



**CRITICAL SUCCESS FACTORS ON TURN AROUND STRATEGY OF MICROFINANCE INSTITUTIONS
IN KENYA**

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ABSTRACT

Microfinance Institutions are pillars to development of small businesses and growth of the informal sector in Kenya. Many MFIs started their operations as program activities for Non-governmental organizations whose funding has continued to decline with time. The pressure to become sustainable has further driven the entities to develop turnaround strategies to achieve sustainability. The general objective of the study was to investigate the critical success factors on turnaround strategy of MFIs in Kenya. Descriptive design was adopted for it met the objectives of the study. Secondary data was also employed through use of current publications, reports to provide background of the study and supplement the primary data received from interviews. The findings of the study indicate that MFIs pursue turnaround strategy due to pressure from shareholders, lenders and donors for profitability, competition from the market, the need to remain competitive on technology and innovations front, pressure to transform to regulated institutions to gain public confidence, increase market share and changes in customer preferences. The study found that the following are critical success factors of a turnaround strategy of MFIs in Kenya; affordable capital, public confidence, skilled staff, branch network, competent manager, composition of board expertise, use of modern technology and use of diversified and innovative products that meet dynamic needs of the clients.

Key Words: Microfinance, Finance Strategies, Critical Success Factors.

INTRODUCTION

Microfinance sector has evolved over time and now accepted on the provision of a wide range of financial services and training to low-income earners. Over the years, institutions offering microfinance services have grown both in outreach and asset base raising safety concerns on the future of such microfinance operations. As demand for microfinance services continues to grow, MFIs continue to have challenges in delivering microfinance services, which adversely impact their future growth, systems, as well as funding strategy. Some of the reasons why NGO MFIs pursue transformation to regulated institutions include being allowed to provide their clients with a wider range of financial services beyond credit; leading to increase access to capital; and to gain legitimacy (CGAP, 2008). In Kenya, microfinance services are offered by institutions registered under the NGOs Act, Societies Act, Trust Act, Companies Act, Co-operative Societies Act, Banking Act and Kenya Post Office Savings Bank (KPOSB) Act as well as financial service associations (FSA) and informal financial providers (Omino, 2005). The development of CBK regulation on financial services provider led to the enactment of microfinance Act, 2006, 2009 and microfinance Act Amendment 2013 which formulated the regulations and licensing

of deposit taking MFIs in Kenya now microfinance banks .

Statement of the Problem

MFIs are pillars to development of the informal sector in Kenya. However their success is threatened by reduction in donor support, changes in financial services sector regulations and intense competition in the industry. MFIs in Kenya are registered under nine different legislations namely: NGOs Coordination Act, Building societies Act, trustee Act, Societies Act, Microfinance Act, Co-operative societies Act, Companies Act, Microfinance Act Banking Act, and the Kenya Post Office Savings Bank (KPOSB) Act. Some of these forms or registrations do not adequately address issues regarding ownership, governance, and accountability hence these gaps have contributed to the poor performance. There are a number of other constraints faced by the industry, namely; diversity in institutional form, inadequate governance and management capacity, technological changes, limited outreach, unhealthy competition, limited access to affordable funds, unfavorable image and lack of performance culture. Given the important role played by MFIs, there is urgent need to develop turn around strategies to attain sustainable profitability, transform to regulated institutions, and attain market leadership by enhancing their competitive advantages. According to annual

report on the microfinance sector in Kenya audited financial statements as of 2010, 2011 and 2012, the microfinance sector recorded low level of profitability and sustainability with return on equity, return on assets and operating self-sustainability reported as 8%, 1% and 107% respectively in 2012. Further the credit only segment of MFIs recorded highest funding expense ratio due to limited pool of financial resources and poor bargaining power. According to Omino (2005), most financial institutions under-performance is due to breakdown between strategy and operations. Local studies on the turnaround strategy include Mwanza (2012), who carried out a study on implementation of a turnaround strategy at Opportunity Kenya, a microfinance company. This study aimed at investigating the critical success factors on turnaround strategy of microfinance institutions in Kenya.

Objectives of the Study

The general objective of this study was to investigate the critical success factors on turnaround strategy of MFIs in Kenya.

