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MFI Institutional Policies and the Transformation of Micro, Small and Medium Enterprises in Kenya

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ABSTRACT

In the recent past, micro-financing has gained prominence among poor and developing countries of Asia, Latin America, Eastern Europe and Africa as a financial tool and solution to the challenges faced by micro, small and medium sized enterprises. The growth and prominence of micro-financing has been propelled and influenced by the intensive search for solutions to poverty alleviation. The general objective of this study was to establish the influence of Microfinance Institutions in transforming micro, small and medium enterprises in Kenya. This study relied on a positivist research philosophy and used a cross-sectional research design, in the form of a survey. The target population of the study was 45 micro finance institutions registered as members of AMFI Kenya. A sample of 135 respondents was selected using stratified random sampling, 3 from each MFI. Respondents were grouped into three strata; top management, middle management and supervisory employees. Pilot testing was done equivalent to 10% of the sample size (14 respondents) from MFIs other than those sampled in the study. This study used primary data that was collected using questionnaires**.** Data was analyzed and presented using the Statistical Package for Social Sciences (SPSS). In addition, spreadsheets were used to supplement SPSS by presenting results in the form of bar graphs, pie charts and frequency tables. Information was sorted, coded and input into the statistical package for social sciences (SPSS) for production of graphs, tables, descriptive statistics and inferential statistics. The study established that, a critical priority of the MFIs is to develop a regulatory and business environment that removes impediments to accessing and providing financial support to the MSMEs. The study also revealed that in order to address the challenges brought about the changing customer needs and tastes, MFIs should ensure that policy and regularity instruments applied on MSMEs clients are developed on the basis of timely research and empirical data that clearly shows market trends. These findings will significantly benefit policy makers. MFI finance managers, credit officers, as well as officials in leadership and governance to develop effective policy to regulate the operations of MFIs in a bid to transform the ever increasing number of MSMEs in Kenya. Awareness of challenges and suggested solutions will enable government and policy institutions to optimize operations of micro, small and medium enterprises. These results will also benefit scholars, researchers and students in terms of opening up a new frontier of information that will enhance their understanding on this important and steadily growing thematic area of the operations of the MSMEs and micro-financing in Kenya, as well as suggestions for future studies. The study makes two recommendations for further studies.

Key Words: Micro, Small and Medium Enterprises; Financial Performance; Transformation and Viability

INTRODUCTION

Micro-finance institutions are considered to be making a significant contribution in the provision of financial and non financial services to the Micro, small and medium enterprises (MSMEs) sector. This sector is increasingly seen as playing an important role in the economies of many countries. Governments throughout the world focus on the development of the MSME sector to promote economic growth. In South Africa, MSMEs contribute 56% of private sector employment and 36% of the gross domestic product (Ntsika, 2002). South Africa, like the rest of Sub-Sub Saharan Africa suffers from high unemployment with an official estimate of approximately 24.5% of the economically active population unemployed as published in the Statistics South Africa's Quarterly Labour Force Survey of 2009. Mahadea (2008) argued that the contribution of the MSME sector cannot be sustained without the creation and support of new MSMEs. The survival rate of SMEs (small and medium enterprises) is relatively low, according to Ligthelm & Cant (2002). The authors argue that less than half of newly established businesses survive beyond five years. This is not only true for South Africa, but also a common phenomenon in the rest of the world. In the South African economy, more than one million jobs have been shed since 1990, bringing the unemployment rate, by February 2002, at 28 percent. The SME sector is widely regarded as the driving force in economic growth and job creation in both developed and developing countries (Sunter, 2000). The important contribution that SMEs can make to employment and income generation is recognized around the world, and in particular in South Africa.

According to Brink, Cant and Ligthelm (2003), it is estimated that the failure rate of micro, small, medium and micro enterprises (MSMEs) is between 70% and 80%. In a paper presented at the 16th annual conference on Small Enterprise Association in Australia and New Zealand, Brink, Cant and Ligthelm (2003) observed that millions of Rands (local South African currency) are being lost on business ventures because of essentially avoidable mistakes and problems. They contend that often the ideas are good and the people behind them are competent, but "they do not have a clue of how to run a business" and have no underlying appreciation of business fundamentals. These scholars state that the problems encountered by small businesses are numerous and can be described amongst others as being environmental, financial or managerial in nature.

Micro, Small and Medium Enterprises (MSMESs) across Africa face many and varied challenges to their growth and operations (Wanjohi, 2009; UNIDO, 2002). These challenges include: inadequate office space, poor infrastructures such as electricity and water services, expensive internet connectivity, inflexible lease terms and poor human skills. The authors contend most of the MSMEs are also located in un-unattractive locations, thus projecting a negative image to potential customers. A study by Wanjohi (2009) and Ndagu and Obuobi (2010) revealed that often such organizations operate from garage floors of a house, or are located in a crowded market area. Image is important for an aspiring MSME (Njagi, 2011) that is trying to establish its credibility, especially one that has just a few employees and is seeking to get service contracts from larger corporations.

Ryne and Otero (2006) argue that most MSMEs are launched by aspiring entrepreneurs who have had no previous experience, possibly even little exposure to a mature corporate environment. These scholars further argue that the enterprises are not planned appropriately, markets are not assessed, products not commercialized, marketing not adequate or imaginative, and good corporate governance frequently lacking. Other challenges faced by MSMEs which affect their growth and profitability, thus diminishing their ability to contribute effectively to sustainable development include: a weak and underdeveloped business environment, complex entry regulations, tedious red tape registration and certification processes, high incidences of corruption, lack of credit, inadequate business skills and infliction of pandemic diseases such as HIV/Aids. These challenges provide few incentives to MSMEs to become (or remain) active in the formal part of the economy There is a major crisis across Africa (Ndagu and Obuobi, 2010; Owualah, 2007; Otero, 1999 and Kereta, 2007) that is also fueled by the nature of a tight labour market and few good opportunities for employment for the annual graduating students where they can watch and learn best practices. These authors contend that individual entrepreneurs have: little access to financial products and services, little training in project management and scheduling, and are unaware of basic business practices like feasibility studies. For these and many other reasons discussed above, in many of these countries, a large share of MSMEs is not participating in the formal economic development.

