Spring 2019

Do policy frameworks affect microfinance participation in Kenya?

Matthew Reed

Do Policy Frameworks Affect Microfinance Participation in Kenya?

An Honors College Project Presented to

the Faculty of the Undergraduate

College of Business

James Madison University

by Matthew J. Reed

May 2019

Accepted by the faculty of the Department of Economics, James Madison University, in partial fulfillment of the requirements for the Honors College.

FACULTY COMMITTEE:

Project Advisor: John R. Subrick, Ph.D
Professor, College of Business

Reader: Melinda Adams, Ph.D.
Professor, College of Arts and Letters

Reader: Philip S. Heap, AbD.
Professor, College of Business

HONORS COLLEGE APPROVAL:

Bradley R. Newcomer, Ph.D.,
Dean, Honors College

PUBLIC PRESENTATION

This work is accepted for presentation, in part or in full, at Honors Symposium on April 5th, 2019.

Table of Contents

Abstract:

The following paper explores the effectiveness of microfinance policy on the registered level of participation in Kenya. The research is conducted through the lens of Acemoglu and Robinson's view of deep institutional issues restraining policy from its intended reform. Specifically, the paper looks at the effectiveness in increasing the total number of borrowers after Kenya's National Microfinance Act of 2006 in regard to property right protection issues within the country. Ultimately, the research reinforces the idea that institutional issues, both political and economic, are a severe handicap to microfinance within a developing country.

Do Policy Frameworks Affect Microfinance Participation in Kenya?

Adviser: Dr. Subrick

Student: Matthew Reed

I. Introduction

Microfinance institutions (MFI) offer an avenue to reduce poverty in sub-Saharan Africa. Currently, 69.9% of people living in this region live on less than the equivalent of $2.00 a day (Forget, 2013). The region also experiences widespread disease and political as well as social unrest that further plague chances at economic prosperity. In Kenya, the prevalence of HIV/AIDS (4.8% for 15-49 year olds) as well as neonatal issues is a huge impediment to individual prosperity for many families. Increasingly, researchers are evaluating tools such as microfinance, to determine the best methods to alleviate poverty in the region. Microfinance is a relatively young and growing industry that relies, much of the time, on donor support to provide credit opportunities to the poor. This paper focuses on the proliferation of microfinance as well as the effectiveness of policies in changing the absolute number of borrowers. Specifically, I focus on the impact of the National Microfinance Act of 2006 in Kenya.

Many economic development scholars recognize the importance of stable institutions for the long-term economic growth of countries as well as specific industries within a country. For example, Daron Acemoglu and James Robinson write that "Economic institutions matter for economic growth because they shape the incentives of key economic actors in society," which will ultimately determine key factors for production, such as the business environment available to all citizens of a given country (Acemoglu & Robinson, 2005, p.389). They continue on to say that political power determines economic institutions. The institutions present in a country are capable of constricting or allowing business to flourish despite trendy policy reforms that do not address deep institutional issues. I examine Kenya’s National Microfinance Act of 2006 through the policy and institutional framework established by Acemoglu and Robinson. Specifically, deep institutional issues are stifling to positive policy attempts.

Property rights and contract enforcement are of first-order importance for the development and sustainability of business in a given country. I argue that property rights are relatively more important for the poor in a society, and at the very least, lack of rights inhibits this demographic the most. This assumption has implications for the state of microfinance in a given country. Much of the target population for microfinance programs, especially in Sub-Saharan Africa, are the poorest in the region. When property rights are disrupted, it disrupts the fundamental point of microfinance institutions. That is, allowing poor entrepreneurs the space and material necessary to thrive. The underlying principle guiding this paper is the assumption that policy initiatives are not capable of pushing economic growth without objectively stable political and economic institutions. The question asked throughout this paper; is policy without strong institutions enough to affect microfinance participation in Kenya? The following paper uses property rights as the measure of institutional effectiveness when evaluating policy implications. The research conducted, points to the idea that proliferation of microfinance in a country is difficult to come by and sustain simply from policy initiatives that are not backed by solid institutions and business environments. Specifically, the lack of microfinance participation in Kenya is due to a lack of property rights enforcement that degrades the business environment for potential microfinance borrowers.

II. Historical Analysis

Microfinance is the financial service provided by intermediaries that offer loans, credit, or insurance to low-income individuals who would not otherwise be capable of financing a business venture (Ann, 2018). Many of the beneficiaries of these financial services cannot secure a traditional bank loan. There are several reasons for this. First, offering, maintaining, and monitoring the status of the loan leads to extremely high transaction costs that make justifying the loan at such a low amount, around $973 on average in developing countries, difficult. The average operating expense for microfinance portfolios has hovered around 26.7% of the total portfolio value which is high in relation to more traditional lending practices (Nkungi, 2013). This operating expense is also high in comparison to the larger microfinance industry. For example, Caribbean microfinance organizations are generally operating at the benchmark of 18.8% (CMA, 2011). Second, most of those in need of microfinance assistance lack credit worthiness to their name and pose too great a risk for little reward to any traditional lender. For example, the first modern version of microlending occurred when Dr. Muhammed Yunus offered 42 women the small funds necessary buy raw materials for the stools they created. No other traditional financial lending institution was present in the area or willing to loan the women such a small amount (Ann, 2018).

MFI is the term commonly used when referring to any organization offering credit and savings opportunities to the poor as a business model. MFIs can be non-governmental institutions, government banks, savings and loan cooperatives, commercial banks, and other financial organizations. There exists a myriad of differing laws and policies that dictate the way in which these organizations can offer and recoup loans. This has implications for the effect and pervasiveness of these organizations in the communities they set out to affect. The World Bank defines microfinance as one of the key development tools when looking to promote economic growth. The organizations that push microfinance and microcredit programs generally involve social intermediation of some sort (Ledgerwood, 1999). Examples of this include "group formation, development of self-confidence, and training in financial literacy and management capabilities among members of a group" as well as training in skills related to the entrepreneurial endeavors many times associated with microloans (Ledgerwood, 1999). The programs do not generally experience success without a related mechanism to teach the beneficiaries the basic principles of business and saving practices (Ledgerwood, 1999).

