EFFECT OF FINANCIAL REGULATION ON FINANCIAL
PERFORMANCE OF DEPOSIT-TAKING MICROFINANCE
INSTITUTIONS IN KENYA

BY

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D61/P/8417/2004

A RESEARCH PROJECT PREPORT SUBMITTED IN PARTIAL
FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF
THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION,
UNIVERSITY OF NAIROBI

NOVEMBER 2012
DECLARATION

This research project is my original work and has not been presented to any other institution or university.

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This research project has been submitted for examination with our approval as the university supervisors.

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ACKNOWLEDGEMENT

I would like to acknowledge and extend my heartfelt gratitude to the following persons who have made the completion of this research possible.

I am highly indebted to Mr. Mirie Mwangi, my research supervisor, for his guidance and support throughout the development of my research paper.

I would like to express my special gratitude to my family for the love and support all through my studies.

Above all, I thank the Almighty God for His favour and blessings throughout my studies, and in my entire life.
DEDICATION

I dedicate this to my parents Nancy and Francis Kirika for their endless love, support and encouragement. Thank you for believing in me.
ABSTRACT

This paper looked at the effect of financial regulation on financial performance of deposit taking microfinance institutions (DTMs) in Kenya. It tried to determine whether benefits of financial regulation outweighed costs and if this would make a case for non-deposit taking microfinance regulation in Kenya.

The research design that was used in this study was both cross sectional and descriptive survey method aimed at establishing the effect of financial regulation on financial performance of deposit taking microfinance institutions. The target population in this study was the 6 deposit-taking microfinance institutions in Kenya. The study collected both primary and secondary data. The primary data was collected using semi-structured questionnaires and the secondary data was collected from the financial statements of the DTMs for the period 2005-2011. Data was analyzed using Statistical Package for Social Sciences (SPSS) program and presented using tables and pie charts to give a clear picture of the research findings at a glance.

The study concludes that the supportive Deposit Taking Microfinance Regulations of 2008 led to the improvement in financial performance of DTMs. The regulations lead to increase in the value of loans outstanding, total assets of DTMs, the profit and shareholders’ equity of DTMs. However, the DTMs encounter challenges such as high costs of transformation, high costs of operation, licensing costs and stiff competition from other financial institutions. The study recommends comprehensive impact analyses prior to implementation of new regulations in the financial sector particularly micro finance institutions; a long-term view when structuring regulatory framework to provide DTMs a
clear view of the thresholds to attain on the path to institutional development and transformation. The study also recommends further research on ways in which financial performance of DTM can be enhanced through regulatory framework
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<tr>
<td>BSD</td>
<td>Bank Supervision Department</td>
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<tr>
<td>CBK</td>
<td>Central Bank of Kenya</td>
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<tr>
<td>CGAP</td>
<td>Consultative Group to Assist the Poor</td>
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<td>DTM</td>
<td>Deposit-Taking Microfinance Institutions</td>
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<td>FI</td>
<td>Financial Institution</td>
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<td>FSD</td>
<td>Financial Sector Deepening</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>KWFT</td>
<td>Kenya Women Finance Trust</td>
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<td>MFIs</td>
<td>Microfinance institutions</td>
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<tr>
<td>MoF</td>
<td>Ministry of Finance</td>
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<tr>
<td>NGO</td>
<td>Non-Governmental Organization</td>
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<td>PCA</td>
<td>Prompt Corrective Action</td>
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<td>RIA</td>
<td>Regulatory Impact Assessment</td>
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<td>ROA</td>
<td>Return On Assets</td>
</tr>
<tr>
<td>SACCO</td>
<td>Savings and Credit Co-operative Society</td>
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<td>SSA</td>
<td>Sub-Saharan Africa</td>
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<td>WB</td>
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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study
The microfinance sector has evolved over the past three decades. It came to prominence in the 1980s, although subsidized credit programs to targeted communities date back to the 1950s and early experiments in Bangladesh, Brazil and a few other countries began in the 1970s. The important difference of microfinance sector was that it avoided the pitfalls of an earlier generation of targeted development lending, by insisting on repayment, by charging interest rates that could cover the costs of credit delivery and by focusing on client groups whose alternative source of credit was the informal sector (Aghion and Morduch, 2005).

As in most developing countries, there are policy and regulatory shortcomings in the Kenyan financial sector in general, and the microfinance industry in particular, especially for non-deposit taking MFIs. The existing microfinance regulation in Kenya, (Microfinance Act 2006), while putting regulation and supervision of Deposit Taking Microfinance Institutions (DTIs) under Central Bank of Kenya (CBK), has, through Section 3(2) of the Act, empowered the Minister for Finance to make regulations specifying the Non-deposit taking microfinance business and prescribe measures for the conduct of the specified business (MF Act, 2006). It is therefore imperative that MFIs be provided with an enabling regulatory environment to reach their full potential.
1.1.1 Microfinance Institutions in Kenya

Microfinance is the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and, their micro enterprises. Micro financing Institutions (MFIs) are defined as institutions whose major business is the provision of microfinance services. Their aim is to become sustainable and expand their microfinance services (Asian Development Bank, 2000).

Microfinance refers to the provision of financial services to low income households, including the self-employed. These financial services include savings, credit, payment facilities, remittances and insurance (Ledgerwood, 1999; Wright, 1999; Christen and Rosenberg, 2000). Microfinance, therefore, encompasses microcredit, micro savings and micro insurance (Roth, 2002). With the passage of time, there has been increasing emphasis on the importance of offering a range of quality, flexible financial services in response to a wide variety of needs of the poor (Wright, 1999).

Although the Kenyan microfinance sector is one of the most vibrant in Sub-Saharan Africa with a diversity of institutional forms and a good infrastructure to serve the poor, microfinance activities were not regulated until 2006. The absence of regulation allowed innovations to take place. Institutions were set up easily without any barrier like minimum capital requirements. In this environment, the microfinance industry has developed and managed to attain reasonably high outreach.
During the last two decades, banks focusing on microfinance have entered the market through a green fielding strategy (e.g. Co-operative Bank) or an institutional transformation approach - Equity Bank and Family Bank have transformed from building societies and K-Rep Bank from an MFI NGO. These institutions offer fully-fledged banking services to micro and SME clients. A high number of NGO MFIs are also serving the same market segment. The NGO MFIs considered various possibilities of expanding their businesses but they were not allowed to collect deposits and therefore had to rely either on expensive funding sources (borrowings) or unreliable subsidies and grants.

1.1.2 Financial Regulation of Microfinance Institutions

The rapid growth of microfinance has brought increasing calls for regulation, but complying with prudential regulations and the associated supervision can be especially costly for microfinance institutions. The best empirical estimates of the costs of such regulation come not from microfinance or other financial institutions operating in developing countries, but from banks in industrialized countries. For example, by one estimate, the costs of complying with regulation in the United States are sizable, equal to 12 to 13 percent of banks’ non-interest expenses (Thornton, 1993; Elliehausen, 1998). According to Christen, Lyman, and Rosenberg (2003), compliance with prudential regulations could cost a microfinance institution (MFI) five percent of assets in the first year and 1 percent or more thereafter.
The Microfinance Act of 2006 and the supportive Deposit Taking Microfinance Regulations of 2008 have together paved the way for institutional transformation in Kenya. With the support of the Financial Sector Deepening (FSD) Kenya, Faulu and Kenya Women Finance Trust engaged in the process that led to their licensing as the pioneer deposit-taking microfinance institutions (DTMs) in Kenya. Both transformations were generally successful and have helped the two institutions to maintain their strategic positioning in the market. However, in both cases, the process required more resources and took much longer than expected. In addition, the transformations raised greater than anticipated organizational challenges. By start of 2009 when Kenya Women Finance Trust (KWFT) embarked on the transformation into a deposit-taking institution in earnest, it was the largest non-bank microfinance institution in Kenya, serving 250,000 women only clients.

