ISSN 2349-7831

International Journal of Recent Research in Social Sciences and Humanities (IJRRSSH)
Vol. 5, Issue 4, pp: (47-55), Month: October - December 2018, Available at: www.paperpublications.org

Effect of Organizational Regulatory Compliance on Strategy Implementation: A Study of Microfinance Banks in Nairobi County, Kenya

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Abstract: **The enactment of the Microfinance Act of 2006 and the related prudential regulations in 2008 was perceived to have been a significant development in the financial services sector. The resultant institutions were authorized by Central Bank of Kenya under this law to mobilize deposits from the public. Past studies on expansion of financial access and more broadly financial inclusion in Kenya have mainly focused on the entire spectrum of financial services providers with none assessing the effect of compliance to the microfinance regulations on the microfinance banks' financial inclusion strategies. This study sought to determine the effect of compliance to the regulations on the implementation of financial inclusion strategies specifically by microfinance banks in Kenya. The objectives of the study were to determine whether compliance to the regulations has enabled the microfinance banks to implement their financial inclusion strategies or not. This study used a descriptive research design. The target population of the study was the 13 licensed microfinance banks as listed on the Central Bank of Kenya as at 25th January, 2017. The study purposively sampled 4 respondents from each of the 13 microfinance banks i.e. 2 senior managers (who are likely to have been highly involved in the development of the strategies) and 2 branch managers (who are highly involved in the implementation of the strategies) thus making a targeted sample of 52 respondents. A questionnaire was used to collect data. Data entry, storage and analysis was done with the aid of Scientific Package for Social Sciences (SPSS). Thereafter, both descriptive and inferential statistical analysis was done. Frequencies and percentages were used and the presentation of the findings prepared in tables. Correlation and regression analysis was used to establish the association and effect of compliance with the microfinance regulations implementation of financial inclusion strategies. The study established and concluded that compliance to capital requirements significantly and negatively affected implementation of financial inclusion strategies by microfinance banks. The study also established that compliance to licensing and supervision requirements have a significant and a negative effect on implementation of financial inclusion strategies by microfinance banks. Further, the study concluded that that compliance to documentation and identification requirements had significant and a negative effect on implementation of financial inclusion strategies by microfinance banks. Unlike the other independent variables, the study concluded that governance and management structures requirements have a significant but positive effect on the implementation of financial inclusion strategies by microfinance banks. The study recommends that CBK should consider setting up different requirements not merely based upon being a microfinance bank but also the perceived risk from the products and target populations that the microfinance bank is focusing on. Further, the study recommends that microfinance banks targeting low-density and poor populations should be offered rebates on taxation as well as lower thresholds in terms of requirements for their access points like branches and third party agents. The study also recommends that alternative know-your-customer and anti-money laundering documents be considered for clients who may not have conventional identification documents. The study recommends that microfinance banks and CBK continue adhering and upholding the requirements on governance and management because it is clear that compliance to these requirements has had a positive effect on implementation of financial inclusion strategies.**

Keywords: **compliance to capital requirements, compliance to licensing & supervision, compliance to documentation &identification and governance & management structures.**

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1. INTRODUCTION

The work of various researchers including (Christen, Rosenberg, & Jayadeva, 2004) has recognized that the development of the financial sector has productivity and growth enhancing effects. According to Claessens (2006), there are many empirical cross-country tests that have shown initial financial development to be one of the few robust determinants of a country's subsequent growth. Claessens posits that finance can help individuals smooth their income, insure against risks, and broaden investment opportunities with it being particularly important for the poor. A more developed financial system can reduce poverty and income inequality. The United Nations' 2030 Sustainable Development Goals (SDGs) amplified the place of financial inclusion as a fundamental underpinning of wider progress resulting to five of the 17 SDGs specifically mentioning the need for improved or universal access to financial services (Economist Intelligence Unit,2016).

