in becoming both operationally and financially self-sufficient, by eliminating the dependency on donor funding and generating self-sustaining income.

Mokoro et al (2010) studied the transition of the Kenyan microfinance institutions into the formal banking sector. They looked at the enabling an inhibiting factors in the transition and development from micro-financing to formal banking among microfinance institutions in Kenya. Many microfinance NGOs have successfully replicated the Grameen Bank method of delivering financial services to the low-income households and Micro and Small Enterprises. From the study, it was found that the key factors that to a very great extent have been undertaken in order to transform from micro financing into formal banking are: increasing customer base; improving the quality of service; changing the Information Technology in the organization; improving the turn-around in loan application; customer segmentation and change of measures in giving loans. The factors that have facilitated the transformed MFI's which are now banks are: a sound customer care desk; the MFI's ability to optimize business volume; understanding organizations exposure to customers; operating through efficient systems and processes; minimizing losses when loans go bad and effective balancing of high and low risk business. They also looked at the inhibiting factors that MFI's transforming into formal banking face: strict rules from the Central Bank; high costs of operation; no proper government policy on MFI's; unscrupulous MFI's spoiling the reputation of the industry and the inability to deliver services to poor or remote populations. They concluded that a successful past for Kenyan micro finance institutions is no guarantee for transformation.

Ndulu (2010) in his study of Kenyan MFI's looked at the factors affecting the transformation of microfinance institutions, with a focus on the regulatory framework. He identified the factors as those arising from the process in which the institution implements it; challenges they are facing and the perception of the future of microfinance business. They factors affect the pace of the transformation process and they are: ability to raise funds for transformation; raising minimum capital; ability to acquire and implement suitable software and Management Information System; meeting capital adequacy requirements; restructuring ownership; ability to solicit shareholders; resource base and size of institution; motivational level for transformation; management inertia; stringent application process and documentation; governance and the delay arising from MFI's wishing to observe the performance of their already transformed counterparts. His research highlighted the importance of regulation in micro-finance. As MFI's grow in outreach and asset base, public interest on security of their resources also increases. The empirical evidence confirms that MFI's targeted for prudential regulation have to undergo a process of transformation.

2.5 Conclusion

Various studies have been done on the changes happening in the micro-finance sector worldwide. They have looked transformation or transformation from different aspects with the end result being the deposit taking factor. In Kenya the study done by Mokoro (2010) on factors influencing the transformation from micro financing to formal banking in Kenya, comes closest to the study being done by the researcher. His study was done prior to the enactment of the amendment to the Microfinance Act (2006) that allowed for the creation of Deposit Taking Microfinance (DTM) Institutions. He therefore looked at the transformation from the perspective of having Kenyan MFI's being regulated under 8 different acts of parliament. This study will incorporate the post-amendment period in which all the MFI's now fall under the Microfinance Act and most importantly, after the deposit taking regulations were formulated. This study shall also look at the transformation of MFI's into DTMs only and will exclude the transformation into banks regulated under the Banking Act Cap 488. The area of focus of this study has therefore not been looked at by any previous research.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter addresses the research design of the study. It discusses the research design, study population and sample. It will also look at the data collection and analysis method to be used.

3.2 Research Design

This study will use a descriptive survey study that will enable the researcher to document determinants of transformation of the non-deposit taking micro-finance institutions into deposit taking MFIs in Kenya. A descriptive study is concerned with finding out the what, where and how of a phenomenon. Descriptive surveys are used to develop a snapshot of a particular phenomenon of interest since they usually involve large samples. The focus of descriptive research is the careful mapping out of circumstances, situation or set of events to describe what is happening or what happened. It can be used when the purpose is to: describe the characteristics of certain items, estimate proportions of people who behave in certain ways and make specific predictions. Descriptive research design has been chosen because it enables the researcher to generalise the findings to a larger population. The study research design was guided by two studies; Mokoro et al (2010) and Ndulu, (2010). Other methodoly aspects adopted from Mokoro et al (2010) and Ndulu (2010) are target population, nature of data used and use of regression and ANOVA in the statistical analysis. This study will therefore be able to generalise the findings to non-deposit taking MFIs in Kenya that may wish to or have already transformed into deposit taking MFIs.

3.3 Research Population and Sample

According to Cooper and Schindler (2000), a population is the total collection of elements about which we wish to make inferences. This definition ensures that population of interest is homogeneous. Population studies also called census are more representative because everyone has equal chance to be included in the final sample that is drawn.The population of interest in this study is the 46 of the 52 MFI's that are members of the Association of Micro-finance Institutions of Kenya (AMFI), as per the 2012 membership list (Appendix III). The study will exclude 4 banking institutions and 2 insurance companies because the Microfinance Act 2006 does not apply to companies licensed under the Banking Act Cap 488, the Insurance Act Cap 487, the Building Societies Act Cap 489 and the Kenya Post Office Savings Bank (KPOSB) Act Cap 493B. Out of the 46 MFI's, 6 are now Deposit Taking (DTM). The target population was chosen because they have micro-finance as their core business.

Cooper and Schindler (2000) define a sampling frame as the list of elements from which the sample is actually drawn. Cooper and Schindler (2000) add that a sampling frame should be a complete and correct list of population members only. According to Mugenda & Mugenda (2003) sampling is the process of selecting a number of individuals for a study in such a way that the individual selected represents the large group from which they are selected. Sampling procedure may be defined as a systematic process of selecting individuals for a study to represent the larger group. The sample of the study will be drawn from the management of 52 Microfinance Institutions in Kenya who are members of AMFI. Since the population is small, a census study will be adopted in establishing the determinants of transformation of non-deposit taking MFI's into DTMs in Kenya. According to Cooper & Schindler (2007), a census is feasible when the population is small and necessary when the elements are quite different from each other. When the population is small and variable, any sample we draw may not be representative of the population from which it is drawn. The researcher has therefore it appropriate to choose census method because the population is small.

