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Rural Financial Services in Kenya: What is Working and Why?

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Betty Kibaara*

Abstract

Access to rural financial services has a potential to make a difference in agricultural productivity, food security and poverty reduction. However, an efficient, sustainable and widely accessible rural financial system remains a major development challenge in most Sub Sahara African countries. The Economic Recovery Strategy for Wealth and Employment Creation (ERS) has identified poor access to farm credit and financial services as a contributing factor to the decline in agricultural productivity. The Strategy for Revitalizing Agriculture (SRA) proposes to improve access to rural financial services in Kenya. As a follow up on SRA, the Agricultural Sector Co-ordination Unit (ASCU) has fast tracked access to rural financial services by establishing a thematic group on inputs and rural financial services with an overall objective of developing an Integrated Farm Input Strategy. In the late 1990's, most mainstream commercial banks closed down the rural branches in order to cut costs and improve profits. Since then, a number of non-traditional financial institutions have emerged to fill the gap created by the mainstream banks which locked out low income and irregular earners.

This study examines the evolving structure of the rural financial services and the extent to which the current financial institutions have improved access to producers and traders in the rural areas. The study identifies successful cases of functioning financial services in the rural areas. It also identifies constraints that hinder increased access to rural financial services and proposes policy interventions that could make the services more accessible to the rural people. The study was carried out in 15 Districts within six agro-ecological zones. Data was obtained from key rural finance stakeholders using a structured checklist. The study is supplemented with information from the Tegemeo Agricultural Monitoring and Policy Analysis (TAMPA) 2004 survey consisting of responses from 1540 rural households.

Findings from the study indicate that a number of key rural financial models have evolved to address the demand for rural financial services in Kenya. These include: Community Owned Rural Financing Models, Private Commercial Bank Led Model, Government Led-Rural Finance Model, Donor Guarantees-Input Supply Model, Managed SACCO-Beach Banking Model and the Informal Group Based Rural Financing Model. The Government on its part has restructured the operations of Agricultural Finance Corporation (AFC) in line with the Strategy for Revitalization of Agriculture (SRA). The emerging leading indigenous banks have also set up fixed and mobile branches in the rural areas.

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List of Acronyms

AFC	Agricultural Finance Corporation
AFRACA	African Rural and Agricultural Credit Association
AGMARK	Agricultural Market Development Trust
AMFI	Association of Micro Finance Institutions
ASCU	Agricultural Sector Co-ordination Unit
CDF	Constituency Development Fund
CGS	Credit Guarantee System
DFS	Decentralised Financial Services
ERSWC	Economic Recovery Strategy for Wealth and Employment Creation
FOSA	Front Office Service Activities
FSA	Financial Services Association
IFAD	International Fund for Agricultural Development
KACE	Kenya Agricultural Commodity Exchange
KSH	Kenya Shilling
KREP	Kenya Rural Enterprise
MMD	Mata Masu Dubara
MFI	Micro Finance Institution
NARC	National Rainbow Coalition
NCPB	National Cereals and Produce Board
NGOs	Non Governmental Organizations
NIB	National Irrigation Board
PRSP	Poverty Reduction Strategy Paper
RMC	Regional Management Company
ROSCAs	Rotating Savings and Credit Associations
SACCO	Savings and Credit Co-operative Societies
SRA	Strategy for Revitalizing Agriculture
STEP	Saga Thrift Enterprise Promotion
TAMPA	Tegemeo Agricultural Monitoring and Policy Analysis
USAID	United States Agency for International Development

1.0 Introduction

1.1 Background Information

Agriculture contributes 23.9% percent of national Gross Domestic Product (GDP) and 60 percent of the total export earnings. In addition, 80 per cent of the population derives their livelihood from agriculture. In spite of the significant contribution, agriculture has experienced low productivity in the past decade. The Poverty Reduction Strategy Paper (PRSP) prioritized agriculture and rural development sector as one of the key sectors that needs urgent intervention. In order to attain the targeted five percent annual growth in this sector, financial systems, extension services, rural infrastructure, marketing and distribution systems need to be addressed.

Promoting an efficient, sustainable and widely accessible rural financial systems remains a major development challenge in most sub Sahara African countries. With about 73% of Africa's population living in the rural areas and experiencing a high incidence of rural poverty, improved rural finance is crucial in achieving pro-poor growth and poverty reduction goals. However, the development of rural financial systems is hampered by the high cost of delivering the services to small, widely dispersed customers; as well as a difficult financial terrain – characterized by high covariant risks, missing markets for risk management instruments and lack of suitable collateral (Onumah, 2002).

Lack of working capital and low liquidity limit the farmer's ability to purchase productivity enhancing inputs like seeds, fertilizers and pesticide. In spite of the relatively high adoption rates of inputs like fertilizers, the quantities used are low and therefore, hybrid variety crops that are dependent on fertilizers may not attain their potential production (Nyoro, 2002). The average production efficiency levels are higher among producers who have access to formal credit, (Awudu and Richard, 2001). Access to credit resulted to higher technical efficiency in maize production in Kenya, (Kibaara, 2005).

Kenya has not developed a comprehensive rural financial services strategy. The rural financial sector is governed by the Banking Act, Building Society Act and the Post Bank Act. The proposed Deposit Taking Micro Finance Bill 2005 and the proposed SACCO Societies Regulatory bill, 2004 are still to be debated in parliament. Through the Economic Recovery Strategy for Wealth and Employment Creation (ERSWC) the

government has identified poor access to farm credit and financial services as a contributing factor to the decline in agricultural productivity. The Strategy for Revitalizing Agriculture (SRA) proposes to encourage an orderly development of micro-finance institutions through the enactment of facilitative legislation, encourage commercial banks to set up operations in the rural areas by providing appropriate incentives, encourage banks to lend to agriculture by reviewing and repealing legal provisions that have undermined banks lending to the sector, recapitalize and streamline the management of Agricultural Finance Corporation so that it can perform its function of providing affordable credit to farmers (Republic of Kenya, 2004). As a follow up on SRA, the Agricultural Sector Co-ordination Unit (ASCU) has fast tracked the rural financial services by establishing a thematic group on inputs and rural financial services with an overall objective of developing an Integrated Farm Input Strategy.

Rural financial services refer to all financial services extended to agricultural and non-agricultural activities in rural areas; these services include money deposit/savings, loans, money transfer, safe deposit and insurance. Demanders/beneficiaries of rural financial services are mainly households, producers, input stockists/suppliers, traders, agro-processors and service providers. Rural financial services help the poor and low income households increase their incomes and build the assets that allow them to mitigate risk, smoothen consumption, plan for future, increase food consumption, invest in education and other lifecycle needs. These needs can be broadly categorized into working capital, fixed asset financing, income smoothing and life cycle events. Access to credit and financial services has the potential to make a difference between grinding poverty and economically secure life. In spite of the importance of a savings account, 77 percent of Kenyan households have no access to a bank account (Kodhek, 2003). In the late 1990's, most mainstream commercial banks closed down some rural branches in order to cut costs and improve profits. The non-traditional financial institutions have emerged to fill the gap created by the mainstream banks which locked out low income and irregular earners.

1.2 Objectives

The primary objective of this study was to examine the evolving models of rural financial service providers with a broad aim of understanding models that are working, why they are working, characteristics, opportunities and constraints. It seeks to understand the extent to which these models have improved access to the rural financial services for producers and traders in the rural areas. The study proposes some policy some interventions that could improve access to financial services.

1.3 Research Questions

The study seeks to answer the following research questions; Are there success cases in the provision of rural financial services? What are the characteristics of rural financial service providers? What are the challenges and opportunities? How can the success cases be replicated and up-scaled? Who is accessing and at what cost? Has the government implemented any SRA proposal of recapitalizing and restructuring AFC?

Results will contribute to a better understanding of the evolving structure of rural financial services and provide an input to the Integrated Farm Input Strategy to be prepared by the thematic group on inputs and rural financial services.

1.4 Methodology

This study utilized data from primary and secondary sources. Secondary data was gathered during the discussions with stakeholders from the rural finance sub-sector i.e. **Banks**-Equity Bank, Co-operative Bank of Kenya, Post bank, Kenya Commercial Bank; **Development partners**-United States Agency for International Development, International Fund for Agricultural Development (IFAD); **Financial Associations**-African Rural and Agricultural Credit Association (AFRACA), Association of Micro-finance (AMFI); **Financial Regulator**-Central Bank- Rural Finance Development Department; **Non-governmental organizations**-Sacred Africa, K-Rep Development Agency (KDA), Kenya Agricultural Commodity Exchange Ltd (KACE), Decentralized Financial Services (DFS), ACIDI VOCA, Agricultural Market Development Trust (AGMARK); **Government**-Agricultural Finance Corporation (AFC), Ministry of Agriculture, Agricultural Sector Co-ordination Unit (ASCU), Ministry of Co-operative Development and Marketing, Ministry of Social Services; **Community Associations** - Diocese of EMBU- Mbeu Savings and Credit Development Association, Archdiocese of

Kisumu-ADOK TIMO; **Micro-Finance Institutions** (MFI)-Krep, MFI-SAGA Thrift and Enterprise Promotions Ltd.

