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Feast and Famine: Financial Services for Rural Kenya

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Introduction

Over the last few years there has been increasing mention of the financing problems facing farmers. Whenever they are asked to list their problems, lack of credit is usually high on the list. As a result all the government recent policy documents have raised the issue and pledged to do something to address it.

In the Poverty Reduction Strategy Paper 2001-2004 agriculture was ranked as the number one sector, crop development the priority sub-sector and inefficient rural financial systems the second most binding constraint. Government noted farmers and the rural sector cannot progress without the credit and financial services they have been starved of, and committed to promoting an innovative an efficient rural finance and credit supply system for smallholders and rural primary processors by developing modalities to support schemes through farmer organizations, NGO's, CBO's, rural SACCOs, input suppliers and processors. The practical details, institutional and policy arrangements were to be worked out before large amounts of public money are channeled into particular institutions.

In the Economic Recovery Strategy for Wealth and Employment Creation poor access to farm credit is given as a cause of the decline in agricultural productivity. Government commits to review the institutional framework with a view to encouraging the development of institutions that are well placed to provide credit to agriculture including micro-finance institutions and the revival of the Agricultural Finance Corporation.

The Strategy for Revitalization of Agriculture also picks up on the agricultural credit problem. In its analysis of the problems facing Kenyan agriculture it states

> "Lack of capital and access to affordable credit: The main factor which farmers, particularly small farmers, point out as causing low productivity in agriculture is inadequate credit to finance inputs and capital investment. In the past, the government, through the AFC, the Cooperative Bank of Kenya and the co-operative movement, provided affordable credit to farmers. Due to mismanagement and political interference, most of these institutions have collapsed or failed to provide the service, thus leaving farmers without a source of affordable credit. A number of micro-finance institutions are however operating in some areas, but they reach only a small proportion of smallholder farmers, provide very short-term credit and their effective lending rates are very high. The formal banking system is yet to develop credit facilities that particularly suit small farming business."

The President in his foreword to the document declares that in order to facilitate the needed transformation of the agricultural sector, establishment of market based agricultural credit and inputs system is one of 5 critical areas requiring public action to modernize agriculture.

The new government found many agricultural problems waiting for it. The Minister of Agriculture formed Task Forces to look into the problems in the sugar and coffee industries. The sugar task force found Ksh 7.5 billion of debt to the Sugar Development Fund of which Ksh 2.5 bn was in arrears. The industry has Ksh 2.5 bn of arrears to the

Levy and Ksh 1.8 bn of arrears owed to farmers. The problems in the sugar industry are intimately related to the way the industry is financed. Farmers are financed through outgrower companies, local monopolies that charge relatively high rates per operation and uncompetitive interest rates. If the Sugar Development Levy Fund were able to develop modalities that give growers freedom to choose competitive service providers, then their cost of production would be brought down and the sector made more competitive.

The Coffee Task Force found Ksh 10.5 billion of debts owed by farmers and Ksh 1.2 bn owed by farmers institutions to commercial banks and multilateral lenders. They proposed a mix of debt write off and restructuring and Ksh 5 bn of new money that is needed to rehabilitate the industry. Many of the problems in the coffee sector stem from the lack of choice as to marketing channels, either at the local cooperative society level, or at the national level where all coffee must go through a central auction. Private treaty sales of coffee could encourage international buyers to pre-purchase and pre-finance production of part of Kenya's coffee crop at very low interest rates.

The mixture of incomplete liberalization and lack of competing marketing channels is a result of difficulties in agricultural financing. Too often farmers finance processors e.g in pyrethrum where the monopoly board owes growers Ksh 1 bn for unsold products and in the milk market. The only positive and problem free sector is small-holder tea where the KTDA handles an annual Ksh 1.5 bn fertilizer loan program to 360,000 growers without problems. A well-organized output market has resulted in tea growers being inundated with offers of credit from commercial banks, building societies, and cooperatives.

Clearly financial issues are a large part of the problems facing the agricultural sector. The reaction of the private commercial banks has been to avoid agricultural lending, and the reaction of the new government, initially at least, was the funding of AFC and an effort to revive the Guaranteed Minimum Return scheme. However this paper argues that a lot more research and reflection is needed before public funds are committed to fulfilling election promises in ways that cannot be sustained. The government commitment made in the PRSP combined with the Presidents statement in the Strategy for Revitalization of Agriculture is to take the time to work out details of market based solutions to the agricultural credit problem in Kenya. This paper is an attempt to begin that process.

The paper gives a brief description of the history and main institutional forms in the agricultural and rural financial services sector – commercial banks, the micro-finance industry, savings and credit cooperative societies, village banks, building societies and the Agricultural Finance Corporation. It ends by raising some of the issues that need to be addressed as we begin to deal with the institutional and regulatory framework for the sub-sector including the cost of funds and the array of existing policy and legislative proposals on the table. The main argument of the paper is that we need to step back and undertake a comprehensive assessment of the sector before government passes new laws, or spends public money in unproductive ways. The paper proposes that the agriculture sector ministries should play a leading role in pushing for that comprehensive assessment. For the sake of their underserved clients.

Commercial Banks

At the end of 2003 Kenya has 51 banking institutions. 43 of these are commercial banks, 2 non-bank financial institutions, 2 mortgage finance companies (holding 30,000 mortgages in a country with 5 million households) and 4 building societies. These institutions have 500 branches between them, 440 belonging to commercial banks, 39 in building societies, 18 mortgage company branches and each non-bank financial institution has a single branch. The bulk of these outlets are in Nairobi.

The banking sector has a total of approximately 1, 910,000 accounts. 73 percent of these are held by the 5 biggest banks as indicated in Table 1. Total deposit liabilities of the banks held in these accounts is Ksh 378 billion.

Table 1. Client Accounts at the Major Banks

Bank	Client Accounts	Of which Businesses
Barclays	495,000	30,000
KCB	353,000	45,000
National Bank	250,000	
Standard Chartered	150,000	25,000
Co-Operative Bank	150,000	
	1,398,000	

Source: Authors communication with staff

The banking sector currently is extremely liquid. Net deposit liabilities of Ksh 378 Bn as at December 31, 2003 are matched by liquid assets of 186 Bn. The statutory minimum liquid assets is Ksh 75 Bn implying Ksh 110 bn that should be being lent out to productive uses. The excess liquidity amounts to 30 percent of deposit liabilities.

Most banks continue to hold large amounts of government paper at extremely low interest rates while agriculture and the rural sector are starved of credit and other financial services. Put another way the commercial banks have Ksh 100 bn of deposits they wish they did not have lying in low performing instruments. Some are reportedly considering charging for holding deposits and taking active measures to discourage further customer deposits. Deposit interest rates below 1 percent do not seem to have done the trick.

Given the excess liquidity and lack of borrower demand for loans, banks have launched a slew of new products in the recent past. Unsecured consumer loans has been the most effective of these in terms of generating good interest income on the back of high interest rates. A large number of banks have also entered new lines such as insurance premium financing, car loans and mortgages. A number are reportedly thinking about, but not sure how, to lend to agricultural trade, and ultimately to production agriculture.

Many banks have been generating profits on charges for bank services. Central Bank and government have managed to lower income from interest on government paper. Recently CBK moved to publish bank fees and charges in the press. Government has stated clearly that banks job, and main source of income should be from loans.

The large commercial banks have not been idle. In the last year Barclays, Standard Chartered and KCB have all launched products directly targeting agriculture. Barclays has the most ambitious venture in the form of a Structured Commodity Finance product currently targeting large-scale wheat producers. The product supports the financing needs from land preparation through to storage and final sale of the commodity. It depends on the services of a managing agent dealing directly with growers on behalf of the bank, actuarial analysis of yield and drought risk, GPS and monthly visits, crop insurance and warehouse receipts. 25,000 ha have been lined up for the coming season. Barclays is building the product on the back of experience gained in South Africa and Zimbabwe as well as with organized small-scale tobacco producers in Malawi.

KCB have a new product called Mavuno. This allows farmers to be advanced credit against any produce already delivered to a reputable buyer. It gets around the problem of farmers waiting to get paid. It mirrors products being offered by building societies and co-operatives to tea and dairy producers that are described later in the paper.

The biggest untapped market for credit is in the rural and agricultural sector. Commercial banks spoken to recognize this and are looking for ways of getting into that market. However the needs are far beyond what any single group of institutions has been able to do thus far. The rest of this paper describes some of the institutions active in the rural areas and in agricultural lending. This information will assist government and the financial sector, develop ways of increasing the flow of funds to these key sectors.

A Brief History

The global depression, drought and locusts were among the poor conditions jn the agricultural sector in the 1930's that led to a freeze on agricultural lending by commercial banks in Kenya. Government responded in part by forming a Land Bank that lent credit on concessional terms to European settlers. Government also established commodity marketing boards e.g Wheat Ordinance 1933 that pooled all wheat produced to be marketed by the KFA. Maize shortages in 1941 led to the Increased Production of Crops Ordinance in 1942. This allowed farmers to submit a cropping plan and be assured a minimum price for their production as well as insurance against unavoidable crop failure (i.e. through no fault of the farmers e.g. through sub-optimal husbandry practices). The government promise to buy a fixed sum at a fixed price was the Guaranteed Minimum Return that was collateral against farm input advances and loans from private and government sources. The Ordinance of Maize Control (1942) made KFA the sole legal buyer. With price and yield risk eliminated, production increased.