The key concern of micro-financing institutions is the provision of high-quality and affordable financial and non financial services such as savings, credit, insurance, payments, and money transfers to low-income people to enable them finance income-generating activities, build assets, stabilize consumption, and protect themselves against risks (Banerjee, Duflo, Glennerster and Kinnan, 2009). Micro-financing is not a new concept; it dates back to the 19th century when money lenders were informally performing the role of the current banking institutions. The informal financial institutions which included village banks, cooperative credit unions, and social venture capital funds helped provide the poor with savings and credit services to finance their micro, small and medium enterprises. They mobilized savings based on established and accepted procedures by the low income clients (Coleman, 2006). In the last two decades, there has been growing enthusiasm for promoting micro-financing as a strategy for poverty alleviation (Coleamn, 2006; Hermes & Lensik, 2011; Yunus, 2007). These authors furthers contend that the micro-finance sector has blossomed in many countries, leading to multiple financial services firms serving the needs of micro entrepreneurs and poor households and also led to the formation of the Grameen Bank in Bangladesh in 1983. Micro financing has gained prominence (Sengupta & Aubuchon, 2008) among poor and developing countries of Asia, Latin America, Eastern Europe and Africa. According to these scholars, the growth and prominence of micro-financing has been propelled and influenced by the intensive search for solutions to poverty alleviation. Micro-financing is now accepted to be the provision of a full range of financial services which include: savings, credit, micro leasing and micro insurance to low-income earners (Littlefield, Morduch & Hashemi, 2008).

Bank Rakyat Indonesia (BRI), another flagship of the micro-financing movement in the form of village banking unit system the largest micro-financing institution and state-owned bank in developing countries was also formed in 1980s It currently serves over 22 million microsavers through autonomously managed micro-banks (Mallick, 2011; Rhyne & Otero, 2006; Otero, 1999). A study by CGAP (2008) revealed that institutions offering micro-finance services in recent years have grown both in outreach and asset base raising safety concerns on such micro-finance operations. Many countries have opted to regulate these operations at varying degrees (CGAP, 2008). The CGAP (2003) defines regulation as binding rules governing the conduct of legal entities and individuals, whether they are adopted by a legislative body or an executive body. Two forms of regulations exist, namely: prudential and non-prudential. Institutions that mobilize deposits threaten the security of the financial sector and pose a risk to depositors hence require prudential regulation (CGAP, 2003). Institutions that meet the prudential regulation are then issued with an operating license to carry out the financial service delivery as per the set rules (CGAP, 2003).

The unmet financial needs and the apparent gap of lack of financial services facing the poor in the world led to establishment of micro financial institutions (MFIs) to meet the market niche of SMEs. Lauer (2008) noted that MFIs arose in the 1980s as a response to doubts and research findings about state delivery of subsidized credit to poor farmers. This was pioneered by the Nobel Prize winner, Prof. Mohammed Yunus with his innovative Grameen Bank of Bangladesh Model. Subsequently, the last two decades have witnessed the mushrooming of MFIs yet the financial needs of SMEs especially agricultural related (farming, agribusiness, livestock) remain unresolved. Nave (2006) reported that the key umbrella MFI organizations in Kenya namely: the Association of Microfinance Institutions (AMFI), in Kenya boasted of 25 MFIs, 4 wholesalers, 59 Financial Services Associations (FSAs) and 40 MFIs respectively by end of 2005, totaling to 128 institutions. Despite the above expansion of the MFIs as an alternative source of finance, SMEs still face the problem of finance. Micro-financing gives people the means to secure finances so as to exploit emerging opportunities and make them responsible for their own future. It broadens the horizons and thus plays both economic and social roles by improving the living conditions of the people (Khandker, 2005; WB; 2012 & 2013). These improvements are assessed from the perspective of the development and growth of Micro, Small and Medium size Enterprises. Institutions that have opted to operate under prudential regulations are, in most cases, required to transform institutionally so as to comply with set requirements (Sengupta & Aubuchon, 2008). The scholars aver that in most cases this transformation has involved change of legal status, ownership, organizational structures, systems and their delivery channels. This change has led to some of the challenges facing MFIs in transforming micro, small and medium enterprises to viable businesses in Kenya (Njihia, 2005).

Study Problem

Kenya's financial sector has undergone through several reforms since the late 1990s with the aim of improving profitability, efficiency and productivity of commercial Banks and other financial institutions as a platform for supporting MSMEs. Commercial banks had left a substantial gap in service delivery to financial service users particularly low income earners and MSMEs. Microfinance Institutions (MFIs) among other financial institutions stepped in to fill the gap and have registered remarkable growth over the last two decades as the unbanked population expanded and started patronizing their services. The MFIs are viewed predominantly as instruments of social change and their performance is often measured by non-financial parameters. The implementation of the

Microfinance Act, 2006 by the Central Bank of Kenya and the SACCO Act 2008 by SASRA, as the regulators of the MFIs and SACCOs, respectively has had a great impact on the operations of the MFIs. To transform micro, small and medium enterprises into viable businesses in the dynamic financial market in Kenya is a huge challenge. The need for steady growth and survival for these institutions by shareholders, government, regulatory authorities and stakeholders has resulted in the expansion of the SACCOs and MFIs in the last 10 years. Much of the literature in this area addresses: the social worth of micro-financing organizations (Bruett, 2005), the impact of village level MFIs (Menkhoff and Rungruxsirivorn, 2011; Kaboski and Townsend, 2005 & 2011), the impact of microcredit on the poor (Karlan and Zinman, 2010), costs and benefits of subsidies in micro-financing and mission drift.

