FINANCIAL INCLUSION FOR RURAL MICROENTERPRISES (FIRM)

QUARTERLY REPORT:

APRIL – JUNE 2012

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FINANCIAL INCLUSTION FOR RURAL MICROENTERPRISES

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SECTION I

INTRODUCTION

The sixth quarterly report on USAID Kenya's Financial Inclusion for Rural Microenterprises (FIRM) activity, hereafter referred to as the "Program," summarizes new and ongoing work for the second period of the calendar year, 2012.

FIRM continues to coordinate with USAID Kenya on a new Performance Monitoring Plan under Feed-the-Future. Other topics covered in this report are related to implementation processes, performance issues and budget expenditures.

During the reporting period from April through June 2012, FIRM made significant gains toward the realization of important program indicators. To highlight, the Program:

- Continued to support the Kenyan Pension Fund Initiative on Private Equity as an asset class to assist in securing buy-in from their clientele (local pension fund managers).
- Began working with FMO on Kenyan Pension Fund Initiative as an anchor and co-investor.
- Continued to support the National Economic and Social Council (NESC) on its credit guarantee scheme for the Government of Kenya that offers a strategy and plan to underpin economic growth and development as articulated under Vision 2030.
- Continued to support the Kenyan Credit Information Sharing Initiative (KCSISI) to expand beyond commercial banks and include DTMs, MFIs and SACCOs in the new Credit Reference Bureau.
- Expanded partnerships with financial institutions in agriculture, clean/renewable energy and ICT.
- Further prepared two new Development Credit Loan guarantee facilities – one with KCB in agriculture and water; the other one split between three MFIs (KWFT, SMEP and Micro Africa) in agriculture and energy.
- Secured financing to fund a portion a KCB's upcoming water DCA loan guarantee from DFID's MAP (Market Access Program). FIRM and MAP also agreed to partner in the analysis of the cotton value chain in HR1 and SA2

FIRM began working to reconfigure its workplan and PMP to support new objectives under Feed-the-Future. FIRM's PMP will undergo significant alterations and, as such, the Program will not report on numeric indicators in this quarterly report as defined in an earlier approved PMP. FIRM anticipates that it will report on quantitative targets in the September and Year End quarterly reports.

In this report, FIRM will discuss major process achievements that will significantly and positively contribute to performance results. Potential changes will be highlighted with analysis as appropriate.

SECTION II

ACHIEVEMENTS

FIRM's work in agriculture finance continued to expand, as the Program grew its existing relationships with current partners. New activities were also initiated. Small-scale clean and renewable energy work multiplied as work began in product research and development with proposed DCA partners. Policy work continued with the National Economic and Social Council in credit guarantee schemes and with the Kenya Credit Information Sharing Initiative.

A few important activities are highlighted below.

The Kenyan Pension Fund Initiative

FIRM developed an important relationship with FMO during the reporting period. FMO is eager to partner and engage the pension fund industry through the fund managers. To incentivize pension industry, FMO expressed interest in co-investing alongside the funds. FMO stated that with the proper structures in place, including a qualified fund-of-funds manager, FMO would consider investing $50 to $100 million.

FIRM facilitated several exchange visits and exploratory meetings with key industry participants, including the Fund Manager's Association and individual pension funds.

New DCA Loan Guarantees

FIRM worked closely with USAID Washington and Kenya to structure three new loan guarantee facilities described below. Both guarantees are expected to close this fiscal year by September 30, 2012.

Multiparty Facilities

The first facility is a USD 13 million, 7-year, competitive/multi-party loan portfolio guarantee (LPG), co-guaranteed by the Swedish International Development Agency (Sida), was designed to encourage the three proposed partner financial institutions to lend to the agriculture and energy sectors in Kenya. Partners are expected to lend at least 10% of their facilities to the clean energy sector. The three institutions (Kenya Women's Finance Trust, Micro Africa and SMEP) will enter into one multi-party agreement that lists the two guarantors specific guarantee percentages (USAID: 20%, Sida: 30%), and the initial maximum cumulative disbursements (MCD) designated to each partner institution. The partner that first fully utilizes its MCD will be rewarded with access to an additional USD 2 million (kept in reserve) in MCD ceiling.

