ROLE OF PLANNING IN TRANSFORMATION OF MICROFINANCE INSTITUTIONS INTO MICROFINANCE BANKS IN KENYA

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Abstract: *The Microfinance Act of 2006, and its subsequent amendments through the Microfinance (Amendment) Act of 2013, provided a legal framework to guide Microfinance Institutions (MFIs) in Kenya that wished to transform into regulated deposit-taking microfinance banks. This was expected to drive growth in the microfinance sector but by 2010, only three (3) MFIs had successfully transformed. Whereas evidence from other countries suggests planning as a major factor affecting the transformation of MFIs, the available information is not conclusive on the specific aspects of planning that affect transformation and the magnitude of the effect. This study, therefore, sought to determine the role of planning in the transformation of microfinance institutions into microfinance banks in Kenya. The specific objectives were to establish the effect of various aspects of planning on the transformation of microfinance institutions into microfinance banks in Kenya and to make recommendations for improving the level of success with transformations in future. The target population was 48 institutions that were members of the Association of Microfinance Institutions in Kenya as at 1st January 2013. The study selected 25 MFIs using purposive sampling. Four respondents, comprising of managers and/or board members, were then selected from each of the 25 MFIs using simple random sampling; thereby giving the survey a total sample of 100. A questionnaire was used to collect data. The Scientific Package for Social Sciences (SPSS) was used to aid in the entry, storage and analysis of data. The study used both descriptive and inferential statistical data analysis. First, descriptive data analysis was undertaken to establish the distribution of various data items using the mode. Inferential statistical analysis was then done to test for the existence and strength of relationship between the independent and dependent variables. This was done using the Pearson Chi-square Test for Independence, which is considered appropriate where the independent and dependent variables are categorical - as was the case in this study. Out of the five aspects of planning, the study established that only convincing the board and management on the need to transform was a significant challenge in the transformation of*

MFIs into microfinance banks in Kenya. Overall, the study found no significant association between planning and MFI transformation status in Kenya and concluded that planning was not a significant challenge. The study recommends that MFIs in Kenya wishing to transform should approach the process with confidence that planning activities will not pose any serious challenges. The study also recommends that MFIs in Kenya that wish to transform into microfinance banks should be prepared to spend time and other resources on educating the board and management way before presenting to them the proposal for transformation.

Key words: *Financial Access, Microfinance Bank, MFI Transformation, MFI Regulation & Supervision, Planning*

1.0 INTRODUCTION

1.1 Background to the Study

It is widely acknowledged that a strong correlation exists between access to financial services and economic development (Christen, Rosenberg, & Jayadeva, 2004). Increasing access to financial services results in employment creation, economic growth, and human development. Nevertheless, it is estimated that about three billion people of the working-age in the world still lack access to a broad range of financial products and services on a sustainable basis (Christen, Rosenberg, & Jayadeva, 2004).

It has been established that the formal banking sector serves less than 20% of the population in developing countries (Robinson, 2001). The rest of the population, typically comprising low-income households, has historically been excluded from accessing formal financial services (Chiumya, 2006). Limited access to financial services in Kenya has over the years been cited as one of the major constraints inhibiting the growth of the Micro and Small Enterprise (MSE) sector (Central Bureau of Statistics, International Centre for Economic Growth, & K-Rep Holdings, 1999; Republic of Kenya, 2005). Yet, the MSE sector makes a significant contribution to the economic development of the country, amounting to up to 18.4% of the country's Gross Domestic Product (Republic of Kenya, 1992; 2005; Gichira, 2005).

According to Atieno (2001), the problem of limited access to credit is largely result of supply-side constraints. Microfinance Institutions (MFIs) emerged in a bid to address the problem and they have been testing and developing a practical approach since the 1970s to serve those historically excluded from accessing financial services from the formal banking sector. Over time, one popular view that has emerged says that major increases in microfinance outreach needs to come from banks (Vogel, Gomez, & Fitzgerald, 2000). This is based on the comparison of size of the typical bank and the typical microfinance institution and the fact that most of the largest microlenders are banks such as Grameen, BRI, and Bancosol.