There is evidence (Cull, Demirgüc-Kunt and Morduch,2007), that raising interest rates results in increased profitability for individual based lending MFIs whereas for solidarity based lenders, the reverse is true. The study by Cull et al., (2007) found evidence that raising interest rates leads to improved financial performance and profitability with lower subsidy dependence and higher operational self-sufficiency. Pankaj and Sinha (2010) concluded that most of the best performing firms are following different business models in India. Ahlin & Maio (2011) examined the determinants of performance of MFIs with variables, such as self-sufficiency, borrower growth or loan-size growth estimated by macroeconomic variables as well as macro-institutional factors, such as corruption control. Locally, Njagi (2011) made an investigation of factors affecting performance of micro-finance institutions in Embu district and concluded that the key reasons behind low performance of MFIs included limited financial resources, loan defaults by recipients, poor management information systems and poor research and development. As demonstrated by the cited empirical studies, there have been a number of studies focusing on the performance of MFIs. However, there exists limited empirical information that details out the influence of micro-financing institutions in transforming micro, small and medium enterprises into viable businesses in Kenya, a gap that this study has addressed.

Objectives of the Study

The general objective of this study was to determine the influence of Microfinance Institutions in transforming Micro, Small and Medium Enterprises in Kenya. Specifically, the study sought to determine if MFIs institutional policies play a role in transforming Micro, Small and Medium Enterprises in Kenya.

LITERATURE REVIEW

Micro-Financing in Kenya

Micro-financing in East Africa has become a hotbed of innovation in financial services (Njihia, 2005). Kenya is fast catching up with South Africa to become the country with the most comprehensive provision of financial services on the continent (WB, 2012). The WB further notes that the business models of champions such as Equity Bank and M-PESA in Kenya have been studied worldwide as a testimony of innovation (WB, 2012). The Kenyan financial sector is broad and well developed in sub-Saharan Africa. The sector is roughly twice as large as Uganda's and Tanzania's, but all the three countries have tremendous growth potential when compared to developed-country financial sectors (WB, 2012; Njihia, 2005). Kenya has 43 commercial banks and boasts of the best developed micro-financing sector in sub-Saharan Africa. Roughly, three-quarters of the East African micro-financing sector is dominated by Kenya. Kenya is also home to Equity Bank, a former building society considered insolvent in 1993 and is today one of the world's most admired retail banks. Another notable institution is the Kenya Women Finance Trust (KWFT), Africa's largest institution targeting women only, with over 250,000 active borrowers and a fast growing number of savers after successful application for a deposit-taking license (WB, 2013). The Key players in the Kenyan Micro-financing sector include Regulated MFIs: Commercial Banks, Non-Bank Financial Institutions (Post Bank) and the to-be-regulated, transforming MFIs under MFI Act; Non-regulated, credit only MFIs financial wholesalers; Insurance companies (micro-insurance providers) and Capacity development institutions (WB, 2012).

Uganda has 24 commercial banks, of which two (Centenary Bank and Equity Bank Uganda) have a micro-financing focus. In addition, the country has five deposit-taking MFIs and a few smaller MFIs. Among the larger financial institutions, only the two mentioned banks and the deposit-taking MFIs are not concentrated in Kampala. The micro-financing sector in Uganda is regulated by the Bank of Uganda. The use of a credit bureau for both positive and negative reporting is mandatory for all major MFIs. Bio-metric data is used for identification, as Uganda does not have a national ID system (WB, 2012).

Tanzania has 50 commercial banks, but less than a dozen major MFIs. Unfortunately, the large number of commercial banks does not reflect a high degree of financial inclusion. Most Commercial banks have a narrow, often government and commodity sector-related business focus and do not serve a substantial number of households or businesses. While the MFIs focus on the latter segment, together they still reach a relatively small number of 300,000 active borrowers and 390,000 savers. The leading MFI, with 100,000 active borrowers, is Arusha-based Pride. As the MFIs slowly fill the immense gaps in financial inclusion, new entrants to the market, such as Access Bank, Advans, and Equity Bank bring a new dynamic. In order to access Tanzania's vast and barely tapped rural areas, more effort to keep pace with the fast evolution in Kenya is needed (IFC, 2013).

Apart from the MFIs discussed previously, semi-formal providers such as savings and credit cooperatives (SACCOs) or informal providers such as savings and credit associations (ROSCAs and ASCAs), unlicensed money lenders, or family and friends thus play an important role, particularly in rural areas. Micro-financing as a financial-sector development pursues the objective of a sound financial sector, consisting of a multitude of formal providers competing for clients from all segments of society. The evolution towards financial inclusion is driven by MFIs who combine the credit cooperatives' willingness to serve poor people with the commercial banks' capacity and professionalism. East Africa is one of the world regions where MFIs have proven that they can handle deposits and grow into full-fledged financial providers. In Kenya, the successful transformation of eight credit-only MFIs into deposit-taking MFIs is a strong signal by the sector (Njihia, 2005). The rapid advancement of financial-sector development in East Africa is a powerful testimony to the important role micro-financing continues to play in emerging economies. The financial sector enables the growth of other industries, and its micro-financing segment caters to a large number of self-employed entrepreneurs, small businesses, and low-income households.

Kenya has a population of 38.8 million according to the 2009 population census released in 2010. The gross national income per capita is estimated at US $ 1560 and about 18.1 million (46%) people live below poverty line (WB, 2011). The Agriculture sector contributes 24% to the GDP and another 27% indirectly through linkages with other sectors. An estimated 60% of all the households are engaged in farming activity. The food component constitutes over 50% of the overall inflation, meaning that stable food supply is critical to macroeconomic stability (KIPPRA, 2013).