Institution	Initial MCD
KWFT	USD 5 million
MALK	USD 2 million
SMEP	USD 4 million
Subtotal	**USD 11 million**
Additional Reserve	USD 2 million
Total	**USD 13 million**

Expected Results

- Outputs: The competitive USAD-Sida co-guaranteed LPG with KWFT, MALK, and SMEP will facilitate the flow of up to $13 million to borrowers operating projects in the agriculture and energy sectors. The guarantee will increase the partners' related lending measured by client base and loan portfolio, and allow it to reduce collateral requirements.

- Outcomes: Due to the guarantee, KWFT, MALK, and SMEP will have a larger lending portfolio to borrowers engaged in the agriculture and energy sector. The guarantee will also establish and/or deepen the credit histories of targeted borrowers. After the guarantee, the partners will likely continue to lend to those borrowers with which they had a positive lending experience.

- Impacts: USAID anticipates that the increased number of borrowers with positive credit histories may strengthen the interest of other MFIs in lending to the agriculture and energy sectors. The success of this guarantee may also incent more MFIs to institute agriculture and energy lending programs, characterized by longer loan tenors.

Borrowers

Qualifying borrowers will be defined as "Individuals and non-sovereign enterprises operating in or supporting the agricultural and clean energy sectors in Kenya. For the avoidance of doubt, Qualifying Borrowers shall include those engaged in the development, production, sale, operation, or marketing of cook stoves." Qualifying borrowers must operate Qualifying Projects, which will be defined as "Investments in the agriculture and clean energy value chains, defined broadly to include production, processing, storage, transportation, and distribution." At least 10% of the Qualifying Loans made by each Guaranteed Party shall be to Qualifying Borrowers operating in the clean energy sector.

Financial Intermediaries

There are three institutions participating in this competitive guarantee. Of them, MALK is a credit-only microfinance institution, while KWFT and SMEP are deposit-taking microfinance institutions (DTMs). None of the proposed partners has partnered with USAID for a DCA before.

KWFT: Formed in 1980, KWFT is the undisputed leader among microfinance institutions (MFIs) in Kenya, with the largest network (221 branches and lending units) providing deep penetration into rural and urban areas. KWFT operated a credit only program for its first 30 years, but in 2010 it received a license from Central Bank of Kenya (CBK) to transform into a deposit-taking institution, in accordance with Kenya's Microfinance Act and CBK regulations. With a USD 130.7 million net loan portfolio, USD 82.5 million in customer deposits, 279,850 active borrowers, and approximately 440,000 total clients, KWFT is the largest of deposit-taking microfinance institutions; in fact it is larger than many banks operating in Kenya.

MALK: MALK is a small, relatively new, and growing MFI based in Nairobi. Originally a 100% payroll lender in Kenya, it has expanded both its product offerings (it now uses both individual and group lending methodologies on ten loan products tailored to the needs of different client segments and sectors. MALK currently serves 9,540 borrowing clients through nine branches in mainly urban areas, and maintains a ~USD 5.1 million loan portfolio. Smaller than its peers, MALK's strategy is to serve the niche financial needs of the economically active poor, meaning that its clients are slightly higher-end micro clients than those of its peers (i.e., higher average loan size, generally based in more urban areas).

SMEP: SMEP began operating in 1975 and focused on provision of loans to enable residents to initiate or expand small-scale businesses as well as providing food assistance. Operating as a credit only institution for its first 35 years, SMEP was licensed as a deposit taking microfinance institution in January 2011. SMEP's operations cover the whole country, with 42 business outlets, of which six are deposit-taking branches (SMEP is working with the CBK to transition more of its marketing units to deposit taking branches in the near future). SMEP currently serves 125,000 borrowers with its USD 16.9 million loan portfolio; to date it has mobilized USD 9.5 million in customer deposits.