In the post independence period government maintained policies conducive to suppliers of agricultural credit. The Agricultural Finance Corporation, AFC was the government main channel for advancing credit to producers with 5 acres or more. Private commercial banks were required to have at least 17 percent of their loans going to the agricultural sector. The network of national cooperative and parastatal organizations were a key element in the post-independence credit system. The Kenya Co-operative Creameries was the sole monopoly buyer of milk, the Maize and Wheat Boards (later NCPB) covered the cereals, KTDA in tea, and the Coffee Board and KPCU in coffee, a monopoly pyrethrum board and monopsonistic sugar factories all thrived. Government controlled prices, import and foreign exchange controls kept imports at bay, and rules and regulations kept private sector competitors from destabilizing the cosy arrangements.

Liberalization of the economy came in 1992 with the lifting of foreign exchange and import controls, and the freeing of many agricultural sectors from regulated monopolies. The process moved at different paces in different commodities, but overall, by the mid 1990's agricultural markets were largely liberalized.

Liberalization brought havoc to the institutional arrangements that supported the agricultural credit system. In maize for example, AFC would advance a mix of money and materials to growers. Advances in the form of farm inputs were collected from the large quasi-government Kenya Farmers Association (later KGGCU) that stocked all agricultural inputs ranging from fertilizer and seed, to farm machinery and diesel. The advances were secured against a promise that the produce would be sold to the NCPB, and that NCPB would pay the farmers less the loan plus interest that would be remitted directly to AFC by NCPB. When farmers sold in side markets to private buyers rather than NCPB, or when AFC failed to remit funds to KGGCU, the system quickly collapsed.

Many, but certainly not most farmers had access to these arrangements. They were limited to relatively large producers of cereals and dairy in the Rift Valley and milk producers in parts of Central Kenya. When funds were in short supply, as was the case in the mid to late 1990's one needed, in addition, to be politically well connected.

The post independence 17 % quota was never effective or enforced. In the mid 1990's large banks reduced their presence in rural areas closing branches. The reduction in the rural branch networks of major banks further reduced access across Kenya not just to credit, but also to basic financial services like savings and checking accounts. The Central Bank allowed the closure of rural branches, and encouraged consolidation of the banking industry in pursuit of a vision of universal banking where one set of capital requirements and ratios was to be applied to all banks, non-bank financial institutions were encouraged to convert to banks, and meet high and rising minimum capital requirements. The CBK plan announced minimum capital requirements rising from Ksh 150 million to Ksh 500 million in a period of 4 years. The current government has reversed the trend and set Ksh 200 million as the minimum capital of a fully fledged commercial bank. CBK and government are also exploring the possibilities of a multi tiered banking system.

A Micro-finance Bill has been on the desk of the Minister of Finance for the last 3 months. The proposed legislation would allow the micro-finance institutions that have mushroomed and provide credit to small businesses to be regulated and to take deposits from the public. The Ministry of Cooperatives is sponsoring 2 draft bills, one for cooperatives in general that has 2 clauses relating to SACCOs and a separate piece of SACCO specific legislation. One of the aims of this paper is to inform the process of making policy in the financial sector with an eye on improving access to financial services - savings as well as credit- to agriculture in particular, and the rural population in general. The focus will be on how to improve access for the relatively poor rural Kenyan agricultural producer.

Current Access To Financial Services

Tegemeo has been undertaking rural household surveys for a number of year. Information from those surveys provides a snapshot of the current access to financial services among rural Kenyans disaggregated by a number of parameters of interest e.g. by income class, household demographics, and geographical zone. However the information summarized in the table below suggests that is really the regional dimension that is the driver of policy relevant lessons from the household data.

Households were asked a number of questions about their access to financial services. On the credit side most common sources were relatives, merry go round groups, the local shopkeeper, co-operatives, banks, and AFC in that order. Information on access to in the form of a bank account is summarized below.

Table 2: Access To Financial Services: Any Type of Account

		Where Held					
Zone		**Bank Account**		**SACCO/Co-op**		**Post Office SB**	
	% w/acc	2002	*1997*	2002	*1997*	2002	*1997*
Central Highlands	92	22	*31*	67	*58*	3	*2*
Western Highlands	56	7	*9*	41	*35*	9	*8*
H Potential Maize Zone	53	37	*45*	10	*6*	7	*6*
Western Transitional	50	28	*31*	19	*16*	4	*3*
Marginal Rain Shadow	42	28	*2*	7	*5*	7	*2*
Eastern Lowlands	39	17	*23*	1	*1*	22	*16*
Coastal Lowlands	27	18	*21*	1	-	8	*5*
Western Lowlands	22	14	*20*	1	*2*	7	*9*
	53	23		22		8	
Average Distance	20.5 Km						

The agricultural sector, particularly the dominant small-scale sector, is starved of financial services. An estimated 77 percent of Kenyan households have no access to financial services. And the average distance to a financial institution by those with some form of an account was 20.5 kilometers in the sample. The financial service need of households is savings products- a safe place to keep or accumulate small amounts of money that may come their way so that they can meet large and lumpy expenditures or emergencies – are not being met. Many agricultural operations even on small farms are relatively lumpy, whether it be tractor ploughing, paying people to plant or weed, or buying a bag of fertilizer. Lump sums are unlikely to be accumulated when the nearest institution is 20 km away. This is part of the cause of low productivity and high production costs in Kenyan agriculture as farmers cannot accumulate the resources required to undertake optimal operations for which the technology exists and they are aware of. This phenomena is clearly recognized by government as reflected in the recently launched Strategy For Revitalizing Agriculture.

There has been a flurry of activity in setting up micro-finance institutions in Kenya to meet the financial needs of the majority of citizens. However after 25 years their total client base is in the range of only 200,000 of Kenya's 5 million households.

Some parts of the country are better off in terms of access to financial services than others. In the Central Highlands the SACCO movement has played a big role in getting financial services to the people on the back of tea, coffee, and dairy co-operatives. 92 percent of households in the region have access to some form of a bank account. The table shows that SACCO's and Cooperatives are the driving force behind that high figure. In the last 5 years the number of households having a co-op account has increased by 9 percentage points, exactly matching the decline in households with accounts in commercial banks.

For the rest of the country less that 50 percent of households have any form of account giving an average across the country of 23 percent. The strength of co-ops in the Central Highlands is also reflected in the western highlands (Kakamega and Kisii) driven by the growing of similar anchor crops that made co-ops popular in central – dairy, coffee, pyrethrum and tea.

The cooperative movement seems never to have taken off in the 3 lowland zones. The result is only one percent of households in each zone having a coop account, probably related to a salaried job. In those areas accounts with commercial banks dominate.

Only 23 percent of the Tegemeo sample had an account in a bank, a figure that is down on 1997 as banks close branches, and raise opening and minimum balances and monthly charges. At Ksh 400 per month, a simple savings account in a commercial bank is out of reach of even many salaried Kenyans. Stories abound about old people who laft a few thousand shillings in their accounts and came some months later to find no money, negative balances or closed accounts. Inconvenient hours, distance from where people are, high transactions costs, the need to be literate and to speak the language officers understand, unhelpful staff attitudes and an intimidating appearance targeting upper and middle class are some of the reasons given by respondents for the unpopularity of banks. The near impossibility of getting a loan was also a factor and helped make alternatives like MFI's and cooperatives popular.

The result has been a surge in the number and client base of alternative financial institutions. Savings and Credit Co-operatives with front office service activities – FOSA- are mushrooming and now number over 100. There are accumulating and rotating savings and credit associations, and newly introduced Financial Service Associations – FSA- also known as village banks. But all these innovations are in need of enabling legislation to clarify their legal status and to set standards. Government has been slow to respond, even to a more limited micro-finance bill that would continue to exclude agricultural households from financial services. No institution has really solved the problems of how to get credit to the typical small-scale farmer outside of the major cash crop areas. That is where large numbers of the poor live and survive without financial services, let alone credit. It will be difficult to finance the needed intensification of agriculture in the absence of financial services.

Financial Sector Statistics

Household survey data confirms that most households, particularly in certain relatively less well-endowed parts of the country, have no access to financial services. Table 3 gives an indication of where those accounts are held.

In total there are 1.4 million borrowers, 5.6 million accounts. Clearly the Post Office Savings Bank has the most account holders with active accounts accounting for almost half of all savings accounts in Kenya. POSB does not lend although there have been suggestions that the legislation that set it up be amended to allow it to make loans.

SACCO's hold 1.3 million of the 3 million remaining accounts with 6.5 times the number of accounts that have been mobilized by all the microfinance NGO's and companies combined.

Table 3. Where the Accounts Are

	Borrowers	**Savers**
Post Office		2,010,000
SACCO's	1,000,000	1,300,000
NGO's	220,000	
Equity	60,000	253,000
Commercial Banks	50,000	1,910,000
K-Rep Bank	44,000	52,000
Family Finance	18,000	60,000
Co-op bank MFI	5,000	60,000
	1,397,000	**5,645,000**

Source Adapted from Dondo, K-Rep, 2003

In terms of deposits mobilized the SACCO movement comes into a respectable second to commercial banks. The data in Table 4 below does reflects some double counting of deposits as the unlent funds of SACCO's are held in bank accounts. But overall statistics confirm the picture that there is excess liquidity in the banking system. The problem for public policy is that at the same time the rural sector is starved of credit, rural agricultural producers cannot access these funds, and the few enterprises that do access credit do so at very high prices.

