EAGER Policy Brief

NUMBER 41 / JUNE 2000

The Transformation of Microfinance in Kenya

The desire to achieve institutional and financial sustainability through improved governance and increased profitability has resulted in the transformation of one of Africa's most successful microcredit programs into Kenya's first commercial microfinance bank. Despite considerable strategic, operational, and regulatory challenges, there is now the potential to access additional sources of capital, particularly from client savings, thereby reducing dependence on donor funds, expanding market outreach, and recycling client savings to microenterprises rather than channeling them through traditional banks to finance wealthier sectors of the economy. This transformation will also facilitate the provision of additional financial services to low-income populations.

The Kenya Rural Enterprise Programme (K-Rep) was established in 1984 by World Education, Inc., a United States based private voluntary organization, with funding from the United States Agency for International Development. It is now one of the most innovative and successful microfinance schemes in Africa. K-Rep provides financial services to the poor who are typically excluded from the formal financial sector, thereby generating income and employment opportunities for low-income people.

In 1994, K-Rep decided to transform its microenterprise credit program into a commercial bank. Five years later, K-Rep has just completed the process of institutional reorganization and diversification. It has: 1) changed its name from Kenya Rural Enterprise Programme to K-Rep Holdings Limited; 2) split its microenterprise credit operations from its research and advisory services, creating K-Rep Bank Limited; 3) received a banking license in March 1999; and 4) secured share capital in K-Rep Bank.

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Equity And Growth through Economic Research– an activity of USAID, Bureau for Africa, Office of Sustainable Development, Strategic Analysis Division

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Profile of K-Rep Bank

Throughout its history, K-Rep has learned from doing. It began as an intermediary NGO that provided on-lending, training, and technical assistance to local NGOs. Concerns about sustainability and effectiveness of its NGO clients prompted K-Rep to start its own direct lending program in 1990. K-Rep's two direct lending products, Juhudi and Chikola, both started out as hands-off group lending schemes modeled after the Grameen Bank in Bangladesh. Over time, the model was adapted to Kenyan conditions. In 1994, K-Rep ceased all wholesale lending to NGOs due to increasing arrears, and combined the administration of Juhudi and Chikola loans for greater operational efficiency. It adopted a 'minimalist' credit approach,emphasizing financial services.

K-Rep has experienced substantial growth in the 1990s. The number of employees has increased four-fold, from 39 in 1991 to 152 in 1998, and the number of distribution outlets has grown from two area offices in 1991 to five area offices and sixteen field offices throughout Kenya by 1998. K-Rep lending has also grown dramatically over the past eight years, increasing almost eight-fold in the number of loans disbursed annually, and increasing twenty-four fold in the value of loans disbursed annually. K-Rep made 1,507 loans totaling KSh 14.3 million in 1991, which had grown to 11,582 loans totaling KSh 347.1 million disbursed in 1998. With the exception of 1994 and 1995, loan repayment rates have remained high at between 96 and 99 percent.

K-Rep gross income more than quadrupled from 1991 to 1998, increasing from KSh 39.9 million to KSh 180.8 million. Of special note is K-Rep's declining dependence on grant income. In 1993, grants comprised 87 percent of K-Rep's income, but grants had fallen to 32 percent of income by 1998. Most of this grant income has been replaced by income from credit schemes and miscellaneous income (primarily interest on treasury investments and income from consulting services).

Strategic Issues

The creation of K-Rep Bank raises two key strategic issues: 1) How will K-Rep Bank's need to be commercially viable and institutionally self-sustaining affect its current microbanking mission and market niche? 2) What are the potential complementarities and contradictions in the missions of K-Rep Bank and K-Rep Holdings?