Majority of the population in Kenya live in the rural areas and they are involved in informal activities which includes micro, small and medium enterprises (MSMEs). However, these businesses remain at the micro level with dismal prospects of growth. MSMEs face various challenges which hinder their transformation to viable businesses. Robinson (2006) identified lack of finance as one of the major challenges which the Micro-financing institutions are trying to address. It is therefore expected that the micro-financing industry will play a pivotal role in deepening financial markets and enhancing access to financial services and products by majority of the Kenyans to grow their MSMEs. The Kenyan Financial Sector has undergone through numerous challenges and transformations during its relatively short span of its existence. Microfinance Institutions have opted to transform and expand the variety of their financial products to outreach more clients while Co-operative Societies have been noted to depart from traditionally being savings and credit institutions to institutions that offer front office services that have been a preserve of commercial banks and other financial institutions (SASRA, 2011). According to Kenya Union of Savings and Co-operatives, Savings and Co-operative Societies movement in Kenya is billed as the largest in Africa and among the top 10 globally. With over Kshs 230 billion in assets and a savings portfolio estimated at Kshs 190 billion, the SACCO movement in Kenya constitutes a significant proportion, about 20%, of the country's domestic savings (SASRA, 2011).

Innovative forms of micro-financing and progressive government policies, as detailed in the Microfinance Act of 2006 have helped to make Kenya's micro-financing sector one of the most developed in Sub-Saharan Africa. The Microfinance Act of 2006 and the Deposit Taking Institutions Regulations 2008 set out the legal, regulatory and supervisory framework for the micro-financing industry in Kenya. Among the reasons why MFIs have transformed and diversified into deposit taking institutions is accelerated growth, enhanced profitability, diversification of risk, reduction of tax liability, financial benefits and increased market power (Gaiha & Nandhi, 2006; Dalla Pellegrina, 2011; Besley, 1994). On the other hand, MFIs are developing a variety of customized products and services to outreach more clients and provide financial access to MSMEs. The push for Micro-financing regulation in Kenya has come from the Association of Micro-financing Institution (AMFI), the umbrella body of MFIs in Kenya which has been lobbying for the regulation for the last ten years to gain access to local deposits. Access to local deposits in form of savings is regarded as a cheap source for MFIs for on-lending (Rosengard, Rai, Dondo & Oketch, 2001). With dwindling availability of donor grants and expensive commercial loans, MFIs have found themselves constrained in their expansion plans.

The Kenyan government has been concerned about the need to protect the poor against losses that could be occasioned by unscrupulous operators. The poor are more vulnerable to slip into extreme poverty than the rich. In a span of two years, between 2005 and 2007, Kenya experienced two financial scandals targeting the poor under the pretext of being a micro-financing and savings scheme. This has prompted the central bank to restrict use of the word ‘finance’ business names to those that are regulated by it. The regulation of micro-financing in Kenya has adopted a three-tier approach: Prudential regulation and supervision for deposit-taking institutions by central bank, non-prudential regulation for credit only by ministry of finance and no regulation for ROSCAs and ASCAs.

Institutional Policies and Transformation of MSMES

Institutional policy development for MSMEs is intended to focus on improving the business climate for MSMEs generally, with a priority on addressing policies and regulations which create impediments to accessing and providing financing for MSMEs (EBRD, 2006). Policy initiatives should be developed to improve both the regulatory and business environments in the areas of corporate governance and remittances. According to EBRD (2006) and Dahiru and Zubair (2008) , the focus on policy dialogue is a valuable supplement to the MSME finance work of the Bank, and it is indeed a unique strength of the EBRD compared with other MSME financiers. Proximity to the market in the shape of the relationships with the partner banks and specialized microfinance banks and, through them, to the entrepreneurs they serve, provides a unique perspective on the impediments encountered by both credit providers and borrowers. By bringing these impediments to the attention of the relevant authorities, targeted policy dialogue efforts contribute to an improvement in the environment both for individual MSMEs and the institutions which lend to them (EBRD, 2006).

There have been conflicting ideas about the impact of micro-financing in the transformation of rural dwellers in Nigeria by various researchers. Brau & Woller (2004) noted that the specific impacts of micro-financing are hard to pin down and even harder to measure. They suggested that impact assessment require the adoption of research methodologies capable of isolating specific effect out of a complicated web of casual and mediating factors. Many have subscribed to the believe that micro-financing is an effective and powerful tool for poverty reduction. To affirm the above statement, Morduch (2011) and Roodman & Morduck (2009) focused on the ability of micro finance to reach the poor and concluded that micro-financing has served people below and above the poverty line. The results of empirical evidence indicates that the poorest can benefit from micro-financing from both on economic and social well being point of views, and that this can be done without jeopardizing the financial sustainability of the micro financial institutions (Dahiru and Zubair, 2008; Nwankwo, 2007).

In a study conducted by Onyeagocha, Chidebelu, Okorji, Ukoha, Osuji & Korie (2012) on the determinants of loan repayment of micro-financing institutions in South East States in Nigeria using a cross-sectional data and a multi-stage sampling technique. The results of the study revealed that the formal segment was more organized, better equipped with higher quality and well motivated staff than the semi-formal and informal segment. Four micro-financing banks were selected as sample size; they are from formal (commercial and development banks), semi-formal (NGO-MFIs and community bank (CB)) and informal (Rotating Savings and Credit Association (ROSCAS). The study also identify outreach, shocks, training duration, loan size and credit officers experience as the determinants of loan repayment rate in South East States in Nigeria. Taiwo (2012), in another study of the impact of micro-financing banks on welfare and poverty alleviation in South West States in Nigeria used regression analysis. The study indicated from the analysis of the data collected from the customers of micro-financing banks in Ogun and Lagos States of Nigeria that micro financing has improved the welfare of the enterprises and the individuals in terms of improved savings, earning (both for individual wage earners and the self-employed), facilitated access to loan facilities, improved sales revenue as well as the level of employment and growth in the micro-enterprises examined. The study recommend that since higher education have been found to increase the income of the micro-financing institutions (MFIs) clients; the MFIs clients should be encouraged by the micro-financing institutions (MFIs) to improve on their current level of education by engaging in adult education or life-long learning as this will have the potency to increase their level of income.

