

# ROLE OF LEGAL COMPLIANCE IN TRANSFORMATION OF MICROFINANCE INSTITUTIONS INTO MICROFINANCE BANKS IN KENYA

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## **Abstract**

The purpose of this study was to establish the role of legal compliance in the transformation of microfinance institutions into microfinance banks in Kenya. The target population was 48 members of the Association of Microfinance Institutions as at 1<sup>st</sup> January 2013. Using purposive sampling, the study selected 25 institutions from which 100 respondents were selected using simple random sampling. A questionnaire was used to collect data. This study established that legal compliance had a significant effect on the transformation of microfinance institutions into microfinance banks in Kenya. Thus, it concluded that legal compliance played a significant role in the transformation of microfinance institutions into microfinance banks in Kenya. The study recommends that for transforming Microfinance Institutions to comply with the legal requirements with ease, they should first fully understand the licensing process. The study also recommends further research to determine the impact of regulating microfinance in Kenya.

Key words: Microfinance, Microfinance Institution, Transformation, Licensing, Legal compliance, Microfinance Bank.



## 1.0 INTRODUCTION

## 1.1 Background to the Study

It is widely acknowledged that there is a strong correlation between access to financial services and economic development (Christen, Rosenberg, & Jayadeva, 2004). Increasing access to financial services contributes to employment creation, economic growth, and overall human development. Nevertheless, about three billion working-age people in the world still lack access to a wide range of financial products and services on a sustainable basis (Christen, Rhyne, Vogel, & McKean, 1995).

The formal banking sector is estimated to be reaching less than 20% of the population in developing countries (Robinson, 2001). The rest of the population, typically composed of the low-income households and informal and small enterprises, has historically not had access to formal financial services (Chiumya, 2006). This has negative effects in the economy. For example, limited access to financial services has over the years been identified as one of the major constraints to the growth of the Micro and Small Enterprises (MSEs) sector in Kenya (Central Bureau of Statistics, International Centre for Economic Growth, & K-Rep Holdings, 1999; Republic of Kenya, 2005). Yet, the MSE sector has immense potential to make a significant contribution to the economic development of the country (Republic of Kenya, 1992; 2005; Gichira, 2005).

The problem of limited access to credit has further been shown to be more as a result of supplyside constraints (Atieno, 2001). Consequently, Microfinance Institutions (MFIs) emerged in the

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1970s and have been testing and developing a practical approach to serve those historically excluded from accessing financial services from the formal banking sector. One popular view has been that major increases in microfinance outreach needs to come from banks. This is based on the comparison of size of the typical bank and the typical microfinance institution and the fact that most of the large microlenders like Grameen, BRI, and Bancosol are banks.

Just like has happened globally, Kenya has 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), which greatly hampered their capacity to grow and serve large numbers of the target clients (KIPPRA, 2001). The enactment of the Microfinance Act 2006 (Republic of Kenya, 2006) addressed this situation by providing for the regulation and supervision of microfinance banks in Kenya. This was expected to stimulate rapid growth in the microfinance sector as microfinance banks would be able to lawfully to mobilize deposits from the public and use the same funds for on-lending.

## 1.2 Statement of the Problem

Research studies have shown that only 19% of the Kenyan adult population uses financial services from the formal financial institutions which are regulated by the monetary authority like banks and building societies and post office savings bank (Arora & Ferrand, 2007). 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. As such, 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. Overall, those who access financial services from informal sources and those who are not served by any source total to 73% of the adult population. According to Arora and Ferrand (2007), this implies that Kenya faces a great challenge in her efforts at developing an inclusive financial system. As such, Kenya needs to raise the formal access to 50% in order to achieve her Vision 2030 development targets.

The global trend in the efforts to improve access to finance is to move microfinance into institutions that are licensed and supervised by a country's financial authorities (Hishigsuren, 2006). For instance, by March 2006, about 43 non-governmental organization (NGO) microfinance institutions (MFIs) were transformed worldwide (Hishigsuren, 2006). One of the models being used to achieve that significant outreach is the transformation of microfinance organizations into microfinance institutions and microfinance banks.

