

**MICROFINANCE IN KENYA: GROWTH AND REGULATORY
FRAMEWORK.**

BY

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G62/71107/2007

**A Thesis submitted in partial fulfillment of the Requirements for the Award
of the Master of Laws Degree of the University of Nairobi**

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DECLARATION

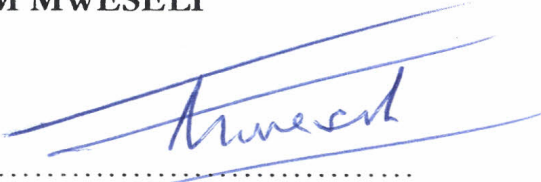
I **RUTTO CHEMTAI STELLA**, do hereby declare that this is my original work, and has not been submitted for the award of a degree in any other University. .

Signed:.....

Dated:..... 28.11.2008

This thesis has been submitted for examination with my approval as University Supervisor.

MR. TIM MWESELI

Signed:.....

Dated:..... 28.11.08

TABLE OF CONTENTS

Dedication	ix
Acknowledgment	x
Statutes	xi
Abbreviations	xii
Abstract	xiv

CHAPTER ONE

INTRODUCTION

1.1	Background	1
1.2	Statement of the Problem	8
1.3	Theoretical Framework	9
1.4	Justification of the Study	13
1.5	Objectives	14
1.6	Research Questions	14

1.7	Hypotheses	15
1.8	Methodology	15
1.9	Literature Review	15
1.10	Limitations	23
1.11	Chapters Breakdown	24

CHAPTER TWO

THE NATURE AND HISTORICAL BACKGROUND OF MICROFINANCE INSTITUTIONS

2.1	What is Microfinance?	25
2.2	Principles in microfinance	26
2.3	Trends in Microfinance	31
2.4	Microfinance Institutions (MFIs)	32
2.5	Characteristics of Microfinance Institutions	34
2.6	History of Microfinance Institutions	34
2.6.1	Early development	34

2.6.2	Development in the 20 th century	36
2.6.3	Microfinance today	37
2.7	Development of MFIs in Kenya	38
2.7.1	Early development	38
2.7.2	Development of the MFI sector in the post independence era	40

CHAPTER THREE

THE SIGNIFICANCE AND WEAKNESSES

OF MICROFINANCE INSTITUTIONS IN A GROWING ECONOMY

3.1	The significance of MFIs in a growing economy	42
3.1.1	Provision of financial services to the poor	42
3.1.2	MFIs as tool for poverty reduction	46
3.1.2.1	The broader picture	48
3.1.2.2	Measuring the impact of MFIs on poverty reduction	51
3.1.3	Impact of microfinance on employment	51
3.1.3.1	How microfinance leads to employment	52
3.1.4	Microfinance as a tool for women empowerment	54
3.1.4.1	Why women?	55

3.2	Disadvantages/Weaknesses of microfinance	58
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CHAPTER FOUR

ANALYSIS OF THE KENYAN REGULATORY FRAMEWORK

4.1	What is regulation?	61
4.2	Rationale and Objectives of Regulation and Supervision of MFIs	62
4.2.1	To protect depositors	62
4.2.2	To ensure the financial system as a whole does not become unstable	63
4.2.3	Other factors that justify regulation	64
4.3	Benefits and Costs of Regulation	65
4.4	Constraints to the Provision of Microfinance Services in Kenya in Absence of a Regulatory Framework.	66
4.5	Background to the passing of the Kenyan legislation on MFIs	69
4.6	The Microfinance Legislation in Kenya	70
4.6.1	The policy underpinning the regime	73
4.7	Analysis of the regulatory framework and its adequacy	75
4.7.1	Licensing requirements	75
4.7.2	Corporate Governance and Performance	78
4.7.3	Accountability, transparency and accounting standards	80
4.7.4	Deposit protection	82
4.7.5	Supervision by the Central Bank of Kenya	83
4.8	What the legislation fails to address	84

CHAPTER FIVE

CASE STUDIES OF MICROFINANCE REGULATION

IN DIFFERENT COUNTRIES.

5.1	Regulation of MFIs in Different Countries	88
5.1.1	Regulation in Bolivia	88
5.1.1.1	Background to the passing of the legislation	88
5.1.1.2	The Regulatory Framework	89
5.1.1.3	Analysis of the regulatory framework	90
5.1.2	Regulation of MFIs in Peru	91
5.1.2.1	Background to the passing of the legislation	91
5.1.2.2	The Regulatory Framework	92
5.1.2.3	Analysis of the Regulatory Framework	94
5.1.3	Regulation in Cambodia	95
5.1.3.1	Background to the passing of the legislation	95
5.1.3.2	The Regulatory Framework	96
5.1.3.3	Analysis of the Regulatory Framework	99

CHAPTER SIX

CONCLUSIONS AND RECOMMENDATIONS

6.1	Conclusions	102
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6.2	Recommendations	103
	Bibliography	106

DEDICATION

To my dear parents,

for a lifetime of intuition and values.

ACKNOWLEDGMENT

I wish to thank all those who have been instrumental in the successful completion of this Thesis. My special thanks go to the God almighty for his guidance; without him, I would not have made it this far. Many people whom I appreciate a lot in many ways have supported me. I recognize the advice, support and guidance of my supervisor, Mr. Tim Mweseli who has tirelessly, guided, constantly, repeatedly and patiently corrected my draft chapters and saw to it that this Thesis is what it is today. Many thanks also go to the staff of Faulu Kenya especially Henry.

I also thank all my friends in and out of the faculty who journeyed with me throughout this programme especially the class of Public Finance and International Trade. We all have different dreams and aspirations and it is my sincere prayer and hope that wherever you go, whatever you maybe, you will all be happy, peaceful and living a satisfying life.

ASANTENI SANA!

TABLE OF STATUTES

1. The Microfinance Act No.19 of 2006.
2. The Microfinance (Categorization of Deposit Taking Microfinance Institutions) Regulations, 2008.

ABBREVIATIONS

MFIs	Microfinance Institutions.
ROSCAs	Rotating Savings and Credit Associations.
FSAs	Financial Services Associations.
SACCOs	Savings and Credit Co-operative Societies.
NGOs	Non Governmental Organisations.
CBK	Central Bank of Kenya.
AMFI	Association of Microfinance Institutions.
IMF	International Monetary Fund.
GDP	Gross Domestic Product.
IFIs	International Financial Institutions.
DFIs	Developed Financial Institutions.
MSEs	Micro and Small Enterprises.
NBIs	Non Banking Institutions.
KWFT	Kenya Women's Finance Trust.
SMEs	Small and Micro Enterprises.
MSEs,	Micro and Small Enterprises.
SMEP	Small and Medium Enterprise Programme.
KSTES	Kenya Small Traders and Entrepreneurs Society.
ECLOF	Ecumenical Loans Fund.
KPSOB	Kenya Post Office Savings Bank.
UNDP	United Nations Development Programme.

ASCAs	Accumulating and Rotating Savings.
UN	United Nations.
DT MFIs	Deposit Taking Microfinance Institutions.
NDT MFIs	Non - Deposit Taking Microfinance Institutions.
DPFB	Deposit Protection Fund Board.
CEO	Chief Executive Officer.
MFRs	Microfinance Regulations.
K-REP	Kenya Rural Enterprise Program.
ILO	International Labour Organisation.
ACP	<i>Acción Comunitaria del Perú.</i>
SBS	<i>Superintendencia de Banca y Seguros.</i>
ROE	Rating of Enterprises.
EDPYMES	Small Business and Micro enterprise Development Institutions.

ABSTRACT

Although microfinance has played a significant role in providing a wide range of financial products and services, many microfinance institutions (MFIs) in Kenya still face major challenges with efficiently and effectively delivering microfinance services in the country. As the demand for these services continues to grow, the sector has been faced by many constraints, the major one being lack of a specific regulatory framework in respect of microfinance institutions. These and other factors have jeopardized MFIs sustainability and have compromised the delivery of microfinance services in the country. With the enactment of the microfinance legislation in June, 2008, much change is expected to the industry especially in respect of transparency and accountability, adoption of acceptable performance standards and promotion of professionalism to enhance service delivery. The aim of this research work is to contribute to the understanding of the significance of the microfinance institutions generally and more particularly in Kenya. It also aims at analysing the Kenyan regulatory framework and assessing its adequacy. The research work is therefore intended to inform the design of a more concrete regulatory policy in respect of microfinance institutions in Kenya.

CHAPTER ONE

INTRODUCTION

1.1 Background

Microfinance is a term for the practice of providing financial services, such as micro credit, micro savings or micro insurance to poor people. By helping them to accumulate useably large of money, this expands their choices and reduces the risks they face. As the name suggests, most transactions involve small amounts of money¹. Micro Finance Institutions (MFIs) are organizations that avail financial services (mostly loans and deposit products) to the bulk of the population that has no access to conventional financial institutions such as commercial banks. Microfinance itself may be defined as the practice of providing financial services to low net worth individuals, households or entrepreneurs (*jua kali*², *mama mboga*³ and the very small businesses operated by the masses in the developing countries). Microfinance now spans the range of finance, from the simplest enterprise to the complexity of capital markets⁴. The genius of microfinance institutions lies in simple ideas, like group lending, that have made it possible to provide financial services to people previously thought to be unbankable⁵. The Kenyan microfinance sector consists of a large number of competing institutions which vary in

¹ Graham Wright. and Leonard Mutesasira. *The relative risks to the savings of poor people*. Mimeo prepared for Microsave, 1999

² This term refers to the artisans who do their work using metal.

³ This term refers to the women who sell groceries in the market or any other place.

⁴ Ingrid Matthaus-Maier J.D Von Pischike, *Microfinance Investment Funds; Leveraging Private Capital for Economic Growth and Poverty Reduction*. Chicago. Springer publishers; August 2007.

⁵ Jonathan Morduch, Ass. Professor of Public Policy & Economics, New York University (with Syed Hashemi and Elizabeth Littlefield) *Is Microfinance an Effective Strategy to Reach the Millennium Development Goals*. Focus Note No. 24. Washington, DC: Consultative Group to Assist the Poor, July 2003.

formality, commercial orientation, professionalism, visibility, size and geographical coverage. These institutions range from informal organizations for example, Rotating Savings and Credit Associations (ROSCAs), Financial Services Associations (FSAs), Savings and Credit Co-operative Societies (SACCOs), Non Governmental Organisations (NGOs), to commercial banks that are downscaling⁶.

The goals of micro financing institutions as development organizations is to serve the financial needs of the unserved market as a means of meeting development objectives.

These objectives include:

- a) Reduction of poverty;
- b) Provision of financial services to the poor.
- c) Empowering women or other disadvantaged population groups;
- d) Creation of employment;
- e) Helping existing businesses grow or diversify their activities and encouraging the development of new businesses.

A study⁷ conducted on the lending for small and micro enterprise projects in Kenya cited three objectives as being important;

1. To create employment and income opportunities through creation and expansion of micro enterprise.

⁶ Dondo, Aleke. *An Overview of the Microfinance Industry in Kenya*. Paper Presented at the Kenya Institute of Bankers' Conference, Nairobi, November 2003. (Unpublished)

⁷ Gallardo Joselito. *Leasing to support small businesses and micro enterprises*. Volume 1. Kuala Lumpur: Asian and Pacific Development Centre. August 1997.

2. To increase productivity and incomes of vulnerable groups especially women and the poor.
3. To reduce rural familiar dependence on drought prone crops through diversification of their income generating activities.

Majority of the rural poor in Kenya do not have access to the basic savings and credit services that most people take for granted and this makes it much harder for them to rise out of poverty. Traditional ways of saving, such as putting money into livestock or land can leave the poor in a weak position when they need funds. Liquid cash is far more convenient. The rural poor need access to micro saving facilities in order to deposit money when they have it for example, after selling their harvested crops, and withdraw it in times of need. Such basic facilities could help to smooth out consumption over the year and make the poor less vulnerable to financial crises. A deposit account can help the rural poor to obtain insurance, giving a sense of security, and it can help them to take out a loan when they need it. Credit facilities are generally not extended to the rural poor, even for highly productive activities, because they have few or no assets to offer as collateral. Unless the poor can borrow, they are likely to remain trapped in poverty. The people who have been able to borrow have often seen their incomes rise and their future transformed.

According to the *Finaccess* study conducted in 2006, about 38 per cent of adult Kenyans are un-served by our financial system indicating a huge market potential for the microfinance industry. The study shows that only 19 per cent of Kenyans are served by formal financial sector, namely commercial banks and the Kenya Post Office Savings Bank, while 8 per cent are served by semi-formal financial service providers such as

microfinance institutions (MFIs) and Savings and Credit Co-operatives societies (SACCOs) and the remaining 35 per cent are served by informal financial service providers ranging from Accumulating and Rotating Savings and Credit Associations (ASCAs and ROSCAs) to shopkeepers and money lenders. This indicates a big gap in access to financial services by Kenyans that it is expected that the deposit-taking microfinance institutions (MFIs) will play a major role in filling it by expanding access. Given this scenario the microfinance deposit taking institutions will be playing a major role in narrowing the service gap⁸. The former United Nations (UN) Secretary-General, Kofi Annan stated that,⁹ *“Sustainable access to microfinance helps alleviate poverty by generating income and wealth, creating jobs, allowing children to go to school, enabling families to obtain health care and empowering people to make the choices that best serve their needs. ...The great challenge before us is to address the constraints that exclude people from full participation in the financial sector.”* This is the challenge to Kenya. A financial system that serves only a minority of a country’s people is biased and unacceptable. All inclusive financial system that provides access for the majority is the central goal of the development of our financial system as envisaged by Vision 2030. The government, as envisaged in Vision 2030, will strengthen alternative financial service providers including MFIs and SACCOs, among others, to play a major role in savings mobilization and wealth creation, thus contributing to poverty reduction and economic growth.

⁸ Jacinta Mwatela: *“Regulation of microfinance in Kenya”* Speech by Mrs Jacinta Mwatela, former Deputy Governor of the Central Bank of Kenya, at the Stakeholders Forum on the Deposit-Taking Microfinance Regulations issued under the microfinance Act, Kenya School of Monetary Studies, Nairobi, 12 May 2008.

⁹ According to a report prepared by former United Nations Secretary-General Kofi Annan for the 2005 General Assembly session. The General Assembly had requested a report on the implementation of the first UN Decade for the Eradication of Poverty (1997-2006) and a draft programme of action for the International Year of Micro credit.

The last two decades have seen “a rapid growth of microfinance institutions across the world”, states the Rural Poverty Report 2001. These include community-run rural banks, savings and credit co-operatives, and grass-roots organizations of indigenous origin. And yet the poorest households often have not been reached by such initiatives. Their need to borrow small amounts of money is not always recognized and they may find it hard to conform with some of the requirements involved for example, attending meetings. The fight against poverty would be given an enormous boost if microfinance facilities were to be extended to the poorest people. The type of microfinance institution required varies from country to country. These institutions are likely to be informal, for example, in parts of Africa and Asia, such informal institutions have been successful in mobilizing savings and organizing credit and insurance.

However, microfinance if made sustainable and if well regulated can have positive far reaching impacts that can impact heavily on the community at large and in the wider sense globally. As microfinance grows over time and primarily deals with money and more importantly poor people’s money, some kind of regulation is necessary.

The microfinance sector in Kenya has faced a number of constraints that need to be addressed to enable them to improve outreach and sustainability. The major impediment to the development of microfinance business in Kenya has been the lack of specific legislation and set of regulations to guide the operations of the microfinance sub-sector. MFIs operating as banking institutions, Savings and Credit Co- Operative Societies and Kenya Post Office Savings Bank are already regulated by Acts of Parliament that specify

different supervisory authorities¹⁰. Microfinance institutions in Kenya are registered under eight different Acts of Parliament for example, the Non Governmental Organizations Co-ordination Act¹¹, The Building Societies Act¹², the Trustee Act¹³, the Societies Act¹⁴ and the Co-operative Societies Act¹⁵.

Some of these forms of registration do not address issues regarding ownership, governance and accountability. They have also contributed to a large extent to the poor performance and eventual demise of many MFIs due to the lack of appropriate regulatory oversight. This has had a bearing on a number of other constraints faced by the industry namely, diversity in institutional form, inadequate governance and management capacity, limited outreach, unhealthy competition, limited access to funds, unfavorable image and lack of performance standard. Another problem was instances of double registration of microfinance institutions for example, the Kenya Women Finance Trust which is currently registered as a company limited by guarantee under the Companies Act¹⁶ and the Non Governmental Organizations Co-ordination Act¹⁷. There were also cases of some microfinance institutions existing with no form of registration at all hence lacked supervision completely. Therefore, to stimulate the development of the sector, appropriate laws, regulations and supervision framework had to be put in place. This

¹⁰ Omino George. *Regulation and Supervision of Microfinance Institutions in Kenya rural finance, including Microfinance*. Essays on Regulation and Supervision. No. 1. A Central Bank of Kenya publication. March 2005.

¹¹ Act No. 19 of 1990.

¹² Cap 489, Laws of Kenya, which is an Act of Parliament to provide for the formation and registration of Building Societies; and for matters incidental thereto and connected therewith.

¹³ Cap 167, Laws of Kenya, which is An Act of Parliament relating to trustees.

¹⁴ Cap 108, Laws of Kenya.

¹⁵ Cap 490, Laws of Kenya.

¹⁶ Cap 486, Laws of Kenya.

¹⁷ Supra note 11.

could best be achieved through enactment of a microfinance legislation that clearly defines the roles to be played by the Government, the Central Bank of Kenya, and the microfinance practitioners, hence the Microfinance laws¹⁸.

Until this year (2008), there was no specific legal structure designed for the MFIs in Kenya. This situation coupled with the emergence of numerous MFIs in Kenya forced the Central Bank of Kenya (CBK) and the Association of Microfinance Institutions (AMFI) to draft the necessary legislation. Calls to regulate the microfinance sector resulted from the government's desire to create an enabling environment for Microfinance Institutions (MFIs) to achieve significant outreach on a sustainable basis in order to increase access to financial services by low income households and reduce the poverty levels in Kenya. It was felt that the only way to achieve the objectives identified of regulating and supervising the microfinance sector would be to introduce microfinance specific regulations. Thus, the process of developing the regulations was started culminating in the passing of the Microfinance Act¹⁹, in 2006 and the microfinance (Categorization of Deposit Taking Microfinance Institutions) Regulations, in 2008. These laws were to start being effective in 2008 although they have not picked up and none of the MFIs is yet to get registered under the same. Much change is expected from the legislation particularly in seeking to meet the financial needs of the poor. Hence the question that begs is whether the same is adequate to effectively regulate the industry. Therefore, an analysis of the regulatory framework in respect of MFIs will be conducted in this research paper so as to ascertain whether the same is adequate in regulating the industry so as to achieve

¹⁸ The laws in this respect refer to the Microfinance Act No. 19 of 2006 and the Microfinance (Categorization of Deposit Taking Micro Finance Institutions) Regulations, 2008.

