EVALUATION OF THE EFFECT ON CONVERSION FROM NON DEPOSIT MICROFINANCE INSTITUTIONS TO DEPOSIT TAKING INSTITUTIONS ON FINANCIAL PERFORMANCE IN KENYA

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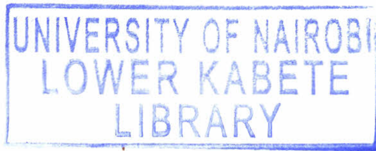
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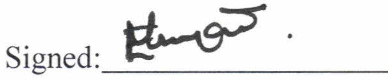
DECLARATION

This project is my original and has not been submitted for a degree in any other University

Signed:  Date: 09/11/12

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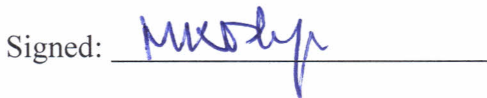
The project has been presented for examination with my approval as University Supervisor

Signed:  Date: 9/11/2012

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DEDICATION

To my parents late Samuel Munyao Mweu and Eunice Waeni Munyao for their love, parental care and their efforts in educating me and their strong belief in the power of education.

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ABSTRACT

The study aimed at evaluating the effect on conversion from non deposit microfinance institution to deposit taking institutions on financial performance in Kenya. DTM is a microfinance institution that deposits as day-to-day basis and any other activity of the business financed wholly or to a material extend. With the conversion the MFIs shall be able to reach their full potential by enhancing deposit mobilization which is in accordance to vision 2030.The study focused on the fully converted DTMs which included Faulu Kenya, Kenya Women Finance Trust, Smep and Uwezo. One year before conversion and one year after conversion.

In the analysis and evaluation of the determinants of financial performance were analysed by use of the two ratios R.O.A and R.O.I .This sought to determine the DTM efficiency by use of its assets while the institutions competitiveness and sustainable growth was determined by use of equity.The finding of the study shows decrease in R.O.A and R.O.I for Faulu Kenya and K.W.F.T indicating that there is fluctuation of the net income or interest margins as a result of the increased cost of operation and infrastructural cost. Therefore a high R.O.A and R.O.I is needed for the institution to attract private capital. SMEP showed increase in R.O.A and R.O.I which could be as a result of financial funds received from national and international organizations.

The study concludes that microfinance has been an important tool in poverty alleviation, empowerment of women and in bringing about financial inclusion. There exists a great opportunity for the microfinance sector to provide credit to the low income population thereby reducing poverty and thus in the development of the country as a whole. Although the microfinance sector has reported an impressive growth, with the ordinances

passed by the government, there is lack of capital for some of the microfinance institutions in the country.

The study recommends that microfinance institutions have faced a lot of issues about its performance and sustainability. Microfinance institutions have been viewed as an important tool in poverty alleviation and financial inclusion. It is an important sector which would improve the living conditions of the poor and lead to the development of the country. Some of the issues faced by microfinance institutions include high interest rates, multiple lending, coercive methods of recovery and lack of transparency.

TABLE OF CONTENTS

DECLARATION ii

ACKNOWLEDGEMENT iii

DEDICATION iv

ABSTRACT v

TABLE OF CONTENTS vii

LIST OF TABLES x

ABBREVIATIONS. xi

CHAPTER ONE 1

INTRODUCTION 1

1.1 Background of the Study 1

1.1.1 Microfinance Institutions 2

1.1.2 Deposit taking Microfinance Institution 3

1.1.3 Deposit Taking Microfinance Institutions in Kenya. 5

1.2 Statement of the Problem 7

1.3 Research Objective 8

1.4 Significance of the Study 8

CHAPTER TWO 10

2.0 LITERATURE REVIEW 10

2.1 Introduction 10

2.2 Theoretical Framework 10

2.2.1 Contingency Theory 10

2.2.2 The Theory of Constraint 11

2.2.3 Theory of Financial Intermediation 12
2.3 Factors Determining Financial Performance in Microfinance 12
2.3.1 Macro-economic Environment Factors 12
2.3.2 Infrastructure and Geographical Framework 13
2.3.3 Firm Specific Factors on Product Innovation 14
2.3.4 International Environment Factors 15
2.4 Empirical Literature 15
2.5 Deposit Taking Microfinance (DTMs) 17
2.6 Challenges in Financial Performance and Conversion of Microfinance 18
2.6.1 Operational Issues 18
2.6.2 Strategic Issues 19
2.6.3 Marketing Issues 20
2.6.4 Regulatory Framework 20
CHAPTER THREE 22
3.0 RESEARCH METHODOLOGY 22
3.1 Introduction 22
3.2 Research Design 22
3.3 Population 22
3.4 Data Collection 23
3.5 Research Model 23
3.6 Data Analysis 24
CHAPTER FOUR 25
DATA ANALYSIS, RESULTS AND DISCUSSION 25
4.1 Introduction 25
4.2 Summary Statistics 25
4.2.1 Faulu Kenya 25
4.2.2 K.W.F.T 26
4.2.3 SMEP 27
4.3 Overall Description of Earning Performance of the DTMs 28

4.4 Discussions 29
4.5 Summary 30
CHAPTER FIVE **31**
SUMMARY AND CONCLUSION **31**
5.1 Introduction 31
5.2 Summary of the Study 31
5.3 Conclusion 31
5.4 Limitations of the Study 32
5.5 Recommendations 33
REFERENCES **35**

LIST OF TABLES

Table 4.2: ROA and ROE presentation for Faulu Kenya 25

Table 4.3: R.O.A and R.O.E presentation for K.W.F.T 26

Table 4.4: ROA and ROE presentation for SMEP 27

ABBREVIATIONS.