Dr. Muhammad Yunus is the founder of modern microfinance. Dr. Yunus gained this title after he began lending money to poor villagers in and around Bangladesh in the mid-1970s. Throughout the 1970s, governmental organizations looked to offer credit to farmers who did not have access to credit dealing institutions (Ledgerwood, 1999). Stimulating agricultural production among low-income farmers was the main goal of many of these organizations. Dr. Yunus looked past the agricultural implications of the credit programs and began loaning money to women at no interest in to help break their cycle of debt (MicroWorld, 2019). Yunus eventually founded the Grameen Bank in 1983 which gave structure to his endeavor and allowed him to reach a larger portion of the rural poor (Ann, 2018). The Grameen Banks encouraged other MFI organizations to begin loaning in small amounts as well (MicroWorld, 2019). Dr. Yunus demonstrated that microfinance is a legitimate business even when working with the poorest would-be entrepreneurs. The Grameen Bank relies on two separate principles to operate. The first is the group liability mechanism, which encourages borrowers to pay back their loans in order to uphold their reputation within the lending group. Second, the bank positions itself in areas where there is little else in the way of lending opportunities. In short, they become the sole supplier in many areas for potential borrowers. These two guiding business principles have led the Grameen Bank to a recovery rate of 96.67% without the requirement of collateral (Pattanaveerangkoon, 2014). This recovery rate may be positive for a sustainable business model, but the organization has received criticisms for high pressure to repay loans at all costs.

Similar ventures to Dr. Yunus' proliferated quickly around the world. Similar to the original model, America ACCION International, a leading group in the microfinance field, successfully implemented a system of group lending to urban vendors in Latin America starting in the 1980s. There was reaction throughout financial institutions other than NGOs. In Indonesia, the Bank Rakyat offered incentives for on time payment and saving between its borrowers and staff associates at the bank (Ledgerwood, 1999). The 1990s brought about further commercialization of the microfinance industry. Institutions found they needed to restructure to better attract commercial investors (MicroWorld, 2019). There was not enough grant funding in order to keep pace with the growth associated with the industry. Due to this change to more formal business practices, there was much more transparency and incentive for formal financial institutions in the funding. For example, Credit Suisse, Deutsche Bank and Citigroup have all entered into microfinance ventures in the last 20 years due to the proven business model (MicroWorld, 2019).

Microfinance continues to grow throughout the world at a rate consistently greater than 9%. In 2016 there were 123 million customers with a total loan portfolio of $102 billion (BNP, 2017). Much of this growth is focused in South Asia, which boasts around 60% of all borrowers around the world. Following them is Latin America and the Caribbean with $42.5 billion in outstanding loans (BNP, 2017). In contrast, Sub-Saharan Africa only has a total of $8.7 billion dollars in the MFI sector. Today, most of the people who borrow around the world are women in rural areas. Along with this, MFIs generally offer several other services to enable their customers and beneficiaries to succeed. These educational services include workshops aimed at disadvantaged group, which in many cases are the women microfinance organizations are lending to.

Many in African countries currently do not have access to any microfinance options to try and pull them out of the cycle of poverty. As of 2007, only 12.7% of the poorest families in Africa had any access to MFIs whereas 78.5% of the poorest in Asia had access to micro lending institutions (UN, 2013). Despite the efforts of many NGOs and financial institutions, there are still many people on the continent not capable of securing the miniscule amount of funding needed for entrepreneurial endeavors. In the early period of microfinance, many countries formed state run programs aimed at the agricultural sector. These early state run programs faced "subsidy dependence, low recovery rates, inadequately diversified portfolios, inadequate credit targeting and rent-seeking by credit officials" (UN, 2013, p.26). The corruption associated with property rights, judicial enforcement, and loan officials was extremely detrimental to the early versions of microcredit lending. These issues made it difficult for microfinance programs to remain viable and cut short the reach these programs could have had otherwise.

African microfinance operations also have high operating costs. The average operating cost of an MFI in Africa in 2010 was 32.6% of their entire loan portfolio (Atikus, 2014). This is slightly higher than the world average of 30% operating costs for MFIs (Kringlen, 2016). These MFIs generally lack the necessary numbers of competent and trained professionals. In the financial sector throughout much of Africa, there are few professionals capable of handling the audit and law sectors of the business (Atikus, 2014). In the World Bank's report on the status of the microfinance industry, it mentions that "Many MFIs never reach either the minimal scale or the efficiency necessary to cover costs" (Ledgerwood, 1999, p.4). This is due to the high risk in certain situations associated with these loans which require high interest rates to stay operational which in turn segment out certain potential clients that would otherwise choose to borrow with more reasonable rates. This situation is further hurt by a lack of property rights as well as contract enforcement. The risk associated with transactions and the loans themselves is raised as institutional issues such as a lack of property rights protection and contract enforcement are degraded. This, in turn, pushes out potential borrowers. As mentioned before, there needs to be a mix of community accountability and need in the area for microcredit opportunities to be viable as it was in Bangladesh for The Grameen Bank.

Donor influence has remained an extremely important force in microfinance operations. This is due to the structure of these organizations and their reliance on the donors. Armendariz and Morduch (2011) write that "profitability has been elusive" for many of these organizations. The lack of established and effective financial practices in regard to these microfinance operations keeps them from profitability and leads them to rely on donors for support in order to keep the operation viable. This leaves much of the power in the hands of the donors who generally are not on the ground or well informed. They also make clear that many times, the MFI programs that cannot remain financially afloat are programs that are most celeb rated for their work in impoverished communities (Armendariz & Morduch, 2011).