Table 4. Where The Money Is

	Ksh Savings	**Ksh Loans Outstanding**
Banks	315,773,000,000	422,209,000,000
SACCO's	75,000,000,000	69,000,000,000
Post Office	9,600,000,000	0
Equity	3,200,000,000	1,800,000,000
Family Finance	1,600,000,000	900,000,000
NGO's	1,300,000,000	2,211,000,000
	406,473,000,000	512,320,000,000

Sources: CBK Statistical Bulletin, Dec 2003, K-Rep 2003, authors communications

The Micro-finance Industry

Kenya has 62 micro-finance NGO's. The total client base of these organisations is 220,000 mainly business people. They have demonstrated that micro-business lending in Kenya is feasible, and that small borrowers do pay. They have pioneered new product types and innovations and some are moving toward sustainability. The microfinance NGO's have played an important part in moving government toward recognition of the small borrower and have been instrumental in advancing the cause of the proposed Micro-Finance Bill, that currently is on the desk of the Minister of Finance before being published and taken to parliament sometime in the coming parliamentary session in 2004.

Table 5: The Major Microfinance Institutions

Institution	# of Clients
KWFT	75,000
Faulu	24,000
BIMAS	14,500
SMEP	14,200
WEDCO	12,000
Micro Kenya	10,000
ECLOF	6,500
KADET	6,100
Pride	6,000
WEEK	5,000
K-Rep D Ag	2,200
Jitegemee	1,300
SISDO	1,200
Total	178,000

Description of the Institutions

Kenya Women Finance Trust, the largest and oldest of the microfinance NGO's was started in 1981 to advance and promote the direct participation of economically active women in viable businesses to improve their economic and social status by providing sustainable financial and non-financial services. Loans are distributed through organized groups of 20 or so members who meet and save weekly or monthly, and must agree to use the group savings as collateral for individual loans to group members. The bulk of loans go toward business but KWFT also offers products to pay for school fees, and hospital bills. Loans are for durations of less than a year and are charged a monthly rate of 1.5 percent. Farmers, and the relatively poorer members of the community cannot access loans from KWFT. The large numbers of institutions that have come into the Kenyan market since KWFT have basically similar products and conditions, do not lend to agriculture and do not reach the poorest members of society. They also are very concentrated in urban areas.

Kenya Women Finance Trust is a registered under the companies act as a company limited by guarantee. Small and Micro Enterprise Program –SMEP, Kenya Ecumenical Loans Fund – ECLOF, and the Jitegemee Trust also are companies limited by guarantee.

Faulu, WEDCO, and Micro Kenya are companies limited by shares. Business Initiative and Management Services BIMAS, Women Economic Empowerment-WEEK, KADET, K-Rep, PRIDE and SISDO are NGO's. Dondo 2003 points out that Kenya MFI's have diverse legal forms and are registered under at least 8 different Acts of Parliament.

NGO MFI's depend on donor funds to get started and to sustain their operations and significant amounts have come in since the documentation of the huge gap in access to finance among Kenyan MFI's first documented in the USAID funded Microped project in the late 1980's. A 1999 study noted that 89 percent of SME's had no access to financing from formal financial institutions. The MFI industry, and NGO's within it have grown, but not enough to make a serious dent in these numbers. Total clients of all the MFI's together is in the region of 220,000 clients in a market of over 1.3 million SME's, and 3 million agricultural households. The 220,000 includes few whose main occupation is agriculture.

The Association of Micro-Finance Institutions, together with the Micro-Finance unit within Central Bank are convinced that regulation through a Micro-Finance Bill for deposit taking MFI's would help increase the outreach and sustainability of MFI's. Regulation would clarify some of the legal uncertainties MFI's face, give the general public more faith in them, attract private investment capital that the industry needs and ensure good management and corporate governance. Most MFI's depend on donor funds, so growth is limited by what can be accessed from that source. Recently donors have moved away from providing for the capital costs of MFI's preferring capacity building and providing access to more commercial lines of credit. A clear regulatory framework could help attract private investor funds to the industry. There is need for more MFI's and private investment would result in more individuals gaining access to a place to deposit money. Regulation in the Banking Act, has actively discouraged deposit taking MFI's unless they are organized as cooperatives.

The Co-operative SACCO sector

Cooperatives were introduced to Kenya in the 1930's and recognized and controlled by government from 1931 when an ordinance to regularize their operations was first passed. In 1945 the Co-operative Ordinance Act was passed that is the predecessor of CAP 490 of the Laws of Kenya, the current Cooperative Act. That act was amended in 1997 removing much of the control the government, through the Commissioner of Cooperatives, had over the movement.

Subsequent events in the cooperative sector have led to the feeling that some of the controls and government oversight need to be reintroduced, but not to the pre 1997 level where a society or union could do almost nothing without the express written authority of the commissioner. The bureaucracy that process entailed created some of the problems in cooperatives. The proposed amendments aim to return a stronger supervisory role for government, but without the stifling and bureaucratic controls. The Act is currently under review with new amendments expected to come to parliament in 2004. The need for amendment of the 1997 Act has been recognized for many years. However cooperative leaders suggest that there is no demand from the side of cooperatives for review and suggest that it is the Cooperatives Department itself that is the main driving force behind the review.

In December 2003 the Kenya National Federation of Cooperatives held a workshop in Mombasa to sensitize the Parliamentary Committee on Agriculture Lands and Natural Resources – that covers cooperatives- on their reservations about the draft bill. In discussions it came out that the cooperative movement has changed a great deal since the days when it was dominated by rural agricultural based co-ops. Today large employer based cooperatives dominate the movement and play a large role in the finance business.

The management problems the Cooperative Societies Amendment Bill 2003 was addressing refer more to small rural crop marketing based cooperatives. Provisions that allow the Commissioner access to audited accounts before members at their AGM, to remove the management committee, call special general meetings and set the agenda, carry out inspections at the cost of the society, and appoint commissioners to take over management were not acceptable to the typical cooperative of today that is a private financial institution in a competitive business. The movement also was not satisfied with the provisions related to setting up a cooperative development fund and a SACCO regulatory authority.

The rules proposed in the draft bill may be appropriate for the typical troubled rural agricultural marketing cooperative. Today there really are 2 types of cooperatives in Kenya. Their regulatory needs are quite different and they cannot be dealt with under one piece of very intrusive legislation.

The draft bill had 2 clauses covering SACCOs. However it was felt that the 2 clauses setting up a regulatory authority were inadequate to the regulatory needs of the industry. Uncertainty exists about when this, as well as hundreds of other pending pieces of legislation, will actually get to, and through, parliament. This gives time for more dialogue and reflection about the regulatory needs of SACCOs. The existence of a draft SACCO specific bill shows that government wishes to do something. But with an MFI draft, and 2 cooperative drafts as well as some disquiet about the Banking Act, it is a good time for reflection on how Kenya wishes to regulate the financial sector.

Cooperative societies with marketing functions have always maintained back office financial services functions related to making payments of proceeds to members. Some members do not immediately withdraw all of their proceeds. This meant that the institutions were effectively running withdrawable savings schemes.

In 1982 the Cooperative Bank of Kenya encouraged the formation of Union Banking Sections in coffee cooperative unions so that farmers proceeds from sales could be channeled direct to farmers accounts, rather than into the accounts of their individual cooperative societies or factories. Mobile units of the UBS's also went closer to farmers to make payments for their proceeds. These accounts also allowed the World Bank funded Cherry Advance Payments System to channel advances against cherry deliveries direct to farmers' accounts. Previously, coffee farmers could access credit from their cooperative societies, but only in the form of farm inputs. In some cooperatives these advances could also be in the form of maize. Cooperatives also were able to assist their members keep their children in school either through making payments or in the form of a letter of undertaking stating that the parent was due to receive money some time in the future giving comfort to the school.

Union banking sections grew very large in all the main coffee growing districts. Since not all growers withdrew all their payments at once, they also became very liquid. Many cooperative unions fell victim to the temptation to use the liquid cash in the UBS to cover some of their general expenses. Fraud, poor accounting and other management and liquidity problems led many UBS's into trouble. Significant effort was put into converting UBS into independent, separate legal entities in order to safeguard members funds. This was resisted by the unions but the shift toward distinct Rural Savings and Credit Societies – SACCO's was almost unstoppable. These SACCO's offered a range of financial services, most significantly loans against members share capital. Over the years SACCO's have thrived while their parent cooperative unions have struggled with many actually collapsing in the wake of marketing problems in their main commodities, most commonly coffee, milk and pyrethrum.

Industry Statistics

Currently there are 3,200 SACCOs in Kenya serving 1,300,000 savers and 1 million borrowers.[1] Many of these are urban and employment based with the largest being Mwalimu SACCO serving teachers, and Harambee SACCO serving employees of the departments under the Office of the President whose assets run to Ksh 4.5 and 3.9 bn respectively. Although many of the loans they give may end up as investments in school fees and buildings in rural areas, they are not considered part of the rural finance sector that is the focus of this paper. However they help to illustrate how big the cooperative

[1] Dondo, K-Rep 2003

SACCO movement has become. A few large cooperatives may bias average figures but simple calculations indicate the average SACCO has Ksh 25 million of deposits in 400 accounts averaging Ksh 61,000 each. ¾ of those members will have borrowed an average of Ksh 64,000 each. To service these clients, rural as well as urban SACCO's are opening Front Office Service Activities – FOSA- to serve as what for all intents and purposes is a bank for their members. FOSA is also one of the few remaining profitable income generating business activity cooperatives can engage in. The law that allows them to take deposits gives them an advantage that may not last in the face of proposed regulatory changes.