AMFIs- Association of Microfinance Institutions

CBS- Central Bureau of Statistics

CBK- Central Bank of Kenya

CGAP - Consultative Group to Assist the Poor

EPS – Earnings Per Share

FSD – Financial Sector Deepening

GDP – Gross Domestic Product

KWFT – Kenya Women Finance Trust

MFIs – Microfinance Institutions

NCCK- National Council of Churches In Kenya

NGO – Non Governmental Organization

R.O.A- Return On Asset

R.O.I- Return On Equity

SPSS- Statistical Package for Social Science.

SACCOs – Savings and Credit Cooperative Society

SASRA- Sacco Society Regulatory Authority

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Muganga (2010) defined Microfinance Institution is an Institution that provides financial services to low income individuals and households as well as micro, small and medium enterprise (MSMEs), using specially designed methodologies that will ensure sustainability for the lenders, and lead to improvement in the standard of life for the consumers, while ensuring a triple bottom line of developing the person positively impacting lives and leading to economic Development of the region". The World Bank estimates that the potential global market for micro enterprise credit currently stands 100million clients. In many developing economies small and Micro businesses comprise of nearly ninety percent (90%) of all firms (Berenbach& Churchill, 1997).

The Micro-finance Act 2006 became operational in May 2008, and creates the legal framework for qualified MFIs to accept deposits and mobilize them as loan funds, providing a valuable source of capital for expansion and financial sufficiency. The act also opens up possibility of MFIs tapping into others sources of capital, including equity capital. The regulations for deposit taking MFIs are very strict and include ,among other things ,operating nationwide throughout Kenya and retaining core capital amounting to between sh20million (USD 252 thousand) and Sh60 million (USD 770 thousand)(Hogarth ,2009).

Micro-finance Act 2006 granted some of the micro-finance institutions in Kenya a legal status as deposit taking institutions. MFIs are feeling squeezed from commercial banks which have begun to attract a larger share of what has traditionally been the microfinance market .This trend is occurring as commercial banks are offering more attractive financial products to the best of performing micro-finance clients, with better terms and more easily met conditions (Hogarth,2009)

There is a clear recognition from the public and the Government that regulation of MFIs is necessary to establish the right environment for a market shifting from donor funded and poverty oriented institutions to for-profit organizations. Former credit-only institutions wanting to leverage deposits from the public can only operate successfully in the market if it is properly regulated thus leading to the conversion of the Credit MFI to deposit taking micro-finance institutions as both Financial institutions and depositors ought to be protected.

With the conversion of MFIs to DTMs ,it will lead to increased number of total assets as more branches will be opened and increased deposits, the net income will be expected to raise after break even has taken place. The increased number of employees to cater for the customers and the day to day activities will increase the operating expenses. With the increased number of customer turnover of the customer deposits and the amount given as loans to customers will lead to increase in the Earning per share.

1.1.1 Microfinance Institutions

The term "microfinance institutions" are the financial institutions that are committed to assist typically poor households and small enterprises in gaining access to financial service. This

commitment may replace other private or public objectives, such as maximization of shareholders value, the direction of investment into priority sectors, or mobilization of savings to finance government operations. (Hardy, et al, 2002).

According to World Bank; Microfinance Institution refers to those institutions that engage in relatively small financial transactions that use various methodologies in order to serve low income households, enterprises, small scale farmers and also those who lack access to traditional banking services (CBS, 1999).

Microfinance institutions offer poor people access to basic financial services, such as loans, savings, money transfer services and micro insurance. Savings services allow savers to store excess liquidity and to obtain returns on investments. Credit services enable the use of anticipated income for current investment or consumption. Over all, microfinance services can help low-income people reduce risk, improve management, raise productivity, obtain higher returns on investment, increase their income, and improve the quality of their lives and those of dependants (Robinson, 1987)

1.1.2 Deposit taking Microfinance Institution

The microfinance Act 2006, defines a deposit taking micro finance business as any in which the person conducting the business holds himself out as accepting deposits on day- to –day basis and any other activity of the business financed, wholly or to a material extent, by lending or extending credit for the account and at the risk of the person accepting the deposit, including the provision of short- term loans to small or microenterprise or low income households and characterized by the use of collateral substitutes.

Transformation of NGO microfinance institutions into regulated deposit-taking institutions has been viewed as one of the key ways to create financial viability and scale among the MFIs, and establish permanent sources of funding for them (Ledgerwood and White, 2006). The proponents of microfinance regulation such as World Bank, Consultative Group to Assist the Poor (CGAP) and the International donor communities argue that the future of micro finance lies in developing a well regulated microfinance environment that will allow the poor to access a wide variety of financial services. (Gallardo 2011).

A well defined regulatory framework, a clear national vision, legal and policy environment are all pre-requisites to a successful transformation. In most countries, a tiered financial and regulatory approach has proved the most effective for enabling transformation, offering clear categorization of the institutions and providing a good basis for a roadmap. The tiered approach is also suited to the increasing demand for diversified microfinance products, as the industry changes from a primarily social development tool to a recognized economic development tool. A broader range of strong financial intermediation institutions is therefore needed. (Robinson 2001).

With the regulations being put in place, it will instill public confidence regarding the MFIs thus moving Micro-finance sector to new frontiers of financial reach through mobilization of public deposits. It has been noted that the traditional sources of donor funds for micro-finance institutions are drying up and cannot be relied to move the sector the next level .The Government of Kenya is also encouraging the SACCOs Regulatory Authority (SASRA) to regulate SACCOs

with the front office operations. The DTMs currently in operation include Faulu Kenya, Kenya Women Finance Trust, Uwezo and Small and Micro Enterprise Programme.

