KENYA ACCESS TO RURAL FINANCE

RISK-BASED MICROFINANCE SUPERVISION CENTRAL BANK OF KENYA

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EXECUTIVE SUMMARY

- This report provides a review of the early experience with implementing the new legal framework for deposit-taking microfinance institutions (*DTMs*) in Kenya. It is acknowledged that it is still too early for a comprehensive impact assessment, but an opportune time to assess the experience of the first DTM applicants.
- With only two DTMs licensed since the microfinance law has been enacted, some market observers, including the Central Bank of Kenya (*CBK*), have deplored the slow uptake under the new DTM regime. It is, however, questionable whether many of the other MFIs in the market have the potential to transform into deposit-taking MFIs. It remains to be seen whether start-up companies, which constitute the majority of current applicants, can fill this gap.
- Most of the respondents highlighted the positive experience of dealing with CBK supervisory staff during the application process and its good knowledge of how MFIs operate.
- CBK's plan to introduce a risk-based approach in DTM supervision in line with what has already been introduced in commercial bank supervision is commendable. It should, however, be noted that a risk-based approach is more demanding for supervisors than a traditional approach of transaction testing and compliance monitoring.
- As regard the costs and benefits of transforming into a DTM it can be shown that the upgrade of the MIS and the licensing of branches incurred the highest costs with the former being unavoidable for an institution venturing into voluntary deposit-taking from the poor. It is too early to say whether the benefits in terms of improved safety and soundness and better access (in particular to savings services) will outweigh the costs.
- A number of proposed amendments to the Microfinance Act and DTM Regulations have the potential of lowering the regulatory burden without unduly increasing the risks. Among these are the introduction of a tiered branching structure, a simple and risk-based system for the use of agents, the partial relaxation and simplification of provisioning requirements, and the introduction of clear rules for exempting DTMs from the 25% single ownership limit.
- No substantial changes are required with regard to supervisory structure and processes. Some minor changes have the potential to facilitate the licensing process such as clear response times for licence applications, the single online submission of all reports, and the adaption of some reporting formats to the specific characteristics of microfinance.
- The single most important step in the near future will be development of a DTM Supervision Manual including a CAMEL-type rating system that takes into account a variety of quantitative and qualitative performance indicators. If outreach indicators are included as part of the composite rating, it is important to consider potential trade-offs with the safety and soundness indicators.
- An area not yet sufficiently addressed is the harmonisation of asset classification and provisioning rules applicable to commercial banks' microfinance portfolios with those applying to DTMs. Likewise, if minimum outreach benchmarks are introduced for DTMs, something similar should also be applied to commercial banks.
- Moving forward, we propose to apply any future regulatory changes concerning delivery channels used by banks also to DTMs, and to watch out for any unnecessarily restrictive AML/CFT requirements under the new AML law.

GLOSSARY/ LIST OF ACRONYMS

AML/CFT	Anti-money laundering and combating financing of terrorism
BCBS	Basel Committee on Banking Supervision
BSA	Banking Supervision Application
CAMEL(S)	Capital, Asset quality, Management, Earnings, Liquidity, (Sensitivity to market risk)
CBK	Central Bank of Kenya
DTM	Deposit-taking microfinance institution
FSA	Financial Services Authority
KWFT	Kenya Women's Finance Trust
LSF	Loan security fund
MFI	Microfinance institution
MIS	Management information system
SACCO	Savings and credit cooperative
SMEP	Small and Micro Enterprise Program
TOR	Terms of reference

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Core team:

Stefan Staschen (Project Manager)
Ahmed Dermish (Associate)

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INTRODUCTION

It has been more than two years since the Microfinance Act became operational and the DTM Regulations were published and more than one year since the first DTM was licensed. This means that time has come to pause and look back on the early experience with implementing the new legal framework for DTMs and to look ahead to any potential amendments of the legal framework and the best way to streamline the licensing and supervision of DTMs. In a recent blog post, the CBK Governor advocated for a "pragmatic regulatory approach" with regard to money transfer services, which can easily also be applied to the regulation of DTMs:

> Regulators grapple with the balance between promoting financial access and stability. Overregulation can stifle innovation and limit financial access. CBK has therefore adopted a risk-based oversight approach to money transfer services pursuant to its statutory mandate of promoting efficient and effective payment, clearing and settlement systems. […] This is essentially a "test and learn approach."[1]

The CBK is concerned about the slow uptake of the Microfinance Act. The Governor expressed a willingness to look into any bottlenecks of the current legal framework that might keep MFIs from transforming into DTMs or new players to apply for a DTM license, be it the licensing procedure of CBK or be it legal requirements stipulated in the legislation.[2] This study analyses the early experience with regulating and supervising DTMs and points towards potential improvements of the current legal framework and supervisory practice.

Purpose of the Report

The purpose of this report is twofold. First, the experience with licensing two DTMs and having received license applications from another ten institutions provides CBK with a timely opportunity to review the early experience with implementing the Microfinance Act and its subsidiary legislation. While it would be premature to assess the impact of the law on the microfinance sector as a whole, the individual experience of applicants during the licensing process allows for the collection of the provisions in the legal framework most hotly debated and an estimation of the social costs and benefits of these provisions. Second, while the CBK has already adapted some of its supervisory practices to the specific characteristics of DTMs, it is now time to comprehensively review its policies and procedures of supervising DTMs and suggest a way forward of how to bring them in line with the risk-based approach followed in commercial banking supervision. In particular, there is an urgent need to draft a DTM Supervision Manual and train CBK staff how to use it.

Methodology

This study was commissioned by DAI for the Central Bank of Kenya. It was conducted by Bankable Frontier Associates LLC. In line with their *Scope of Work*, the consultants undertook the following tasks:

- They conducted background research on the existing legal framework for DTMs and relevant experience with supervising deposit-taking MFIs in other countries.

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1 See http://tinyurl.com/2vrva94.

2 Nguguna Ndung'u, "Kenya: Giving microfinance sector muscle will spur country towards Vision 2030," *Business Daily* (Nairobi), 23 February 2010.

- They spent a week in Kenya to interview CBK staff, the two DTMs and one of the DTM applicants. They also collected relevant documents on the current supervisory practice of CBK. At the end of the visit, they presented their initial findings to CBK.
- Finally they drafted this report, which is based on the information collected during the interviews and a comprehensive review of relevant material provided by CBK.

The focus of the interviews with DTMs and the DTM applicant was on the specific experience they had with the licensing process under the Microfinance Act, while interviews with CBK helped to understand the current practice of licensing and supervising DTMs. An important benchmark in the analysis is the regulation and supervision of commercial banks, as these can and sometimes do offer microfinance services.

Structure of the Report

This report first briefly describes CBK's current practice of licensing and supervising DTMs. Chapter 3 defines a risk-based approach with reference to international experience and compares this practice with the risk-based approach used in commercial banking. Chapter 4 assesses major costs and benefits in becoming a DTM with a focus on major issues identified by DTMs and DTM applicants in complying with the legal framework. The final two chapters provide recommendations on how to amend the Microfinance Act and DTM Regulations (Chapter 5) and how to develop a risk-based approach in DTM supervision including, among others, a roadmap for the development and implementation of a DTM Supervision Manual (Chapter 6).
Table 1 below shows how this report addresses the issues listed in the consultants' terms of reference. In all chapters, the report draws on international experience with supervising deposit-taking MFIs. A summary of international experience and its relevance for Kenya can be found in Annex B.