¹⁹ Act No. 19 of 2006.

the desired outcomes. The research work will also seek to identify any lacuna in the said regulatory framework.

1.2 Statement of the Research Problem

Micro Financing Institutions (MFIs) have been growing tremendously in Kenya in the last 15-20 years. They can therefore be described as being ubiquitous as they are found in every corner of the country. This is attributed to the fact that they promise to reach the poor but productive, so as to generate income through easy savings and loan schemes and few requirements such as collaterals, which are replaced by self co-guaranteeing groups using character based approaches, repayment discipline, and higher repeat and few defaults among the recipients. Despite this, MFIs in Kenya have remained largely unregulated. MFIs were lumped together with all the other non governmental organizations and loosely coordinated by the Non Governmental Organizations Coordination Act (1990)²⁰. Most MFIs fell under the NGO category as they could be well defined as groupings of individuals, not operated for profit or for other commercial purposes but which had organized themselves nationally or internationally for the promotion of social welfare, development and charity. It was only in recently²¹ that the Microfinance Act²² and the Microfinance (Categorization of Deposit Taking Micro Finance Institutions) Regulations, 2008²³ were passed and this has marked the start of regulation of the MFIs where they are now regulated under their own specific legislation. Since there is now a legislation that regulates the MFI sector, this study will aim at

²⁰ (Act No. 19 of 1990).

²¹ The Act was passed in 2006 while the Regulations were passed in 2008.

²² (Act No. 19 of 2006).

²³ Legal Notice No. 57.

analyzing the regulatory framework and assessing whether the same is adequate in effectively regulating the microfinance industry or whether there are gaps and weaknesses which might necessitate reform.

1.3 Theoretical Framework

MFIs normally target the informal sector. Ndirangu et al,²⁴ have discussed the following theories of the informal sector;

- 1) **The Dual Economy theory**²⁵ refers to an economic theory in which capital intensive modern sectors exist in the same model as comparatively poor, traditional labor intensive sectors²⁶. This theory is relevant to the MFIs in that the microfinance industry exists side by side with Macro enterprises like the commercial banks. The theory will however not be adopted to this study because its main focus is the regulatory framework in the microfinance industry and not to compare how the two different institutions coexist within the same economic system. Additionally, it is too economical fro this study.
- 2) **The Rural Urban Migration theory**²⁷ refers to a situation where potential rural migrants respond to the urban employment probability. The theory is based on differences in expected income between the urban and rural sectors. High urban unemployment is inevitable given the large expected income differentials between

²⁴ Ndirangu Lydia, Ronge Eric and Nyangito Hezron. *Review of government policies for the promotion of micro and scale enterprises in Kenya*. Nairobi. Kenya Institute for Public Policy Research and Analysis. January, 2002.

²⁵ This theory is attributed to J.H Boeke from the study of postwar. Indonesia.

²⁶ www.economyprofessor.com/economic-theories.(last accessed on 12th June 2008)

²⁷ This theory is based on the Harris Todaro model.

the rural and urban sectors which exist in many Least Developing Countries²⁸.

This theory is relevant to this study in that most MFIs target the rural areas where financial services are not accessible to many. This may prevent the rural urban migration which may be caused by lack of such facilities. However, this theory is out of the context in light of this study in that the study is seeing to analyse the existing regulatory framework of the MFIs; for this reason, it shall not be adopted.

3) **The Micro Enterprise theory**²⁹ is based on the use of micro enterprise programs as both an effective and efficient approach to reducing poverty. It refers to 'helping the poor to help themselves' through the extension of credit to underwrite small business ventures. The micro enterprise programs use social relationships as an alternative source of collateral by lending not to individuals, but to groups, thereby dispersing risks and lowering costs by devolving to borrowers' social relationships or "social capital" tasks that are ordinarily performed by material or monetary assets. The social capital of the poor thus acts as a substitute for what they lack by way of physical or financial capital³⁰. This theory best fit in the microfinance sector but within an economical perspective, in that it is a way of helping the poor who have no form of collateral to rise out of poverty by using social groupings as security. However, this theory is too economical in approach hence shall not be adopted in the study.

²⁸ www.amazon.co.uk/economic-development (last accessed on 12th july.2008)

²⁹ Some of the adherents to this theory include Pfau, Kay, and Seymour.

³⁰ Woolcock Michael. *Micro Enterprise and Social Capital: A Framework for Theory, Research and Policy*. No. 1. New York: Oxford University Press. 2001.

The above three theories share the belief that informal activities are performed beyond regulation because of the inadequacy of the regulatory system. However, they all have an economic perspective hence the fourth theory which is distributive justice.

4) **Distributive justice**- The principles of distributive justice are normative principles designed to guide the allocation of the benefits and burdens of economic activity. The most widely discussed theory of distributive justice in the past three decades has been that proposed by John Rawls³¹ in *A Theory of Justice*³², and *Political Liberalism*³³. Rawls proposes the following two principles of justice³⁴:

- a) Each person has an equal claim to a fully adequate scheme of equal basic rights and liberties, which scheme is compatible with the same scheme for all; and in this scheme the equal political liberties, and only those liberties, are to be guaranteed their fair value. This principle is also known as strict egalitarianism (strict principle), which also advocates the allocation of equal material goods to all members of society.
- b) Social and economic inequalities are to satisfy two conditions: (a) They are to be attached to positions and offices open to all under conditions of fair equality of opportunity; and (b), they are to be to the greatest benefit of the least advantaged members of society. This is also known as the difference principle which allows allocation that does not conform to strict equality so long as the inequality has the

³¹ 1921-2002.

³² Rawls, John. *A Theory of Justice*. Harvard, MA: Harvard University Press. 1971.

³³ Rawls, John. *Political Liberalism*, New York: Columbia University Press. 1993.

³⁴ Bix Brian. *Jurisprudence: Theory and Context*, (4th Edition). London. Sweet and Maxwell. 2006

effect that the least advantaged in society are materially better off than they would be under strict equality.

The strict principle is a principle of distributive justice which governs the distribution of liberties, while the difference principle is on the distribution of opportunities. Since the focus of this study is distribution of opportunities and not liberties, the difference principle is what forms the theoretical framework for this study. In addition, the principle of distributive justice is too wide (even principles of retributive justice will be included on the basis that they distribute negative goods) hence the need to narrow down to one principle which is relevant to this study, which is the difference principle.

Throughout most of history, people were born into, and largely stayed in a fairly rigid economic position. The distribution of economic benefits and burdens was seen as fixed, either by nature or by God. Only when people realized that the distribution of economic benefits and burdens could be affected by government did distributive justice become a live topic. Governments continuously make and change laws affecting the distribution of economic benefits and burdens in their societies. Almost all changes, from the standard tax and industry laws through to divorce laws have some distributive effect, and, as a result, different societies have different distributions. Every society then is always faced with a choice about whether to stay with the current laws and policies or to modify them. Distributive justice theory contributes practically by providing guidance for these unavoidable and constant choices. For instance, advocates of the difference principle argue that we should change our policies and laws to raise the position of the least advantaged in society.

Micro financing has been defined as the provision of financial services to poor and low income households which lack access to formal financial institutions³⁵. It is also described as banking for the poor. The microfinance industry therefore developed due to the need to serve the least advantaged in the society. Their main focus is the poor who lack collateral to borrow from the commercial banks. These institutions play a significant role in uplifting the economic conditions of the poor in the society and for this reason, there is a need to encourage their growth. This can be done by developing a regulatory framework within which they can operate. Hence many policy makers have called upon the government to develop laws which will enhance the growth of these institutions to make them serve the poor better. The main argument here is that, there are laws and policies which cater for the financial institutions that serve the “haves” in the society, then why not develop laws and policies that serve the interests of the “havenots”, hence the difference principle.

1.4 Justification of the Study

MFIs in Kenya have grown tremendously in Kenya and it has provided a means of many people especially the poor to access credit. However, it was only in 2008 that a legal framework was put in place to regulate the microfinance industry. This research work is therefore intended to analyse the legal framework in respect of MFIs and to find whether it is adequate. This study will therefore be of great value academically and in informing policy in the regulation of MFIs.

³⁵ Aliyu Dahiru Mohammed and Zubair Hasan. *Microfinance in Nigeria and the Prospects of Introducing Its Islamic Version There In The Light Of Selected Muslim Countries*. Malaysia. International Islamic University Malaysia (IIUM). 2008

1.5 Objectives

The general objective of this research is to analyse the current regulatory framework for MFIs and its adequacy. The specific objectives are:

- a) To determine the nature and role played by microfinance institutions in a growing economy such as Kenya.
- b) To identify the constraints that were occasioned by lack of regulation of the microfinance industry hence the reason why regulation was necessary.
- c) To analyse the Kenyan regulatory framework on MFIs and to identify any gaps or weaknesses.
- d) To suggest what reform can be made to the regulatory framework so as to make the same achieve the desired outcomes.

1.6 Research Questions

- a) What is the role and/or function of the microfinance institutions in a growing economy such as Kenya?
- b) What are the constraints occasioned by lack of regulation of the microfinance industry?
- c) Is the present legal framework regulating the activities of microfinance institutions in Kenya adequate?
- d) What reforms could be adopted to the regulatory framework to make it adequate?

1.7 Hypotheses

- a) The microfinance institutions are significant to a growing economy.
- b) There is a need to have a regulatory framework in the microfinance industry which should be able to address all issues that affect the growth and the operations of the industry.

1.8 Methodology

The research was primarily library based. Primary sources included statutes, while secondary sources included textbooks, articles, journals, newspaper articles and internet sources. This study also incorporated case studies.

1.9 Literature Review

The available literature on the regulation of microfinance institutions was written before Kenya had a regulatory framework. Therefore much of it calls for regulation of the industry. Hereinbelow is the literature referred to in this study;

Laws and Regulations Affecting Development and Growth of Microfinance Enterprises in Kenya³⁶ is an article where the authors examined the various laws and policies that affect the growth and development of MFIs in Kenya. In this respect, all the relevant laws and policies were explored and discussed in detail. In his conclusion, the author calls for a Kenyan regulatory framework in respect of microfinance institutions in

³⁶Mutinda Cosmas. *Laws And Regulations Affecting Development and Growth of Microfinance Enterprises in Kenya*. Nairobi. African Economic and Financial consultants. November 2003.

Kenya. There is now a specific legislation regulating the microfinance industry in Kenya and this study therefore seeks to analyse its adequacy.

Another article forming part of the literature review in this study is called the **“Regulation and Supervision of Microfinance Institutions in Kenya³⁷.”** It is noteworthy that this article was written before the enactment of the MFI legislation. In his article, the author explored the rationale and the justification for the regulation of the industry so as to enable it develop and grow and compete favourably in the financial market with other financial institutions. Since there is now a regulatory framework in respect of microfinance institutions in Kenya, this study seeks to build on the author’s work by analysing the adequacy of the regulatory framework.

Non Kenyan authors have written on regulation of MFIs and most have given the benefits and the rationales for the same, for example; **Microfinance Institutions and Public Policy³⁸** is a paper where the authors discussed the need and the role of the governments and nongovernmental organizations to adopt policies so as to promote the growth of microfinance institutions (MFIs). The paper further discussed the appropriate level and form of support for MFIs on the basis of a review of key MFI characteristics. It further explored some principles concerning the extent and coverage of MFI regulation and supervision. This study intends to develop on this research work by examining how adequate the Kenyan regulatory framework in supporting MFIs.

³⁷Omino George. *Regulation and Supervision of Microfinance Institutions in Kenya*. No. 1. Essays on Regulation and Supervision, IRIS Centre, University of Maryland, 2003.

³⁸Hardy Daniel, Holden Paul and Vassili Prokopenko. *Policy International Monetary Fund*. Washington. D.C. IMF Publications. 2002.

Regulation of microfinance institutions; General reflections and the case of Bangladesh³⁹

is another article that initially looks at the growing calls for regulation of the microfinance sector and then places Bangladesh, as a case study, within the context of the subsequent debate. It starts with a consideration of the need for appropriate regulation and supervision of the microfinance activity, particularly as it endeavours to ensure the safety of deposits, especially of the poor, as well as securing the other aspect of the double bottom line, the financial sustainability of the organizations. This is followed by a review of possible options for regulation and supervision, and the potential shortcomings of the conventional approaches. This article then reflects on the possibility of placing microfinance regulation and supervision in Bangladesh under the Palli Karma–Sahayak Foundation (PKSF) or Rural Employment–Generation Foundation, an autonomous apex financial institution. Finally, there is a summary of principal conclusions, policy suggestions, and signposts for future research. This article will therefore provide useful information to this study especially since it's written in the context of a developing country like Kenya.

Regulation & Supervision of Microfinance Institutions: Stabilizing a New Financial Market⁴⁰ is a focus note which reports on the highlights of a meeting held in November

³⁹ Kenneth Jackson and Tazul Islam. *Regulation of microfinance institutions; General reflections and the case of Bangladesh*. International Journal of Rural Management. Vol. 1, No. 1, 45-57, Thousand Oaks, California. SAGE Publications, 2005.

⁴⁰ Otero Maria, Rock Rachel and Rosenberg Richard. *Regulation & Supervision of Microfinance Institutions: Stabilizing a New Financial Market*. FocusNote_04, CGAP: Washington. D.C. Consultative Group to Assist the Poor. August, 1996.

1995, under the auspices of ACCION International.⁴¹ Some of the highlights of this important meeting are; There is a huge unmet demand for financial services in the micro enterprise sector; Despite some success stories, MFIs probably reach fewer than 5 percent of potential clients; Serving this market will require access to funding far beyond what donors and governments can provide; However, MFIs and micro loan portfolios cannot be safely funded from commercial sources, especially public deposits, unless appropriate regulation and supervision regimes are developed. The importance of this literature is that there is an acknowledgment that regulation of the microfinance industry is necessary for any country. The literature will provide material for this study especially on the benefits of regulating the microfinance industry.

Protecting Microfinance Borrowers⁴² is a focus note which touches on consumer protection especially in the way it might apply to financial services for the poor. As commercialization and competition increase, vulnerable borrowers may be more exposed to potentially abusive lenders. Low-income borrowers may be functionally illiterate, first-time consumers, or insufficiently informed about their rights and can be pressured into making poor borrowing decisions. Strategically, enhanced consumer protection measures can be a more constructive alternative to new or lowered interest rate ceilings. This Focus Note discusses two approaches to enforcement of such measures voluntary codes and state regulation in the context of developing countries. This will be relevant to this

⁴¹ This meeting brought together 21 high level officials from bank regulatory institutions in 15 Latin America countries and the United States along with 200 development professionals, to address issues related to supervision and regulation of Microfinance Institutions (MFIs).

⁴² Helms Brigit and Porteous David. *Protecting Microfinance Borrowers*. Focus note no. 27. Washington. D.C. CGAP. May, 2005.

research paper as it discusses regulation of microfinance industry as being one of the measures that enhances consumer protection.

The Experience Microfinance Institutions with regulation and Supervision⁴³ is a survey note which examines the views of some institutions on the experience of being supervised, including perceived costs and benefits. This literature will be useful to this research work in that it will provide information on the costs and benefits of regulating the microfinance industry.

Regulation and supervision of Microfinance Institutions: the Experience in South Africa⁴⁴ is an article which made a case study on the regulation and supervision of MFIs in South Africa. It argued that in most developing countries the institutions inherited from our former colonial masters largely continued to exist past their "sell-by dates" and that they have not changed to reflect the demands or requirements of post-colonial realities. This is certainly true in the financial sector, especially when considering this sector's support for small entrepreneurs. The irony is that in most of the former colonial powers' banking institutions have moved towards accommodating and enabling small entrepreneurs, while in the former colonies the institutions have been trapped in time and reflect their historical legacy. The authors argue that the current paradigm for prudential

⁴³ Rhyne Elisabeth (Senior Vice President, Research, Development and Policy ACCION International) *Regulation and supervision of Microfinance Institutions: the Experience in South Africa*. Washington D.C. ACCION International Policy Paper. 2002. Available at www.papers.ssrn.com (last accessed on 12th July, 2008)

⁴⁴ G. Coetzee. *Rural Development and Finance; Development Southern Africa*. Vol. 9, No. 1:89-104, University of Ouagadougou (Burkina Faso). 2000.

regulation and supervision has been designed for conventional collateral based finance, which presupposes the existence of "wealth". Wealth in these terms is normally seen as a freely transferable asset. In most poor communities assets are by definition scarce, however they are not easily transferable outside of the community. The findings of this article provide useful insights in the Kenyan context given the fact that the regulation adopted by Kenya in respect of the microfinance industry is prudential. Hence, it will help in examining whether such a regulatory framework is relevant or will it erode the primary objective of microfinance institutions which is provision of financial services to the poor who have no collateral.

Other authors have taken the view that regulation is not good for the MFIs in the developing world, for example Chiara Chiumya in her thesis titled; *ZAMBIA: Thesis on Regulation of Microfinance Institutions*⁴⁵; where she uses Regulatory Impact Assessment (RIA) to assess the potential impact of regulating microfinance institutions in Zambia. The author's abstract follows: "*The aim of the research is to contribute to the understanding of regulatory and supervisory issues in relation to microfinance in order to inform the design of regulatory policy in Zambia, and other developing countries in sub-Saharan Africa*". This thesis provides a critical evaluation of the potential impact of regulation on microfinance institutions, using the Zambian case. The analysis is done at two levels, micro and macro. At the micro level, the potential impact of regulation and supervision on the three microfinance institutions licensed by the supervisory authority during the period of the study is evaluated. At the macro level, the analysis is extended to

⁴⁵ Chiara Chiumya. *ZAMBIA: Thesis on Regulation of Microfinance Institutions*. Baltimore, Maryland. Consultative Group to Assist the Poor (CGAP) in conjunction with the IRIS centre at the University of Maryland. March, 2006.

the entire microfinance sector using Regulatory Impact Assessment (RIA). One main finding of the study is that the regulation of the microfinance sector at the current stage of development would have a detrimental effect on the development of the sector. Moreover, the evidence suggests that the objectives for regulating the sector are unlikely to be met. The evidence also suggests that the costs of compliance would be considerable and would outweigh any potential benefits that would be gained. Consequently, the introduction of microfinance specific regulations would most likely result in regulatory failure. This article looks at regulation of the microfinance industry as being harmful as opposed to being beneficial. Since this research is intended to analyse the Kenyan regulatory framework, Chiara's article would be useful as it will help in critically analysing our regulatory framework and whether the same would erode the benefits of informality.