3.4 Data Collection

Primary data will be collected for this study using a questionnaire. A questionnaire with open and close-ended questions will be administered to the management of each MFI in order to collect data that will be evaluated to determine the factors that the organizations consider in deciding whether or not to convert into a DTM. Secondary data on the financial performance of the institutions will be obtained from their financial statements.

3.4.1 Data Validity and Reliability

Validity is the degree by which the sample of test items represents the content the test is designed to measure. Content validity which is employed by this study is a measure of the degree to which data collected using a particular instrument represents a specific domain or content of a particular concept. Mugenda and Mugenda (2003) contend that the usual procedure in assessing the content validity of a measure is to use a professional or expert in a particular field. To establish the validity of the research instrument in this study, the opinions of experts in the field of study specifically, the supervisor facilitating the necessary revision, shall be used.

Reliability refers to the consistency or stability of measurement and is frequently assessed using the test-retest reliability method. Reliability is increased by including many similar items on a measure, by testing a diverse sample of individuals and by using uniform testing procedures. Reliability of the research instrument in this study will be enhanced through a pilot study that will be done on four MFIs to allow pre-testing of the research instrument.

3.5 Data Analysis

The whole process which starts immediately after data collection and ends at the point of interpretation and processing data is data analysis (Cooper & Schindler, 2003). The data analysis method to be used will be based on quantitative approach using descriptive statistics. The coded data will entered into the Statistical Package for Social Sciences (SPSS) for analysis.

Data analysis will be based on the variables that have been identified in the literature review in section 2.3 above. The independent variables are Commercialization; Self-sustainability and Automation of Customer Products and Services. The data will be entered into the Statistical Package for Social Sciences (SPSS) for analysis. The findings will be communicated through use of tables and charts.

In this study the probit model will be applied to identify the factors that determine the transformation of MFIs, as not all MFIs transform into DTMs. the probit model is a type of regression where the dependent variable can only take two values, one or zero. Therefore the dependent variable is the transformation of the MFI and will take the value one or zero if the MFI transforms or does not transform respectively.

The study will use a regression model to analyze the factors that determine the transformation of Kenyan MFI's into DTMs. The model will be used to estimate the relationship between the indicated determinants and the transformation process. Three separate regressions shall be run to establish the level of significance of the determinants for each category of microfinance institution, the deposit and non-deposit taking, to ascertain whether the influence of the determinants varies. The comparison of the results of the regression models will be used to explain if there is a correlation between deposit taking and non-deposit taking per determinant.

The three regression models are shown below:

1) All MFIs (Appendix III)

$$y = p_0 + P1X1 + p_2X_2 + P3X3 + e$$

2) Deposit Taking microfinance (DTM) (Appendix III)

$$y = Po + p_{ID}X_{ID} + p_{2D}X_{2D} + p_{3D}X_{3D} + E$$

3) Non-deposit taking MFIs (Appendix III)

$$y = Po + p_{IN}X_{IN} + P2NX2N + p3NX_{3N} + e$$

Where:

y= Transformation

Po ~ Constant Term

Pi … p4 — Beta coefficients

Xi = Commercialization

X2 = Self-sustainability

X3 = Automation of Customer Products / Services

D = Deposit Taking Microfinance Institutions

N = Non deposit taking Microfinance Institutions

e = error term

Transformation in itself cannot be measured as it is a process of change. In this study, it will take the value of one if the MFI transforms and zero if the MFI does not transform.

Commercialization will be measured by the quantity and monetary value of the market-based sources of funds such as commercial banks, equity and client deposits.

Self-sustainability will be measured by total operating revenues, total administrative and financial expenses.

Automation of Customer Products and Services will be measured by the number of client products that the MFI has automated as a proportion of the total products offered.

The regression model will be tested using SPSS to see how well it fits the data. The significance of each independent variable will be tested using the Fischer distribution test or F-Test. It measures the ratio between the model mean square divided by the error mean square. The F-test will be used to test the significance of the overall model at a 5 percent confidence level.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents analysis and findings of the study based on data collected from the field. The analysis was focused on answering the research questions. The research study questionnaire was administered to forty six MFI whereby thirty six were successfully filled and returned (Appendix III). The analyzed data was presented in form of tables and charts.

4.2 General Information

4.2.1 Duration of Operation as an MFI

The study established that 47% of the firms had operated for 10-20 years as MFI's while 31% of the respondents indicated that their firms operated for 10-20 years as MFI's. 17% of the respondents indicated that the firms had operated for 21-30 years and 5 % indicated that the firms had operated for 31-40 years.

4.2.2 Customer Base

The research sought to find out the firms' customer base in some specific categories. 28% of the respondents had less than 10,000 customers, 50% revealed that they had 10,001 to 50,000 customers. On the other hand, 47% revealed that they had less than 10,000 borrowers while 36% had 10,001 to 50,000 borrowers; 41% had less than 10,000 savers while 33% had 10,001-50,000 savers.

4.2.3 Products Offered

The study sought to find out the products offered by the MFIs. The figure above indicates that 77% of the firms agreed that they offered credit services,23% did not agree that they were offering credit services, while 33% of the firms agreed that they offered savings services and 67% of the firms did not agree that they offered savings services.