Table 1: Terms of Reference Checklist

Issue to be covered	Reference
Compliance with international risk management standards	The standards are introduced in Section 3.1, compliance is discussed in 3.2
Assessment of the impact on financial inclusion	As agreed with CBK during the first meeting, it is still too early to assess this impact. Chapter 4 includes a first rough assessment
Prudent growth of the microfinance sector	Discussion of outreach benchmark in Section 6.1
Recommendations for revising the current regulations and the Microfinance Act	Chapter 5
Reviewing and finalising the DTI Supervision Manual to include a rating system for MFIs and recommendations to the current manual based on changes recommended to the regulations and possibly the Microfinance Act	As the Manual did not yet exist, it was agreed that the consultants provide a roadmap for its development instead: Section 6.2
Staff training and capacity building requirements	Will depend on the Supervision Manual still to be drafted

CURRENT PRACTICE OF LICENSING AND SUPERVISING DTMS

Institutional Structure of DTM Supervision

In May 2008, the Microfinance Act (2006) became operational thereby introducing a new lower tier for regulated deposit-taking institutions specifically targeted at the microfinance market. Even the year before CBK set up a separate division under the Bank Supervision Department dealing with on- and off-site surveillance of DTMs. This division currently has five staff with one more staff member due to join in the near future. It reports to the same Assistant Director as the division in charge of commercial bank surveillance, which helps to ensure consistency in the supervisory approach of DTMs and commercial banks. Considering the still small number of regulated DTMs, the division can be regarded as well staffed. Its main focus to date has been on licensing DTMs rather than supervising licensed institutions. As of now, neither of the two licensed DTMs has been visited by CBK since they received their license.[3] However, ten more institutions have sent in their license application, of which two have been issued a letter of intent (see Section 0 explaining the various stages in the application process).

All staff members in the division have received specialized training on microfinance and each has spent two weeks with one of the MFIs to gain some first-hand experience on microfinance operations.

Licensing Process

This section summarizes the main steps in the licensing process of DTMs. The objective is not to describe each step in detail, but to highlight its main elements and the extent to which it has been tailored to the specific characteristics of microfinance.[4] The most important documents for applicants are the Microfinance Act (No. 19 of 2006) and the Microfinance (Deposit-Taking Microfinance Institutions) Regulations, 2008 (henceforth referred to as *DTM Regulations*). Part II of the Regulations is on Licensing and the First Schedule includes all relevant forms to be submitted by applicants, namely the general license application form, fit and proper tests of directors and substantial shareholders, and a questionnaire on inspection of premises. The application forms have mostly been copied from the Licensing Guidelines for banks. Important differences between banks and DTMs are, among others, the much lower minimum capital (KSh350 million vs. KSh20 million and KSh60 million for community and nation-wide DTMs, respectively) and a slightly higher core capital adequacy ratio of 10% (as opposed to 8% for banks).[5]

In addition, CBK has published a guide with the title "The A-Z of Licensing Deposit-Taking Microfinance Institutions," which explains in more detail the four stages of licensing, viz. approval of name, application of license, letter of intent, and issuance of license. The general approach is that MFIs only have to prepare their premises, choose their senior management, and put in place the MIS once they have been issued a "Letter of Intent" based on the documents submitted with the license application. This letter acts as an interim approval of the application and does not allow the institution to start conducting deposit-taking business. The license will only be issued once the Central Bank is satisfied with the standards of the premises, the MIS and other institutional structures required to operate deposit-taking business and paid its license fee

[3] The first on-site inspection of a regulated DTM is scheduled for September this year (FAULU), probably followed by the inspection of KWFT at the end of 2010.

[4] The analysis is based on the current legal framework and supervisory practice for DTMs. We acknowledged that some of this is currently under revision, but it was only possible to comment on what is currently in place.

[5] The minimum capital requirement for banks will gradually increase to KSh1 billion by the end of 2012.

(Sec. 5 DTM Regulations). Such an approach has the advantage of keeping MFIs from incurring substantial expenses only to be informed later that they will not be able to comply with the licensing conditions.

The DTM Regulations are somewhat less comprehensive than the Prudential Guidelines applying to banks. Some of the issues dealt with in the Banking Guidelines are not yet covered in the DTM Regulations. In particular, DTMs are not yet subject to specific rules on combating money laundering and terrorist financing except for basic know your customer rules (Sec. 37 DTM Regulations),[6] and no separate regulations have been issued on agent banking. As experience from other countries confirms, the fact that deposit-taking MFIs and banks are regulated under two different laws makes it the more challenging to create a level playing field for both types of institutions, which does not mean that regulatory provisions should be identical, but similar rules should apply for similar activities conducted.

The current regulations as they apply to different delivery channels used by banks and DTMs can illustrate this point and will therefore be explained in more detail. An important step in each license application is the preparation of premises according to CBK standards once a letter of intent has been issued. The checklist for opening a place of business for a DTM (Form 4 of the First Schedule, DTM Regulations) is almost identical to that of banks except for a separate section on "Agency Premises Requirements." The use of agents can potentially play an important role in expanding access, as it allows DTMs to lower their cost of distribution by leveraging existing infrastructure (Mas and Siedek 2008). The term of agency lacks clarity as to whether this is a place of business of a DTM or a third party operating as an agent on behalf of the DTM. According to the interpretation section of the Microfinance Act, an agency is one potential form of place of business, which seems to suggest that it is not a third party and is subject to the same approval requirement as any other place of business (Sec. 13 Microfinance Act). In contradiction to this, Section 2 of the DTM Regulations defines an agency as a place of business within third party premises **or** a third party contracted by the DTM to provide deposit-taking microfinance services.[7] It is understood that CBK expects similar standards of security from a DTM using the premises of a third party than it does from a DTM opening a branch. The legal reference for this is Sec. 12 of the DTM Regulations. To date none of the DTMs has received approval for making use of agencies.

Ongoing Supervision of DTMs

Once a DTM has been issued with a license, it starts reporting regularly to CBK. The submission of the following returns is required according to the Fifth to Eleventh Schedule, DTM

[6] However, DTMs will also in the future have to comply with the Proceeds of Crime and Anti-Money Laundering Act, 2009, which was operationalized on 28 June 2010.

[7] Sec. 79 of the Finance Bill (2010) introduces some changes to the Microfinance Act by, for the first time, defining the terms 'agency' and 'branch' and by proposing changes to the term 'place of business'. Agency is defined almost identical to the definition in the DTM Regulations. But even with these changes in place, an agency would still be regarded as a place of business defined as "premises" of a DTM and thus its opening and closure still require prior approval by CBK (Sec 13 (1(b)) Microfinance Act).

Regulations

Table 2: Reporting requirements of DTMs

Return	Frequency
Liquidity Statement	Twice per month
Analysis of Balance due to/from Financial Institutions	Twice per month
Capital to Risk Weighted Assets Return	Monthly
Maturity Analysis	Quarterly
Risk Classification of Assets	Quarterly
Activity and Portfolio Report	Annually
Audited Financial Statements	Annually

In addition to these returns, CBK has a general authority to ask DTMs for other periodic reports (Sec. 36 Microfinance Act). Overall, CBK has defined twenty different returns for DTM's, most of which are similar to the returns used by commercial banks. Some have been adjusted to reflect differences in benchmarks between banks and DTMs (e.g., a stricter core capital adequacy requirement or lower absolute capital requirements; stricter asset classification rules, etc.), while others have been added to take cognizance of the special role of MFIs in increasing outreach (such as a monthly "Activity and Portfolio Report" including information on number and type of customers), and again others had to be changed due to the difference in business activities between banks and DTMs (for example the fact that they do not offer foreign exchange services). All these returns are Excel-based and can be submitted online through the Banking Supervision Application (BSA) used by CBK. Both DTMs are now using the system of online submission via a secure weblink (FAULU since September 2009 and KWFT since April 2010).

However, they still have to enter the information into the forms manually.[8] While the input side has been tailored to microfinance and DTMs now use specific DTM templates for submitting their returns to CBK, on the output side CBK is still in the process of developing a special rating system tailored to DTMs. In the meantime, CBK uses the rating system for banks that follows a simple CAMEL approach with a single quantitative benchmark used for capital adequacy, asset quality, earning, and liquidity, and a qualitative rating of management based on information collected through on-site inspections.[9] Something similar, but not identical, is suggested for DTMs using a ranking in line with the specific risk profile of DTMs and also assessing the DTMs performance on the outreach dimension. One suggestion is to use a CAMEL**O** rating instead of a CAMEL rating (with the O for outreach). We will come back to this in Chapter 6 below.