Karlan and Zinman (2010) in a field experiment, where, neither group nor individual liability loans are backed by any form of physical collateral, so that the same borrowers can be subject to one or the other form of liability, used randomized control trial to evaluate the impact of group liability on the performance of clients and the profitability for a lending institution in Philippines. The result showed that, one, individual liability compared to group liability leads to no change in repayment but is better at attracting new clients and keeping existing ones. Two, there is a statistically significant evidence of some of the mechanisms discussed in the group liability literature, such as screening and monitoring, but they did not find that it adds up in an economically meaningful way to higher (or lower) default.

In a comprehensive review of literature carried out by Brau and Woller (2004), a conclusion was made that MFIs provide similar products and services to their customers as formal sector financial institutions. The scale and method of delivery differ, but the fundamental services of savings, loans, and insurance are the same. Notwithstanding, to date most efforts to formalize micro-financing have focused on enterprise lending (loans for enterprise formation and development) which remain by far today the dominant product offered by MFIs (Woller, 2002). This, however, has slowly begun to change. Increasingly today MFIs have begun to offer additional products, such as savings, consumption or emergency loans, insurance, and business education. Hudon & Traca (2011) review the context and rise of micro-financing products and argues there is a need for savings and insurance services for the poor and not just credit products. He goes on to argue that MFIs need to provide tailored lending services for the poor instead of rigid loan products. Supporting the assertion, Khandker (2005) developed a model of small construction management contractors and MFIs in developing countries that provides a tailored lending structure for microenterprise contractors.

Gomez and Eric (2005) provide empirical evidence of the importance of social collateral. In an empirical study of 612 group borrowers and 52 individual borrowers in Canada, they report that group lending and the presence of neighbors have a positive correlation with self-employment earnings. It follows that borrowers with higher earnings will have an easier time of servicing their microloans and performance of MFIs and SACCOs depends on the profile of its members. The loans demanded by smaller enterprises are smaller than those requested by larger ones but the interest rates remain the same. This indicates that, per unit cost is high for MFIs targeting customers with very small loans and possessing small savings accounts (Robinson, 2006). Even though the interest rate is high for applicants requesting very small loans, they are able to repay and even seek repeatedly for new loans. The social benefits that are gained by clients of MFIs supersede the high interest charged. The high interest rate is also as a means to tackle the problem of adverse selection where a choice is made between risky and non risky projects. The good clients suffer at the expense of the bad ones (Graham, Bannok and Partners, 2007). Micro-financing clients admit that convenience is more important to them than return (Schmidt and Zeitinger, 2004).

Low-income men and women have a serious hindrance in gaining access to finance from formal financial institutions. Ordinary financial intermediation is not more often than not enough to help them participate, and therefore MFIs have to adopt tools to bridge the gaps created by poverty, gender, illiteracy and remoteness. The clients also need to be trained so as to have the skills for specific production and business management as well as better access to markets so as to make profitable use of the financial resource they receive (Banerjee et al., 2009). In providing effective financial services to the poor requires social intermediation. This is “the process of creating social capital as a support to sustainable financial intermediation with poor and disadvantaged groups or individuals” (Banerjee et al., 2009). Some micro-financing institutions provide services such as skills training, marketing, bookkeeping, and production to develop enterprises. Social services such as health care, education and literacy training are also provided by some MFIs and both enterprise development and social services can improve the ability of the low-income earners to operate enterprises either directly or indirectly (Wydick et al., 2011).

METHODOLOGY

This study adopted and relied on a positivist research philosophy. A cross-sectional research design in the form of a survey was used in this study. The population of this study comprised of 45 units of analysis which are the micro finance institutions registered by the Association of Micro-financing Institutions of Kenya (AMFI) in Kenya. The target population comprised of top management, middle management and supervisory level employees from the micro financing institutions. Questionnaires were used to collect data from a sample of 135 respondents selected using stratified random sampling.

RESEARCH FINDINGS AND DISCUSSION

Response Rate

The researcher distributed 135 questionnaires from which 108 were duly filled and returned, making a response rate of 80.0%. Nwankwo (2007) poised that survey researches face a challenge of low response rate that rarely goes above 50%. They further suggest that a response rate of 50% and above is satisfactory and represents a good basis for data analysis. According to Mugenda and Mugenda (2003) a 50% response rate is adequate, 60% is good and above 70% is very good. This also concurs with Kothari (2004) assertion that a response rate of 50% is adequate, while a response rate greater than 70% is very good. This implies that based on this assertions; the response rate based on the correctly returned questionnaires and used for analysis of 76% was adequate for proceeding with the study. Table 1 presents the response rate results.

Table 1: Response Rate

s	Response
onnaires distributed	135
onnaires returned	108
onnaires returned and correctly filled for analysis	102
nse Rate	**76%**

RESULTS AND FINDINGS ON THE TRANSFORMATION OF MSMES

Reliability Test for Transformation of MSMEs

The study carried out a reliability test on the dependent variable, Transformation of MSMEs. The results from this test are summarized in Table 2. The results indicate a Cronbach reliability alpha score of .807, which is higher than the recommended threshold of .7 alpha score.