Regulation and supervision of microfinance institutions: state of knowledge⁴⁶ was an extensive study by Stephan Stachen and Eschborn. The aim of the study was to compare the theoretical rationale for regulating financial institutions with current practice based on the findings of financial market theory, particularly the notion of prudential regulation of financial microfinance institutions, they set these off against the specific features of the microfinance sector. Initial practical experience gained in regulating and supervising MFIs was assessed to point out necessary adjustments to the regulatory framework and above all indicate where further studies need to be conducted. The authors also examined

⁴⁶ Stachen Stephan Eschborn. *Regulation and supervision of microfinance institutions: state of knowledge*. Berlin. GTZ - Deutsche Gesellschaft für Technische Zusammenarbeit GmbH press, August 1999.

the motives for regulating the sector set against the theoretical background and identify possible actors in regulation. In this study, the authors examined the South Africa regulatory framework only, and for this reason this research work is intended to analyse the Kenyan regulatory framework.

The following books have looked at MFIs as tools of economic development and have not touched on any aspect of regulation.

First is, **“Microfinance Investment Funds; Leveraging Private Capital for Economic Growth and Poverty Reduction⁴⁷.”** In this book, the authors offered a comprehensive range of perspectives and themes related to microfinance investment and its promotion. They looked at how MFIs expand the range of opportunities for investing and how they avail a diversity of products for micro entrepreneurs and small businesses. There is however no discussion as to how relevant regulation is relevant to the growth of the microfinance industry which is part of what this research seeks to do.

Secondly, is the book entitled **“The Triangle of Microfinance; Financial Sustainability, Outreach & Impact⁴⁸”**. The book examines donor driven rural finance. It looks at how successful microfinance can to some degree be invigorated and that the same can be done through better rural financial systems, which is a challenging task. The

⁴⁷ Ingrid Matthaus-Maier J.D Von Pischike. *Microfinance Investment Funds; Leveraging Private Capital for Economic Growth and Poverty Reduction*. Chicago. Springer publishers; August 2007.

⁴⁸ Manfred Zeller & Meyer Richard. *The Triangle of Microfinance; Financial Sustainability, Outreach & Impact*. Baltimore, Maryland. Johns Hopkins University Press, 2003.

book offers empirical work as to how this challenge can be overcome. It however does not discuss how regulation can be used to make the microfinance industry more vibrant, hence this research work partly intends to do that.

This literature review indicates that there is available literature in respect of microfinance institutions. However, it is noteworthy that most of it relates to the importance of microfinance institutions, the benefits and rationales for regulating the industry. Some of the authors have analysed the adequacy of the regulatory framework in other jurisdictions like South Africa and Zambia. However, there is no analysis on the adequacy of the Kenyan regulatory framework hence the reason why this research work is important. Further, Kenyan authors have written calling for regulation of the microfinance industry and since there is now a regulatory framework in place, this research work will seek to develop on that literature work by analysing the adequacy of the regulatory framework.

1.10 Limitations

This research work was mainly constrained by lack of adequate literature on the Kenyan regulatory framework on MFIs. Lack of implementation of the regulatory framework further made it difficult to conduct a field study. However, this was supplemented by literature from other jurisdictions. The research work was also done in a period of six months due to time constraints hence some information might not have been gathered. That notwithstanding, there is still scope for further research. Funding was another limitation as the research was not funded by any organization.

1.11 Chapters Breakdown

Chapter One is basically an introduction of the whole study starting with the background, the statement of the problem, the theoretical framework, the justification of the study, the objectives of the study, the research questions, the hypotheses, the methodology, the literature review, the limitations and the chapters' breakdown.

Chapter Two looks at the nature and the historical background of microfinance institutions.

Chapter Three basically addresses the significance of microfinance institutions as well as their disadvantages/weaknesses.

Chapter Four addresses the issue of regulation. In particular, it examines and critically analyses the existing legal framework regulating the microfinance institutions in Kenya while identifying any existing gaps and weaknesses.

Chapter Five is a case study of three different countries namely; Bolivia, Peru and Cambodia. This includes looking at the regulatory framework in those countries and analysing the same.

Chapter Six is the final chapter and it draws a conclusion of the whole study. It also makes recommendations for reform.

CHAPTER TWO

THE NATURE AND HISTORICAL BACKGROUND OF MICROFINANCE INSTITUTIONS.

Introduction

This chapter attempts to give a definition to microfinance and to Microfinance Institutions (MFIs). It also traces the growth of microfinance right from its early development in the west in as early as the 18th century and to what it is today and how the notion spread to other parts of the world including Kenya.

2.1 What is Microfinance?

Microfinance can be defined as the provision of comprehensive financial services to micro-entrepreneurs⁴⁹. The vast majority of the population in emerging economies works in the informal sector of urban and rural areas. These micro-entrepreneurs, traders, artisans or farmers are excluded from mainstream economic growth and must rely on themselves to survive. Their income often depends exclusively on the success of a small business in which they invest their frequently impressive skills, creativity and energy. Unfortunately, their ventures rarely extend far beyond the subsistence level, mostly because of lack of capital or exploitation by loan sharks⁵⁰.

⁴⁹ Doyle, K. *Microfinance in the wake of conflict, challenges and opportunities*. Bethesda. USAID, 1998.

⁵⁰ Evans T. G & Adams, A. M. *Demystifying nonparticipation in micro credit; A Population-based analysis*. New York. World Development index. 1999.

Microfinance combines the profit-seeking motive with the priorities of social development. Over the past recent past, specialised financial intermediaries have successfully targeted this market and developed products and methodologies that are perfectly adapted to its needs and characteristics. They have proved that microfinance is a risk-manageable and profitable business: micro-entrepreneurs borrow at market rate and boast a repayment track record that beats that of most commercial banks⁵¹. Experience has also shown that microfinance is not only a business per se, but also a powerful development tool: even very modest loans generate huge business productivity gains and contribute to both job creation and better family living standards (adequate nutrition, better health and housing, more education).

2.2 Principles in microfinance

The key principles of microfinance are as stated hereunder⁵²:

1. **Poor people need a variety of financial services, not just loans;** like everyone else, the poor need a range of financial services that are convenient, flexible and affordable. Depending on circumstances, they want not only loans, but also savings, insurance and cash transfer services. In Kenya, most poor people need a wide range of financial services for example; insurance which is not accessible to many.

⁵¹ Chen Martha and Snodgrass, Donald. *Managing resources, activities and risk in urban India: the impact of microfinance*. Washington D.C. USAID, 2000.

⁵² Consultative Group to Assist the Poor (CGAP) Website at www.microfinancegateway.org/resource_centre/reg. (last accessed on 7th May, 2008)

2. **Microfinance is a powerful tool to fight poverty.** When poor people have access to financial services, they can earn more, build their assets and cushion themselves against external shocks. Poor households use microfinance to move from everyday survival to planning for the future: they invest in better nutrition, housing, health, and education. Microfinance has helped many poor people in Kenya to climb out of poverty through the provision of financial services to boost their income and also through the creation of employment especially in the informal sector.

3. **Microfinance means building financial systems that serve the poor.** In most developing countries, Kenya being an example, poor people are the majority of the population, yet they are the least likely to be served by banks. Microfinance is often seen as a marginal sector ~ a “development” activity that donors, governments, or social investors might care about, but not as part of the country’s mainstream financial system. However, microfinance will reach the maximum number of poor clients only when it is integrated into the financial sector and this can better be achieved through regulation of the microfinance industry.

4. **Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people.** Most poor people cannot get good financial services that meet their needs because there are not enough strong institutions that provide such services. Strong institutions need to charge enough to cover their costs. Cost recovery is not an end in itself. Rather, it is the only way to reach scale and impact beyond the limited levels that donors can fund. A financially sustainable institution can continue and expand its services over the long term. Achieving

sustainability means lowering transaction costs, offering services that are more useful to the clients, and finding new ways to reach more of the un banked poor. In Kenya, this can be done by the government helping the MFIs to become strong institutions that can survive financial crises; this can be by creating a conducive business environment where the transaction costs are low.

5. **Microfinance is about building permanent local financial institutions.** Finance for the poor requires sound domestic financial institutions that provide services on a permanent basis. These institutions need to attract domestic savings, recycle those savings into loans, and provide other services. As local institutions and capital markets mature, there will be less dependence on funding from donors and governments, including government development banks. This can be seen as being already practiced in Kenya through the creation of funds for example; the youth and the women fund where the government provides the funding for the enterprising youth and women hence less reliance on donor funding.

6. **Micro credit is not always the answer. Micro credit is not the best tool for everyone or every situation.** Destitute and hungry people with no income or means of repayment need other kinds of support before they can make good use of loans. In many cases, other tools will alleviate poverty better for instance, small grants, employment and training programs, or infrastructure improvements. Where possible, such services should be coupled with building savings. Most MFIs in Kenya encourage savings as opposed to just borrowing. When the borrowers make use of their loans, say through putting up a business, they are encouraged to plough back the profits in the form of savings

7. **Interest rate ceilings hurt poor people by making it harder for them to get credit.** It costs much more to make many small loans than a few large loans. Unless micro lenders can charge interest rates that are well above average bank loan rates, they cannot cover their costs. Their growth will be limited by the scarce and uncertain supply of soft money from donors or governments. When governments regulate interest rates, they usually set them at levels so low that micro credit cannot cover its costs, so such regulation should be avoided. At the same time, a micro lender should not use high interest rates to make borrowers cover the cost of its own inefficiency. The Central Bank of Kenya as the regulatory body should aim at controlling interest rates set by the MFIs as high interest rates hurt poor people hence eroding the benefits of microfinance.
8. **The role of government is to enable financial services, not to provide them directly.** National governments should set policies that stimulate financial services for poor people at the same time as protecting deposits. Governments need to maintain macroeconomic stability, avoid interest rate caps and refrain from distorting markets with subsidized, high-default loan programs that cannot be sustained. They should also clamp down on corruption and improve the environment for micro-businesses, including access to markets and infrastructure. In special cases where other funds are unavailable, government funding may be warranted for sound and independent microfinance institutions. The Kenyan regulatory framework has attempted to do this by providing for corporate governance principles in the microfinance legislation and by providing for strong

supervision by the Central Bank of Kenya in case of malpractices by the officials of the MFIs.

9. **Donor funds should complement private capital, not compete with it.** Donors provide grants, loans, and equity for microfinance. Such support should be temporary. It should be used to build the capacity of microfinance providers; to develop supporting infrastructure like rating agencies, credit bureaus, and audit capacity; and to support experimentation. In some cases, serving sparse or difficult-to-reach populations can require longer-term donor support. Donors should try to integrate microfinance with the rest of the financial system. They should use experts with a track record of success when designing and implementing projects. They should set clear performance targets that must be met before funding is continued. Every project should have a realistic plan for reaching a point where the donor's support is no longer needed.

10. **The key bottleneck is the shortage of strong institutions and managers.** Microfinance is a specialized field that combines banking with social goals. Skills and systems need to be built at all levels: managers and information systems of microfinance institutions, central banks that regulate microfinance, other government agencies and donors. Public and private investments in microfinance should focus on building this capacity, not just moving money. The microfinance industry in Kenya should strive to do this by building capacity within the institutions so as to make them more efficient in service delivery.

11. Microfinance works best when it measures and discloses its performance.

Accurate, standardized performance information is imperative, both financial information (for example, interest rates, loan repayment and cost recovery) and social information (for example, number of clients reached and their poverty level). Donors, investors, banking supervisors, and customers need this information to judge their cost, risk, and return. The Kenyan microfinance legislation provides for disclosure of financial statements only but makes no mention of disclosure of interest rates or loan repayment track records. The MFIs should on their part take initiative to disclose such information to the public.

2.3 Trends in Microfinance

Microfinance is becoming a new asset class and an integral part of mainstream finance. It is no wonder that microfinance is now quickly gaining momentum: about 10,000 institutions are engaged in it today throughout the world. They are still a varied lot, in terms of size, legal structure and vision⁵³. However, three widespread and promising trends accompany the success of this new industry, reinforcing it structurally⁵⁴.

- 1) Microfinance institutions are now engaging into commercial funding as a way of reinforcing their long-term sustainability. Commercialization has indeed proven to be one of the essential conditions of stability, growth and independence for all leading microfinance institutions.

⁵³ Ames B et al *Macro Economic Issues*. Washington D.C. World Bank publication. 2000.

⁵⁴ Excerpts from the EACES Workshop. *The Role of Microfinance in Promoting Sustainable Development in Southeast Europe*. Faculty of Economics, University of Pula (Croatia), held on the Island of Brioni, Croatia July 5-6, 2007.

- 2) The microfinance industry increasingly requires financial expertise and specialised know-how. A growing number of talented business professionals have successfully achieved economies of scale, product diversification and profitable growth in this increasingly competitive market.
- 3) Microfinance is maturing into a transparent and regulated industry. Regulators, well-known business auditors and rating agencies pay significantly closer attention to leading microfinance institutions, given their growing importance in national capital markets. Their involvement provides a solid legal, financial and political framework to sustain the growth of the industry.

This evolution does not mean that microfinance is shifting away from its focus on poverty alleviation. On the contrary, commercialisation, expertise and regulation are the means to improving the scale and quality of impact on the socio-economic situation of the micro-entrepreneurs and their families. Sustainability is the key to this long-term effort and this in turn is based on the economic longevity of the microfinance institutions themselves.⁵⁵

2.4 Microfinance Institutions (MFIs)

Microfinance Institutions (MFIs) are specialised providers of financial services to micro-enterprises. Contrary to traditional money lenders, the MFIs tend to offer a large number

⁵⁵ Bornstein M. *The Micro credit Movement is Revolutionising International Development Micro credit*. Washington D.C .ACCION International. 1998.

of clients the opportunity to enter into a virtuous cycle of growth and capital accumulation thanks to their scale of operations and cost efficiency⁵⁶.

Although there is still considerable variety in this sector, there is an international trend towards MFIs becoming for-profit, regulated, audited, evaluated and rated, full-scale financial intermediaries. Microfinance institutions are not confined to the sphere of social development, but rather represent the latest expression of the ongoing globalisation of the world financial system, of which they form an integral part. They offer access to capital to a portion of the world population that was formerly excluded.

MFIs have developed competencies that allow them to be efficient financial intermediaries. Years of experience and an intimate knowledge of the socio-cultural environment of their target market have taught them to:⁵⁷

- Develop an original credit distribution methodology based on proximity, through intensive presence of loan officers in the field.
- Adapt credit risk analysis techniques by incorporating their knowledge of the micro-enterprise environment and particular risk factors linked to this sector.
- Create and update products and services to meet the needs of their clients and design adequate collateral or guarantee requirements.
- Integrate and adapt commercial banking technologies: good Management Information System (MIS), credit scoring techniques, debit cards and automated machine (ATM) networks.

⁵⁶ CGAP. *Commercialisation and mission drift; The Transformation of microfinance in Latin America*. Occasional Paper no.5. Washington D.C. CGAP. January 2001.

⁵⁷ Ledger Wood. *Microfinance Handbook; An Institutional and Financial Perspective*. Washington D.C World Bank Library Publication, 1998.

2.5 Characteristics of Microfinance Institutions.

The main characteristics of MFIs are their excellent credit repayment rates and hence their high solvability. Worldwide, mature microfinance institutions will have portfolio at risk rates under 3% (Africa 2%, Asia 2%, Eastern Europe 1%, Latin America 3%), which largely beats the non-performing loans levels of mainstream finance and commercial credit banks⁵⁸. In Kenya for example, the leading MFIs have maintained reasonably low default rates by international standards. The top ten MFIs have an average default rate of 5% which compares very favourably with that of the commercial banks that have an average default rate of 35%.⁵⁹ Today, industry specialists estimate that there are about 10,000 microfinance programmes worldwide. About 300 of these are commercially sustainable and offer excellent prospects for fixed-income or equity investment⁶⁰.

2.6 History of Microfinance Institutions

2.6.1 Early development

In order to fully understand MFIs it is of great importance to trace their trend in development. MFIs came up as governmental agencies as donors pumped billions of dollars into agricultural credits especially small farmers' programmes in developing countries. The initial objective of these programmes was to expand the supply and reduce the cost of loans especially for small farmers. From this point of view, it was expected

⁵⁸ Supra note 9.

⁵⁹ Alila. O and obando. P. *Institutionalizing Rural Development in Kenya: Small Holder Credit Origins and Perspective*. Working Paper No. 473 University of Nairobi, Institute of Development Studies, 1990.

⁶⁰ Supra note 10.

that through rural finance, technological range would accelerate agricultural output and that small farmers' output would rise⁶¹.

Formal credit and savings institutions for the poor have been around for decades, providing customers who were traditionally neglected by commercial banks a way to obtain financial services through co-operatives and Development Finance Institutions. One of the earlier and longer-lived micro credit organizations providing small loans to rural poor with no collateral was the Irish Loan Fund system, initiated in the early 1700s by the author and nationalist Jonathan Swift. Swift's idea began slowly but by the 1840s had become a widespread institution of about 300 funds all over Ireland. Their principal purpose was making small loans with interest for short periods. At their peak they were making loans to 20% of all Irish households annually.⁶²

In the 1800s, various types of larger and more formal savings and credit institutions began to emerge in Europe, organized primarily among the rural and urban poor. These institutions were known as People's Banks, Credit Unions, and Savings and Credit Co-operatives. The concept of the credit union was developed by Friedrich Wilhelm Raiffeisen and his supporters. Their altruistic action was motivated by concern to assist the rural population to break out of their dependence on moneylenders and to improve their welfare. From 1870, the unions expanded rapidly over a large sector of the Rhine Province and other regions of the German States. The co-operative movement quickly spread to other countries in Europe and North America, and eventually, supported by the

⁶¹ Adams, D., Grahan, D. and J.D. Von Pischke. *Undermining Rural Development with Cheap Credit*. Boulder, Colorado. West view Press, 1984.

⁶² Johnson S and Rogely B, *Microfinance and Poverty Reduction*. U.K and Ireland, Oxfam Publication 1997.

cooperative movement in developed countries and donors, also to developing countries. In Indonesia, the Indonesian People's Credit Banks (BPR) opened in 1895. The BPR became the largest microfinance system in Indonesia with close to 9,000 units⁶³.