Commercialization and Corporatization of K-Rep Bank

The experience of microfinance NGOs elsewhere that try either to attain commercial viability as NGOs or to transform themselves into banks, is that financial pressures compel them to make larger loans than they had made previously. The motivation is clear: the more lent per loan officer, the lower the cost per unit lent. While this has not necessarily led to a deterioration of loan portfolio quality, it has led to a re-examination of the microfinance institution's mission and that institution's current market niche.

Until recently, the trend at K-Rep had been increasing average loan sizes. This trend alarmed K-Rep management, as default rates were higher for the larger loans in K-Rep's portfolio. However, the average K-Rep loan has decreased over the past year and a half due to K-Rep's "back to basics" policy of refocusing attention on lower-income borrowers, both to better achieve K-Rep's mission, and to improve credit risk management.

Potential Complementarities and Contradictions of K-Rep Bank and K-Rep Holdings

An important strategic challenge for K-Rep Bank and K-Rep Holdings is to foster synergies created by their complementary core competencies, while minimizing the effects of different institutional functions. The K-Rep Group Coordination Office should facilitate interactions between K-Rep Holdings and K-Rep Bank.

The most important synergy between K-Rep Bank and K-Rep Holdings is the Bank's integration, or adaptation and commercial replication of K-Rep Holdings' microfinance innovations to enhance K-Rep Bank's outreach and coverage. The challenge will be to make use of banking products and delivery systems developed by K-Rep Holdings, such as the Financial Services Associations (village banks), in a financially viable manner. The area most likely to cause confusion in terms of overlapping and competing functions is the simultaneous delivery of microcredit via both K-Rep Bank and K-Rep Holdings. To avoid such a conflict, K-Rep Holdings and K-Rep Bank are currently working in different geographical areas and targeting different clients. This has had the unintended effect of making it more difficult for K-Rep Bank to benefit from K-Rep Holdings' innovations.

Operational Issues

The creation of K-Rep Bank raises three critical operational issues: 1) How will K-Rep Bank mobilize voluntary savings, and what will be the relationship between voluntary and mandatory savings? 2) How can K-Rep Bank improve the efficiency while maintaining the quality of its lending operations? 3) How can K-Rep Bank ensure sustainability?

Savings Mobilization

The mobilization of voluntary savings in successful microfinance institutions depends on easy access to one's deposits, the perceived safety of these deposits, and a fair return on funds deposited in the microbank. In marketing savings products not tied to borrowing, K-Rep Bank's license and concomitant deposit insurance might satisfy consumer demands for safety, and a market interest rate might meet consumer requirements for a fair return, but there is still the danger that K-Rep's well-known policy of requiring mandatory savings as a condition of borrowing might lead potential savers to doubt the accessibility of their voluntary savings, despite K-Rep Bank's assurances.

Cost-Effectiveness of Credit Operations

K-Rep has developed a successful methodology for delivering credit to entrepreneurs who previously did not have access to formal credit institutions, and ensuring that most of these loans are paid back on time and in full. Over time, K-Rep Bank must increase the amount lent per credit officer, by increasing either value (making larger loans) or volume (making more loans). The key is to achieve economies of scale in a manner that balances the greater credit risk of larger loans with the higher transaction costs of smaller loans. This will entail a re-examination of current credit operations to determine which attributes are intrinsic to K-Rep's success to date, and which characteristics can be modified for increased cost-effectiveness.

Ensuring Sustainability

K-Rep Bank must continue to charge its borrowers enough to cover its costs and generate a profit for its owners to ensure institutional sustainability. In this context, its main concerns will be to see that product pricing still covers lender transaction costs, the cost of loanable funds, and provisions for bad debts, while at the same time trying to keep these costs to a minimum.

Regulation and Supervision Issues

Issuance of K-Rep's banking license raises regulation and supervision issues in three key areas related to CBK (Central Bank of Kenya) oversight of microfinance in Kenya: 1) regulation and supervision of K-Rep; 2) regulation and supervision of other potential microfinance banks; and 3) regulation and supervision of non-bank microfinance institutions. In each of these areas, the concerns are the same regarding the efficient and effective prudential regulation and supervision of microfinance banks in Kenya: 1) Are the CBK's commercial banking statutory requirements and prudential norms and regulations appropriate for microfinance banks? 2) Can the CBK monitor and enforce these provisions in a cost-effective manner for microfinance banks?