Primary data on the emerging models were gathered purposively from 15 districts within six agro-ecological zones (Table 1). The rural financiers were interviewed using a structured checklist mainly covering the history of the organization, operations, outreach, costs, performance indicators, financial services provided, socio-economic characteristic of the client, requirements, use of loans, transaction charges, default rates, sustainability, constraints, opportunities among others .

Table 1: Sources of Primary Data by Agro-Ecological Zones

Agro-Ecological Zones	Districts	Models
Eastern Lowlands	Embu, Kitui, Makueni	Community Owned RF Model
Central Highlands	Naivasha, Nyandarua, Murang'a, Meru,	Private Commercial Bank Led model
High Potential Maize zone	Eldoret, Kakamega, Narok,	Government Led model, Informal Group based model
Western Lowlands	Kisumu	Donor-guarantee Input Supply, Beach banking,
Western Highlands	Bungoma, Kakamega, Mumias, Kisii	Community mobilized model, Table banking
Marginal Rain Shadow	Kajiado	Government led model

Source: Rural finance study, 2006

The study uses supplementary data from the Tegemeo Agricultural Monitoring Project Analysis (TAMPA) panel data. This is cross-sectional panel (2000 and 2004) household data comprising of 1540 rural households. The data covers eight agro-ecological zones (High Potential Maize Zone, Central Highlands, Western Highlands, Western Transition, Western Lowlands, Eastern Lowlands, Marginal Rain Shadow and Coastal Lowlands). This data provided information on agricultural credit; demand and sources of agricultural credit and repayment mode and household information on self-help groups.

The second section of the paper gives an overview of agricultural credit in Kenya, demand and suppliers of agricultural credit and outlines characteristics of beneficiaries of agricultural credit. Section three discusses the emerging models of rural financial services and section four outlines the key findings and policy implications.

2.0 An overview of the Agricultural Credit in Kenya

This section highlights access of general credit in Kenya, demand and supply of agricultural credit, characteristics of borrowers of agricultural credit and repayment mode.

2.1 The Role of Rural Credit in Increasing Agricultural Productivity

Credit is an important input into the production system and it contributes to increased food productivity. Results from TAMPA Panel data 2004 shows that households who received credit for maize production had a higher productivity averaging 7.65 bags per acre as compared 6.5 bags per acre among households that did not receive credit (Table 2). Access to credit increases the farmers' working capital enabling the farmers to buy productivity enhancing inputs such as good quality seeds, fertilizers and chemicals.

Table 2: Maize Productivity and Access to Agricultural Credit, 2004

Agricultural credit	Mean Yield in bags ¹ per acre	Standard Deviation
Received	7.88	6.45
Did not receive	6.50	6.08

Source: Tegemeo household survey, 2004

These results were subjected to *Levene test of equality of variance* and an evaluation of t-statistics shows that there is an overall statistical significant (at 1% significance level) difference between maize productivity among households with and without credit.

2.2 Demand and Supply of Rural Credit

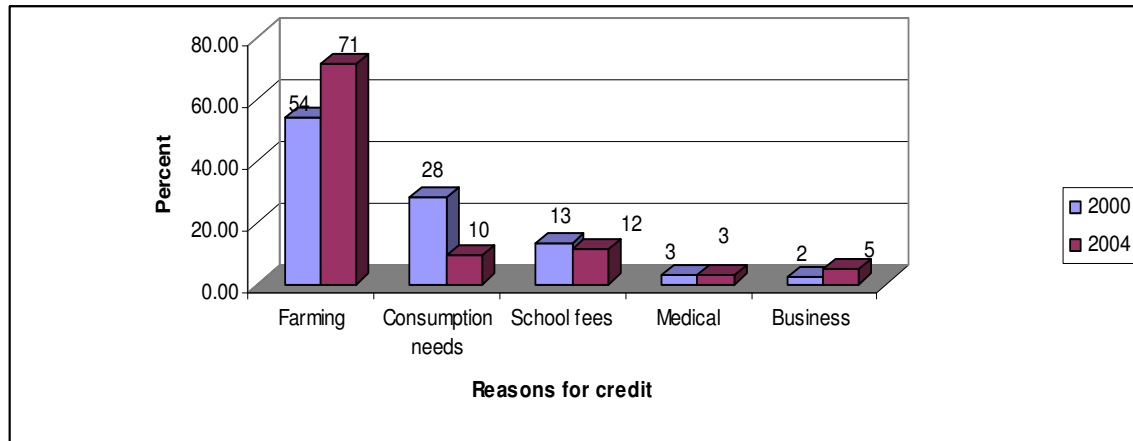
2.2.1 Demand

Data from the 2004 Tegemeo survey shows that only 39% of the households sought credit. The main reasons for trying to access credit were farming, consumption needs, school fees, medical and business. Figure 1 compares levels of demand for credit in 2000 and 2004. Credit for farming purposes remains the most dominant need because majority of the rural households, derive their livelihood from agriculture. Demand for

¹ Bag weights 90 kilograms

credit for agricultural purposes has increased from 53.71% in 2000 to 71.15% in 2004. Demand for credit for school fees has declined from 13.29% in 2000 to 11.50% in 2004 partly attributed to free primary education policy in Kenya implemented in 2003.

Figure 1: Reasons for borrowing, 2000 and 2004



Source: Tegemeo household survey, 2000 and 2004

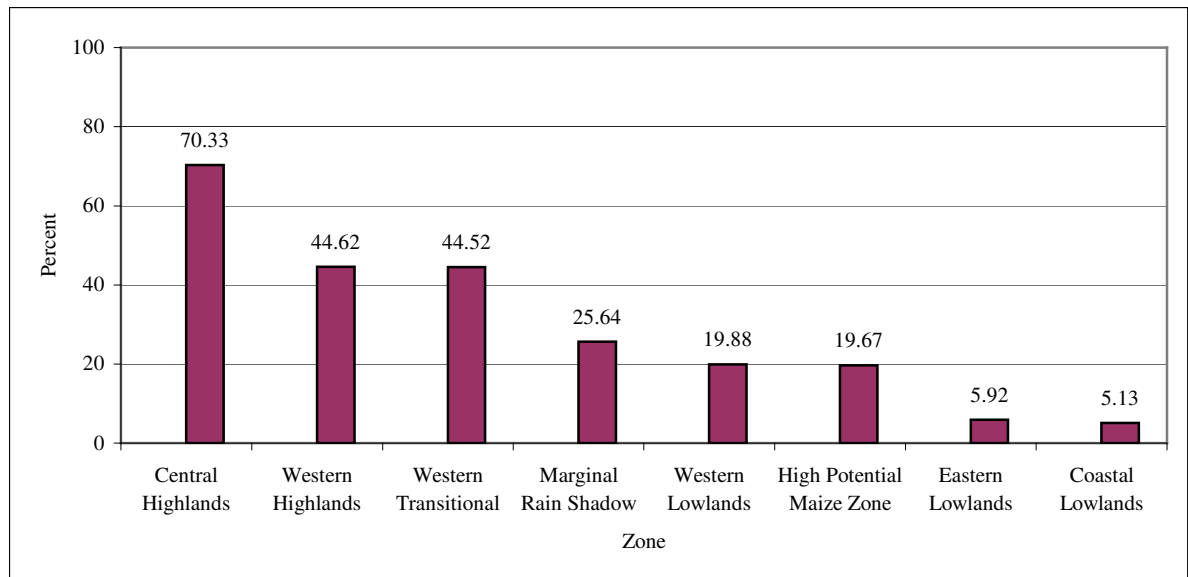
Demand for credit for business purposes had increased from 2% (2000) to 5% (2004). This could partly be attributed to the increasing importance of off-farm income earning activities in the rural area. This is supported by Tegemeo panel data set which reveals that off-farming income sources such as business enterprises are increasingly becoming an important contributor to the aggregate household income. The contribution of off-farm income as a percentage of total household income has increased from 24.4% in 2000 to 45% in 2004. Credit demand for medical needs remains unchanged.

82% of those that tried to obtain some sort of credit actually received. However, among those who did not receive credit, 62% had tried to borrow for farming purposes. An indication that although there is a dominant need for farm credit, most farmers do not get the required credit. This is partly associated with the nature of agricultural farming which has high covariant risk

Access to agricultural credit in Kenya is skewed towards the more productive agro-ecological zones. Households in the high potential areas have more access to credit as a result of embedded credit component for the perennial crops such as sugar, coffee and tea. In 2004, 70 % of the producers in the Central Highlands received credit; as

compared to 44.62% in Western Highlands; Western Transitional (44.80%) and High Potential Maize Zone (19.67%). The low production-potential regions had a lower percentage of farmers that obtained credit; Marginal Rain Shadow (26%); Western Lowlands (19.8%); Eastern Lowlands (5.92%) and Coastal lowlands (5.13%). This shows that there is need to improve access to credit services in the lowlands- Arid and Semi-arid regions (Figure 2).