Muganga (2010) noted that conversion of the credit MFIs to Deposit taking MFIs will enable the Institutions to reach their full potential, by enhancing deposit mobilization which is in accordance to Kenya's pillar vision 2030 ,leading to the increase of the Kenya's savings level (Kenya intends to raise the gross national savings to 27.7 per cent of GDP and expand the level of investment to 32.6 per cent of GDP 2012) and improving the quality of life for all citizens(MoF Strategic plan, 2009-2012).Through the regulations laid down for the DTMs, this will do away with some uncertainties and risks in terms of the cost, unhealthy competition, operational challenges, limited funding sources, sustainability

1.1.3 Deposit Taking Microfinance Institutions in Kenya.

Faulu established itself as a company limited by share capital in 1999 in order to obtain debt funds from the market. In 2004 the institution decided to go a step further and become a public limited company, issuing a bond to raise additional funds for operations. Once this was accomplished, the main challenge was to identify new, like-minded shareholders/investors. Ideally, incoming shareholders would not only share Faulu's social objectives, but also the Christian faith of its current investors. The new Microfinance Act limits individual shareholding to 25% of the total share capital. The Act gives transforming institutions four years to comply with this requirement following licensing. Faulu Kenya was converted to a deposit taking Microfinance Institution May 2009.

KWFT was the second MFI To be converted to a DTM institution in the year in March 2010.the reason for the conversion is to enable the institution to manage the growing demand for their expanding customer base that currently stands at 450,000 as well as internal staff operations and regulatory reporting. KWFT has a total of 215 businesses, 10 being deposit taking branches.

SMEP Deposit Taking Microfinance Limited evolved from the Small Scale Business Enterprises Programme (SSBE) which was registered in 1999 and fully owned by NCCK. The transformation into Deposit Taking Microfinance institution will enable the institution offer savings products to its clients in addition to the loan products. The institution boasts of 87,500 clients and an outstanding loan balance of Sh 1.1 billion. SMEP was converted to a DTM institution in the year 2010.The main goal of SMEP is to improve the standard of living of economically poor and marginalized entrepreneurs by providing access to credit and other services to stimulate economic growth.

Uwezo DTM limited was established in the year 2007 .Uwezo word is a Swahili word meaning empowerment. Their objective is to facilitate economic growth through community financial inclusion it was registered as a Deposit Taking Microfinance Institution in November 2010 .

Bankakademie (2012) in a study about the transformation experience of Faulu Kenya and Kenya Women Finance Trust (KWFT) noted that the desire to serve clients better was the motivation for transformation from a non-governmental organization (NGO) or a non-regulated microfinance institution (MFI) into one which is regulated or the deposit taking Institution. For the process to be successful it requires easier mobilization of funding, greater outreach and a more efficient delivery of services than is common in a credit only MFI. Amongst the benefits of

transformation are cheaper access to funds through deposits (in the long-term), increased governance, and greater competitive positioning contributing towards achieving greater financial sustainability and equity investments.

1.2 Statement of the Problem

The study of Deposit taking microfinance institutions (DTMs) in Kenya has been an area of limited study despite numerous researches on their non deposit taking counterparts. This has been attributed to the short time they have been in operation since conversion and lack of adequate information on their performance; moreover there are just a few of such institutions in Kenya.

Ndulu (2010) studied Factors affecting institutional transformation, a case for microfinance regulatory framework in Kenya and concluded that the main factor affecting transformation included raising minimum capital, meeting capital adequacy requirements, restructuring ownership, setting up branches that meet regulatory requirements, setting up MIS that support the required documentation, restructuring governance and management and increase in operational costs. Gathuku (2010) looked at responses to micro finance institutions to regulation through the microfinance Act 2006 and realized that there is need for the MFIs to enhance their understanding of the legal and regulatory requirement to determine the risks and constraints in the context of each regulatory environment and avoid the pitfalls of predecessors.

Buttit (2010) in his research on the relationship between credit risk management practices and profitability of microfinance institutions in Kenya found out that credit risk management is one

of the most important practices to be used especially by the MFIs for getting assurance about the reliability of the operations and procedures being followed. Financial Sector Deepening (FSD) survey "conversion from a credit microfinance institution to a CBK-licensed, deposit taking micro lender" concluded that the process of conversion is a costly venture that is made even more expensive by elaborate regulatory requirements. Therefore to encourage other organizations which are performing well to transform, a review of actual risks for DTMs would be necessary to lower some of the requirements and therefore costs. Oriaro (2000) looked at the characteristics of MFIs that supported or hindered regulatory process and identified appropriate regulatory approaches that could be suitable for MFIs in Kenya. There is no known documented study on the effect of financial performance on conversion of MFIs to DTMs.

There is no known documented study that has been carried out on the effect of financial performance when there is conversion from the MFIs to DTMs.

1.3 Research Objective

The study sought to evaluate the effect of conversion from Non-deposit Microfinance institutions to deposit taking institutions on financial performance.