Related Existing or Planned Technical Assistance

Financial Inclusion for Rural Microenterprises (FIRM) is USAID/Kenya's technical assistance program charged with expanding financial services outreach to underserved rural and agricultural areas, including women, the very poor, and youth. The project focuses on agriculture, clean/renewable energy, ICT, and policy initiatives. Operated by DAI, FIRM employees maintain good relationships each of the lending institutions in this guarantee, and will continue to support them with TA as needed.

Collaboration with Other Parties

As described above, this project is co-guaranteed by Sida – with Sida assuming 30% risk coverage, and USAID assuming 20% coverage – on a pari passu basis. Sida played a crucial role in the project development and risk assessment processes for this project.

The second guarantee is a seven year, USD 15,000,000 50% co-guarantee (with the Swedish International Development Agency – Sida – assuming 30% of risk and USAID assuming 20% of risk) loan portfolio guarantee (LPG) that will help strengthen Kenya Commercial Bank's (KCB) ability to extend loans to borrowers engaged along select agricultural value chains. The guarantee is designed to support USAID/Kenya's Feed the Future strategy and Sida/Government of Kenya's Agricultural Sector Development Support Program (ASDSP). It is structured with flexible terms to ensure that viable World Food Program Purchase for Progress (WFP-P4P) smallholder farmers' organization contract holders will be among qualifying borrowers, which are defined as "non-sovereign Kenyan individuals, businesses, and organizations (e.g., Savings and Credit Cooperatives), including those smallholder farmer organizations with forward delivery or direct contracts from WFP-P4P." Qualifying projects are defined as "investments along the dairy, drought-resistant crops (e.g., millet, sorghum), horticulture, beans (excluding French/green beans), and maize value chains – defined broadly to include inputs and production (e.g., seeds, fertilizer, water/irrigation, etc.), capital investments (e.g., tractors, tools), aggregation, storage, processing, handling, and transportation (e.g., trucks)." At least 40% of all Qualifying Loans should be for Qualifying Projects in the Coast, Eastern, Nyanza, Rift Valley, and Western Regions of Kenya.

Expected Results

- Outputs: The DCA LPG with KCB will facilitate the flow of up to USD 15,000,000 to borrowers operating projects in the agriculture sector. The guarantee will increase KCB's related lending measured by client base and loan portfolio, and allow it to reduce collateral requirements.

- Outcomes: Due to the guarantee, KCB will have a larger lending portfolio to borrowers engaged in the agriculture sector. The guarantee will also establish and/or deepen the credit histories of targeted borrowers. After the guarantee, KCB will likely continue to lend to those borrowers with which they had a positive lending experience.

- Impacts: USAID anticipates that the increased number of borrowers with positive credit histories may strengthen the interest of other commercial banks in lending to the target sectors. The success of this guarantee may also incent more commercial banks to institute lending programs, characterized by longer loan tenors that support agriculture projects.

Borrowers

Qualifying borrowers are defined as non-sovereign Kenyan individuals, businesses, and organizations (*e.g.*, Savings and Credit Cooperatives), including those smallholder farmer organizations with forward delivery or direct contracts from WFP-P4P and those supported by Sida/Government of Kenya's Agricultural Sector Development Support Program (ASDSP). Qualifying projects are defined as investments along the dairy, drought-resistant crops (e.g., millet, sorghum), horticulture, beans (excluding French/green beans) and maize value chains. Qualifying Projects shall be defined broadly to include inputs and production (e.g., seeds, fertilizer, water/irrigation, etc.), capital investments (e.g., tractors, tools), aggregation, storage, processing, handling, and transportation (e.g., trucks). At least 40% of all Qualifying Loans should be for Qualifying Projects in the Coast, Eastern, Nyanza, Rift Valley, and Western Regions of Kenya.

Financial Intermediary

KCB is one of Kenya's largest and most reputable banks, with over 160 branches and a wide variety of savings and loan products. Its multi-branch subsidiaries operate in Rwanda, Southern Sudan, Tanzania and Uganda. KCB's low non-performing loans, strong management, and experience working with USAID make it a strong partner for this guarantee.