Figure 2: Percent of households that obtained credit by zone, 2004



Source: Tegemeo household survey, 2004

2.2.2 Supply

Market share for agricultural credit is dominated by commodity based credit providers (Tea, Sugarcane, French beans) whose provision of credit to beneficiaries has increased from 53.5% in 2000 to 62.7% in 2004. Thus the role of contracted farming in provision of embedded services such as credit for agricultural inputs has become increasingly important. The producer cooperatives/SACCOs remain a significant supplier of agricultural credit and especially in the Central Highlands and Western Transitional zones. However, the market share has slightly declined from 25% in 2000 to 20.6% in 2004 partly because of spillover effect of wrangles and mismanagement of cooperatives.

Table 3: Source of Agricultural Credit in Percent, 2000 and 2004

Source of credit	2000	2004
Commodity Based Credit Providers	53.5%	62.7%
Cooperative/ Saccos	26%	20.6%
Informal money lenders ²	12.1%	9.9%
Local trader/input stockists	6.8%	3.9%
AFC	0.4%	1.3%
Commercial bank	0.6%	1.0%
MFI/ NGO	0.6%	0.5%
	100%%	100%

Source: Tegemeo household survey, 2000 and 2004

The informal money lenders and local traders/input stockists are more important than the formal banking institutions. They provide close to 20% of the agricultural credit in Kenya.

The government owned Agricultural Finance Corporation has gained from 0.4% in 2000 to 1.3% market share in 2004. This gain is partly associated to financial revamp by the government in addition to the current restructuring of the institution. For example, the reintroduction of seasonal crop credit scheme from 2003/04, which had been terminated in 1995/96.

Provision of agricultural credit through the mainstream commercial banks has increased slightly following the recent innovative products associated with retail banking such as loans to tea and dairy farmers, reduced bureaucracy, excess liquidity as investment opportunities are thinned following reduction of government/treasury bills which was estimated to contribute 50% of the bank's income. However, the commercial bank's contribution to agricultural credit is insignificant.

The Micro Finance Institutions (MFIs) provide agricultural credit to only to a mere 0.6% of the rural households. The MFIs have been in existence for the last 20 years, focus on the economically active poor/entrepreneurs and have played a pivotal role in helping the low-income earners access non-agricultural loans. In terms of monetary value, AFC and the commercial banks gave the largest amounts of credit per household but only to a few households, while the co-operatives/Saccos and commodity based credit providers (such as Tea, Tobacco, French beans and sugar companies) disbursed low amounts of credit to a larger clientele base.

² Informal money lender includes shylocks, self help groups, merry-go-rounds, community associations

The credit market is segmented with specific credit providers concentrating on specific regions. Over 70% of Commodity Based Credit Providers served the Central Highlands and Western Transitional Zones. 86% of the Co-operatives and 57% of the mainstream Commercial banks served the Central highlands. In 2004, 64 percent of credit disbursed by AFC was disseminated to the High Potential Maize Zone, 45% of MFI/NGOs served the High Potential Maize Zone, 27.7% served the Central highlands and 22.7% served the Eastern Lowlands. 43.8% of the Informal moneylenders provided agricultural credit to High Potential Maize Zone, 19% to Western Lowland and 17% Central Highland.

2.3 Characteristics of the Households that Received Agricultural Credit

The Tegemeo household survey 2004 shows 92.30% of households that received credit had at least one family member belonging to a group (self help, producer, co-operative) as compared to 67% who did not receive credit. Household assets act as collateral for loan repayment. Table 4 shows households that received credit had high asset value (in Ksh) than those who did not receive.

Households that received credit had higher annual income. Dis-aggregating annual household income into income quartile reveals that the lowest income quartile is 15 times poorer than the high income quartile. Among the low income quartile, only 23% of the households received agricultural credit as compared to 39% of the households in the high income quartile. Therefore, any intervention targeted towards improvement of rural financial services should not be uniform, but should consider the different income levels.

In addition, those that received credit had a higher proportion of households that engaged in off-farm income as compared to those who did not receive credit.

Table 4: Selected Characteristics of households that received credit, 2004

Indicator	Received Agricultural Credit	
	Yes	No
% received agricultural credit	32%	68%
Belongs to a group	92.30%	67.60%
Asset Value in Ksh	264,678	170,994
Annual Household Income in Ksh	189,037	147,469
Incomes by Quartiles		
<i>Lowest income Quartile in Ksh</i>	24,818 (23%)*	25,227
<i>Second lowest income Quartile in Ksh</i>	76,356(33%)*	76,221
<i>Third lowest income Quartile in Ksh</i>	141,988(33%)*	142,774
<i>Highest income Quartile in Ksh</i>	399,107(39%)*	384,170
% engaged of household head in off-farm activities	36%	34%
Education level		
<i>No formal education</i>	16%	23%
<i>Primary</i>	52%	52%
<i>Secondary</i>	23%	19%
<i>Post secondary</i>	6%	5%
Gender of the Household Head		
<i>Male-headed</i>	32.90%	67.06%
<i>Female-headed</i>	27.50%	72.54%

Source: Tegemeo household survey, 2004

* The values in bracket shows the percentage of households that received agricultural credit

Education is also a key determinant of access to rural financial services. The table shows that households that received credit had higher literacy level. Gender influences access to rural agricultural credit. From this study, male-headed households had higher access to credit (32.90%) as compared to female-headed households (27.50%). These characteristics indicate that improving access to rural credit and other financial services will require a holistic rural development approach that addresses all aspects of development.

2.4 Agricultural Credit Type and Repayment Mode

82% of the agricultural credit was received in-kind while 18% was received in form of cash. 91% of the agricultural credit was disbursed in form of operating inputs such as fertilizer, seeds, chemicals and labor, 7% on livestock and livestock feeds and 2% on investment in capital assets.

90% of operating inputs was repaid from crop revenue. 66% of the livestock credit was repaid from livestock revenue. However, this was supplemented from crop and off-farm income. 55% of investment in capital asset was mainly repaid from off-farm income. Crop revenue is an important source of repayment for capital investment (Table 5). This shows that households that have access to off-farm income are more likely to borrow for capital investment.

Table 5: Credit Type and Repayment Mode

Type of credit	Mode of Repayment in Percent				
	Crop revenue	Livestock Revenue	Off farm income	Livestock and crop revenue	Total
Operating inputs	89.50	3.40	5.90	1.20	100
Livestock and feed	13.60	66.10	11.90	8.50	100
Investment in capital assets	31.80	9.10	54.50	4.50	100
Total	83.10	7.70	7.50	1.80	100

Source: Tegemeo household survey, 2004

3.0 Emerging Models of Rural Financing

Since Rural Financial services is broader than agricultural credit, this section discusses selected emerging models of providing financial services in the rural areas; the Community Owned Rural Finance Model, Private Commercial Bank Led Model, Government Led Rural Finance Model, Donor Guarantee-Input Supply Model, Managed SACCO-Beach Banking Model, and the Informal Rural Financing Model. The section looks at the principle behind each model, outreach (in terms of number of beneficiaries), rural financial products, costs, constraints and opportunities.

3.1 Community Owned Rural Finance Model

The community owned rural finance model is a rural finance model that is owned and managed by the rural community with assistance from the donor agency. The community forms registered associations. Membership is through purchase of shares from the associations. The objective of this model is to reduce poverty through improved access to financial services mainly in the low population density areas with high incidences of poverty such as parts of Eastern and Western Lowland regions. The main beneficiaries are the low and medium income population who have few alternatives to financial services. The study found some cases where the community financing models were set up using the Constituency Development Fund (CDF). Examples of the community owned rural finance model are the Financial Service Associations and the church based Mbeu Savings and Credit Association.

3.1.1 Financial Service Associations

The Financial Services Associations (FSA) are also referred to as village 'bank's and are mainly promoted by K-rep development agency since 1997. The association is registered as a self help group under the Ministry of Culture and Social Services. Membership is acquired through purchase of at least one share at a cost ranging from Ksh. 300 to Ksh. 400. For the model to be operational, it requires a minimum of 300 shareholders. The community contributes towards the share capital and setting up of a physical financial transaction structure that acts as a 'banking' hall. The cost of setting

up a physical structure ranges between Ksh. 100,000 and Ksh. 400,000. The donor agency contributes towards institutionalization (building, furniture, insurance, audit fee) and capacity building. The agency has a clear exit strategy. The FSA is run by a board of directors comprising eight members who are elected annually in a general meeting. The agency monitors the activities of the FSA and has formed Regional Management Companies (RMC) to provide management expertise in addition to supervision and training. RMC charge a fixed rate of 15% (though this may vary between FSAs). The day to day activities are run by lean and low income earning staff members from the community.