1.4 Significance of the Study

This information generated by this study will be of great importance to the following stakeholders;

i. Government-the findings of the study will significantly assist the Government in policy formation that encourages the growth and development of the DTMs.

ii. Regulators-the study will add impetuous into the ongoing process of consolidating the sector under a regulatory framework that protects the players' interests.

iii. DTM managers-In their course of work they tend to evaluate their performance against (targets) .This study would interest them in that the results will confirm how conversion has impacted on their performance.

iv. The study will contribute to development of academics literature and theory by providing empirical evidence for use by educators, and researcher in the field of study

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This chapter will focus on the review of theoretical and empirical literature related to the study. The chapter discusses the theory of constrained, theory of financial intermediation and contingency theory. It reviews the empirical studies on microfinance in general with specific focus on the deposit taking microfinance institutions (DTMs) and the challenges of conversion from microfinance institutions (MFIs).

2.2 Theoretical Framework

2.2.1 Contingency Theory

Contingency theory is a class of behavioral theory that claims there is no best way to organize a corporation, to lead a company, or to make decisions (Galbraith, 1973). Instead, the optimal course of action is contingent (dependent) upon internal and external situation. Several contingency approaches were developed concurrently in the late 1960s.

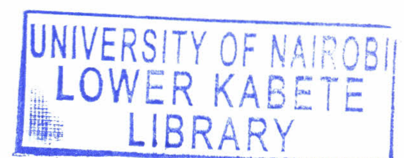
Contingency theory (Galbraith, 1973 and 1977) defines contingency as the variables which makes the organization contingent upon is environment. Hence organization design, and organizational choice, depends on the concept of uncertainty. Uncertainty can be associated with the mathematical concepts of probability and fuzziness (Klir&Folger, 1988) or propositions of bounded rationality (Nobre, 2008).

These two approaches to uncertainty are complementary to each other since the greater the amount of information that an organization needs to have an order to perform and to complete a task. Therefore contingency theory can be used to explain that of each of the changes in the business environment present a different challenge to managers to come up with responses to fit the situation

2.2.2 The Theory of Constraint

Silber (1975, 1983) presented the theory as one of the most influential theories of financial innovation. The theory considers product innovation as response of organization to the constraints placed up on it. Innovations have many causes. Firms may need to stop the loss of deposits, enter new geographic or product markets and deliver services with cheaper and better technology. In addition they may also want to increase their capital base, alter their tax position, reduce their risk profile or cut operating cost (McConnell and Shwarch, 1992).

White and frame (2002) stated that the profit seeking enterprise and individuals are constantly seeking new and improved product processes and organizational structure that will reduce their cost of production, better customer demands and yield greater profits. Drucker (1998) stated that most innovations result from a concise, purposeful research for innovation opportunities, which are only found in a few situations. The four areas where such opportunities exist within an organization include unexpected occurrences, incongruities process needs and industry and market changes. Opportunities outside the company in its social and intellectual environment include demographic and perception changes.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2.2.3 Theory of Financial Intermediation

Allen and Santomero (1996) observed that in traditional Arrow-Debreu model of resource allocation, firms and households interact through markets and financial intermediaries play no role. When markets are perfect and complete, the allocation of resources is Pareto efficient and there is no scope for intermediaries to improve welfare. Moreover Modigliani-Miller theorem applied in the context that financial structure does not matter: household can construct portfolios which offset any position taken by tan intermediary and intermediation cannot create value.

Leland and Pyle (1977) observed that banks provide cheaper capital to corporation than capital markets. James (1987) and Smith (1986) underscore that capital market financing were costly and disruptive. They separately documented positive returns to corporate shareholders following the announcement that a firm has obtained a loan from a commercial bank but negative return to shareholders following announcement of new equity security issues.

Leland and Pyle (1997), suggest that an intermediary can signal its informed status by investing its wealth in assets about which it has special knowledge. The authors suggest that financial intermediation which is difficult to explain in traditional models of financial equilibrium; can be viewed as natural response to asymmetric information.

2.3 Factors Determining Financial Performance in Microfinance

2.3.1 Macro-economic Environment Factors

Westley (2005) suggests that borrowers in the Caribbean countries are not used to the high interest rates charged by MFIs due to the long history of macroeconomic stability. Consequently, the demand for micro-financial services is low. Hartarska (2005) finds that microfinance

institutions are reaching more clients in the high inflation countries in the Central and East European states.

Westley (2005) states that regions with higher levels of income have less developed microfinance sectors. He offers two reasons. Firstly, micro-entrepreneurs with higher incomes have more opportunities to self finance through savings. Secondly, they may benefit more easily from informal finance through family and friends, as well as from formal finance.

Goldfajn and Rigobon (2000) shows that microeconomic stability, determined by stable inflation and real interest rates, plays a major role in financial sector development. According to Rhyne (2001), the process towards a more stable economy and especially lower inflation rates, attracts more potential microfinance providers. Vander Weele and Markovich (2001) provide evidence of the devastating effects of inflation and especially hyperinflation on the performance of microfinance institutions.

2.3.2 Infrastructure and Geographical Framework

Transaction and information costs influence financial development. In some cases they lead to market failures (Stiglitz and Weiss, 1981). Good interconnectivity between regions, the availability of electricity, communications and sanitation networks diminish these costs. A high population density also plays an important role in lowering these costs. According to Sriram and Kumar (2005), this can lead to two contradictory arguments. One reason could be that formal financial institutions may be more developed in regions with higher population density and good regional interconnectivity. Thus the need for specific microfinance institutions may not be

present. The second is that if the development of the two sectors is complimentary, these factors could eventually also stimulate the development of the microfinance sector.

Latin American evidence has shown that urban microfinance institutions are more common than rural ones (Rhyne, 2001). Schreiner andColombet (2001) argue that the absence of an adequate infrastructure plays a hindering role for the development of microfinance. Moreover Yaron and McDonald (1997) see the absence of good infrastructure and sparse populated areas as one of the main reasons why financial sectors in rural areas are so underdeveloped. Hulme and Moore (2006) also support the hypothesis that microfinance tends to develop much faster in dense populated areas.