It can be concluded that the institutional structure for DTM supervision is fully established and the unit in the Bank Supervision Department staffed with a sufficient number of officers conversant with microfinance. The main legal requirements have been defined in the Microfinance Act and DTM Regulations. The "A-Z of Licensing DTMs" provides a detailed guide of the steps required as part of the application process. However, the current legal framework lacks clarity with regard to the use of offices providing fewer services than fully-fledged branches and the use of agents. Therefore the supervisory practice by CBK has so far only partly been adapted to the specific requirements of DTMs.

[8] It is our understanding that CBK provides banks with an interface that directly links into their core banking system and generates the necessary reports for submission to CBK. The same seems not yet to exist for DTMs.

[9] As no on-site inspections have been conducted yet (except for the pre-licensing inspections), CBK currently only uses a CAEL approach.

TOWARD A RISK-BASED APPROACH IN MICROFINANCE SUPERIVSION

It is CBK's declared goal to follow a risk-based approach to microfinance supervision in line with international standards and similar to what has already been introduced in commercial banking supervision. This chapter first reflects upon the international use of the term risk-based supervision and then looks at the risk-based approach as used in commercial banking supervision. The objective is to point out necessary adjustments to the current practice of DTM licensing and supervision.

Definition of Risk-Based Approach

To use a risk-based approach has long been advocated for in financial regulation in general and microfinance regulation in particular.[10] However, the term "risk-based" has at times been used inflationary and without a clear definition of what it stands for. There is no universally accepted definition. Broadly speaking, two aspects of risk-based supervision with reference to the methodology of on-site inspections can be distinguished (Carmichael and Pomerleano 2002: Box 2.1).

- The question of how to supervise: According to this approach, supervisory resources are focused on institutions with the highest risk. The intensity of supervision, i.e. the frequency of inspections and their scope, depends on the specific risk profile of the individual institution.
- The question of what to supervise: Focusing supervision on the risk management process of the financial institution. Instead of comprehensive transaction testing and monitoring of compliance with certain regulatory benchmarks, the supervisor is more interested in the financial institution's risk management process and its ability to "identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile" (BCBS 2006: Principle 7).
- The idea is that risk-based supervision saves regulatory resources and moves from an exercise that mostly looks at past performance of institutions and their compliance with pre-defined benchmarks towards a system that relies more heavily on the institution's risk management capacity once a specific risk materializes in the future. Traditional supervision using transaction testing still plays an important role once significant risks arise, as it is required to quantify the significance of the problem.

An interesting example of a well set-up risk-based examination schedule is the FSA's ARROW framework (FSA 2006a and 2006b). ARROW stands for the Advanced, Risk-Responsive, Operating Frame Work. The intensity of supervision depends on the impact a financial institution has on the FSA's statutory objectives. Three types of examinations can be identified (ARROW Small Firms, ARROW Light, and ARROW). The intensity of supervision depends on the impact of the firm and the probability of any problems arising, which together constitute the risk the institution poses to the achievement of the FSA's statutory objectives.

Basel II follows a risk-based approach in as far as its internal ratings based (IRB) approaches allow banks to make use of their own risk-measurement system. However, it is unlikely that DTMs will have the resources and expertise to implement these demanding approaches if Basel II were to be applied to microfinance (BCBS 2010). Pillar 2 of Basel II – the supervisory review process – provides supervisors with the necessary flexibility to impose higher capital requirements if the overall risk of an institution is judged as being excessive.

[10] See van Greuning et al. (1999) and Fitzgerald and Vogel (2000) as early proponents of a risk-based approach in microfinance regulation.

The move towards risk-based supervision also has important implications for supervisors:

- They must be in a position to understand and assess the risk profile of supervised institutions in order to identify those posing the greatest risk.
- It requires the use of more targeted inspections focusing on areas of greatest risk.
- It requires a higher degree of judgment.

From this it is clear that the implementation of a risk-based approach required specialized training of supervisors and a high familiarity with microfinance operations.

Risk-Based Approach of Supervising Commercial Banks

CBK conducted a survey about risk management practices of banks in 2004 and subsequently adopted risk-based supervision for commercial banks in 2005. In particular, the Central Bank issued comprehensive "Risk Management Guidelines" in August 2005, which prescribe minimum standards for the risk management system of commercial banks and other financial institutions regulated by CBK (this could presumably include DTMs, although they did not exist at the time).[11] The guidelines are not specific to the Kenyan context, as they mostly summarize international best practices in risk management of banks. According to Appendix II of the Guidelines, CBK requires all financial institutions to develop their own comprehensive Risk Management Program. Reportedly, DTMs are also required to present a similar risk management program upon application.

In 2008, CBK drafted a Bank Supervision Manual, which puts a strong emphasis on implementing a risk-based approach to supervision. According to this, the regulatory effort should be focused on high-risk areas as a strategy to increase the efficiency of supervision. The frequency of on-site examinations depends on the risk profile of the respective institution with high-risk banks being subject to more frequent inspections. Thus the supervision of banks is in line with both aspects of a risk-based approach as described above. As this consultancy assignment was focused on DTM supervision, we did not confirm how the risk-based approach in supervising commercial banks is implemented in practice. It is the understanding of the consultants that the DTM Supervision Manual should not be developed by adapting the existing manual for banks, but by developing something unique tailored to the specific characteristics of microfinance.

An important instrument of supervising banks is the CAMEL rating. Quantitative ratings in the areas of capital adequacy, asset quality, earning, and liquidity and a qualitative rating of management are combined into a composite CAMEL rating, with each of the component ratings and also the composite rating ranging from 1 (strong) to 5 (unsatisfactory). The composite rating is based on the mean of the component rating so that a poor performance in one area can be compensated for by a good rating in another area.

[11] According to CBK, these Guidelines are currently being revised. They are not issued with reference to a law and are therefore likely to be simply guidelines without any legal force.

MAJOR COSTS AND BENEFITS OF BECOMING A DTM

It is notoriously difficult to measure the costs and benefits incurred by an MFI to come under central bank regulation. The two licensed DTMs have both transformed from credit-only MFIs. The challenges of transforming are well documented (Ledgerwood and White 2006) and experience shows that the long-term benefit of higher growth rates typically only shows after a couple of years. There is no experience yet with start-up companies being licensed as a DTM. The focus therefore has to be on the experience with the licensing process of transforming institutions. This chapter draws on the main issues being raised during the interviews with DTMs and DTM candidates, while the two subsequent chapters give some recommendations regarding potential amendments of the legal framework (Chapter 5) and the supervisory practice (Chapter 6).

Even though only a limited number of interviews could be conducted during the field visit, a list of "top issues" quickly emerged that is similar for all MFIs. A general perception is that the legal framework for DTMs is leaning towards a "banking-light" approach. In the following, we will provide a list of these issues and discuss them with reference to experience in other countries and their economic justification.

Top on this list are the **high costs of transformation**. The two DTMs claim that they have spent something between KSh400 million and KSh800 million on this (US$5 to 10 million).[12] The two most important cost items are the cost of upgrading their offices to the standards required by CBK of DTM branches, which have been around KSh20 million per branch (US$250,000), and the cost of upgrading the MIS (KSh100 to 300 million). Both these issues will be discussed in turn. In international comparison, the combined costs are extremely high.[13]

It is obviously difficult to say how much the two MFIs would have spent on **upgrading their MIS** in the absence of being regulated. All three MFIs we talked to chose the same software system, which is a technically advanced banking software and thus relatively expensive. One major impact of being regulated is that DTMs have to provide regular and timely reports to CBK, which require daily closure of accounts. However, as liquidity management plays an even more important role for a deposit-taking MFI than for a credit-only MFI, it can be argued that an MIS upgrade was indispensable. Furthermore, these costs will amortize over time and should increase the efficiency of operations and the information available to the management, which both constitute important benefits for the institution.