4.2.4 Non-Financial Services

The study sought to find out some of the non-financial services in the MFIs. From the findings it was indicated that MFI participation can be limited to locating their clients, linking clients and other community members to relief operations by providing information. Other non-financial services are entrepreneurial trainings, business skills and some others.

4.2.5 Existence of Other Branches

The study sought to find out whether the MFI had any other branches.

From the findings 78% of the respondents indicated that there were other branches of the MFI in the country while 22% of the respondents indicated that there were no other branches of the MFI.

4.2.6 Number of Branches

The study sought to find out the number of branches of the MFI's available in the country. From the findings 50% of the respondents indicated that there were less than 5 branches, 22% of the respondents did not give any response while 17% of the respondents indicated that the branches were between 5-10 and 11% of the respondents indicated that the number of branches were above 10.

4.3 Transformation of MFIs

4.3.1 Type of MFI

The study sought to find how on what type of MFI the firms operate on. From the findings it was indicated that majority of the respondents indicated that 83% of the firms are non-deposit taking while 17% of the firms are deposit taking.

4.3.2 Number of Years as a DTM

The study sought to find out for how long the firms have been operating as DTMs. From the findings it was indicated that 50% of the firms have been operating as DTMs for 2-3 years, 33% of the firms have been operating as DTM for 1-2 years, while 17% of the firms have been operating as DTM for 3 and above years and none of them operated between 0-1 years.

4.3.3 Decision in Regard to the Operations

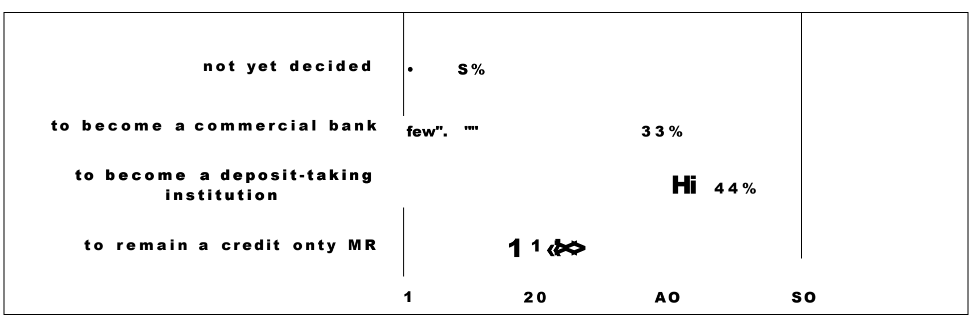

Figure 4.1 Decision in Regard to the Operations

Source: Survey Data, 2012

The study sought to find out what decision the organizations taken in regard to their operations. From the findings it was established that 44% of the firms indicated that they had decided to become deposit taking institutions, 33% of the firms indicated that they had decided to become commercial banks, while 18% indicated that they would remain as MFI in the credit sector and 5% of the firms had not yet decided.

4.3.4. Stage of Transformation

The study sought to establish what stage the firms were in the transformation process. From the findings it was indicated that 31% of the firms had not yet started the transformation process, 28% of the firms indicated that they were applying for a license, 19% of the firms indicated that they had been issued with a DTM license, 14% of the firms indicated that they were pushing for their names approval while 5% of the firms were awaiting for the banking license and 3% of the firms indicated that they were pursuing for the assessment and letter of intent.

4.3.5 License Applied or Intend To Apply For

The study sought to find out what type of license the firms had applied for. From the findings it was established that 47% of the firms had applied for the nationwide DTM, 31% of the firms indicated that they had applied for a community DTM license while 14% of the firms indicated that they were not applying for any license and 8% of the firms indicated that they were applying for a banking license.

4.3.6 Strategic Options Considered

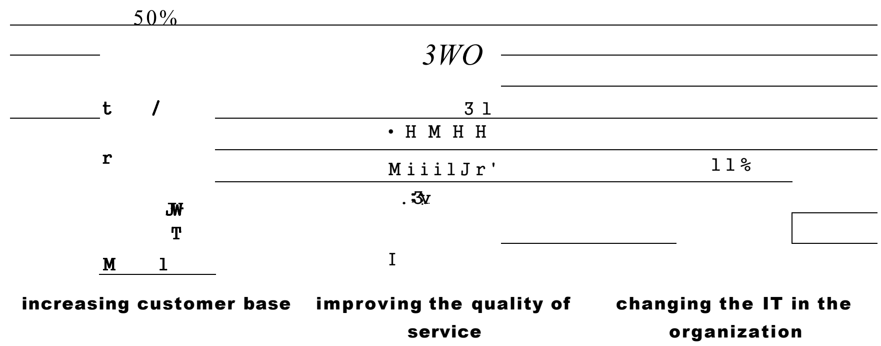

Figure 4.2 Strategic Options Considered

Source: Survey Data, 2012

The study sought to establish the strategic options that the firms were considering. From the findings it was found out that 50% of the firms were considering of increasing the customer base, 39% of the firms were considering improving quality service while 11% of the firms revealed that they were considering changing the IT in the organization.

4.3.7 Whether Time and Effort Is Invested in Order to Transform

The study sought to establish whether the MFI had invested time and effort in order to transform from non-deposit to deposit taking microfinance in Kenya. From the findings it was indicated that 81% of the firms agreed that the MFI had invested time and effort in order to transform from non-deposit to deposit taking microfinance in Kenya while 19% of the firms disagree that the MFI had invested time and effort in order to transform from non-deposit to deposit taking microfinance in Kenya.