The main financial services offered are; compulsory savings, voluntary savings, fixed deposit, money transfer, business loans, agricultural loans, education loans, emergency loans and safe deposit. The financial services are open to the non-shareholders at a higher fee. Each FSA operates a bank account with a link mainstream bank located in the nearest town center where surplus money is deposited and money transfer is transacted. Members interested in borrowing loans are required to be members of a primary group and secondary groups. The group members scrutinize the borrower and also guarantee to repay the loan in case of default. The borrower is loaned three times the amount of accumulated shares. The loan attracts an interest rate ranging between 3% and 7% per month on reducing balance, depending on the loan type, repayment and credit history. The loans are insured at a small fee averaging Ksh. 80 per month. The monthly revenue per village bank averages Ksh. 100,000 and the expenditure is about Ksh. 50,000. This shows the FSAs are making some reasonable amounts of profit.

The number of FSAs have grown by 105% from 34 (1999) to 70 (2005). The FSAs have registered a 2233% growth in number of savers from 3000 in 1999 to 70,000 in 2005. The rural poor have mobilized a total of Ksh.82 millions through shareholding. The value of savings was Ksh. 1.3 billion while cumulative disbursed loan was Ksh. 524 million (Table 6).

Table 6: Statistical for Financial Service Association, 1999-2005

Year	No. of shareholders	Shares capital in Ksh. Millions	loans in Ksh. Millions	No. of savers	Saving in Ksh. Millions	Average savings/member (Ksh)	Average loan/member (Ksh)
1999	12,958	7	9	3,833	8	2,087	4,284
2000	21,686	17	38	10,620	49	4,614	5,685
2001	27,377	30	101	16,137	125	7,746	7,011
2002	33,978	36	163	19,369	264	13,630	8,506
2003	42,148	48	236	25,199	438	17,382	8,660
2004	52,925	67	329	35,372	677	19,139	8,590
2005	58,897	82	524	70,683	1,354	19,156	7,215

Source: K-rep development Agency

The cumulative average savings per member is Ksh. 19,000. In addition, the amount of average loan averages Ksh. 7,215. The proportion of loans clients to saving clients is 38%, re-enforcing the finding that the rural folks have a higher demand for a save haven for their money rather than for credit/borrowing.

3.1.2 Mbeu Savings and Credit Association

Mbeu savings and credit association is another example of a community owned model. It is promoted by the Catholic Diocese of Embu in conjunction with a foreign donor who has a clear exit strategy. The association became operational in 2001 and targets the Embu and Mbeere Districts. It uses the basic principles of FSA; however, the only deviation is that it does not set up a fortified financial transaction structure ‘banking hall’. The loan officers take the financial services to the people using motor cycles where the groups are located. The groups meet under big trees, church compound or a shopping center to collect money and make financial transactions such as compulsory Ksh. 200 monthly saving, voluntary saving, loans and money transfers (school fees). The model has also provided a channel for remitting contributions towards the National Hospital Insurance Fund (NHIF). The association penetrates deep into the interior where many have not succeeded or have not considered viable for banking services. In this model, the members do not have to incur two-way transport cost to the nearest town to access financial services thus saving time and scarce financial resource. All loans attract a 12% p.a interest rate and additional 2% for loan insurance premium.

A recent study shows that 60% of households in the remote Mbeere Districts of Kenya deposit their savings with Mbeu Savings and Credit Association (Kibaara, et.,al, 2006). Households that save with this association live below the poverty line i.e. earn less than one US dollar per day (Table 7).

Table 7: Where do Mbeere District Households save?

Where save?	Mbeere	Mean Annual Household income In Ksh.	Daily earning (in dollar/day)
Mbeu savings and Credit Association	60%	108,676	0.66
Sacco	12%	161,825	0.99
Commercial bank	28.8%	190,439	1.16

Source: Kibaara et al, 2006

The association has seen a tremendous growth in membership, shares and loans. There is a 550% growth in membership from 1140 members in 2001 to 7408 in Feb 2006. In addition, there is a remarkable increase in shares, from Ksh. 1.7 million in 2001 to 30.2 million in Feb 2006. Loans increased from Ksh. 0.12 million in 2001 to Ksh. 22.48 million (Feb 2006). The tremendous increase in membership, shares and loans implies that the association is on the path of growth. Cumulative average saving per member is Ksh. 4,077. Only 30% of the members borrowed loans averaging Ksh. 10,000. This again is an indication that most rural households are mainly interested in other financial services and not only on loans/credit.

The Mbeu model can be replicated and scaled up in other regions of the country at low costs. For example, the foreign donor contributed only Ksh. 17 million towards setting up of Mbeu savings and credit association.

Challenges and Opportunities of the Community Owned Model

Challenges

- i. The *insecurity* in the urban areas has infiltrated to the rural areas. For example the FSAs reported close to 10 robberies in 2005. The monetary loss from these incidences has been estimated at Ksh 1 million, not to mention bodily harm to the security guards. The targeted robberies are attracted by money that is kept in the safe and yet it's not economical to regularly transport the money to the link banks due to infrastructure problems. In order to avoid or reduce such losses in the

- future, the agency has invested in expensive break-proof safe and insured money in the safe and on transit. This additional cost will be absorbed by the members of FSA and will certainly impact on profitability of the FSAs.
- ii. *Poor infrastructure* – the rural infrastructure (road and communication network) is poorly developed in most rural areas. Poor road net work increases transaction costs of transporting monies to the link banks regularly. For example, the Marsabit FSA is far from the main link-bank, thus making it almost impossible for the agency to monitor the activities. In addition, most FSA operates their activities manually because of lack of electricity.
 - iii. *Policy and regulatory framework.* Lack of proper policy framework to spur the growth of rural financial services has also been identified as a key challenge. These community associations offer unregulated Front Office Services Activities (FOSA). In case of the collapse of the association, the members will have no recourse of recovering their deposits.
 - iv. *Management* personnel lack the necessary management skills required to run financial services associations. In an attempt to overcome this challenge, FSAs hire services of the regional management company.
 - v. *Sustainability* of the community owned model remains a big challenge. The donor has a clear exit strategy and yet the associations have not yet attained sustainability.
 - vi. *High interest rate* charged by FSA may discourage borrowing thus deny the revenue required for sustainability. For example Ksh. 10,000 loan at 4% p.m, repayable on reducing balance translates to 34 % annual interest rate. Some key findings from the study show that the borrowers are willing to pay the high interest rates due to lack of alternatives. In addition, the FSAs are owned by the borrowers and any income accruing from loans is disbursed in form of dividends at the end of the year.

Opportunities

- As the associations move towards sustainability, they can consider other sources of financing from the upcoming wholesalers of rural finance.

- To increase the revenue base, Mbeu saving association should extend their financial services such as money transfer to non-shareholders at a higher fee.

3.2 Private Commercial Bank Led Model: a Case of Emerging Indigenous Banks

Commercial banks are potentially an important source of rural financial services. However, most mainstream banks have undergone major restructuring such as closing branches in the rural areas to cut down on costs and improve profits. This has left a gap in the rural financial services which has partly been filled by the emerging indigenous banks such as Equity bank. The equity bank model works on the principle of taking banking services closer to the people. The bank financial services to rural clients make up 68 percent of Equity's bank clients but with only 28 percent of the total deposit volume, given the relatively lower average savings account size of rural clients (CGAP, 2004). Although the bank reaches a wide range of clients, the majority of its clients are low-end salaried workers, and micro and small businesses. In addition, the rural farming community can access supervised short term loans for horticulture, dairy, coffee and tea farmers.

The bank has captured a market niche in the banking sector in Kenya of the low income earners by addressing the perceived exorbitant price and attendant charges of loan and savings products. The main financial services offered are savings/deposit, loans, cheque clearance, money transfer. The deposit products are designed to target the low income clients who cannot be considered by the mainstream banks. For example, the operating balance on the deposit account is only Ksh. 400. Ease of opening a bank account and all that is needed is a national identity card and the opening balance. The bank uses a digital camera to take free passport photographs. Unlike other banks, there is no ledger fee or maintenance fee. In addition, withdrawal charges of Ksh. 50 are affordable to the low income clients. The interest on loan ranges between 1% and 1.5 % per month or 12% to 18% per year.

Equity bank has focused specifically on the outreach component of mobile banking services, and on improving service efficiency and proximity for clients.

The number of branches has increased by 55% from 20 in 2004 to 31 in 2005. The customer base increased by 33% from 413,000 clients in 2004 to 560,000 clients in 2005, this constitutes 22% of all the deposit accounts in Kenya. Customer deposits grew by 76% from 5.1 Ksh. billion in 2004 to 9 billion in 2005. The loan portfolio has also grown by Ksh. 97% from Ksh 3 billion in 2004 to Ksh 5.9 Billion in 2005. Profit has increased by 130% Ksh. 218 million in 2004 to Ksh 501 million in 2005. The ratio of borrowing clients to total clients is 21% showing that the need for other financial services is greater than the need for credit/loan. Average loan per client is Ksh. 42,942 while savings Ksh 16, 071.