This study was guided by the following specific objectives:

- i. To establish the effects of regulations and ownership control on turnaround strategy of MFIs in Kenya

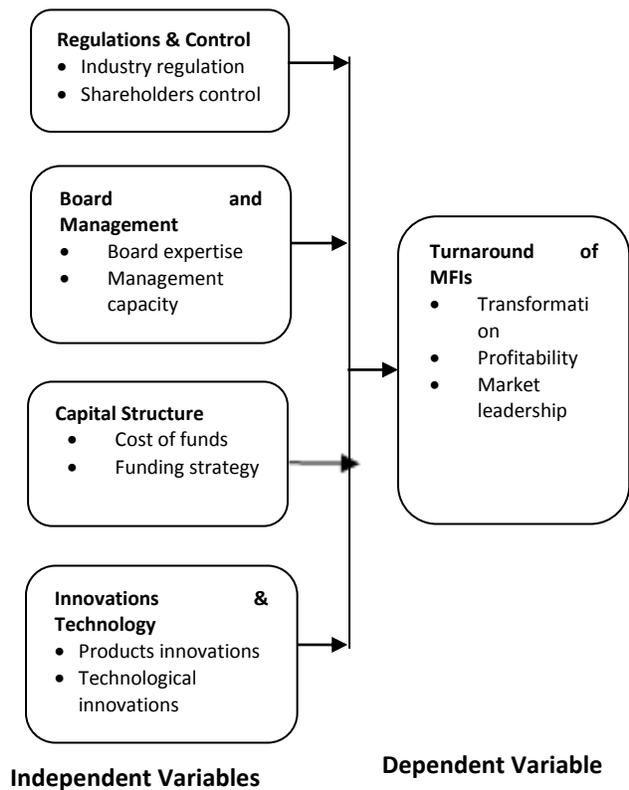
- ii. To establish the extent to which Board and Management affect the turnaround strategy of MFIs in Kenya
- iii. To assess the effects of Capital structure on the turnaround strategy of MFIs in Kenya
- iv. To find out how Innovations & Technology affects the turnaround strategy of MFIs in Kenya

Research Questions

This study sought to answer the following research questions:

- i). What are the effects of regulation and ownership control on turnaround strategy of MFIs in Kenya?
- ii). To establish how the board and management affect the turnaround strategy of MFIs in Kenya?
- iii). What are the effects of capital structure on the turnaround strategy of MFIs in Kenya?
- iv). To what extent does innovations and Technology affect the turnaround strategy of MFIs in Kenya?

Conceptual Framework



Board and Management

Board composition is a central issue in the multiplicity of corporate governance guidelines and codes of best practices that have been published at the international and national level (e.g. OECD Principles of Corporate Governance, ICGN Statement, World Bank Framework for implementation). Most of these guidelines are directed at increasing board accountability to Shareholders and improving board effectiveness. There have also emerged voluntary codes of conduct that include governance as part of a larger corporate social responsibility agenda, e.g., Standards within the

Global Reporting Initiative and the UN Global Compact. Usually, these Governance recommendations call for more board independence, and in some instances also for increased board diversity and better response to stakeholders. (Oman, 2001). According to Cochran and Warwick (1988) One would expect shareholders to demand a composition of experts serving on their company's board. Presumably, directors who demonstrate high levels of industry knowledge, experience, formal education, social ties, or intellect, will make better decisions.

Regulations and Control

In the literature, ownership is widely reported to be a determinant of financial institution profitability. Several studies (Bashir, 2000, Berger *et al.*, 2000, Clarke *et al.*, 2000 and Naceur, 2003) have concluded that foreign owned banks are more profitable than their domestic counterparts in developing countries and less profitable than domestic banks in industrial countries, perhaps due to benefits derived from tax breaks and other preferential treatments. Privately owned banks have also been assessed to be more profitable than their state owned (public) counterparts (La Porta *et al.*, 2002, Barth *et al.*, 2004, Micco *et al.*, 2004 and Sapienza, 2004). Specifically, Micco *et al.* (2004) and Athanasoglou *et al.* (2005) posit that public banks' low profitability is due to the fact

that, rather than maximizing profits, they respond to a social mandate.