Morduch and Armendariz summarize research pointing to the idea that reliance on donors has given the donors a larger and more effective voice, but that with this voice the donors have generally called for a reduction in subsidies. They write that donors fear past mistakes and now prefer subsidization only cover startup costs (Armendariz & Morduch, 2011). The question of the amount of subsidies in microfinance naturally brings up the question of what effects and reasons were the subsidies there in the first place. Morduch makes clear that the argument for subsidies within the microfinance industry is justifiable when thinking of the social impact it can have on a community, but that the financial prudence of the subsidy is a more difficult question to answer (Armendariz & Morduch, 2011). Microfinance operations are there for credit lending purposes, but they are also around to provide positive social impact for many poor people. Few studies however have been able to effectively analyze the impact of positive externalities on these poor communities. For example, Kenyan NGOs that offer microfinance services many times also offer educational outlets that improve residents' future prospects as well as help integrate them into the advancing economy around them. One such example of an NGO that does both in Kenya is the Tembo Education Group and its affiliates. Policies aimed at the microfinance industry must consider all of the secondary and tertiary effects of their actions and funding decisions.

In addition to the issues facing state run microfinance institutions in Africa during the 1980s, private financial organizations faced issues staying in the market of micro lending, as state run endeavors and heavy subsidization of other programs forced them out (UN, 2013). Financial sector reforms spread across Africa in the late 1980s, which led to a more market based response to banking. This included the liberalization of interest and exchange rates, privatized most banks, and opened the finance sector to foreign competition. After this liberalization of the finance industry, there was a second round of financial reforms that swept in the 1990s that included improvements to the auditing, accounting, and regulatory systems (UN, 2013). This is where there was a split in the belief of the effect of microfinance regulation. The two opinions were that deepened regulation either would provide more structure and positive regulation for MFIs or would simply make the legal structure too complicated for small MFIs to operate.

The debate over the impact and stated importance of microfinance is most clear when analyzing debates of the microfinance schism. The term, coined by Morduch, refers to the disagreements between institutionalists and welfarists in the field of microfinance. Institutionalists generally expect a financial model of microcredit lending that emphasizes financial sustainability and "best practices" utilized by credit granting organizations (Brau & Woller, 2004). This model typically makes the institution much less reliant on donor opinion and also emphasizes the importance of a sustainable business model. Welfarists do not focus as much on sustainability in the financial model, rather they focus on the depth of outreach provided by these programs (Brau & Woller, 2004). Depth of outreach includes things like social impact and the ability of the organization to pull a large quantity of an area's poor out of poverty. This is in contrast to the view of institutionalists who place sustainability as a business model above all else.

Research suggests that there is a trade-off between depth of outreach and the financial sustainability of a given microfinance organization (von Pischke, 1996). This leads to institutionalists and welfarists as diametrically opposed with the question of subsidies as the point of contention. Both sides have viable arguments as the welfarists conclude that donations and subsidies are counted in the form of equity (Brau & Woller, 2004). They believe these donors are social impact investors and that if an organization is only financially sustainable through their help, it is still a viable model. In addition, research points to the idea that true self-sufficiency is achieved in countries in which the borrowers are only slightly above or slightly below the poverty line (Navajas et al., 2000).

III. History and Current State in Kenya

Kenya has served as an economic leader in East Africa and has recently experienced years of growth as well as some stagnation in their GDP. The country sits just under $1,170 per capita per year which outpaces its southern neighbor Tanzania at $900 per capita per year. Annual GDP growth increased from 0.2% in 2002 to 7% in 2007 (ATC, 2013). Following this economic upturn, violence surrounded the 2007 elections which predictably had an adverse effect on the economic climate of the country and the region. The country and citizens experienced a large amount of displacement and civil unrest. Over one million people were displaced and around 500,000 lost residences as unrest spread. This unrest had a direct impact on the Kenyan economy in the form of millions of lost Kenyan shillings in property value and had a direct adverse effect on the microfinance industry (ATC, 2013). The country's GDP began to get back on track as of 2009, but the economic climate is still altered. The World Bank reports that 72% of the increase in GDP from 2006 to 2013, the year the National Microfinance Act was instituted, was due to an increase in the service sector. That said, the agricultural sector is still fairly stagnant with growth at 2% (ATC, 2013). This has profound impacts on microfinance in Kenya, as well as many other rural regions, as microfinance is historically meant to bolster agricultural production and microenterprises.

Microfinance is a substantial industry within Kenya today and has impacts ranging from financial to positive social externalities. Microfinance is a relatively new industry within Kenya and though it was around in the 1980's, did not receive recognition and much awareness until the 1990's (Hospes, 2002). An indirect bolster occurred in the microfinance industry within Kenya from 1992-1994 in the form of financial restructuring. The government of Kenya implemented a Structural Adjustment Program which led to a liberalization of the economy (Hospes, 2002).

This led to a more accessible business environment for would-be entrepreneurs. The Government also anticipated effects against those not protected in the newly competitive economy and responded by identifying programs and initiatives that may require donor support, which included microfinance enterprises. The government identified a lack of access to credit as a major blockade to entrepreneurial development within the country. Following this liberalization of the economy, donations and subsidies were extremely common leading to estimates of around 80 million USD between the two from various NGOs and private donors by just 2002 (Hospes, 2002). At this point, several different types of microfinance agencies emerged. This includes agencies that are modeled off best business practices as well as agencies that simply used microfinance as a vessel for positive social impact initiatives. The lines between these two types of agencies are blurred, but the difference is in the objective of the company. Many companies are focused on the profit possibilities of microfinance, whereas others see microfinance as one of many tools to affect the lives of the poor.