As regards **costs of branch licensing**, FSD Kenya (2010) reports costs for a bank branch in Kenya to be about US$100,000. The only explanation for even higher costs for DTMs would be that it is more expensive to open branches in remote locations. However, all of the current branches of DTMs are located in urban centers. According to the DTMs, CBK is reluctant to lessen any of the security requirements for branches, which include, among others, safes, strong rooms, CCTV cameras, and guards. Both DTMs had an extensive network of offices even before transformation (KWFT now has 204 "unit offices" and FAULU 93 "marketing offices") and have received branch licenses for only a minority of these (FAULU has 24 branches and KWFT 4). Regardless of whether the stated costs have been inflated or not, it is obvious that lower cost delivery channels will be needed in the future. Mitigating the risk of different channels by focusing on the physical security of premises and the business case for opening a branch at a specific locale seems insufficient, as MFIs have to use low-cost delivery channels in underserved

[12] These are the figures reported during our interviews. FAULU's Annual Report 2009 lists transformation related expenses for 2008 and 2009 amounting to KSh97.3 million and capital cost of KSh207 million for the MIS, which adds up to a lower figure of about KSh300 million.

[13] Staschen (2010) estimates that in Uganda each transforming MFI spent about US$1.8 million in total, which is about KSh140 million.

markets and often venture into unexplored territory, where the business case is difficult to prove ex ante. At the moment, DTMs use their unlicensed offices for everything except taking cash. As mentioned above, none of the DTMs is currently authorized to make use of third-party agents (something at least some of them did before by using the Post Office as a low-cost delivery channel). We will make some suggestions regarding possible amendments of the current legal framework in Chapter 5 below.

One of the most pressing issues seems to be the **maximum of 25% of capital that can be owned by a single owner** (Sec. 19 (2) Microfinance Act).[14] The law provides for a general one-year transition period for complying with its requirements from the date of commencement of the law, which applies to MFIs that were already carrying out deposit-taking microfinance business at that time (Sec. 49). This period ended in May 2009. Interestingly, only those MFIs that qualified for this transition period also qualified for an additional four-year transition period until they have to comply with the 25% ownership limit. CBK has taken a liberal stance on this and allowed all MFIs a four-year transition period *from the day of licensing* that had applied for a license by May 2009.[15] All start-up foundations and also all existing MFIs that had not applied by May 2009 have to comply with the ownership rule on the first day.

All three interviewed MFIs benefitted from this 4-year period and will have to dilute their ownership stake in the future. While one of the DTMs regards the divestiture as being in its own interests,[16] the two others consider it as a serious challenge. Their main concern is losing control over the institution. The argument is that new, more commercially oriented investors would have to be admitted that might lead to a change in the MFI's mission to serve the poor. While this does not necessarily imply financial costs for the MFI, it would lead to social costs if access for the poor would be curtailed. Financial costs can be caused by the search for potential investors and the legal costs of setting up an ownership structure in compliance with the law.[17]

The Microfinance Act includes a provision that would allow the Minister of Finance to exempt individual financial institutions from the 25% rule (Sec. 19 (3b)), but this section has not been invoked. One reason for this is that the Central Bank, which has to make a recommendation to the Minister for such an exemption to be granted, did not regard the arguments in favor of an exemption compelling enough to forward them to the Minister. The law and regulations do not include any guidance on who would qualify for an exemption.

A third issue, besides the high costs of licensing and the ownership restrictions, is **strict performance quality rules** leading to higher provisioning expenses and a deterioration of portfolio quality indicators. Of particular concern is that loans are considered to be past due and fall in the "watch" category after a single day of delay in payments (or after having missed a single installment) triggering a provisioning requirement of 5%. At least one DTM reports that the way account reconciliation is conducted at headquarters does not allow for loan tracking on the same day. As a result, many loans show as being in arrears and clients get frustrated as they do not understand the reason for this. Such *reported* repayment problems can be infectious in a solidarity group approach as they undermine the incentive of other group members to repay. Another problem is that all provisioning requirements are based on number of days payments are overdue *or* on the number of installments missed. This creates a disincentive to offer loans with frequent payments. For example, a loan with weekly payments would be categorized as a loss and written

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[14] This provision does not apply to wholly-owned subsidiaries of a financial institution.

[15] This means that for some of the MFIs the four-year period has not started yet as they applied, but have not been licensed yet.

[16] Not by coincidence, this is also the only transforming MFI which had been a shareholding company even before. Its majority owner is not interested in remaining a shareholder in the DTM.

[17] One of the start-up applicants spent in the range of USD 130,000 on legal costs alone.

off after one month only. Frequent installment payments have been used very successfully by MFIs around the world to instill repayment discipline and should therefore not be discouraged. Other changes mentioned during our interviews, leading to higher costs, and being caused by regulation are the following:

- **Compulsory savings** collected by DTMs (referred to as Loan Security Fund or *LSF*) are treated as any other deposit and therefore increase the liquidity requirement of DTMs. Some MFIs have argued that it is not appropriate to treat LSF as any other demand deposit as compulsory savings only have to be returned once the respective loan has been paid back in full.[18]
- In line with experience from other countries, the **cultural change** from a credit-only NGO to a commercially oriented DTM was a major challenge for all transforming institutions. In particular, the hiring of bankers led to frictions with experienced senior staff and preparations for transformation were a major distraction for key staff from conducting their day-to-day business. Where approval of clients as members of the MFI was necessary, this required serious effort as clients were not easy to convince that a transformation was in their interest. Some respondents argued that compliance with the licensing requirements is easier for start-up companies as they do not have to go through this challenging and lengthy cultural transformation process and can structure their operations around the regulations. It seems that this is something difficult to avoid for transforming NGOs.
- New costs might potentially arise in the future once the recently enacted **Proceeds of Crime and Anti-Money Laundering Act** is fully operational. This law includes comprehensive reporting and record-keeping requirements, which can easily drive up the costs of DTM business. This is a topic beyond the reach of the Microfinance Act, but one that should be watched closely.

These costs are certainly accompanied by benefits of regulation. For example, the strict provisioning requirements can be expected to improve the portfolio quality of DTMs, and the addition of bankers to the staff of DTMs and the upgrading of their MIS (once it has amortized) should have a positive impact on their financial performance. It is still too early to measure these benefits also considering that the impact of the law will be overshadowed by the short-term impact of transformation and licensing. Some early positive observations are that no significant shifts towards individual lending and larger loan sizes can be observed to date and that both DTMs continued to grow in line with the trend of previous years.[19] While both DTMs admit that deposit mobilization takes time, they show impressive growth rates. At the end of 2009, 66% and 43% of the loan portfolio of FAULU and KWFT, respectively, were financed by deposits (the figures for 2008 are 50% and 38%, respectively).[20] DTMs report that their policies and procedures have also improved since they transformed into regulated institutions.

A final observation is that a surprising number of start-up companies have applied for a license with all except one being promoted by private domestic investors (6 out of 12 applicants). While it is good to see that this new legal form is not only attractive for existing microfinance NGOs, it remains to be seen whether applicants are attracted by a genuine desire to promote financial inclusion, or simply by lower minimum capital requirements and the high profitability of the banking sector in Kenya. The Microfinance Act's definition of deposit-taking microfinance

[18] In Uganda, the liquidity requirement for Microfinance Deposit-Taking Institutions (*MDIs*) is calculated net of compulsory savings. However, the loan insurance fund (as it is called there) has to be kept in liquid assets and cannot be used for lending (the equivalent of a 100% liquidity ratio on LSF). As a result of MDIs not being able to make use compulsory savings, most have now shifted to individual lending (Staschen 2010).