Kenya has, like other countries in the world, experienced a rapid growth of the microfinance sector since the 1980s. However, the MFIs operated without a proper legal and regulatory framework (Atieno, 2001; Republic of Kenya, 2005) and this greatly hampered their capacity to grow (KIPPRA, 2001). For instance, until 2006, MFIs that wanted to could only transform into commercial banks because only banking laws were in place at the time. However, the commercial banking law was considered to be too stringent, not responsive to the special needs of the microfinance sector, and largely prohibitive. This was evident from the experience of Kenya Rural Enterprise Programme (K-Rep), the first case of transformation in Kenya, and which occurred in the absence of a legal framework for the regulation and supervision of MFIs. Ultimately a commercial bank, K-Rep Bank, was created following the transformation of K-Rep from an NGO to a diversified holding company, but among many other handicaps, the process took too long (Rosenngard, Rai, Dondo & Oketch, 2000).

The enactment of the Microfinance Act 2006 (Republic of Kenya, 2006; 2008; CBK, 2008) and the Microfinance (Amendment) Act of 2013 (Republic of Kenya, 2013) provided the environment for the second round of transformations. From 2006, MFIs that wished to transform started seeking to do so with a regulatory framework specific for MFIs in place. These statutes provided for the regulation and supervision of deposit-taking microfinance banks in Kenya. This legal framework provided transforming MFIs with a second option of becoming regulated microfinance banks in addition to the option of converting into commercial banks. This was expected to stimulate rapid growth in the microfinance sector as the microfinance banks would be allowed, lawfully, to mobilize deposits from the public and use those funds for on-lending. However, by the end of 2010, only three (3) MFIs had successfully completed the process of transformation and had been licensed.

1.2 Statement of the Problem

According to Arora & Ferrand (2007), 19% of the Kenyan adult population uses financial services from the formal financial institutions like banks, building societies, and post office savings bank, which are regulated by the central bank. Alternative formal financial institutions which are not regulated by the central bank, like Savings and Credit Cooperatives (SACCOs) and microfinance institutions (MFIs), reach 8% of the adult population. This means that only 27% of the adult population access financial services from banks and other formal regulated non-bank financial institutions. Another 35% of the adult population uses financial services from informal sources like Rotating Savings and Credit Associations (ROSCAs) and Accumulated Savings and Credit Associations (ASCAs). The other 38% of adult Kenyans do not use financial services from any source.

The people who access financial services from informal sources plus those who are not served by any source total to 73% of the adult population in Kenya. These are said to be "unbanked" because they are excluded from the formal sources. According to Arora and Ferrand (2007), this implies that Kenya has a great challenge in her efforts at developing an inclusive financial system. They further observe that those levels of access compare favourably to Kenya's regional neighbours, yet, in the context of the Vision 2030, Kenya seeks to benchmark its economic performance either with rapidly growing countries (such as Vietnam) or middle-income countries (like South Africa, Namibia or Thailand) which have considerably higher levels of access. As such, Kenya would have to raise the formal access to 50% in order to achieve those benchmarks by the year 2030.

For a country to successfully deal with the challenge of access to finance, it is necessary to ensure that financial services reach large numbers of people. According to Hishigsuren (2006), the global trend is to move microfinance into institutions that are regulated and supervised by a country's financial authorities. Worldwide, about 43 non-governmental organization (NGO) microfinance institutions (MFIs) were transformed by March 2006 (Hishigsuren, 2006). One of the models being used to achieve significant outreach is the transformation of microfinance organizations into regulated deposit-taking financial institutions.