There are several lending strategies that are in Kenya due to inspiration from the Grameen Bank style of lending. First, there is the group-lending model which puts prospective borrowers into larger cohorts to take advantage of possible economies of scale as well as diversify the risk for borrowers. With large groups of borrowers, portfolio managers are more capable of organizing and keeping track of the group, and the group may also build a formal accountability system amongst the members. Second, many lending decisions are based off of an informal character appraisal system. When collateral is not an option for the client, this system is generally used. This is the main method utilized by The Grameen Bank. The bank or microfinance organization relies on community pressure to ensure the paying back of loans.

Third, there is a focus of the institutions on offering credit to very low income people and very small businesses (Hospes, 2002).

A census conducted by the Government of Kenya in 2007 evaluated the current state of microfinance in Kenya. The census included a broad review of the financial sector as well as a review of the more niche microfinance industry. Looking at the overview of the financial sector, there were 5,122 SACCOs (savings and credit cooperatives), 42 commercial banks, 3 public banks, 2 mortgage financing companies, and 1 non-banking financial institution. Focusing in on the microfinance industry, it is necessary to analyze a 2003 study. In this study there were 3,460 legally constituted microfinance service providers. This broke down into 3,397 savings and credit cooperatives, 56 microfinance institutions, four commercial banks, two building societies, and the Kenya Post Office Savings Bank. Interesting to note is the number of organizations and groups listed in the study that are not registered by the Government of Kenya. The study revealed 17,305 rotating savings and credit organizations, 115,884 registered women groups', 1,342 primary agricultural producer and marketing cooperative societies. These unregistered organizations also play a role in distributing credit and bolstering savings among Kenyans (ATC, 2013).

Despite the rapid growth of microfinance in Kenya, the report indicates that 35.2 % of Kenyans need more access to savings and credit services. Another 30.2% on Kenyans are reportedly unable to secure any sort of financial services. Analyzing the St. Louis Fed's data regarding microfinance organization's registration numbers, the Microfinance Act of 2006 did not have the intended impact and outreach in registration it was expected to at the time it was implemented. Estimates report that 3.8 million Kenyans depend entirely on NGOs, cooperatives, and the Kenya Post Office Savings Bank for financial service services. Along with this, 1.1

million Kenyans rely on the informal associations and networks previously mentioned due to a lack of red tape, as well as a last resort. The violence surrounding the 2007 elections disrupted the microfinance industry. Many MFI portfolios lost customers due to displacement (ATC, 2013). In addition to this, MFIs needed to deal with the increased risk associated with the volatility in the financial market. Due to this increased risk, rates increased which ultimately pushed even more potential borrowers out of reach of these financial services (ATC, 2013).

There are several characteristics of Kenya's microfinance industry that make it unique. First, it is very concentrated with Equity Bank holding 80.4% of the industry's total assets (Nkungi, 2013). It is also an industry that has experienced around 30.4% growth in the last several years. This is not surprising due to immaturity of the industry. The microfinance industry makes up 7.33% of the total GDP of Kenya (Nkungi, 2013). This is in line with other developing countries where microfinance has been growing. In the same year, microfinance made up 8.6% of Cambodia's total GDP. The current interest rate on average in Kenya is 9.90% which reflects the high risk of lending in the industry (Kodongo, 2013). In addition to this, the average age of an individual receiving a loan is 37; which fits into the narrative that Kenya's lending market is stringent in the microfinance sector (Kodongo, 2013).

Additionally, the informal sector of microfinance in Kenya is dominated by two different types of organizations known as Rotating Savings and Credit Associations (ROSCAS) and Accumulating Savings & Credit Associations (ASCAS) (Ouko, 2006). These groups fall outside the normal reach of government regulation. ROSCAS are groups of persons who agree to meet for a well-defined period of time in order to save and borrow amongst themselves. It is known more commonly as a "merry-go-round." This type of savings and lending group is utilized mostly by women in rural communities. Members of a standard ROSCAS group will contribute a set amount to a pot of money at designated times and this pot of money is distributed to a selected member through consensus or casting lots (Ouko, 2006). There is also a bidding system that can determine who will take the current pot. As with all operating procedures regarding informal organizations such as this, it up to the specific ROSCAs. That said, it is commonplace for a certain amount of funds to remain in the pot in order to meet savings and risk alleviation goals.

ASCAs are distinct from ROSCAs in several ways. First, the funds in ASCAs are left to accumulate for a given time to develop a base for the group to lend from. There is a more long term focus on the lending and savings process in the ASCAs. Many times, groups of these organizations or people start off as small scale ROSCAs and develop into larger organizations and transition into an ASCA format. Both the ROSCAs and ASCAs are autonomous and completely voluntary for the depositors. Ultimately, most of the informal microfinance operations in Kenya are classified as some sort of mix between ROSCA and ASCA. The informal sector of microfinance is an extremely important aspect of the microfinance industry in Kenya as it is the only vehicle available to many poor Kenyans. The informal sector of microfinance in Kenya used to consist mostly of informal loan agents, and community savings groups. As is analyzed later in the paper, there are now more options for the poor as formal MFI institutions became available. Beyond policy and regulation, the Kenyan Government has implemented financial support periodically for informal groups of ROSCAs and ASCAs. There are questions as to the pass through and eventual usefulness of funds earmarked for these informal institutions. Low literacy and general education levels affect the ability of members in informal institutions to apply for formal funding from the Kenyan Government as well as preparing a constitution for the organization.

IV. Structure and Policy Analysis in Kenya

The immaturity of the microfinance industry in Kenya makes it difficult to analyze the effects of different policies as so few are implemented. In addition to this, there is not always adherence to the published rules. This is due to the lack of monitoring and enforcement of standards in the financial industry. The most important and most direct policy initiative affecting the microfinance industry is the National Microfinance Act of 2006. The act focuses on registering deposit taking microfinance organizations and providing protections to borrowers in these formal institutions. There are various other structural, legal, and policy initiatives that affect this young industry.

