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Undoing Performance in Micro Finance Institutions: Reflections on Regulatory Framework in Kenya

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Cover Page Footnote

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Undoing Performance in Micro Finance Institutions: Reflections on Regulatory Framework in Kenya

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Abstract

The performance of Micro Finance Institutions (MFIs) has been affected negatively by the current hypercompetitive economic environment which has beencharacterised by as unfair competition. Huge losses have been reported among MFIs in Kenya, this has forced MFIs to innovate differently; product, financial, organisational or market innovation. This has not yielded better results. The study sought to establish the moderating effect of the regulatory framework on the relationship between strategic innovation orientation and performance of MFIs using the case of Kenya. The indicators for the regulatory framework were; prudential guidelines, non-prudential guidelines, and government laws. A descriptive and explanatory research design was adopted as the research design with a target population of 13 MFIs from which a sample of 352 respondents was obtained using a proportionate stratified and simple random sampling technique. Both financial and non-financial measures of performance were collected and analysed using mutiple regression. The regulatory framework was found to have a moderating effect on the relationship between strategic innovation orientation and performance. The findings established that regulatory framework had a moderating effect on the relationship between strategic innovation orientation and performance of MFIs. This informs the importance of regulation and control by regulatory bodies and the government.

Key words; Strategic innovation orientation, regulatory framework, Micro Finance Institutions and Performance.

1. Introduction

The environment within which firms operate has other competitors and hence not a vacuum. MFIs offer more client trust (Mersland & Strom 2009). This environment within which they operate has regulators, hence a key determinant of their overall performance. Establishing a specific legal framework for MFIs in Morocco has helped improve the growth of MFIs (Allaire, Ashta, Attuel-Mendes, & Krishnaswamy 2009). Most MFIs are affected by changes in the regulatory framework (Ouma & Kilika, 2018). Firms' dynamic capabilities determine how they respond to the different regulatory framework (Zahra, Sapienza & Davidsson, 2006).

The regulatory framework indicators include organisational and national culture, government laws and regulations, prudential and non-prudential guidelines and industry self-regulation (Okibo & Makanga 2014; CBK, 2017; Mugo, Muathe & Waithaka 2017; Oketch, Kilika & Kinyua, 2020). Regulations laid down by regulation bodies ensure that financial institutions are financially stable and that the competition amongst the firms is sound (Abel, Khobai & Le Roux 2017; Musau, Muathe & Mwangi 2018).

Prudential and non-prudential guidelines are critical. Prudential guidelines ensure the safety and soundness of institutions so that they do not fail. It involves increasing bank capital thresholds timelines, improving asset quality and slow down the excessive competition (Abel, Khobai & Le Roux, 2017). Further, it ensures customer confidence and trust (Jones, 2002; Muriuki & Ragui, 2013). Non – prudential guidelines involve pricing guidelines by the central bank and moral suasion tools that influence the market behaviour (Abel *et al*, 2017). Moral suasion tools are used to influence and pressure but not force MFIs to adhere to policies and guidelines. In KENYA, the MFI sector needs a legislation review, especially during the COVID-19 pandemic (CBK, 2020).

Reforms like the Micro Finance Act of 2006, MFI Regulations 2008, Credit Reference Bureau (CRB) regulations of 2009, Guidance Note on Cybersecurity in 2017, interest rates caps of 2015 and current interest rate uncapping regulations of 2019 have seen ripple effects in the MFIs. Customer relationship management reforms have also increased as part of the reform agendas in Kenya's financial industry (CBK, 2017).

Despite these reforms and initiatives, Kenya's MFIs have declined in their overall performance with a combined loss before tax of Kshs. 622 Million in 2017 and Kshs. 1.4 Billion as of December 2018 (CBK, 2018). This effect in financial status has a ripple effect on the non – financial performance perspectives as well. Improvement in the performance of MFIs can be achieved through the adoption of strategic innovation orientation (Theodosiou, Kehagias, & Katsikea, 2012; Ferraresi, Quandt, dos Santos, & Frega, 2012) and the detailed understanding of the regulatory framework of MFIs.