The experience from other countries like Cambodia, Philippines, Bolivia, India, Nepal, Mongolia, Peru, Pakistan, and Uganda shows that the process of transforming MFIs could be everything but easy. Among others, MFIs in those countries faced planning, management, financial, infrastructural, legal, institutional change management and other challenges when transforming (Campion & White, 1999, Hishigsuren, 2006). The available information suggests that MFI transformation was affected by challenges caused by five aspects of planning. These aspects are convincing the board and management on the need to transform, assessing the readiness for transformation, agreeing and commissioning a transformation manager, preparing a transformation plan, and making initial consultations with the regulator. While the small number of successful transformations in Kenya from 2006 to 2010 may be attributed to any or all of the five planning aspects, the available information is not conclusive on the specific ones affecting MFI transformation in Kenya and the magnitude of the effect. This study, therefore, sought to determine the role of planning in the transformation of microfinance institutions into regulated deposit-taking microfinance banks in Kenya with a view to making recommendations for more successful future transformations.

1.3 Objectives of the Study

This study addressed the following specific objectives:

1) To establish the effect of various aspects of planning on the transformation of microfinance institutions into microfinance banks in Kenya.
2) To make recommendations for improving the level of success with transformation of microfinance institutions into microfinance banks in Kenya.

1.4 Hypothesis

This study was guided by the following null hypothesis and its alternative hypothesis:

H_0 There is no significant effect of various aspects of planning on the transformation of microfinance institutions into microfinance banks in Kenya.

H_a There is a significant effect of various aspects of planning on the transformation of microfinance institutions into microfinance banks in Kenya.

2.0 LITERATURE REVIEW

In order to gain a deep understanding of the dynamics of microfinance transformation, this study undertook a comprehensive review of the relevant literature. The literature review also helped in identifying the variables for the study. Consequently, one dependent and one independent variable were identified. The independent variable was planning for transformation while the dependent variable was transformation status.

2.1 Planning for Transformation

The initial consideration in the planning is to secure an agreement from the board and senior management on the need to transform. This is important because an MFI needs to review its mission and vision to ensure that it is in line with the expected deposit taking status. Getting this agreement is considered so critical that Ledgerwood and White (2006) and Frankfurt School of Finance & Management (2012) argue that without it the plans for transformation should be abandoned or put on hold until such a time that the key people in the MFI reach an agreement. This matter has been a challenge in the transformation when the board and senior management either fail to agree on the need to transform or take too long to agree.

Another aspect of planning that has been found to affect transforming entities is the assessment of the readiness to transform. This is because there are numerous strategic issues to be considered and decisions to be taken at the planning stage (Ledgerwood & White, 2006; Frankfurt School of Finance & Management, 2012). Another issue for assessment is whether the MFI is prepared emotionally and financially to substantially develop its capacity so as to become a true financial intermediary. This is complicated by the question of how much control the MFI is willing to give up, the structure of the board of the DTM in terms of the number of board members and the number of board committees and whether the MFI will continue to exist and what its role will be. This includes decisions on whether the NGO will take shares in the new DTM, and how many the shares will be and the role of the founders of the MFI in the governance of the new DTM. Another issue to be assessed is whether or not there exists adequate management and staff skills and capacity required of a true financial intermediary; and whether the MFI is ready to hire externally if the available capacity is inadequate. In addition, decisions have to be made on the adequacy of the current board to oversee the transformation process and whether the board has the capacity to oversee a financial intermediary. Finally, the willingness to open up to outsiders regarding MFI operations as well as the willingness to seek technical assistance where the capacity is inadequate has to be assessed. This assessment has not been easy and often requires the assistance of external consultants (Hudson, 1995).

Transformation requires a strong change agent (Denhardt, Denhardt & Aristigueta, 2002). Therefore, central to the initial planning is the need for a transformation manager – a champion to lead the process and ensure consensus building amongst the key stakeholders. Transforming MFIs face difficulties identifying such a person, who should ideally be a senior person from within the MFI. Internal power and politics make it difficult for organizations to quickly agree on who the change agent should be. It could also become a challenge when the transformation manager selected turns out to be incompetent or not to be enthusiastic about transformation. This can ultimately delay the process with the possibility of completely derailing it.

As part of the planning, transforming MFIs also require a well prepared transformation plan. The challenge is that this plan should take into account everything that the MFI needs to consider to become a financial intermediary (Rosenberg, 2010; Frankfurt School of Finance & Management, 2012). The plan should outline the "one-off" activities that need to take place to develop the capacity of the MFI to be licensed to take deposits. It should show where the organization is currently and where it needs to get so as to both comply with the central bank regulations and become a successful, profitable deposit-taking financial intermediary. Finally, the plan shows what needs to be done to get from point A to B. Preparation of transformation plan is not easy and often requires the assistance of external consultants (Hudson, 1995).