2.3.3 Firm Specific Factors on Product Innovation

Microfinance institutions are affected by internal factors such as lack of leverage, liquidity and risk management challenges, distribution challenges and human resource challenges (Gathuku, 2010). Microfinance is a capital-intensive activity, and MFIs require sustained injections of capital for on-lending (Moussa, 2007). Most MFIs need to make intensive investments in promoting new and poor clients. Alarcon (2008) indicates that the most important constraint for MFIs not to expand their outreach is the limited sources of funds. Brugger (2004) notes that MFIs, like any other financial institution, must have a minimum amount of its own capital for reducing the risks of its lenders and depositors and that the costs of doing business are high relative to the value of loans and deposits involved. Smaller MFIs struggle to cover the high operational costs and diversify their product offerings in order to compete with larger microfinance providers (Gupta, 2008).

2.3.4 International Environment Factors

The international donor community has historically played an important role in subsidizing the emergence and further development of microfinance programs. As most institutions started as non-governmental organizations, external financial intervention was needed (Imboden, 2005). To gauge the extent of external intervention and international support, the amount of subsidies is a good indicator. During the last decade, the role of subsidies in microfinance has become a more controversial one. Yet, it is widely known that a lot of microfinance institutions still depend on subsidies (Morduch 1999). Although microfinance institutions are encouraged to become independent from donor subsidies, the role of start-up subsidies or 'smart-subsidies' is still seen as necessary and therefore favoured (Armendariz de Aghion and Morduch, 2005).

2.4 Empirical Literature

Bankakademie (2012) investigates the factors that influence product innovation in microfinance institutions in Kenya, including the legal environment , competitive pressure and organizational factors such as leverage, liquidity and risk management challenges, distribution and human resource challenges. Results from the study establish that there is a positive correlation between legal environment, liquidity management and human resources for MFIs and product innovation.

Richter et al cited in strong (2008) in their research on the contribution of microfinance to economic growth concluded that not much contribution came from that angle. They observed developed societies are wealthy because they are efficient. Microfinance then is a stop-gap measure that does not accelerate the pace at which economies transition from the rural to the

urban, from populations largely engaged in agriculture to populations largely engaged in manufacturing or I.T careers.

Mukama(2005) assessed the role of institutional lending policies of formal and credit institutions in determining the access to and use credit facilities by small scale entrepreneurs in rural Kenya. Conclusion from the study are; a large number of potential borrowers who did not seek credit do not mean that they do not need credit, only 15% of the sample was found to be not credit constrained. This result suggested that lack of supply creates lack of demand, displayed in the low revealed demand. This has resulted in the credit rationing by both informal and formal credit markets observed from the results and the creation of a credit gap in the market. Hence although the potential borrowers need credit, the lending terms and conditions prevent them from seeking credit. In the formal sector, these terms focus on concerns with default risk and high transaction costs. In the informal sector, the study suggests that the failure to seek loans is due top failure by the different lenders to offer credit package required by specific borrower categories.

Richter (2004) studies the role of Apex mechanism in Kenya and Uganda. The research investigates apex mechanism as one devise for channeling support to microfinance. In particular, it aimed at understanding how apex mechanism functions and how they contribute to sustainable expansion of microfinance. The research findings support both cautions and encouraging views micro-finance apex mechanism.

Roth (1997) in his study on microfinance and successful enterprise was a critical of the microfinance evangelists who create a vision of the rural poor as a collection of budding

entrepreneurs, waiting for salvation from the credit agencies, which on receipt of credit, will develop a successful micro enterprise and leave poverty forever. Their promotional activity gives rise to worrying spectra of a return to a "blueprint", implicit in the new microfinance approach to development. To respond to a potential demand for a good or service, a rural micro-entrepreneur may need access to one or more of the following; transport, communication, power, water, storage facilities, a legal system for enforcing contracts and settling disputes. Apart from infrastructure, micro entrepreneurs need access to information about market trends and skills to run their macro enterprise.

2.5 Deposit Taking Microfinance (DTMs)

The new institutional perspective suggests that firm obtains legitimacy by conforming to the dominant practices within their institutional field (DiMaggio & Powell, 1991). The microfinance ACT 2006 is an ACT of parliament that makes provision for the licensing, regulating and supervision of microfinance business and for connected purposes. It provides a regulatory framework for MFIs and pro poor programs. The Act applies to every deposit taking microfinance business and specialized non deposit taking microfinance business providing loans or other facilities to micro or small enterprises and low-income households.

Transformation of NGO microfinance institutions into regulated deposit taking institutions has been viewed as one of the key ways to create financial viability and scale among the MFIs, and to establish permanent sources of funding for them(Ledgerwood and White,2006). The proponents of microfinance regulation such as World Bank, consultative Group to Assist the Poor (CGAP) and the International donor communities argue that the future of microfinance lies

in developing a well-regulated microfinance environment that will allow the poor to access a wide variety of financial services (Gallardo,2001)

2.6 Challenges in Financial Performance and Conversion of Microfinance

Schreimer and Colombet (2001) highlights problems associated with the microfinance sector at four levels. The strategic level focuses on issues of outreach, the education level of staff and management information systems. Level two relates to the operational issues such as the profitability and sustainability aspects, relative to the high costs. The third level focuses on the aspect of marketing with regard to the diversity of products offered by the MFI. Finally, the fourth level deals with the capitalization issue with respect to access to capital.