KCB has successfully implemented two DCA guarantees. The first was a $7.9 million LPG approved by the CRB in 2006 to encourage lending to SMEs (especially those operated by women) and microfinance institutions (MFIs). Of this facility, KCB utilized $7,823,579 (99.03%).

KCB also successfully implemented a $5.75 million LPG approved by the CRB in 2010 to encourage lending to micro-, small-, and medium-sized enterprises (MSMEs), MFIs, and Savings and Credit Cooperatives (SACCOs) for projects that supported the development of the agriculture, clean energy, commerce, Constituency Development Fund projects, construction, and manufacturing sectors. Of this facility, KCB utilized $5.75 million (100%).

KCB is uniquely positioned to successfully implement this new guarantee, which – unlike predecessor guarantees – focuses exclusively on agricultural lending and is intentionally linked to KCB's agriculture expansion strategy, which USAID helped develop. KCB was also specifically listed by WFP-P4P producer groups as one of three institutions seen as able to implement this project. DCA explored guarantees with all three institutions and selected KCB on the basis of its appetite and strategic alignment.

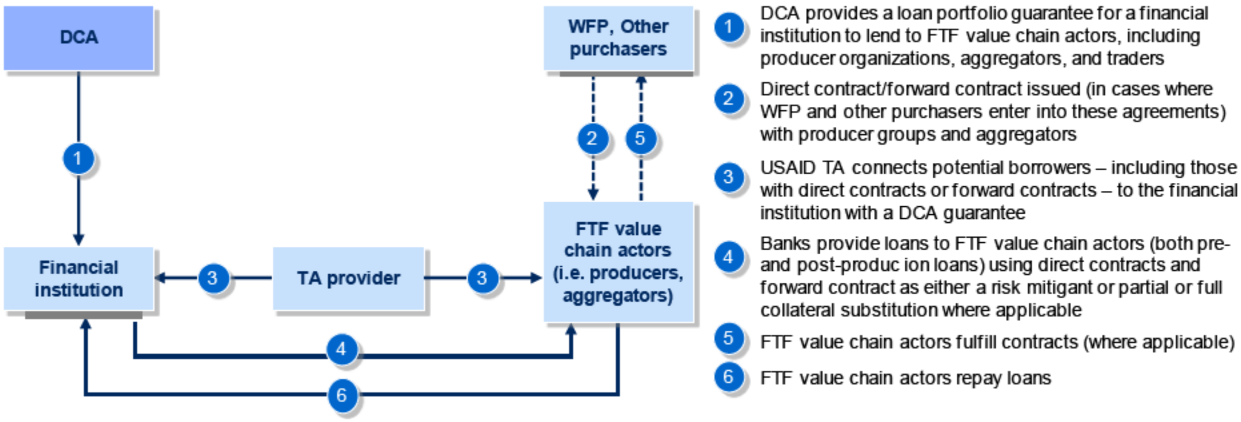
Related Existing or Planned Technical Assistance

USAID/Kenya plans to support its DCA guarantees through its Financial Inclusion for Rural Microenterprises (FIRM) technical assistance program. On the borrower side, FIRM is working closely with WFP-P4P to identify and support smallholder farmer organizations that have forward delivery and/or direct contracts. Assistance will be targeted to the needs of the borrower group, and may include developing cash-flow statements, business plans, and financial documents; introducing appropriate governance structures and ensuring official registration; offering training on general business development services such as basic bookkeeping/accounting; and connecting the groups to KCB for consideration of their loan applications. On the lender side, FIRM is helping KCB develop and roll out its agriculture lending strategy, including supporting its physical expansion into rural areas and increasing the quantity of loan products designed specifically to support agriculture value chains.

Collaboration with Other Parties

As described above, this project is co-guaranteed by Sida – with Sida assuming 30% risk coverage and USAID assuming 20% risk coverage on a pari passu basis. Sida played a crucial role in the project development and risk assessment processes for this project.