[19] The DTMs report a share of group lending of 98% for FAULU and 85% for KWFT, respectively. According to MixMarket data, average loan size for both FAULU and KWFT slightly decreased during the year 2009.

[20] Data from http://www.mixmarket.org.

business is broad enough to allow the provision of other financial services than microfinance such as consumer lending.[21] In theory, regulatory arbitrage in the sense of institutions taking advantage of lower capital requirements should not be of much concern as a capital of KSh60 million for nationwide operations is certainly not enough if an applicant also has to comply with all the other legal requirements for DTMs. However, the gradual increase of the minimum capital for banks to KSh1 billion by the end of 2012 might increase the pressure for smaller players in the banking sector to look for alternatives such as the legal form of a DTM.

PROPOSED AMENDMENTS TO THE MICROFINANCE ACT AND DTI REGULATIONS

The analysis of the early experience with regulating DTMs suggests a number of possible amendments to the Microfinance Act and the DTM Regulations, which have the potential to lower the burden for existing DTMs and new entrants without compromising on the safety and soundness of the sector. It is important to stress that the uptake of the law with twelve applicants (of which two already received a license) and many more business names for DTMs being registered (as the first step in the licensing process) has been impressive. It has been argued that there is room in the market for up to ten DTMs, which might well be the case. However, the bottleneck seems to be the availability of sufficiently mature MFIs as transformation candidates or of promoters of start-up companies experienced enough to serve the microfinance market. An amendment of laws and regulations will only have limited impact unless there is a critical mass of institutions making use of the legal form and increasing access to financial services for the poor.

It appears that CBK is well aware of the main cost-drivers of the legal framework for DTMs and that some of the issues listed above are currently under revision. As we do not want to pre-empt the outcome of these discussions, the following recommendations are based on the legal environment as it applies to date.

In our view, the most promising approach to reduce compliance costs for DTMs would be a **reform of the regulatory framework for DTM branches and agents**. The recent study on the regulation and supervision of bank channels (FSD Kenya 2010) has analyzed in detail the current system as it applies to banks. One of the recommendations of this study is to move from an orthodox approach of individually licensed branches towards a risk-based approach in which banks are pre-authorized to use different channels such as branches, ATMs, and agents based on their risk-management capability. Any reform initiative for DTMs should consider the applicable regime for banks in order to create a level playing field between banks and DTMs. We suggest a two-pronged approach of (i) liberalizing the current branching regime for DTMs and (ii) clarifying the legal framework for using agents.

Countries as diverse as Russia and Indonesia have been successful in **reducing the cost of branching by introducing a tiered structure**. In Russia, fully-fledged branches are heavily regulated (among others, the branch manager has to be approved by the Central Bank), but credit-and-cash offices and operational cash offices allow for more limited services (mostly cash transactions with individuals) and are subject to less stringent regulations. In early 2010, there were 3,200 bank branches in Russia, but 40,700 of these lower tier offices (CGAP 2010). In Indonesia, a commercial bank can conduct its business through branches, sub-branches, cash offices, and functional offices.[22] While the Microfinance Act distinguishes a branch, office, agency, and mobile unit as potential place of business, it does not clearly specify what each of

[21] The loan size limit of 2% of core capital for a single loan and 5% of core capital for the aggregate extended to a single borrower does not restrict DTMs from issuing consumer loans if they bring sufficient capital.

[22] Bank Indonesia Regulation 11/1/PBI/2009, Articles 35 to 40 (http://tinyurl.com/39t4e4b).

these is.[23] Furthermore, the opening of all types of place of business requires prior approval by the Central Bank. One option would be that CBK issues new regulations under the Act clearly specifying the different types of place of business, their permitted activities, and potentially also allowing for the bulk approval of certain channels. Even better would be an amendment of Section 13 of the Microfinance Act to the effect that not each place of business (which even includes agencies) requires authorization but rather that CBK will receive specified details and be notified in advance of branch openings.[24] The guiding principle in a risk-based environment should be the DTM's capacity to manage the unique risk profile of each channel.

Equally important would be that **DTMs are authorized to use agents** (defined as a third party, whom is not an employee of the DTM and operates under a service contract with the DTM).[25] Currently, banks can use DTM offices (and not only the branches) as agents for various banking activities according to the Guidelines on Agent Banking, but the DTMs can only use their licensed branches to handle cash. It will be important that CBK issues similar Agent Banking Regulations under the Microfinance Act. At the moment, the term "agency" is not defined in the law. But if the Finance Bill 2010 becomes law, as expected, on 1st January, 2011, the interpretation section of the law will, for the first time, define the term "agency" and authorize the Central Bank to prescribe the details of approval of agents and the type of business they can offer.[26]

The rationale for a **single ownership limit** of 25% is to ensure a diversified ownership structure with sufficient checks and balances. Such a limit is used in a number of countries around the world. According to an international database on bank regulation, in 2002 66 out of 118 countries did allow for 100% ownership of a bank by a single owner, while the remaining countries had some kind of single ownership limit, albeit often with an exemption clause authorizing the regulator to allow larger ownership stakes under specific conditions (Barth et al. 2006). The current regime, as described in the previous chapter, puts start-up companies and transforming MFIs that did not apply for a license before May 2009 at an unfair disadvantage as they have to comply with the 25% rule from the first day of operations. One suggestion is to extend the one-year transition period for existing MFIs. The Minister had the authority to do so by notice (Sec. 49 (1)). However, as the one-year period has already lapsed more than a year ago, it is doubtful whether it would be possible to do this retrospectively.

Instead, we would like to propose to go back to the main rationale for ownership limits and to consider how this could be achieved while at the same time introducing some more flexibility. A valid concern is that a single owner could decide about the fate of a DTM. This is even more of a problem if this single owner is an NGO, which is controlled by a board without any personal money at stake (and often also without the ability to add capital easily in times of crisis).[27] While we sympathize with the DTMs' concern that new shareholders can create a risk of mission drift if they are purely commercially oriented, there is no shortage any longer of double bottom line investors such as Microfinance Investment Vehicles. The Microfinance Act includes a provision

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[23] The Finance Bill 2010, once passed, will change the definition of "place of business" in the Microfinance Act, by also allowing for sub-branches, satellite branches, outlets, marketing offices, and such other premises as approved by CBK in addition to the current list, and by authorizing CBK to make regulations prescribing the manner in which a place of business is approved. The Act itself, however, would still not define any of these term accept for "agency" and "branch".

[24] Compare Recommendation 5 in Sec. 6.2, FSD Kenya (2010), which proposes the same for the Banking Act.

[25] Compare the discussion about the thin line distinguishing branches and agents in FSD Kenya (2010: Sec. 4.1).

[26] Confusingly, the new definition of "agency" has two meanings with (a) a DTM's place of business operated within third party premises and (b) a third party contracted by a DTM to provide deposit-taking business. It would be better to restrict the use of the term "agency" to the second meaning (as it is also the case for commercial banks) and regard (a) not as an agency, but as one form of place of business in a tiered structure.

[27] This is a common problem when an NGO transforms into a regulated MFI.

authorizing the Minister, on recommendation of the Central Bank, to exempt DTMs from the 25% rule. An amendment of this section could increase the likelihood that it will be used in the future.

In particular:

- The authority to exempt DTMs could be shifted to the Central Bank as it is the authority in charge of prudential regulation and best positioned to decide about it
- Instead of an outright exemption that allows for 100% shareholding, one could only increase the limit to a higher percentage such as 49% under certain conditions (which would rule out majority shareholding)
- Conditions for an exemption could be clearly specified with a view to having a diversity of ultimate beneficiaries of the DTM, which does not necessarily mean to have many different shareholders. For example, a legal person with a diverse shareholding structure might qualify to hold a larger stake as could a microfinance investment vehicle.
- Similar to the transition period in Sec. 19 (2), a relaxation of the shareholding limit could be time-bound with a clear time schedule for divestiture.