Table 2: Reliability Test for Transformation of MSMEs

Reliability Statistics

Cronbach's Alpha	N of Items
.807	4

Factor Analysis for Transformation of MSMEs

A factor analysis was carried out to determine how various factors would load on Transformation of MSMEs. The findings summarized in Table 3 shows that all the factors loaded highly on the dependent variable (Transformation of MSMEs) as all of them had scores above the threshold of .4.

Table 3: Factor Analysis on the Dependent Variable (Transformation of MSMEs)

Component Matrix

ı Item	Component
:s over the last 5 years enhanced transformation of MSMEs that we sup	.821
ucts and services we offer helped transform MSMEs of our clients	.801
tive Return on Investment (ROI) over the last 5 years has transfoı we support	.796
has experienced an increased number of transformed MSMEs in the	.779

ın Method: Principal Component Analysis

Descriptive Statistics for Transformation of MSMEs

An analysis of the descriptive statistics on the dependent variable (Transformation of MSMEs) was carried out. Findings from the study were expressed as percentages and are summarized in Table 4.

Table 4: Descriptive statistics for Transformation of MSMEs

ı Item	rongly Disagı	Disagree	Neutral	Agree	trongly Agr
has experienced an increased number of trans in the last 5 years	0.0%	1.9%	7.4%	67.6%	23.1%
:s over the last 5 years enhanced transformati that we support	0.0%	1.9%	10.2%	66.7%	21.3%
tive Return on Investment (ROI) over the las formed the MSMEs we support	0.0%	4.6%	17.6%	53.7%	24.1%
ucts & services we offer have helped transfor of our clients	0.0%	1.9%	7.4%	57.4%	33.3%

These results indicate that a majority of the respondents (67.6%) agreed that their MFI institution had experienced an increased number of transformed MSMEs in the last five (5) years, 66.7% agreed that their improved assets base over the last 5 years had enhanced transformation of MSMEs that they supported, 53.7% agreed that their positive return on investment (ROI) over the last 5 years had transformed the MSMEs they supported, while 57.4% agreed that the products and services that they offer had contributed to the transformation of MSMEs owned by their clients. These findings corroborate literature by Khandker (2005), WB (2012, 2013) which concluded that Micro-financing gives MSMEs the means to exploit emerging opportunities and make them responsible for their own future. These authors argued that MFIs broaden the horizons of the business enterprises, thus playing both economic and social roles by improving the living conditions of the people involved. Institutions that operate under prudent regulations are, in most cases, required to transform institutionally so as to comply with set requirements (Sengupta & Aubuchon, 2008). The scholars aver that in most cases this transformation has involved change of legal status, ownership, organizational structures, systems and their delivery channels. This change has led to some of the challenges facing MFIs in transforming micro, small and medium enterprises to viable businesses in Kenya (Njihia, 2005).

Based on the findings of this study, it is noted that a majority of the respondents (over 53.7%) agreed with all the four research questions put to them that, indeed, MFIs play a significant role in transforming the growth of MSMEs through the products and services they provide to them, the financial and asset base of the MFI which provides a cushion of the vulnerabilities of the MSMEs

Influence of Institutional Policies

Literature reviewed revealed that the main aim of institutional policy development for MSMEs is to focus on improving the business climate for MSMEs, with particular emphasis on addressing policies and regulations which create impediments to accessing and providing financing for MSMEs. Policy initiatives should are developed in order to improve both the regulatory and business environments in the areas of corporate governance and remittances. EBRD (2006) and Dahiru and Zubair (2008) averred that by bringing these impediments to the attention of the relevant authorities, targets policy development efforts to contribute to an improvement in the environment both for individual MSMEs and the institutions which lend to them, the MFIs. This study sought for responses on five key investigation areas relating to institutional policies and transformation of MSMEs. The findings and results obtained from this investigation are discussed below.

Reliability Check for Institution Policies

A reliability test was carried out on Institution Policies of MFI's to establish their influence on the transformation of MSMEs in Kenya. The results from this test are summarized in Table 5. These results indicate that institution policies had a Cronbach reliability alpha score of .758 which is above higher than the recommended threshold of .7 alpha score..

Table 5: Reliability Test on Institution Policies

ch's Alpha	ms

Factor Analysis for Institution Policies and Transformation of MSMES

A factor analysis was carried out on Institution Policies to establish how different factors load in relation to the transformation of MSMEs. The findings presented in Table 6 show that all the factors loaded highly as none had a score below the threshold of .4 and therefore none was eliminated from further analysis.

Table 6: Factor Analysis for Institution Policies

Component Matrix

	Component
	1
tution requires that all the information gathered about our clients is p edit operations for review	.790
nstitution, written procedures and instructions are given a special im cial focus on our MSMEs clients	.770
tution collects comprehensive and current data on the economic and of the MSMEs	.727
itution has a formal and written discipline policy to effectively sup clients	.681
it operations unit does preliminary review of the completeness and co rrowers' data (MSMEs)	.590

Descriptive Statistics for Institution Policies

An analysis of the descriptive statistics for Institution Policies was carried out and a descriptive statistics table was generated from SPSS Software and presented in form of percentages as shown in Table 7.