The search for a sustainable regulatory system is necessary as government and donor funds are not capable of meeting all of the demand for microfinance (Saaid Ali, 2015). This logically leads to the conclusion that if microfinance client demand is met worldwide the void needs filled with self-sufficient microfinance institutions that adhere to reasonable and enforceable regulations (Marguerite S. Robinson, 2001). The issue Kenya's financial sector struggles with is its relative informality when dealing with contract enforcement and regulation (Saaid Ali, 2015). Along with this, there are informational asymmetry issues that ultimately drive up risk for the financial intermediaries in Kenya. The policies and regulatory structures put in place focus on providing mechanisms and reasonable ways that guarantee enforcement.

One of the points of contention in the microfinance industry is whether the focus of regulation should be on the actual MFIs themselves or the customers (Ouko, 2006). The argument for regulation revolving and catering to the MFIs is that they must be tightly regulated to remain financially viable and ultimately capable of serving the public without being heavily subsidized. The other side of the argument is that MFIs should instead focus on the clients with their number one goal being financial inclusion. The argument stems from the same source as many disagreements among experts in microfinance; is microfinance more important for its financial or social impact effects? There have been attempts to create such a model that would analyze the population density discrepancies as well as the poverty differences among different regions in the country and tailor a non-uniform approach to fit these regions (Wanjau, 2006).

The Government in Kenya has a relatively heavy hand in the development of the microfinance market and utilizes the Central Bank of Kenya to regulate the industry. An important distinction is that the microfinance industry splits into two different classifications. These classifications split as deposit taking MFIs and non-deposit taking MFIs. The Central Bank of Kenya is only able to effectively regulate the deposit taking MFIs. This leads to a lack of control for the Kenyan Government in their attempt to control and protect the infant industry. The Central Bank of Kenya is not able in any way to regulate less formal institutions which leads to a lack of regulation for borrowers. Borrowers in this situation are not guaranteed the protections given to borrowers of formal deposit taking institutions. In fact, the non-deposit taking institutions, or credit-only institutions, are not directly controlled by any Kenyan Government entity. They are still self-regulated by their own missions whether it be profit motive, social motive, or a mix of the two, as well as the agreements they come to with supplementary organizations. Many times, credit-only institutions and organizations rely on relationships established by people within close proximity. An example of this are groups of women that come together to build their pool of funds for lending opportunities and risk alleviation. They rely on their ability to judge character as well as simply remembering how responsible each member and potential member are when considering whether or not to loan certain individuals money. This is the most informal sector of the industry as it simply cannot be regulated by the government, but is much of the time guided by the framework of a separate organization such as an NGO.

One of the biggest problems associated with non-deposit taking MFIs is that predatory institutions can take advantage of poor customers (Ouko, 2006). Many times, unfavorable loan conditions are the only way the financial institution or organization can make a profit from their portfolios. They rely on relatively high interest rates as well as unreasonable collateral expectations. This is where regulation seen as capable of supporting vulnerable borrowers. Morduch (2005) suggests that microfinance generally does not help the most poor in a given country. The Central Bank of Kenya is not capable of reacting to or preemptively stopping these MFIs from taking advantage of desperate customers (Kamau, 2014). There were arrests made by law enforcement associated with the Central Bank of Kenya on top officials in Kenya Akiba Micro Financing Ltd. The officials were suspected of illegal and immoral banking practices. Ultimately though, convictions did not follow the arrests as the organizations fall into a grey area of the microfinance law. Originally, the Microfinance Act of 2006 was going to include portions that would regulate credit-only institutions, but this did not pan out (Kamau, 2014). The law was actually drafted, but ultimately not voted into effect (Kamau, 2014).

The four most prominent policies that regulate the Kenyan microfinance industry are the Banking Act, Companies Act, Central Bank of Kenya Act, and the Microfinance Act of 2006. The policy with the most direct effects on the microfinance industry in Kenya is the Microfinance Act of 2006. Before 2006, the microfinance industry in Kenya remained unregulated, with the exception of registration requirements (Ouko, 2006). All MFIs registered either as NGOs or as SACCOs. There was no split and distinction between formal and informal MFIs. In addition, there were no capital or licensing requirements set by the Central Bank of Kenya. In essence, microfinance organizations were not regulated beyond becoming registered and were capable of operating in any way they saw fit thereafter.

The new Microfinance Act of 2006 provided the licensing and continued regulation requirements for microfinance organizations in Kenya. The act itself passed in 2006, but policies within it did not affect the market until 2008. The most important classifications defined in the act are between deposit-taking organization, credit-only institutions, and informal organizations. As mentioned earlier in the paper, the act only applies to deposit taking organizations, leaving out many credit only and informal organizations from the regulatory frameworks set out by the Central Bank of Kenya. In order for a deposit taking MFI to be fully registered, it must be registered under either the Companies Act or Banking Act as well as separately registered under the Microfinance Act. In order to become licensed, the organization must provide documents of registration as well as indicate the areas in which it will be operating (Ouko 33). Another effect of the instituted Microfinance Act is the inclusion of registered deposit taking MFIs under the "Deposit Protection Fund Board (a deposit insurance scheme) that protects depositors' deposits up to KES 100,000" (Saaid Ali, 2015).

There is a tier of microfinance institutions defined by the most recent update to the Microfinance Act as of 2014. This tier of microfinance institutions includes credit only MFIs that register only with the Ministry of Finance. Due to this, the Ministry of Finance is the only body capable of regulating and enforcing regulation against this second tier of MFIs (Saaid Ali, 2015).

The regulation of deposit taking institutions could force many NGOs and charitable organizations out of the market that are attempting to help alleviate Kenyan poverty.