2.6.1 Operational Issues

Adjasi et al., (2006) cited a study by Adams, et al. (1984) that interest rates and savings mobilization are among the problems that causes the lack of sustainability and the eventual failure of such financial schemes. Mukama, et al. (2005) similarly cite the cost component of assessing and processing of loan applications as being the same regardless of the size of the loan. The small loan amounts lead to high operational costs especially in view of the fact that micro-enterprises require relatively smaller loans than larger enterprises to start or expand their business.

Another cost driver of MFI operations cited is the issue of the perceived risk of lending to people without collateral and credit reference because MFIs need to consider the risks in the borrowed funds Ruit(2002). Ruit (2002) and Adjasi et al. (2006) identify the issue of perceived risk of

lending to people without adequate collateral and credit references as challenges to the MFIs operations because of possible moral hazard and adverse selection. Moral hazard and adverse selection mainly arise from information asymmetry.

Moral hazards refer to problems of repayments and defaults whilst adverse selection relates to inability to screen out those likely to default. Moral hazard occurs because of the inability of the MFIs to ensure that clients are attempting to fully make their investment projects successful or when the borrower tries to abscond with the money whilst adverse selection arises because MFIs are unable to easily determine the credit worthiness of clients (Aghion and Morduch, 2005). However, to circumvent the above mentioned challenges, group lending with joint liability can be an effective mechanism to enforce repayment. Peer monitoring in group lending with joint liability reduces the moral hazard of the group member because of the joint liability (Franklin and Manfred, 2006).

2.6.2 Strategic Issues

Staff productivity and efficiency are important aspects in microfinance service delivery. Ledgewood (1999) argues that the main responsibility for effective outreach and loan repayments remains with the loan officer. Provision of timely management information is valuable in effective delinquency management. In addition, Mukama (2005) stresses that the education level of staff and management is of utmost importance in that it puts better into perspective the necessary marketing conditions that translate into profitability, financial sustainability, enhanced equity loan book, improved quality service to attract customers, minimal fraud, savings mobilization, regulatory compliance and shareholders accountability.

2.6.3 Marketing Issues

Marketing for microfinance institutions is an important analytical tool to be informed about the client. It tackles to questions relating to who the MFI clients are, how many clients there are, the target market and the market share it hope to capture (Innovations in Microfinance, 2000). A target market represents a define market segment that contains identifiable clients who demand or represent a potential demand for microfinance services. Target markets are defined by the characteristics of the clients such as poverty level, gender, ethnicity and religion. In selecting a target market for microfinance services, MFIs need to spell out their own objectives, understand what inspires the clients, and assess whether the target market is reachable in a financially sustainable way (The Microfinance Gateway, 2005).

2.6.4 Regulatory Framework

A conducive policy, legislation and regulatory environment, and institutional capacity are prerequisites to a thriving microfinance sector development. The stability of financial and other markets enables micro enterprises and consequently microfinance services to become viable (Ledgerwood, 1999). Regulatory approaches of microfinance range from self-regulation in which the industry develops its own supervisory and governance bodies to full regulation through existing laws specific to MFIs. The aspect of regulation of the microfinance sector should be observed within the broader developmental agenda that recognizes the significance of the sector in reduction of poverty and contribution to wealth (Moyo, 2008).

The chapter tackled theoretical framework consisting of three theories that can explain the micro finance aspect, factors determining financial performance of the micro-finance institutions which

were converted to be DTMs, empirical literature written about the DTMs and also the challenges faced when converting MFIs to DTMs.

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Introduction

This chapter will discuss the research methodology to be used as the basis of this study. The chapter will also discuss the research design, data collection methods as well as data analysis and data presentation methods to be employed in the study.

3.2 Research Design

An event research design will be adopted in carrying out the study. An event study brings out an analysis of the present and future impact of a particular significant event related to a firm or a financial market. The study will determine whether the event already has or will have a significant effect on the firm or market.

3.3 Population

The populations in this study included three fully converted MFIs which include Faulu Kenya, Kenya Women Finance Trust; SMEP whereas Uwezo limited being a fully registered DTM was not in operation as a credit only MFI therefore data for comparison was not available. The institutions are fully registered with the CBK and licensed to carry on with the activities as a DTM institution. The financial performance parameters will be gathered.

3.4 Data Collection

Secondary data will be the main source for the study and will involve the collection of financial statements and reports for the two year period that is before the conversion and after conversion. The performance parameters to be used include total assets, net income, return on equity. Data will be presented in tables, graphs and charts to depict the chance in the parameters chosen for the period of the study

3.5 Research Model

This seeks to find the financial performance of the Institutions.

$$R.O.A = \frac{\text{Net income}}{\text{Average Total Assets}}$$

$$R.O.E = \frac{\text{Net income}}{\text{Total equity}}$$

R.O.A = Return on Asset

R.O.E = Return on Equity

ROI has an established position in the performance measurement of marketing actions and investments – the traditional computed ROI is the ratio of investment net present value to investment costs. The net present value, then, is usually defined as the sum of discounted future inbound net cash flows, i.e. profits. There are several definitions of "profit" and "return" in different fields of business, but in this thesis return is understood as the NPV of gross margin less

marketing investment costs. Consequently, a ROI figure of 0% would indicate a breakeven point – the profit is sufficient to cover the marketing investment costs but does not bring in additional cash flow.

If both the investment cost and net cash flows can be decomposed on different parts or levels of the overall investment, the ROI can also be computed separately for each part. In the customer relationship marketing context, this could mean that ROI can be assessed to a certain marketing campaign or separately to each different treatment belonging to that campaign.