Descriptive Typology Of Rural SACCO's

There are 10,000 registered cooperatives in Kenya. About 120 have opened front office services. In the rural sector 4 categories of SACCO with front office services can be identified based on fieldwork undertaken as part of this study.

1. Large, old, usually based on former district wide cooperative union. More than 10,000 members, can go over 100,000.
2. Medium sized fairly new, many based on tea 2-10,000 members
3. Small, newly launched front office activity to supplement income from decline in milk business, plus to service milk producers
4. Tiny, almost village banks, new activity, or NGO/developmental base.

Table 6: Descriptive Typology of Rural SACCOs

	Clients	**Members**	**Share capital** (millions	**Savings** (millions)	**Loans Out** (millions)	**Shares per member**	**Savings per member**	**Loans per member**
Murata F	108,000		170.0	730.0	303.0	1,572	6,759	
Mumias OG	39,941		155.1	120.1	116.9	3,883	3,004	3,000
Nyeri F	45,000		78.0	500.0		1,733	11,111	
Gusii	100,000		66.4	240.0	58.0	664	2,400	580
Aberdare M	14,000		30.0	90.0		2,143	6,429	
Meru F	126,000							
Murata B1	4,000	3,500	7.5	17.0		1,868	4,250	
Murata B2	7,500	5,000	14.9	57.9		1,987	7,720	
Kiegoi T	3,400		26.0	21.0		7,647	6,176	
Kisumu R	4,000		24.8		16.0	6,200		4,000
Ol Kalou F	5,000		18.0	30.0	32.0	3,600	6,000	6,400
Nyamira T	6,000		7.2	33.8	30.0	1,200	5,633	5,000
Saga	4,454		3.4		3.4	763		754
Ndetika	1,998		35.0		39.0	17,518		19,520
Muki	1,700			20.0	18.0		11,765	10,588
Nanyuki E	500		30.0		1.5	60,000		3,000
Ainabkoi	693		5.6	1.0	5.1	8,081	1,443	7,417
Akukurunut	517		1.6	1.0	0.8	3,095	1,838	1,451

Source: Authors visits, records. Incomplete data unavoidable

In the very large rural coops, (Murata, Nyeri Farmers, Meru Farmers) loans are an important part of the reasons for joining, but an examination of their operations and client balances indicate that savings is actually the major reason members use the service. Among the large rural coops visited savings are 3 to 5 times the amount of shares reflecting relatively lower demand for loans.

In the newer smaller coops (Ainabkoi, Akukurunut) the average member holds 2 to 5 times more shares than savings showing that those who join new coops early are relatively more interested in the ability to access loans. This is one of the reasons for more strict vetting of those setting up new deposit taking coops. Today it is very easy and needs approval of a single District Copoerative Officer who has very limited powers, inclination or skills, to oversee operations.

The demand for savings services is also shown by the number of clients who are not members or shareholders. These typically are salaried people working in, but not from the area, such as policemen, and teachers and some business people.

SAGA was a small operation based in Bondo that was able to reach the poorest clients seen during field investigations. It is managed by a private company, but the individual operating units are cooperatives. SAGA acts as an umbrella of the rotating and accumulating savings and credit groups common all over Kenya, but the only financial institutions in that relatively poor and remote district. ROSCA's – rotating savings and credit associations - are the ubiquitous merry go rounds where people (most commonly women) meet weekly to save a small sum by giving the weeks savings to one of the members. ASCA's - accumulating savings and credit associations – are less common but also meet weekly to save toward some lump sum e.g. cutlery or a water tank for each member. Both types of organization are informal and unregistered and use peer pressure to assist members maintain the discipline of saving.

SAGA has opened a front office that is the equivalent of a village bank where members can save even very small amounts either as a group or individually. In very poor parts of Kenya they were able to raise large sums of deposits from apparently near destitute men and women. SAGA branches also were able to bring banking services to fishermen along the shores of Lake Victoria, 100 kilometers from the nearest commercial banks in Kisumu. Fishermen were saving and not consuming all of their income daily as they normally do. However the small banking facilities were having some problems getting credibility with potential customers following previous organisations that went under without refunding depositors. SAGA is majority owned by K-Rep and is an attempt to roll out financial services in poor and remote communities.

<u>Dividends and profits</u>

Most SACCO's generate profits and pay dividends to members of between 2 and 6 % of the value of their shares. Provisions are made as not all the profits are paid out as dividends – usually only between ½ and 2/3 of profits are distributed.

Running costs, and management

Staffing costs are the biggest cost in the running of cooperatives. Costs related to the boards and its many committees come second. Cooperative management principles require elected board members to have a very big say in the day to day running of the societies. This is the source of some tension between boards and managers who feel overly constrained by the often relatively less educated board members who are their bosses.

This tension has played out in different ways in different coops. At one extreme qualified managers are forced out by politicized boards wishing to have more control for a range of possible reasons ranging from wanting to have a person from their own clan as manager (all coops were managed by people from the local tribe), to wanting opportunities to employ relatives or to misappropriate funds. In a number of co-operatives this misappropriation is in the form of board members granting themselves loans they are subsequently unable or unwilling to pay. Working in coops was reported to be difficult due to politicization of appointments, and relatively low wages.

The other extreme was where management was left to handle most normal management matters without interference from board members who only came for regularly scheduled meetings. This was relatively rare as the cooperative principle demands that board members keep a close watch over society issues and day to day running. In many cases managers were better educated than board members. Rural based board members also have time on their hands with many of the more recent boards having been infiltrated with well educated former teachers and civil servants who have retired to their home areas. Every meeting at the society offices results in the payment of sitting allowances that range from Ksh 500 to 3000 among societies visited.

Income sources

The bulk of cooperative SACCO incomes comes from interest on loans. SACCO's with front office services FOSA also make money from ledger fees, bankers cheques, and withdrawal charges. In some SACCO's with FOSA these banking related charges generated as much or more income than actual loan interest. FOSA services are opening up all over the country as co-ops recognize it as one of the few profitable cooperative activities they can engage in after the decline of income from traditional cooperative marketing and input supply activities.

Interest charges, sale of pass books, levies, standing charges and withdrawal fees, penalties on loan defaulters, interest on investments e.g. fixed deposits and Treasury bills, cheque clearance and loan application forms are the primary income sources for SACCOs. This is the same as in large banks and building societies, in Kenya and around the world.

Products

SACCO's recruit members through sale of shares that are an investment for the members. These shares are the source of funds for lending. Typically members are allowed to borrow between 2 and 5 times their shares. Societies lending 2 times are performing poorly and are liquidity constrained. 4 times shares is the most commonly occurring ratio.

SACCOS offer a range of loan products with each one having its own unique products, terms or conditions. The following were the most common types of loans

- School fees: This is the most common accounting for between 60 and 80 percent of loans among societies visited
- Hospital Bill Loan- a quick disbursing product where the cheque is written to a medical facility
- Medium term loans – 3 years
- Development loans of 3-5 years
- Advance against agricultural produce payments

SACCOs also mobilize savings

Competition

Competition among coops and between coops and other financial institutions is fierce. Within the coops there has been the rivalry between the large old district unions and newer separate rural SACCO's. In the tea growing areas there has been competition with recently formed Tea SACCO's that KTDA has been promoting to avoid having to carry monthly payments to thousands of growers on monthly basis in cash. The competition between SACCO's is best seen in 3 examples.

In Nanyuki 2 SACCO's are in court as technically Nanyuki town falls outside Nyeri district (by 200 meters) but the 10 branch 45,000 member Nyeri Farmers SACCO has opened a branch there. Competition and the legal challenges is coming from the 500 member, municipal council employee based Nanyuki Equator SACCO.

In Karatina town, Mathira Division of Nyeri district there are 4 SACCOs' with FOSA and 5 commercial bank branches all within 200 meters of each other. The SACCO's are Nyeri Farmers SACCO Society that has branches in all the divisions of the district, Nyeri Tea Growers that is in the 3 tea growing divisions of the district, Mathira Tea Growers SACCO Society, and Mathira Tea and Dairy Farmers SACCO Society.

In Maua Town in Meru North all commercial banks had pulled out by 1999. Meru North Farmers Cooperative Society that previously had a membership of 40,000 coffee growers opened a FOSA in the late 1990s. Among its clients are17,000 active accounts of which 7,600 are tea farmers. Meru North has 3 branches, and 3 mobile units. More recently the tea farmer specific Keigio Tea Farmers SACCO opened in the town and has managed to get 3400 members. The largest employer in the town, Maua Mission Hospital also opened a FOSA primarily to ease the payment of salaries to staff. Services are also open to members of the public. Maua is a relatively large town in a busy commercial area that is the center of the highly liquid multi-million shillings per day miraa business. It survived the closure of all its commercial banks through these cooperative societies. Meru North Cooperative assisted the miraa business by opening agency branches in

Eastleigh Nairobi, and in Mombasa. Recently Consolidated Bank opened a branch in the town.

Issues

A number of key issues need to be addressed to consolidate the gains made by the vibrant SACCO sector. Key among them are issues of regulation. Following the Cooperative Societies Amendment Act of 1997 the Commissioner of Cooperatives has extremely limited control over the operations of SACCO's or any other cooperatives. SACCO's are the only non-banking institutions allowed to take deposits from members of the public. Currently Ksh 70 billion, as compared to 400 billion in the entire banking sector is in the hands of unregulated SACCO's. There have been a number of SACCO's that have gone under unable to refund members their savings or shares. The biggest worry is if one of the bigger SACCO's was unable to make good members withdrawals and there was a general loss of confidence in SACCO's and mass withdrawals. Thousands of Kenyans would lose their savings. SACCO's do not subscribe to any form of deposit protection.