Regulation and Supervision of K-Rep Capital Adequacy

At a minimum, microfinance banks should be subject to the same capital adequacy requirements as general commercial banks. The CBK might also consider making these requirements even more stringent for microfinance banks, given the relatively faster and larger impact losses have on a microfinance bank's capital base.

Asset Quality

The CBK should require microfinance loans to be classified by time overdue in keeping with the prevalent repayment period for a microfinance bank's loans, and loan provisioning implemented using a rules-based, non-discretionary system based on historical performance and periodic sampling of arrears, and regardless of collateral pledged. Likewise, write-offs should be automatic according to pre-determined rules.

Management Quality

The CBK should insist on a minimal organizational structure that separates key functions for internal control, such as cashiering and bookkeeping, but not require overly complex organizational structures or top-heavy staffing regimes for microfinance banks. CBK reporting requirements for microfinance banks should cover the same basic categories as those provided by commercial banks, but should be adapted to the products and operations of microfinance banks, especially regarding the use of aggregate rather than nominative data for credit reporting. Loan documentation requirements should also be simplified, given the high volume and small value of individual microfinance loans.

Earnings

The CBK should continue to allow microfinance banks to set their interest rates at levels sufficient to ensure financial viability and long-term sustainability, and then measure profitability as it would for any other bank.

Liquidity

At a minimum, microfinance banks should have the same reserve and liquidity requirements as general commercial banks. The CBK might make these requirements even more stringent for microfinance banks, given their relatively greater exposure to liquidity risk and their more limited access to possible sources of quick liquidity injections. However, higher reserve requirements would increase the cost of doing business for a microbank by reducing the loanable funds portion of its deposit base.

Regulation and Supervision of Other Microfinance Banks

The CBK should examine its licensing standards for the establishment of other microfinance banks in Kenya, particularly in regard to minimum capital requirements. There is no obvious relationship between size and quality in banking, and the CBK should minimize regulatory barriers to entry for small, local microfinance banks. This does not entail compromising standards for safety or soundness, but rather, simply not making size or scale of activity part of the criteria for determining risk.

The CBK should also consider creating positive incentives to conform with its CAMEL** bank soundness requirements by the active dissemination of transparent CAMEL criteria and standards for microfinance banks. It is difficult for a microfinance bank to alter behavior for improved performance if evaluation measurements are unclear.

Regulation and Supervision of Non-Bank Microfinance Institutions

The CBK should not regulate and supervise non-bank microfinance institutions (MFIs). MFIs are not allowed to accept deposits from the public, and protection of these deposits would be the principal reason for central bank oversight. In addition, the task of regulating and supervising the numerous MFIs in Kenya would impose a tremendous financial and administrative burden on the CBK, diverting scarce resources from CBK's primary mission of ensuring the safety and soundness of Kenya's banking system. Finally, without dramatic and substantial modification of current operations, CBK regulation and supervision of MFIs would most likely stifle rather than foster the growth of microfinance in Kenya.

** Accounting framework which documents Capital, Asset Quality, Management, Earnings and Liquidity of an organization.

This policy brief is based on EAGER Research, Microfinance Development in Kenya: Transforming K-Rep's Microenterprise Credit Program into a Commercial Bank, 1999, by Jay K. Rosengard [jrosenga@hiid.harvard.edu] and Ashok S. Rai, [arai@hiid.harvard.edu], Harvard Institute for International Development, Cambridge, Massachusetts, and Aleke Dondo [krep@arcc.or.ke] and Henry O. Oketch [krep@arcc.or.ke], K-Rep, Nairobi, Kenya.

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