Table 7: Descriptive Statistics for Institution Policies

	rongly Disag	Disagree	Neutral	Agree	trongly Agre
itution has a formal and written discipline ly support our MSMEs clients	0.0%	1.0%	4.9%	34.3%	59.8%
procedures and instructions are given a ce with special focus on our MSMEs clients	0.0%	1.0%	4.9%	37.3%	56.9%
tution collects comprehensive and current da and personal situation of the MSMEs	1.0%	1.0%	16.7%	46.1%	35.3%
itution requires that information gathered a passed on to the credit operations for review	1.0%	3.9%	5.9%	34.3%	54.9%
dit operations unit reviews the completer cy of the borrowers' data (MSMEs)	0.0%	1.0%	3.9%	26.5%	68.6%

These results show that a majority (59.8%) strongly agreed that their institution had a formal and written discipline policy to effectively support their MSMEs clients, 56.9% also strongly agreed that in their institution, written procedures and instructions are given a special importance with special focus on their MSMEs clients. A majority (46.1%) agreed that their institution collects comprehensive and current data on the economic and personal situation of the MSMEs, 54.9% strongly agreed that their institution requires that all the information gathered about their clients is passed on to the credit operations for review, while 68.6% strongly agreed that the credit operations unit does preliminary review of the completeness and consistency of the borrowers' data (MSMEs).

These results strongly corroborates with conclusions made by a number of authors whose literature has been reviewed, including EBRD (2006), and Dahiru and Zubair (2008) nwho said that institutional policy development for MSMEs is intended to focus on improving the business climate for MSMEs generally. These authors recommended that policy initiatives should be developed to improve both the regulatory and business environments in the areas of corporate governance and remittances. These results are also in agreement with conclusions reached by a study conducted by Onyeagocha, Chidebelu, Okorji, Ukoha, Osuji & Korie (2012) in South East states of Nigeria that deliberate policies to institute formal segmentation for was more organized, better equipped with higher quality and well motivated staff than the semi-formal and informal segment. This study also revealed that policies on outreach, shocks, training duration, loan size and credit officers experience, among others lead to more effective transformation and growth of MSMEs in South East States in Nigeria. These results further concur with a study conducted by Taiwo (2012) which stated that micro-financing banks had a huge impact on welfare and poverty alleviation in South West States in Nigeria. The results also augment the findings of Gomez and Eric (2005) who carried out a study on 612 group borrowers and 52 individual borrowers in Canada and concluded that good policies on group lending and the presence of neighbors have a positive correlation with self-employment earnings, meaning that borrowers with higher earnings will have an easier time of servicing their microloans and performance of MFIs and SACCOs depends on the profile of its members.

These results indicate that all the questions raised were either agreed or strongly agreed with by the respondents. On the basis of these findings obtained, therefore, and relating them to the literature reviewed in chapter 2, the study strikes a strong affirmation that institutional policies of MFI's have a significant impact on the lives of entrepreneurs who often are the owners of the MSMEs in society. It can, therefore, be inferred that good MFI intuitional policies that touch on interest rates and other credit lending policies have a significant impact on the performance of MSME clients. It can also be averred from these results that lots of positive social benefits accrue from the development of strong MFI institutional policies.

Linearity Test between Institution Policies and Transformation of MSMEs

The study sought to establish whether institution policies and transformation of MSMEs had a linear relationship between them. A curvilinear graph was generated from SPSS data and presented in Figure 1. This graph shows that the scatter dots fall within the curvilinear line. This implies that a positive linear relationship exist between Institution Policies and Transformation of MSMEs.

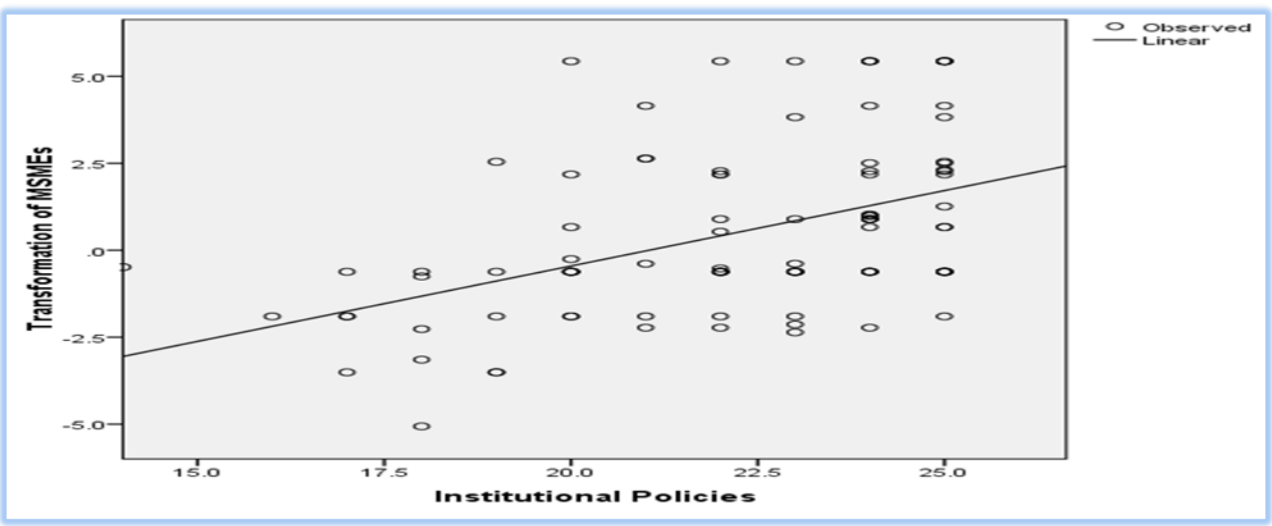

Figure 1: A curvilinear graph for Institution Policies and Transformation of MSMEs

Correlation between Institutional Policies and Transformation of MSMEs

Pearson's Correlation coefficients indicates the extent of interdependence between two variables. The study sought to establish whether there was correlation between institutional policies and transformation of MSMEs.

The findings are summarized in Table 8. From the table, a positive correlation coefficient of .463 or 46.3% was found to exist between institutional policies and the transformation of MSMEs.