Specifically, registering a company for a more informal deposit taking institution such as an NGO can be difficult in more rural areas for several reasons. First, it can be difficult for many to physically go to Nairobi to register the company, as this is only done in Nairobi. Many involved in more informal organizations may not believe this is necessary. This may be especially true considering Kenya's lack of government and judiciary enforcement when considering contracts and policies. In addition, the literacy issues in many rural parts of the country make it difficult for informal groups that must communicate with authorities in Nairobi. Also, if there is no overarching program looking out for poor groups that are deposit taking, none of the individuals are likely capable of going to the lengths to register and license the group and the group likely also does not meet the base requirements set out in the act.

Many microfinance programs specifically target the poor involved in the agricultural industry. This is a problem for registration as MFIs located very far from Nairobi are at a distinct disadvantage. There is simply very little enforcement compelling these small rural programs from registering under the new policy. Mentioned in several journal articles is the idea that an NGO loses the charitable aspect of its operations as soon as it registers as a deposit-taking microfinance organization (Ledgerwood, 1999). Many believe that registering the organization will make it more profit driven and less financially inclusive. Whether there is truth behind this implication is dubious, but regardless many organizations likely feel this perception would hurt their image and elect not to make the jump to register under the new act. Keeping in mind, the Microfinance Act actually provides restrictions on companies that help keep customers safe from negative lending practices.

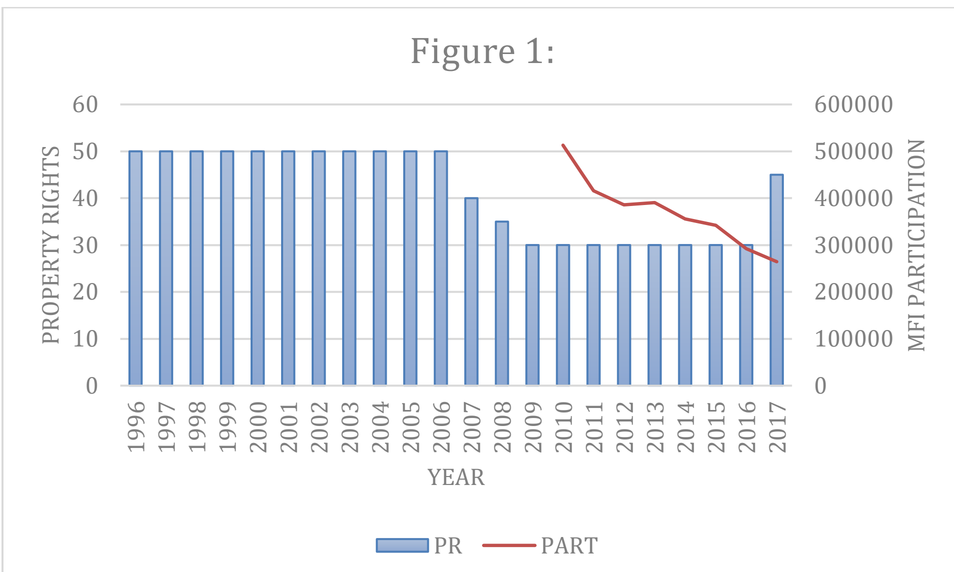
There are several aspects of the regulatory environment and judicial structure that have great impact on the economic efficiency of an industry. The microfinance industry is subject to many of the same conditions that dictate success for other industries. The following sections will explore the importance of these separate conditions as well as use the Index of Economic Freedom as the rating method for Kenya's success levels. The first condition that can determine success and possible proliferation of the industry is the attention paid to property rights in a given country. This is an especially important factor as property rights need to be clearly established by the rule of law and enforced consistently for business to flourish. Another key aspect of property rights measurements is the measure of risk that land and subsequent business activities may be expropriated. Similarly, the judiciary and its enforcement as well as possible corruption falls under this category as well. Kenya consistently scored around the world average for this measure, but took a large hit downward when violence surrounding the 2007 elections erupted. The country has since recovered in order to hover again around the world average which is still generally not conducive to bolstering economic prosperity.

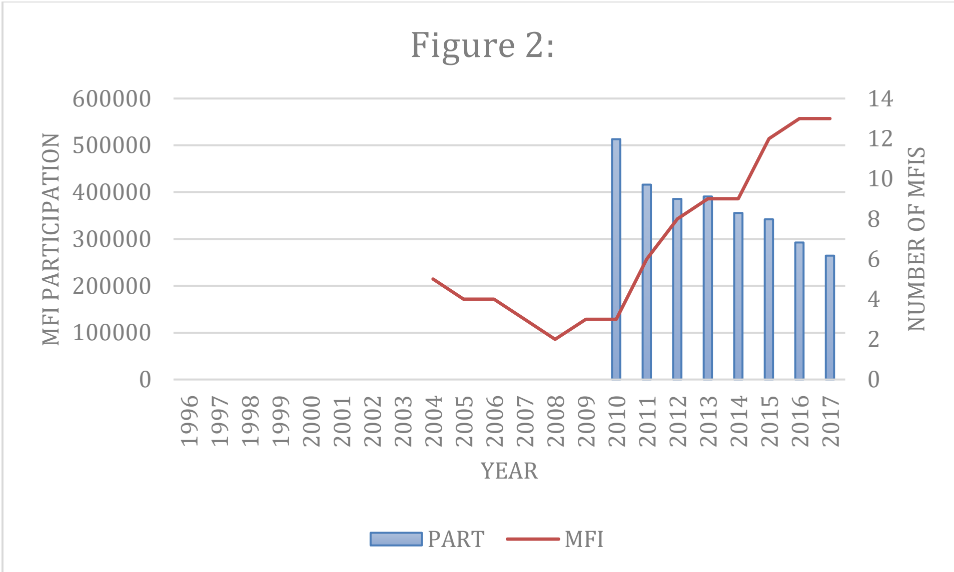
Another business condition measured by the Economic Freedom Index is government integrity. Since the 1990's, Kenya consistently ranks below the rest of the world's average. This indicates high levels of corruption and uncertainty in the business world. An interesting aspect of this is that there is no significant dip in the violent years surrounding the 2007 election. Rather, the consistently low score indicates the continued issue of corruption in the country. Possibly the most important variable measured by the index in relation to microfinance is the amount of business freedom in a country. Business freedom covers the essential aspects of starting, operating, and closing a business as well as the regulatory efficiency of the government in regard to these three functions. This has obvious ties to the previously mentioned stipulations for starting and licensing microfinance organizations outlined in the latest updates of the Microfinance Act of 2006. Business freedom reached a peak in Kenya at 67% in 2009, beating the world average of 64.6% and the Sub-Saharan Africa average of 51.4%, but dropped severely at that point, possibly indicating negative effects from the microfinance policy that did not actually take effect until 2008.