In discussing tradeoffs in regulation of microfinance, Christen, Lyman, and Rosenberg (2003) draw an important distinction between prudential and non-prudential regulation. According to their definition, regulation is prudential when “it is aimed specifically at protecting the financial system as a whole as well as protecting the safety of small deposits in individual institutions.” The assets of microfinance institutions remain substantially less than those of formal providers of financial services, most notably banks, and thus they do not yet pose a risk to the stability of the overall financial system in most countries. However, an increasing share of microfinance institutions take deposits from the public, and many of the depositors are relatively poor. Protecting the safety of those deposits provides a rationale for improved regulation and supervision of microfinance
institutions, and thus Christen, Lyman, and Rosenberg (2003) argue that prudential regulations should generally be triggered when an MFI accepts retail deposits from the general public.

There are several ways in which the industry might gain from financial regulation (Llewellyn, 1999). It might enhance competition and the overall efficiency of the industry; increase consumer welfare and encourage a better management of financial risks by the supervisees. However, regulation is not imposed without costs, which are faced by the supervisees, the supervisor and the market itself. The latter could include a possible inhibition of competition, the stifling of innovation and forced choice of consumers (Goodhart et al, 1998).

1.1.3 Financial Performance

This is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation (Bernardin and Russel, 1998). There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt. Ultimately
the universal measure of business performance is money and the ultimate forms of this measurement are the final accounts of the company. Money has the advantage that it can be used to measure the effectiveness and efficiency not only of different business functions (marketing, engineering, production etc.) but also of different businesses (from manufacturing companies to retailers and from hotels to garages).

According to Richard (2009), organizational performance encompasses three specific areas of firm outcomes financial performance (profits, return on assets, return on investment, etc.); product market performance (sales, market share, etc.); and shareholder return (total shareholder return, economic value added, etc.). In a survey on the quality, uses and perceived importance of various financial and non-financial measures. Lingle and Schiemann (2006) report wider disparities between the perceived quality and importance of non-financial measures as compared to financial measures. Perceived inadequacies in a traditional performance measurement system that focuses on financial measures have led many organizations to switch to and put greater emphasis on forward-looking non-financial measures such as customer satisfaction, employee learning and innovation (Ittner and Larcker, 2008).

As microfinance firms are viewed predominantly as instruments of social change, their performance has been often measured by non-financial parameters. The concept of social performance has seemed to overshadow the state of financial health of these enterprises. However, the accepted criteria in a number of studies to study the performance of any MFI have been the twain of Financial Performance and Outreach (Chaves and Gonzales-
Vega 1996, Ledgerwood 1999, Yaron, 1992, Yaron 1994, Yaron et al., 1998, as cited in Arsyad, 2005). However, there exist various social performance assessment tools and institutionalized rating processes but assessment of financial performance has yet to gain ground.

The financial performance assessment is devoid of such a multitude of options and methodologies despite critical importance of financial sustainability. Though an ambition for sustainable institutions has been often articulated, there was also an opinion that most microfinance institutions working in this field have been unsustainable (Dayson and Quach 2006). Research studies have shown that this is predominantly connected to the perception of micro borrowers’ risk and creditworthiness, and the diseconomies of scale in making small loans (Dayson and Quach 2006). Microfinance has been attractive to lending agencies because of demonstrated sustainability and low cost of operations. In India, the engagement of NABARD and SIDBI shows that they see long term prospect for this sector (Srinivasan and Sriram, 2006).

1.2 Statement of the Problem

Regulation remains a precondition for deposit mobilization in many countries thus more MFIs seek to transform into regulated entities to access cheap and local currency deposits. Regulation opens the door to a variety of funding opportunities and helps to reduce the overreliance on subsidies. Understanding how regulation affects performance matters. On one hand costs of designing and enforcing regulatory policies to address the specific challenges of microfinance are substantial (Hartaska and Mersland, 2009). On
the other hand, complying with supervisory requirements is costly. Barth et al., 2004 have reviewed the implications of supervision on the performance of financial intermediaries.

Deposit taking involves a potential risk of loss depending on how the deposits are employed. There are also a number of techniques and sensitivities associated with deposit taking that would justify external regulation and supervision. These include convenience to depositors in terms of location and premises and provision of qualitative and physical security of deposits including insurance of deposits. Others include adequate liquidity, as depositors should be able to withdraw without subjecting the MFIs to solvency risks: attainment of acceptable rates of returns since MFIs expect good returns.

To date, much of the research has been limited to case studies of successful MFIs in Asia, Africa and Latin America. These studies have tended to focus on micro-economic impacts and the relationships between MFIs and their recipient credit clients (Hulme and Mosley, 1996; Wood and Sharif, 1997; Khandker, 1998 Coleman, 1999; Morduch, 1998). There has been very little research into the regulation and supervision of MFIs and the impact of regulation and supervision on the development of the sector. What research has been done has tended to be in the form of descriptive case studies charting the experiences of selected MFIs that have been licensed in their respective countries (Churchill, 1997; Rock and Otero, 1997).
There has been no study undertaken in Kenya to establish the effect of prudential regulation on the financial performance of MFIs that have been licensed to carry out deposit taking business and this is the knowledge gap motivating this study. The research aims to explore whether there is motivation for a MFI to transform itself to a deposit taking microfinance institution.

1.3 Objective of the Study
The objective of this study is to establish the effect of financial regulation on financial performance of deposit taking microfinance institutions in Kenya.

1.4 Significance of the Study
This study shall be of importance to the following parties;
Central Bank of Kenya especially those working in the financial regulatory department will find information out of this study useful in their quest to discharge the functions efficiently. An understanding of the importance of the financial regulation begins with the observation that productive ability and opportunity are not evenly distributed throughout the economy. This observation suggests that segments of the economy may possess the opportunity to engage in productive enterprise but may lack the economic
ability to do so. The opposite situation also exists, where individuals with economic 
ability lack access to productive opportunities.

Scholars especially academicians engaged in research in MFI, finance, investment and 
public finance will find this study useful as one of the working documents. A most 
important question to be answered prior to reading this thesis is whether or not 
policymakers should intervene during financial sector crisis or distress.

Consultants especially in the area of MFI and investment will find this report useful in 
their quest to provide appropriate, feasible and informed advice to both public and private 
sector organizations and players.

Researchers and students particularly those pursuing postgraduate studies in Finance, 
Economics and Accounting will find this study useful in their quest to understand MFI 
control in the public sector.
CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction
This chapter presents the literature review; with focus on the variables of the study, and the theoretical review of new theory of financial regulation, theory of micro prudential regulation and the theory of liquidity and regulation of financial intermediation. The other sections outline rationale for financial regulations micro finance institutions in Kenya and finally on the importance of financial statements in determining the extent of regulation.