2. Review of Literature

2.1 Theoretical Review

2.1.1 Resource Based View

Edith Penrose is the principal proponent of Resource-Based View (RBV) (Penrose, 1959). The theory emphasized the constructs of a firm’s resources. Assets and dynamic capabilities are crucial determinants of competitive advantage and performance. The RBV describes a firm as an amalgamation of tangible and intangible assets, resources, or competencies associated with the institution and are tedious to duplicate. Strategic innovation orientation as a capability is anchored on the RBV.

Studies by Lioukas, Reuer and Zollo (2016) on the effects of information technology capabilities on strategic alliances used RBV as the anchor theory of the study. Further, Donnellan and Rutledge (2019) used RBV as the main theory in establishing the performance of banks through proper alignment of strategies. Therefore, the strategic innovation orientation variable will be anchored on this theory. Edith Penrose is the principal proponent of Resource-Based View (RBV) (Penrose, 1959). The theory emphasized the constructs of a firm's resources. Assets and dynamic capabilities are crucial determinants of competitive advantage and performance. The RBV describes a firm as an amalgamation of tangible and intangible assets, resources, or competencies associated with the institution and are tedious to duplicate. Strategic innovation orientation as a capability is anchored on the RBV.

2.1.2 Institutional theory

Meyer and Rowan are the main proponents of institutional theory (Meyer, Rowan & DiMaggio, 1991). The institutional theory argues that firms are geared towards legitimacy in the sector they are operating in. Legitimacy entails regulations, rules and policies that shape the behaviour of firms in a specific environment (Dacin, Oliver & Roy2007). The institutional theory looks at firms as social institutions that need to be regulated. MFIs are social institutions that are in constant competition with each other and thus need regulations and guidelines for them to survive (Covin & Miller 2014).

According to Malika and James (2016), institutional theory among firms is based on the social structure within which firms operate in. Social desires ensure that firms behave responsibly. Nair and Bhattacharyya (2019) used institutional theory to anchor the external operating environment, which controls the economic behaviour of firms. In addition, Brower and Dacin (2020) argued that institutional theory helps in minimising risks to any firm. The institutional theory helps in understanding clearly the organisational behaviour and attitudes (Hermes, 2019).

The Top Management Team (TMT) of MFIs need to make critical decisions that are in conformity to the regulations in the sector. Thus, the study used the institutional theory in anchoring the regulatory framework, which moderates the behaviour of MFIs.

2.1.3 Dynamic Capabilities Theory

Teece, Pisano and Shuen (1997) posited that dynamic capabilities theory reflects on the firm's potential to gain new and revolutionary ways of competitive advantage despite path dependencies and core rigidities in its operational and technical processes. The dynamic capabilities theory borrows from RBV, which found out that firm-specific resources are the foundation for dynamic capabilities. Dynamic capabilities theory expounds further on firms importance of altering their capabilities to sustain their performance in a dynamic environment.

Studies by Torres, Sidorova and Jones (2018) used dynamic capabilities perspective in exploring the firm performance through business intelligence and analytics. Dynamic capabilities theory will be used to explain the strategicinnovation orientation construct.

2.2 Empirical Review

A study by Mugo, Muathe and Waithaka (2017) on the moderating effect of government policies on the relationship between mobile technology services and deposit-taking SACCOs in Kenya using descriptive and explanatory research designs found that government policies had a moderating effect on the relationship. Data was collected from 86 Deposit-Taking SACCOs by use of questionnaires. The dimensions for government policies were; data security policies, mobile banking policies and Sacco Societies Regulatory Authority (SASRA) policies. The research adopted a positivist philosophy. Performance indicators were; Return on Assets (ROA), liquidity ratio and membership. However, a contextual gap exists because the study was based on deposit-taking SACCOs. In addition, the study was limited in scope since it dealt with SACCOs only.

The effects of regulations have inconsistency; research by Saraswathy, Kannan and Parthasarathy (2019) found out that government regulations on demonetization had no negative impact on MFIs performance. Ndegwa, Kilika and Muathe, (2020) found that the external environment had no significant moderating effect on the relationship between resource isolating mechanisms and sustainable competitive advantage. The study had government regulations and laws as an indicator for the external environment. Correctly implemented regulations will enhance corporate governance, resilient business models, transparency and customer management mechanisms.

Research by Mutinda (2016) on the impact of the prudential regulatory framework on financial performance found out that the prudential regulatory framework had a significant effect on the performance of deposit-taking SACCOs in Kenya. The study used minimum liquidity requirements, minimum capital requirements, loan provisioning requirements, minimum investment requirements as the indicators of the prudential regulatory framework. In addition, return on Equity was used as the measure of performance. However, the study was limited in scope because it dealt with SACCOs only.