Central Bank has stated that it does not have the capacity to regulate over 3,000 SACCO's and 100 plus FOSA's. However they also recognize the need for some form of regulation, and suggest a regulatory body that they become members of, but do not control i.e. regulation outside of the Banking Act. This would either be under a revised Co-operative Act, or under SACCO specific legislation. There is general agreement that some form of regulation is necessary not least to ensure SACCO's meet and report on common prudential, and reporting standards to an independent regulatory body. Issues as to capital adequacy, ownership and governance, lending policies and risk analysis, auditing and reporting audit findings, and qualifications of management are some of the areas where government driven regulation needs to be brought to bear.

Today literally any group of 10 individuals can start a SACCO and begin mobilizing huge deposits from the public, and lending them almost as they wish. Debate about the form of cooperative legislation is currently ongoing. The Bill has been published and is scheduled to come to parliament in 2004. A microfinance bill introducing the concept of multi-tiered banking with different requirements and standards for different types of institutions also will be in parliament around the same time. Government still needs to decide if SACCO's will be under cooperative, or microfinance legislation. They could also be brought under an amended Banking Act reflecting a global trend toward unified financial sector regulation. Kenya is bucking the trend by continuing to propose the creation of numerous distinct financial sector regulators in banking, microfinance, SACCO's, capital markets, retirements benefits etc.

SACCO's are a big industry, particularly in the parts of rural Kenya where there is, or has been, a remunerative cash crop. However in the bulk of the country where this is not the case, SACCOs have not penetrated in a big way. Cooperative SACCO's are thus perpetuating the imbalance where better off parts of the country get better services and more choice. In the next section Village Banks, an endeavor to address this shortcoming, are examined.

Village Banks

K- Rep Development Agency was behind importing the concept of village banks to Kenya. Officially known as Financial Services Associations (FSAs) their number has grown to just under 160 spread around relatively poorer parts of Kenya where there are no commercial banks or cooperative SACCOs. 75 of those are sponsored by K-Rep. Catholic Relief Services are the other big sponsor of village banks.

Table 7 FSAs in the Districts Visited.

District	**# of FSAs/ Village Banks**
Kitui	5
Taita- Taveta	9
Kilifi	7
Kwale	7
Makueni	5
Bomet	6
Suba	2
Migori	2
Bondo	3
Busia	1
Butere/Mumias	1
Total	**48**

FSA's are popularly known as village banks. They are community owned, through sale of shares to members. Each share costs Ksh 300 and members are not limited in terms of how many they can buy. Members can access loans worth a multiple of their shares with 4 times share-holding being the most commonly occurring multiple. Loans are disbursed to members strictly from the share capital. In cases where savings have been loaned out, this has led to a near collapse of the particular village banks when savers wish to withdraw savings and the liquid funds are not available. Shares cannot easily be withdrawn.

Village banks operate under the principle of 'savings first' that is common among microfinance institutions and SACCOs. Savings first implies that people actually need savings services more than loans. It also is used to develop the habits of putting aside regular amounts of money that is an important element in building the discipline required to repay a loan. For many of the members of village banks the institution is their first opportunity to have any form of bank account, and to put money aside outside of revolving groups.

FSA's main service is actually savings as much as credit. By offering savings facilities to members and the wider community (associate savers) FSA's are able to make the financial dealings of community members much simpler, particularly for services such as check clearing, and writing checks for community members with no access to their own accounts in commercial banks. FSA's charge for these services, but the cost o the client/member is considerably lower than the cost of traveling to the next major town, or the cost of maintaining a bank account that is on the order of Ksh 250-500 per month and out of the reach of the poor majority. Most FSA's do not charge a fixed monthly fee, but charge per transaction, usually per withdrawal.

FSA's are community financed and community managed, and run by staff who come from the community. The language of business is the local one and business hours are as determined by the community. The same applies to service charges.

As a result of the locational convenience and reasonable charges FSA's attract non member clients who hold no shares but use the facility as a savings bank account. Most of these are salaried people from outside the area such as teachers, policemen and business people. The product tailored for such individuals is called the associate savings scheme. An individual member or associate saver can access his/ her savings any time, within the stipulated working hours. The minimum balance is Ksh. 200 for members and Ksh. 400 for associate savers and a range of fees is charged on withdrawals.

Each FSA develops its own loan products. However the most common are:
- Business loans for business startup or expansion
- School fees
- Medical/ emergency loans
- Development loans- to put up structures, business premises, houses.
- Consumption loan- to buy food or other needs.

All loans taken are repaid within one year with repayment periods ranging from 4 to 12 months. Members are free to negotiate shorter repayment periods. Usually this is done so as to qualify sooner for a larger subsequent loan. Loans are guaranteed by the shares of the loan recipient and those of 2 or more guarantors. Apart from the savings and credit scheme, FSAs offer cheque clearance and money transfer services to members.

Table 8 Typical Charges among FSA's

Withdrawal Fees	
Amount (Ksh)	**Charges (Ksh)**
20- 100	5
101- 1,000	10
1,001- 10,000	50
10,001 and above	100
Other sources of income	**Ksh.**
Registration fees	100
Passbook	60
Loan application. Form	100
Affidavit	10

Table 9. Interest Rates charged by different FSAs

FSA	Interest rates (%) p.a.	Penalty (%) on amount due/ day
Nzambani	180 – 60	0.5
Mathima	120 - 48	0.5
Werugha	120 – 24	0.5
Ngerenya	22 - 18	
Tiwi	20	0.05
Makimenyi Bomet	16 – 22	0.10
Rongo, Migori	14 – 25	0.08
Magunga, Suba	16 – 30	0.10
Mbita. Suba	15	
Bumala	14 – 25	

In case loan repayments are delayed, there is a penalty charged of 0.5 % per day or 15% per month, on the amount due.

Organization of FSA's

For purposes of borrowing and co- guaranteeing, members are organized into groups of between 5 and 10 members, called *Kikundi cha mkopo*, (KCMs). Several KCMs form a larger group called *Muungano*. The *Muungano*, appraises and approves loans to borrowers. The group members elect a chairman, secretary and treasurer to run the affairs of the KCM. The KCM meets regularly to save, and a member can save as little as Ksh. 20 per week. This is a mandatory group saving which will guarantee member loans. The KCMs also put pressure on a member with a loan to make regular weekly repayments

An 8 member Board of Directors, (BoD) oversees the running of the village banks. Board members must be shareholders and go through a democratic election process. They cannot be politicians or from the provincial administration as this has in the past caused problems with loan recoveries. The board is composed of a chairman, 3 internal auditors, 2 persons from the credit committee, and 2 bank signatories. The board must be at least one-third women.

One manager, a loans officer, and a cashier, run the day-to-day affairs of the village bank. Activities include member recruitment, training, loan disbursement, loan recovery, accepting savings and paying withdrawals. A watchman who guards the premises is also part of the team. The community identifies suitable employees from the local area. The monthly wage bill in a typical FSA usually is less than Ksh 35,000 in a stand-alone FSA, Ksh 10,000 in a branch. Wages, including board members sitting allowances, constitute 60 to 90 percent of running costs.

The community contributes towards the costs of starting up the FSA. If there is construction they cover 1/3 of cash costs with each member making a cash contribution of Ksh 100 or more. They also contribute building materials such as sand, bricks, hardcore etc and provide some labor. K-Rep through funding by the Danish development agency Danida, provides two-thirds of cash needs, a safe, stationery, help with marketing and outreach, training, and ongoing monitoring and external auditing services. There has been mixed success in having FSA's continue to run in the absence of some continuing external backstopping support. The financial support required to set up a village bank is on the order of Ksh 200,000 excluding ongoing backstopping.

The potential of FSA's to improve lives in relatively marginal areas is apparently quite great. A few examples of help make the point. Perhaps the most striking was a lady member at the coast who held a single Ksh 300 share, borrowed Ksh. 1,200, 4 times her single share, to start a business in her house- selling paraffin, soap, cooking oil. In 2 months, her business has doubled, she has increased her shares to 3 (worth Ksh 1,200) and grew her personal savings to Ksh. 2,000.

Another member had an existing but poorly stocked retail shop. He took a loan of Ksh. 12,000 and split it between school fees - Ksh. 4,000, and business Ksh 8,000. In one month his business, stock, and profits had grown to more than enough to service the loan. Meanwhile his child stayed in school.

FSA money is not cheap. Initially first loans were charged at 6 or 8 percent per month, the second at 5 percent. Term of such loans would be less than Ksh 5,000 over 3 or 4 months. Payments would be Ksh 1,550 per month for 4 months on the Ksh 5,000 loan so despite the high interest rate total interest paid would be a seemingly small Ksh 1,200 over 4 months for the privilege of having Ksh 5000 in cash. On an annual basis the interest rate implied is 96 percent. But clients were happy to access the loan. Recently interest rates have been reducing driven by competition, and lack of demand for loans in some localities.

FSA's become more accessible because they take unique forms of collateral. Apart from shares and guarantees from other members, FSA's take pledges of household assets – like radio and TV sets, sofa sets, tables, bicycles, livestock, personal pledges, and group savings. For larger loans, usually above Ksh 10,000, the borrower must sign an affidavit with a commissioner of oaths, at a small extra cost. In case of default the provincial administration, usually in the form of the assistant chief and his administration policemen are used to attach pledged securities and encourage defaulters to repay their loans.