In Kenya, the Microfinance Act 2006 was enacted with the hope that it would facilitate transformations. However, by 2010, only three MFIs had transformed. This small number of transformations in Kenya was attributed to diverse challenges faced during the transformation process (Frankfurt School of Finance & Management, 2012). The experience from other countries like Bolivia, Cambodia, India, Mongolia, Nepal, Pakistan, Philippines, Uganda, and Peru indicates that the transforming microfinance institutions faced numerous challenges in complying with various legal requirements. These are incorporation of business, application for license and accompanying documentation, issuance of license, and fit and proper test (Campion



& White, 1999, Hishigsuren, 2006). However, the available information was not conclusive on the specific legal compliance challenges and their effect on transforming MFIs in Kenya. This study, therefore, sought to establish the role of legal compliance in the transformation of microfinance institutions into microfinance banks in Kenya.

## 1.3 Specific Objective of the Study

This study addressed the following specific objective:

1) To determine the effect of legal compliance on the transformation of microfinance institutions into deposit taking financial institutions in Kenya.

# 1.4 Hypothesis

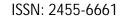
This study was guided and tested the following Null Hypothesis:

H<sub>0</sub>: There is no significant effect of legal compliance on the transformation of institutions into microfinance banks in Kenya.

## 2.0 LITERATURE REVIEW

## 2.1 Introduction

The outcome of successful compliance with legal requirements in MFI transformation is to be issued with a license to operate as a microfinance bank. Research studies in different countries suggest that this licensing process was the most difficult aspect of transformation for most institutions (Hishigsuren, 2006). Transforming MFIs had difficulties in meeting the legal requirements of an acceptable ownership and management structure (Hishigsuren, 2006; Lauer, 2008). An MFI that fails this 'fit and proper' test is denied registration. For instance, the





approval may be denied if the original NGO owns a major shareholding in the proposed microfinance bank.

In Kenya, the Microfinance Act 2006 and regulations spell out the process and licensing requirements for a microfinance bank (Republic of Kenya, 2006; Republic of Kenya, 2008). The regulations split the licensing process into three broad stages, namely, approval of the name, application for license and meeting documentation requirements, and finally the issuance of letter of intent and license (CBK, 2008).

# 2.2 Legal Compliance and MFI Transformation

The first step for an MFI seeking to transform into a microfinance bank under the Microfinance Act 2006 is to make a search and reserve three names with the Registrar of Companies and Business Names (CBK, 2008). Names that have close similarities to existing institutions which may cause confusion, or those that may offend the public or lean towards religious, political, or ethnic inclinations are not acceptable. The applicant should then submit the names to the CBK clearance (CBK, 2008). Once the proposed names are approved by CBK, the applicant can proceed to incorporate, or change the name of the company.

In the second stage, the institution completes and submits an application form with supporting documents attached, duly certified as true copies of the original by a commissioner of oaths or public notary (CBK, 2008). The main documents of which copies should be attached include Certificate of Incorporation, Tax Personal Identification Number (PIN) Certificate, Registered Memorandum and Articles of Association indicating the core capital, verified Official



Notification of Company's Registered Place of Business and the prospective places of business (head office and, branches, agency and outlets, if any). One should also attach payment (banker's cheque) for the appropriate non-refundable application fee.

The CBK then issues a letter of intent upon fulfilment of stage 1 and 2 requirements (CBK, 2008). The letter advises the applicant on the next steps and requirements to be fulfilled before issuance of a license and approval to commence operations. Once satisfied that the institution has fulfilled all the requirements, the CBK issues a license and the microfinance bank starts operations. The CBK also publishes the name of the new microfinance bank in the Kenya gazette within 14 days.

Whereas the process appears linear and simplistic, in reality, the applicants move back and forth as they complete various activities due to the stringent requirements at each step. Indeed, it is prudent for a transforming MFI not only to reach out to CBK to walk along with it but also to strive to meet most, if not all, of the requirements before formally starting the process.

#### 3.0 RESEARCH METHODOLOGY

#### 3.1 Introduction

This section presents the methodology that was followed in carrying out this study. The section is organized in four sub-sections, namely: Introduction, Research Design; Target Population, Sample and Sampling Procedures; and Research Instruments and Data Collection and Analysis.



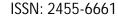
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## 3.2 Research Design

This study used the mixed methods approach, the modern approach to designing and conducting research which is becoming quite common in studies across disciplines such as social, behavioural, health sciences and education. According to Creswell and Clark (2006), the mixed methods approach is a procedure for collecting, analyzing, and mixing both quantitative and qualitative data in a single case study or a series of studies.