3.2.1 Mobile Banking with Equity Bank

Mobile banking comes in many variants such as a Grameen loan officer visiting a Grameen group on a motorcycle, an automated teller machine visiting a remote village to pay out pension and provide savings facilities. Mobile banking has been widely accepted in many countries such as South Africa, Vietnam, Thailand, Indonesia, West Africa and Bangladesh as an innovative and low-cost distribution system of improving financial services in remote areas where there are no formal banks (Coetzee et.,al, 2003). In most cases the benefits outweigh the costs.

The concept of mobile banking involves taking banking services to the rural areas using an equipped mobile van. This is done 2-3 times in a week. Other requirements of a mobile bank include; permanent premise, motor vehicles, at least two banking staff and two security personnel. Currently, there are 52 Equity mobile banks in Kenya that contributes an estimated 15% of the Equity's banking business. For sustainability, one mobile unit requires to have at least 1500 clients. Most mobile Equity banks reported a clientele base of up to 3000 members. These mobiles are demand driven and in most cases, some have converted into fully fledged branches in less than one year. The mobile bank charges an addition to a fixed monthly charge of Ksh. 50. In most cases most branches handle between 250-300 transactions per day on busy days. Mobile banking services are beneficial to clients because most save money that could have been used on transport. For example a client based in Siakago pays Ksh. 160 (2 way) for transport to access financial services in Embu (about 40 Km). However, with the mobile bank in

Siakago, the same client is charged an extra Ksh. 50 to access his financial services via the mobile bank. The clients also save traveling time in addition to convenience. The estimated cost of running a mobile unit is Ksh. 70,000 per month and mobile unit generate a monthly profit of Ksh. 100,000.

Challenges and opportunities

The main challenge is related to infrastructure and especially when taking the mobile services to the people in the rural areas. In most cases, a mobile van travel as far as 60 kilometers on poor road conditions. In most cases, the mobile hubs have no electricity therefore necessitating the use of generators. There is also a lot of congestion in the banking halls. The other challenge is insecurity for money on transit.

The model has demonstrated that the low income population in the rural area is bankable and an opportunity exists for expansion. The bank has proposed to expand the number of branches from 31 to 43 and mobile banks from current 52 to 58 by the end of 2006. The mobile banking services were first supported by the donor but now, they are sustainable.

3.3 Government Led Rural Finance Model: a case of AFC

This is a government owned, financed and managed model that provides credit services mainly to large scale farmers with an objective of promoting food production in the country. The main actors are the government, a non-bank financial institution, the farmer and in some cases the donor. In Kenya, the model works through the Agricultural Finance Corporation. There are 31 AFC branches country wide. The corporation has been instrumental in the implementation of many government and donor supported programs such as mechanization of the agricultural sector, livestock development programs, the Guarantee Minimum Return, the Seasonal Crop Credit and the Emergency Livestock Off-take Program. Since early 1990's, the corporation started experiencing operational difficulties due to poor governance, political interference and effects of economic liberalization that led to subsequent collapse of some agricultural marketing bodies. By 1992, the non-performing loan portfolio reached 89% (AFC, 2005). The

government and other donors stopped funding AFC and the recovered monies were used for recurrent expenditure. AFC stopped lending officially from 1997 to 2001.

The National Rainbow Coalition (NARC) government pledged to improve access to rural credit and financial services from 2003. Since then, the government has implemented some of its pledges as stated in the Strategy for Revitalizing Agriculture (SRA) such as restructuring the operations of the corporation: The government has:-

- i. Approved AFC restructuring by appointing a new board and a chief executive officer.
- ii. Implemented the performance contract signed by the managers in order to improve management and increase accountability
- iii. Written-off accumulated debts owned by the corporation.
- iv. Released Ksh. Ksh. 1.3 billion being equity injection to be disbursed over a period of five years from 2003 to 2007 at Ksh. 260 million per year.
- v. Channeled the Japanese grant of Ksh. 759 million to AFC to finance the seasonal crop credit.

The main beneficiaries of the credit from the corporation are the large scale farmers who own at least 5 acres of maize and wheat farms. The loan attracts an interest rate of 10% per annum. The main credit products offered are:-

a. Seasonal crop credit

This loan is for production of hybrid maize and wheat in high potential gazetted areas. Condition for loaning includes; land must be suitable for the crop to be financed; Minimum acreage financed is 5 acres; client to raise 20% of the project cost; applicants with land not owned must provide a lease note of not less than 3 years, registered by the local land register; payment period is within 12 months (one installment) and for each loan 25% of the loan funds is retained for harvesting. The maximum loan disbursed is Ksh. 3.3 million.

b. Development loans

These include machinery, water development, livestock development and fisheries. The repayment period for development loans is 3 to 5 years.

- c. Cash Crop Loans such as tea, coffee, sugarcane, pyrethrum, cashew nuts, citrus, mango trees and bananas. Mainly for Crop establishment; Crop maintenance; processing equipment, operating costs.
- d. Horticulture and floriculture loans
- e. Oil crops loans
- f. Value addition loans at 15%

Table 8 shows trends in development and seasonal crop credit. As at 2004/2005 year, the corporation had advanced a total of one billion Kenya shilling to 5253 farmers. Seasonal loans account for 52% of the total loans, while development accounts for 48% . For wheat and maize seasonal crop credit, the beneficiaries receive Ksh. 11,000 per acre of land. On the other hand, the minimum amount disbursed is Ksh. 50,000 for the development loans.

Table 8: AFC Development and Seasonal Credit, 1996 to 2005

Year	Total development ³ loans (SS, LS, ranches)		Seasonal crop ⁴ credit		Total loan (Dev+ Seasonal)		Average loan/beneficiary In Ksh	
	No.	Amount in 000'	No.	Amount in 000'	No.	Amount in 000'	Small scale ⁵	Large scale ⁶
1995/96	112	202,877	831	142,228	943	345,105	96,364	2,111,223
1996/97	283	290,863	0		283	290,863	40,307	1,590,458
1997/98	133	87,941	0		133	87,941	133,333	675,357
1998/99	105	157,872	0		105	157,872	150,000	1,544,333
1999/00	117	130,728	0		117	130,728	236,667	1,190,722
2000/01	56	112,638	0		56	112,638	182,500	2,510,182
2001/02	1	225	0		1	225	225,000	0
2002/03	590	90,772	0		590	90,772	100,824	635,017
2003/04	2314	187,030	2077	338,612	4391	525,642	15,464	503,452
2004/05	2663	497,991	2580	537,624	5243	1,035,615	152,023	499,591
Average loans							133,248	1,126,034

Source:AFC

Prior to the year 2002, the corporation advanced 98% of the development loans to the large scale farmers. But after the year 2003, lending to large scale farmers averages 36%. AFC's average loans to small scale farmer averages Ksh. 130,000 while the large scale averages Ksh. 1.1 million.

³ Dairy, poultry, pigs, farm infrastructure, farm mechanization etc

⁴ Seasonal credit loans –specifically for production of marketed wheat , maize and potatoes

⁵ Small scale loans have a maximum loan ceiling of Ksh. 200,000 and a minimum of Ksh. 50,000

⁶ Large scale loans with a minimum loan of Ksh. 200,000 and a maximum of Ksh. 1 million

Challenges and opportunities

Challenges

- i. *Prohibitive loan transaction costs for small scale farmers, for example* if AFC was to lend a supervised seasonal loan to a small scale borrower amounting to Ksh. 11,000 to plant maize on one acre, the loan transaction costs before repayment of interest would be Ksh. 8,715 (Ksh. 2500 application fee, Ksh. 6050 conveyance fee and Ksh. 165 commitment⁷ fee). This shows that the cost of loaning to individual small scale farmers is too high.
- ii. *Bloated workforce.* Between 1997 and 2002, the corporation carried out an organizational and staff restructuring, reducing the branch network by 37% (from 49 to 31) and staff members reduced by 53% i.e. from 1200 to 570 workers. However further analysis shows that 64% of the current staff is composed of non-technical (support) staff, leading to lots of inefficiencies in the system. This is an indication that the staff restructuring is still not efficient and the support staffs should be reduced. Maybe its time the government considered outsourcing some of the non-core activities.
- iii. *Delayed payment for produce delivered to the National Cereals and Produce Board (NCPB).* The beneficiary of the seasonal crop credit loan signs an irrevocable order (IRO) with AFC to deliver maize to the NCPB, which in return deducts the loaned amount and the balance is paid to the producer. However, the IRO cannot be strictly enforced in a liberalized market and producers can sell their maize elsewhere and repay the loan. Producers who sell their produce through the board experience incidences of delayed payment. Currently only about 30% of farmers sell grains through NCPB while 70% sell through other channels. This makes the loan recovery a tedious process.
- iv. *Sustainability.* In the past, AFC has solely relied on the government and donor agencies for funding. However, the corporation is expected to attain some level of sustainability. Several AFC branches visited acknowledged that it will be difficult to operate without the Government support given the low interest rates charged on loans.