The last aspect of planning that could affect the transformation of MFIs is the initial consultations with the regulator, that is, CBK in Kenya. The experience in other countries suggests that the consultations should start early so that the transforming MFI will get to understand the specific requirements for transformation, especially on the required procedures and necessary documentation (Chiumya, 2006). This has presented challenges where the MFI starts the consultations late or the relationship between the sector and the regulator is not very friendly (Mutahi, 2008).

2.2 Transformation Status

Transformation is defined as the establishment of a regulated financial institution (RFI) by a nongovernmental organization (NGO), or a group of NGOs, by transferring all or part of its loan portfolio to the RFI (Fernando, 2004). It is also defined as the process by which an NGO

MFI converts into a "formalized" or regulated financial institution (Ledgerwood & White, 2006).

A study by Hishigsuren (2006) shows that the process of MFI transformation has taken varying forms depending on the legal framework in a given country. For instance, it may take the form of an existing MFI converting into an RFI. It may also be in the form an existing MFI, alone or in collaboration with other organizations, establishing an RFI. Whatever form it takes, it culminates in the application for registration as an RFI and finally being granted a license by the regulating authority to operate as such.

An institution is considered to have transformed successfully if it manages to overcome the challenges faced before and during the process of transformation. Successful transformation, therefore, is indicated by an MFI ultimately gaining the RFI status by getting issued with a license to operate as a DTM in Kenya (CBK, 2008).

3.0 RESEARCH METHODOLOGY

3.1 Research Design

This study used quantitative designs so as to benefit from the advantages inherent in such methods. According to Kombo and Tromp (2006), the quantitative approach relies on the principle of verifiability, that is, confirmation, proof, corroboration or substantiation. It is applicable where the researcher incorporates the statistical element designed to quantify the extent to which the target group is (or thought or believed to be) aware of, or is inclined to behave in a certain way. It is also applicable when frequencies are required to explain meanings, thus necessitating the collection of numerical data in order to explain certain phenomenon. Finally, it is useful when data analysis is mainly statistical.

3.2 Target Population, Sample and Sampling Procedures

The sampling frame was the AMFI on-line register of members as at 1st January 2013. The register had 48 member institutions (AMFI, 2013). The target population of this study, therefore, comprised of 48 MFIs.

This study used both purposive and simple random sampling to select the sample. Purposive sampling is a sampling technique that allows a researcher to use cases that have the required information in relation to the study objectives (Mugenda & Mugenda, 1999; Mutai, 2000; Kothari, 2004; Chandran, 2004; Oso & Onen, 2009). From the list in the sampling frame, wholesale MFIs as well as non-microfinance institutions were eliminated. In this way, a total of 25 institutions were selected. Simple random sampling was then used to select four respondents from each selected institution, giving a total sample of one hundred respondents.

3.3 Research Instruments and Data Collection and Analysis

This study used a questionnaire because it was considered the most appropriate too to collect quantitative data (Mugenda & Mugenda, 1999; Kombo & Tromp 2006). Data entry, storage and analysis were done with the aid of Scientific Package for Social Sciences (SPSS). After data collection, all the questionnaires were coded as part of the data cleaning. A coding scheme was developed to facilitate the development of an appropriate data structure to enable its entry and storage in the computer. After all the data was entered into the computer, it was checked and corrected for any errors.

This study undertook both descriptive and inferential statistical data analysis. Descriptive data analysis was done first and it involved measuring numerical values from which descriptions using the mean (mode) for various data items were calculated. Inferential statistical analysis was then used to test for the existence of relationships between the variables. Specifically, the study used Pearson Chi-square Test for Independence because it is considered appropriate for establishing the degree of association between categorical variables (Kombo & Tromp, 2006).