Additionally, this project is part of a broader partnership with WFP-P4P to increase access to finance for smallholder farmer organizations in East Africa (Ethiopia, Kenya, South Sudan, and Tanzania). The partnership intentionally links USAID technical assistance with WFP-P4P producer groups, and ensures that the groups are eligible to draw on the guarantee facility.



The third facility is a ten year, $5.5 million, 60% guarantee is designed to strengthen KCB's ability to finance loans to non-sovereign enterprises in the water sector in Kenya. The subsidy cost of the transaction will be co-funded by USAID and DFID. Qualifying Borrowers will be defined as "Creditworthy non-sovereign and sub-sovereign enterprises, established under Kenyan law, which work in the water sector, and whose debt is not backed by the sovereign government of Kenya. Qualifying Borrowers may include municipal utilities and water service providers that operate on a commercial basis." Qualifying Borrowers must be engaged in Qualifying Projects, defined as "Investments in the water sector in Kenya, including sanitation projects." USAID's Sustainable Water and Sanitation in Africa Water (SUWASA) technical assistance program, a Nairobi-based regional project funded by USAID/Washington, is able to support with project design services.

Rationale for Guaranteeing More Than 50%

KCB is a current DCA partner for lending to small- and medium-sized enterprises (SMEs) and the agriculture sector. Both previous guarantees feature 50% risk coverage and have been highly successful. While KCB is satisfied with 50% coverage for SME and agriculture lending, the 60% risk coverage for this transaction is deemed necessary for several reasons:

- Lending to the water sector in Kenya is generally untested and the perceived risks of lending to the water sector are higher than those other sectors. While there has been one DCA guarantee supporting the water sector in Kenya (with K-Rep Bank), that project's revenue streams are linked to funds from the Global Partnership for Output Based Aid, while the proposed project's revenue streams are from private sources.

- KCB has never lent to the water sector. Its lack of experience and data for water sector lending make KCB highly risk averse.

- In the process of developing this guarantee, DCA and USAID/Kenya iterated on multiple project structures with multiple financial institutions, all of which stated that entering into the water sector would require more than 50% risk coverage. Of the potential financial institution partners, only KCB was willing to enter into the guarantee with 60% risk coverage. All other partners demanded at least 75% risk coverage.

Expected Results

- Outputs: A DCA LPG with KCB will facilitate the flow of up to $5.5 million to borrowers operating projects in the water sector. The guarantee will increase KCB's related lending measured by client base and loan portfolio, and allow it to extend loan tenors.

- Outcomes: Due to the guarantee, KCB will, for the first time, develop a lending portfolio to borrowers engaged in the water sector. The guarantee will establish and/or deepen the credit histories of targeted borrowers. After the guarantee, KCB will likely continue to lend to those borrowers with which it had a positive lending experience.

- Impacts: USAID anticipates that the increased number of borrowers with positive credit histories may strengthen the interest of other commercial banks in lending to the water sector. The success of this guarantee may also incent more commercial banks to institute lending programs, characterized by longer loan tenors that support water projects.

Borrowers

Qualifying Borrowers will be defined as "Creditworthy non-sovereign and sub-sovereign enterprises, established under Kenyan law, which work in the water sector, and whose debt is not backed by the sovereign government of Kenya. Qualifying Borrowers may include municipal utilities and water service providers that operate on a commercial basis." Qualifying Borrowers must be engaged in Qualifying Projects, defined as "Investments in the water sector in Kenya, including sanitation projects."

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KCB is uniquely positioned to successfully implement this new guarantee, which – unlike predecessor guarantees – focuses exclusively on water lending. In selecting a partner, DCA explored guarantees with multiple institutions and selected KCB on the basis of its appetite and strategic alignment.

Related Existing or Planned Technical Assistance

Sustainable Water and Sanitation in Africa Water (SUWASA) is a Nairobi-based regional project funded by USAID/Washington and implemented by ARD Inc. SUWASA's goal is to promote innovative reforms and sustainable financing for safe water and sanitation in Africa. In Kenya, SUWASA aims to increase private sector financing of water through designing and rolling out specialized water and sanitation finance products, promoting innovative and financially sound partnerships, and ensuring high performing water-related loan portfolios. It is currently working with Family Bank and K-Rep Bank to encourage loans of $200,000-$300,000 in Nakuru and Kisumu, respectively, with five-year repayment periods and one year grace periods. SUWASA ends September 2015, with SUWASA/Kenya currently scheduled for phase-out September 2013.

