KENYA ACCESS TO RURAL FINANCE

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INTRODUCTION

The first quarterly report of the new project, Kenya Access to Rural Finance, covers the period October 1, 2007 through March 31, 2008. Impact from post-election violence contributed to the consolidation of the first and second quarterly reports. Activities undertaken in both periods are covered in this single quarterly report.

During the period from October 2007 through January 2008, DAI managed two financial service projects funded by USAID Kenya: the Kenya Microfinance Capacity Building Program (KEMCAP) and Kenya Access to Rural Finance (KARF). KEMCAP was in the process of winding down its activities, including a major technical assistance project with the Central Bank of Kenya. KARF had just commenced project start-up, initiated the process of transferring operations from KEMCAP while identifying and launching a new series of activities geared to rural finance. Following the parliamentary and presidential elections held in December 2007 and the violence that followed, Kenya entered a state of paralysis, forcing KARF to briefly suspend implementation until the country regained normalcy.

During the ensuing post-election phase of uncertainty and chaos unravelling nationwide, it became immediately apparent that banks, MFIs and SACCOs working in the microfinance sector were significantly impacted by the hostilities. In many places throughout Kenya, providers of financial services were forced to close and suspend operations. Their physical locations were under threat of destruction and, more importantly, the lives of their employees were at risk. Likewise, clientele (consumers) of their products and services were unable to carryon operations – many businesses were destroyed with owners forced to flee for their lives or relocate. Under these conditions, KARF shifted into crisis mode with other industry actors to support the immediate rehabilitation of the industry. Support to the microfinance industry will continue throughout the life-of-project since many revitalization activities were designed and partially implemented.

Toward the end of March, KARF began slowly working with potential partners in the rural finance sector. Shifting the project focus during the first six month of operations should not materially impact ultimate success or the attainment of deliverables outlined in the contractual agreement with USAID Kenya.

Implementation Chronology

October 2007

- KARF implementation formally begins and running concurrent with Kenya Microfinance Capacity Building Program (also implemented by DAI); both are administered by the same project management team.
- KARF holds project kick-off workshop with KEMCAP and other potential partners to begin integrating them into KARF project design and implementation.

November 2007

- KARF attends the 3rd Annual BDS conference in Mombasa.
- KARF signs a Memo of Understanding and Confidentiality Agreement with Ideal Matunda to support their work in avocado production and marketing with smallholder farmers.

December 2007

- Ideal Matunda produces a lessons learned paper based on the multi-year KBDS experience.
- KARF supports AMFI in its delivery of a three-day workshop on the SEEP Frame Tool.
- Kenyan presidential and parliamentary elections held.

January 2008

- Post-election erupts, causing widespread implementation confusion and uncertainty. The microfinance industry and their clientele are deeply affected.
- KARF, AMFI, and FSD convene an emergency meeting on how to support the troubled microfinance industry.
- KARF, AMFI and FSD prepare a literature review on *Microfinance Disaster Responses* to help guide the industry.
- AMFI, assisted by KARF, holds extraordinary board meeting on the crisis and documents its discussions.
- AMFI, assisted by KARF, convenes the First Industry Forum on the Impact of Post Election Violence on Microfinance Providers and Potential Responses.
- AMFI, assisted by KARF, drafts a paper summarizing the findings and a way forward from the Industry Forum.
- KEMCAP ends.

February 2007

- AMFI, assisted by KARF, holds the Second Industry Forum on the Impact of Post Election Violence on Microfinance Providers and Potential Responses, vetting the draft paper for discussion and adoption.
- KARF, AMFI and FSD design a three-pronged solution to the crisis facing the microfinance industry: (1) a $10 mm liquidity fund backed by the Development Credit Authority; (2) a technical assistance fund to support struggling MFIs meet the demands of the radically altered lending environment; and (3), a conflict prevention and mitigation response activity to support peace building and social reconstruction.
- The Office of Development Credit conducts its first post conflict on-site assessment, assisting KARF and the MFI industry to structure a rescue facility backed a potential $10 DCA facility.

March 2008

- The Office of Development Credit conducts its second on-site risk assessment. ODC undertakes a due diligence risk assessment of Equity Bank and Oiko Credit. Both are potential partners of the MFI rescue facility. The ODC examiner reviews two other potential transactions. One is a micro health insurance product with Faulu. The other supports debt/equity investments by a MFI wholesaler with Jitigemee Trust. (The assessment continues in April).
- KARF, AMFI and FSD finalize a three-pronged solution to the crisis facing the microfinance industry: (1) a $10 mm liquidity fund backed by the Development Credit Authority; (2) a technical assistance fund to support struggling MFIs meet the demands of the radically altered lending environment; and (3), a conflict prevention and mitigation response activity to support peace building and social reconstruction.

POST-ELECTION VIOLENCE REPONSE

The disputed elections in Kenya on December 27th 2007 were the prelude to significant violence between Kenyan communities that resulted in significant loss of life, burning and looting of businesses and internal displacement. By March 2008, sporadic violence continued at a lower intensity but at a sufficient level to make a return to normal operations in many places, very difficult, if not impossible.