Statement of the Problem:

In enacting the Microfinance Act, the expectation was that the microfinance industry would play a pivotal role in deepening financial markets and enhancing access to financial services and products by majority of the Kenyans. Following the enactment of the Microfinance Act 2006 and the Prudential Guidelines in 2008, several microfinance institutions that were initially non-deposit taking microfinance institutions (credit-only) applied for licenses to become deposit taking microfinance institutions or microfinance banks with four of them succeeding to get the microfinance banks licences Government Printer (2013). The four which transformed from credit-only to deposit taking are Faulu Kenya, KWFT, SMEP and U & I. In addition, as of December, 2016, there were nine start-up institutions that had obtained microfinance banking licences making a total of thirteen microfinance banks in Kenya CBK (2016). In May 2012, the Central Bank of Kenya allowed regulated deposit taking microfinance institutions to operate not only through third party agents, but to operate agencies for deposit taking within their credit offices (Central Bank,2012). The Microfinance Act was also amended in 2013 to allow, among other changes, the use of the names "microfinance banks" by deposit taking microfinance institutions, conducting of Forex business and issuance of third party cheques by the microfinance banks (CBK, 2013).

According to the 2016 FinAccess Household Survey, only 3.6% of Kenya's population using financial services were accessing them from microfinance institutions in general (CBK,FSD Kenya & KNBS,2016). The level of financial inclusion rose from 26.4% in 2006 (CBK & FSD Kenya, 2007) to 82.6% in 2016 CBK, FSD Kenya & KNBS, 2016). This study seeks to determine the effect of compliance to the microfinance regulations on implementation of financial inclusion strategies by microfinance banks in Kenya. While appreciating that financial inclusion has usage, access and quality dimensions, the study is focused on financial access for formerly excluded areas which are mainly rural and remote regions in Kenya. The access indicators reflect the depth of outreach of financial services such as penetration of bank branches or point of sale (POS) devices in rural areas or demand –side barriers that customers face to access financial institutions (The World Bank,2012).

Several studies including Satta (2003), Omino (2005) and SOS Faim (2015) imply that an appropriate legal and regulatory framework helps to promote financial access. According to Rosenberg et al. (2003) providing a regulatory framework for microfinance activities has the effect of increasing the volume of financial services delivered and the number of clients served but should also be accompanied with a caution not to over-specify the regulatory structure so as not to stifle innovation and competition. Llewellyn (1999) implies that the benefits of regulation that include enhanced competition and the improvement of the overall efficiency of the financial industry could lead to an increase of consumer welfare and financial access. Goodhart et al (1998) on the other hand notes that regulation comes with costs on the regulator, the regulated and the market itself which in turn could inhibit competition, stifle innovation and lead to forced choice to consumers hence diminishing financial access. This study seeks to fill this important knowledge gap in regard to what the effect of compliance to the regulations has been on microfinance banks' strategies to expand financial access in Kenya.

Most of the studies, including the FinAccess Surveys carried out by the Central Bank of Kenya and Financial Sector Deepening Kenya have neither focused on the implications of compliance to regulations on financial access expansion nor on microfinance banks on their own in spite of the regulations governing these institutions having been in existence since 2008. In addition, the FinAccess Survey which has been one of the key studies in regard to financial access has been a

ISSN 2349-7831

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demand-side survey focusing on the customer while the current study focuses on the supply side with emphasis being on the perceptions of the formulators and implementers of financial access strategies within the MFBs. This study seeks to address this gap by focusing on the effect of the compliance to the regulation on the implementation of the financial inclusion strategies.

Objectives:

i. To determine the effect of compliance to capital requirements on successful implementation of financial inclusion strategies by microfinance banks in Nairobi County;

ii. To examine the effect of compliance to licensing and supervision requirements on implementation of financial inclusion strategies by microfinance banks in Nairobi County.

iii. To determine the effect of compliance to documentation and identification requirements on implementation of financial inclusion strategies by microfinance banks in Nairobi County;

iv. To determine the effect of governance and management structures on implementation of financial inclusion strategies by microfinance banks in Nairobi County;

2. THEORETICAL REVIEW

Agency Theory:

The agency theory postulates that an agency relationship exists where two parties voluntarily commit to an agreement in which the agent will work in the interests of the principal (Mersland & Strom, 2007). The agent is supposed to advance the principal's goals (Jean et al, 2002). In the context of strategy implementation, an agency relationship exists between the senior management (the principals), who are highly involved in the development of strategies, and the strategy implementers at the lower cadres of the organization (the agents). There is also an agency relationship between the board of directors and the chief executive officer. A balance of these interests should be merged in order to arrive at the corporate objectives of the organization through the agent because he/she is in charge of the vast resources of the organization (Otungu et al,2011).