2.6.2 Development in the 20th century

In the early 1900s, various adaptations of these models began to appear in parts of rural Latin America. While the goal of such rural finance interventions was usually defined in terms of modernizing the agricultural sector, they usually had two specific objectives: increased commercialization of the rural sector, by mobilizing “idle” savings and increasing investment through credit, and reducing oppressive feudal relations that were enforced through indebtedness. In most cases, these new banks for the poor were not owned by the poor themselves, as they had been in Europe, but by government agencies or private banks. Over the years, these institutions became inefficient and at times, elusive⁶⁴. Between the 1950s and 1970s, governments and donors focused on providing agricultural credit to small and marginal farmers, in hopes of raising productivity and incomes. These efforts to expand access to agricultural credit emphasized supply-led government interventions in the form of targeted credit through state-owned development finance institutions, or farmers' co-operatives in some cases, that received concessional loans and on-lent to customers at below-market interest rates. These subsidized schemes were rarely successful. Rural development banks suffered massive erosion of their capital

⁶³ Yunus, M. *Soul from the Ground Up*. Chicago. Noetic Sciences Review, spring publishers, 1997. Available online at www.microcreditsummit.com (last accessed on 4th July, 2008)

⁶⁴ Supra note 9.

base due to subsidized lending rates and poor repayment discipline and the funds did not always reach the poor, often ending up concentrated in the hands of better-off farmers⁶⁵.

Meanwhile, starting in the 1970s, experimental programs in Bangladesh, Brazil and a few other countries extended tiny loans to groups of poor women to invest in micro-businesses. This type of micro enterprise credit was based on solidarity group lending in which every member of a group guaranteed the repayment of all members. These “micro enterprise lending” programs had an almost exclusive focus on credit for income generating activities (in some cases accompanied by forced savings schemes) targeting very poor (often women) borrowers⁶⁶.

2.6.3 Microfinance today

Microfinance as we know it today effectively started out with the provision of small credits to the “entrepreneurial poor”, but today it is a major “industry” providing not only micro credit but savings, insurance and other financial services to poor individuals. The way it is institutionalized differs, going from NGOs, donor founded entities to specialised commercial Microfinance banks. In the last 30 years, the idea to provide small loans to the poor as part of a poverty reduction process has become one of the most promoted concepts of all time. In its most commercial format, where Microfinance institutions are expected to survive by “earning their keep on the market” and thus require no further

⁶⁵ Supra note 11.

⁶⁶ Goetz, A.M. and R. Sen Gupta. *Who takes the Credit? Gender, power and control over loan use in rural credit programmes in Bangladesh*. Vol. 24. New York. World Development, January 1995.

government or international donor subsidies, the concept was gradually incorporated into standard international donor-led poverty reduction programmes⁶⁷.

Starting at first in developed countries and later spreading to the transition countries, Microfinance has now achieved iconic status. The International Financial Institutions (IFIs), particularly the World Bank, have been key supporters of the Microfinance concept, providing not only the initial capitalisation for many Microfinance programmes and large quantities of technical assistance, but also a vigorous lobbying effort to persuade governments to support the concept where they might otherwise have chosen to focus on East Asian-style “local industrial policy” interventions.

2.7 Development of MFIs in Kenya

2.7.1 Early development

In recent years, the microfinance sector has taken Kenya by storm. A host of international and domestic organisations have introduced several microfinance models both in the rural and in the urban areas⁶⁸.

The growth of MFIs on Kenya came mainly after independence. It was not until after independence that the Savings and Credit Co-operative Societies (SACCOs) were registered in Kenya. The main reason is that the colonial administration favoured neither independence nor credit to the Africans. The Africans formed local and clan associations

⁶⁷ Excerpts from the EACES Workshop “*The Role of , Microfinance in Promoting Sustainable development in Southeast Europe*”, Faculty of Economics, University of Pula (Croatia), held on the Island of Brioni, Croatia July 5-6, 2007.

⁶⁸Rock Rachel, Otero Maria and Saltzman Sonia. *The Principles and Practices of Microfinance Governance*. Washington D.C. ACCION International, 1998.

consisting mostly of welfare societies, burial societies and of thrift associations in the late 1940s and 1950s with the encouragement of the African elite. The growth of these organisations was thwarted by the colonial administration that turned down earlier attempts to register them as savings and credit associations under the development of co-operatives development⁶⁹.

Up to the 1960s, the financial system was oriented towards agricultural exports and other primary production activities and some foreign trade catering especially for the expatriate communities. The formal institutions consisted of a few institutions mostly foreign owned banks which had branches in the major cities only, Post Office Savings Bank and Co-operative Societies. The small number of money lenders who were available provided funds to trading companies, mines and plantations which were often foreign owned. The formal financial institutions mainly financed the foreign trade and were accessible only by the expatriates. These led to local businessmen being financially sidelined. Due to the local small businessmen being unable to access the commercial banks, the indigenous informal sector cropped up. This informal financial sector was made up of moneylender's traders and pawn brokers who thus provided the needed resources hence satisfying the borrowing needs of the local farmers and small businessmen. They served their customers while maintaining close contact with them and acquiring intimate knowledge of their operations. Their services were easily accessible and included Rotating Savings and Credit Associations (ROSCAS) among others⁷⁰.

⁶⁹ Alila. O and Obando. P. *Institutionalizing Rural Development in Kenya: Small Holder Credit Origins and Perspective*; Working Paper No. 473 University Of Nairobi, Institute of Development Studies. 1990.

⁷⁰ Dondo Aleke. *Broadening the Outreach of the Microfinance Sector in Kenya*. Central Bank of Kenya publication. 2000.

2.7.2 Development of the MFI sector in the post independence era

The development of the financial sector in the post independence era has seen major changes. These changes include among others the creation and support of Developed Financial Institutions (DFIs) geared to provide long term finance to particular sectors including the Micro and Small Enterprises (MSEs). These DFIs failed mainly because they relied heavily on foreign aids as their major source of financing. The financial sector has evolved over the years with notable development being in early 1980s. This saw the birth of Savings and Credit Co-operative Societies (SACCOs) and Non Banking Institutions (NBIs) expand rapidly to fill the leading gap prevailing but were only for the salaried workers who needed them least. During this period, K-Rep and the Kenya Women's Finance Trust (KWFT) were established. They were heavily subsidized, relied mainly on donor funding and used the integrated (credit and training) approach to assist the Small and Micro Enterprises (SMEs). Further, their loans were not tied to tangible collateral. This made them attractive to those who were in need of credit facilities especially the SMEs⁷¹.

Currently, there were more than 100 institutions involved in microfinance operations in Kenya. By June 1st 2001, Association of Microfinance Institutions (AMFI) had registered 10 MFIs as its members with K-Rep being the first MFI to become a fully fledged bank. However, there is no evidence that anyone has carried out a census and documented the total number of MFIs in the country but it is estimated that over 130,000 organisations practice some form of microfinance business in Kenya. There are many types of MFIs in

⁷¹ Kimenyi M.S et al. *Strategic Issues in Microfinance*. Washington D.C Ashgate Publishing company, 2000.

Kenya that range from formal banks like K-Rep, the co-operative bank, family finance to Christian based savings and credit societies, merry go rounds, Non Governmental Organisations (NGOs) like Faulu Kenya and some that are gender specific institutions like the Kenya Women Finance Trust (KWFT). On top of that, many MFIs are limited private companies and are thus registered as limited liability companies. The Kenya Post Office Savings Bank is also a player in the MFI sector but only to the extent of providing savings and money transfer facility⁷².

Conclusion

MFIs are by their nature meant to offer micro credit services to the poor. Therefore, they have unique characteristics as compared to other financial service providers given the market they target. However, they have evolved to become financially viable institutions and they have grown from simple to complex institutions. This chapter therefore addressed the nature of MFIs and it also gave a detailed discussion of their historical background. This was necessary to set pace for the next chapter which dresses the significant role of MFIs in a growing economy.

⁷² Information obtained from AMFI.

CHAPTER THREE

THE SIGNIFICANCE AND WEAKNESSES OF MICROFINANCE INSTITUTIONS IN A GROWING ECONOMY

Introduction

This chapter addresses the significance of microfinance institutions in a growing economy like Kenya. The significance of MFIs can be highlighted as provision of financial services to the poor, reduction of poverty, creation of employment and women empowerment. The disadvantages and weaknesses of MFIs are also discussed.

3.1 The significance of MFIs in a growing economy

Microfinance has been recognised for the active role it can contribute to economic development and poverty alleviation in the rural areas. It has been recognised as an important development tool, key among these being poverty alleviation, women empowerment and linking the poor to formal financial institutions. These impacts overlap and the effect of one has a spiral effect leading to the other impacts. For example access to financial services by the poor leads to creation of self employment which then leads to poverty alleviation and in cases where women are involved it translates to women empowerment.

3.1.1 Provision of financial services to the poor

The implementation of economic liberalization and reform programs in Kenya in 1993 sparked an explosion of micro-enterprises. It was noted that Kenya had more exposure to

micro-finance than any other country in sub-Saharan Africa, with micro-credit programs dating back to the early 1980s. However, except possibly for the Kenya Post Office Saving Bank, banks in Kenya have not paid much attention to the poor⁷³.

MFIs have gained credence in the recent years replicating the Grameen bank philosophy⁷⁴. The restructuring in the banking industry through liberalization and rationalisation has led to banks closing down rural branches thereby locking out the rural population. Where they remain open, they have substantively increased their minimum balance. MFIs have come in to fill the bid to increase the financial services to the poor. The rich households are well served by the vast formal institutions⁷⁵. The rich have many sources of capital to fund their businesses. They can access abundant consumer credits, mortgages, insurance premiums that reflect the risk of losses safe interest bearing savings accounts and cheap ways of transferring money. In light of the foregoing, it is quite clear that financial services to the poor are wanting or missing altogether.

Finance is so crucial to the economic development and poverty alleviation for any country and hence, providing financial services to the poor to support their economic activities contribute immensely to poverty alleviation. The role of microfinance in investment, employment and economic growth in the Kenyan economy is significant. Over 60% of Kenya's population lives on a per capita of \$ 1 a day. The majority of the

⁷³ Kithinji E. *Development and the nature of microfinance in Kenya* published by Women and Environments International. Chicago. Spring publishers, 2002.

⁷⁴ Grameen Bank was founded in Bangladesh by Professor Muhammad Yunus in 1976 as a project, and was incorporated as a for-profit, specialized bank for the poor in 1983. It serves more than six million poor Bangladeshi families with micro credit, micro savings, micro insurance and other services. It is owned by the borrowers. It has been a model for microfinance institutions worldwide.

⁷⁵ According to a survey of the microfinance conducted by the Economic Journal in November, 2005.

population is poor and has no access to financial services⁷⁶. Microfinance, the provisions of financial services to the low-income households and micro and small enterprises (MSEs), provide an enormous potential to support the economic activities of the poor and thus contribute to poverty alleviation. Widespread experiences and research have shown the importance of savings and credit facilities for the poor and MSEs. This puts emphasis on the sound development of Microfinance institutions as vital ingredients for investment, employment and economic growth.

The potential of using institutional credit and other financial services for poverty alleviation in Kenya is quite significant. About 18 million people, or 60% of the population, are poor and mostly out of the scope of formal banking services. There are close to 1.3 million MSEs employing nearly 2.3 million people or 20% of the country's total employment and contributing 18% of overall GDP and 25% of non-agricultural Gross Domestic Product (GDP)⁷⁷. Despite this important contribution, a paltry of the MSEs receive credit and other financial services.

The formal banking sector in Kenya over the years has regarded the informal sector as risky and not commercially viable. A large number of Kenyans derive their livelihood from the MSEs⁷⁸. Therefore, development of the financial sector represents an important means of creating employment, promoting growth, and reducing poverty in the long-term. However, in spite of the importance of this sector, experience shows that provision

⁷⁶ Lennon Barry and Mark Rostal. *The role of microfinance in economic development in Kenya- Market Survey of Kenya Microfinance Industry*. Washington D.C. Annual Report CGAP Microfinance Publication. 2003.

⁷⁷ According to the National Micro and Small Enterprise Baseline Survey of 1999.

⁷⁸ According to the Poverty Reduction Strategy Paper (PRSP) of 1999.

and delivery of credit and other financial services to the sector by formal financial institutions, such as commercial banks has been below expectation. This means that it is difficult for the poor to climb out of poverty due to lack of finance for their productive activities. Therefore, new, innovative and pro-poor modes of financing low-income households and MSEs based on sound operating principles like MFIs are necessary.

Over 100 organizations, including about 50 NGOs, practice some form of Microfinance business in Kenya. About 20 of the NGOs practice pure micro financing, while the rest practice micro financing alongside social welfare activities. Major players in the sector include Faulu Kenya, Kenya Women Finance Trust (KWFT), Pride Ltd, Wedco Ltd, Small and Medium Enterprise Programme (SMEP), Kenya Small Traders and Entrepreneurs Society (KSTES), Ecumenical Loans Fund (ECLOF) and Vintage Management (Jitegemee Trust). The Kenya Post Office Savings Bank (KPSOB) is also a major player in the sector but only to the extent of providing savings and money transfer facilities⁷⁹. Many Microfinance NGOs have successfully replicated the Grameen Bank method of delivering financial services to the low-income households and MSEs.

It is evident that The MFIs have improved accessibility to financial services by low income Kenyans although the improvement has been rather low. While MFIs have effectively delivered services to cities and densely populated urban areas, they have achieved limited access in rural areas more than few kilometers from the urban centers. It is only in a few cases that they have reached sufficient clients to make a difference on a

⁷⁹ Information obtained from the Association of Microfinance Institutions (AMFI)

national sale⁸⁰. There is therefore a need to expand the MFI sector so as to make it more effective in assisting the poor access financial services.

3.1.2 MFIs as tool for poverty reduction

“Microfinance can make the difference between hope and despair for billions of people living in dehumanizing poverty,” says Fazle Hasan Abed⁸¹. Many public policies in Kenya, in the recent times have been focused towards poverty reduction, finding ways to improve household productivity and thereby incomes. Since the 1960s and 1970s, there have been policies on the role of microfinance in the rural development process. The term “microfinance” pertains to the lending of extremely small amounts of capital to poor entrepreneurs in order to create a mechanism to alleviate poverty by providing the poor and destitute with resources that are available to the wealthy, albeit at a smaller scale⁸². This particular form of lending has existed in the world for quite some time, though formalized by Mohammed Yunus in Bangladesh during the 1970’s. Yunus won the Nobel Peace prize in 2006 for his efforts in combating poverty and providing resources to the poor via the Grameen Bank and the microfinance model.

Historically, microfinance has existed among the poor in various shapes and forms. The most common example cited is that of a rotary club, where people pool their savings into a certain fund every month, and then are randomly picked (without replacement) to

⁸⁰ Dondo Aleke.C *Status of Microfinance in Kenya*. Paper Presented at The Annual Conference on New Development Finance, 27th September to 1st October, 1993 Goethe University of Frankfurt.(unpublished)

⁸¹ Founder of the Bangladesh Rural Advancement Committee (BRAC), Advisor to the International Year of Micro credit and winner of the 2004 Mahbub ul Haq Award for Outstanding Contribution to Human Development. Global Health in June 2004.

⁸² Amin Rai, & Topa, G. *Does micro credit reach the poor and vulnerable? Evidence from Northern Bangladesh*. Washington D.C. Journal of Development Economics, 70(1), 59-82, 2003.

receive the entire fund every year. This method required, of course, that each member of the club belong to a tightly knit social circle in order to be trusted and thus, allowed to participate. This “*pooled savings*” method of financing has been quite popular in various cultures across the globe. Furthermore, there have existed informal lending institutions extending credit to the poor and vulnerable, though on very strict and often extraordinary terms⁸³. Today, microfinance institutions (of which the Grameen Bank is the pioneer, but many other institutions have also joined the market) allow for both the “*pooled savings*” model as well as the small lending using favorable terms. The concept is simple, loan small funds to the poor for a small fixed period of time, and thus the individual is able to access further lending at points of repayment or thereafter⁸⁴. This would tend to empower would-be entrepreneurs to take up a trade and allow them to start earning and thus to provide their families with income stability. Women are actually favored by this form of lending, since it is seen (on average) that the repayment rates of women are actually higher than that of men⁸⁵. Micro credit and other financial services for poor people are important instruments for poverty reduction and for empowerment, especially for women⁸⁶. Expanding outreach can contribute to achieving the goals of the major conferences and summits as well as the Millennium Development Goals, particularly

⁸³ Copestake J., Bhalotra, S., & Johnson, S. *Assessing the impact of micro credit: A Zambian case study*. Washington D.C Journal of Development Studies, 37(4), 81-100, 2003.

⁸⁴ Park, A. *Microfinance with Chinese Characteristics*. New York. World Development, 29(1), 39-62, 2001.

⁸⁵ Kabeer, N. *Conflicts over Credit: Re-Evaluating the Empowerment Potential of Loans to Women in Rural Bangladesh*. New York. World Development, 29(1), 63-84, 2001.

⁸⁶ According to a report prepared by former United Nations Secretary-General Kofi Annan for the 2005 General Assembly session. The General Assembly had requested a report on the implementation of the first UN Decade for the Eradication of Poverty (1997-2006) and a draft programme of action for the International Year of Micro credit.

targets related to halving the proportion of the people living in extreme poverty by 2015, and promoting gender equality and empowerment of women⁸⁷.

Access to microfinance has also been found to promote increased expenditures on education and related improvements in health among poor clients and, in this respect, it can enhance human capital in the long term. As the path out of poverty is rarely linear, other sets of data point to the importance of targeted assistance in helping the very poor before they can make good use of financial services. Though there is some concern that official development assistance will be diverted from health, education and clean water projects, helpful interventions that are focused on increasing the incomes of poor people may also range from building infrastructure and opening up new markets for the produce of the poor to providing business development services. As financial services are not right for every situation, it is often these interventions that will create conditions and opportunities for microfinance and not the other way round⁸⁸.

3.1.2.1 The broader picture

It is also helpful to look at the significance of microfinance in respect of poverty reduction within the broader, long-term development picture. By its very nature microfinance serves the poor and low income people thus, it follows that microfinance institutions are a significant part of the infrastructure necessary for development. Adding to the survival toolkit of the poor who often do not have access to other basic services, microfinance connects this population with little or no assets to productive capital. Thus

⁸⁷ Supra note 15.

⁸⁸ S. Johnson and B. Rogaly. *Microfinance and Poverty Reduction*. Oxford, United Kingdom. Oxfam, 1997.

the relationship to the poor established by these institutions underscores the necessity of sustainable institutions not only because of the value in providing loans, savings, and transfer services, but because they connect poor people to the larger financial system in a country⁸⁹.