4.3.8 Measures Being Undertaken

The study sought to establish what measures had being undertaken to achieve the transformation of non-deposit to deposit taking microfinance in Kenya.

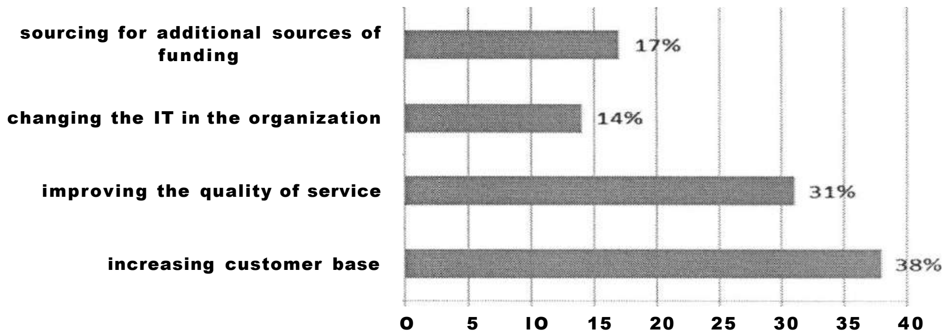

Figure 4.3 Measures Being Undertaken

Source: Survey Data, 2012

From the findings it was established that 38% of the firms had increased the customer base, 31% of the firms indicated that they had improved the quality of service, while 17% of the firms indicated that they had sourced for additional sources of funding and 13% of the firms indicated that they had changed the IT in the organization.

4.4 Factors Affecting Transformation

4.4.1 Commercialization

Table 4.1 Amount of Funding Received From the Various Sources of Funds Annually

	Less than 50 Million		**51-100 Million**		**101-200 Million**		**Above 200 Million**		**No Response**	
	F	%	F	%	F	%	F	%	F	%
Donors	4	11.1	6	16.7	9	25.0	2	*5.6*	15	41.7
Commercial Banks	2	5.6	5	13.8	7	19.4	3	8.3	19	52.8
Non-Commercial Investors	3	8.3	5	13.8	5	13.8	2	5.6	21	53.3
Client Deposits	5	13.8	6	16.7	11	30.6	4	11.1	10	27.8
Equity Sources	7	19.4	9	25.0	8	22.2	3	8.3	8	22.2

The study shows that 25% of the respondents indicated that they received donors funding of between Kshs.100 -200 million annually while 16.7% revealed that they received donor funding of between Kshs. 51-100 million annually. On loans from commercial banks, 19.4% of the respondents revealed that they received between Kshs. 101-200 million while 13.8% indicated that they received between Kshs. 51-100 million. On the other hand, 13.8% of the respondents revealed that they received funding of Kshs. 51-100 million and Kshs. 101-200 million respectively from non-commercial investors. Moreover, 30.6% of the respondents revealed that they received funds of between Kshs.101-200 million from clients deposits while 16.7% revealed that they received between Kshs. 51-100 million from this source. Lastly, 25% of the respondents revealed that they received between Kshs. 51-100 million from equity sources while 22.2%

revealed that they received Kshs. 101-200 million from the same source. However, majority of the respondents did not responded to some of the questions on this section.

4.4.2 Self-Sustainability

Table 4.2 Amount of Income that the Organization Generates

	Last year Before Transformation (Kshs)							
	Less than 100 Million		**101-500 Million**		**501 Million -1 Billion**		**Above 1 Billion**	
	F	**%**	**F**	**%**	**F**	**%**	**F**	**%**
Value of Total Assets	.	.	4	11.1	8	22.2	3	8.3
Value of Net Assets	2	5.6	5	13.8	2	5.6		
Share Capital	.	.	.	.	.	.	.	.
Value of Deposits								
Total Cost of Operations	5	13.8	3	8.3	2	5.6	.	.
Revenue	.	.	6	16.7	9	25.0	.	.

For the income the last year before transformation, 22.2% of the respondents, their total value of assets is between Ksh 501 million to 1 billion while 8.3% revealed that their total asset value is above Ksh. 1 billion. On the other hand, 13.8% revealed that they had a net value of Ksh. 101-500 million while 5.6% revealed they had a net asset value of less than Ksh.100 million and Ksh.501 million-1 billion. On the revenue, 25% of the respondents revealed that their MFIs earned revenue of between Kshs. 501 million-1 billon while 16.7% earned revenue of between 101-500 Million. However, majority of the respondents did not give out their financial information.

Table 4.3 Incomes after Transformation

	1st year after Transformation (Kshs)							
	Less than 100 Million		101-500 Million		501 Million -1 Billion		Above 1 Billion	
	F	%	F	%	F	%	F	%
Value of Total Assets					2	5.6	3	8.3
Value of Net Assets					3	8.3	1	2.8
Share Capital								
Value of Deposits								
Total Cost of Operations	1	2.8	3	8.3	1	2.8		
Revenue			3	8.3	1	2.8		

On the amounts earned after the transformation, 8.3% of the respondents revealed that they had a total value of assets of Kshs. above 1 billion one year after transformation while a similar percent revealed that they had a net assets value of Ksh.501 million to 1 billion. On the other hand, 8.3% of the respondents indicated that had total operations cost of between Ksh.101-500 Million while a similar percentage revealed that they had revenue of the same amount; Ksh.101-500 Million.