Stakeholders Theory:

Freeman (2010) identified groups considered to be stakeholders of a firm. According to him, suppliers, customers, employees, owners or shareholders, local community, management in its role as agent for these groups are all stakeholders of an organization. He argues for a rethink around the question of for whose benefit and at whose expense should managers operate the firm. He therefore pushes the idea of the stakeholders, not just shareholders deciding the future of the firm, a train of thought that is at the heart of strategy implementation and strategic planning at large. According to Richman (2008), the board members think about the interests of the corporate constituents and describe how such organizations are actually managed.

Systems Theory:

According to the theory, an organization is a social system which comprises individuals who interrelate within a formal framework, drawing resources, people, and finance from their environment and putting back into that environment the products they produce or the services they offer. For an organization to be effective, according to the systems theory, it has to adapt to its environment. The environment constitutes the events occurring in the world that have any effect on the activities and outcomes of an organization (Weihrich et al, 2008). The environments within which strategies are implemented can either be static or dynamic but rarely are they one or the other but will most often be shifting from static; relative stability to dynamic; experiencing some level of change.

Resource Based Theory:

The theory asserts that the sources and drivers to firms' competitive advantage and superior performance are mainly associated with the attributes of their resources and capabilities which are valuable and costly-to-copy (Mills, Platts & Bourne, 2003). They further posit that a firm's resources include all assets,capabilities,organizational,processes,firm attributes, information and knowledge controlled by a firm that enable the firm to conceive of and implement strategies that improve its efficiency and effectiveness. Pearce & Robinson (2009) note that the training and development of the

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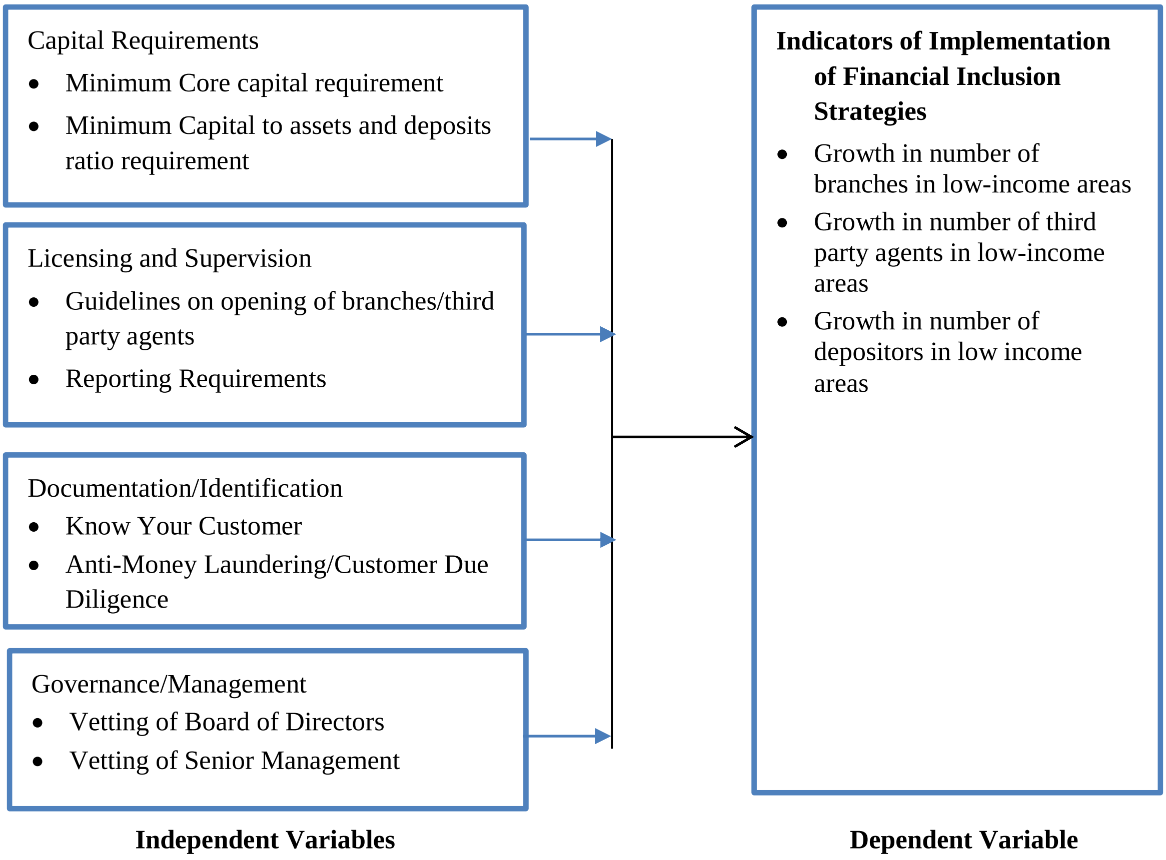
human resources enhances the productive capacity of the other resources in achieving and organization's strategic goals. Certain resources will be considered strategic while others will be considered non-strategic depending on how easy it is for a competitor to acquire the resources; a resource is strategic to the extent that it is valuable, rare, difficult to imitate, and non-substitutable (Barney, 1991; Chi, 1994).