The power of this link is enhanced when a microfinance institution becomes a regulated part of the formal financial system. Yet the real dynamism of these reciprocal relationships is yet to be fully realized as only a small fraction of those who could benefit from microfinance currently have access. To ensure wide and deep outreach, financial institutions should aspire to operate on a sustainable basis⁹⁰. Without well-managed sustainable and regulated institutions, it is very difficult to meet the unmet and perpetual demand for financial services. The most important role for governments and the international community in ensuring an enabling environment where microfinance may flourish is the promotion of better governance and accountability through regulation.

Microfinance means constructing financial systems that serve the needs and demands of poor people and this is a multi-dimensional process that involves many actors. While it is not a panacea to poverty, it has transformed not only people's perceptions of the poor during the recent years but also their role in the development process itself. Microfinance has proved its value, in many countries, as a weapon against poverty and hunger. It really can change peoples' lives for the better especially the lives of those who need it

⁸⁹ Maria Otero. *Bringing Development back into microfinance*. Washington DC: ACCION International. 1999. Available at www.microfinancegateway.org/files (last accessed on 14th September, 2008)

⁹⁰ Dunn Elizabeth and Arbuckle Gordon. *Micro Credit and Micro Enterprise Development Performance: Impact Evidence from Peru*. West Hartford: Kumarian Press. December 2001.

most. A small loan, a savings account, an affordable way to send a pay-cheque home, can make all the difference to a poor or low-income family. With access to microfinance, they can earn more, build up assets, and better protect themselves against unexpected setbacks and losses. They can move beyond day-to-day survival towards planning for the future. They can invest in better nutrition, housing, health, and education for their children. In short, they can break the vicious circle of poverty. Therefore, if we are to reach the Millennium Development Goals, that is exactly the kind of progress we need to make. Microfinance is not charity. It is a way to extend the same rights and services to low-income households that are available to everyone else. It is recognition that poor people are the solution, not the problem. It is a way to build on their ideas, energy, and vision. It is a way to grow productive enterprises, so as to allow communities to prosper⁹¹. As a matter of fact, the microfinance industry has evolved rapidly in Kenya during the last 30 years and now more and more commercial banks are leveraging their considerable financial resources and infrastructure and offering financial services to poor people. The market recognition, expansive networks and human resources of these larger banks are starting to help the small, often unregulated institutions to increase the volume of small transactions and the number of clients.

⁹¹ Linking financial services that serve poor people to poverty alleviation and social development, Mark Malloch Brown, Administrator of the United Nations Development Programme (UNDP) called the Year, 2005 a "unique window of opportunity to ensure that microfinance can truly transform development and offer jobs and business and economic growth at the grassroots in a way which makes it take its proper place as one of the main contributors to achieving the Millennium Development Goals, to the benefit of the World's poor."

3.1.2.2 Measuring the impact of MFIs on poverty reduction

The impact of microfinance on poverty reduction has been measured in terms of several dimensions, such as improved income, employment and household expenditure, and reduced vulnerability to economic and social crises. These measurements have tended to focus on a specific geographic area, an institution or a small client group and are difficult to generalize or draw conclusions that reach across borders, income levels, gender or socio-economic status. For MFIs, it becomes hard to obtain measures on the exact impact of their services and products on their clients' lives. There is also no clear answer to the question of what proportion of the population even has access to credit and savings⁹². In general, it appears that clients who participate in microfinance programmes on a continuing basis eventually realize better economic outcomes than non-clients. For instance, in terms of income poverty, there is evidence that access to credit has given many poor people the means to increase, diversify and protect their sources of income. In addition, microfinance institutions in many parts of the world have reported improved food expenditures and employment opportunities among their clients.

3.1.3 Impact of microfinance on employment

In Africa over 48% of the labour force is engaged in informal activities, while in Central and South America the figure stands at 45% and in Asia, the figure is 33%⁹³. They are own account workers or micro-enterprises engaged in a variety of survival activities. It is

⁹² Honohan Patrick. *Measuring microfinance Access: Building on Existing Cross-Country Data*. (Prepared for UNDP, World Bank and IMF Workshop on the Access of Poor and Low Income People to Financial Services). October 26, 2004. Unpublished.

⁹³ Balkenhol Bernard. *The Impact of Microfinance on Employment; What Do We Know?* Social Finance Programme, ILO, OL UK Annual Report, 2004.

this clientele operating in the informal economies that use Micro Finance Institutions. Some of the pertinent questions in this respect are; how has microfinance after several decades of successful and often growing operations changed the living and working conditions of the poor? Have loans and other financial services helped to create jobs? Is microfinance a strategy for job creation? Has it changed the demand for labour in the informal economy? All these questions can be reduced to one which is the underlying big question; has microfinance had an impact on employment? I proceed and attempt to answer this question herein below.

3.1.3.1 How microfinance leads to employment

Employment is key to the attainment of the Millennium Development Goals and without access to productive employment and decent work, poverty will not be halved by 2015. Logically the question comes up: what can microfinance do to help job creation? After all, microfinance is attractive and in many cases superior to alternative anti-poverty strategies, for several reasons: it has rapid, massive and verifiable effects; it can be measured and evaluated; it can often be scaled up quickly; it can be targeted with precision at the poor and sometimes even the very poor; unlike grant or transfer-based programs in poverty reduction, microfinance recycles financial resources, they do not get lost but stay in the local economy⁹⁴. Nevertheless, above all, microfinance treats the poor as autonomous individuals who are expected and want to take charge of their lives. The

⁹⁴ CGAP. *Is microfinance an effective strategy to reach the Millennium Development Goals?* Focus Note 24, Washington D.C. CGAP. January 2004.

concern for job creation resonates increasingly in the microfinance industry itself: major microfinance networks justify their work also with the expected impact on job creation⁹⁵.

The word “employment” may not actually mean full time, stable and remunerated jobs, but it can also include largely unpaid family jobs. Indeed, the notion “employment” is elusive in an environment like the informal economy where most clients are own account workers with unpaid family workers. Mostly, MFIs create employment through income-generation, the most common way being the provision of microfinance services like credit facilities to start or expand an income-generating activity in a micro enterprise. This allows entrepreneurs to build assets and to create and sustain jobs⁹⁶. By helping a poor family to increase their income, micro-enterprise development has an immediate and lasting impact on economy and quality of life, the ability to afford food, shelter, education and healthcare. As business income increases, the business is able to expand, and the effect spreads beyond the family into the local community, through employment and contribution to the local economy. Thus, the benefits of micro-enterprise development help grow not just businesses, but stronger communities as well⁹⁷.

⁹⁵For example, Opportunity International claimed having created or maintained over 1.2 million jobs in 2004 worldwide which is an impressive figure.

⁹⁶ Pischke Von J.D. *Poverty, Human Development and Financial Services*. UNDP Occasional Papers 25, New York, UNDP. 1999

⁹⁷ Wright Graham. *Examining the impact of microfinance services – increasing income or reducing poverty?* SED, vol.10, No.1, p.38; where Mohamad Yunus is quoted as saying: “Wage employment is not a happy road to the reduction of poverty. The removal or reduction of poverty must be a continuous process of creation of assets...”

3.1.4 Microfinance as a tool for women empowerment

Microfinance is now a proven strategy for reaching poor women. In fact in Kenya there is a women based MFI, the Kenya Women Finance Trust (KWFT). The Micro credit Summit Campaign reports that 14.2 million of the world's poorest women have access to financial services which account for nearly 74% of the 19.3 million poorest served by microfinance⁹⁸. Through microfinance, women have become active participants in economic activities. Furthermore, as a result of microfinance, women own assets, including land and housing, play a stronger role in decision-making, and take on positions of leadership in their communities. Some areas have witnessed a shift in values and expectations that affect women's role in society. However in others, women's successful businesses have only added to their burden; women may be bringing in significant money through their work and dedication to their economic activities though this does not always translate into more power in the home; they often work in the market all day and then come home to the same domestic and family responsibilities that are not shared among the male members of the household. Though some studies indicate many loans are extended to women and paid back by women, they are in fact used by men⁹⁹. Thus empowerment cannot be assumed to be an automatic outcome of microfinance programmes, especially given socio-cultural settings where women are extremely "disempowered" to begin with.

⁹⁸ Downing, J. 1990, *Gender and the growth dynamics of micro enterprise*, Development Alternatives Inc., Washington, DC quoted by Mayoux, L. 1998a, "*microfinance programmes and women's empowerment: Approaches, evidence and ways forward*", Discussion Paper, Open University, Milton Keynes.

⁹⁹ Berger, M. "*Key issues in women's access to and use of credit in the micro- and small-scale sector*", quoted in L. Dignard and J. Have, *women in micro- and small-scale enterprise development*, London. IT Publications. 1995.

3.1.4.1 Why women?

There are good reasons to target women. Gender equality turns out to be good for everybody. The World Bank reports that societies that discriminate on the basis of gender have greater poverty, slower economic growth, weaker governance and a lower standard of living. The United Nations Development Programme (UNDP's) 1995 Human Development Report found that 70% of the 1.3 billion people living on less than \$1 a day are women. Studies in Latin America, and elsewhere, show that men typically contribute 50% to 68% of their salaries to the collective household fund, whereas women "tend to keep nothing back for themselves." Because "women contribute decisively to the well-being of their families," investing in women brings about a multiplier effect. Finally, every microfinance institution has stories of women who not only are better off economically as a result of access to financial services, but who are empowered as well. Simply getting cash into the hands of women by way of working capital can lead to increased self-esteem; control and empowerment by helping them achieve greater economic independence and security.

In the 1990s microfinance targeting women became a major focus of gender policy in many donor agencies. Literature prepared for the 1997 Micro Credit Summit, donor policy documents and NGO funding proposals all present an extremely attractive vision of increasing numbers of expanding, financially self-sustainable microfinance programmes reaching large numbers of women borrowers. Through their contribution to women's ability to earn an income, these programmes are assumed to initiate a series of

‘virtuous spirals’ of economic empowerment, increased well-being for women and their families and wider social and political empowerment¹⁰⁰.

Microfinance programmes have significant *potential* for contributing to women’s economic, social and political empowerment. Access to savings and credit can initiate or strengthen a series of interlinked and mutually reinforcing “virtuous spirals” of empowerment. Women can use savings and credit for economic activity, thus increasing incomes and assets and control over these incomes and assets¹⁰¹. This economic contribution may increase their role in economic decision making in the household, leading to greater wellbeing for women and children as well as men. Their increased economic role may lead to change in gender roles and increased status within households and communities. These virtuous spirals are potentially mutually reinforcing in that both improved wellbeing and change in women’s position may further increase their ability to increase incomes and so on. This process of empowerment may be further reinforced by group formation focusing on savings and credit delivery.

However, these changes are not an automatic consequence of savings and credit alone or of group formation. Evidence suggests that, even in financially successful microfinance programmes, *actual* contribution to empowerment is often limited in that¹⁰²,

1. Most women remain confined to a narrow range of female low-income activities.

¹⁰⁰ Mayoux, Linda. *Participatory Programme Learning for Women’s Empowerment: Negotiating Complexity, Conflict and Change*. Open University, Milton Keynes. IDS Bulletin, 29(4), 1998.

¹⁰¹ Mayoux, Linda. *Questioning Virtuous Spirals: Microfinance and Women’s Empowerment in Africa*. Journal of International Development. Geneva. ILO. December, 1999.

¹⁰² Mayoux, Linda. *Tackling the Dark Side: Social Capital, Women’s Empowerment and Microfinance in Cameroon; Development and Change*, 3(3). Geneva. ILO. 2001.

2. Many women have limited control over income and/or what little income they earn may substitute for former male household contributions, as men retain more of their earnings for their own use.
3. Women often have greater workloads combining both production and reproductive tasks.
4. Women's expenditure decisions may continue to prioritise men and male children, while daughters or daughters-in-law bear the brunt of unpaid domestic work.
5. Where women actively press for change, this may increase tensions in the household and the incidence of domestic violence.
6. Women remain marginalised in local and national level political processes. This is not just a question of lack of impact, but may also be a process of disempowerment:
7. Credit is also debt since savings and loan interest or insurance payments divert resources which might otherwise go towards necessary consumption or investment.
8. Putting the responsibility for savings and credit on women may absolve men of responsibility for the household.
9. Where group meetings focus only on savings and credit, this uses up women's precious work and leisure time, cutting programme costs but not necessarily benefiting women.

10. Repayment pressures may increase tensions between women and/or lead to the exclusion of the most disadvantaged women who may then be further disadvantaged in markets and communities.

From the above, it can be seen that the impacts of microfinance in women empowerment are very complex and furthermore, at both household and community level different women may be affected in different ways. The question of women empowerment through microfinance cannot therefore be discussed in one single paragraph since it is a complex issue that may require a new study altogether.

3.2 Disadvantages/Weaknesses of microfinance

Despite the significance of MFIs in a growing economy, there are some disadvantages related to them namely;

- 1) An inherent disadvantage of MFIs is the limited size of the loans available to individuals, which causes most of the borrowers to live in an unbreakable cycle of borrowing and repayment. In reality, micro loans generate just enough income for the client to buy a small inventory of goods to resell, pay some personal expenses and repay the loan. Then, the business owner is forced to return to the lender for another loan to replenish the inventory and the cycle begins again. The bottom line is that it is practically impossible for micro enterprise owners to

generate enough income to save money, to expand their businesses and to become debt free¹⁰³.

- 2) In addition, because the choice of businesses to operate is limited by the small size of the loans, a profusion of hawkers and bicycle taxis are competing for the same customer. Unfortunately, as micro loan programs and micro enterprises grow, these consumer dollars will be spread among more and more small businesses, meaning decreasing profits for individuals.
- 3) Another disadvantage is that, while micro finance loans infuse the local economy with capital, in essence, this capital is merely being recycled among members of the community. A vendor sells tomatoes to his neighbor, and then turns around and uses the income to buy tea from his neighbor. The result is that no new capital is generated from the micro loans because the borrowers are operating in a closed economy¹⁰⁴. This can however be countered by a group of 10-15 individual borrowers pooling their resources to create a large enough enterprise that will allow them to not only create personal wealth, but to retain profits in the business that can be used for operating capital and future business expansion. In addition, larger enterprises will create additional employment opportunities in the community. But most importantly, a larger enterprise will have the means to access external markets and bring new capital into the local community.
- 4) There is also no diversification when it comes to microfinance due to the narrow range of products and services they offer. This problem is further compounded by

¹⁰³ <http://www.socialedge.org/features/> (last accessed on 19th November, 2008)

¹⁰⁴ World Bank. *World Development Report*. World Bank: Washington DC. 1989.

the fact that they serve a narrow spectrum of clients. This makes them potentially more risky.

- 5) Another disadvantage of microfinance is that a household's or enterprise's resources may not match those required to harness an investment opportunity within a reasonable time frame. Thus, a household or an enterprise may not be able to take advantage of a high-productivity investment opportunity. The scale of an economic activity or an enterprise will have to be limited by the amount of finance¹⁰⁵.

Conclusion

Microfinance plays a very significant role in a growing economy like Kenya and this is what this chapter has dealt with. However, despite the significant role of the MFIs, there are also some disadvantages associated with the MFIs although these are minimal compared to their significant role. This was meant to set pace for the next chapter which will focus on analysing the adequacy of the Kenyan regulatory framework in respect of MFIs and why the same is necessary given the significant role microfinance plays in any economy.

¹⁰⁵ McKinnon. *Money and Capital in Economic Development*. The Brookings Institution: Washington DC. 1973.

CHAPTER FOUR

ANALYSIS OF THE KENYAN REGULATORY FRAMEWORK

Introduction

This chapter discusses what is meant by regulation and includes analysing the benefits and costs of regulation. It also discusses at length the rationale and objectives of regulation and supervision of microfinance institutions which are protection of depositors' funds and ensuring a stable financial system. In addition to that, it also analyses the Kenyan regulatory framework in respect of Microfinance Institutions (MFIs) in Kenya and its adequacy.

4.1 What is regulation?

The term regulation is very complex and for this reason, this research work shall adopt the definition of Chavez and Gonzalez-Vega who state that¹⁰⁶, "*Regulation refers to a set of enforceable rules that restrict or direct the actions of market participants, altering, as a result, the outcomes of those actions. Regulation should not be confined to government regulation since it also denotes the self-regulation of groups of institutions via networks or associations, provided that this actually induces the actors to alter their behavior*".

¹⁰⁶ Chavez Rodrigo and Claudio Gonzalez-Vega. *Should Principles of Regulation and Prudential Supervision be Different for Micro enterprise Finance Organisations?* Gemini Working Paper No. 38 Bethesda Maryland: Development Alternatives, Inc; April 1993

4.2 Rationale and Objectives of Regulation and Supervision of MFIs

It is generally accepted that financial institutions should be subject to regulation and supervision for two main reasons, to protect depositors and to ensure a stable financial system¹⁰⁷:

4.2.1 To protect depositors.

This is particularly in respect of small depositors, from loss of their savings if the financial institution becomes insolvent. In the deposit business, there is an asymmetric distribution of information available to the depositors on the one hand and the financial institutions on the other. In the principal agent theory, the financial institution is defined as the agent of the depositor (principal). The objective of regulation must be to match the actions of the agent with the interests of the principals, its clients. This can be done by controlling their actions and restricting their decision-making powers, which they could otherwise exercise at the expense of the principals. With financial institutions, both approaches play a role. Perhaps the most obvious solution, **direct control of the agent** by the principal, is not sufficient. Checking how their money is used would incur unreasonable costs for depositors. This control is a public good, which would be in short supply in a pure market setup. As a consequence, clients would have no effective control over their financial institutions. This affords the owners and the management of financial institutions scope for opportunistic behavior, that is, for pursuing personal gain at the expense of the creditors. It may be worthwhile for the owners, for example, to finance

¹⁰⁷ The World Bank Strauss Commission. The Interim Report of the Commission of Inquiry into the Provision of Rural Financial Services and the Final Report of the Commission of Inquiry into the Provision of Rural Financial Services. Pretoria: Government Printer, 1996.

high risk projects in lending business, since there are no limits on profit-sharing, while losses are confined to their shares and the remainder must be borne by the lenders. Control of the agents must therefore be supported by a third party, preferably an independent supervisory agency. The second option, **curbing the decision-making powers of management**, involves placing a serious constraint on managers although this form of control is limited.