4.4.3 Automation of MFIs Functions and Products / Services

On the automation of the back office functions, 44.4% of the respondents revealed that they had automated loan administration to some extent while 30.6% revealed that they had automated this to a large extent. On the other hand, 47.2% of the respondents indicated that they had automated the human resource functions to a large extent while 19.4% indicated that they had automated this to a very large extent. Further, 30.6% of the respondents indicated that they had automated the accounts while 22.2% indicated that they had automated the accounts to some extent. The study also established that most of the MFIs had automated the management reporting to some extent as revealed by 36.1% of the respondents while 25% revealed they had automated this to a large extent.

On the automation of customers products / services; the study established that majority of the MFIs had not automated the ATM services as revealed by 94.4% of the respondents. On the other hand, 36.1% of the respondents indicated that they had automated the electronic transfers to a small extent while 30.6% revealed that they had automated this to a large extent. On mobile banking, 33.3% of the respondents indicated that they had automated this to some extent while 25% indicated that they had automated to a small extent. The study also found out that the MFIs had not automated internet banking as revealed by 36.1% of the respondents; however, 30.6% indicated that they had adopted internet banking to some extent with only 13.9% indicating that they had automated this service to a large extent.

4.5 Regression Analysis

A multivariate regression model was applied to determine the relative importance and the relationship between the indicated determinants and the transformation process. Three regression analyses were conducted as shown below.

4.5.1 Regression Analysis for All MFIs

Table 4.5 below shows the regression analysis model summary for all MFIs that took part in the study.

Table 4.4Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.845(a)	0.714	0.697	0.257

Predictors: (Constant), Commercialization, Self-sustainability, Automation of Customer Products / Services

The R2 is called the coefficient of determination and tells us how transformation of MFIs varied with the determinants commercialization, self-sustainability, and automation of customer products / services. From Table 4.7 above, the value of adjusted R^2 is 0.697. This implies that, there was a variation of 69.7% of transformation with the three factors; that is; commercialization, self-sustainability, and automation of customer products / services. This means that if the three determinants were to be implemented, they would achieve transformation up to 69.7%.

Table 4.5 ANOVA Results

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	8.79	3	2.930	44.231	.000(a)
	Residual	2.112	32	.066		
	Total	10.902	35			

Predictors: (Constant), Commercialization, Self-sustainability, Automation of Customer Products / Services

Dependent Variable: Transformation

The study used ANOVA to establish the significance of the regression model from which an f-significance value of $p<0.001$ was established. This shows that the regression model has a less than 0.001 likelihood (probability) of giving a wrong prediction. This therefore means that the regression model has a confidence level of 99.9% hence high reliability of the results.

Table 4.6 Coefficients Results

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	0.116	.186		.623	.535
Commercialization	0.577	.068	.559	8.478	.000
Self-sustainability	0.052	.024	.139	2.115	.038
Automation of Customer Products / Services	0.008	.001	.505	7.097	.000

Dependent Variable: Transformation

Table 4.7 shows that there is a positive relationship between transformation of MFIs with and the Predictor factors: Commercialization, Self-sustainability, Automation of Customer Products / Services.

The established regression equation was

$$Y = 0.116 + 0.577Xi + 0.052X2 + 0.008X_3$$

From the above regression model, holding commercialization, self-sustainability, automation of customer products / services constant, transformation would be at 0.116. It was established that a unit increase in commercialization would cause an increase transformation by a factor of 0.577, a unit increase in self-sustainability and automation of customer products / services would lead to an increase in transformation by a factor of 0.052 and 0.008 respectively. The study further shows a significant relationship between transformation of MFIs and the three determinants; commercialization (p= 000<0.05), self-sustainability (p = 0.038<0.05) and automation of customer products / services (p= 000<0.05) as shown by the p values.

4.5.2 Regression Analysis for Deposit Taking Microfinance

$$y = P_o + P_1 D X_{1D} + P_2 D X_{2D} + p_3 D X_{3D} + E$$

y= Transformation

Po = Constant Term

Pi ... P4 = Beta coefficients

Xi = Commercialization

X2 = Self-sustainability

X3 = Automation of Customer Products / Services

D = Deposit Taking Microfinance Institutions

e = error term

Transformation in itself cannot be measured as it is a process of change. In this study, it will take the value of one if the MFI transforms and zero if the MFI does not transform.

Commercialization will be measured by the quantity and monetary value of the market-based sources of funds such as commercial banks, equity and client deposits.

Self-sustainability will be measured by total operating revenues, total administrative and financial expenses.

Automation of Customer Products and Services will be measured by the number of client products that the MFI has automated as a proportion of the total products offered.

Table 4.7 Model Summary

R	R Square	Adjusted R Square	Std. Error of the Estimate
0.894	0.799	0.682	.401

Predictors: (Constant), Commercialization, Self-sustainability, Automation of Customer Products / Services

A correlation value of 0.894 was established which shows a high relationship between dependent and independent variables. This is also shown by a coefficient of determination value of 0.682. The determination coefficient value indicates that the regression line accounts for 68.2% of the total observations. This implies that, the three determinants (commercialization, self-sustainability, automation of customer products / services) explain (accounts for) 68.2% of transformation in the Deposit Taking Microfinance Institutions (DTMs).

Table 4.8 ANOVA

	Sum of Squares	df	Mean Square	F	Sig.
Regression	3.177	3	1.059	1.186	,001a
Residual	1.786	2	.893		
Total	4.963	5			

Predictors: (Constant), Commercialization, Self-sustainability, Automation of Customer Products / Services

Dependent Variable: Transformation

The study used ANOVA to establish the significance of the regression model from which an f-significance value of $p<0.001$ was established. This means that the regression model has a confidence level of 99.9% hence is highly reliable.