2.2 Theoretical Review
2.2.1 New Theory of Financial Regulation
The rationale for a new theory of financial regulation is the need to recognize first that regulation is required to promote a stable economic structure in order to prevent the price and output volatility that can lead to financial crises. This can be achieved by central banks having an independent preeminent role to target inflation and induce the correct price signals regarding the cost of capital in order to mould market participants’ behaviour as to the allocation of scarce resources. Second regulation is multi-faceted and also involves establishing a regulatory model the role of which is to contain and mould the risk taking and management behavior of both financial and non-financial institutions as well as market participants through prudential supervisory systems appropriate to the strengths or weakness of the protective measures (Campbell, 2006).
2.2.2 Theory of Micro Prudential Regulation

A micro prudential is an approach which regulation is partial-equilibrium in its conception, and is aimed at preventing the costly failure of individual financial institutions. By contrast, a macro prudential approach recognizes the importance of general-equilibrium effects, and seeks to safeguard the financial system as a whole. There seems to be agreement among both academics and policymakers that the overarching orientation of financial regulation needs to move in a macro prudential direction. Bernanke (2008) states that the risk of caricature, traditional micro-prudential regulation of banks can be said to be based on the following logic. Banks finance themselves with government-insured deposits. The safety-and-soundness regulation, supervisors often focus on the financial conditions of individual institutions in isolation. An alternative approach, which has been called system wide or macro prudential oversight, would broaden the mandate of regulators and supervisors to encompass consideration of potential systemic risks and weaknesses as well.”

While deposit insurance has the valuable effect of preventing bank runs, it also creates taxpayer exposure and an accompanying moral hazard problem for bank managers (Diamond and Dybvig, 1983). The goal of capital regulation is to force banks to internalize the losses on their assets, thereby protecting the deposit insurance fund and mitigating moral hazard. Thus if the probability of the deposit insurer bearing losses is reduced to a low enough level, micro prudential regulation is by definition doing its job. An important element of capital regulation as it is implemented in practice is the principle of prompt corrective action (PCA), which requires that a bank take immediate steps to
restore its capital ratio in the wake of losses. If the volatility of its assets remains unchanged, in order for its probability of failure over the, micro prudential regulation can be understood as follows. When a micro prudentially-oriented regulator imposes PCA on a troubled bank, and pushes the bank to restore its capital ratio, he does not care whether the bank adjusts via the numerator or via the denominator i.e., by raising new capital or by shrinking assets. Either way, the bank’s own probability of failure is brought back to a tolerable level, which is all that a micro prudential regulator cares about.

\[ \text{2.2.3 A Theory of Liquidity and Regulation of Financial Intermediation} \]

The regulation of financial intermediaries is an important function of central banks and is a topic of frequent debates in the policy-making community. The study mechanism designs a model of financial intermediaries as providers of liquidity similar to (Diamond and Dybvig 1983; Allen and Gale, 2004). Intermediaries invest in short and long term assets and over a risk-sharing contract that pools risk across agents. It is easy to show, as in Prescott and Townsend (1984) and Allen and Gale (2004), that markets provide optimal allocations, and, therefore, there is no role for government intervention. The regulation takes the form of the imposition of liquidity and that stipulates a minimal portfolio share to be held in the short term asset by intermediaries. The liquidity increases the amount of the period aggregate resources and drives the interest rate on the private markets down. The liquidity can be chosen to implement the optimal solution. This simple regulation resembles the different forms of reserve requirements imposed on banks. In practice, reserve requirements were mostly developed as an answer to different concerns pertaining to systemic risk or the fear of bank runs. According to Allen and
Gale (2004), analysis contribute to mitigating the efficiency that highlight the market failure and the required regulation that we consider are novel but are close in spirit, to some arguments that were made in the early stages of financial regulation during the National Banking era, as described in a classical study by Sprague (1910) and in a modern exposition by Chari (1989).

2.3 Financial Regulation

Financial regulations are implemented in most countries to secure financial stability and to prevent systemic financial risk. Prudent financial regulation and supervision are considered essential in banking industry since consumers cannot monitor banks’ complexity of financial products effectively (Dewatripont and Tirole 1994). However, the fragility of financial market can be originated from inconsistent government policy which hampers the effective regulations and supervisions and leads to financial crisis (Caprio et al. 2008).

Financial regulation is the revelation of traditional philosophy of low returns on money embodied in interest rate ceilings or regulation as baseless, counterfactual, and perilous at least in the environment of the developing countries (Caprio et al. 2008).

Three types of financial regulations capital regulation, official supervisory power, and private monitoring are often discussed in existing studies because they are consistent with the three pillars of the Basel II Accord (Petersen et al., 2009). Barth et al. (2008) argue that the Accord reduces the financial stability since capital requirements under the
Accord will increase in bust and fall in boom. On the other hand, Barth et al. (2008) categorize 7 regulatory indices including the three pillars of the Accord: overall restrictions on bank activities, entry requirements, diversification, capital regulation, private monitoring, government-owned banks, and official supervisory power. The extended indices are worth considering since particular regulatory combinations can have different effects on financial stability. However, the effects of each element of the indices on containing financial crisis are controversial.

Financial regulation formulated to enhance the development of the financial sector has not been the exception to be, in some cases, the product of intuitions, of rational reflections that transit throughout reality’s periphery without arriving at it, and, in other cases, the mechanical intent of transplantation of foreign experiences or purely empirical normative models (which has been the situation of financial liberalization in countries that did not engage previously to capital markets openness in the design of a consistent financial safety net and, in general, in the constitution of all the context-specific competitive and preventive conditions that are necessary to increase the potential benefits and reduce the probable drawbacks of financial integration). There may be countervailing or amplifying effects between various elements of regulations, if implemented simultaneously (Caprio et al. 2008). Greater restrictions on bank activities can be essential in countries with insufficient private monitoring, whereas restricting bank entry with weak official supervision may lead to financial stability (Barth et al. 2008).
2.4 Financial Performance

Financial performance refers to the subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm’s overall financial health over a given period and can be used to compare similar firms across the same industry or sectors in aggregation (Whetherly, 1998). Pradeepkumar (1993) used growth rate analysis to analyze the growth in physical and financial performance indicators of horticultural producer’s cooperative marketing society limited, Bangalore. The indicators considered were membership share capital, owned funds, sales, inventories, fixed assets, current assets, total assets, current liabilities and total liabilities.

Jacobson (1999) defines financial performance as measuring the results of a firm’s policies and operations in monetary terms and results are reflected in the firm’s return on investment, return on assets and value added. It is essentially the action of achieving in relation to predetermined goals and objectives.

Many scholars like (Bacidore et al 1997, David et al 2008 and Louis, 1996) have developed independently the measures of financial performance any modern firm can adapt. Profit describes how much wealth your company has created (profit) or consumed (loss) over a certain period of time. These figures are reflected in the profit and loss account of the firm. Four useful measures of a firm’s profitability are the rate of return on the firm’s assets (ROA), rate of return on the firm’s equity (ROE) operating profit margin and net firm income. A full measurement of profit must take into account owner’s
compensation and the higher the profit levels, does the same with financial performance (Louis, 1996).