4.2.2 To ensure the financial system as a whole does not become unstable

The second argument for regulating financial institutions picks up on the first. The financial system risks becoming unstable through loss of confidence as a result of major financial institutions becoming insolvent. Due to the difficulty of objectively judging the performance of a financial institution, there is the danger of a “run” that is, a panic leading to the withdrawal of all deposits, forcing the financial institution into inevitable bankruptcy. A run can be a perfectly rational behavior on the part of depositors. The best strategy for the individual depositor when there is a general loss of confidence in a financial institution is to follow the “herd instinct” and withdraw his deposit also. A run on a bank can for example be triggered simply by its having a similar name to a bank that has gone bankrupt. The greatest threat is posed by the contagious effect of a single bank collapsing which then triggers a chain reaction. This is also known as a systemic risk¹⁰⁸. This problem can however be mitigated by regulatory measures. Regulatory measures may therefore be appropriate for reasons of investor security. Hence, the broader notion

¹⁰⁸ Rhyne Elisabeth (Senior Vice President, Research, Development and Policy ACCION International). *The Experience of microfinance institutions with Regulations and Supervision*. Rio de Janeiro. ACCION International. 2002.

of consumer protection, which includes the protection of the depositors as well as the borrowers. Consumer protection regulation is often informed by a risk-based analysis, not unlike that applied to risk-based bank supervision¹⁰⁹. Accordingly, the scope and reach of consumer protection regulation will vary as policymakers seek to balance the nature of the perceived harm or risk to the consumer against the regulatory compliance cost to the provider of the financial services and products in question. So it should come as no surprise that consumer protection regulation as applied to financial services, of which microfinance is a part, takes many forms from jurisdiction to jurisdiction. It varies as to, the range of institutions and activities to which consumer protection regulation applies, the formality (or not) of such regulation and the authority charged with enforcement and the content and scope of consumer protection regulation.

4.2.3 Other factors that justify regulation

There are also a number of responsibilities and sensitivities associated with deposit taking that would justify external regulation and supervision. These include¹¹⁰ convenience to depositors in terms of location and premises and provision of qualitative and physical security of deposits including insurance of deposits. Other reasons relate to maintaining adequate liquidity, this is because depositors should be able to withdraw whatever amount of money they intend to, without subjecting the MFIs to solvency risks.

¹⁰⁹ Supra note

¹¹⁰ Rock, Rachel and Otero Maria (eds). *From Margin to Mainstream: The Regulation and Supervision of Microfinance*. Monograph Series No. 11. Washington DC: ACCION International. 1997.

In Kenya, like in many other countries, approaches to the regulation of MFIs are complicated by the fact that many institutions are involved in providing microfinance services under different legal structures. This presents a challenge in identifying an appropriate regulatory approach, which is conducive to the development of the sector while providing adequate flexibility to microfinance activities.

4.3 Benefits and Costs of Regulation

The institutions involved in a study conducted by one author at the Ohio State University, Columbus, Ohio were overwhelmingly pleased to be regulated¹¹¹. All reported that the benefits of being regulated outweighed the costs. None would even begin to contemplate reverting to their NGO status. This message is highly significant as it means that even when debate over specifics of regulation becomes heated, the underlying fundamentals are there. The process of becoming regulated has brought microfinance institutions the benefits they sought as stated hereunder¹¹²:

- 1) Greater access to sources of funds for both equity and debt, especially commercial sources.
- 2) Ability to achieve growth and quantitative outreach goals due to improved and more professional operations through meeting higher standards of control and reporting which has in turn enabled them serve more people.

¹¹¹Chaves Rodrigo. *The Behavior and Performance of Credit Co-operatives: An Analysis of Co-operative Governance Rules*. PhD Dissertation. Department of Agricultural Economics and Rural Sociology, Ohio State University, Columbus, Ohio, 1994.

¹¹²Supra note 108.

3) Greater ability to offer products beyond micro credit, especially savings and transfers.

4) Enhanced legitimacy in the financial sector and with clients.

These very profound benefits must be weighed against very practical costs. Every regulation incurs costs. For one thing, complying with regulatory standards for example, reporting and disclosure requirements incur costs for the financial institution itself. However, it is important to note that many of the initial costs involve internal improvements required to meet supervisory requirements, most of which are necessary for running a strong microfinance institution. The only general negative factor that comes with regulation could be a loss in ability to experiment with unconventional ideas, particularly those involving products or markets that have not yet proved their viability.

4.4 Constraints to the Provision of Microfinance Services in Kenya in Absence of a Regulatory Framework.

The microfinance sector in Kenya has faced a number of constraints that need to be addressed to enable them to improve outreach and sustainability. The major impediment to the development of microfinance business in Kenya has been the lack of specific legislation and set of regulations to guide the operations of the microfinance sub-sector. MFIs operating as banking institutions, Savings and Credit Co- Operative Societies and Kenya Post Office Savings Bank are already regulated by Acts of Parliament that specify

different supervisory authorities¹¹³. Microfinance institutions in Kenya are registered under eight different Acts of Parliament namely:

- The Non Governmental Organizations Co-ordination Act¹¹⁴
- The Building Societies Act¹¹⁵
- The Trustees Act¹¹⁶
- The Societies Act¹¹⁷
- The Co-operative Societies Act¹¹⁸
- The Companies Act¹¹⁹
- The Banking Act¹²⁰
- The Kenya Post Office Savings Bank (KPOSB) Act¹²¹

Some of these forms or registrations do not address issues regarding ownership, governance, and accountability. They have also contributed to a large extent to the poor performance and eventual demise of many MFIs due to the lack of appropriate regulatory oversight. For example, if a microfinance institution is registered under the Trustees Act, there will be no form of regulation or supervision once it is in operation. Other MFIs

¹¹³ Omino George. *Regulation and Supervision of Microfinance Institutions in Kenya rural finance, including Microfinance*. No. 1. Essays on Regulation and Supervision. Nairobi. Central Bank of Kenya Publication. March 2005.

¹¹⁴ Act No. 19 of 1990.

¹¹⁵ Cap 489, Laws of Kenya, which is an Act of Parliament to provide for the formation and registration of Building Societies; and for matters incidental thereto and connected therewith.

¹¹⁶ Cap 167, Laws of Kenya, which is An Act of Parliament relating to trustees.

¹¹⁷ Cap 108, Laws of Kenya.

¹¹⁸ Cap 490, Laws of Kenya.

¹¹⁹ Cap 486 which is an Act of Parliament to amend and consolidate the law relating to the incorporation, regulation and winding up of companies and other associations, and to make provision for other matters relating thereto and connected therewith.

¹²⁰ Cap 488 (as amended through to 2004) Laws of Kenya. This Act is meant to regulate the business of banking and matters incidental thereto and matters connected therewith.

¹²¹ Cap 493B Laws of Kenya which is an Act of Parliament to establish the Kenya Post Office Savings Bank and to encourage and facilitate personal saving.

have double registration and this creates confusion in that, it is not clear which supervisory body is in charge of regulating that institution. The problem is compounded if for example, the MFI fails to comply with the laws and regulations applicable under that statute, and it gets deregistered; the problem will not have been solved since that institution would still have a legal status under the other statute.

Lack of a specific regulatory framework in respect of MFIs has had a bearing on a number of other constraints faced by the industry namely; Diversity in institutional form given the various number of statutes which MFIs could be registered under. This led to most MFIs existing in different forms of organisations. There was also the problem inadequate governance and management capacity due to lack of specific legislation which could specify governance requirements. There were also problems related to limited outreach, unhealthy competition, limited access to funds, unfavorable image and lack of performance standards.

Therefore, to stimulate the development of the sector and to deal with the problems occasioned by a lack of a regulatory framework, appropriate laws, regulations and supervision framework had to be put in place. This could best be achieved through the enactment of a microfinance legislation that clearly defines the roles to be played by the Government, the Central Bank of Kenya, and the microfinance practitioners, hence the Microfinance laws¹²². The lack of oversight, however, has enabled them to innovate and develop different techniques of providing micro finance services.

¹²² The laws in this respect refer to the Microfinance Act No. 19 of 2006 and the Microfinance (Categorization of Deposit Taking Micro Finance Institutions) Regulations, 2008.

4.5 Background to the passing of the Kenyan legislation on MFIs

The Micro Finance legislation in Kenya has been developed by the Central Bank of Kenya (CBK), the Association of Microfinance Institutions in Kenya (AMFI), the Ministry of Finance and the Attorney General. The laws were discussed with the stakeholders in various forums and their inputs were incorporated in the law. The CBK is the implementing agent of the Government in respect of the MFI laws. In this regard, the Bank in the year 2000, set up a microfinance division in the Bank Supervision Department (now Financial Institutions Department) to participate in the drafting of the MFI laws and to develop prudential Guidelines/ Regulations to be used on the implementations of the provisions set out in the laws¹²³. In 2004, the Central Bank established a Rural Finance Department to address various policy issues concerning rural finance, including microfinance. This Department, in liaison with the Financial Institutions Department, was involved in developing capacity to regulate and supervise those MFIs that are licensed under the Deposit Taking Micro Finance Regulations 2008.

In the past, microfinance institutions (MFIs) in Kenya established using either an NGO or a Savings and Credit Co-operative Societies (SACCOs) framework have been important sources of credit for a large number of low income households and Micro Small and Medium Sized Enterprises (MSMEs) in the rural and urban areas of Kenya. The MFIs have, however, operated without an appropriate policy and legal framework. There was therefore need to focus more on these institutions to enhance their effectiveness in the provision of savings, credit and other financial services to the poor and MSMEs. The Government of Kenya recognized that greater access to, and sustainable flow of financial

¹²³ Supra note 3.

services, particularly credit, to the low-income households and MSMEs is critical to poverty alleviation. Therefore, an appropriate policy, legal and regulatory framework to promote a viable and sustainable system of microfinance in the country was developed by the passing of the Microfinance Act¹²⁴ and the Microfinance (Categorization of Deposit Taking Micro Finance Institutions) Regulations, 2008¹²⁵. In drafting the new law, the Government consulted with stakeholders to get their views on the best way to create the required enabling environment for the microfinance sector. In addition, full-fledged microfinance units have been established in the Ministry of Finance (the Treasury) and the Central Bank of Kenya (CBK) to formulate policies and procedures to address the challenges facing microfinance institutions, especially in the rural areas, and to build a database to facilitate better regulation and monitoring of their operations. Many microfinance NGOs have successfully replicated the Grameen Bank method of delivering financial services to the low-income households and MSMEs. For this reason, the law aims at ensuring that the licensed MFIs contribute to poverty alleviation and at the same time comply with the requirements of financial sector safety and soundness. The MFIs which are regulated under the law provide savings, credit and other financial services to MSMEs and to low-income households in both rural and urban areas.

4.6 The Microfinance regulatory Legislation in Kenya

The launch of the Microfinance Deposit Taking Regulations 2008 in May 2008, chartered a new path for an industry that is striving to adopt reforms aimed at supporting the Micro Small and Medium Sized Enterprises (MSMEs) to become competitive in the local and

¹²⁴ No.19 of 2006.

¹²⁵ These regulations were enacted in 2008 by the Minister of Finance in exercise of the powers conferred by sections 7 and 8 of the Microfinance Act.

global markets. The enactment of the new rules effectively makes it possible for MFIs to develop attractive products that would fulfill the much needed growth and value addition needs of MSMEs. The regulations specify how regulated Deposit Taking (DT) MFIs can mobilize savings, provide credit services and undertake domestic money transfers. Like banking institutions, DT MFIs will also be subject to making disclosures on their accounts and providing for bad debts. They will however, refrain from operating current accounts, trading in foreign currency, underwriting or placement of shares and engaging in wholesale or retail trade. The regulation and supervision of institutions is anchored on a legal and regulatory framework that requires, first and foremost, the assessment of the adequacy of the institutions' capital to meet their business requirements to match their risk profiles and to protect the interests of their depositors. Although prudential regulations, which subscribe minimum corporate governance standards, capital adequacy levels, liquidity requirements and adequate provisioning for loan losses, create a stringent regime, it is essentially necessary for deposit-taking microfinance institutions. This is to ensure the protection of their financial soundness in order to protect depositors' funds and uphold confidence in the financial system. Although prudential regulation is considered necessary when there are depositors to protect, it is not appropriate for credit-only MFIs which fund themselves from donors' funds or commercial loans¹²⁶. Such MFIs require relatively non-intrusive, non-prudential regulation, involving, for example, screening out unsuitable owners/managers or requiring transparent reporting and disclosures¹²⁷. To this end, the microfinance Act, Section 3 makes appropriate provisions for the deposit taking and credit only microfinance institutions respectively to allow for the expansion of

¹²⁶ *Supra* note 113.

¹²⁷ Morris Aron. *Credit Kenya, CBK delays launch of microfinance rules*. Business Weekly, Tuesday May 13, 2008.

microfinance in Kenya. The laws specify the terms for regulated deposit taking micro - finance institutions to offer a variety of financial services and products, including savings mobilisation, credit facilities and domestic money transfers. According to the regulations, Micro-Finance Institutions (MFIs) will be required to maintain a liquidity ratio of 20 per cent of all their liabilities. The regulations also require MFIs with offices throughout the country to have a capital base of Sh60 million while those confined to a community will have Sh20 million. The institutions will be expected to seek the approval of the Finance minister for any acquisition of more than 25 per cent of their shares. Sale of more than 10 per cent of the shares will, however, be possible with the CBK approval. A key aspect of the new regulations is the provision for external auditing of the MFIs. The auditors will be required to communicate any evidence of irregularities or illegal acts by any officer of the institution.

In addition, MFIs will also be required to make disclosures like those currently obtaining for banks. Loans will be classified as normal, under watch, sub-standard and doubtful depending on the anticipated level of default. The provisions for bad debts attached to the four categories are one per cent, five per cent, 25 per cent, 75 per cent and 100 per cent. The laws also forbid MFIs from offering certain financial services such as operating current accounts, foreign exchange trading, investing in enterprise capital, wholesale or retail trade, underwriting or placement of shares¹²⁸. The law is expected to provide an improved environment for small investors and increase access to banking services and other financial services and increase access to banking services and other financial

¹²⁸ Supra note 20.

services especially to the low income tier, a group traditionally considered highly risky to do business with and which has been shunned by the conservative banks for long¹²⁹.

4.6.1 The policy underpinning the regime

The policy underpinning the regime is based on a three tiered approach to regulation and supervision of the microfinance industry, with the DT MFIs and Non-Deposit Taking (NDT) MFIs falling under the Act. Informal microfinance institutions will remain unregulated. The DT MFIs are categorized into two: the community MFIs and the nationwide MFIs with a minimum capital requirement of Ksh.20 million and Ksh.60 million, respectively. The nationwide MFIs will operate countrywide, while the community MFIs will operate with one Government Administrative District or Division if operating in a City. The tiered approach recognizes the inappropriateness of the existing banking legislation for the regulation of specialized activities of microfinance and the diversity of the institutions engaged in the less-regulated sector. The Deposit Taking Micro Finance Regulations, *inter alia*, specifies the following three different tiers of MFIs and who should regulate and supervise them as discussed below.

➤ First tier

Under this group, we have the formally constituted Deposit-taking MFIs. MFIs intending to take deposits from members of the public will be regulated and supervised by the Central Bank of Kenya via the Deposit Taking Micro Finance Regulations. The Deposit Taking Micro Finance Regulations will empower the Central Bank of Kenya to license,

¹²⁹ MSME Competitive Project (*An Information Sharing Tool For MSME Competitiveness Project Implementing Partners*), Issue No.7 June 2008.

regulate and supervise formally constituted MFIs intending to take deposits from members of the public. Specific performance parameters and appropriate guidelines will be developed to facilitate supervision of this group of MFIs. This group of MFIs will also be members of the Deposit Protection Fund Board (DPFB) in order to have a deposit insurance scheme, that is, protection of depositor's deposit up to Kshs. 100,000.

➤ **Second tier**

In this category, we have the formally constituted Credit-Only MFIs that do not take deposits from the public but accept cash collateral tied to loan contracts will be regulated and supervised by the envisaged Micro Finance Unit in the Ministry of Finance through Regulations issued by the Minister for Finance for the time being. The Deposit Taking Micro Finance Regulations and the legislation establishing the Micro Finance Unit could empower it to enforce compliance with its laid down Regulations.

➤ **Third tier**

Under this group, we have the informally constituted MFIs like the Rotating Savings and Credit Associations (ROSCAs), club pools, and Financial Services Associations (FSAs) which should not be supervised by an external agency of the Government. Donors, commercial banks, and government agencies from which they obtain funds or that support them should carry out due diligence and make informed decisions about them.

4.7 Analysis of the regulatory framework and its adequacy

Some key silent regulatory and supervisory requirements for deposit-taking MFIs include licensing requirements; corporate governance and performance; accountability, transparency and accounting standards; deposit protection; and supervision by the Central Bank. The regulatory framework further specifies limits on lending to ensure that MFIs retain their core business of extending services to the poor, low-income households and MSMEs as their core market segments and minimize dealings with insiders. Hereinbelow is an analysis of the regulatory framework based on the salient regulatory requirements;

4.7.1 Licensing requirements

Part II of the Microfinance Act deals with the licensing provisions and in particular, Section 4(1) provides *“no person shall carry out any deposit taking microfinance business, hereinafter referred to as “deposit taking business”, unless such a person is-*

- a) A company registered under the Companies Act whose main objective is to carry out such business; or*
- b) A wholly-owned subsidiary of a bank or a financial institution whose main objective is to carry out such business; and*
- c) Licensed under this Act.”*

Section 4(2) of the Act creates an offence in case one contravenes the provisions of the sub section (1).

Part II of Regulations which run from Regulation 3 to Regulation 6 provide for the licensing requirements. Regulation 3(1) provides, “*no person shall carry out deposit taking business without a valid license.*” The above provisions in the Act and in the Regulations further set out the procedure and form to be used in the application for a license. The provisions further provide that the feasibility study and three year business plan of the proposed deposit taking business in Kenya, detailing the mission, vision, scope and nature of business operations, profitability analysis and internal controls and monitoring procedures, including the proposed shareholding structure and the proposed organizational structure, the domestic economic situation and its relevance for the operation of the proposed institution and an analysis of the financial sector environment and the market to be served by the proposed business company be provided. A schedule of the preliminary expenses including the institutions costs, all expenses relating to the establishment or transformation of the institution be given. The institution must also provide a projected balance sheet, income and expenditure statements and cash flow for three years. Regulation 7 further provides that, “*no person shall carry on business under a name which is likely to mislead the public or give the impression that the institution is carrying on any other business than deposit taking microfinance business*”

These provisions in the regulations are clearly aimed at achieving one of the functions of regulation and supervision which is protection of investors and which borders on consumer protection. This is also in line with one of the objectives of regulation which is that of improving the integrity and credibility of MFIs that are licensed. Licensing implies that the supervisory authority (in this case, the CBK) is vouching for or is prepared to assume the responsibility for the financial soundness of the regulated

financial institution which the public may be dealing with hence enhancing confidence in the microfinance sector. As MFIs will have to obtain a license, entrants will be vetted. This will make it more difficult for unscrupulous individuals to own and manage MFIs, reducing the probability of criminal and fraudulent activity. Thus, it is likely that the integrity and credibility of MFIs will be improved.