Chepkutwo, Jagongo and Okech (2019) research on CBK prudential guidelines on MFI operations in Kenya found out that MFIs have not fully implemented CBK prudential guidelines, and thus, it affects the attainment of their objective. The prudential guidelines aim to increase the source of funds of MFIs and ensure MFIs maintain a liquidity ratio of 20% of all their liabilities.

An exploratory study by Muithya and Muathe (2020) found out that the regulatory framework regulated the dynamic capabilities and performance of MFIs. The study conceptualized regulatory framework as organisational and national culture, government laws and regulations, prudential and non-prudential guidelines and industry self-regulation. Differences in the conceptualisation of regulatory framework call for further analysis on the concept.

Research on prudential guidelines effect on the financial performance of Nigerian deposit-taking banks by Adeghe, Aguwamba and Edobor (2019) established that prudential guidelines proxied as capital adequacy, liquidity, asset quality and leverage had varied effects on performance. Liquidity and capital adequacy had a positive but insignificant effect, while asset quality had a negative but significant effect on bank performance. Leverage had a positive and significant influence on bank performance. Bank size was the moderating variable in the study. The study had inconsistent effects of prudential guidelines on performance; besides, the study used only prudential guidelines as indicators of the regulatory framework. Prudential guidelines were conceptualized as the independent variable, while financial performance was the dependent variable. Further, the study was conducted among Nigerian commercial banks, which are better established than MFIs, thus a contextual gap. The current study will be conducted amongst Kenyan MFIs, with the regulatory framework as a moderating variable, and both financial and non-financial measures of performance will be used.

Juma and Atheru (2018) study on the effect of financial risks on the performance of Commercial Banks in Kenya found out that liquidity risk, credit risks, interest rate risks and foreign exchange risks; which form part of the prudential guidelines, had varied effects on return of assets of commercial banks in the country. Liquidity risk and interest rate had a positive and significant effect on performance, while credit risk and exchange risk had a negative and significant effect on the performance of Commercial banks in Kenya. The study focused on the financial aspects of performance. The current study will focus on financial and non-financial measures of performance. The study will be conducted among MFIs that are not well established, like commercial banks. Further, the study will adopt prudential guidelines as part of the regulatory framework.

Amahalu, Okoye, Nweze, Chinyere and Christian (2017) study on the effect of capital adequacy on financial performance of quoted deposit money banks in Nigeria established that capital adequacy; which forms part of prudential guidelines, had a positive and significant effect on the performance of Nigerian banks. The study was conducted among Nigerian banks which are more established than MFIs. The current study will be conducted among MFIs in Kenya and will use prudential guidelines as part of the regulatory framework.

Wanjohi, Wanjohi and Ndambiri (2017) research on the effect of financial risk management on the financial performance of commercial banks in Kenya, established that financial risk management, which is part of prudential measures, had varied effects on the financial performance of commercial banks in Kenya. Financial risk management was conceptualized as liquidity risk, credit risk, interest rate risk and foreign exchange risk. Using panel regression for analysis, the study established that liquidity risk, credit risk, interest rate risk and foreign exchange risk had a significant effect on the financial performance of Kenyan commercial banks. Financial risk management was conceptualized as the independent variable, while financial performance was the dependent variable. Further, the study was conducted among Kenyan commercial banks, which are better established than MFIs, thus a contextual gap. The current study will be conducted amongst Kenyan MFIs, with the regulatory framework as a moderating variable, and both financial and non-financial measures of performance will be used.

The study by Musau, Muathe and Mwangi (2018) used the operating environment as the moderating variable in the relationship between financial inclusion and stability of commercial banks in Kenya. The indicators for the operating environment were inflation and gross domestic product. The study found out that the operating environment significantly moderated the relationship between financial inclusion and stability of commercial banks in Kenya. The study used panel multiple regression for analysis. The study was in the realm of commercial banks, which are mainly developed and stable.

A study by Okafor and Asuzu (2018) on the impact of prudential measures on the performance of 17 deposit money banks in Nigeria found out that prudential measures significantly affected financial performance. The study used only financial measures of performance of banks; liquidity, non-performing loans and bank leverage. There are other measures of performance; non-financial measures, that can be used to measure performance. The look into non-prudential guidelines is also essential. The current study will look into various aspects of the regulatory framework; government laws, prudential and non-prudential guidelines.