Some transforming MFIs have argued that an increase of the general limit to 33% would already help as it guaranteed that the interests of the founder and promoter of the institution would be heard. Considering that banks are subject to the same 25% rule, the above-suggested increase of the limit on a case-by-case basis seems to be more appropriate.

The arguments by practitioners that **asset classification requirements** are unnecessarily strict seem to be justified. There are obvious challenges for some of the MFIs to undertake daily account reconciliation, and it is at least not obvious that an extension of the "normal" category to loans with payments overdue for, let's say, 5 or 7 days would lead to a noticeable change in repayment discipline. Empirical evidence from Uganda shows that strict provisioning requirements can be one of the reasons why regulated MFIs have issued increasingly large loans creating the risk of mission drift (Staschen 2010). As regards the classification of provisioning requirements, using the number of missed installments as one of the criteria creates an unwanted incentive to reduce the frequency of payments. The repayment risk increases with the number of days since either interest or principal payments were not made in full. The fact that another payment was missed in the meantime does not necessarily increase the risk of non-payment. We would therefore argue for deleting the reference to the number of installments missed and basing the classification purely on the number of days payments have been overdue.[28] Both these changes would affect the DTM Regulations only and could thus be implemented by CBK (with approval of the Minister of Finance).

An issue of an unlevel playing field arises as banks that also provide microfinance services (depending on how one defines microfinance, some of the banks like Equity Bank, Family Bank, K-Rep Bank are heavily involved in microfinance) are not subject to the stricter provisioning requirements for DTMs. To solve this issue, CBK could revise the Guideline on Risk Classification of Assets and Provisioning under the Banking Act by defining what constitutes microfinance (this could be in terms of loan size) and apply the same, stricter asset classification and provisioning requirements to this part of the loan portfolio of commercial banks. This is exactly what Bank of Uganda did.[29]

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[28] An alternative could be to use the overall maturity of the loan as another criterion by, for example, using two different classification regimes depending on whether this is above or below three months. See also a recent article by Sanjay Sinha, who argues for a variable classification depending on the loan term (see "How to calm the charging bull – An agenda for CGAP in the decade of the 'teenies', http://tinyurl.com/38wn8xx).

[29] Sec. 12 (2) of the Ugandan Financial Institutions (Credit Classification and Provisioning) Regulations, 2005, reads: For micro finance loans, which shall be properly segregated and identified in the books of the financial

As regards the treatment of **compulsory savings**, it is common practice in microfinance to stipulate a reserve ratio that measures the ratio of liquid assets to total deposit liabilities. Netting off the compulsory savings depending on the maturity of the loans would require quite a sophisticated loan tracking system for purposes of liquidity management. Considering that it is also common practice to stipulate a liquidity ratio of liquid assets to total assets of 15% to 20%, it is unlikely that the reserve ratio is binding and it also does not seem to be particularly high. We would therefore recommend leaving the reserve ratio as it is and consider including a liquidity ratio.

An issue that CBK is well aware of, but that should be mentioned for reasons of completeness, concerns the current set up of credit reporting in Kenya. Firstly, only a small part of the microfinance market is covered as only DTMs have access to the DTM database, but not any of the unregulated credit-only institutions.[30] Secondly, three different databases for banks, DTMs, and SACCOs are currently being set up, which are not linked to each other. This segregation of the market certainly reduces the effectiveness of the credit information system. All three laws – the Banking Act, the Microfinance Act, and the SACCO Societies Act – would have to be changed to allow for linking the databases and sharing data across the entire microfinance sector. Finally, the Risk Management Guidelines are currently very much focused on commercial banking. One option would be to issue separate guidelines for DTMs that reflect the specific risk profile of DTMs. CBK could also, with the approval of the Minister of Finance, issue specific Risk Management Regulations under its broad authority of Sec. 48 (1) of the Microfinance Act. The one issue where CBK probably cannot offer any relieve to DTM applicants is the high costs of upgrading the MIS. This requirement is driven by the need to provide timely and accurate information on all operations of the DTM. It is therefore not only in the interest of the regulator, but also of the DTM itself.

institution, the credit classification and provisioning requirements issued under the Micro Finance Deposit-Taking Institutions Act, 2003, shall apply." Unfortunately, the regulations do not define "micro finance loans," which provides banks with an incentive to use a narrow definition.

[30] The latter are permitted to report to the Credit Reference Bureau, but would not be able to enquire about the credit history of borrowers.

Table 3: Suggested amendments to the Microfinance Act and DTM Regulations

Suggested Change	Legal Reference
Introduce a tiered branching structure with a notification regime instead of an approval regime	Sec. 79 of the Finance Bill 2010, once enacted, will introduce different tiers of places of business (branch, sub-branch, satellite branch, agency, outlet, mobile unit, marketing offices, and others). All these terms except branch and agency are not defined in the law, but could be specified in subsidiary legislation issued by CBK
Clarify definition of "agency" in the Microfinance Act	Change the definition of "agency" in Sec. 2 of the Microfinance Act (as suggested by Sec. 79 of the Finance Bill) to bring it in line with the same definition in Sec. 2 of the Banking Act
Authorise DTMs to use agents	Issue Regulations on Agency Banking under Section 48 (1) of the Microfinance Act that are identical to the Guidelines on Agency Banking issued under the Banking Act.
Shift the authority to exempt DTMs from the 25% ownership limit to the Central Bank and include the option to specify a limit higher than 25% (but lower than an outright exemption)	Amend Sec. 19 (3b) of the Microfinance Act
Clarify the conditions for an exemption from the single ownership limit of 25%	CBK, with approval by the Minister of Finance, to issue regulations under the general authority provided by Sec. 48 (1) clearly specifying the conditions for an exemption under Sec. 19 (3b) of the Microfinance Act
Change the definition of the "watch" category of the asset classification rules and delete the reference to the number of instalments missed in the classification rules	Tenth Schedule to the DTM Regulations
Apply the same stricter provisioning requirements for DTMs to the microfinance portfolios of commercial banks	Amend the Guideline on Risk Classification of Assets and Provisioning (CBK/PG/04) issued by CBK under the Banking Act to include a definition of microloan and either refer to the asset classification requirements for DTMs or repeat them in the Guideline
Include a liquidity ratio of 15 to 20% defined as liquid assets / total assets as a regulatory benchmark	Amend Sec. 23 of the DTM Regulations to include this statutory minimum (with reference to Sec. 12 (1) of the Microfinance Act)
Allow for the provision of credit reference services across MFIs (credit-only and DTMs), SACCOs and banks	Amend the credit reference provisions of the Microfinance Act, SACCO Societies Act, and Banking Act in order to allow for sharing of information

ROADMAP TO DEVELOP A RISK-BASED APPROACH TO DTM SUPERVISION

This last chapter proposes a roadmap for how to further develop the current supervisory regime for DTMs in line with a risk-based approach. We first look at some potential operational changes mostly based on feedback we received from the MFIs regarding their experience of interacting with CBK. We then propose a roadmap for the specific task of developing a DTM Supervision Manual.

Operational Changes in DTM supervision

Table 4 below summarizes the main suggested changes to the current supervisory practice with reference to issues raised during our interviews. The predominant response we received from talking to DTMs and DTM applicants was that the Central Bank has a good understanding of their operations, is sympathetic to the particular challenges of transforming a mostly mission-driven institution towards a regulated, deposit-taking institution concerned about the double bottom line of sustainability and outreach, is responsive, and listens. There were only few complaints on how CBK licenses and supervises DTMs, most of which were related to the challenges and costs of complying with specific regulatory requirements (see the preceding chapter).