Louis (1996) also puts forward two measures of financial performance that are being applied in modern businesses today that is Market value added (MVA) and Economic value added (EVA). MVA assesses the effect of managerial actions on shareholder wealth from the organization’s inception while EVA assesses managerial effectiveness in a given year. Unlike traditional profitability measures, MVA and EVA measures take into account the cost of equity capital. Financial managers should familiarize the selves with the definitions, rationale and potential uses of these measures.

Bacidore, et al (1997) also contends that, getting on top of financial measures of your financial performance is an important part of running a growing business and put forward three key accounting ratios that measure financial performance which include: Liquidity ratios, which tell you about your ability to meet your short-term financial obligations, Efficiency ratios, which tell you how well you are using your business assets and Gearing ratios, which tell you how sustainable your exposure to long-term debt is.

2.5 The Rationale for Financial Regulations of Microfinance Institutions in Kenya
Governments primarily regulate industries with a view to protecting consumers. This, for example, is why Governments regulate public utilities which may use monopoly positions to exploit consumers. In the financial sector, an additional motivation for
regulation is maintaining financial stability, which is a clear public good. Financial sector supervision thus requires a more elaborate framework and tends to be more rigorous and intensive than is the case in other sectors. One of the principal reasons for government regulation is to correct market failure. This is sometimes referred to as the ‘economic’ rationale for regulation (Llewellyn, 1999). Market failure is said to exist when the market is unable to produce an outcome that maximizes economic welfare. Regulation in such cases is justified because an “uncontrolled market place will, for some reason, fail to produce behaviour or results in accordance with public interest” (Baldwin and Cave, 1999: 9). Regulation of the financial sector should achieve the following key principles.

2.5.1 Systemic Considerations

Because DT FIs, especially banks, are closely connected to each other financially through the inter-bank market, the payments clearing system and the holding of deposit balances, the failure of one FI is likely to affect another and do so more quickly than the failure of a firm in another industry. The banking system is, thus, perceived as being more susceptible to systemic risk, “the risk that disturbances in a financial institution or market will spread across the financial system, leading to widespread bank runs by wholesale and retail depositors, and possibly, the collapse of the system” (Heffernan, 1996: 218).

The systemic argument is based on the premise that risk taking by FIs should be regulated; because unlike in other industries, the failure of a FI may, through confidence and contagion effects, undermine the stability of the financial system as a whole. It implies that exit is more costly than in other sectors because of substantial externalities
related to disruptions in the provision of financial services, especially credit, which may have a knock on effect on the economy. This systemic risk would not be factored into the FI’s pricing or portfolio behaviour as the market mechanism assumes a zero cost of exit from the industry (Llewellyn, 1986).

2.5.2 Information Disclosure

There is an asymmetrical relationship in many financial transactions between the provider and the consumer. Because of the information asymmetries associated with financial transactions, consumers may have inadequate information and tend to be less well informed than the suppliers of financial services (Benston, 1998). Consequently, consumers can be more easily exploited and have problems in assessing the quality of services and products being purchased, or the safety and soundness of FIs, except at inordinate cost.

Furthermore, information is in effect a pure public good (Llewellyn, 1999). Its consumption by one individual does not detract from another’s consumption and it is very costly, if not impossible, to exclude others from its consumption. Thus, there are (positive) externalities involved in its acquisition. Others benefit from the information acquired by an individual, what has been termed the ‘free-rider’ problem. Because of these features, there will be underinvestment. Thus, markets which are information intensive, such as financial markets, are likely to be imperfectly competitive and generally inefficient.
Information disclosure is a particularly important element in regulation, thus alleviating the information asymmetry problem. Disclosure of relevant information is considered an essential ingredient of customer protection. Mandatory disclosure facilitates comparison between alternative products and hence lowers consumers’ transaction costs, if disclosure is made on the same basis by all firms. Furthermore, standardized information can help consumers make choices. Lastly, the consumer is often uncertain about what is relevant information to demand when complex products are involved. Thus, mandatory disclosure sets out the minimum disclosure requirements on a consistent and standardized basis that all firms must adhere to for all retail customers (Benston, 1998).

2.5.3 Economies of Scale in Monitoring

Because of the nature of financial contracts between financial firms and their customers, the behaviour of financial firms must be continuously monitored. This is particularly important for long-term contracts since customers cannot exit at low cost. Although not as applicable to depositors as they can exit at low cost, depositors may not have the necessary information to make such a decision. This monitoring cannot be undertaken effectively by customers as it is too costly. In effect, customers delegate monitoring to a supervisory agency and the agency supplies monitoring services to customers of financial firms.

There are potentially substantial economies of scale to be gained through the collective regulation, supervision and monitoring of financial firms (Llewellyn, 1999). This avoids duplication and excessive social costs resulting from the loss of economies of scale.
gained from a specialist regulator acquiring expertise and establishing effective monitoring systems. Therefore, the monitoring of FIs is a ‘natural monopoly’, in that its duplication by several parties is technically wasteful. By delegating monitoring in this manner, consumers are able to reap the benefits of expertise and economies of scale and the ‘free-rider’ problem is avoided.

2.5.4 Preserving Financial Sector Soundness

The core objectives of financial regulation are to preserve the stability and soundness of the financial system and to protect the deposits of the public (Llewellyn, 1999). A primary reason for regulating and supervising traditional financial institutions is consumer protection for public depositors in financial institutions. main approaches to financial regulation impose limits or constraints on the supervisees so as to deter them from engaging in certain activities that entail excessive risk, and to provide financial firms with a set of incentives that would induce them to align their private objectives to social goals. Thus, regulation is meant to define the rules and incentives by which market participants must behave, but without constituting a barrier for the natural development of the industry (Stiglitz, 2001).

2.6 The Microfinance Act

The law applies to microfinance institutions which are involved in deposit-taking business. The DTM regulations state that any MFI willing to conduct deposit-taking business should apply for license with the Central Bank of Kenya (CBK). Credit-only MFIs are not under the scope of the DTM regulations and neither are the SACCOs,
Microfinance Act and the supportive regulations are too stringent and similar to a banking regulation, thus not appropriate for the microfinance sector. The Microfinance Act and related regulations have set up entry barriers for institutions planning to undertake deposit-taking business by fixing the minimum capital amount and license fees. The license fees are high, relative to size for the community based DTM compared to nationwide DTMs and Banks. The rationale for this might be that the CBK is less keen to take on the supervision burden of institutions which do not pose significant danger to the stability of the overall financial sector, therefore seeking to limit the number of such institutions.

**Control for mission drift;** The DTM regulations state that MFIs licensed to conduct deposit-taking business should dedicate more than 70% of their portfolio to microfinance loans. At the same time, large exposures (loans between 2% and 5% of core capital) should represent less than 30% of the portfolio.

**Prudential ratios;** The DTM regulations have defined the following prudential ratios: (1) capital adequacy ratios including a core capital of 10% of total risk adjusted assets plus risk adjusted off balance sheet items, core capital of 8% of total deposit liabilities, total capital of 12% of total risk adjusted assets plus risk adjusted off balance sheet items; (2) a minimum liquidity ratio of 20%; (3) a limit on insider loans which should not exceed 2% of core capital and should be contained on aggregate within a ceiling of 20% of core capital.
**Reporting requirements;** Deposit-taking MFIs must submit the following periodic reports and other disclosures to the CBK: biweekly liquidity information, monthly reports on capital to risk weighted assets, quarterly unaudited financial statements and annual audited financial statements.