This study used interviewing, a qualitative method, and descriptive and regression analysis, both quantitative methods. Qualitative research sought to describe and analyze the culture and behaviour of humans and their groups from the point of view of those being studied (Orodho & Kombo, 2002; Kombo & Tromp, 2006). In qualitative research, feelings and insights are considered important. The designs here rely on a research strategy that is flexible and interactive, such as interviewing and focus group discussions. This study thus used interviewing in order to capture the feelings and insights of the microfinance institutions. According to Kombo and Tromp (2006), the qualitative approach is applicable when the subject matter is unfamiliar and the study seeks to relate particular aspects of behaviour to the wider context. It is also applicable when meanings rather than mere frequencies are sought and when flexibility of approach is needed to allow for discovery of the unexpected and in-depth investigation of particular topics.

At the same time, the 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.

## 3.3 Target Population, Sample and Sampling Procedures

The sampling frame was the AMFI on-line register of members as at 1<sup>st</sup> 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 sampling frame, wholesale MFIs as well as non-microfinance institutions were eliminated. In this way, a total of twenty five institutions were selected. Simple random sampling was then used to select 4 respondents from each selected institution. Simple random sampling is a technique that allows the researcher to select a sample without bias from the target or accessible population (Mugenda & Mugenda, 1999; Mutai, 2000; Kothari, 2012; Chandran, 2004; Oso & Onen, 2009). Ultimately, a total of one hundred respondents were selected from the sampled institutions.



# 3.4 Research Instruments and Data Collection and Analysis

This study used a questionnaire 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 field data collection, all the questionnaires were coded as part of 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.

The data was first explored for the underlying factor structure among the study variables through factor analysis. Factor analysis was done using Principal Component Analysis (PCA) which helped in reducing the number of variables into fewer factors of similar characteristics. The extracted variables were then explored using descriptive statistics and logistic regression.

Data analysis was then carried out using descriptive and inferential statistics. Descriptive data analysis was done first and it consisted of measuring numerical values from which descriptions (such as the mean and mode) were worked out for various data items. Inferential statistical analysis was then used to test for the existence of relationships between the variables.

## 4.0 RESULTS AND DISCUSSION

## 4.1 Introduction

This section contains the presentation and discussion of the findings of this study. The objective of the study was to determine the effect of legal compliance on the transformation of microfinance institutions into deposit taking financial institutions in Kenya. The independent

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variable was legal compliance while the dependent variable was MFI transformation status. Results of descriptive analysis are presented first followed by results of inferential analysis. The section is organized in three sun-sections: Introduction; Response Rate; and Legal Compliance and MFI Transformation in Kenya.

# 4.2 Response Rate

The study targeted all the 48 institutions that were members of AMFI by 1<sup>st</sup> January 2013. From the target population, a sample of 25 retail MFIs was drawn. From each of the 25 institutions, the study randomly selected four respondents. As such, questionnaires were distributed to a total of 100 respondents. The results on the questionnaire return rate are presented in Table 4.1.

**Table 4.1: Questionnaire Return Rate** 

Participants	Questionnaires	Questionnaires	Percentage
	issued	returned	returned
Individual respondents	100	60	60
Institutions involved	25	18	72

Sixty questionnaires were returned by respondents from 18 out of the 25 institutions sampled by the study. This represented an overall response rate of 60 % of individual respondents and 72% of institutions involved in the study. Babbie (2002) observes that in descriptive research, a response rate of above 50% is adequate for analysis. The response for this study was, therefore, considered adequate and was attributed to the largely face to face administration of the



questionnaires. It was also consistent with the expected return rate of about 75% for face to face administered questionnaires (Saunders, Lewis & Thornhill, 2007).

## 4.3 Legal Compliance and MFI Transformation in Kenya

The objective of the study was to establish to what extent legal compliance is a significant challenge in the transformation of microfinance institutions into microfinance banks in Kenya. The respondents were asked to indicate the level of difficulty in complying with the requirements of various steps of the licensing process. The responses were measured on a four point Likert scale of 1 to 4 with 1 as 'very low', 2 as 'low', 3 as 'high', and 4 as 'very high' level of difficulty. Descriptive statistics were calculated and the results are presented in Table 4.2.