4.0 RESULTS AND DISCUSSION

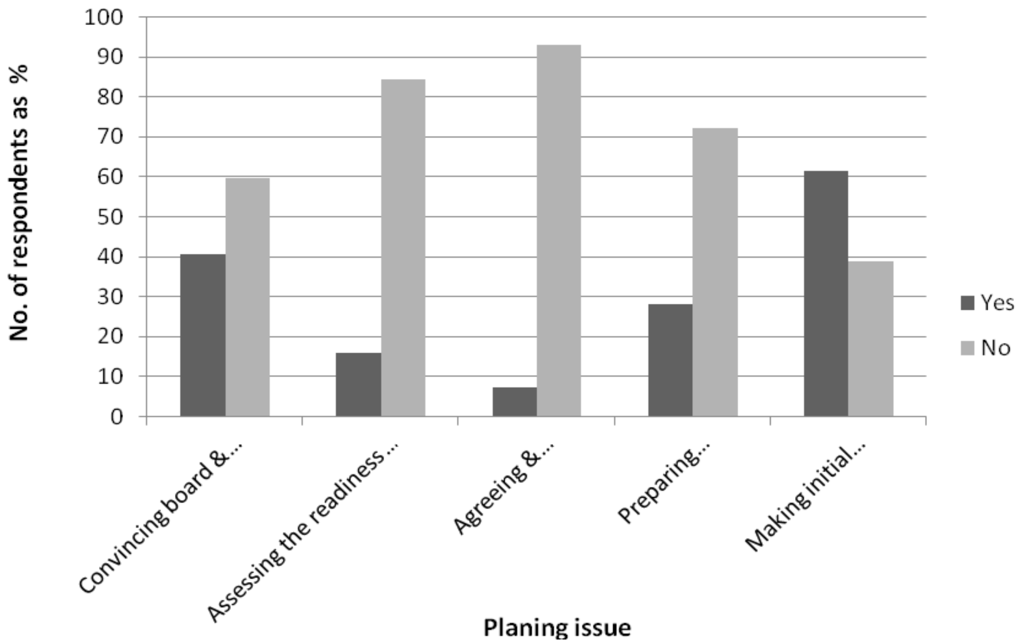
The objective of this study was to establish the effect of planning on the transformation of microfinance institutions into microfinance banks in Kenya. Planning for transformation was conceptualized to be measured using five items. The five items are convincing the board and management on the need to transform, assessing the readiness for transformation, agreeing and commissioning a transformation manager, preparing the transformation plan, and making initial consultations with the regulator, that is the CBK. The respondents were asked to indicate whether or not those planning items or issues had posed challenges that affected their MFIs when transforming. The findings are presented in Table 1 and Figure 1.

Table 1: Whether Planning Items Affected MFI Transformation

Planning Issue/Item	No. of Respondents as Percent		
	Yes	No	Total
Convincing board & management on need to transform	40.4	59.6	100
Assessing the readiness for transformation	15.8	84.2	100
Agreeing & commissioning a transformation manager	7	93	100
Preparing transformation plan	28.1	71.9	100
Making initial consultations with CBK	61.4	38.6	100

n = 57

For more emphasis and further clarity, the results in Table 1 were converted into a bar graph and presented in Figure 1.



n = 57

Figure 1: Whether Planning Issues Affected MFI Transformation

The planning issue most frequently mentioned as a challenge to MFI transformation in Kenya was making initial consultations with the central bank (61.4%) *(see Table 1 and Figure 1)*. The planning issue that was least frequently mentioned as a challenge was agreeing on and commissioning a transformation manager (7%). This can be attributed to the fact that making consultations with the CBK is a process that is largely outside the control of MFIs. This is unlike agreeing and commissioning a transformation manager which is a process that is largely within the control of an MFI, and thus less of a challenge. For instance, FAULU Kenya easily settled on the Internal Audit Manager as the transformation manager (Frankfurt School of Finance & Management, 2012). This was intended to ensure that the transformation manager was familiar with the company and to provide guidance on the needs of the organization and proper co-ordination of the process.