The following is a list of issues that has been raised by respondents:

- There are some indications that the application process could be streamlined. The "A-Z of Licensing a DTM" has been very useful in guiding the applicants. However, at times applicants had to go through several rounds of providing additional information to CBK or some of the required documents had changed without them being aware. Some of the applicants were also not aware of all the requirements they had to comply with or of what it means to become a DTM. We were not able to verify whether this is something CBK is to be blamed for or whether the applicants simply did not make sufficient use of available information. In either case, CBK could try to communicate even better what a DTM is and what the requirements are. In order to reduce the number of "loops" in the application process, upon receipt of an application CBK could clearly state which documents are missing and only start processing the application once it has received it in full.
- In one case an applicant complained of CBK delaying the application process by taking a long time to respond. CBK introduced a "Citizen Service Delivery Charter" in 2008 (CBK 2008) according to which it has 30 days to process applications once received in full and 7 days to issue the license. It appears that not all applicants are aware of this charter (which is also not easy to find on CBK's website). Considering the complexity of the licensing process, these time periods are very short and it is doubtful that CBK is able to comply with them in all cases.[31] We would suggest to extend these periods to more realistic timeframes (e.g., three months for processing once the application has been received in full) and to communicate them better to applicants, e.g., by including them in the "A-Z of Licensing a DTM."
- In theory, a single submission of all DTM reports through the BSA web interface should be sufficient if all officers within CBK that deal with DTMs have access to the BSA. We realize that the two DTMs have only recently started to submit their reports online. Once the system is running smoothly, there should not be cases any longer where they are approached by different officers within CBK and have submit the same report more than once.
- According to our information, both FAULU and KWFT have not integrated the BSA templates with their core banking system (as it is the case for commercial banks). It would be

[31] In Uganda, for example, the MDI Act gives the Central Bank six months to respond to a license application.

good to assist them with doing so in the future by providing DTM with a plug-in that can generate these reports, as this reduces the risk of false data entries.

An analysis of the returns DTMs have to submit to CBK shows that most of them have already been adapted to the specific characteristics of microfinance, while a few still too much reflect what is asked from commercial banks (CBK used the bank returns as a starting point for developing the DTM returns). CBK puts a stronger emphasis on monitoring outreach as can be seen from its monthly Activity and Portfolio Report (Eleventh Schedule, DTM Regulations). Interestingly, DTMs also have to complete a monthly return on "Deposit and Lending Interest Rates," which is not explicitly mentioned in the law or its regulations. This could be relevant information for purposes of market transparency.[32]

The two forms that need some revisions to render them more useful for microfinance are the returns on "Risk Classification of Assets and Provisioning" and "Sectoral Distribution of Loans and Advances." Microloans typically finance working capital or even flow into consumption. The MFI's lending decision is not based on an analysis of a specific investment project, but on the cash flow of the household. Even if it were possible for DTMs to enquire about the use of the funds, there would be no way for them to confirm whether the money has not been used for anything else. Therefore, we suggest not using the form on sectoral distribution any longer or, if CBK decides to keep it, to use much broader categories such as trade, agriculture, education, household expenses, etc. The guiding question should be what the information will be used for. The same applies for the sectoral breakdown of the risk classification return. In addition, microloans make use of unconventional collateral. It is not clear why the risk classification and provisioning return asks for the type of security held if this does not affect the provisioning requirements (which would be difficult to implement).[33]

CBK is currently working on an amendment of the CAMEL rating used for banking supervision that considers the specific risk profile of DTMs and their unique role in improving access. While the rating is part of the Supervision Manual still to be developed, an important discussion will be about the role of outreach in a suggested CAMELO approach, as outreach is of a different quality than the other benchmarks that are mostly concerned with the financial performance of DTMs. CBK does not have a statutory role in increasing outreach as the Microfinance Act and DTM Regulations do not explicitly state any regulatory provisions measuring DTMs achievements regarding improved access to financial services. However, the economic development plan of the Government of Kenya (Vision 2030) assigns access to finance an important role. The First Medium Term Plan (2008-2012) under the Vision 2030 identifies as one of three pillars the Economic Pillar and Financial Services as one of six elements under this pillar. The increase of financial access through the formalization of microfinance is explicitly stated as one of the flagship projects in this sector.

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[32] In 2007 and 2008, CBK published four CBK Surveys on Bank Charges and Lending Rates (available from http://www.fsdkenya.org/publications/index.html), which drew on exactly this kind of information provided by banks. Unfortunately, this initiative has since been discontinued.

[33] For example, Uganda's Micro Finance Deposit-Taking Institutions (Asset Quality) Regulations (2004) do not ask for a breakdown of the loan portfolio by sector or a reference to the security held (see http://www.bou.or.ug/bouwebsite/export/sites/default/bou/bou-downloads/acts/supervision_acts_regulations/MDIRegulatns/MDIRegulatns2004.pdf, p. 411-2).

If CBK decides to include outreach as one of the parameters of the rating, it is important to consider its special characteristics:

- While poor ratings in any of the other areas of a CAMELO rating trigger corrective actions and sometimes also sanctions by the Central Bank, the same would be difficult to impose on a DTM that does not sufficiently increase outreach.
- High growth rates can be a high-risk strategy, thus it is important to consider trade-offs between outreach and financial performance indicators. It can be a sound business decision of a DTM to curtail growth in order to improve its safety and soundness.
- The choice of the right quantitative benchmark(s) will be crucial. Looking at growth in absolute numbers of clients provides as an advantage for larger DTMs, while looking at growth rates is likely to lead to better ratings of small DTMs. Average loan size has serious shortcomings as an indicator for depth of outreach (Armendáriz and Szafarz 2009).
- The role of increasing outreach is best not confined to DTMs, but equally important for commercial banks. If outreach is added as a new element to the CAMEL rating of DTMs, the same could be done with the CAMEL rating for commercial banks.

The rating could draw on a wider range of quantitative and qualitative indicators, whether it is a CAMEL rating or a CAMELS rating (the latter also considering Sensitivity to Market Risk as a sixth component). ACCION's CAMEL, for example, includes quantitative and qualitative indicators for each of the five elements (except for Management, which only uses qualitative indicators).[34] Table 4 below provides the list of suggested changes.

Table 4: Suggested Changes to Supervisory Practices

Current Practice	Suggested Changes
CBK often receives incomplete applications and has to go back to applicants and ask for additional information. Applicants are not fully aware of all licensing requirements and the response time of CBK for each step	Better communicate the list of licensing requirements and what it means to become a DTM. Only process applications once complete. Set realistic timelines for each step in the application process and include this information in the "A-Z of Licensing a DTM"
At times, DTMs had to send reports more than once and to different people within CBK	Provide all people within CBK with access to the BSA and communicate to them that they should not approach DTMs individually
The "Risk Classification of Assets and Provisioning" and "Sectoral Distribution of Loans and Advances" forms require DTMs to provide a detailed breakdown of loans by sectoral distribution	Stop using the sectoral distribution or restrict the number of sectors by using much broader categories that can realistically be tracked by DTMs

[34] ACCION has not published its methodology except for an early technical note from 1998 (Saltzman and Salinger 1998).

CAMEL rating with one single quantitative rating for CAEL and a qualitative rating for management. CAMELO rating suggested for the future.	Use several quantitative (except for management) and qualitative indicators for each component rating. If outreach is included, take into account potential trade-offs between growth and safety and soundness. Choose meaningful indicators for outreach.

The most important step in introducing risk-based supervision of DTMs, however, will be to develop a DTM Supervision Manual including an appropriate rating scheme and supervisory training/capacity building. Producing and implementing such a manual takes considerable time and resources. It was therefore agreed with CBK that this assignment would provide a roadmap for producing a manual in terms of its outline and contents, possible training and capacity issues, and timelines. The following section will provide such a roadmap.

Roadmap for the development and implementation of DTM Supervision Manual

CBK has started drafting an "Operational Manual for Deposit Taking Microfinance Institutions" that includes forms detailing the examination procedures for DTMs in the following areas: strategic risk, corporate governance risk, credit risk, operational risk, liquidity risk, interest rate risk, and foreign exchange risk. We think that this work provides a good basis for developing the supervision manual, which would, however, benefit from input of experts of supervisory procedures with a strong background in microfinance and information technologies that can be used to assist examiners. It is our belief that the drafting of the Supervision Manual itself constitutes only a minor part of the overall work to be done.