Regulation 8 further provides that the central bank must in every twelve months, publish in at least two newspapers of nationwide circulation, the names of all institutions licensed to carry out the deposit taking business. The objective of this provision is to protect the depositors against unlicensed institutions. In addition to that, the Central Bank of Kenya (CBK) has committed itself to continue to educate the public and publish licensed deposit-taking MFIs in the Kenya Gazette and once in a year print media with national circulation¹³⁰. Anyone taking deposit from the public without a license from the CBK will be committing an offence under the Banking Act and Microfinance Act except those exempted under the respective legislations.

Although this is a good provision, it has a disadvantage in that, there are the costs associated with obtaining the license and the annual license fee on the part of the DT MFIs. In addition to this, there will be costs of having an annual audit; and the fees which need to be paid for every new branch opened. These costs will increase the operating expenses of the MFIs. These costs will be transferred to the depositors hence the financial services will be costly. It may also lock out many MFIs from being in operation given the

¹³⁰ Jacinta Mwatela: "*Regulation of microfinance in Kenya*" Speech by Mrs. Jacinta Mwatela, former Deputy Governor of the Central Bank of Kenya, at the Stakeholders Forum on the Deposit-Taking Microfinance Regulations issued under the microfinance Act, Kenya School of Monetary Studies, Nairobi, 12th May 2008.

costs of obtaining a license. Their outreach will therefore be curtailed and it may further compound the problem of inaccessibility to financial services.

4.7.2 Corporate Governance and Performance

Part III of the Act and Part VI of the regulations cover governance and performance of the MFIs. Section 20(1) of the Act provides that “*every institution shall be managed by a board of directors consisting of not less than five directors.*” Regulation 25(1) in particular provides “*every institution shall be managed by a board which shall have at least two thirds of its members being non executive members*”. The regulations are more elaborate as they provide for the committees to be established¹³¹ under every institution and the membership, role and responsibilities and governance of the committees. The regulations further provide under Regulation 26(1) 6 that the Chief Executive Officer (CEO) of an institution shall not be a member of the audit committee. This is meant to ensure transparency and proper governance of the institutions. Regulation 30(1) also provides for the monitoring and evaluation of the board’s performance. Each board in every institution is supposed to assess its own performance and that of the management in the discharge of their duties and responsibilities. This assessment is to be submitted to the Central Bank. Contravention of this regulation attracts an administrative sanction. Further, every institution shall appoint its chief executive officer after an approval by the Central Bank of Kenya¹³². The regulations also set out the qualifications of any person who can be appointed as a CEO¹³³. These qualifications are really high hence will result

¹³¹ The specified committees in this regard are the Audit, Credit and the Assets and Liabilities Management Committees.

¹³² Regulation 31(2).

¹³³ Regulation 32 (3).

in experts being hired. The expertise will be good for the institutions but MFIs will incur increased staff costs associated with training and retaining the CEO regardless of their size. Regulation 32(1) provides against reckless and fraudulent activities by the institutions or a scheme of arrangement with its creditors. There are also restrictions on trading and investments and single borrower limits whereby an institution is prohibited from extending loans exceeding five per centum (5%) of its core capital to a single end user borrower¹³⁴. There are also limits on insider lending particularly to significant shareholders and directors of the institutions. The regulation provides many limitations on when the lending can be extended.

All These provisions are meant to ensure good governance and strengthen the management in the institutions and in that regard, investor protection. This is mainly because every MFI needs return on its capital in order to lend again. Also, due to competition from other financial intermediaries, the MFI too, needs return on its capital in order to survive in the market. However, setting minimum performance standards, for MFIs may not be the ultimate solution to protect investors in that, being regulated and supervised does not automatically result in improved performance. This depends more on the implementation and enforcement of the regulations. Where enforcement is weak, regulation will have very little impact, if any at all. Hence we need a strong enforcement mechanism to ensure that the regulations achieve the objectives intended. In addition to that, this does not guarantee that institutions will not fail, although it may reduce the probability of failure through the requirement to adhere to minimum performance

¹³⁴ Regulation 35(1)

standards and the maintenance of internal control systems to monitor and manage risk, enforcement is still the safest way to go.

4.7.3 Accountability, transparency and accounting standards

Section 24(1) of the Act provides “*An institution shall keep accounts and records which-*

- a) Show a true and fair state of affairs;*
- b) Explain all transactions and financial positions to enable the Central Bank determine whether the institution has complied with the provisions of this Act.”*

Section 25 further states that “*...the accounts and other financial records of the institution...shall comply with the requirements of...the International Accounting Standards and such other requirements as the Central Bank may prescribe.”*

These provisions are meant to ensure that accountability and transparency in the MFIs in respect of financial matters. Section 27 of the Act has provisions on disclosures to be contained in the financial statements which include the following;

- a) The persons, if any, who hold more than twenty five percent (25%) of the total shares of the institution;
- b) Any advance or credit facility exceeding such limit of its core capital as may be prescribed by the Central Bank; and
- c) Any lending to insiders.

This provision on disclosures ensures that the members of the public get to know about the financial institution especially if they intend to deposit money in the institution, It ensures transparency in the way the institution runs its financial affairs. The Regulations in part III of the schedule also have a host of many disclosures to be made by the

institutions which include gross non performing loans, interest in suspense, total non performing loans net of interest in suspense, net nonperforming loans and impairment loss allowance.

There is also a provision¹³⁵ to the effect that “...every institution shall exhibit throughout the year in a conspicuous position in every office and branch, a copy of its last audited financial statements and shall within four months at the end of each financial year cause a copy of the balance sheet and profit and loss account for that year to be published in a national newspaper...”

There is a regulation¹³⁶ similar to this provision only that the period of submission of the financial statements to the Central Bank is three months which is a shorter period as compared to that contained in the Act.

From these provisions above, it is clear the laws have ensured that there is greater legitimacy, accountability and transparency which will not only enable MFIs to source adequate debt and equity funds, but could eventually enable MFIs to take and use savings as a low cost source for on-lending. They also help in generating confidence among the depositors. However, there are cost implications that come with this provision in that, there are the costs, in terms of time, effort and resources, associated with meeting the reporting requirements of publication and prudential reports. This may result in higher operating costs on the MFIs which costs may subsequently be passed on to the depositors.

¹³⁵ Section 31(31) of the Act.

¹³⁶ Regulation 44(1)

4.7.4 Deposit protection

The MFI laws do not specifically or directly address the issue of protecting depositors' funds although Part V of the Act is titled "protection of deposits". In that respect, section 38(1) provides for the appointment of a liquidator by the Central Bank once an institution becomes insolvent. Section 40(1) provides that *"A customer of an institution shall upon the institution becoming insolvent, lodge a claim with the Deposit Protection Fund Board... for payment to the customer out of the fund of any protected deposit which the customer would, but for the insolvency, have been paid had the customer demanded payment from the insolvent institution."*

This provision helps cushion the depositor against any adverse risks in the event of the MFI becoming insolvent. Section 40(1) of the Act provides that the amount to be maintained by a customer of an institution as a protected deposit shall be prescribed by the Deposit Protection Fund Board (DPFB) by an order in the Kenya Gazette and the amount is similar to that of banks and it is Kshs 100,000. In order to protect clients from losing their savings in situations where they are net savers, there would have to be a need to increase the alternative safety net mechanism already in place, by raising the amount due to a depositor of a collapsed institution. This could also be done by requiring the institutions to obtain private insurance, if available. This is given the fact the protected deposit of Kshs 100,000 provided for under the Act is very low and may not satisfy each client's claim.

4.7.5 Supervision by the Central Bank of Kenya

The Central Bank has been given powers under the Act and the Regulations to supervise and oversee the operations of all the deposit taking institutions and this will include the “pyramid schemes” which have been receiving deposits from the public. In the recent past, the Central Bank of Kenya made press statements in the print media warning the public on the illegal operations of pyramid schemes in Kenya. The building of an all inclusive financial system including the strengthening of surveillance on alternative financial service providers is expected to stem off the mushrooming of pyramid schemes and similar schemes.

Part IV of the Act provides for the supervision by the Central Bank. The Central Bank has the right to cause an inspection of an institution¹³⁷. The inspection is in respect of the inspection of the books of accounts, records, correspondence, statements and any information relating to the business of the institution. Section 36(1) of the Act also provides that “...the Central Bank may require an institution to furnish it with periodic reports of its business operations...” The reports referred to include, the quality of the institution’s earning assets, the composition and quality of its assets and liabilities, the adequacy and performance of its management and the compliance by the institution with the prescribed capital requirements.

Section 37(1) also gives the Central Bank power to intervene in the management where;

- a. The institution contravenes the provisions of the Act or the conditions upon which its license is granted;
- b. The business of the institution is being conducted in a manner detrimental to the interest of the depositors or creditors;

¹³⁷ Section 35(1) of the Act.

- c. The institution has failed to maintain the prescribed minimum core capital;
- d. The institution has insufficient assets to cover its liabilities.

These provisions strengthen the supervisory mechanisms of the Central Bank. The Central Bank, on its part, has committed itself to continue to ensure macroeconomic stability and to provide an enabling regulatory environment for the financial sector growth and development. The supervisory and regulatory capacity of the CBK is strong and is continually being enhanced to cope with market dynamics and new skills and knowledge¹³⁸. However, these annual inspections by the CBK will increase the costs to MFIs, in terms of both time and resources, associated with preparing for the inspection, assisting inspectors during the inspection and the disruption caused to the business as a result. The CBK will also incur costs in supervising the sector, especially taking into consideration the geographical dispersion of MFIs, in addition to those already incurred in establishing the regulatory framework. The regulatory process though good for the industry can also prove to be a bit costly.

4.8 What the legislation fails to address

The legislation does not however cover all possible microfinance services for example, very informal lending outfits for example shylocks, shopkeepers and club investments. Despite having formal institutions which lend money Kenya, there are still very informal outfits which lend money like shylocks and charge exorbitant interests rates. Without regulation by an appropriate body, this could mean that the problems of having unregulated outfits could still be existent. Although the legislation has created “Credit Only” institutions in the tiered regime, the institutions contemplated are very formal

¹³⁸ Supra note 21.

hence does not cover the ordinary informal institutions which only lend money under no form of contract at all.

Too much formality could also be disadvantageous in terms of high costs and bureaucracies. There are also very simple transactions which do not require any regulation at all and if regulated too much there could be problems as the positive aspects of informality could be eroded. In this regard, some financial transactions should not be regulated otherwise commerce will be impeded.

There are also no mechanisms of setting disputes under the legislation. This breeds too many problems in case of disputes especially in respect of deposits. The only channel left to the aggrieved depositors would be the ordinary courts which are characterized by high costs, too much formality and delays. There should have at least been a tribunal akin to the Capital Markets Tribunal to look into such disputes.

Conclusion

The main benefit of passing the microfinance legislation is that the ambiguity and confusion that existed has been clarified, thus sending a clear signal to all participants in the microfinance sector, specifically MFIs, investors and, to some extent, customers on the legal position and the treatment of deposits. All MFIs now have to apply for a license or risk prosecution. The other benefits are that more information is readily available to the public as well as the CBK. MFIs now have to publish their financial statements on a quarterly basis. Additionally, MFIs are required disclosing their charges and interest rates in relation to the services and products being offered. Capital levels in the industry will be higher, thus reducing the probability of failure and fostering financial system stability.

However, access to funding would still be limited as MFIs are not permitted to mobilize public deposits. In relation to obtaining funding from other sources, such as the capital market, this will also be limited. However, there are also disadvantages that come with regulation and especially in respect of cost implication for example, the licensing requirements, cost of meeting reporting requirements, facilitating inspections and governance. Despite these cost implications, it is more beneficial to regulate and supervise the MFIs since deposit taking involves a potential risk of loss depending on how the deposits are employed. As such, MFIs intending to take deposits must be regulated and supervised by an external authority to ensure that deposits are prudently employed and cushioned by adequate capitalization. Having regulations is not all and there is need to have in place a strong regulatory body. For this reason the CBK should be more effective in enforcing the regulations since it will be futile to have beautiful laws with no enforcement.

CHAPTER FIVE

CASE STUDIES OF MICROFINANCE REGULATION IN DIFFERENT COUNTRIES.

Introduction

Several countries have attempted to regulate the microfinance sector, Kenya being one of such countries. For this reason, this chapter attempts to do a case study of various countries in the developing world where the microfinance industry is regulated. This helps in giving an insight in to how regulation came about the respective countries. The three countries involved in the study were Bolivia, Peru and Cambodia. The countries were selected due to the different kinds of regulation adopted and the rationales for the same.

Peru was selected due to the fact that it has adopted prudential regulations to regulate its microfinance industry and this has yielded positive results. The regulatory framework for MFIs is very similar to that of commercial banks and both types of institutions are regulated under the same financial law.

Bolivia was chosen because the regulations are there in place but there is no enforcement. Regulations just exist in theory but not practically since the industry has been liberalized and the government believes that prudential regulation may stifle the industry. The system which works is the apex organisations system which is sort of self regulatory in nature.

Finally for Cambodia, the growth of the industry was very unique. Microfinance started after the country had emerged from an internal conflict which had lasted for over thirty years. This was meant to rebuild the country. As the sector grew tremendously, regulation became necessary and hence the National Bank of Cambodia laid down regulations which are strictly enforced. The mode of regulation is also similar to the one proposed in Kenya which involves categorization of microfinance institutions to three based on capitalisation and their national outreach.

From that background, this study proceeds to analyse the regulatory framework in the respective countries.

5.1 Regulation of MFIs in Different Countries.

5.1.1 Regulation in Bolivia

5.1.1.1 Background to the passing of the legislation

Bolivia's approach to microfinance regulation and supervision was crafted within a financial sector policy of rigorous liberalization, which began earlier than similar reforms in many other countries. This liberalization created the space for microfinance to develop. In addition, Bolivian authorities have been highly supportive of microfinance, viewing it as a way to address the important gap left by liberalization. Authorities have even been willing to tolerate a certain degree of ambiguity in the regulatory framework during the development stage. This unique combination of a non-interventionist financial sector

policy with a strong (though non-interventionist) backing for microfinance resulted in a mature, competitive microfinance industry in Bolivia¹³⁹.

5.1.1.2 The Regulatory Framework.

The regulatory body in Bolivia have created a set of rules that enable the financial system to serve all market niches where the capital level for entry is lower than for commercial banks, but so is the number of permissible activities. The Prudential requirements regarding capital-risk assets ratios and legal reserves are the same for all institutions, bank and non-bank. The loan documentation requirements have also been lowered to fit the risks of micro lending, group guarantees have been ruled as valid for micro loans and micro lenders are required to demonstrate best practice micro lending¹⁴⁰. An important aspect of regulation in the Microfinance sector in Bolivia is the role played by Apex Organisations¹⁴¹. These act as a sort of intermediary whereby the organisation acts as an umbrella over many MFI's. It receives the money from international and domestic donors or from government and transforms the resource in some way and then passes it on to the MFI's.

¹³⁹ Loubière, J. T., Devaney, P. L. & Rhyne, E. *Supervision & Regulation in Microfinance: Lessons from Bolivia, Colombia and Mexico*. Washington D.C. ACCION International. 2002.

¹⁴⁰ Supra note 137.

¹⁴¹ CGAP. *The Challenge of Growth for microfinance institution: The BrancoSol Experience*. Focus Note No. 6. Washington D.C. CGAP. March 1997.

5.1.1.3 Analysis of the regulatory framework

Regulation of MFIs in Bolivia is quite lax. The laws in Bolivia are there in theory but because the regulatory body for Microfinance Institutions (MFI's), the *Contraloria General de la Republica* is often busy with the longer established sector of finance in Bolivia it has little time or inclination to practice close supervision of the MFI sector. This is indeed good in some ways as it means that the MFIs are not halted by government bureaucracy. In addition to that, political intrusion into Microfinance is kept to a minimum. This has led to success of the microfinance industry in Bolivia. This success to some extent has led to a proliferation of mainstream commercial banks lending to customers of Microfinance banks.

The existence of apex organisations in Bolivia has also helped develop the Microfinance sector in Bolivia. This is because an apex organisation can assist in providing support that simply an injection of cash does not, for example MFI's may require financial support in their outreach to support to maintain their sustainability. Technical assistance to an MFI can be invaluable, the shared research and development of several already up and running MFI's that fall under the umbrella of an apex organisation can greatly assist a new start-up. It is also worth noting that the Bolivian authorities are concerned with the ownership and governance structure of non-bank institutions even though the performance of profit banks may be no better¹⁴². However, the laissez-faire approach also contributed to (or failed to prevent) the problematic entry and exit of consumer lending into the

¹⁴² Gomez Arelis; Tabares Germán; Vogel Robert. *Regulation and supervision-Bolivian case-study*. Washington D.C. CGAP. January 2000.

microfinance market, which stressed the Bolivian microfinance industry severely in the late 1990s¹⁴³.

5.1.2 Regulation of MFIs in Peru

5.1.2.1 Background to the passing of the legislation

The microfinance sector in Peru represents about 5% of the total financial sector, but during the last ten years average annual rates of growth of the loan portfolios of MFIs has been 32.3%. While microfinance remains a small percentage of the total financial sector, the picture is altered if the focus is on the number of clients rather than portfolio size, and it is estimated that MFIs have 30-40% of the borrowers in the financial system¹⁴⁴. The majority of the approximately 55 non-bank MFIs operating in Peru are regulated. In terms of portfolio size, the vast majority of the sector is regulated as the non-regulated MFIs tend to have relatively small portfolios. MFIs vary greatly in quality and size. As one commentator remarked, the sector has “both ants and elephants”¹⁴⁵. Most of credit provided by the microfinance sector is directed towards micro-enterprises as opposed to consumer credit. Mortgage lending is an increasing area of focus for many MFIs. Rural microfinance is considered both unprofitable and highly risky, as a result only 3.2% of formal MFI lending is for agricultural and livestock credits¹⁴⁶.

The regulation and supervision of microfinance in Peru began as early as the 1980s, when the first municipal savings banks were opened. Peru’s regulatory body then created two

¹⁴³ Supra note 141.