Each of the five items in the scale was then subjected to further analysis in order to test the null hypothesis, which was stated as follows:

> *H_0 There is no significant effect of various aspects of planning on the transformation of microfinance institutions into microfinance banks in Kenya.*

The Chi-square test for independence was used to test the hypothesis. This test is considered the appropriate where both the dependent and independent variables are categorical (Morgan & Griego, 1997; Pallant, 2007; Nicol & Pexman, 2010) as was the case in this study. The results are presented in Table 2.

Table 2: Chi-Square Test for Independence for Planning Items

Item	χ^2	Df	Asymp. Sig. (2-sided)
Convincing the board and management on the need to transform	11.946	1	0.001
Assessing the readiness for transformation	0.219	1	0.640
Agreeing and commissioning a transformation manager	0.421	1	0.516
Preparing the transformation plan	2.336	1	0.126
Making initial consultations with CBK	0.005	1	0.946

n = 57

Key:

Criteria for determining the overall significance of planning as a challenge:

- The Independent Variable (Planning) was considered significant if the results of the Chi-square test for independence was significant for 50% or more of the items in the scale.

The Chi-square test for independence indicated a significant association between convincing the board and management on the need to transform and successful transformation status, χ^2 (1, n = 57) = 11.946, *P* = 0.001 *(see Table 2)*. This means that the difficulty faced in securing board and management approval was a significant determinant in the successful transformation of MFIs in Kenya. This indicates that the more difficult it is to convince the board and management on the need to transform, the more difficult it will be to succeed in transformation. If the board and management are not enthusiastic at the very first step, it is highly unlikely that they will give their support in subsequent steps. The effect is that it will be difficult for such an MFI to succeed in transforming.

For each of the other four items, the test results showed that their association with successful transformation status was not significant. The item with the least association with successful MFI transformation status in Kenya was making initial consultations with CBK. The Chi-square test for independence indicated no significant association between difficulty of initial consultations with CBK and successful transformation status, χ^2 (1, n = 57) = 0.005, P = 0.946 as shown in Table 2. This means that the difficulty (or ease) of making initial consultations with CBK was not a significant determinant in the successful transformation of an MFI in Kenya. This may be attributed to the fact that this process is largely outside the control of MFIs and whose success is largely affected by government bureaucracy (Campion & White, 1999).

The above findings imply that that the study established a significant association between successful MFI transformation status in Kenya and only one (1) out of the five (5) planning items. This translates to only 20% of the items in the scale, which is way below the threshold of 50% plus. Based on the findings, the null hypothesis (H_0) that *"There is no significant effect of various aspects of planning on the transformation of microfinance institutions into microfinance banks in Kenya"* was accepted. The study, therefore, concluded that planning does not play a significant role in the transformation of microfinance institutions into deposit taking financial institutions in Kenya.

5.0 CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

This study sought to determine the role of planning in the transformation of microfinance institutions into regulated deposit-taking microfinance banks in Kenya. The specific objectives were to establish the effect of various aspects of planning on the transformation of microfinance institutions into microfinance banks in Kenya and to make recommendations for improving the level of success with future transformations.

Planning for transformation was measured using five items, namely, convincing the board and management on the need to transform, assessing the readiness for transformation, agreeing and commissioning a transformation manager, preparing the transformation plan, and making initial consultations with the regulator, that is the CBK. Only a small proportion of the items (20%) had a significant association with transformation of MFIs into microfinance banks in Kenya. This was convincing the board and management on the need to transform. The study, therefore, concluded that, to a large extent, planning does not play a significant role in the transformation of microfinance institutions into regulated deposit taking microfinance banks in Kenya.

5.2 Recommendations

This study makes the following general recommendations:

(a) MFIs in Kenya that wish to transform into regulated deposit taking microfinance banks should embark on the process with confidence that planning will not present a serious challenge.

(b) MFIs in Kenya that wish to transform into regulated deposit taking microfinance banks should be aware of the likely source of planning challenges, namely, convincing the board and management on the need to transform. MFIs should thus be prepared to spend time and other resources on educating the board and management way before presenting to them the proposal for transformation.

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