Investment freedom is the ability of individuals and organizations to move capital and resources internally as well as across the country's borders. This measure is important for the larger microfinance firms and their ability to move and allocate investment capital. Kenya's score hovers around 50%, but increases slightly after the year 2015. This still indicates fairly poor conditions for capital allocation. The last measurement utilized is the index for financial freedom. This freedom measures the level of banking efficiency present in the financial markets as well as the level of government interference in the sector. The measurement takes into account any state level run banks and factors in the country's central bank and its ability to regulate and enforce contracts in order to facilitate business activities. The index dictates that ideally a high score in this category denotes that credit is lent at the market rate, financial institutions are generally self-sufficient and run as they see fit, and the central bank simply focuses on enforcing contracts and preventing fraud. Kenya has consistently scored around the world average of 50% since the early 2000s. Enforcing of contracts remains at the forefront of guaranteeing economic efficiency. Bentley Macleod writes about the high costs of contract enforcement and emphasizes the ability of informal networks utilizing factors such as reputation to regulate contract enforcement in the business world. The value of relationships is especially important in growing economies such as Kenya's as exemplified in the supply shock to Kenyan rose exports (Macchiavello, 2015). These relationships are what ultimately hold together the microfinance industry in Kenya.

V. Data

The data utilized all comes from reputable sources such as the St. Louis Fed, the Economic Freedom Index, and the IMF. Figure 1 graphs the dip in microfinance participation collected from the St. Louis Fed as a function of the drop in property rights measured from the Economic Freedom Index within Kenya. Figure 2 depicts the relationship between MFI participation in Kenya and the number of deposit-taking MFI institutions registered in the country which was taken from the IMF. Discussion of the actual implications behind the graph and data set is found in the analysis section.





There is a sufficient amount of data to make this analysis and review of the microfinance industry in Kenya. There are several considerations when considering data from Kenya. The microfinance industry is a relatively young industry that strictly records data in certain areas, such as in Bangladesh. Second, there are a myriad of different types of microfinance organizations and attempting to account for all types without leaving out a critical portion is not feasible. Therefore, essential portions of the industry and factors that affect it directly are included in the collected data set. Third, sectors of the industry do not record data at all. For example, donor contributions are rarely accounted for and certainly not made public for many of the NGOs that operate in the region. Ultimately, the data is not complete, but can still help to tell the story of a policy's lack of effect on actual microfinance participation despite the expectation that it would attract more borrowers.

The three variables that make up Figure 1 and Figure 2 are number of MFIs, MFI participation, and property rights. Respectively, the data for the three variables in order was pulled from the IMF, the St. Louis Fed, and the Economic Freedom Index. The number of MFIs measures the number of registered microfinance institutions in Kenya during the year given. The registration factor gives borrowers of these institutions extra safeguards such as protection against high pressure repayment practices. MFI participation is the actual number of borrowers associated with these registered MFIs in a given year. Lastly, property rights is the measure of Kenya's score in property right protection and enforcement given by The Economic Freedom Index.

VI. Analysis

Analyzing the given data set revolved around the theory that policies may have little effect if institutional issues are not kept in check. The theory posits that negative political or economic institutions can severely debilitate growth within a given country as well as growth within specific industries. The data seemingly support this framework for economic development by showing the correlation between a drop in property rights and a subsequent drop in microfinance participation. Basic assumptions suggest that an increase in microfinance protections that make more suitable business and entrepreneurship environments with less risk would lead to increased demand for microfinance loans. That said, the data show a puzzling lack microfinance institutions registering under the National Microfinance Act of 2006.

On the surface it seemed as if violence sweeping through the country was the only factor at play, but microfinance institutions were still multiplying and registering under the new act. As seen in the data, registered deposit taking microfinance organizations increased from 5 to 13 institutions from 2004 to 2017. While the number of organizations were increasing there was a simultaneous decrease in the actual number of borrowers in the deposit taking microfinance sector. Over the same period, property rights experienced a decline while claims, which represents the health of the credit sector as a whole, continued to trend upwards. The correlation between the two variables is at -0.76. Also, on the surface policy did have an effect on the number of institutions registered as they both trended upwards after the implementation year of 2008.

The given data allow for a murky picture unless the Acemoglu and Robinson view of institutions frames the data set. With this framework in mind, Kenya's National Microfinance Act positively affects the number of microfinance institutions that are present and registered in the country, but the Act alone is not capable of overriding the issue of property rights instability. Property rights instability is likely due to a combination of violence, corruption, and bad business practices. This occurred around the 2007 elections and obviously had an adverse impact on business conditions at the time. This instability is an institutional issue that affects the number of actual microfinance borrowers in the country, and specifically the number borrowing from formal institutions. The issue seems magnified in the microfinance sector as the rest of the credit sector in Kenya continued to trend upward suggesting a healthy industry. The microfinance industry is a sector that is likely affected at a greater rate due to the stated purpose of the industry. It serves the poor of society, which is much more sensitive to poor business conditions as was measure by the Economic Freedom Index.