Research by Khomsatun, Rossieta, Fitriany and Nasution (2021) on the moderating effect of regulatory framework among Islamic banks found out that regulatory framework significantly impacted Islamic banks' performance. The regulatory framework was conceptualized as Sharia accounting standard and Sharia Supervisory Board regulation. However, the current study was in the realm of MFIs which are not fully established like the Islamic banks.

Araka, Otieno and Mogwambo (2021) research on the influence of interest rate regulation on the relationship between loan lending policies and financial performance of commercial banks in Kenya using multiple linear regression method found out that interest rate regulation had a significant and negative effect on the Return on Assets. The effect was different from other studies; further, the study used financial measures of performance only. In addition, the study was limited in scope since it dealt with commercial banks only.

Research on the effect of regulatory capital on the risk-taking by Pakistani banks by Hussain, Musa and Omran (2019) established that regulatory capital, which was proxied by capital adequacy ratio, had a positive and significant effect on the risk-taking behaviour of banks. Analysis was by use of Random-effects model. Regulatory capital was conceptualized as the independent variable, while risk-taking was the dependent variable. Further, the study was conducted among Pakistan commercial banks, which are better established than MFIs, thus a contextual gap. Therefore, the current study will be conducted amongst Kenyan MFIs, with the regulatory framework as a moderating variable.

Vianney, Iravo and Namusonge (2020) research on the moderating influence of legal framework onboard leadership practices and corporate governance amongst Rwandese public institutions found out that ethical practices and advocacy significantly moderated the relationship. However, the study used different concepts of the legal framework, and it was in the context of Rwandese firms. The current study was in the context of MFIs in Kenya.

Research by Ofei, Asante and Andoh–Owusu (2020) on the moderating effect of government policy on banks' financial performance in Ghana found out that government policy did not significantly moderate the relationship. However, the study used only five banks and thus had a methodological gap. Besides, the study was in the context of commercial banks, which are more established. The study results were inconsistent with other studies, hence the need for further research on government policy's moderating effect, similar to the legal framework.

Amma, Kannan and Parthasarathy, (2019) research on the impact of regulation on the performance of MFIs in India found out that they had a significant effect. The regulations included government regulation son lending, customer protection lending. The current study adopted and adapted some of these regulations in the regulatory framework. The regulatory framework variable was an independent variable in the study, yet it is an external factor that should be considered a moderator variable.

Based on the reviewed literature, there exist differences in the conceptualisation and influence of regulatory framework on the relationship between different constructs. Thus the current study hypothesizes that;

***H_{01}**: Regulatory framework has no significant moderating effect on the relationship between strategic innovation orientation and performance of MFIs in Kenya.*

3. Research Methodology

The study collected both financial and non-financial data which was analysed using multiple linear regression where Baron and Kenny (1986) two step approach was applied in testing the hypothesis on whether regulatory framework had no significant moderating effect on the relationship between strategic innovation orientation and performance of MFIs in Kenya.

4. Findings and Discussions

The test of the hypotheses involved two steps; Strategic Innovation Orientation and Regulatory Framework as explanatory variables of performance of MFIs and step two involved Regulatory Framework as moderating variable of relationship between Strategic Innovation Orientation and performance of MFIs.

4.1 *Test of Hypotheses*

Step One: Strategic Innovation Orientation and Regulatory Framework as Explanatory Variables of performance of MFIs.

In the first step, regression analysis was conducted with strategic innovation orientation and regulatory framework as predictor variable of performance of MFIs.

Table 1 Step One: Test for Moderating Effect of Regulatory Framework

		B	**Std. Error**	**Beta**	**t**	**Sig.**
Coefficients	(Constant)	6.998	1.778		3.936	0.000
	Strategic Innovation Orientation	5.088	0.535	0.612	9.515	0.000
	Regulatory Framework	0.616	0.372	0.107	1.657	0.099
		Sum of Squares	Df	Mean Square	F	Sig.
ANOVA	Regression	4691.702	2	2345.851	74.985	.000b
	Residual	5662.423	181	31.284		
	Total	10354.13	183			
Model Summary	R	.673a				
	R Square	0.453				
	Adjusted R Square	0.447				
	Std. Error of the Estimate	5.59322				

a Dependent Variable: MFI Performance

b Predictors: (Constant), Regulatory Framework, Strategic Innovation Orientation

The results in Table 1 show that strategic innovation orientation had a coefficient β=5.088, p=0.000<0.05 while Regulatory Framework (moderating variable) had a coefficient β=0.616, p=0.099>0.05. Since the coefficient for moderating variable was insignificant, the findings implied that regulatory framework was not an explanatory variable of performance of MFIs hence it could only moderate the relationship between strategic innovation orientation and performance of MFIs.