⁷ Commitment fee is 1.5% of the loan amount

Opportunities

- i. *Value addition loans.* Traditionally, the corporation has concentrated on financing for primary production. Some branches have started lending to borrowers for value addition of agricultural products such as asset financing for a borrower to set up an abattoir, a tea nursery and Small and Micro Enterprise (SME) in milk processing.
- ii. *Wholesale/group lending approach.* This involves lending to organized groups. The group must be registered, must have management structure, must have a history of success- (must have undertaken an activity together at least for the last three years), must provide security e.g. title deed or deposit 15% of the loan amount with AFC as security.

The corporation intends to reduce the cost of offering credit by implementing the wholesaling/group lending as stipulate in its Strategic Plan 2005-2010. The corporation proposes to reach 68% (340,000) clients through wholesaling/group lending of credit to MFIs, co-operatives and organized registered groups. In addition, it intends to retain 32% (160,000) of its clientele for retailing. The study shows that some branches have initiated the group lending approach. For example in the four branches visited by the research team, at least 8 groups/cooperatives were in the loan appraisal stage. In total, the loans will benefit at least 16,000 individuals (150% more clients than the current retail level) with a total of Ksh. 42 million, thus this is a more efficient and effective way of improving access to rural credit. On average, each member of the wholesaling group will probably get a loan of Ksh. 18,721 per member, this is about 70% lower than the current amount loaned to the AFC 'small scale farmers'.

3.4 The Donor Guarantee-Input Supply Model

The model has two components, i.e. the stockists credit guarantee system and the credit voucher system.

A guarantee is a promise to repay credit or a loan incase of default. This is done to promote private sector lending to decrease credit risks, build lending capacity and potential for sustained activity and address a market imperfection.

3.4.1 Stockists Credit Guarantee System

The credit guarantee system is a model of building lending capacity between the commercial manufacture of agricultural input and the input stockists. The rural stockists/shopkeepers are an important source of credit for agricultural inputs to the rural areas. Data from the 2004 Tegemeo survey shows that rural stockists provide 4 % to 7% of credit in-kind. The rural stockists face challenges such as lack of the required capital to meet the input requirements of the producers, lack of knowledge on inputs and business skills. This has contributed to low usage of agricultural input that translates to low agricultural productivity. The overall objective of the guarantee system is to improve agricultural productivity and incomes of smallholder farmers in Western Kenya⁸. The central strategy is to strengthen commercial linkages between enterprises in the private sector distribution system, from input supply companies to regional wholesalers to rural stockists- from whom farmer's access inputs – in order to increase the range and quantity of inputs available. This will increase the smallholder farmers' sustainable access to and use of agricultural inputs and services (including dairy) by improving their availability.

How does the credit guarantee system work?

The credit guarantee system involves the following parties; the donor, agricultural input stockists/wholesaler, a local non-governmental organization (NGO) in this case Agricultural Market Development Trust and an input manufacturing company. To increase the creditworthiness of the input stockist, the donor through an NGO offers seven modules on business training courses at a cost of Ksh. 500 per module. As at January, 2006, 138 stockists had been trained. The NGO avails the list of trained stockist to the input company. The input manufacturing company then enters into agreement with the trained stockist to supply inputs (companies and wholesalers) on credit. The donor guarantees to pay 50% of the default loan balance and the company will absorb the other half. The guarantee fund worth over US \$40,000 (Ksh 2.9 million) is held by the donor. The program was piloted in 2005 in Western Kenya.

⁸ Kisumu, Siaya, Bungoma and Vihiga districts

As at January, 2006, five companies had received a revolving credit⁹ guarantee of enabling them to extend credit valued at Ksh. 866, 364 to two wholesalers who in turn guaranteed 50 new stockists who have received inputs worth Ksh. 3.6 million on credit. There has been excellent repayment, with only one defaulter, amounting to Ksh. 222, 285. The organization has already paid for 50% default though the process of repayment is lengthy, taking approximately 2-3 months.

A recent study shows that the effect of the credit guarantee has trickled down to the farmer. Stockists affiliated to the credit guarantee system are doing better than the non-affiliated stockists in credit provision; about 34% stockists gave credit to farmers compared to 29% of the non-affiliated stockists (AGMARK, 2006).

Challenges and Opportunities

The credit guarantee fund of \$40,000 is limited and can only guarantee limited beneficiaries. On the other hand, the 'free things mentality' among the people is a problem towards repayment of credit, which might slow down repayment rates.

The model could be replicated and scaled up to other parts of the country where many stockists need empowerment in business skills and credit services. The trained stockist are now more attractable to banks and other financial institutions and can therefore benefit from the upcoming wholesaling and group lending financiers such as the AFC.

3.4.2 Credit Voucher System:Rice Production in Ahero Irrigation Scheme

The credit voucher system is a model of providing agricultural inputs on credit to farmers. The principle involves provision of input using a combination of a credit voucher and cash (where vouchers cannot be used). The voucher reduced the likelihood of credit diversion to other life cycle needs. Provision of credit vouchers is staggered during the production. The model involves a number of actors i.e. the donor, a micro finance institution, SACCO, input stockists, government, and buyer of the agricultural

⁹ Credit inform of fertilizer, seeds, crop protection chemicals and animal feeds.

output. The credit voucher system otherwise referred to as ¹⁰Mkulima loan is being piloted in Ahero rice scheme since March 2005.

The donor guarantee to repay offers a 50 % of any defaulted loans. The MFI-SAGA Thrift and Enterprise Promotion Limited (STEP) is a rural financial organization that facilitates the delivery of financial services to people living in the Kenyan districts¹¹ around Lake Victoria region. It comprises of SAGA SACCO and SAGA Thrift and Enterprise Promotion Limited (STEP), the later manage the affairs of the SACCO. SAGA operates a Front Office Service Activities (FOSA). Members buy shares from the SACCO at Ksh 25 with a minimum of 4 shares per month (Ksh 100 per month). The shareholder can then access loan and savings products. All loans attract an interest rate of 2% per month with a rebate of 0.5% on timely repayment. The 1.5% of the interest earned is shared equally between the SAGA Sacco and the management company – STEP.

The farmers who are members of the SACCO get mkulima loans up to three times the amount of shares held in the SACCO. The loan attracts a 2% per month interest rate or 24% p.a. In addition, the beneficiaries pay an insurance fee of 2% of the loan amount. No tangible collateral is required. All loans are secured by SACCO members and guarantors savings. The 75% of the mkulima loans is disbursed via the credit vouchers and 25% through cash vouchers. **Cash vouchers** cover, *transplanting, weeding and harvesting* and credit **vouchers** include but not limited to cost of *ploughing and rotavation, seeds, fertilizers, chemicals and gunny bags*. During the 2005 crop production year, the organization disbursed a total of Ksh. 6.7 million to 617 farmers in Ahero rice irrigation scheme.

The farmers obtain the vouchers from MFI-SAGA and submit the vouchers to the stockists for the supply of the inputs/services, the stockists then remit the voucher to SAGA for payments. All farming activities in the scheme are supervised by the credit officers; this ensures that credit is used for the intended purposes. The disbursement of the vouchers is staggered over the production period and the loan officers supervise the farmers to ensure that the inputs and cash are not diverted. The loan for irrigated rice is

¹⁰ Meaning a farmer loan

¹¹ Kisumu, Bondo, Busia and Rachuonyo

repaid using the balloon payment method (deducted from sale of produce-check off system) upon sale but for horticulture there is a grace period of 3 months. The farmer is expected to contribute towards the cost of production by meeting the labor and transport costs. The maximum loan is Ksh. 17,500 per acre of rice and Ksh. 20,000 for horticultural crops. On average each farmer gets a loan of Ksh. 10,630.

Rice yield ranges between 20 -30 bags per acre leading to an estimated net profit of Ksh. 8,600 /acre. Given that most farmers cultivate 4 acres, then majority of farmers take home between Ksh. 30,000 and Ksh. 120,000 as net profit for each growing season. The 'high interest rate' does not deter the farmers from borrowing. Decomposition of the cost of capital as a fraction of overall cost of production reveals that the cost of capital accounts for only 7% of the total costs. Farmers in the scheme are now better off economically and there is a spill over effect in the business community which is now more vibrant and has recorded improved sales/business.

The government has contributed to the revival of the once dead Ahero scheme by reviving the scheme in 2005 following a Ksh. 20 million intervention bankrolled by the state and the Food and Agriculture Organization (FAO) that saw two pumps (with a capacity to handle 600 liters of water per second) installed and its 10 kilometer irrigation canals rehabilitated. The cost of water amounts to Ksh. 3,100 per acre and it is paid in advance directly to the National Irrigation Board (NIB) by the micro-finance institution before planting. The output market prices are negotiated before planting.

Challenge and opportunities

The model has incorporated Front Office Service Activities (FOSA), whose legal status is not very clear.

However, there exist a big opportunity for expansion into other rice schemes. For example, the management company is replication the model in Bunyala rice scheme. Since the model has worked so well and the default rate is minimal, the management company did not need the donor credit guarantee.