Table 4.9: Regression Coefficients

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	**Std. Error**	**Beta**		
(Constant)	1.191	1.367		0.871	**0.000**
Commercialization	0.119	0.176	0.109	0.675	0.003
Self-sustainability	0. 206	0.182	0.023	0.145	**0.000**
Automation of Customer Products / Services	0.432	0.273	0.246	1.461	0.041

Dependent Variable: Transformation

The following regression analysis was obtained:

$Y = 1.191 + 0.119X7 + 0.206X2 + 0.432X3$

The regression results show that there is a positive relationship between transformation and the three predictors/ determinants. This implies that commercialization, self-sustainability, automation of customer products / services if employed in the MFIs would all increase transformation. The study further shows that there is a significant relationship between transformation of DTMs and commercialization (p=0.003), self-sustainability (p=0.000) and automation of customer products / services (P=0.041).

4.5.3 Regression Analysis (Non-Deposit Taking microfinance)

y = Po+ Pidxid + $p_{2D}X_{2D}$ + $p3_DX_{3D}$ + ?

y= Transformation

Po = Constant Term

Pi … P4 = Beta coefficients

X_1 = Commercialization

X2 = Self-sustainability

X_3 = Automation of Customer Products / Services

N = Non deposit taking Microfinance Institutions

e = error term

Table 4.10 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.775(a)	0.600	0.545	.31207

Predictors: (Constant), Commercialization, Self-sustainability, Automation of Customer Products / Services

R^2 is the coefficient of determination and tells us how transformation of non-deposit taking microfinance institutions varied with commercialization, self-sustainability, automation of customer products / services (independent variables). From the regression model summary above, the value of adjusted R^2 is 0.545. This implies that three determinants commercialization, self-sustainability, automation of customer products / services explains 54.5% of transformation in non-deposit taking microfinance institutions. The remaining 45.5% would be explained by other variables not included in the study.

Table 4.11 ANOVA

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	3.177	3	1.059	10.871	.000(a)
	Residual	2.522	26	.097		
	Total	5.699	29			

Predictors: (Constant), Commercialization, Self-sustainability, Automation of Customer Products / Services

Dependent Variable: Transformation

The study used ANOVA to establish the significance of the regression model from which an f-significance value of $p<0.001$ was established. This shows that the regression model has a less than 0.001 likelihood (probability) of giving a wrong prediction. Hence the regression model has a 99.9% confidence level.

Table 4.12 Coefficients Results

	Unstandardized Coefficients		**Standardized Coefficients**	**t**	**Sig.**
	B	Std. Error	Beta		
(Constant)	2.821	0.604		4.673	**0.000**
Commercialization	0.157	0.110	0.191	1.424	0.165
Self-sustainability	0.332	0.067	0.717	4.946	**0.000**
Automation of Customer Products / Services	0.034	0.106	0.040	0.322	0.749

Dependent Variable: Transformation

From the regression analysis, the following regression equation was established:

$Y = 2.821 + 0.157Xi + 0.332X_2 + 0.034X_3$

The study shows that there was a positive relationship between transformation and the three determinants (Commercialization, Self-sustainability, Automation of Customer Products / Services). The study also shows that there is a significant relationship between transformation and self-sustainability as shown by the $p= 0.000<0.005$.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter provides the summary of the findings from the previous chapter, and also it gives the conclusions and recommendations of the study.

5.2 Summary of the Findings

The study found out that majority of the respondents had 10,001 to 50,000 customers. On the other hand, 47% of the respondents revealed that they had less than 10,000 borrowers while 36% had 10,001 to 50,000 borrowers; on the other hand, a number of respondents indicated that they had less than 10,000 savers while others had 10,001-50,000 savers. Majority of the MFIs agreed that they offered credit services, while a number agreed that they offered savings services. The MFIs also offered other non-financial services which includes entrepreneurial trainings and business skills. It was established that majority of the MFIs had a network of branches in the country whereby majority revealed that they had less than 5 branches, while a few had 5-10 branches.

The study found out that majority (83%) of MFIs were non-deposit taking while a few of the MFIs were deposit taking. The study sought to find out for how long the firms have been operating as DTMs. Majority of the DTMs revealed that they have been operating as DTM for 2-3 years, while a few have been operating as DTM for 1-2 years 3 and above years respectively. It was established that most of the MFIs had decided to become deposit taking institutions; others had decided to become commercial banks, while a few revealed that they would remain as MFIs in the credit sector. The study sought to establish what stage the firms were in the transformation process and most of the MFIs revealed that they had not yet started the transformation process, while other MFIs indicated that they were applying for a license, others had been issued with a DTM license, a few of the MFIs revealed that they were pushing for their names approval while others were awaiting for the banking license.

The study established that most of the MFIs had applied for the nationwide DTM, while a few indicated that they had applied for a community DTM license while 14% of the firms indicated that they were not applying for any license; only a few indicated that they were applying for a banking license.

On the strategic options that the MFI were considering in the transformation process, majority of the MFIs revealed that they were considering increasing the customer base, while others were considering improving quality service and changing the IT in the organization. From the findings majority of the MFIs agreed that they had invested time and effort in order to transform from non-deposit to deposit taking microfinance in Kenya. In order to achieve the transformation, most of the respondents revealed that their MFIs had increased the customer base, while others had improved the quality of service, and sourced for additional sources of funding; others indicated that they had changed the IT in the organization.