**Protection of depositors;** although not included in the DTM regulations, the Microfinance Act states that all institutions should contribute to the Deposit Protection Fund. The Fund would prescribe the level of the contribution, and disclose the maximum balance per customer protected in case of insolvency. Sanctions detailed and tough administration sanctions are listed in case of non-compliance with the capital adequacy standards without indicating the sequence of these sanctions. All the other offences are left to the appreciation and the discretionary power of the CBK.

**2.7 Empirical Review**
Armendariz and Morduch (2004) conducted a study on effective financial intermediation of MFI and concluded that MFIs cannot provide effective financial intermediation without a ‘well-functioning regulatory framework’ in the country. Woller and Woodworth (2001) cite many impact studies and conclude that governments must “create a macroeconomic environment characterized by stable growth, low inflation, and fiscal discipline”. They further suggest that poor macroeconomic, regulatory and trade policies will undermine the viability of small business owners and the MFIs that support them. Hubka and Zaidi (2005) find that governments can help market-based microfinance by eliminating unfair competition from public institutions; undertaking overall regulatory
reform; and improving the overall business environment. Ledgerwood (1999) discusses the impact of policy and regulatory issues on MFIs. Many policy issues are addressed, but two are recognized as playing a large role for sustainability an appropriate regulatory environment, and strong property rights. Zeller and Meyer (2002) also found that improvements in the policy environment of a country contribute to the overall performance of its institutions.

According to the CGAP Update on Regulation of Branchless Banking (2010c, pg.2) “South Africa has a vibrant and sophisticated financial sector, the strength and stability of which have provided the foundation for over 10 years of uninterrupted economic expansion.” The Africa Competitiveness Report (2009, pg.38) further notes that “South Africa, ranked 1st in the region and 24th globally, has highly sophisticated financial markets, on a par with Belgium and France, with relatively easy access to capital from various sources, sound banks, and a well-regulated securities market.” This therefore provides important lessons for other countries to emulate. Studies by Staschen, (1999) concluded that “the issue of regulating and supervising microfinance institutions (MFIs) is attracting growing interest. Harper (2007) portrays Microfinance as “promoting debt and not thrift, as it forces clients into perpetual dependence on debt, based on lending and not savings and use of inappropriate Asian models to promote indebtedness in Africa.

Hartarska and Nadolnyak (2007) find that regulation has no impact on financial performance and weak evidence that regulated MFIs serve less poor borrowers. Mersland and Strøm (2009) use an endogenous equations approach to find that regulation does not
have a significant impact on financial or social performance, where regulation is measured by a regulation dummy variable.

Okwachi, (2008) examined effectiveness of state regulation of the insurance industry in Kenya, he explains ‘the extent and nature of the regulation may differ markedly between banks and non-banks depending on the role the latter institutions play in the economy’. Some issues involved in prudential regulation of insurance industry are different from the ones applied to banks because for the former ones, systemic risk, contagion and the potential disruption of the payments system do not constitute threatening issues. The core objectives of financial regulation are to preserve the stability and soundness of the financial system and to protect the deposits of the public.

Gathuku (2010) carried out a study on responses of microfinance institution to regulation through Microfinance Act 2006. She examined the potential sources of financial regulation in the inter-bank market and the effects on interest-rate spreads, loan/deposit flows and bank equity and argued that while a considerable potential for contagion results from asymmetric information among contracting parties, due to imperfect information collection and monitoring costs in markets for uncollaterised loans, the actual settlement process itself creates an ‘institutional’ contagion potential. This arises not just from the ability to spread credit risks of participating banks, but those relating to sovereign risk and liquidity risk.
Kusewa (2007) did a study on the impact of regulation of the retirement benefits sector on the financial performance of occupational pension schemes in Kenya. The regulations were based on the Constitution of Kenya, the Exchequer and Audit Act and the Paymaster-General’s Act and Regulations which all contained relevant provisions regarding the control and management of government finances. The enactment of the Government Financial Management Act of 2004 augmented the aforementioned efforts towards realization of an effective and efficient Public Financial Management System and supportive of public service delivery and socioeconomic development.

2.8 Summary

To the extent that it enhances competition and overall efficiency in the industry, regulation creates a market which works more efficiently. If consumer confidence is improved by setting minimum standards, the increased demand for financial services and products is beneficial to both consumers (to the extent that they are no longer discouraged from buying what might be desirable and competitive products) and the industry itself. To the extent that ‘cowboys’ are removed, the industry’s reputation is enhanced through the removal of badly behaved firms that contaminate the reputation of all firms in the industry. Similarly, regulation benefits the industry to the extent that it guarantees to all firms, that what they believe to be appropriate behaviour will also be followed by their competitors. Lastly, in the case of prudential regulation, financial firms’ own counterparty risks should be reduced. As the industry also stands to gain, the regulatory process need not be antagonistic in nature (Llewellyn, 1999).
The public interest approach is one that has dominated thinking on regulation for most of
the twentieth century and is still taken for granted in discussions of regulation (Barth et
al, 2006). “Public interest assumes that the state, acting in the public interest, establishes
a legal framework to realize a specific set of regulatory objectives” (Llewellyn, 1986:
11). The emphasis is on the credibility and disinterestedness of expert regulators in whose
public-spiritedness and efficiency the public can have confidence (Baldwin and Cave,
1999).
CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction
This chapter outlines the methods that were adopted by the study in obtaining information on the effect of financial regulation on financial performance of deposit taking microfinance institutions in Kenya. The chapter also describes and explains the research instrument that used in the study. The chapter is thus structured into research design, target population, data collection and data analysis techniques.

3.2 Research Design
The research design that was used in this study was both cross sectional and descriptive survey method aimed at establishing the effect of financial regulation on financial performance of deposit taking microfinance institutions. This method allowed for prudent comparison of the research findings. A cross sectional and descriptive survey attempts to describe or define a subject often by creating a profile of a group of problems, people or events through the collection of data and tabulation of the frequencies on research variables or their interaction as indicated.

3.3 Population of Study
The target population in this study was the 6 microfinance institutions (appendix II) which are involved in deposit-taking.
3.4 Data Collection
The study involved both primary and secondary data. The data collection instrument used in this study was a semi-structured questionnaire (appendix I). Secondary data was collected from the financial statements of the DTMs for a period of three years before their transformation from MFIs into DTMs and three years after. This enabled comparative analysis of performance of the 6 DTMs before and after their transformation.

3.5 Data Analysis
The process of data analysis involved several stages. Quantitative method of data analysis was used. Data was coded and thereafter analyzed using Statistical Package for Social Sciences (SPSS) program and presented using tables and pie charts to give a clear picture of the research findings at a glance. Results were presented in tables and charts. Correlation and regression analysis will be used to establish the association and effect of independent variables and the dependent variable.

The data was analysed by use of descriptive statistics (e.g. mean score and standard deviation) and inferential statistics; correlation and linear regression model.