3.5 Managed SACCO: a case of ‘Beach Banking’ Model

This model involves a SACCO and a micro finance institution (in this case, MFI-SAGA Thrift and Enterprise Promotion Limited) which oversees the management of the SACCO at a fee recovered from paid up interest rates. Members in the SACCO buy shares which are used as collateral for leveraged loans. A share is valued at Ksh 25 with a minimum of 4 shares per month (Ksh 100 per month).

The model operates eight service points otherwise referred to as ‘Beach banks’ along Lake Victoria beaches in Kisumu and Bondo District. The motivation behind this innovation is to contribute towards poverty alleviation among the fisher folks. Kenya earns about Ksh 6.9 billion annually from fishing. However, with such large amounts of money, there has been insignificant impact of fisherman’s physical and economic lifestyle, what a paradox? Most of the fishermen along Lake Victoria have been exploited by the middle men and others squander their hard earned cash due to lack of banking institutions.

The service points have front offices that operate like conventional banks, providing saving and credit products. It has a current membership of 3,000 clients with a total savings of Ksh. 15 million. The beach ‘banks’ contribute 36% (Ksh. 15 million out of Ksh. 42 million) of the total savings in MFI-SAGA. On average each beach ‘banker’ has a savings of Ksh. 5000.

About 55% of the beach bank savers are female fish mongers and the rest are male fishermen. Previously, most of the female fishmongers were initially constrained by lack of capital for business transactions. However, the beach banks have facilitated, thus reducing financial dependency on fishermen.

3.5.1 Market Day Loans

The beach ‘bank’s offer a variety of loan products, the market day loans are a special loan facility, a very short-term loan for business people dealing with fast moving goods with quick returns. The loan is processed within the same day and is payable in 5 days with 2% interest rate. The leverage ratio is 1:2. In addition, a borrower pays a 2% insurance premium incase of death. This product is popular among fishmongers and

traders. This is one of the most innovative rural finance product developed by MFI-SAGA. The market day loans account for 62% of the total beach 'bank' loans. Members can borrow as low as Ksh. 200 per visit and in addition; they can borrow for a number of times in a day. The cumulative average loan amount disbursed to the beach bankers is about Ksh 18,152. The ratio of borrowers to savers is 30%.

Challenges and Opportunities

Insecurity remains a big challenge for the success of the beach 'banks'. There have been cases where the service points have been broken into and large sums of monies stolen. In addition, the migratory nature of the fishermen reduces the business activities thus affecting the performance of the beach 'banks'. The beach 'banks' have a potential for expansion, currently only reaching 3,000 fishmongers but there exists a potential of 12,000.

3.6 Informal Group Based Rural Financing Model

Informal systems are an important source of basic rural financial services, table 3 showed that these models provide between 10% to 12% of the agricultural credit, the contribution could even be higher for the non agricultural credit. The informal group based rural finance models come in various forms such; merry-go-round, Mata Masu Dubara (MMD), table banking and Rotating Savings and Credit Association. The main principle behind the informal system lies in group formation.

3.6.1 Merry go –round

Merry-go-round is composed of less than 20 members who contribute a specified amount of money regularly. Members vote on who is to be given lump sum amount. The merry go –rounds are most common with women mainly for the purposes of buying household items. This model does not charge any interest rate.

3.6.2 Mata Masu Dubara (MMD)

The Mata Masu Dubara (MMD) model first originated from Niger in West Africa and it is currently being piloted in Rachuonyo, Homabay, Migori and Suba District of Kenya

under CARE international which offers training to groups on self selection, groups formation, leadership, constitution and record keeping. The model works on the group principle; the members contribute regularly towards an objective such as purchase of agricultural inputs for the planting season. Loans are also offered at low interest rates. In addition, members save as low as Ksh. 300 in a month. There are no other charges paid by the members such as loan application, insurances and membership fee. As at September 2005, there were 163 MMD groups with a total membership of 2,560 who had mobilized a saving of Ksh. 2.7 million, a total of Ksh 4.5 had been disbursed as loans; Ksh. 934,000 had been shared out among the group members. Loan amounts ranged between Ksh 50 and Ksh 10,000. The money accumulates for a specified period after which the members divide the money and the group disintegrates.

3.6.3 Table ‘Banking’

Table ‘banking’ is a unique rural finance concept that is widely practiced in Western Kenya especially in Bungoma District. It involves group members who come together and make regular contributions. The members contribute shares to a revolving fund, which is loaned to members. During the meetings, the members who have loans make their payment plus the interest, and then every member makes the agreed contribution. All the cash collected is intended to be loaned out in the same meeting. All the transactions are recorded and every member is required to obtain a loan. The loans do not require collateral and there is a high degree of accountability and trust since all the money transactions are done on the table in the presence of all members. The members are willing to take loans at high interest rate for they know they stand to gain from the interest accruing from the loans. The interest rate varies from group to group but ranges between 10 to 20 % per loan period. The repayment period is short-term usually monthly but varies with the group.

3.6.4 Rotating Savings and Credit Associations (ROSCAs)

The Rotating Savings and Credit Association (ROSCAs) variant is an advanced version of merry go round where the members contribute some monthly shares and also disburse loans to members. They have their roots in the traditional mutual guarantee

system. The actual number of ROSCAs in Kenya is not known, however these associations provide credit to many low-income people. A typical ROSCA involves a group of 5 to 30 members. The Merry go round is embedded in the model. The association offer short-term loans to members at interest rates that range between 5-20% per period. Some ROSCAs and especially in Rift Valley are financially very strong and have managed to buy assets such as land and buildings.

3.7 Group Membership in Rural Kenya

Group formation is a prerequisite for the formation of community owned rural finance models. Tampa data 2004 shows that 78.8% of the household had at least one member involved in some form of a group. 50.2% were in the informal/self help group, 34% in producer co-operatives, 13.1% in savings and credit co-operative and 2.5% in multipurpose co-operatives. Table 9 shows the distribution of the groups by types by agro-regional zones.

Table 9: Group Type by Zone, 2004

Zone	Group Type				Total
	Producer Cooperatives	Multi-purpose cooperatives	Savings & Credit cooperatives	Self help groups	
Coastal Lowlands	17.80		4.10	78.10	100
Eastern Lowlands	17.30	0.90	7.80	74.00	100
Western Lowlands	20.30	1.30	6.30	72.20	100
Marginal Rain Shadow	27.90	1.60	4.90	65.60	100
High Potential Maize Zone	37.30	2.50	10.70	49.50	100
Western Transitional	68.70		4.50	26.90	100
Western Highlands	69.30		5.80	24.80	100
Central Highlands	71.20	3.60	3.10	22.00	100

Source: Tegemeo household survey, 2004

Over 70% of the self help groups are in the low income zones of Kenya. These are the zones that are least served by the formal financial systems. An implication that there exist an opportunity for the community mobilized models of rural financing to thrive better in these areas. In addition, these groups can benefit from the current group lending through the government corporation.

3.8 A Comparative Analysis of the Models

The following section looks at a brief analysis of the described models of rural finance. Table 9 outlines a comprehensive description of these models. Rural financing model are designed to meet different objectives; the Government led model and Donor-guarantee credit voucher system are designed to increase food security in the country. The emerging bank model is mainly for expansion of rural financial services. The community owned model and managed Saccos-beach banking models are mainly designed for poverty reduction.

Compared to other models of financing, the emerging indigenous banks have the greatest outreach in the rural areas partly associated to mobile banking, affordable rates and reduced bureaucracy. The community owned models have the second largest clientele outreach partly because of the group masses. However, this model has a great potential for outreach. While AFC has the lowest, there exist potential for greater outreach under the group lending. The model is unlikely to meet a large clientele since only a small proportion of Kenyan land is under irrigation.

Estimated annual household income generated from Tampa 2004 household survey shows that AFC clientele are above the poverty line as defined by the dollar a day (averages US \$1.4 per day. Although the emerging indigenous banks have a greater clientele outreach, the model is mainly reaching the middle income group who are slightly above the poverty level (averages \$ 1.2 per day). The community owned rural finance model, the donor-guarantee credit voucher system and the beach banking models reach the rural poor of low land regions. The beneficiaries earn a range US \$ 0.5 to US \$0.8 per day. This implies that any policy that promotes development of the community owned models is most likely to have a greater impact in improving access to rural financial services.

The community models provide the lowest amounts of loans averaging from Ksh. 7000 to Ksh. 10,000 per beneficiary per year, indication that the models serve the poor in the community. The beach banking disburses slightly higher amount of loans partly because of the market day loans.