**Table 4.2: Descriptive Statistics for Level of Difficulty with Legal Compliance** 

Item	N	Mean
Name Search - Registrar of Business Names		1.97
Name approval by CBK		2.28
Application form and support documents		2.82
Providing Evidence of Capital		1.98
Submitting Feasibility Study and Business Plan		2.30
Fit and Proper forms – Individual		2.83
Fit and Proper forms - Corporate		2.66
Other Requirements Local Applicants	43	3.05
Meeting Other requirements - Foreign Subsidiaries	38	1.53
Getting Letter of Intent and Final Steps		2.37
Getting Issued with License	40	3.05

Key:

Mean of 1.00 - 2.44: Low level of difficulty

Mean of 2.45 - 4.00: High level of difficulty

The findings presented in Table 4.2 show that two steps in the licensing process presented the highest level of difficulty (3.05). These were meeting other requirements for local applicants and issuance of license while the step with the least level of difficulty was meeting other requirements for foreign subsidiaries (1.53). Getting issued with a license had the highest level of difficulty the step is outside the control of MFIs. Even after an MFI meets all the requirements, it has to wait for the CBK to issue the license. The latter is subject to bureaucracy which can



seriously slow down the transformation process. Likewise, before getting the license, an MFI cannot start operations as a microfinance bank.

The findings were further subjected to factor and regression analysis. Factor analysis was used so as to decompose the information contained in a set of variables into information about an inherent set of latent components or factors. This assisted in reducing a number of variables into fewer factors which are of similar characteristics and isolate factors with main effects to the characteristics of the dependent variable (successful transformation of the MFI).

The correlation matrix of the factors making up the legal compliance scale revealed that there were twenty one (21) factors at 95% and 99% confidence interval with correlation coefficients of 0.3 and above. Thus the data for these variables was considered suitable for factor analysis.

Further extraction revealed a total of four factors with eigenvalues of 1 and above and these accounted for 74.6% of the variance. Through Principal Component Analysis (PCA) method, four factors were extracted. These are presented in Table 4.3.



**Table 4.3: Structure Matrix and Means for Legal Compliance** 

	Component			
	1	2	3	4
Submitting Feasibility Study and Business Plan				
Name Search - Registrar of Business Names		.325		
Providing Evidence of Capital		354		345
Meeting Other requirements - Foreign Subsidiaries		456		431
Application Form		.736		.308
Name Approval		.722		
Getting Issued with License			.936	
Getting Letter of Intent and Final Steps			.798	469
Other Requirements Local Applicants		.315		.890
Fit And Proper forms for Individuals	450			.799
Fit And Proper forms for Corporates		.646		.727
Means	1.99	2.54	2.73	2.85

# Key:

- Variable Extraction Method: Principal Component Analysis; Rotation Method: Oblimin with Kaiser Normalization.
- Criteria for factor analysis: loading of 0.5 and above on a component was accepted.
- The factor "fit and proper forms for corporates" loads strongly on components 2 and 4. However, it conceptually fitted more with the other factors in component 4. It was thus analysed as part of component 4.
- Mean of 1.00 2.44: Low level of difficulty
- Mean of 2.45 4.00: High level of difficulty



The resultant four components were re-named as: component 1 (incorporation of business), component 2 (application for license and documentation), component 3 (issuance of license), and component 4 (fit and proper test). Component 1 (incorporation of business) comprised of four variables. These were submitting feasibility study and business plan, name search - registrar of business names, providing evidence of capital and meeting other requirements for foreign subsidiaries. Component 2 (application for license and documentation) comprised of two variables. These were application form and support documents and name approval by the central bank. Component 3 (issuance of license) comprised of two variables. These were getting issued with license and getting letter of intent and final steps. Component 4 (fit and proper test) comprised of three variables. These were meeting other requirements for local applicants, submitting "fit and proper forms" for individual shareholders, and submitting "fit and proper forms" for corporate shareholders.

The means for the re-named factors were calculated using the average scores for each factor (see Table 4.3). The findings show that only one factor (incorporation of business) had a low level of difficulty (1.99). All the other factors had high level of difficulty with fit & proper test having the highest level of difficulty (2.85). This is explained by the fact that incorporation of business is a process that involves the MFI and the Registrar of Companies rather than the CBK. All the other factors involve dealing with the CBK, within the guidelines issued by CBK under the Microfinance Act 2006.