The model specification was as follows;

\[ Y = \alpha + \beta_1 X_1 + \varepsilon. \]

Where;

\[ Y = \text{Financial Performance (ROA)} \]

Return on assets is:
Net Income

Total Assets

\[ X_1 = \text{Deposits held by DTM} \]

The number of deposits before licensing of the DTM will be zero. The aim is to determine the effect of the deposits on the return on assets for these institutions.

\[ \varepsilon = \text{error term} \]

\[ \beta = \text{coefficient} \]

\[ \alpha = \text{constant} \]

The methodology to be used in this research is the Regulatory Impact Assessment (RIA), which involves a ‘process of systematically assessing the benefits and costs of a new regulation or an existing regulation, with the aim of improving the quality of regulatory policy’ (Kirkpatrick and Parker, 2003). The research is a ‘regulatory evaluation’, which entails an ex-post assessment of already implemented regulatory measures (Kirkpatrick, 2001; Kirkpatrick and Zhang, 2004).
CHAPTER FOUR
DATA ANALYSIS, RESULTS AND DISCUSSIONS

4.1 Introduction
This chapter entails presentation, analysis and interpretations of study findings. The main objective of the study was to establish the effect of financial regulation on financial performance of deposit taking microfinance institutions in Kenya. Data was collected from 6 microfinance institutions which are involved in deposit-taking business. The institutions are: Faulu Kenya DTM Limited, Kenya Women Finance Trust, Rafiki Deposit Taking Microfinance Ltd, Remu DTM Limited, SMEP DTM Limited and Uwezo DTM Ltd. The primary data was collected using semi-structured questionnaire while the secondary data was collected from the financial statements of the DTMs for a period of three years before their transformation from MFIs into DTMs and three years after. The findings of the study are presented in form of bar graphs and tables.

4.2 General Information
The study collected information on the duration that DTMs investigated had been in operation, the number of branches the DTMs have in Kenya, customer base of the DTMs and the length of time taken by CBK to issue license to DTMs. The study findings are presented in table 4.1 below.
### Table 4.1: General Information of DTM

<table>
<thead>
<tr>
<th>Demographic Characteristics</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Duration of Operation of DTM (Years)</strong></td>
<td></td>
</tr>
<tr>
<td>Below 10</td>
<td>20.0</td>
</tr>
<tr>
<td>10-30</td>
<td>60.0</td>
</tr>
<tr>
<td><strong>The Number of Branches of DTM in Kenya</strong></td>
<td></td>
</tr>
<tr>
<td>Less than 10</td>
<td>16.7</td>
</tr>
<tr>
<td>10-20</td>
<td>50.0</td>
</tr>
<tr>
<td>Above 20</td>
<td>33.3</td>
</tr>
<tr>
<td><strong>Customer Base of DTM in Kenya</strong></td>
<td></td>
</tr>
<tr>
<td>Less than 50,000</td>
<td>16.7</td>
</tr>
<tr>
<td>50,000-100,000</td>
<td>33.3</td>
</tr>
<tr>
<td>Above 100,000</td>
<td>50.0</td>
</tr>
<tr>
<td><strong>The Length of Time Taken by CBK to Issue License to DTM</strong></td>
<td></td>
</tr>
<tr>
<td>Less than 1 year</td>
<td>67.7</td>
</tr>
<tr>
<td>More than 1 year</td>
<td>33.3</td>
</tr>
</tbody>
</table>

The study findings indicate that majority (60.0%) of the DTM have been in operation for periods between 10 and 20 years while 20.0% have been in operation for less than 10 years. Majority (50.0%) of DTM in Kenya have between 10-20 branches in Kenya. According to Central Bank of Kenya (2012), there are currently six licensed DTM in the country with a branch network of 63 branches by the end of May 2012. The study findings also show that majority of the DTM in Kenya have a customer base of between above 100,000 and 67.7% of DTM received their licenses from CBK within one year of the application.
4.3 The Effect of Financial Regulation on Financial Performance of DTMs in Kenya

The main objective of the study was to establish the effect of financial regulation on financial performance of deposit taking microfinance institutions in Kenya. In order to fulfill the main objective, the study established the trends in various financial paradigms within microfinance institutions in Kenya. The study findings are illustrated in the following subsections.

4.3.1 Number of Deposit Accounts

The study examined the trends in the number of deposit accounts in the pre-transformation (2005-2007) and post-transformation period (2009-2011). Figure 4.1 illustrates the study findings.

**Figure 4.1: The Trends in the Number of Deposit Accounts**

![Graph showing trends in the number of deposit accounts](image)

The study finding in figure 4.1 shows that there were no depositors in the pre-transformation period. In the year 2009 Faulu Kenya limited was the only DTM in Kenya
and a total of six DTM s were registered by the year 2011. The number of depositors gradually increased in the post-transformation period. The study findings reveal that the supportive Deposit Taking Microfinance Regulations of 2008 lead to increase in the number of depositors in Kenya as DTM s expanded their customer base.

4.3.2 Total Value of Loans Outstanding

Figure 4.2 illustrate the findings on the total value of loans outstanding in the period 2005-2011.

Figure 4.2: The Value of Loans Outstanding

The study findings in figure 4.2 indicate that the total value of loans outstanding increased from KSh. 0.9 billion in 2005 to KSh. 6.4 billion in 2007. The increment in the total value of loans outstanding in post-transformation period was significant. The total value of loans outstanding increased from KSh. 11.8 billion in 2009 to 37.7 billion in
2011. The results reveal that the total value of loans outstanding increased as a result of the supportive Deposit Taking Microfinance Regulations of 2008.

4.3.3 Total Assets of DTM in 2005-2011

The study established the total assets of DTM in the period 2005-2011. The study findings are illustrated in figure 4.3 below.

**Figure 4.3: The Total Assets of DTM in the Period 2005-2011**

The study findings in figure 4.3 show a slight increase in the value of total assets of DTM in the pre-transformation period (2005-2007). The value of total assets of DTM increased from KSh. 2.1 billion in 2005 to KSh. 3.6 billion in 2007. On the other hand, the post-transformation period registered great increment in the value of total assets of DTM. The value of total assets increased from KSh. 4.3 billion in 2009 to KSh. 32.7 billion in the year 2011. The findings indicate that the introduction of regulations that
allowed registration of DTMs in Kenya led to increase in the value of assets of the registered micro-financial institutions.

### 4.3.4 Profit/loss of DTMs in the Period 2005-2011

The study established the profit/loss of DTMs in the period 2005-2011. The study findings are illustrated in figure 4.4 below.

**Figure 4.4: Profit/Loss of DTMs in the Period 2005-2011**

From the study findings in figure 4.4, there was a slight increase in the overall profit of DTMs. The financial statements indicated that the slow increase in the profit made by DTMs resulted from increased expenses. The additional expenses were incurred during transformation emanating from the new regulations. However, it the results indicate that the overall profit increased in the year 2011 because majority of the DTMs had implemented most of the changes that resulted from the supportive Deposit Taking Microfinance Regulations of 2008.
4.3.5 Trends in Shareholders Equity and Liabilities of DTMs for Period 2005-2011

The study investigated the trends in Shareholders Equity and liabilities of DTMs for period 2005-2011. The study findings are illustrated in figure 4.5.