A Supervision Manual is typically broken down in an Off-Site Reporting and Analysis Manual and an Examinations Manual with the former providing the basis for defining the scope of examinations in a risk-based environment. The off-site analysis procedures are mostly determined by the specific reporting requirements according to the Microfinance Act and DTM Regulations. The on-site examination part of the manual will provide detailed guidance on the review of a DTM's operations and performance. It should reference the main risk areas of DTM operations (as listed in the draft Operational Manual). In a risk-based environment, the scope of the examination should be based on the specific risk profile of the institution. One possible way of implementation is to conduct pre-examination visits mostly targeted at identifying main risk areas by reviewing the DTM's policies and procedures and its governance structure and a clearly specified data extraction from the DTM's database. Based on this, previous inspection reports, and data collected through off-site surveillance, a scope memorandum can determine the scope and frequency of the examination including the suggested sampling procedure and the level of transaction testing.

The terms of reference (*TOR*) for the consultancy should clearly define the CBK's approach towards risk-based supervision and the main structure of the Manual as indicated above.
The following is a suggested list of the main steps needed to develop and implement a DTM Supervision Manual:

- In a first step, the consultants draft a detailed work plan, which is based on an analysis of the legal environment governing DTMs and existing policies and procedures in DTM supervision (including pre-licensing examination reports) and discussions with CBK staff. To ensure a level playing field between DTMs and commercial banks conducting microfinance and a uniform approach across all regulated financial institutions, the consultants also have to

review the current practice of supervising commercial banks. This work plan has to be mutually agreed between the consultants and the CBK.

- In other countries it has proved useful to have the consultants join an on-site examination at an early stage so that they familiarize themselves with the local environment. They could even test some of their envisaged procedures in the field at this early stage. The result will be a first report to be discussed with CBK.
- The third step is the actual drafting of the Supervision Manual broken down in an Off-site Reporting and Analysis Manual and Examinations Manual, as discussed above. Part of this would be a CAMELS rating (or similar rating) as a broad measure of general performance of the DTM. The consultants should also advise on the appropriate use of computer-assisted examination techniques to increase the efficiency of inspections. These techniques – which could make use of basic spreadsheet and database management software such as Excel and Access – can be used both for data analysis and reporting purposes. At this stage, a second report will be sent to CBK's management for soliciting comments on the proposed Manual.
- As a fourth step, the DTM Supervision Manual will be pilot-tested at one or (better) two DTMs. This will also provide the consultants with an opportunity for on-the job training of examiners and incorporating any adjustments to the policies and procedures, if needed. As part of this final step, examiners at the CBK will also receive comprehensive classroom training on risk-based supervision of DTMs covering, among others, the risk-based approach as used by CBK, the main risk-categories of DTMs and how they can be assessed.

Preferably, the consultancy services will be offered by one firm that can provide the full range of expertise and skills. The core skills required are in microfinance supervision, which could either be provided by someone who has worked as a bank examiner, but also a solid understanding of the specific characteristics of microfinance, or by a microfinance expert, who has closely worked with supervisory authorities. Also needed is an IT-specialist who has experience with computer-assisted examination techniques and methods of data extraction from the software system used by DTMs. The classroom training in step four requires an experienced trainer on risk-based supervision techniques in microfinance.[35]

The overall length of the assignment could be anything between three and five person months depending on how much use will be made from previous policies and procedures in DTM supervision and how much on-the-job and classroom training will be required.[36]

[35] BFA would be happy to assist CBK with a list of potential consultants/consultancy firms with the required skill set.

[36] As one example, in Uganda a team of two consultants worked on this for 5.5 person months (4.5 for the supervision expert an 1 person month for the IT specialist). A different consulting firm conducted the four-day classroom training with two trainers working on this for 10 days each.

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ANNEX A: PEOPLE MET

Institution	Name	Title
Central Bank of Kenya	Matu Mugo	Assistant Director, Banking Supervision
Central Bank of Kenya	Peter Gikang'a	(Senior?) Manager, Banking Supervision
Central Bank of Kenya	Luke	Banking Supervision
Central Bank of Kenya	Evelyne Kilonzo	Banking Supervision
FAULU DTM	Anne Kimani	Head of Finance
FAULU DTM	Pauline Githugu	Company Secretary
KWFT DTM	Mwangi Githaiga	Managing Director
KWFT DTM	Gichimu Waweru	General Manager - Marketing
KWFT DTM	Peninah Mwangi	Operations Manager
SMEP	Phyllis Mbungu	Chief Executive Officer
SMEP	Symon Kamore Mwangi	Head of Finance
SMEP	Simon Wanjohi Karimi	Head of Operations
SMEP	Joseph Sukure Sukumerr	Head of ICT
SMEP	Simon Gathecah	Head of Internal Audit

ANNEX B: INTERNATIONAL COMPARISON TABLE

This table summarizes some of the relevant international experience with supervising deposit-taking MFIs and its relevance for Kenya.

	International Experience	Lessons for Kenya
Harmonizing microfinance law and banking law	Relevant subsidiary legislation has to be issued under both laws to create a level playing field Asset quality regulations for microfinance portfolios should be the same regardless of the type of institution offering the service	Agent banking guidelines still have to be issued under the Microfinance Act The Guideline on Risk Classification of Assets and Provisioning (CBK/PG/04) could be amended to impose the same asset classification and provisioning rules on microfinance portfolios of commercial banks
Using a tiered structure of branches and offices	Russia and Indonesia are two examples for countries having introduced a tiered structure ranging from fully-fledged and heavily regulated branches to offices offering a more limited range of services, but being less heavily regulated	Consider establishing such a tiered structure (as will be easier once the Finance Bill 2010 has become law) not only under the Banking Act, but also for DTMs
Use of agents as low-cost delivery channels	In a number of countries (Brazil being the best known example), the introduction of agency banking has led to a significant increase in access	Allow the use of agents in the same way as banks can use them
Introducing a risk-based approach in supervision	Requires the operationalization of the term "risk-based" and specialised training of supervisors	Clearly define the term "risk-based approach," draft the DTM Supervision Manual accordingly, and train CBD staff on implementing the approach
Transformation takes time to lead to higher growth rates and improved performance	Transformation from a credit-only MFI into a deposit-taking MFI is a demanding process of cultural and operational change, which often only bears fruits after a couple of years	Do not expect quick results in terms of improved performance and high growth rates. Kenya two DTMs compare favourably to Uganda's MDIs just after transformation.

Transformation costs	Upgrading of MIS and MFI's premises to standards required by regulator constitute highest expense items. The former is often indispensable for deposit-taking MFIs, while the latter can be substantially lowered through the introduction of alternative delivery channels	It is not recommendable to compromise on the quality of the MIS, but alternative delivery channels have a high potential for reducing transformation costs
Diversified ownership structure	Most countries that use some kind of ownership limit also allow for exemption of individual institutions under certain conditions and with approval by the regulator (Barth et al. 2006)	Consider making use of the existing exemption clause, but under specified conditions
Portfolio quality	Strict portfolio quality requirements have been identified as one of the potential reasons for MFIs issuing larger loans with a potential risk of mission drift (Staschen 2010). Most other countries allow for at least a few days of overdue payments before assigning loans to the "watch" category	Consider relaxing the definition of the "watch" category
Treatment of compulsory savings	Uganda is the exception with regard to the treatment of compulsory savings, which have to be kept in liquid assets. This is something that led to strong opposition by the practitioners. Otherwise compulsory savings by regulated institutions are typically treated as any other deposits and subject to the same reserve ratio as these	Regard compulsory savings as any other deposit with regard to the treatment under the reserve ratio