<u>Returns on Investment</u>**.**

Some of the village banks visited are moving toward sustainability and have been able to make profits from their operations. Profits are shared out in form of dividends to shareholders. Excess money was invested in Treasury Bills when rates were high. Now FSA's are under pressure to keep money loaned out as the returns to money in the bank is negligible. However they face the risk of deteriorating loan quality if the urge to lend overcomes the need for caution. However an FSA that does not lend cannot survive. This is part of the reason for recent declines in interest rates charged. The problems of running an FSA are the same as for any financial institution around the world.

Well run FSA's have been able to show markedly improved performance from year to year and some may soon become self sustaining. Members are particularly pleased when they get a dividend on their shares and committees compete to generate high dividends.

However this has to be balanced against the need to retain earnings and build the capital base of the institutions. Table 7 shows dividend payout in select FSA's per Ksh 300 share.

Table 10. Dividend Payout in Selected FSA's

FSA	Year	Earnings/ share	Dividends	Retained Div.
Nzambani- Kitui	2001	9	0	0
	2002	70	28	60
Werugha- Taita- Taveta	1999	87.5	0	70
	2000	175	72	70
	2001	195	78	70
	2002	301.25	78	128
Makimenyi	2002	50	0	50

FSA's face a number of challenges. Initially FSAs started lending to individuals but high default rates resulted in the near closure of some of the pioneers. The group co-guaranteeing system was introduced, and has been quite effective in loan recovery. However it is a disincentive to more established business people and many FSA clients may, as a result, graduate away from the FSA to other types of financial institutions. Given the development objective of FSA's this is not a bad thing.

FSA's also face marketing challenges. Some have difficulties in recruiting new members due to competition from other micro-finance institutions that offer similar services, using the group co- guaranteeing system, as well as merry- go- rounds. High interest rates, ranging between 24% and 180% p.a also have proved a problem. However, in most FSAs, there is a dramatic decline in interest rates, in each of the first few years of operation in order to keep loan demand high. Most FSA's are short of borrowers. Members avoid taking loans due to fear of losing property in case of failure to service the loan.

Low skill levels in FSA communities also has been a problem that manifests in low management capacity in the staff and the governing boards. However those skills are being built up and FSA's do have a developmental goal. The FSAs have moved quite slowly away from dependence on the promoting sponsor K-Rep. On the management side fraud due to lack of close supervision of management staff, tedious manual daily transactions, and lack of electricity and computers have been a concern.

FSA's have not been able to make many loans to agriculture and recognize it as one of their shortcomings. Business and school fees represent over 90 percent of loans disbursed across FSA's visited. Given the need to purchase shares and be able to demonstrate the ability to make weekly payments, FSA's do not reach the poorest members of the communities they are in. But they do reach a poorer strata of Kenyans than most other types of financial institutions. FSA's also are in remote market centers that no other financial institution would have come to for very many years.

Table 11. An Analysis of How Borrowed Money Was Used in One Month in 2003

Credit Institution	Loan Purpose	No of loans	Amount of loan (Ksh)	(% of total loans)	Comments Avg amount borrowed
Nzambani FSA	School Fees	13	71,600	18	6,000 (range 1,200- 10,000)
	Development (Construction)	6	108,600	27	8000 (range 5,000- 60,000)
	Business	17	197,000	49	6,000 (range 2,000- 40,000)
	Hospital	4	20,500	5	5,000
Mathima FSA	Business			60	Range 20 – 60, 000
	School Fees			20	Range 8 – 10,000
	Farming			5	1 – 2,000
	Investment/ Development			10	Power saw
	Others			5	
Werugha FSA	Business	8	372,800	84	3 – 36,000, 57% of all borrowers
	Farm inputs	4	30,800	7	Fert., dairy meal, agro-chem, 29% of borrowers
	Hospital	1	5,000	1	5,000 emergency
	Water pump	1	36,000	8	1 borrower
Mangunga FSA –Suba	Business	10	214,800	87	6,000 – 20,000
	School fees	4	32,000	13	8,000
Mbita FSA	Business	10	104,000	73	10,000
	School Fees	5	30,000	21	6,000
	Emergencies - Medical	2	9,000	6	5,000
Bumula FSA - Busia	Business Expansion	7	149,000	82	2,000 – 68,000
	School Fees	3	32,800	18	7,000
FINCA (The Foundation for International Community Assistance)	1.Commerce/business 2.Production i.e. cooking, food products, sewing, tailoring, crafts			>= 70 22	
	3.Service-based businesses, hair, bicycle repair			6	
	Agriculture crops & L/stock			2	

Village banks have not been able to address the credit needs of rainfed agricultural in the areas where they operate. This applied in relatively marginal production environments as well as relatively productive cereal producing areas. Many traders were accessing loans from village banks as is shown in the table above. But as with other types of rural financial institutions in Kenya the bulk of their loans go to business, followed by school fees and medical emergencies.

Building Societies

2 institutions survived the purge of domestic financial institutions that followed the 1988-banking crisis – Equity Building Society, and Family Finance. The Building Societies Act allowed limited liability companies with only Ksh 200,000 of share capital to collect deposits. A mixture of legislative slowness, regulatory laxity, greed, mismanagement and a desire to see indigenous Kenyans owning banks led to a surge in small building societies and finance houses such as Rural Urban, Prudential, Kenya Finance and a host of others that are now part of the history of the Kenyan financial sector.

Equity Building Society started in 1984 and survived the collapse of domestic and indigenous financial institutions in the late 1980's. Currently it is the third largest financial institution in Kenya by number of clients - 255,000 that is 12 percent (1 in 8) of all Kenyans with bank accounts. Table 8 presents a summary of their 2003 results.

Table 12: Equity Building Society Results

	2003 Figures	% Change over 2002
Depositors	252,186	+ 62
Customer Deposits	3.37 billion	+ 54
# of Borrowers	65,145	+ 57
Loans and advances	1.6 billion 21% return	+ 43
Assets	3.9 bn	+52
Pre Tax Profit	142.7 million	+ 29
Excess Liquidity	2 billion	
Government Securities	870 million 4.3% return	+ 91 % from 454 million
Deposits with other Banks	969 million 2.9% return	+ 59 % from 611 million
Return on Equity	29%	

Equity has mobilized Ksh 3.37 bn. in savings and deposits. An indication of its outreach is the fact that the average account has a balance of less than Ksh 3000. Equity had less than 4000 borrowers in 2001. This rose to 40,000 in 2002 and 65,000 in 2003. Much of this growth has been driven by a strategic look at what gaps there were in the financial market, and the demographics and characteristics of large numbers of underserved clients. To these clients were offered low minimum balances (Ksh 400), no monthly charges, and access to a variety of loan products that were processed speedily. The growth in delivering innovative products began the agricultural sector with lending to tea farmers against their monthly deliveries or end of year bonus.

Equity has proved a major competitor for SACCO's in the tea growing areas around Mt. Kenya. The competition is fierce for the business of some 360,000 plus small-scale tea growers. SACCO's noted that Equity spent a lot more than they did on marketing.

Equity generates more profit than many far larger financial institutions and is continuing on an aggressive growth path. In 2003 it opened 3 new branches. In November Equity opened in Nakuru and had 14,000 new clients in a month. Family Finance also opened a branch there around the same time. Equity plans to open in at least Eldoret and Kisumu before the end of the year. They are reaching out to many Kenyans that are still searching for a financial institution that can meet their needs.

Equity already has benefited from lending to agriculture and states that it is keen to do more financing of agriculture. However they point out that for every commodity and region the specifics of the marketing systems would demand different loan products. It would be unlikely that one model could fit all scenarios. Products for tea and dairy are already developed but Equity sees difficulties in rolling out products for other commodities due to the costs related to product development, and the relatively less developed marketing systems in the other crops. However they expressed a willingness to do agricultural lending on agency basis and feel that no government body could be more cost efficient in getting loans and other services to agricultural producers. They say there is room for dialogue and that they would be happy to discuss the modalities of a government supported agricultural credit facility.

Equity has rolled out a profitable and low cost business model that can make money lending an average of Ksh 20,000 per loan. Commercial banks reported that loans of that size were of no interest to them and set lower limits of Ksh 50,000. The typical agricultural borrower in Kenya would need closer to Ksh 20,000 than 50,000. This suggests a benchmark for one hallmark of a potentially successful agricultural lender in Kenya. The biggest problem for financial institutions like Equity and Family Finance is excess liquidity. Despite aggressive advertising campaigns they are finding it difficult to find profitable channels for lending. If products could be developed for them to lend more to agriculture they could meet a good proportion of the need for agricultural credit without the need for government funds. They have deposits adequate to cover a greatly expanded loan book. Government could play a role in encouraging product development and underwriting losses incurred while learning to reach farmers.

Equity has been making efforts lend where marketing systems are well developed such as in small-holder tea and in dairy. One micro-finance specialist spoken to suggested that the best bank for farmers is not a bank, but a functioning marketing system. Such a system gives certainty that the produce will be sold, and results in financial institutions falling over themselves to serve the needs of the farmers producing the commodity.

AFC - The Agricultural Finance Corporation

The AFC was formed under Cap 323 in 1963 combining the government programs supporting agricultural credit to Europeans and Africans. In 1969 it was reconstituted to take over the Land and Agricultural Bank. At its formation AFC's functions were to assist the development of agriculture by making loans to all farmers, co-operative societies, public bodies, local authorities and any other person involved in the agricultural sector. In practice it primarily served the large farm sector while the Cooperative Bank targeted the small farm sector (and cooperative commodities).