Figure 4.5: The Trends in Shareholders Equity and Liabilities of DTMs for Period 2005-2011

The study findings show that shareholders equity of DTMs gradually increased in the post transformation period. The great increase in liabilities in the post transformation period was caused by increase in the value of customer deposits. The study findings show that supportive Deposit Taking Microfinance Regulations of 2008 had a positive impact on financial performance.
4.3.6 The Impact of Regulatory Factors on Financial Performance of DTM's In Kenya

The respondents were requested to indicate the extent to which the regulatory factors shown in table have affected the financial performance of their DTM's. The response was rated on a five-point scale where 1 = No extent, 2= Less extent, 3= Moderate extent, 4= Great extent and 5= Very great extent. The mean and standard deviation were calculated and results presented in table 4.2 below

Table 4.2: The Impact of Regulatory Factors on Financial Performance of DTM's in Kenya

<table>
<thead>
<tr>
<th>Factor</th>
<th>Mean</th>
<th>Std. Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>High costs of transformation</td>
<td>4.436</td>
<td>0.0574</td>
</tr>
<tr>
<td>High costs of operation (branch infrastructure)</td>
<td>4.773</td>
<td>0.0678</td>
</tr>
<tr>
<td>Stringent reporting requirements</td>
<td>3.931</td>
<td>0.2601</td>
</tr>
<tr>
<td>Inability to conduct current accounts for customers</td>
<td>1.208</td>
<td>0.1658</td>
</tr>
<tr>
<td>Licensing costs and procedures</td>
<td>4.214</td>
<td>0.1699</td>
</tr>
<tr>
<td>Stiff competition from other financial institutions</td>
<td>4.473</td>
<td>0.0745</td>
</tr>
<tr>
<td>High costs of transformation</td>
<td>4.538</td>
<td>0.0137</td>
</tr>
</tbody>
</table>

From the study findings in table 4.2 above, majority of the respondents agree that financial performance of their DTM's are, to a great extent, affected by high costs of transformation (M=4.436), high costs of operation (M=4.773), stringent reporting requirements (M=3.931), licensing costs and procedures (M=4.214), stiff competition from other financial institutions (M=4.473), and high costs of transformation.
4.4 Regression Analysis
The researcher performed a regression analysis to establish the association between the independent variables with the dependent variables.

The regression model was as follows:

\[ y = \beta_0 + \beta_1 X_1 + \epsilon \]

**Where:**

\( y \) = Financial Performance of DTMs, measured using ROA

\( \beta_0 \) = Constant Term

\( \beta_1 \) = Beta coefficients

\( X_1 \) = Deposits held by DTMs

\( \epsilon \) = standard error

4.4.1: Strength of the Model

Analysis in table 4.2 shows that the coefficient of determination (R2) equals 23.286 which imply that the percentage variation in the dependent variable (financial performance of DTMs) is explained by the independent variable (regulation of DTMs). The P- value less than 0.05 imply that the model of CME-RH is significant at 95% percent level of confidence.
Table 4.3: Model Summary

**ANOVA**

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Squares</th>
<th>df</th>
<th>Mean Square</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Regression</td>
<td>93.144</td>
<td>4</td>
<td>23.286</td>
<td>79.730</td>
</tr>
<tr>
<td></td>
<td>Residual</td>
<td>53.739</td>
<td>56</td>
<td>.292</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>146.884</td>
<td>60</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

a. Predictors: (Constant), Deposits held by DTMs

b. Dependent Variable: Financial Performance of DTMs

*Source: Researcher 2012*

ANOVA findings (P-value of 0.00) in table 4.3 show that there is correlation between the predictor’s variable (Deposits held by DTMs) and response variable (Financial Performance of DTMs). An F ratio is calculated which represents the variance between the groups, divided by the variance within the groups. A large F ratio indicates that there is more variability between the groups (caused by the independent variable) than there is within each group, referred to as the error term (Pallat, 2005).
Table 4.4: Coefficients of Regression Equation

<table>
<thead>
<tr>
<th>Model</th>
<th>Unstandardized Coefficients</th>
<th>Standardized Coefficients</th>
<th>t</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Model</td>
<td>B</td>
<td>Std. Error</td>
<td>Beta</td>
<td>t</td>
</tr>
<tr>
<td>1</td>
<td>(Constant)</td>
<td>.240</td>
<td>.258</td>
<td>.930</td>
</tr>
<tr>
<td></td>
<td>Deposits held by DTMs</td>
<td>.294</td>
<td>.077</td>
<td>.297</td>
</tr>
</tbody>
</table>

a. Dependent Variable: Financial Performance of DTMs

Source: Researcher 2012

The established multiple linear regression equation becomes:

\[ Y = 0.240 + 0.294X_1 + 0.58 \]

Where

Constant = 0.240, shows that if deposits held by DTMs is rated as zero, financial performance of DTMs would be 0.240.

\[ X_1 = 0.294 \]

shows that one unit change in Deposits held by DTMs results in 0.294 units increase in financial performance of DTMs. The positive value of the regression coefficient denote direct proportionality and imply that the supportive Deposit Taking Microfinance Regulations of 2008 led to improved financial performance of DTMs.
CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction
This chapter presents a summary of the research findings presented in chapter four above. The conclusion drawn from the findings of the study are also presented in this chapter. Besides, the chapter presents recommendations and areas for further study.

5.2 Summary of the Study
The main objective of the study was to establish the effect of financial regulation on financial performance of deposit taking microfinance institutions in Kenya. In order to fulfill the main objective, the study established the trends in various financial paradigms within microfinance institutions in Kenya. The study findings indicate that the regulations influenced the financial performance of DTMs. The regression results indicated that there is a direct relationship between the supportive Deposit Taking Microfinance Regulations of 2008 and financial performance of DTMs, that is, the regulations led to improved financial performance of DTMs.

The study findings indicated that as a result of the uptake of deposits by the DTMs, there was an increase in the value of loans outstanding, total assets of DTMs, as well as the profit and shareholders’ equity of the DTMs.

The study also established that the profit of DTMs did not increase greatly immediately after transformation period as a result of the costs of transformation.
5.3 Conclusions
The study concludes that the supportive Deposit Taking Microfinance Regulations of 2008 lead to the improvement in financial performance of DTMs. The regulations lead to increase in the value of loans outstanding, total assets of DTMs, the profit and shareholders’ equity of DTMs.

The study also concludes that the ability of DTMs to realize greater improvements in financial performance after the implementation of the regulations were hindered by high costs of transformation, high costs of operation, licensing costs, stiff competition from other financial institutions and high costs of transformation.

The study draws a conclusion that all parties concerned benefit from a regulatory framework that is transparent and clearly provides a continuum where DTMs can progressively evolve into formal financial institutions. In this context, the regulatory framework serves to identify the thresholds of financial intermediation activities which would trigger a requirement to satisfy external or mandatory regulatory guidelines. As financial institutions, it would be prudent for all DTMs to observe internal or voluntary guidelines for risk management.

The study comes to a conclusion that regulation on microfinance institutions in Kenya has the ability to effectively mobilize enough resources to accommodate the financing and investing needs of deposit financial securities and instruments. The regulations led to
improved performance of DTM\textsc{s} because the laws applies only to voluntary deposits and do not cover forced savings or mandatory deposit schemes which are specifically tied to loan contracts.

The study draws a further conclusion that regulatory policy framework for microfinance institutions in Kenya clearly provide guidelines for suspending, canceling or revoking microfinance for legitimate operation in those cases where the institutions cannot perform up to acceptable standards. The guidelines clearly define performance and operating standards. This helps DTM\textsc{s} to strategize their operations in a manner that does not lead to poor financial performance.