Step Two: Regulatory Framework as Moderating Variables of relationship between strategic innovation orientation and performance of MFIs**.**

In the second step, an interaction variable was computed using the product of strategic innovation orientation and regulatory framework. A regression model was conducted using strategic innovation orientation and interaction variable (SIO*RF) as predictor variables.

Table 2 Step Two: Test for Moderating Effect of Regulatory Framework

		B	**Std. Error**	**Beta**	**t**	**Sig.**
Coefficients	(Constant)	4.139	1.968		2.103	0.037
	Strategic Innovation Orientation	3.911	0.819	0.47	4.773	0.000
	SIO*RF	0.263	0.11	0.236	2.397	0.018
		Sum of Squares	Df	Mean Square	F	Sig.
ANOVA	Regression	4782.632	2	2391.316	77.686	.000b
	Residual	5571.493	181	30.782		
	Total	10354.13	183			
Model Summary	R	.680a				
	R Square	0.462				
	Adjusted R Square	0.456				
	Std. Error of the Estimate	5.54813				

a Dependent Variable: MFI Performance

b Predictors: (Constant), SIO*RF, Strategic Innovation Orientation*Regulatory Framework

The results in Table 2 show that strategic innovation orientation had a coefficient of β=3.911, p-value=0.000<0.05 while the interaction variable (SIO*RF) had a coefficient of β=0.263, p-value=0.018<0.05. Since the coefficient of interaction variables (SIO*RF) was significant, the study rejected null hypothesis; regulatory framework has no significant moderating effect on the relationship between strategic innovation orientation and performance of MFIs in Kenya.

The findings imply that a regulatory framework is vital since it moderates the relationship between strategic innovation orientation and the performance of the MFI. This is in resonance to studies by Mugo, *et al*. (2017) and Oketch *et al*. (2020) who found out that the legal environment had a moderating effect on the relationship between Top Management Team psychological characteristics and organizational performance. Further, research by Khomsatun *et al.* (2021) on the moderating effect of regulatory framework among Islamic banks resonates well with the findings of this study.

Further, this corroborates with the study by He, Wang, Wang and Wang (2018) on the legal environment and government competition on regional research and development in China. Besides, the study supports the findings of Amma *et al.* (2019) who found out that the impact of regulation on the performance of MFIs in India was significant.

5. Conclusion and Policy Recommendations

5.1 Conclusion

This study sought to establish the moderating effect of regulatory framework on the relationship between strategic innovation orientation and performance of MFIs in Kenya. It established that regulatory framework moderates the performance. Thus if favourable laws and policies are enacted this will improve the performance of microfinance institutions in Kenya.

5.2 Policy Recommendations

The study recommends that management of MFIs needs to lobby or petition the Government to provide favourable laws and policies to boost the performance of the sector. It is essential for the Government and other regulating bodies to review the guidelines and regulations to ensure optimal and controlled performance.

To ensure MFIs and other lenders remain disciplined, there is a need for the regulatory body to have all players included, especially during this time of COVID-19 pandemic. This will prevent the ripple of a health crisis to a financial crisis. Further, policy makers in firms need to continously update themselves on the regulations in the market for them to realign their policies for sustainability.

5.3 Limitations and future research

The study was focused on licensed MFIs and thus a limitation in scope. Future studies can be conducted on other sectors like hospitality, agricultural etc to validate the results.Further, there is need for future research to use Tobit Spatial Lag Model and Tobit Spatial Error Models when analysing the data that ought to be time series as the legal environment change is fluid. The current study used mutiple regression analysis.

In addition, an empirical research on the impact of the regulatory framework during the COVID-19 pandemic should be conducted as this will provide an in-depth understanding of why regulation is important.

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