On a side note, the formal banking sector may also be picking up prospective microfinance borrowers who are averse to the risk posed by the lack of property right stability. This falls in line with the idea that the poorest members of society are more susceptible to property right instability. The poor within a developing country are more likely to be affected and offered fewer protections against institutional issues. These issues include property rights issues, corruption at all levels, and the poor do not have the funds to attempt to navigate a convoluted legal system. Ultimately, despite the National Microfinance Act's incentive and success in to increasing the number of registered MFIs, the Act is not capable of mitigating the risk and convincing prospective borrowers to work with these registered MFI institutions when property rights continue to trend downward in the country.

VII. Conclusion

Significant research, specifically from Acemoglu and Robinson, suggests that the presence of solid and positive institutions are a necessary requirement for the economic growth of a country and specific industry. When attempting to analyze this point of view in regard to the microfinance industry in Kenya it is evident that there are structures and conditions preventing the full intended effect of a given policy. In this case, the intended protections of the National Microfinance Act of 2006 seem stunted due to the declining property rights within the country. There is also evidently more of an effect on the poorest in society and subsequently the microfinance industry as a whole. Ultimately, this is obviously only one aspect of the development argument, but is an important consideration when deciding on development programs that involve monetary aide or policy initiatives.

VIII. References

Acemoglu, D., & Robinson, J. (2005). INSTITUTIONS AS A FUNDAMENTAL CAUSE OF LONG-RUN GROWTH. Handbook of Economic Growth, 1A.

Ann, R. (2018, April 25). Microfinance: What It Is and Why It Matters. Retrieved from https://www.businessnewsdaily.com/4286-microfinance.html

Armendariz, B., & Morduch, J. (2011). The economics of microfinance. New Delhi: PHI

Learning Press.

ATC Consortium. (2013). Retrieved from https://web.archive.org/web/20130603203238/http://www.mfi-upgrading-initiative.org/000001985b0d93482/00000198660ae2e07/032d539c050945b02/index.html

Brau, J., & Woller, G. (2004). Microfinance: A Comprehensive Review of the Existing Literature. The Journal of Entrepreneurial Finance.

Caribbean Microfinance Report 2011. (2011). Retrieved from https://www.microfinancegateway.org/sites/default/files/mfg-en-paper-mfi-performance-report-2011-jul-2013.pdf

Easterly, W., & Rebelo, S. (1993). Fiscal policy and economic growth An empirical investigation. Journal of Monetary Economics, 32(3), 417-458.

Forget, J. (2018, January 10). 5 Shocking Statistics on Poverty in Sub-Saharan Africa. Retrieved from https://borgenproject.org/5-poverty-statistics-on-sub-saharan-africa/

Hospes, O. (2002). An Evaluation of Micro-Finance Programmes in Kenya as Supported through the Dutch Co-Financing Programme (Rep.). Steering Committee for the Evaluation of the Netherlands' Co-financing Programme.

Kamau, M. (2014). Why credit-only MFIs escape Central Bank of Kenya scrutiny. Retrieved from https://www.standardmedia.co.ke/article/2000127353/why-credit-only-mfis-escape-central-bank-of-kenya-scrutiny

Kodongo, O. (2013). Individual lending versus group lending: An evaluation with Kenyas microfinance data. Review of Development Finance, 3(2), 99-108. doi:10.1016/j.rdf.2013.05.001

Kringlen, M. (2016). The relationship between default on loans and operating costs in microfinance institutions. University of Agder.

Ledgerwood, J. (1999). The new microfinance handbook: A financial market system perspective. Washington, D.C.: World Bank.

Macchiavello, R. (2015). The Value of Relationships: Evidence from a Supply Shock to Kenyan Rose Exports. American Economic Review, 105(9), 2911-2945. doi:10.1257/aer.20120141

Macleod, W. B. (2007). Reputations, Relationships, and Contract Enforcement. Journal of Economic Literature, 45(3), 595-628. doi:10.1257/jel.45.3.595

Microfinance Barometer 2017: Global trends of the sector... (2017). Retrieved from https://group.bnpparibas/en/news/microfinance-barometer-2017-global-trends-sector

MICROFINANCE IN AFRICA Overview and Suggestions for Action by Stakeholders (Rep.). (2013). United Nations.

Microfinance Status Report 2014 (Rep.). (2014). Atikus.

Nkungi, B. (2013). 2012 Annual Report on Microfinance Sector in Kenya. AMFI, 1.

Ouko, O. (2006). REGULATION AND SUPERVISION OF MICROFINANCE INSTITUTIONS IN THE DEVELOPMENT OF FINANCIAL INCLUSION IN KENYA: BLESSING OR CURSE? (Doctoral dissertation, University of Nairobi). University of Nairobi.

Pattanaveerangkoon, A. (2014). The Grameen Bank Model: Corporate Success and Fulfilment of Its Social Objectives. Academia.

Robinson, M. S. (2001). The microfinance revolution: Sustainable finance for the poor. Washington (D.C.): World Bank.

Saaid Ali, A. E. (2015). The Regulatory and Supervision Framework of Microfinance in Kenya.

International Journal of Social Science Studies, 3(5). doi:10.11114/ijsss.v3i5.1004

Story of the Microcredit. (2019). Retrieved from https://www.microworld.org/en/about-microworld/about-microcredit

Wanjau, K. (2006). Tackling the frontiers of microfinance in Kenya: The role for decentralized services. Small Enterprise Development, 17(3), 41-53. doi:10.3362/0957-1329.2006.030