The 1997 Tegemeo household survey was able to shed some light on the operations of AFC in the mid 1990s. Agricultural Finance Corporation (AFC) gave loans to only one percent of households (15 in random survey of 1500 rural households), and was responsible for 3.5 percent of the value of actual loans made, implying relatively large individual loans. 99 percent of loans were made in 2 of the 9 regions covered - 86 percent in the Rift Valley and 13 percent in the Central Highlands. The loans went to large farms averaging 19 acres compared to an average farm size of 4.3 acres in the whole sample. And loans were made largely to individuals with salaried jobs. 73 percent of those who had accessed a loan from AFC had sources of off-farm income. 93 percent of AFC's borrowers used fertilizer and financed its purchase with funds from AFC or off-farm sources. The AFC is not serving the credit needs of farmers and its role has been taken over by self-finance, and co-operatives. Of all households using fertiliser, 46 percent financed the purchase with earnings from farming, 24 percent with off-farm income, and 16 percent through co-operatives.

AFC's loan products covered land transfer, cereals (GMR and seasonal credit schemes), livestock and cash crop production, on-farm infrastructure, farm mechanization, agricultural transport equipment and input distribution. Over the years the branch network grew from 6 in 1964 to a peak of 49. Currently there are 30 branches. But activity for the last decade has been too low to justify even this reduced infrastructure.

How AFC Came to Where it is Now

The insurance element of the GMR scheme was abused and exploited in the late 1970's. Politically and/or financially powerful farmers would have their crop declared a failure and in return have their production loans written off. Meanwhile their produce would be sold, unencumbered in side markets or through other names. Government and AFC officers were not able to hold these individuals to account, and also participated in and benefited from the scam. Government discontinued GMR in 1978.

A New Seasonal Credit Scheme was started in 1980 to replace GMR. By June 1992 the non-performing portfolio was Ksh 1.5 billion, 49 percent of the 3.4 bn portfolio. In 1996 the scheme was suspended due to diminished revolving funds as a result of the build up of a huge non-performing portfolio of 6.2 bn on a loan portfolio of 6.8 bn, or 89 percent. AFC had been almost literally giving away Ksh 500 million per year for 10 years.

Government budgetary allocations have not been forthcoming. Government was to compensate the corporation for write offs GOK directed AFC to give, including a large sum late last year, but stretching back since 1978. Recoveries have gotten worse over time. In the year ending June 1996 Ksh 860m was collected. By 2001 this had dropped to Ksh 400m and in 2002 only 156m. or Ksh 13m per month. Those who had not benefited from the write offs were not paying.

Compounding of interest on arrears is another reason for poor loan repayment and has made many loanees give up in the face of huge loans build up of arrears i.e. a loan that started as small with a principle of Ksh 500,000 a few years ago now standing at Ksh 8 million. The new management at AFC has offered concessions on accumulated arrears and interest for borrowers who come forward and enter into negotiations to regularize their accounts. But some borrowers are not convinced why they should pay when a group of wealthy and powerful people had their loans written off completely.

Donor supported loan programs to AFC also have dried up. As a result there has been minimal new lending, and the bulk of loan recoveries are used to service running costs, particularly payroll that runs to around Ksh 160 million per year. Other running costs are budgeted for Ksh 80 million. At the beginning of 2003 AFC held Ksh 250 m of their own to lend that was supplemented by Ksh 260 million from government for development loans. Another Ksh 260 million is expected for seasonal credit.

<u>The AFC's Plan</u>

In 2002 a large number of non performing loans were written off. The process was extremely political and many relatively better off loanees escaped, many relatively poorer ones did not. Government ministers, senior politicians and civil servants, dominated the list. Disagreements about revealing the list, and who should or should not be on it were reported to be part of the reasons for the exit from office of a recent PS in the Ministry of Agriculture.

The debt write off, and a new loan concession program are aimed at making more of the loan book performing as a means of cleaning the balance sheet to attract new funding from government and donors. The corporation has requested the equivalent of Ksh 1.46 bn per year for the next 5 years (Ksh 7bn) and argues that after that injection of new capital it will be self-sustaining.

With current running costs of Ksh 160 m for 520 staff and Ksh 80 m for operations per year AFC requires Ksh 250m per year to run in its current form. This would require a loan book of Ksh 2.5bn at their advertised 10 percent interest rate to be sustained. Operating costs of Ksh 200, 000 per branch per month appear adequate. The wage bill would need to rise if new lending operations to be commenced and also need to fund a retrenchment program although natural attrition has reduced staff numbers significantly. AFC is short of key cadres i.e. loan officers and recently advertised for a large number of new staff, probably on the strength of government promises to do something about reviving the institution.

Currently AFC has loanable funds of their own amounting to Ksh 250 m. In response to pre-election promises to revive AFC government made an initial injection of KSh 260 m for farm development, followed by a similar amount for seasonal credit for a total of Ksh 520m. AFC needs a Ksh 2 bn injection of some form quite soon if they are not to continue to require government subventions. Demand for AFC loans does not appear to be a problem. Staff report that current loan applications for the Ksh 260 of development loans advanced by government stand at Ksh 3.5bn. Demand for seasonal credit is yet to be ascertained but staff suggest that total loan demand is in the region of Ksh 10 bn per year.

AFC is also looking for ways of being shielded from politicians and political/government interference. Conversations with staff indicate that they see political interference and liberalization as their biggest problems. Staff talked to propose that since agricultural lending is risky, government must shoulder the costs of the operation for the foreseeable future. They are do not seem keen on proposals about privatizing, or becoming a deposit taking institution.

Options For AFC

The government has a number of choices as to what to do with the AFC.

1. Government pump in the Ksh 7 bn they have requested as it would strengthen balance sheet and may attract concessional donor funding. Does not address the fundamental reasons for the high default rates – 15 times higher than in the rest of the rural finance industry and 2.5 times that in the poorly performing banking sector.
2. Government inject Ksh 2 bn.
3. Government assist AFC to access concessional lines of credit
4. Convert AFC into a deposit taking agricultural bank.
5. Close down AFC.
6. Become a wholesaler of money with retail functions undertaken by commercial banks, building societies and SACCOs that already dominate the rural areas and have developed sustainable systems of disbursing credit and keeping default rates low.

This paper has already shown that no institution in Kenya has really perfected lending to normal agriculture per se and most of their loans go to school fees, business development and building houses or commercial premises. The typical agricultural portfolio in the range of Kenyan financial institutions is around 2 percent. And most of this money is used as consumer credit or is advances against regular or lump sum payments for tea and milk.

These institutions in some areas and at some times of the year are short of loanable funds and SACCO's in particular have been borrowing from commercial banks - Co-operative, Stanbic, KCB, Standard Chartered, K-Rep.

Most rural based financial institutions suggested that they would be willing to manage special products on behalf of government and suggested that AFC could never match their systems and efficiency. The extra costs and risks of running a tied agricultural program would have to be covered by the sponsor. Institutions also pointed out that each commodity and marketing system probably will need a different loan design that would be difficult for a bureaucratic national organization to handle. Institutions spoken to also pointed out that if they were to handle government funds they would not like it to be widely known, or for it to look very different from their other products as delinquency rates would rise across their entire loan portfolio.

Looking at the way forward, and beyond AFC there is need to recognize that the rural sector has been able to mobilize large amounts of funds with shares, deposits and loans running to hundreds of millions. Dividends are paid on shares implying that players are able to undertake their current operations at a profit. Rural SACCOs probably are holding Ksh 20 billion and are serving 500,000 borrowers and more savers. All SACCOS have 66bn in deposits, 1,000,000 borrowers. Post Office has 10 bn saved and 2 million active accounts. NGO's have about 200,000 clients nationwide, Building societies 250,000, K-Rep and Co-op Bank about 50,000 each. The question for policy is whether AFC is really being missed, or whether the problem is more one of the lack of agriculture friendly products and whether this problem needs an agriculture focused institution to address it.

Many institutions already have products that advance money against the annual tea bonus getting around the problem of needing to make regular payments that is difficult for agricultural borrowers. Others are thinking about trying new ways of reaching farmers. The need now is to understand better the process of product innovation and how to encourage it, perhaps even subsidizing product development and experimentation, rather than subsidizing a particular institution or its relatively well off clients. Such a process would be far cheaper, and much more beneficial, and potentially reaching more of the right type of clients than AFC, as currently structured, can ever hope to.

AFC is currently undertaking a strategic planning process.

Policy Issues Facing Rural Financial Services In Kenya

Numerous and confusing ways of calculating interest rates were encountered during the course of this study. Some institutions were charging monthly interest rates calculated on a flat rate basis. This was most common among small village banks and NGO's making small loans to business people. Rates charged were as high as 8 percent per month for a first time borrower. However over time these maximum rates have come down to the range of 4 to 6 percent per month due to competition and lack of demand for loans when rates are that high. It was notable that village banks could start with very high rates, but after a year or two were faced with excess cash and the need to generate more demand for loans through reduced interest rates.

The actual cost of money implied by rates of even 5 percent per month is 193 percent on an annual basis. However typically such loans were for small amounts for about four months. These loans, typically under Ksh 5,000, are the preserve of quite poor people, but beyond the reach of the poorest in all the areas visited. The relatively poor pay fairly high interest rates, but the absolutely poor have no access at all.