Table 10: A comparative Analysis of selected Models

Indicator	Government led	Commercial Bank	<u>Community Owned Model:</u>		Donor Guarantee	Managed Sacco
	Model: AFC	Model	FSA	Mbeu	Input Supply System (Voucher system)	(Beach banking model)
Objective	Food Security	Profit making	Poverty reduction	Poverty reduction	Food security	Poverty reduction
Interest rates per annum	10%	12% to 18%	20% to 34%	12%	24%	24%
Outreach (no. of clients)	5,200	380,800**	70,000	7,400	617	2,700
Average annual * HH income in Ksh	260,489	227,103	159,130	159,130	99,317	99,317
Per capital income in US Dollar per day	1.4	1.2	0.8	0.7	0.5	0.6
Average loans per client	320,000	42,942	7,215	10,000	10,000	18,153
Insurance on loans	No	Yes	Yes	Yes	Yes	Yes
% loaned members***	N/A	21%	38%	30%	N/A	30%
Unit cost of lending 1 Ksh	0.5	0.22	0.13	0.08	0.09	0.02
Average Savings per client	N/A	16,071	19,000	4,077	3,635	5,797
Sustainability	Low	High	Average	Average	Average	High
Source of funds	Government	shareholders	shareholders/interest rates/donor		shareholders/interest rates	

Source: Author's computation;

* Annual household income and dollar per day computed from TAMPA household survey, 2004

** 60% of the total clients,

The government led model and the emerging bank provide relatively higher loan amount. The results show that across these models, the proportion of rural borrowers ranges between 30% and 39%, reinforcing the fact that most households prefer to have access to a saving facility rather than a borrowing facility. This is also supported by Tampa household survey 2004 on agricultural credit, which showed that only 39% of the households tried to obtain any credit. The unit cost of lending ranges between Ksh. 0.02 and Ksh 0.5. AFC lending is the most costly; each shilling loaned out incurs an expense of Ksh 0.5. The community owned models are low cost models. Insurance on loans ensures recovery of loans in case of the death of a beneficiary. Results show that all the financiers with an exception of AFC including the community based models insure the loaned amount, insurance averages at 2% of the loaned amounts.

The interest rates vary across the models. AFC has the lowest interest rate of 10% per annum. FSAs have the highest interest rates ranging from 20% to 34% per annum. The interest rates by FSA are set by the shareholders, the interest rates are highest partly because of lack of alternative to other financial institutions, to increase monthly revenue as the FSA attempts to move towards sustainability and finally earned interest is paid as dividends at the end of the year. Where markets and other support services exist, high interest rates do not deter borrowing because there are reduced covariant risks.

3.8.1 Sustainability and Outreach

Most of these models have an external source of funding; in most cases the donor has a clear exit strategy. However the issue of financial sustainability remains a big challenge.

AFC is mainly supported through a budgetary allocation and in some cases the donor. Given its current form, the corporation has low sustainability and low outreach. However, the implementation of group lending will most likely improve outreach, but the issue of sustainability will be uncertain because it will depend on the ability to recover loaned amount to the registered groups. Figure 3 demonstrates an outreach and sustainability frontier.

The community owned models have a high outreach and low sustainability. Some attempts made to move towards sustainability are; piloting of regional management

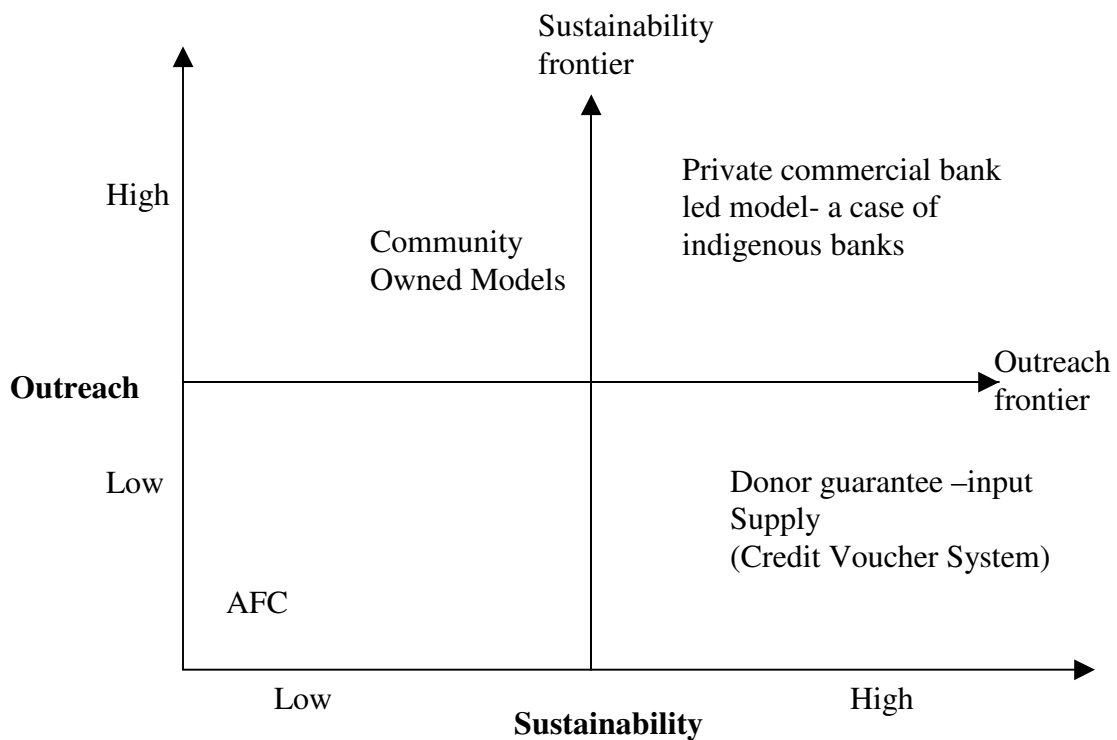
companies by FSA, withholding dividends on interest rates by Mbeu savings and credit association. Financial sustainability will require an increase in shareholding membership and improved management.

The emerging indigenous banks demonstrate the high outreach and high sustainable model because the operating expenses are sourced mainly from the local shareholders capital and earned interests. The rapid expansion is demand driven.

The Donor guarantee–input credit voucher system has high sustainability as evidenced by the fact that the MFI promoting the voucher system has expanded to Bunyala without the donor guarantee. However, outreach is low because in Kenya, the proportion of irrigated land is very low. The development of irrigation scheme would provide and opportunity for the expansion of the voucher system.

The Managed Sacco-beach ‘banking’ model has high sustainability because it lends from the voluntary and compulsory savings from local shareholders. Currently, it has low outreach because of the few service points. There is a potential for expansion to cover 12,000 beach bankers. The informal models have high sustainability and high outreach.

Figure 3: Outreach and Financial Sustainability Frontier



3.9 Future Scenario of Rural Financing

This section looks at the future scenario of rural financing. Given this background, most likely, the mainstream banks will concentrate on the niche markets in the urban centers. The emerging indigenous banks will continue to expand in the rural areas.

The AFC will most likely to transform itself in order to survive. Wholesale and group lending will enable the corporation to reach more clients reach at lower costs.

The MFIs will continue to serve the middle and upper income earners and will be transforming themselves into commercial banks. They will be profit motivated. Their transaction charges will go up as they go national.

The rural SACCOs, ROSCAS, self-help groups will continue serving the rural people and will transform themselves into community based micro-credit units. This will most likely reduce unemployment in the rural areas. We are likely to see some form of urban-rural migration as some skilled workers will probably move to the rural areas to work in the community based micro-credit units. The credit guarantee works on limited scale and may not address the needs of the masses in the future

4.0 Key Findings and Policy Implications

1. Most households in the rural areas borrow credit for farming. However, two third of those who did not receive credit had borrowed for farming. An implication that few providers are willing to lend to agriculture. Provision of agricultural credit is skewed toward the production region and it's mainly provided by the commodity Based Credit Providers and co-operatives. Therefore any intervention that strengthens the performance of the above will improve access to rural credit.
2. Different models of rural financing have evolved over time and borrowing accounts for less than 40% of the rural financial activities. This shows that rural finance is more than credit provision and policies that promote increased access to rural financial services should consider provision of other financial services.
3. The Government on its part has restructured the operations of Agricultural Finance Corporation (AFC) in line with the Strategy for Revitalization of Agriculture (SRA) enabling the corporation to resume its lending to the agricultural sector. However, AFC has the lowest outreach and the lowest sustainability. It also has the highest cost of lending; one of the ways of reducing this cost is by rationalizing the current support staff that constitutes over 60% of the total staff. Implementation of wholesaling and group lending approach is likely to increase outreach.
4. The emerging indigenous banks have focused to the rural areas. This model has registered an impressive growth because of its target on the low income population through setting up fixed and mobile banks. However, the government needs to give incentives for the banks to reach a higher number of rural clientele by improving the infrastructures such as roads and power provision.
5. The community owned models has a wide outreach and it's a low cost model. Policy intervention whose objective is to increase financial service should strengthen the community owned model. The rural communities could consider setting up similar facility using the Constituency Development Fund (CDF) money.
6. The Managed Saccos and the community owned models of rural financing offer unregulated front office services activities (FOSA). There is need for the government to regulate the sector through enactment of the proposed SACCO Societies Regulatory bill, 2004

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