Conceptual Framework:



Critique of Literature Reviewed:

There exist many studies on regulation and its impact on financial access. Several of them are demand side surveys without a specific focus on regulation. This is the case of FinAccess Surveys of 2006,2009,2013 and 2016, FSD Kenya 2006 et al (2015), FSD Kenya 2009 et al (2015), FSD Kenya et al (2013) and CBK et al (2016) and Satta (2004) which focus on financial access and more broadly financial inclusion (access, usage and quality). The studies' are household surveys based on demand side data from a nationally representative sample of the financial services consumers. The fact that data was collected through face to face interviews, the survey being in English and translated into various languages creates an opportunity to bias the respondents most of whom may have low literacy levels. In addition, the access, usage and quality of financial services in question is not only from regulated microfinance institutions but the whole spectrum of formal financial services providers which include commercial banks, microfinance banks, unregulated MFIs, SACCO and mobile money providers.

Satta (2004) carried out a study regarding microfinance regulation influence on small firms' financing in Tanzania. The study was a demand-side study of 136 small firms in Tanzania. The other finding from empirical studies is that most of them are prior (ex ante) to implementation of the regulation. This is the case of Satta (2004). Ex ante regulatory impact assessment study are aimed at contributing to the best regulatory design for challenges in a country or a sector (Gidvani, Dermish & Staschen, 2012).

Frankfurt School of Finance & Management (2012) undertook a case study of Faulu and KWFT microfinance banks where their main focus was on the experience of these institutions in transforming from non-regulated MFIs to regulated ones. Ordinarily, case studies will have the advantage of provide detailed information but which is specific to the cases at hand. It will be more descriptive rather than predictive of the phenomenon and as such making it more difficult to generalize the results from the studies (Oso & Onen, 2009).

In addition, several of the studies do not address microfinance regulation alone but across the spectrum of financial services providers. This includes Mwega (2014) and Mutebile (2015) who looks at the trade-offs between financial regulation and financial stability with a major bias toward commercial banks and the latter who look at commercial banks, deposit-taking MFIs,SACCO and mobile money providers respectively. The studies have not considered the peculiarity of the regulated microfinance banks and the different regulatory circumstances that they need to operate under from those of other financial service providers.

Summary of Literature:

This chapter comprises a detailed review of the literature relevant to this study. The theoretical framework has covered some selected theories of strategy implementation which are the agency, stakeholders, resource-based and the systems theories. The theories of regulation are the Public Interests, the Private Interests and the Chicago Theories.

The conceptual framework that guides this study was also presented in this Chapter. A review of concepts and their literature review relating to the microfinance regulatory requirements in Kenya were also undertaken. These concepts include capital requirements, licensing and supervisory requirements, documentation and identification requirements and the requirements by CBK on governance and management of MFBs. These concepts represent the independent variables. The dependent variable, implementation of financial inclusion strategies, was also reviewed. A critique of the existing literature relevant to this study was undertaken. Consequently, research gaps were identified. The research gaps relate to scope, type of data used and period in which comparable studies have been conducted.