Table 10 overleaf shows the different cost of money across institutions encountered. The range is from 193 percent in a new small village bank, down to 14 percent in the car loans market where rates are based on a flat rate, or in the corporate market where large firms pay near the advertised base rate, minimal charges and on a reducing balance basis. However the best offer is from AFC that is only beaten by an offer of 5.5 percent financing, fixed rate, (10.15% reducing) introductory offer from a local car dealer in conjunction with their bank.

Fixed rate loans return interest charges ranging from 193 to 14 percent. Reducing balance loans ranged from 65 to 12 percent. Kenya has a segmented credit market where such wide variations suggest market failure. And dealing with market failure is a legitimate role for the state, even where, as in Kenya, the state was responsible for the segmented market, market failure, in the first place.

Before MFI's, SACCOS, and village banks and similar institutions came up the market was even more segmented than it is today. The vast majority of enterprises and individuals currently accessing credit through these institutions had no access at all to the financial system. The picture depicted overleaf is a half full glass, not an empty one. Things have improved through the efforts of hundreds of individuals, donors, institutions that have been promoting micro-finance in Kenya. Unfortunately too many Kenyans, particularly small-scale producers of most agricultural commodities are still out in the cold. This should be the new thrust of funding and innovation in the financial market in Kenya.

Table 13. Interest Rates and the Actual Cost of Money in Kenya

Fixed Rate

	VB Start	VBk Hi	FOSA	VBnk Lo	NGO	NGO II	Bnk 1	Bank II	Bk+TSC	Car
LOAN	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
int rate/Mth	1.08	1.05	1.05	1.03	0.03	1.15	1.65	1.5	1.25	0.583
Int rate /year							19.80	18.00	15.00	7.00
int rate mth	8	5	5	3	3	1.5	1.65	1.50	1.25	0.58
Charges	600	600	300	600	600	20,600	2,500	2,000	2,500	0
Net L	99400	*99,400*	*99,700*	*99,400*	*99,400*	*79,400*	*97,500*	*98,000*	*97,500*	*100,000*
Avg Loan	49700	*49,700*	*49,850*	*49,700*	*49,700*	*39,700*	*48,750*	*49,000*	*48,750*	*50,000*
Total Int	96,000	60,000	60,000	36,000	36,000	18,000	19,800	18,000	15,000	7,000
16 Week	32,000									
12 month	**1.932**	**1.207**	**1.204**	**0.724**	**0.724**	**0.453**	**0.406**	**0.367**	**0.308**	**0.140**

Reducing Balance

	VBnk Hi	VBnk Lo	NGO	BS US	BS S	Corp	City	New AFC
LOAN	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Int rate/Mth	1.05	1.03	1.5		1.5	1.5	1.083	
Int rate /year			18	18	18	18	13	10
Int rate mth	5	3	1.5					
Charges	600	600	10,396	10,396	3,396	3,000	0	10,000
Net L	*99,400*	*99,400*	*89,604*	*89,604*	*96,604*	*97,000*	*100,000*	*90,000*
Avg Loan	*49,700*	*49,700*	*44,802*	*44,802*	*48,302*	*48,500*	*50,000*	*50,000*
Total Int	32,500	19,500	9,750	9,750	9,750	7,041	7,042	5,417
12 month	**0.654**	**0.392**	**0.218**	**0.218**	**0.202**	**0.145**	**0.141**	**0.12**

Key: VB Start is the first laon in a village bank, VBk Hi is a high cost Village Bank, Lo is a lower cost one. Bnk I,II are commercial banks, + TSC is loans too teachers – TSC employees.
BS US and S is unsecured and secured facilities at a Building Society, Corp and City are deals between city companies and commercial banks, City is the corporate. New AFC is the current offer from the Agricultural Finance Corporation that is bound to elicit excess demand.

Figure 1. APR Equivalents For Reducing Balance and Flat Rate Loans

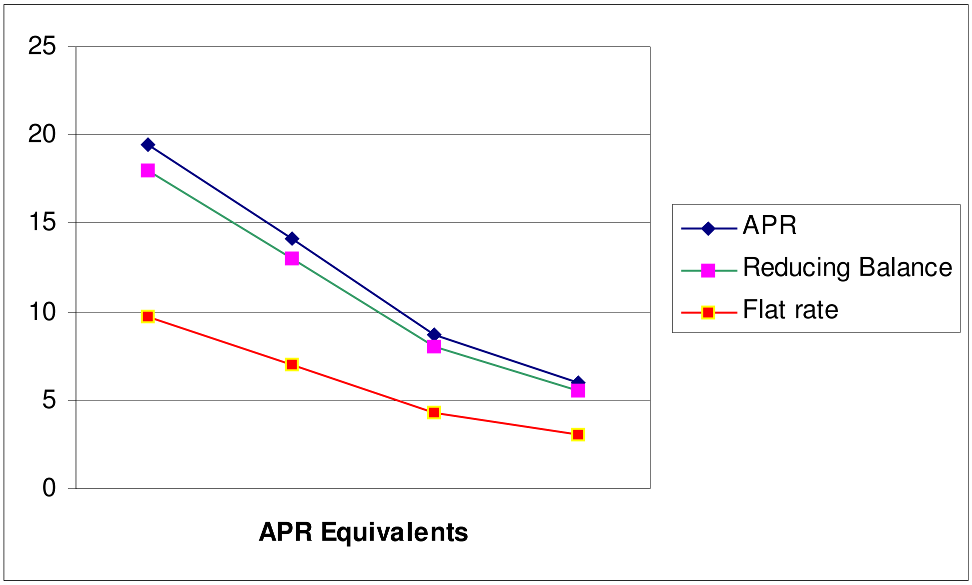

Figure 1 shows the Annual Percentage Rate equivalents for loans quoted on flat rate or reducing balance basis. A loan at 10 percent flat rate is equivalent to 18 percent on reducing balance basis. In a number of countries policy has increased transparency in lending rates and charges with different methods of calculation by demanding that financial institutions prominently inform potential clients of the actual cost of the money they are borrowing. APR makes it easier for consumers to compare across lenders. The Central Bank of Kenya has begun to improve consumer information by publishing bank charges and interest rates in the press. However some of the hidden charges are not clear from those tabulations.

On the policy front a number of threads are coming together at the same time and giving the opportunity for a reevaluation of the rural financial services market. On the regulatory and legislative side government has 3 bills and an existing Act that can form the basis of finding a way forward.

The Micro-Finance Bill proposes to allow groups able to raise Ksh 60 million of share capital and a series of other prudential and management standards that continue to be negotiated, to take deposits from the public. Regulation would be by a body separate from the Central Bank. However CBK would be wiling to be on the board of that regulatory body. Regulation and a clear legal framework for deposit-taking MFI's, it is hoped, will attract funds from private investors, and more business from wary depositors.

Regulation and prudential standards also would allow the development of deposit protection for MFI depositors. Currently in Kenya it is the relatively wealthy who can afford to bank at a commercial bank who are afforded deposit protection. There is no deposit protection where the poor do their banking. The industry anticipates that clear prudential and reporting standards under a regulatory body would remove potential opportunists who can sully the name of the entire MFI industry. However the current draft MFI bill would do little to increase the access of agricultural producers to credit.

The draft Cooperative Societies Bill proposes a regulatory body for SACCOs. Another draft SACCO Bill from the same ministry also proposes a SACCO regulatory body. SACCO's have played a large role in increasing access to financial services in both urban and rural areas. However not enough work has been done in examining whether 2 separate regulators are needed. There are also questions about the number of MFI's and SACCO's that would want to convert to new institutional forms proposed in the draft legislation.

Government has already made a policy move in this area through the reducing of the minimum capital requirement for a commercial banking licence to Ksh 200 million. Many of the Co-ops visited would easily qualify if they so wished. A banking licence brings strict financial and reporting standards, as well as deposit protection and more credibility with depositors. Around the world some of the largest banks trace their origins to cooperatives. Within Kenya, Equity Building Society has been invited to apply for a banking licence but is yet to proceed. And it is not clear that a number of the larger MFI's really want to take deposits other than the forced savings that are part of their current operations.

Conclusion

Agriculture sector stakeholders have not been part of the emerging debate about how to avail financial services to rural Kenyans. Farmers are particularly disadvantaged because advances have been made in developing products for rural businesses, but not for agriculture. The new government pledged to make credit available to farmers and moved to examine the possibilities for reintroducing Guaranteed Minimum Returns and funding AFC as a means of implementing this pledge. This paper has shown that the rural finance sector is far broader than the AFC. It has also shown that industry players and even innovators have yet to design products that reach the bulk of agricultural producers.

Players in the rural finance sector can see the need, and business potential, of lending to the largest sector of the economy. But despite the many different institutions, institutional forms and products, difficulties in the product markets, and problems with the regulatory framework has slowed product development. Government can play a more proactive role in advancing dialogue and underwriting product development in the agricultural credit sector. The focus should go far beyond a single government owned institution that provides subsidized credit to a few large farmers.

Global experiences and best practices should be part of that examination, as well as the potential for insurance arrangements to reduce the risks of lending to rainfed agriculture. And donor support of the type Uganda is receiving targeting the development of products and institutions to serve agriculture should be sought. The Strategy for Revitalizing Agriculture suggests that the agriculture related ministries should take more interest in national debates about the evolution of the countries financial system to ensure that agriculture does not spend more decades starved of financial services. The preparation of a policy and sessional paper on agricultural finance could be a useful way forward, and could be a framework within which government decides many of the issues raised above, including the future of AFC.

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