Collaboration with Other Parties

The subsidy cost of the transaction will be co-funded by USAID and the UK's Department for International Development (DFID). DFID, through its Market Access Programme (MAP) operated by Adam Smith International (ASI) is transferring $200,000 in its funds to the USAID Gift Account, which will further transferred to the DCA subsidy account for this project. DFID-MAP-ASI has been a part of the project development process for this transaction.

This project may benefit from the support of the World Bank's Water and Sanitation Program, which is setting up a water financing and technical assistance facility in Kenya. Under this program the World Bank plans to lend approximately $5 million to several Kenyan banks for on-lending to the water sector; each participating bank will match this contribution with at least $5 million of its own risk capital. Additionally, the World Bank will provide technical assistance for financial feasibility studies. KCB is interested in participating in this project and has been short-listed by the World Bank. Regardless of its participation, the DCA legal agreement explicitly states, and KCB understands, that USAID will only guarantee private funds, and therefore will not guarantee any of the World Bank's funds.

Partnership with DFID's MAP (Market Access Program)

FIRM held a series of exploratory meetings with MAP in order to determine whether both programs could work together by marrying FIRM's financial services and MAP's market access approach. Opportunities will take shape during the first quarter of the calendar year; however, FIRM and MAP agree to pursue mutually beneficial activities in water and agriculture across commodities and throughout geographic zones identified as essential to the success of Feed the Future.

SECTION III

UPCOMING QUARTERLY PLAN AND PROPOSED DEVIATIONS

In a key mission-wide performance monitoring and performance (PMP) evaluation, FIRM and other USAID Kenya programs began working with external consultants to reconfigure their PMPs to support new objectives under Feed-the-Future. In December, the Program received an updated PMP reporting framework from USAID Kenya that completely reconfigures FIRM's reporting indicators.

The Program began making changes to its PMP and workplan for fiscal 2012 and the remainder of the life-of-project years. During the reporting period, FIRM submitted a revised PMP to USAID Kenya for review and comment. At the writing of this report, the Program has not received feedback on its revised PMP submission. And, as such, FIRM does not have an approved PMP to report into. The Program expects to receive approval during the upcoming, final, quarter of the fiscal year. FIRM has begun preparing its partners for the reporting information.

GENDER ISSUES AND OTHER DYNAMICS

FIRM works to ensure that entrepreneurs, businesses and individuals have access and choices, not only to credit but also to savings, secure transfer services, etc. To this end, the Program is focused on strengthening the overall financial system at multiple levels so that it becomes more inclusive. FIRM's focus is not strictly on credit and that it alone will transform entrepreneurs, businesses and individuals. Without a developed financial sector, growth and opportunities are seriously constrained since a financial sector will always undershoot its potential if it is unable to commercially serve a majority of the population. Therefore, as part of FIRM's approach, it works to improve the overall system that facilitates products tailored to the low-income market segment that includes, but is not exclusive to, women and the youth. FIRM's approach and partnership with financial/non-financial institutions and the government of Kenya helps some poor people and not others but it offers choices for everyone. Overtime, it will draw unbanked cash into the financial where it hopefully be intermediated and bring down borrowing costs across the board.

ENVIRONMENTAL ISSUES AND ACTIONS

No environmental issues were encountered during the reporting period and therefore no corrective or other actions were taken.

PROBLEMS ENCOUNTERED AND CORRECTIVE ACTIONS

No technical problems were encountered during the reporting period. FIRM will make adjustments to its PMP and workplan as noted in the section, "Upcoming Quarterly Plan and Proposed Deviations" when prompted by USAID Kenya.

EVALUATIONS AND ASSESSMENTS

No evaluations or assessments were performed.

[redacted]