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Direct logistic regression was then performed to assess the impact of a number of factors on the likelihood that respondents would report successful transformation. The null hypothesis was stated as follows:

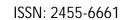
 $H_0$  There is no significant effect of legal compliance on the transformation of microfinance institutions into microfinance banks in Kenya.

Direct logistic regression was chosen because it is the appropriate technique where the dependent variable is dichotomous or categorical (Morgan & Griego, 1998; Pallant, 2007; Nicol & Pexman, 2010). In this study, the dependent variable (transformation status) was categorical (transformed / not transformed). The model contained four independent variables (incorporation of business, application for license and documentation, issuance of license, and fit and proper test). The results are presented in Table 4.4.

Table 4.4: Logistic Regression Predicting Likelihood of Reporting Successful
Transformation from Legal Compliance Factors

Component	Df	Sig.	Exp(B) (Odds Ratio)
Incorporation of business	1	0.01	0.13
Application for License & Documentation	1	0.38	2.43
Issuance of License	1	0.50	0.64
Fit & Proper Test	1	0.484	0.488
Constant	1	0.171	189.180

n = 38





 $\chi^2 = 12.862$ ; df = 4; Sig. = 0.012.

Cox and Snell R square (0.287); Nagelkerke R square (0.384).

The full model containing all predictors was statistically significant,  $\chi^2$  (4, N=38) = 12.862, P=0.012 indicating that the model was able to distinguish between respondents who reported and did not report successful transformation (see Table 4.4). The model as whole explained between 28.7% (Cox and Snell R square) and 38.4% (Nagelkerke R square) of the variance in transformation status, and correctly classified 68.4% of cases. Only one of the independent variables (incorporation of business) made a unique statistically significant contribution to the model. The strongest predictor of reporting successful transformation was application for license and providing supporting documentation, recording an odds ratio of 2.43. This indicates that respondents who had difficulty with the requirements for application for license and providing supporting documentation were 2.4 times less likely to report successful transformation than those who did not have a difficulty with that requirement, controlling for all other factors in the model. Based on the results, the null hypothesis ( $H_0$ ) there is no significant effect of legal compliance on the transformation of microfinance institutions into microfinance banks in Kenya was rejected.

The above findings are consistent with the findings of the case studies in Kenya on the transformation of K-Rep, KWFT, and Faulu (Rosenngard *et al.*, 2000; Frankfurt School of Finance and Management, 2012). The case studies showed that compliance with CBK regulations is both time and resource consuming which narrows the chances of effective institutional transformation. This explains why, whereas nearly 15 MFIs were expected to



transform within two years from the date of implementation of the Act, by the end of 2010 only three had successfully completed the process and been granted a license. Faulu Kenya Microfinance Bank Limited was licensed in May 2009, Kenya Women Finance Trust Microfinance Bank Limited in April 2010, and Uwezo Microfinance Bank Limited in November 2010. Nevertheless, over 30 more institutions had passed the initial stage of approval, that is, approval of business name by the end of 2009.

When applying for a license, an MFI is required to provide various supporting documents, duly certified as true copies of the original by a commissioner of oaths or public notary (CBK, 2008). The documents to be attached include Certificate of Incorporation, Tax Personal Identification Number (PIN) Certificate, Registered Memorandum and Articles of Association indicating the core capital, verified Official Notification of Company's Registered Place of Business and the prospective places of business (head office and, branches, agency and outlets, if any). One should also attach payment (banker's cheque) for the appropriate non-refundable application fee. It, therefore, follows that if an MFI has difficulties providing the above supporting documents, it will most likely not report successful transformation.

## 5.0 CONCLUSION AND RECOMMENDATIONS

## 5.1 Conclusion

The full model containing all predictors was statistically significant, indicating that the model was able to distinguish between respondents who reported and those who did not report successful transformation. This study found out that legal compliance had a significant effect on the transformation of microfinance institutions into microfinance banks in Kenya. Thus, the

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study concluded that legal compliance played a significant role in the transformation of microfinance institutions into microfinance banks in Kenya.

#### 5.2 Recommendations

Based on the findings, this study recommends that all players in the sector need to appreciate that the steps in the licensing process are not sequential. Transforming MFIs thus need to understand the steps in the whole transformation process upfront in order to be well prepared to meet the requirements of each step.

This study recommends further research to determine the impact of the regulation of microfinance in Kenya. It also recommends a study to determine the impact of MFI transformation on overall financial inclusion.

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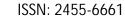
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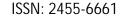
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