The ROA ratio helps to indicate the condition of capital, assets quality, management, earning and liquidity position of different types of banks. Financial ratio analysis is also used to quantitatively examine the differences in performance among firms.

3.6 Data Analysis

Data collected from the above sources will be thoroughly examined and entered into the statistical package for social sciences (SPSS) version 10 for analysis; the information will be analyzed by the use of descriptive statistics with the use of ratios.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the data findings drawn from the research instrument and the information processes there-of by way of data analysis. This analysis presents evaluation on the effect on conversion from non-deposit microfinance institutions to deposit taking institutions on financial performance in Kenya.

4.2 Summary Statistics

4.2.1 Faulu Kenya

Table 4.1: ROA and ROE presentation for Faulu Kenya

	Before Conversion(2009)	After conversion(2011)
R.O.A	-1.68%	-3.58%
R.O.E	-11.1%	-29.7%

Source: Author

Table 4.1, shows the level of earning and performance as measured by Faulu Kenya. In 2009 (before conversion) the R.O.A was -1.68% and R.O.E stood at -11.1%, while in 2011(after conversion) the ROA was -3.58% and ROE turned to -29.7%which indicates that R.O.A and R.O.E not sufficient, making Faulu Kenya make a loss. The low ROA and ROE means that Faulu Kenya's assets are not being product and that they are not being managed well. In

2009,earning in terms of return on asset were deficient, earning was insufficient to support operations and maintain appropriate capital and interest levels, the DTM was characterized by event fluctuations in net income or interest margins. This was brought about by increase in cost of operation, infrastructural costs due to expansion of the branch network, nominal or unstable earnings, intermittent loses or a substantive drop in donations from the previous years .Therefore, high R.O.A and R.O.E is required by Faulu Kenya to attract private capital to achieve its mission of poverty alleviation. MFIs have a small asset base which impacts their profitability. The R.O.E for a majority of MFIs is mostly in the form of grants .The small equity bases for the MFIs mostly report a higher R.O.I for them .Other financial institutions like commercial banks have a higher R.O.E due to their other sources of income as well as income from their deposits whereas MFIs are not allowed to accept deposits. The similarity in R.O.E and R.O.A means that K.W.F.T carried no debt this is because R.O.A measures the total return to all providers of capital (debt and equity).

4.2.2 K.W.F.T

Table 4.2: R.O.A and R.O.E presentation for K.W.F.T

	Before Conversion(2010)	After conversion(2011)
R.O.A	1.89%	1.6%
R.O.E	1.98%	1.57%

Source: Author

Table 4.2 depicts that K.W.F.Ts earnings were satisfactory to support operations. In 2010(before conversion) the DTM recorded a high of 1.89% in R.O.E. The high return-on-assets ratio

indicates that the microfinances assets were productive and well managed which in turn translated to the microfinance institution being able to support its operations and maintain adequate capital.. Despite the fact that K.W.F.T maintained a lead in R.O.A in 2010, it experienced a declining R.O.A percentage of 1.6% in the following year (2011) after conversions. The declining trend in the R.O.A means that the institution assets were not being managed well, it can as well mean that the assets were depreciating in value hence the low return on assets. In 2010(before conversions) the institution recorded a high of 1.98% in R.O.E. This means that K.W.F.T had large equity bases thus reporting the high R.O.E ratio. However, the R.O.E declined in the following year to a low of 1.57% meaning that the DTM equity base decreased from the previous year. The decrease in the R.O.E indicates the low profits were generated by the institution from the money invested by its shareholders.

4.2.3 SMEP

Table 4.3: ROA and ROE presentation for SMEP

	Before Conversion(2010)	After conversion(2011)
R.O.A	1.02%	1.31%
R.O.E	2.06%	2.19%

Source: Author

Table 4.3 indicates that in 2010(before conversion) SMEP recorded a 1.02% in R.O.A and in the following year it recorded an increase in percentage of ROA to record a high of 1.31% in 2011(after conversions).This increase in R.O.A indicates that SMEP generated high earnings from its investments. These numbers also indicate that SMEP may have been better at turning its assets into revenues in 2010 than it was in 2011.

As for SMEPs R.O.E, the firm recorded a high shareholder's equity (the value of its assets was high than its liabilities) of 2.06% in 2010(before conversion) and a more higher percentage of 2.19% in the following year, 2011 (after conversions).The sustainable growth of in SMEPs R.O.E and ROA could be attributed to the financial funds received from either national and international organizations.

4.3 Overall Description of Earning Performance of the DTMs

With analysis of table 4.1, 4.2 and 4.3, in 2010 K.W.F.T and SMEP showed stable financial condition and strong performance while in 2009 and 2010 FAULU KENYA revealed weakness in earnings and hence supervisory requirement was needed. In 2011,K.W.F.T showed a decline in financial stability in terms of earnings, followed by SMEP which showed sound financial stability.

4.4 Discussions

Primary dimensions of microfinance institutions performance could be grouped into the three categories of effectiveness, efficiency, and adaptability. But there is little agreement as to which measure is best. Thus, any comparison of microfinance institutions performance with only these three dimensions involve substantial trade-offs: good performance on one dimension often means sacrificing performance on another microfinance institutions performance can be achieved through four dimensions of customer satisfaction: competitive pricing, product variety, delivery service, and product quality.