Table 8: Correlation between Institutional Policies and Transformation of MSMEs

Correlations

		nsformation of MSM	nstitutional Policies
nation of MSMEs	Correlation	1	.463**
	iled)		.000
		102	102
nal Policies	Correlation	.463**	1
	iled)	.000	
		102	102

elation is significant at the 0.01 level (2-tailed).

Regression Analysis between Institutional Policies

A regression analysis was carried out in order to determine whether the independent variable, institutional policies could be relied on in explaining the change in the dependent variable, the transformation of MSMEs in Kenya. The model summary of the regression coefficients findings are presented in Table 9. The coefficients obtained indicate that the correlation coefficient (R) between the independent variable and the transformation of MSMEs in Kenya was .463 which is a positive correlation relationship. From Table 9, this variable achieved a coefficient of determination (R^2) of .215, which means that this variable alone can explain up to 21.5% of the total variability in the dependent variable, transformation of MSMEs in Kenya. .

Table 9: Model Summary for Institutional Policies and Transformation of MSMEs

Model Summary

	R	R Square	Adjusted R Square	td. Error of the Estimat
	.463	.215	.207	1.453

ctors: (Constant), Institutional Policies

ANOVA for Institutional Policies

An ANOVA test was performed on the variable, institutional policies and the results obtained are summarized in Table 10. From this Table 10, the model is found to be statistically significant in explaining the change in the dependent variable, transformation of MSMEs as its p-value is less than .05. This means, therefore, that the null hypothesis that institutional policies do not have a statistically significant influence on the transformation of MSMEs is rejected and instead the alternative hypothesis that institutional policies have a statistically significant influence on the transformation of MSMEs is accepted.

The table shows that the variable has a P- value equals to .000, demonstrating that the model is statistically significant in explaining the change in the dependent variable, considering that the P-value is less than .05 at the 95% level of confidence.

Table 10: ANOVA Test for Institutional Policies and Transformation of MSMEs

	Sum of Squares	df	Mean Square	F	Sig.
ion	57.721	1	57.721	27.352	.000
l	211.034	100	2.110		
	268.755	101			

To compliment the findings on Intuitional policies and transformation of MSMEs generated from the ANOVA test results, Person's correlation coefficients were also generated. The results of the person's correlation are presented in Table 11. These results show that institutional policies contribute a statistically significant value (p-value = .000) of .297 to the regression model.

Table 11: Coefficient for Institutional Policies and Transformation of MSMEs

	Unstandardized Coefficients		dardized Coeffic		
	B	Std. Error	Beta	t	Sig.
nt)	10.121	1.269		7.976	.000
onal Policies	.297	.057	.463	5.230	.000

Using the summary presented in Table 11, a linear regression model of the form, Y = α + βX*i* can be fitted as ***Y = 10.121 +0.297X₁ + e***

CONCLUSION AND RECOMMENDATION

The study established that; a majority of over 94.1% of the respondents either agreed or strongly agreed that their MFI institutions had formal and written discipline policies that enables them to effectively support their MSMEs clients; over 94.8% majority agreed that written procedures and instructions were critical in driving the quality of their support to MSMEs; over 84.4% majority were strongly supported the idea that empirical data collected from time to time was very useful in assessing the performance of their clients, the MSMEs; over 89.2% supported the argument that their MFI institutions valued the information gathered about their clients for purposes of credit operation reviews; and that an overwhelming response of over 95.1% agreed that their MFI credit operations thoroughly checked the completeness and the consistency of their MSMEs client borrowers in a bid to support their transformation. The results also established that there existed a positive linear relationship between institutional policies and the transformation of MSMEs with a correlation coefficient of 46.3%. The results further established that institutional policies, alone, as a predictor variable could explain up to 21.5% of the total variability in the dependent variable, the transformation of MSMEs. The Analysis of variance (ANOVA) confirmed that institutional policies were statistically significant in explaining the change in the dependent variable considering that its P-Value result was less that .05 at 95% level of significance.

CONCLUSIONS

MFIs have a significant transformative influence of MSMEs through the establishment of effective internal institutional policies aimed at improving their business climate. Critically, the priority of the MFIs is to develop a regulatory and business environment that removes impediments to accessing and providing financing to MSMEs. The results of this study turned a resounding message that having formal and written regulatory policies that instill discipline in the operating environment enables MFIs to effectively support the transformation of MSMEs clients. It can also be concluded, based on the results that having written policies, procedures and instructions are critical in driving the quality of support provided my MFIs to their MSME clients. It can also be concluded that one way of addressing the changing customer needs from time to time is to ensure that policy and regularity instruments applied on MSMEs clients are developed on the basis of timely research on customer tastes. So, reliance on empirical data collected regularly is very useful in assessing the performance of their clients and at the same time making effective changes that support the transformation of MSMEs. It is also an important practice that MFIs thoroughly checks the completeness and the consistency of information gathered from their MSMEs clients who are interested in borrowing funds in order to ensure that credit decisions are based on accurate information if transforming these MSMEs is to be a big success. Based on the findings of this study, it can also be concluded that institutional policies, indeed, have a statistically significant effect in the transformation of MSMEs and there should be more focus in their continuous development and application.

RECOMMENDATIONS

MFIs should develop and document effective internal institutional policies aimed at improving their business climate. In particular, the MFIs should; develop a regulatory and conducive business environment that removes impediments to accessing and providing financing to MSMEs; should have formal and written regulatory policies that instill discipline in the operating environment which enables MFIs to effectively support the transformation of MSMEs clients; in order to effectively respond to the changing customer needs from time to time, policy and regularity instruments applied on MSMEs clients should developed on the basis of timely research on customer tastes; and that MFIs should regularly and thoroughly check the completeness and the consistency of information gathered from their MSMEs clients who are interested in borrowing funds in order to ensure that credit decisions are based on accurate information if transforming these MSMEs is to be a big success;

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