The financial and psychological impact on the post electoral crisis in Kenya has been considerable. Though the financial impact has moderated as better information became known, nevertheless, the impact remained considerable and therefore required an institutional response from AMFI, the FSD Trust, USAID and other stakeholders.

Considering an appropriate way forward is difficult for a number of reasons. The NGO heritage of the Kenyan microfinance industry predisposes many MFIs to anticipate direct donor funding to manage the impact of the crisis. Given the impact on the sector and in particular institutions, a case for donor support was developed wand widely presented.

The impact of the crisis on the industry could potentially run into millions of dollars which makes a grant-based approach challenging. Furthermore, the donor industry has evolved from providing grants to individual institutions to facilitating market development and creating legal and regulatory enabling conditions. Moving background to previous conditions of direct donations and then making an adjustment to providing grants would be a retrogressive step, even if *arguably* in some cases a necessary one – a veritable clash of cultures.

To make matters more challenging, present industry structures were not designed nor do they operate with sufficient capacity to manage a widespread response to crisis. These institutions include the Association of Microfinance Institutions (the industry group), MESPT (a wholesaler), Jitigemee Trust (a wholesaler) Oiko Credit (a wholesaler), or MicroSave (a training and technical assistance provider).

Therefore, creating an industry response is a question of balance between different perspectives, of sourcing better information on which to make decisions, of consulting stakeholders widely, and seeing how others can be of assistance. Pragmatic responses are required to establish workable mechanisms matched to specific and different problems.

All of this is happened though no doubt more must be done.

The need for pragmatism, speed and information animated the evolution of a strategy for supporting the Kenyan microfinance industry. An outline of the response began to emerge in February and was finalized in March. It was comprehensive and included well coordinated public and private sector inputs channeled through the industry association, AMFI.

FSD Trust secured $5 mm from DFID to finance rehabilitation efforts across three interventions. USAID sent a representative from the Office of Development Credit to research the possibility of developing a loan guarantee mechanism to route financing to cash-constrained institutions for lending and liquidity purposes.

The microfinance industry rescue package ultimately conceived and slated for implementations was underpinned by three connected interventions, namely:

1. *A **Liquidity Fund** supporting MFIs and SACCOs (Savings and Community Credit Organizations) whose clients have experienced repayment problems.*

   Through a Development Credit Authority (DCA) loan guarantee for $10 mm, USAID will risk share lending into the sector with Equity Bank and Oiko Credit.

   KARF has taken the technical lead in this area with FSD paying the subsidy cost to the US Treasury, approximately $433,500, which covers expected losses. Two unique features of the DCA facility include the subsidy paid by FSD, which is normally financed by USAID, and linking a single loan agreement between both financial institutions, so that if one fails to utilize their assigned portion, balances can easily be transferred between lenders.

   These two innovations are new to Kenya.

2. *A **Technical Assistance Fund** complimenting the liquidity fund to aid banks and wholesalers in their due diligence and credit analysis of distressed MFIs and SACCOs.*

   The fund will also support product innovation and development for institutions working in areas negatively impacted by violence, tribal clashes, and resettlements. The association has taken the technical lead in this area with FSD underwriting all costs.

3. *A **Conflict Prevention and Mitigation Response** effort to aid social reconstruction and peace building.*

   CPMR will educate financial institutions on the role of peace strategies and interventions. The work will serve as a linkage to existing peace networks and other relevant structures as a means to mitigate and overcome destructive behaviors.

   In addition, financial service providers and peace networks will incite communities to lobby for incremental political improvements through a common platform of economic growth and development. KARF has taken the technical lead in this area with the association coordinating implementation and FSD underwriting costs.

DEVELOPMENT CREDIT AUTHORITY

Ensuring the likelihood of success for existing credit enhancements and promoting a continuation of activities already underway, KARF inherited a number of DCAs from KEMCAP, including four banks and seven agreements totaling $23,100,000.

Summary of DCA credit enhancements transferred to KARF

Cooperative Bank of Kenya	$1,000,000 $1,500,000 $1,500,000 $3,000,000	9/2003 – 9/2008 9/2003 – 9/2008 9/2003 – 9/2008 7/2004 – 7/2009	MSME, MFI, NGO SMEP, an MFI Faulu, an MFI Warehouse receipting for smallholder maize farmers
K-Rep Bank	$3,200,000	9/2005 – 9/2010	SME (50% to women-owned businesses)
Kenya Commercial Bank	$7,900,000	9/2006 – 9/2011	SME, MFI, Other Special
Fina Bank	$5,000,000	9/2006 – 9/2011	SME
Total:	**$23,100,000**		

All agreements were meeting contractual expectations with the exception of the Cooperative Bank of Kenya maize warehouse receipting agreement. KEMCAP and USAID's Kenya Maize Development Program (KMDP) strived for three years to prompt lending by the bank. KEMCAP and KDMP marketed the warehouse receipting scheme they jointly developed to the banking industry. Eventually, Equity Bank adopted the model working with the East African Grain Council (EAGC). The agreement with Cooperative Bank of Kenya was cancelled by USAID and the subsidy balance retained by the mission for the creation of a new DCA facility in the near future.