In an increasing business competitive environment, MFIs and the DTMs in specific should balance their growth objectives with the need to improve the quality of client services and ensure the long term sustainability of client relationships. More emphasis will be needed to regularly assess client satisfaction and the behavioral dynamics of markets. DTMs must adapt their systems to meet the complete credit needs of their clients. This would imply being able to provide loans that are compatible with the needs of the client. Most DTMs need to make intensive investments in promoting new products that target the needs of poor clients. Typically these new clients with low levels of economic activity start with very small loans, which in turn imply high transaction costs for the DTMs. With the growth of the economic activities of the clients, their loan repayments also increase. DTMs should be able to cater for higher loan demands by clients as their businesses expand.

4.5 Summary

Profitability in DTMs is determined by the ability of the institution to retain capital, absorb loan losses, support future growth of assets and provide return to investors. In this study profitability was measured by two ratios which are, return on assets and return on equity. Return on equity directly reflects corporate competitiveness strength and sustainable growth. It is an important indicator in the attractiveness of the equity in the eyes of investors. Return on Asset effectively reflects corporate profitability which can be used to evaluate the performance of management in the utilization of the assets. It is calculated by dividing net income by average value of total assets over the same period. This intends to measure DTMs efficiency using its asset. Net interest income to average interest bearing assets; this ratio is calculated by taking total interest income less total interest expenses divided by average of the bearing assets. This intend to measure DTMs efficiency in using its bearing assets.

CHAPTER FIVE

SUMMARY AND CONCLUSION

5.1 Introduction

This chapter presents the summary of the study, conclusion, limitations of the study and recommendations.

5.2 Summary of the Study

Profitability in DTMs is determined by the ability of the institution to retain capital, absorb loan losses, support future growth of assets and earning hence provide reasonable level of return to investors. In this study profitability was measured by two ratios which are, return on assets and return on equity. Return on equity directly reflects corporate competitiveness strength and sustainable growth. It is an important indicator in the attractiveness of the equity in the eyes of investors. Return on Asset effectively reflects corporate profitability which can be used to evaluate the performance of management in the utilization of the assets. It is calculated by dividing net income by average value of total assets over the same period. This intend to measure DTM efficiency using its asset. Net interest income to average interest bearing assets; this ratio is calculated by taking total interest income less total interest expenses divided by average of the bearing assets. This intend to measure bank efficiency in using its bearing assets.

5.3 Conclusion

Microfinance has been an important tool in poverty alleviation, empowerment of women and in bringing about financial inclusion. There exists a great opportunity for the microfinance sector to

provide credit to the low income population thereby reducing poverty and thus in the development of the country as a whole. Although the microfinance sector has reported an impressive growth, with the ordinances passed by the government, there is lack of capital for some of the microfinance institutions in the country. Therefore, continuous efforts are required to diversify the sources of funding available for the microfinance institutions in order to attract funds from private equity firms and other institutions in order to sustain its expansion plan in order to serve the rural low income population, increase efficiency of staff members, alleviate poverty and also make them profitable. The awareness in promoting the microfinance sector and to incorporate financial inclusion, many DTMs have become committed in providing their service. The government has also taken an increasing interest in promoting the sector.

The government is required to develop legal and regulatory framework for the microfinance sector in order to promote its growth and in turn achieve the objective of poverty alleviation and Contributing to the development of the country. Though the performance of microfinance institutions have improved significantly over the past years, sufficient regulatory and governance would help achieve the goal of poverty alleviation and financial inclusion and this could be achieved with the combined cooperation of banks, government and other players in the country. Thus with development of effective strategies and with the combined effort of all players in the society such as donors, government, banks, corporations, NGOs, etc, the long term goal of the government to achieve financial inclusion and poverty alleviation would be attained.

5.4 Limitations of the Study

The researcher is likely to encounter various limitations that tend to hinder access to information sought by the study.

The researcher is likely to encounter problems of time as the research is being undertaken in a short period which limits time for doing a wider research. Some of the microfinance firms may withhold the R.O.A and R.O.E data due to confidentiality. The researcher is also likely to run out of funds during the research since no sponsorship is done.

5.5 Recommendations

Microfinance institutions have faced a lot of issues about its performance and sustainability. Microfinance institutions have been viewed as an important tool in poverty alleviation and financial inclusion. It is an important sector which would improve the living conditions of the poor and lead to the development of the country. Some of the issues faced by microfinance institutions include high interest rates, multiple lending, coercive methods of recovery and lack of transparency.

The MFIs incur high operating costs because of their business model which is the door step service delivery model. They incur these costs because of training of staff and small loan sizes. These higher operational costs are the major reason for the higher interest rates of the MFIs. These operating costs could be reduced by the use of technology. Mobile banking would also provide a valuable tool for reducing costs. Technology is an important tool in building operating system for identification of borrowers and communication of data. In order to be profitable and self sufficient, some of the MFIs make larger, more profitable loans to more viable clients and this hinders the goal of providing credit to the poor. In order to avoid such issues, a separate regulatory authority is required for the MFIs in order to achieve development of the country.

The microfinance institutions lack transparency. Central Bank of Kenya should set up a regulatory authority to monitor the performance of the microfinance institutions. Though the microfinance institutions follow the norms and standards set by the R.B.I, a separate regulatory authority would more efficiently monitor the performance of the MFIs. Sufficient microfinance institutions should be allowed to accept deposits from the public. This would improve the profit margins for the microfinance institutions as well as reduce the interest rates.

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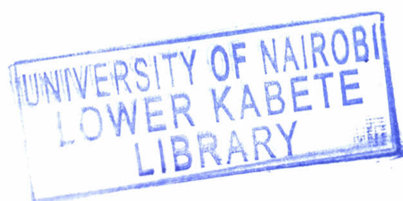

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