The study shows that most of the respondents indicated that they received donors funding of between Kshs.100 -200 million annually while a few revealed that they received donor funding of between Ksh. 51-100 million annually. On loans from commercial banks, most of the respondents revealed that they received between Kshs. 101-200 million while a few indicated that they received between Kshs. 51-100 million. On the other hand, most respondents revealed that they received funds of between Kshs. 101-200 million from clients deposits while a few revealed that they received between Kshs. 51-100 million from this source. On equity sources, most the respondents revealed that they received between Kshs. 51-100 million from equity sources while a few revealed that they received Kshs. 101-200 million from the same source.

Most of the respondents revealed that their total value of assets is between half a billion to 1 billion Kenya shillings; while a few revealed that their total asset value is above Ksh. 1 billion. On the other hand, it was found that most MFIs had a net value of Ksh. 101-500 million while a few had a net asset value of less than 100 million and 501-1 billion. On the revenue, most of the respondents revealed that their MFIs earned revenue of between Kshs. 501 million-1 billon while a few earned revenue of between Kshs. 101-500 Million.

On the amounts earned after the transformation, few of the respondents revealed that they had a total value of assets of Kshs. above 1 billion one year after transformation while a similar percent revealed that they had a net assets value of 501 million to 1 billion Kenya shillings. On the other hand, the respondents indicated that had total operations cost of between Kshs.101-500 Million. However, majority of the respondents did not give out their financial information.

On the automation of the back office functions, most of the respondents revealed that they had automated loan administration to some extent while others revealed that they had automated this to a large extent. On the automation of the human resource functions to most of the respondents indicated that they had automated this to a large extent. Further, the respondents indicated that they had automated the accounts to some extent. The study also established that most of the MFIs had automated the management reporting to some extent and to a large extent respectively.

On the automation of customers products / services; the study established that majority of the MFIs had not automated the ATM services while a number indicated that they had automated the electronic transfers to a small extent and to a large extent respectively. On mobile banking, most of the respondents indicated that they had automated this to some extent and to a small extent respectively. The study also found out that the majority of the MFIs had not automated internet banking while only a few had adopted internet banking to some extent.

On the regression analysis, the study shows that there is a significant relationship between all the MFIs and the three determinants; this is same case with the DTM. However, a regression analysis on the non DTM shows that though there is a positive relationship between transformation and the three determinants, only self sustainability showed a significant relationship with transformation. This implies that self-sustainability played a great role in transformation of non DTMs.

5.3 Conclusions

The study concludes that the process of transforming an institution is costly and time consuming. From the findings majority of the MFIs agreed that they had invested time and effort in order to transform from non-deposit to deposit taking microfinance in Kenya. Moreover, to transform, the MFIs need to increase their customer base, improve the quality of service they are offering including automation of services, and sometimes also source for additional funds.

The study also concludes that transformed institutions have been able to grow because they have access to commercial and semi-commercial resources as well as increasing amounts of public deposits. Because they have access to public deposits they are no longer relaying on external funding; this improves the sustainability of the MFI. The study found out that most of the transformed MFI had high number of clients; they had automated most of their products and services; increased customers and deposits and eventually this leads to increased revenue.

5.4 Recommendations

The study recommends that there should be adequate motivation for Micro Finance institutions to operate at most convenient environment for them and to promote their transformation. The government and the MFIs regulating bodies should support the MFIs to facilitate their transformation hence ensuring sustainability. Sustainability of MFIs is essential for growth in outreach, quality and reliability of provision of more financial services to the poor. Sustainable MFIs are able to increase their capital through retained earnings and hence increase capacity to reach more loan customers especially those who cannot access financial services in convectional banks.

The MFIs wishing to transform should come up with a transformation plan. There were several dimensions to the transformation which includes; capacity building, human resources management, cultural adaptation and geographic development. These should be integrated into a strategic transformation plan with the assistance of all stakeholders in the industry. Moreover, the process of transformation should be enhanced through increase their customer base (this means increased deposits and assets value), improved quality of service offered and automation of products/services and adoption of technology in service delivery.

5.5 Limitations of the Study

The researcher experienced various challenges while conducting this study. One of the challenges was that, majority of the MFIs targeted did not disclose some important information, for example their financials, which limited the findings of the study which could have helped to make a better comparison and judgment on the determinants of microfinance transformation. The use of primary data especially for sensitive financial information proved to be a limitation. Secondly, a few of the respondents did not respond to the questionnaires, this limited the study in terms of hitting the 100% response that the study had targeted.

5.6 Suggestions for Further Research

The researcher recommends the following areas for future studies. In order to overcome the limitation of non-disclosure of financial information by the MFIs, further studies can incorporate secondary financial performance information on the MFIs. This will enable researchers to determine the full effect of commercialization on transformation. Future research can be carried out Similar studies can be replicated in other developing countries to find out the factors that determine the transformation of non-deposit taking MFIs into DTMs.

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APPENDICES

Appendix I: Letter of Introduction

To whom it may concern

Dear Sir/Madam,

INTRODUCTION LETTER

REF: LUCY NDEERI - D61/P/8383/2004

I am a post graduate student at the University of Nairobi pursuing a master's degree in Business Administration. In addition to the pre-requisite course work, I am carrying out a research project to determine the factors that affect the transformation of Micro-Finance Institutions in Kenya into Deposit Taking Micro-finance Institutions. The study will be carried out on the MFI's that are members of the Association of Microfinance Institutions of Kenya (AMFI). The findings will be confidential and will be used strictly for academic purposes.

Your authorization and assistance will be highly appreciated.

Yours Faithfully,

Lucy Ndeeri.