Capital Requirements

Microfinance institution's capital can be seen in two ways. Narrowly, it can be seen as the amount contributed by the owners of the institution (paid-up share capital) that gives them the right to enjoy all the future earnings of the MFI. More comprehensively, it can be seen as the amount of owners' funds available to support the institution's business (Athanasoglou *et al.*, 2005). The later definition includes reserves, and is also termed total shareholders' funds (Anyanwaokoro, 1996). No matter the definition adopted, a MFI's capital is widely used to analyze the status of its financial strength (Bobáková, 2003). Positive correlation between returns and capital has been demonstrated by Furlong and Keeley (1989), Keeley and Furlong (1990), Berger (1994), Berger (1995), Naceur (2003) and Kwan and Eisenbeis (2005). Investigating the determinants of Tunisian banks' performances during the period 1980-1995, Naceur and Goaid (2001) indicated that the best performing banks are those who have struggled to improve labour and capital productivity and those who have been able to reinforce their equity. Bourke (1989) and Naceur (2003) agree that well-capitalized banks face lower need to external funding and lower bankruptcy and funding

costs; and this advantage translates into better profitability. Therefore, researchers widely posit that the more capital a financial institution has, the more resistant it will be to failure (Uche, 2001: 30).

Innovations and Technology

IT systems have important contributions to the managerial control of MFIs as well as the efficiency of customer services. Porter and Millar (1985) argue that investing in IT plays an important role in lowering the total costs of a firm (giving a cost advantage) and differentiates its products (giving a competitive advantage), which should be reflected in increased net profit. Using evidence from accounting data, Holden and El-Bannany (2006) empirically investigated whether investment in IT systems affected financial institutions profitability in the UK during the period 1976 – 1996. Their results revealed that investment in IT systems (proxied by number of automated teller machines) had a positive impact on bank profitability. Similarly, several other researchers (Abdullah, 1985, Katagiri, 1989, Shawkey, 1995 and Gupta, 1998) have posited that the deployment of ATMs by MFIs results in greater turnover in services without needing to recruit more staff and open more branches, thereby reducing transaction costs and eventually improving profitability. The use of the Internet to effect banking transactions has also helped to reduce

transaction costs and enhance profitability. Daniel and Storey (1997) refer to the results of a survey in which the unit transaction cost for a non-cash payment is £1.08 for a branch, 54p for a telephone bank, 26p for a PC bank and just 13p for an internet bank.

METHODOLOGY

Research Design

Descriptive research design was good for this study in collecting information that will demonstrate relationships or association between variables of the study. Kombo and Tromp (2006) a descriptive design is a description of the state of affairs, as it exists. Borrowing from Mugenda and Mugenda (1999) survey research is a self-report study which requires the collection of quantifiable information from the sample, this study collected information from a sample of microfinance institutions in Kenya which was quantified and analyzed.

Population Frame

The target population was three levels of management staff which included top level management, middle level and lower level management from each of microfinance institutions with AMFI-K membership. The MFIs include both regulated (deposit taking) and

credit only (unregulated) MFIs. The management staffs in MFIs were targeted to participate in this study because by the virtue of their positions, they are more knowledgeable on turn around strategies employed within the sector. Therefore, the target population for the study was 432 respondents comprising of staff from different departments and sections.

Sample Size

The stratified random sampling method was best suited in this research because the population consisted of different people who work for different MFIs in Kenya under three levels of management. The method was best because it minimized biasness. The general procedure for taking a stratified sample was to stratify population, defining a number of separate partitions using sample size, and then the researcher combined the results to obtain the required stratified sample. The sample was therefore drawn from each stratum from which respondents were selected. The researcher took 10% of the target population.

Data Collection Instruments and Procedure

The researcher used a questionnaire as the data collection tool to collect views from the respondents on the study. The questionnaires were structured in a way that all relevant information was given. The questionnaire consisted of three sections; where the first part

mainly contained demographic information. This enabled the researcher to know the level of understanding of microfinance operations by respondents in Kenya. The second part was open ended questionnaires in order to provide respondents with room to share their practical understanding of turnaround strategies employed in the sector while the third part focused on investigating the CSFs on turnaround strategy of microfinance institutions in Kenya specific for this study.

DATA ANALYSIS AND PRESENTATION

Data collected was both qualitative and quantitative. Qualitative data was analyzed using content analysis. Quantitative data was analyzed using descriptive statistics such as frequencies and percentages. Data collected was presented using tables, graphs and charts. Multiple regression was used to obtain an equation which describes the dependent variable in terms of the independent variables based on the regression model (Patton, 2002). This assisted in determining the level of influence the independent variables had on the dependent variable.