Research Gap:

The first research gap observed from the review of the relevant literature concerns the scope of regulation. The theoretical and empirical literature reviewed shows that numerous studies have been carried out on regulation across the broad spectrum of financial services providers yet according to CGAP (2009), microfinance institutions have a specific challenge in that their operations and measurements are defined not by the type of institution but by the market segment served.

The second research gap identified regards the data collected with most of the studies focusing on demand-side data. Demand-side data, for several countries, is obtained from country -level household and enterprise surveys. Indeed, a growing number of countries implement national household surveys that now include questions about financial access. The challenge with this is because it is difficult or impossible to compare survey results across countries because of differences in questions and methods. The other limitations are that most national surveys are not conducted regularly and may not be comparable from year to year, because questions and household samples change over time. In addition, household surveys are costly, often requiring interviewers to travel across the country to collect the data. They can take a year or more to implement. There are also concerns about sampling and the representativeness of results, especially in large countries CGAP (2007). This study uses supply side data from the microfinance banks in Kenya which offers various advantages that include the fact that the data collected with be after a reasonable period of most microfinance banks having implemented their strategies in a regulated environment. Second, it is not subject to potential sampling biases, because data will be collected from the entire population of microfinance banks. Third, the cost of collecting such data is relatively small because the population of microfinance banks is only thirteen with twelve of them having their head offices in Nairobi, where the researcher is based, and only one in the neighboring Kajiado County. Fourth, the basic indicators for implementation of financial inclusion strategies are fairly easy to compute and report for institutions with most of them using standard information systems.

The final gap identified concern the fact that several studies on regulation are either ex ante or are conducted within such a short time after the regulation as was the case of Frankfurt School of Finance & Management (2012) which makes it difficult to provide reliable findings on the effect of regulation due to the short time span of implementing the regulation. The ex-ante studies are often developed to inform policy makers in designing enabling regulation that addresses identified regulatory loopholes. This is the case of such studies like Chiumya (2006) and Satta (2004).

3. RESEARCH METHODOLOGY

The research design used in this study was descriptive research design. The population in this study was the thirteen (13) regulated microfinance banks in Kenya as per the Central Bank of Kenya website CBK (2017) and herein marked as Appendix 1. The units of observation for this study were the microfinance banks while the unit of analysis were the managers' responses; with the institutions being homogeneous in regard to the legal status i.e. all of them are limited liability companies as per the MFI Act and organizational nature i.e. microfinance banks. In the study, the sampled managers were the Chief Executive Officer and the Head of Finance and Strategy or their designates due to their active involvement in strategy development of the banks and a random selection of two branch managers from each of the microfinance banks due to them being heavily involved in strategy implementation. There were a total of 52 respondents. The data collection instrument for this study was a questionnaire. The questionnaire had both open ended questions and a Likert Scale on some questions. The questionnaire was pre-tested with a small representative sample aimed at identifying potential misunderstandings or biasing effects for various questions. The data was coded and thereafter analyzed using descriptive statistics (mainly percentages, mean, variance and standard deviations) and inferential statistics (mainly linear regression models) with the aid of Statistical Package for Social Sciences (SPSS) program and presented using appropriate tables to give a clear picture of the research findings at a glance. A multiple linear regression analysis was performed to test the effect of the independent variables on the dependent variable

Model:

The model was specified as follows: $Y=\alpha+\beta 1X1+ \beta 2X2+ \beta 3X3+ \beta 4X4+\varepsilon$.

Where;

Y= Implementation of Financial Inclusion Strategies (Growth in Number of Branches, Third Party Agents and Number of Depositors in low-income populations)

α= constant

β=coefficient

X1= Compliance to capital adequacy requirement;

X2 = Compliance to licensing and supervision requirements;

X3 = Compliance to documentation and identification requirements

X4 = Compliance to governance and management requirements

ε= error term

4. REGRESSION RESULTS

Table 4.1: Significance of Independent Variables

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.637	.075		.000	.000
	Compliance to capital requirements	-.963	.087	-.896	-6.708	.000
	Compliance to Licensing and supervision requirements	-.545	.112	-.664	-.4.861	.000
	Compliance to documentation & Identification requirements	-.462	.118	-.581	-.3.907	.000
	Compliance to Governance & Management requirements	.667	.102	.768	6.567	.000

a. Dependent Variable: Implementation of Financial Inclusion Strategies

The results in Table 4.1 indicate that compliance to capital requirements significantly and negatively affected implementation of financial inclusion strategies by microfinance banks in Nairobi County.