Appendix II: Research Questionnaire

Section A: General information

1. Name of MFI

2. Please state your position in the Organization

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

Below 10 years ( )

10-20 Years ( )

21-30 Years ( )

31-40 Years ( )

41 and above years ( )

4. Please indicate your customer base and specific category as indicated below.

	Less than 10,000	10,001-50,000	50,001-100,000	100,001 and above
Total No. of Customers				
Borrowers				
Savers				

5. What products do you offer your customers?

a) Credit ( )

b) Savings ( )

c) Non-financial services. Specify

6. Do you have any branches?

Yes ( ) No ( )

If Yes, using the categories below, please indicate the number of branches you have.

Less than 5 ( )

₩

Between 5-10 ( )

Above 10 ( )

Section B: Transformation

7. What type of MFI are you?

a) Non-deposit taking ( )

b) Deposit taking ( )

8. If you are a DTM, for how many years have you been deposit-taking?

0-1 Years ( )

1-2 Years ( )

2-3 Years ( )

3 and above years ( )

9. What decision has your organization taken in regard to operations?

a) To remain a credit only MFI ( )

b) To become a deposit-taking institution ( )

c) To become a commercial bank ( )

d) Not yet decided ( )

10. At what stage is your organization in the transformation process?

a) Not yet started ( )

b) Approval of name ( )

c) Application for a license ( )

d) Assessment and letter of intent ( )

e) Issued with a DTM license ( )

f) Awaiting banking license ( )

11. Which license have you applied or intend to apply for?

a) None ( )

b) Nationwide DTM ( )

c) Community DTM ( )

d) Banking ( )

12. What other strategic options are you considering?

a) Merging with other MFI(s) ( )

b) Selling the microfinance business ( )

c)None ( )

13. Has your MFI invested time and effort in order to transform from non-deposit to deposit taking microfinance in Kenya? Yes( ) No( )

If "Yes", indicate what measures are being undertaken to achieve this from the ones given,

a) Increasing customer base

b) Improving the quality of service

c) Changing the IT in the organization

d) Sourcing for additional sources of funding

e)Any other

Section C: Factors Affecting Transformation Commercialization

14. What is the amount of funding that you receive from the following sources of funds annually?

	Kshs
Donors	
Commercial Banks	
Non-Commercial Investors	
Client Deposits	
Equity Sources	
Other. Specify	

Self-Sustainability

15. What is the amount of income that your organization generates from the following:

	Last year Before Transformation (Kshs)	**1st year after Transformation (Kshs)**
Value of Total Assets		
Value of Net Assets		
Share Capital		
Value of Deposits		
Total Cost of Operations		
Revenue		

Automation

16. To what extent have you automated the following back office functions?

1- To a very large extent; 2- To a large extent; 3- To some Extent; 4- To a small extent;

5- To no extent.

	1	2	3	4	5
Loan administration					
Human Resource Functions					
Accounts					
Management Reporting					
Other. Specify					

17. To what extent have you automated the following customer products / services?

1- To a very large extent; 2- To a large extent; 3- To some Extent; 4- To a small extent;

5- To no extent.

	1	2	3	4	5
ATM services					
Electronic Transfers					
Mobile Banking					
Internet Banking					
Other. Specify					

Appendix III: List of MFIs

	MFI	Participation in the I Survey
	Deposit Taking MFIs	
1.	Faulu Kenya DTM Ltd	Yes
2.	Kenya Women Finance Trust DTM Ltd	No
3.	Rafiki Deposit Taking Microfinance Ltd	Yes
4.	Remu DTM Ltd	Yes
5.	SMEP DTM Ltd	No
6.	Uwezo DTM Ltd	Yes
	Non-Deposit Taking MFIs	
1.	AAR Credit Services	Yes
2.	ADOK TIMO	No
3.	Aga Khan First Microfinance Agency	Yes
4.	BIMAS	No
5.	Blue Limited	Yes
6.	Canyon Rural Credit Limited	No
7.	Century DTM Ltd (Interim)	Yes
8.	ECLOF Kenya	Yes
9.	Fusion Capital Ltd	Yes
10.	Greenland Fedha Limited	Yes
11	Indo Africa Finance	Yes
12.	Jitegemea Credit Scheme	No

13.	Jitegemee Trust Limited	Yes
14.	Juhudi Kilimo Company Limited	Yes
15.	K-Rep Development Agency	No
16.	KADET	Yes
17.	Kenya Entrepreneur Empowerment Foundation (KEEF)	Yes
18.	Kilimo Faida	Yes
19.	Micro Africa Limited	Yes
20.	Micro Enterprises Support Fund (MESPT)	Yes
21.	Microensure Advisory Services	Yes
22.	Molyn Credit Limited	Yes
23.	Muramati SACCO Society Ltd / Unaitas	Yes
24.	Musoni	Yes
25.	Ngao Credit Ltd	Yes
26.	Oikocredit	Yes
27.	One Africa Capital Limited	Yes
28.	Opportunity International	Yes
29.	Pamoja Women Development Programme (PAWDEP)	No
30.	Platinum Credit Limited	Yes
31.	Renewable Energy Technology Assistance Programme (RETAP)	No
32.	Rupia Limited	Yes
33.	Select Management Services Limited	No
34.	SISDO	Yes
35.	Sumac Credit Ltd	Yes

36.	Swiss Contact	Yes
37.	Taifa Option Microfinance	Yes
38.	U & I Microfinance Limited	Yes
39.	Women Enterprise Fund	No
40.	Yehu Microfinance Trust	No

Source: AMFI