The study concludes that the DTM\textsc{s} record slight improvement in financial performance on the inception of transformation because there is insufficient institution building before the regulations are implemented. DTM\textsc{s} were not effectively induced on the ways through which the new regulations can enhance financial performance. Building the institutional capacity of DTM\textsc{s} enables microfinance practitioners as a group to influence the design of policies and information reporting standards set by government agencies. Capacity balding enables DTM\textsc{s} to develop efficient management information systems for identifying and managing financial risks and satisfy relevant data and information requirements of stakeholders.

The study concludes that the principal drawback to the supportive Deposit Taking Microfinance Regulations of 2008 is the potential repression of the innovation and
flexibility of DTMs. Moreover, the supportive Deposit Taking Microfinance Regulations of 2008 did not necessarily correct market inefficiencies in discriminating between sustainable and non-viable providers of microfinance services. This kind of market-oriented distinction is best accomplished through the operations of market based institutions such as licensed commercial banks doing business with DTMs or through independent, credible credit-rating agencies.

The improvement in financial performance of DTMs was also attributed to the fact that the essence of transforming to deposit taking was to allow the institutions access cheaper funds, which they could then lend to the public at a lower rate rather than depending on expensive credit from macro-financial institutions which charge high rates on their borrowers.

5.4 Limitations of the Study
The study was limited by shortfalls in financial statements. Past financial performance, good or bad, is not necessarily an accurate predictor of future performance. Financial statements do not disclose the firms’ future prospects or the customers’ recent decision to enter or exit from DTMs. The audited statements do not guarantee accuracy because they are subject to a degree of manipulation. Moreover, the fact that financial performance of DTMs is gradually growing, there was no clear justification that deposits held by DTMs is the cause of growth. Other factors affecting financial performance were not measured.


5.5 Recommendations
This section presents recommendations for policy intervention and recommendations for further study.

5.5.1 Recommendations for Policy Intervention
The study recommends that comprehensive impact analyses should be conducted prior to implementation of new regulations in the financial sector particularly micro finance institutions. The impact analyses will help the Central Bank of Kenya to come up with effective policy reforms that will lead to better performance of financial institutions.

The study also recommends that the implementation of regulatory policies in Kenya should be preceded by consideration of whether or not the regulatory authorities have the institutional capacity and staff resources for DTM supervision. This consideration is important because the power to regulate deposit-taking from the public through licensing provides the platform by which bank regulatory agencies can then supervise the other operations and activities of regulated institutions. It is also important to consider the incremental costs to DTMs of having the required organizational, technical and staff resources to comply with the reporting requirements and supervisory procedures.

The study recommends the Central Bank of Kenya should take a long-term view when structuring regulatory framework to provide DTMs a clear view of the thresholds to attain on the path to institutional development and transformation. Besides, the assessment of MFIs’ financial statements and the results of activities which these
statements report on will help to identify threshold at which different categories of risk are being taken and different degrees of regulation which may be warranted.

5.5.2 Recommendations for Further Studies

The study recommends further research on ways in which financial performance of DTM s can be enhanced through regulatory framework. Exploration of ways in which financial performance of Kenyan DTM s can be enhanced through regulatory framework will supplement the findings of this study by enabling the government to structure a good economic environment for DTM s.
REFERENCES


Microfinance Act 2006

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Appendix I: Questionnaire

Section A: General Information

1. Institution name………………………………………………………………………

2. Physical address of head office………………………………………………………

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 and above years ( )

4. Using the categories below please indicate the number of branches you have in Kenya.
   - Less than 5 ( )
   - Between 5 - 10 ( )
   - Between 11 - 20 ( )
   - Above 20 ( )

5. Please indicate your customer base by ticking any of the categories below.
   - Less than 10,000 ( )
   - Between 10,001 and 50,000 ( )
   - Between 50,001 and 100,000 ( )
   - Above 100,001 ( )

6. When did you submit your application to the CBK for licensing as a deposit taking microfinance institution? ............When did you receive the license? ........................................
Section B: Factors Influencing Financial Performance

1.

<table>
<thead>
<tr>
<th>No. of deposit accounts</th>
<th>0 + 3</th>
<th>0 + 2</th>
<th>0 + 1</th>
<th>0</th>
<th>0 - 1</th>
<th>0 - 2</th>
<th>0 – 3</th>
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</thead>
<tbody>
<tr>
<td>Average value of deposits</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Total no. of loans outstanding</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Total value of loans outstanding</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Profit/loss</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders/members’ equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retained earnings</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Indicate to what extent the following regulatory factors have affected your financial performance since your conversion to a DTM using a scale of 1-4 in which 1=Strongly Agree; 2=Agree; 3=Disagree; 4=Strongly Disagree

i. High costs of transformation (1) (2) (3) (4)

ii. High costs of operation (branch infrastructure) (1) (2) (3) (4)

iii. Stringent reporting requirements (1) (2) (3) (4)

iv. Inability to conduct current accounts for customers (1) (2) (3) (4)

v. Licensing costs and procedures (1) (2) (3) (4)

vi. Stiff competition from other financial institutions (1) (2) (3) (4)
Appendix II: List of MFIs involved in Deposit Taking Business

1. Faulu Kenya DTM Limited
2. Kenya Women Finance Trust
3. Rafiki Deposit Taking Microfinance Ltd
4. Remu DTM Limited
5. SMEP DTM Limited
6. Uwezo DTM Ltd
Appendix III: Financial Performance and Deposits held by DTMs

Indices (2005-2011)

<table>
<thead>
<tr>
<th>DTM</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
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<tbody>
<tr>
<td>Faulu Kenya DTM Limited</td>
<td>0.417</td>
<td>0.508</td>
<td>0.511</td>
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<tr>
<td>Kenya Women Finance Trust</td>
<td>0.518</td>
<td>0.560</td>
<td>0.571</td>
</tr>
<tr>
<td>Rafiki Deposit Taking Microfinance Ltd</td>
<td>0.277</td>
<td>0.278</td>
<td>0.261</td>
</tr>
<tr>
<td>Remu DTM Limited</td>
<td>0.291</td>
<td>0.301</td>
<td>0.243</td>
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<tr>
<td>SMEP DTM Limited</td>
<td>0.255</td>
<td>0.211</td>
<td>0.259</td>
</tr>
<tr>
<td>Uwezo DTM Ltd</td>
<td>0.303</td>
<td>0.308</td>
<td>0.311</td>
</tr>
</tbody>
</table>

Y= Financial Performance of DTMs (ROA)

<table>
<thead>
<tr>
<th>DTM</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Faulu Kenya DTM Limited</td>
<td>0.025</td>
<td>0.827</td>
<td>0.028</td>
</tr>
<tr>
<td>Kenya Women Finance Trust</td>
<td>0.027</td>
<td>0.828</td>
<td>0.029</td>
</tr>
<tr>
<td>Rafiki Deposit Taking Microfinance Ltd</td>
<td>0.015</td>
<td>0.824</td>
<td>0.017</td>
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<tr>
<td>Remu DTM Limited</td>
<td>0.018</td>
<td>0.825</td>
<td>0.023</td>
</tr>
<tr>
<td>SMEP DTM Limited</td>
<td>0.013</td>
<td>0.824</td>
<td>0.19</td>
</tr>
<tr>
<td>Uwezo DTM Ltd</td>
<td>0.021</td>
<td>0.826</td>
<td>0.026</td>
</tr>
</tbody>
</table>

Key:

X= Deposits held by DTMs

Y= Financial Performance of DTMs (ROA)