Further, compliance to licensing and supervision requirements have a significant and a negative effect on implementation of financial inclusion strategies by microfinance banks in Nairobi County.

From the results it is also clear that compliance to documentation and identification requirements had significant and a negative effect on implementation of financial inclusion strategies by microfinance banks in Nairobi County.

Governance and management structures requirements are also shown to have a significant but positive effect on the implementation of financial inclusion strategies by microfinance banks in Nairobi County. This is the only independent variable that positively affects implementation of financial inclusion strategies according to the study.

The highest positive effect (considering the positive beta coefficient) is witnessed by compliance to governance and management requirements while the highest negative effect is shown by compliance to capital requirements, followed by licensing and supervision requirements with the least negative effect being from documentation and identification requirements.

The goodness of fit model results as represented on Table 4.21 reaffirms the significance of the model where the R-Square, the Coefficient of Determination is 0.846 which confirms that the model (the selected variables) explain 84.6% of the variations or change in the dependent variable. The adjusted R-Square at 0.823 still shows well selected variables.

The model $Y= \alpha + \beta 1X1+ \beta 2X2+ \beta 3X3+ \beta 4X4+ \beta 5X5+\varepsilon$ explained 82.3% of the variations in implementation of financial inclusion strategies in Nairobi County. The model can be consequently fitted as follows:

$Y= 2.637-0.963X1-0.545X2-0.462X3+ 0.667X4$

Where;

Y= Implementation of Financial Inclusion Strategies

X1= Compliance to capital adequacy requirement;

X2 = Compliance to licensing and supervision requirements;

X3 = Compliance to documentation and identification requirements

X4 = Compliance to governance and management requirements

5. CONCLUSION

The study concluded that compliance to capital requirements significantly and negatively affected implementation of financial inclusion strategies by microfinance banks in Nairobi County. The compliance to minimum capital requirements has had a tendency of making the microfinance banks ask for higher returns to what is perceived to be idle cash which in turns increases the cost of lending passed on to the borrowers thus reducing access to small businesses and low-income individuals.

The study also concluded that compliance to licensing and supervision requirements have a significant and a negative effect on implementation of financial inclusion strategies by microfinance banks in Nairobi County

The study further concluded that compliance to documentation and identification requirements had significant and a negative effect on implementation of financial inclusion strategies by microfinance banks in Nairobi County.

The study finally concluded that governance and management structures had a significant but positive effect on the implementation of financial inclusion strategies by microfinance banks in Nairobi County. Out of all the regulatory requirements that microfinance banks are supposed to comply with, this is the only requirement whose compliance was found out to be overwhelmingly supportive of implementation of their financial inclusion strategies.

6. RECOMMENDATIONS

The study recommends that Central Bank of Kenya balances its regulation regarding capital requirements with the objective for which microfinance banks are set up which is expansion of financial inclusion. CBK should consider setting up different requirements not merely based upon being a microfinance bank but also the perceived risk from the products and target populations that the microfinance bank is focusing on.

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The study also recommends that the government and CBK should review regulations related to opening of branches and third party agents to encourage geographical spread of financial access and hence implementation of financial inclusion strategies..

The study further recommends that there should be a balance and innovativeness in documentation and identification requirements on microfinance banks. Due to the fact that many of the microfinance banks target rural and low-income populations, some of them may not have conventional documents that are typically available with commercial banks' type of clients like National Identity cards, Kenya Revenue Personal Identification and Tax Compliance Certificates..

Since governance and management structures play a significant role in enhancing implementation of financial inclusion strategies, microfinance banks should ensure that the requirements of the MFI Act on separation of powers between the board and the senior management are well complied with.

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