¹⁴⁴ Cisneros Pinilla Susana. *Banking on the Poor: Peru’s Small and Micro Enterprise Sector*. Washington D.C. World Bank, 1997. Also available at <http://poverty.worldbank.org/library/view/10257> (Last accessed on 14th September, 2008)

¹⁴⁵ <http://www.worldbank.org/wbi/governance/peru/> (last accessed on 24th July, 2008)

¹⁴⁶ <http://www.pwcglobal.com/> (last accessed on 24th July, 2008)

other licenses: rural savings banks and regulated, credit-only NGOs which both offer microfinance as well¹⁴⁷. In 1990, the Government of Peru decided to make a major effort to facilitate the formalization of large micro enterprises and small businesses operating in the informal sector. To do so, they slashed the time required for registration and permitting from 300 days to one day, created a single authority/point of contact for the transactions, and reduced the cost from US\$1,200 to US\$174. More than 670,000 previously informal operations became legal entities between 1991 and 1997 and this number has continued to rise steadily¹⁴⁸.

5.1.2.2 The Regulatory Framework

The *Superintendencia de Banca y Seguros* (SBS) is the public agency that regulates formal MFIs in Peru. The regulatory framework for MFIs is prudential and very similar to that of commercial banks. Both types of institutions are regulated under the same financial law. For example, MFIs are required to report financial information similar to the information commercial banks must report information on loan portfolio quality, interest rate risk and foreign exchange risk. SBS also requires MFIs to do their own internal auditing as well as receive external auditors at least once a year¹⁴⁹. The financial services that each type of MFI can offer are different for example; Small Business and Micro enterprise Development Institutions (EDPYMES) are only permitted to offer credit. These institutions can obtain resources from bank credit, equity markets, and

¹⁴⁷Ebentreich, A. *Microfinance Regulation in Peru: Current State, Lessons Learned and Prospects for the Future Microfinance Regulation and Supervision*. Peru. Resource Center, Peru, April 2005.

¹⁴⁸ Peck Robert and Rosenberg Richard. *The Rush to Regulate: Legal Frameworks for Microfinance*. Occasional Paper No. 4. Washington D.C. CGAP. April, 2000.

¹⁴⁹ Marr, Ana "Microfinance and Poverty Reduction: The problematic experience of Communal Banking in Peru" School of Oriental and African Studies, University of London, PhD Research Thesis.

Corporacion Financiera de Desarrollo (COFIDE) refinance. With prior approval of SBS and with a capital base of \$1.4 million, these institutions can take public deposits. *Cajas Municipales de Ahorro y Credito* (CMACs) are permitted to offer savings services, and pension and current accounts (no checking), personal and business loans, bill payments, and forex operations. These institutions cannot offer savings services or pawn loans before their first year and cannot offer micro enterprise loans before the third year. *Cajas Rurale de Ahorro y Credito* (CRACs) can offer passbook savings services and term deposits (they cannot offer current accounts). Commercial microfinance banks can offer full financial services. The minimum capital to start a commercial microfinance bank is \$5.3 million¹⁵⁰. The regulated sector consists of commercial banks with microfinance operations, thirteen municipal savings banks (*Cajas Municipales de Ahorro y Credito* [CMACs]), twelve rural savings banks (*Cajas Rurale de Ahorro y Credito* [CRACs]) and fourteen regulated NGOs (EDPYMEs [Small Business and Micro enterprise Development Institution]). The SBS estimates that non-bank formal MFIs have about 1.5 million clients and direct loans of \$684 million in 2003. Regulated institutions have to comply with auditing and reporting requirements stipulated by the supervisory body SBS, conduct strict loan loss provisioning, and report to the SBS on a monthly basis. The general policy support for the microfinance sector is high, with a legislative framework that specifically targets MFIs in place. In addition to that, the regulatory framework allows all regulated MFIs to take deposits, does not place any restrictions on interest rates charged, and does not hinder foreign investment¹⁵¹.

¹⁵⁰ Sean Kane Divya Nair Victor Orozco Shampa Sinha. Report on the Peru Microfinance Investment Environment Profile, Peru January 2005.

¹⁵¹ Jansson, Tor “*From Village to Wall Street*”, IADB, Washington DC, 2001

5.1.2.3 Analysis of the Regulatory Framework

The legal framework for the licensing and regulation of MFIs was a critical factor that has encouraged their growth and sustainability. The appropriate legal status has allowed MFIs in Peru to expand their microfinance portfolios by mobilizing savings to finance increasing loan portfolios and borrowing from commercial loan markets¹⁵². From the experience in Peru, it has been evident that having formal legal status greatly enhances the ability of large micro enterprises and small businesses to participate actively in the formal economy. Even where micro enterprises continue to be serviced by non-bank MFIs, it makes it easier for the MFIs to refinance or rediscount with commercial banks their own loans to legally registered micro enterprises¹⁵³.

Further, strict *Superintendencia de Banca y Seguros* (SBS)¹⁵⁴ supervision has had an effect on portfolio quality as delinquency rates for regulated non-bank formal MFIs have fallen from greater than 10% in December 2000 to 5.7% by the end of 2003 while loan loss provisioning currently covers 130% of portfolio at risk. Formal MFIs have in general been profitable, showing ROEs in excess of 15% with the exception of the crisis in 1997/1998 when ROE plunged to 5%¹⁵⁵.

¹⁵² Gilberto.M. Llanto. *Philippine Credit Policy and microfinance Institutions: Some Lessons from the Latin American Experience*. Manila. Philippines Institute for Development Studies, September 1999.

¹⁵³ Supra note 148.

¹⁵⁴ Superintendencia de Banca y Seguros (SBS) – The SBS is responsible for the regulation of Peru's financial system. Regulated microfinance institutions must report operational and financial results to the SBS on a monthly basis.

¹⁵⁵ The SBS rates; available at <http://www.sbs.gob.pe/PortalSBs/Estadistica/index.htm>(last accessed on 24th July,2008)

Since the establishment of prudential regulation for MFIs in Peru more than a decade ago, microfinance activities have expanded. Regulation has brought more benefits than costs to the industry as a whole. Below are some of these benefits¹⁵⁶;

- 1) The impact of regulation could be understood as a positive sum game where all microfinance stakeholders have gained in that the regulation has acted as a facilitator for enhancing the growth and development of MFIs in the country.
- 2) Also, financial regulation might impact in different ways the behavior and performance of microfinance stakeholders. This can be seen as a consequence of following a financial system approach that integrates microfinance with the conventional financial environment.
- 3) Regulation has also helped promote the level of competition in the microfinance market.

5.1.3 Regulation in Cambodia

5.1.3.1 Background to the passing of the legislation

Microfinance started in the early 1990s as Cambodia came out from a long period of internal conflict. Micro credit was first provided by NGOs, to fill the gaps left by the banking sector. The first microfinance experiments were credit-oriented, to provide a kick-start to new business activities. Without a working banking system, the first organisations to provide financial services had to first run micro credit projects by physically handling cash transfers themselves. After 1993 and the international

¹⁵⁶ Supra note 148.

recognition of a new Cambodian government, aid started to flow in the country¹⁵⁷. However, by 1994, microfinance initiatives were only reaching a limited number of people totaling 44,000 which led to their transformation into larger, more focused institutions, capable of increasing significantly their outreach. By 1998, the new industry was serving about 214,000 people. Reaching a significant size also meant increased risks for clients as well as for microfinance promoters, and the microfinance stakeholders felt that a regulatory framework was needed¹⁵⁸. The National Bank of Cambodia (NBC) issued a sub-decree to license large deposit-taking institutions and to register the smaller ones. Since then, microfinance has grown to encompass more than 75 MFIs in the country¹⁵⁹. Since 2004, microfinance has become an industry in Cambodia, with a diversity of players (commercial banks, microfinance institutions and credit unions) and a growth of outreach and increased diversity of services provided. The newest entrants in the industry are private companies with a business background, but no prior NGO experience. At the end of 2004 the microfinance industry in Cambodia was serving approximately 450,000 borrowers and 150,000 depositors¹⁶⁰. This tremendous growth necessitated regulation of the microfinance industry.

5.1.3.2 The Regulatory Framework

For the first time in the year 2000, the NBC issued Regulations on the classification of MFIs, classifying all MFIs into three categories according to the level of their operation

¹⁵⁷ <http://www.bwtp.org/arcm/cambodia/> (last accessed on 24th July, 2008)

¹⁵⁸ ACLEDA website <http://www.acledabank.com.kh/> (last accessed on 24th July, 2008)

¹⁵⁹ AMRET website <http://www.amret.com.kh/> (last accessed on 24th July, 2008)

¹⁶⁰ Supra note 157.

with different criteria for being licensed and registered. The biggest of MFIs must be licensed by the NBC. The regulations to be complied with by them are very similar to those to be complied by the commercial banks, except the minimum capital required is substantially lower. The medium-sized MFIs must only be registered by the NBC and are subjected to lighter regulations and in particular reports to be sent to the NBC are simplified. The smallest MFIs can operate freely with no requirement to be regulated and supervised due to high operating costs. The regulations issued by the NBC include criteria for licensing and registration, minimum capital requirement, solvency ratio liquidity ratio, uniform chart of accounts, reporting requirements, and interest calculation. Licensing is required for MFI to collect savings from their members and from the public, acquire long term borrowing from foreign and local organizations and employ these funds to provide loans in rural areas. According to the regulations in Cambodia, an MFI must be registered and incorporated as a legal entity such as a company, co-operative or have a legal status according to the law. An MFI must obtain a license from the NBC upon application with the required documents¹⁶¹.

In terms of supervision and regulation, the NBC is responsible for maintaining integrity and a sound banking and financial system in order to encourage public confidence, to protect depositors from fraud and encourage good governance. To do this, a complete set of criteria was issued such as licensing and registration procedures, minimum capital requirement, solvency ratio, liquidity ratio, uniform chart of accounts and reporting

¹⁶¹ <http://www.nbc.com.kh/> (last accessed on 24th July, 2008)

requirement. Some rules and supervision guidelines to be followed can be summarized as follows¹⁶²;

- **Licensing requirements**

A microfinance institution is required to be incorporated as a limited liability company or as a co-operative. In addition, MFIs need to have at least KHR 250 million in capital. The license is valid for a period of 3 years and can be renewed. The submission fee is KHR 50,000 with the annual license fee being KHR 1 million.

- **Reporting requirements**

Registered MFIs need to submit quarterly reports. These reports include: statement of assets and liabilities; statement of profit and loss; breakdown of loans/deposits by category; breakdown of loans/deposits by currency; loan classification and delinquency ratio and network of branches and offices. Licensed MFIs need to present monthly reports, and annual reports including audited financial statements, the Board of Directors annual report, statistics of staff and salaries; updated organisation chart. Suspicious transactions should also be reported.

- **Supervision**

Elements of supervision include: Board of Directors and management oversight; availability of policies and procedures; internal controls and management information systems. The approach to supervision includes understanding and assessing risks of MFIs, planning and scheduling supervision activities, defining examination activities, perform onsite examination and reporting of findings.

¹⁶² Presentation by Phan Ho, Director, Bank Supervision Department, National Bank of Cambodia, during the BWTP Regional Microfinance Workshop, Phnom Penh, "Microfinance Regulations and Public Intervention in Microfinance" December 2004.

5.1.3.3

Analysis of the Regulatory Framework

The main objective of regulating MFIs in Cambodia is not to restrict their activities but to promote them. The NBC is normally confronted with conflicting targets. On the one hand, microfinance, as with all other financial activities, must be regulated to avoid incompetence, and some case dishonesty, which can undermine the system. On the other hand, if regulation is too harsh, and in particular if the capital requirement is too high, microfinance might exhibit the same behavior as banks, flee from rural areas and concentrate their activities in major cities. Therefore, the National Bank of Cambodia (NBC) released a set of regulations according the size of MFIs. The “Law on Banking and Financial Institutions” enacted in November 1999 and the government decree (Prakas) for implementation, enacted in early 2000, recognizes three categories of banking institutions¹⁶³:

1. Commercial banks, which require a minimum registered capital of US\$13 million and can carry out all banking activities.
2. Specialized banks, which require a minimum registered capital of Riel 10 billion (US\$2.5 million) and can carry out a limited number of banking activities, as specified in the terms of their license.
3. Micro Finance Institutions (MFIs), which require a minimum registered capital of Riel 250 million (approx US\$62,500).

Therefore, the NBC is basically enforcing two main alternatives for microfinance operators in Cambodia: licensing for the “medium-sized” microfinance providers or

¹⁶³ Supra note 59.

registration for the “small” microfinance providers. Notably, these regulations are similar to those adopted by Kenya especially the tiered regime.

The NBC also conducts off-site and on-site supervision on a regular basis as per the regulations and this has helped ensure that all MFIs are operating in a professional and prudential manner. Further, the prudential regulations have enabled the NBC as the supervisory authority to strengthen prudential regulations in order to protect and build public confidence in using microfinance services in rural areas. The NBC as part of its role under the regulatory framework also encourages the non-licensed Non-Governmental Organizations to build up their capacity to transform into licensed microfinance operating under the laws and regulations. The prudential regulation has also led to the fast-growing microfinance industry hence helping it to develop into an integral part of the financial system in Cambodia which plays a pivotal role in deepening financial markets by expanding access of affordable financial services and products to majority of Cambodians. The regulation and supervision of the sector also enables the NBC to define, and enforce, rules and procedures for MFIs operations, entrance, exit, and ultimately create an environment for fair competition and efficiency in the sector. These regulations have also contributed to the stable and efficient performance of these institutions and in the protection of clients particularly¹⁶⁴.

Conclusion

The experiences from other countries suggest that the frameworks for licensing, regulating and prudential supervision need to be well adapted with flexibility designed to

¹⁶⁴ The opening address of H.E Chea Chanto, the Governor of the National Bank of Cambodia at the Regional Conference on Microfinance Kampong Cham Province, 08 December 2006.

reflect the specific characteristics and the stage of evolution of the microfinance sector. Each of the countries included in the case study reveal that there are various forms of regulatory strategies from prudential regulation to lax regulation. There is therefore no best practice for regulation hence each country should chose the best mode of regulation depending on its circumstances. In addition, the peculiarities of the microfinance sector necessitate either a dedicated law for the sector, or that the peculiarities be addressed adequately under other legislation that can be applied to regulate the sector.

CHAPTER SIX

CONCLUSIONS AND RECOMMENDATIONS

6.1 Conclusions

This study involved looking at regulation of the microfinance industry generally and more particularly, the Kenyan regulatory framework. It emerged that many poor people especially in the rural areas rely on microfinance so as to be able to access financial services. The microfinance institutions play a very significant role in a growing economy like Kenya. There are many organisations in providing some form of microfinance in Kenya. However, these organisations are registered under eight different Acts of parliament. This creates a lot of confusion as to what body is in charge of regulating and supervising the microfinance industry. In extreme cases, some organisations exist with no form of registration at all. This is hazardous in that they fall under no regulatory body. There are also cases of double registration where an organisation is registered under more than one statute. This further compounds the problems of supervision and regulation.

The process of developing the Kenyan regulatory framework was started in the year 2000 culminating in the passing of the Microfinance Act¹⁶⁵, in 2006 and the microfinance (Categorization of Deposit Taking Microfinance Institutions) Regulations, in 2008. 2008 marked the beginning of regulation of the MFIs in Kenya although not even one organisation has been registered under the statute.

An analysis of the regulatory framework gives mixed results. On the one hand, there will be benefits, specifically, the clarification of the legal position of MFIs and the treatment

¹⁶⁵ Act No. 19 of 2006.

of savings as deposits; increased confidence in the sector through improved credibility derived from being a licensed institution and the vetting of entrants; increased transparency through the disclosure of information; and increased capital levels which are likely to foster financial system stability. On the other hand, the costs of implementation are quite high for example the licensing requirements, cost of meeting reporting requirements, facilitating inspections and governance. There are also gaps in the legislation, for example very small associations are not covered for example shylocks and investment clubs. This may necessitate some review of the legislation to make it more adequate and to enable it to indeed fulfill the expectations in respect of the desired outcomes.

Different countries have adopted different modes of regulating the microfinance industry. Some of these practices can be borrowed by Kenya for example, in Bolivia, regulation is through apex system. This is a bit informal hence it can be used to cure the negative effects brought about by too much formality.

6.2 Recommendations

Some of the recommendations that can be adopted to our regulatory framework so as to allow MFIs to become more competitive in a highly commercialized context, while achieving their goals of serving the micro- entrepreneurs and low-income households are;

- 1) The microfinance regulations should require that MFIs have in place clear procedures for dealing with complaints. The regulations should be specific as to how disputes are to be resolved. Therefore, the issue of redress should be included

in the regulatory framework and should be dealt with comprehensively. This is given the fact that the courts could be a slow method of dispute resolution, hence a tribunal similar to the Capital Markets Authority Tribunal could be established to serve the microfinance industry.

- 2) The regulatory framework should also aim at enhancing the supervisory capacity of the CBK. In some cases, the importance of supervision of the microfinance sector is minimized because it generally represents less than one percent of the total assets in the financial system. The CBK should approach the regulatory and supervisory systems with an open mind rather than assume that it can simply adapt a few of the traditional banking sector's regulations.
- 3) There should be established a Credit Reference Bureaus (CRBs) to vet borrowers. CRBs play a crucial role in the healthy development of financial systems because they improve financial entities' knowledge about the borrowing habits of their debtors. The creation of CRBs in Kenya should go a long way in helping reduce the level of bad debt in the industry. The government through the CBK should dedicate resources to developing, facilitating or upgrading CRBs and ensuring that they include microfinance borrowers.
- 4) The government should provide tax incentives to microfinance providers. For this purpose, the tax man should provide a number of tax incentives for MFIs and for banks issuing micro loans. However, income generated from the portfolio should have a preferential tax treatment. This way, the micro loans would be cheaper and thus more accessible to the Kenyan public.

5) Professional associations of the MFIs in Kenya should also be encouraged and supported in their quest to become the main advocates for the microfinance industry as well as develop standards and monitoring mechanisms. MFI associations should be used effectively to promote capacity building among their members and a healthier industry. While MFI associations could serve as a clearing house for donor support to the industry and to individual MFIs, conferring supervisory powers to MFI associations may not be a good idea as it may be subject to a high degree of conflict of interest. In this respect, self regulation should be encouraged in the long run, but not at this early stage since it could be too risky given the fact that the industry is still young.

In conclusion, supervision of MFIs in Kenya should be practical for both institutions and the regulatory authorities. The Central Bank of Kenya and its microfinance department should be granted the overall primary responsibility of supervising MFIs as they are better equipped than Ministries of Finance to undertake such a task.

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