The regression was calculated using the basic regression model

$$Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4 + e$$

Multiple Regression Analysis

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	7.978	.984		8.110	.000
	Capital Structure	.302	.117	.272	2.302	.005
	Board and Management	.132	.165	.025	.195	.004
	Innovations & Technology	.205	.148	.256	2.065	.003
	Regulation & Control	.361	.180	.275	2.175	.001

The regression equation ($Y = \beta_0 + \beta_1X_1 + \beta_2X_2 + \beta_3X_3 + \beta_4X_4$) was interpreted to mean

$$Y = 7.978 + .302X_1 + .132X_2 + .205X_3 + .361X_4$$

Y = Turnaround of MFIs

X_1 is Capital Structure X_2 Board and Management, X_3 is Innovations & Technology and X_4 is the Regulation & Control.

According to the equation, taking all factors (Regulation & ownership control, Board and Management, Capital Structure and Innovations & Technology) constant at zero, overall Turnaround of MFIs will be 7.978. The data findings also show that a unit increase Capital Structure will lead to a 0.302 increase Turnaround of MFIs; a unit increase Board and Management will lead to a 0.132 increase in Turnaround of MFIs; a unit increase in Innovations & Technology, will lead to a 0.205 increases in Turnaround of MFIs and a unit increase in Regulation & Control Will lead to a

0.361 increase in Turnaround of MFIs. This means that the most significant variable is regulation and ownership control and Innovations and technology.

DISCUSSION AND CONCLUSION

The study findings indicate that MFIs regulated by CBK achieve turnaround faster due to public confidence on regulator. The MFIs owned by NGOs face turnaround challenge due to conflict between social and profit objective of the entities while limited companies pursue positive returns for the shareholders with more ease. NGO owned MFIs mainly pursue client's transformation as opposed to commercial objective hence creating a big challenge to board and management on profitability. The study also demonstrated that government taxation policy lack incentives considering the role of MFIs in serving the un-bankable. MFIs in Kenya operating as credit only institutions do not enjoy tax benefit on withholding tax on investment income earned from treasury bills and placements with commercial banks. Further the study finding indicate that stringent CBK regulations lead to high compliance cost on MFIs operations hence slowing down turnaround of MFIs.

The study findings indicate that the capital structure is also determined by ownership structure. MFIs with diversified ownership enjoy funding inform of equity, debt finance, grant funding and customer deposits while NGO owned entities funding is largely grant funding

with minimal debt finance and equity or none at all. Regulated MFIs operating as Microfinance banks have wide access to capital including cheaper customer deposits hence leading to reduce funding costs. Further MFIs operating under global organization are subject to parent organizations funding and growth strategies. The study indicated that heavy reliance on high cost debt (common with credit only MFIs) as opposed to customer deposits and equity delay business profitability and hence deposit taking MFIs perform better due to lower cost of capital. Regulated MFIs have access to wider funding due stronger governance structures, risk management policies, ability to attract investors leading to high growth and profitability.

The findings on board and management indicate that the strength of management in terms of skills and capacity to execute the strategy affect the level of success. The findings showed that the board composition and level of expertise determine the performance through provision of strategic direction of the business. The study found out that management drive to pursue turnaround is motivated highly by job security and higher compensation while the board is driven by maximization of return to shareholders.

The study findings show that innovations and technology drive MFIs toward the achievement

of the turnaround strategy of MFIs through cost reduction and growth. Investment in modern technology enables MFIs to lower total operating costs of a firm, support growth and access to financial services in remote areas. Innovations on product development and diversification provide MFIs with a competitive edge in addition to meeting dynamic needs of the clients. The study indicate that MFIs have employed the use of the Internet, ATMs and mobile money technology to significantly reduce transaction costs, service accessibility, operational efficiency and profitability.

The study concludes that for MFIs in Kenya turnaround strategy to succeed the availability and affordable source of capital is key driver to achieve growth and profitability. To achieve adequate funding, public and investor confidence is important hence the need to transform respective MFIs to microfinance banks. Transformation to microfinance bank will provide access to equity by investors, debt finance and access to customer deposits. The access to funding is also determined by the

ownership structure of the MFI. The expertise of the board on strategic direction and management strength in execution of the strategy is critical to successful implementation of the strategy.

The study further concludes that investment in technology enables MFIs to develop innovative products, increase operating efficiency, expand customer base, growth in outreach beyond physical branches, and develop partnerships hence promoting overall business growth. The use of modern technology inform of internet, mobile banking, automated teller machines and mobile money have enhanced access to financial services, affordability and growth in MFI business hence a key driver to achieve turnaround in Kenya.

Recommendation for further study

The study investigated the critical success factors on turnaround strategy of microfinance institutions in Kenya. Therefore further researchers recommend further study to be carried out on the impact of ownership on funding strategy of MFIs in Kenya.

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