Adding to the DCA facilities inherited from KEMCAP, KARF worked to add four new transactions to the portfolio:

- The first two deals underpin the industry effort to help resuscitate the microfinance industry following the post-election crisis. It is a $10 mm dollar facility evenly divided between Equity Bank and Oiko Credit. The agreement will be signed and functional by September 2008. The subsidy – insurance premium for expected losses – will be paid by FSD.
- The third transaction supports a community water project, structured on commercial principles, and in partnership with K-Rep Bank and the World Bank. The facility is $5 mm. The subsidy will be paid by the Office of Development Credit and the agreement will be signed by September 2008.
- The fourth facility underwrites a micro-health insurance product offered by Faulu, a MFI. The facility is $5 mm. The transaction is a partnership between the MFI, USAID Kenya's Office of Public Health and the Agriculture, Business and Environment Office.

- The transaction was first considered in July 2006 under KEMCAP. The subsidy for this DCA will be paid by USAID's Office of Public Health. This type of credit enhancement is the first of its kind in Kenya.

The fifth DCA was designed and fully considered by USAID Kenya and the Office of Development Credit. It was conceived to underwrite mezzanine finance (a hybrid form of debt and equity) for a MFI and SACCO loan wholesaler, Jitigemee Trust. The guaranteed amount has not been decided upon. The subsidy will be financed by FSD Trust. A DCA of this construction would be the first of its kind ever completed by USAID's Office of Development Credit.

The most significant innovation from the package of DCAs designed during the reporting period was a third party paying the substantial subsidy amounts. Officials from ODC were able to name one other transaction underwritten this way. It was in Angola with the subsidy paid by Chevron.

Leveraging third party finances is important for a number of reasons, namely:

- USAID Kenya or local missions do not always have the resources to underwrite DCA transactions. If financing cannot be found to pay subsidies, it might result in lost opportunities and the ability to create the necessary stimulus for bank lending into underserved sectors that otherwise might not happen.
- It creates valuable partnerships between actors, usually private and public sectors, leveraging scarce resources.
- Successful partnerships build history and track records that lead to future collaboration. For example, with the turnaround of Fina Bank in 2005/2006, FSD Trust supplied on-site technical assistance and USAID Kenya underwrote the DCA loan guarantee for the SME product line. Two years later, Fina was voted the leading Kenyan SME bank. Leveraging this successful partnership, FSD later agreed to pay the subsidy for the MFI rescue facility in 2008.
- It provides a positive endorsement on deals that might receive less consideration either by USAID or the partner.

All subsidies for the new DCAs in Kenya will be financed by FSD Trust or from Washington – not the local USAID Kenya mission.

RURAL FINANCE

Under the previous project, a partnership was developed with USAID's Kenya Business Development Program (KBDS). KEMCAP designed an out-grower lending scheme, in the avocado value chain, to finance a pest and disease control spray program essential to the productivity of small holder farmers. KEMCAP spent considerable time working with the KBDS market linkage firm it subsidized to carryout the activity.

During the timeframe when KBDS began winding down its engagement in the value chain, one of the market linkage firms approached KARF requesting assistance in commercializing its work – moving from a subsidized donor activity to a standalone profitable business

working for itself and the benefit of small holders. Work began by reviewing the prior four years of partnership with KBDS, understanding the business rationale and case for moving forward, and making field visits. As KARF began to more fully comprehend the request for assistance and the justification for building upon the successful track record of KBDS in the avocado value chain, which included maintaining continuity, work was halted abruptly following the December 2007 elections.

KARF and the linkage firm, Ideal Matunda, agreed to postpone further action until the consequences of the violence on small holder farmers and their markets was fully understood.

RURAL AND AGRICULTURE FINANCE MARKET ASSESSMENT

The RAF market assessment is a contract deliverable.

The Central Bank of Kenya, in collaboration with FSD Trust, is undertaking a phase II of the financial services assessment completed in 2006. Rather than duplicate work already underway, the CBK agreed that KARF could join the partnership and leverage the strength of the established networks, the successful first phase and the already underway phase II well funded effort.

A meeting was scheduled for all partners in January 2008 but it was indefinitely postponed due to the fallout from the post-election violence. (Planned field work necessary to inform the second phase would not have been possible before March 2008.)

KARF will keep USAID appraised any changes that might materially affect production of this deliverable.

EMERGING OPPORTUNITIES

The Central Bank of Kenya submitted a request to USAID Kenya to continue the capacity building the ended under KEMCAP. Their request represents and opportunity to build upon the success technical assistance provided as part of the work undertaken to pass and enact the Microfinance Act, to write the microfinance regulations, etc.

PROBLEMS ENCOUNTERED

The post-election crisis created opportunities and challenges.

First, it created the opportunity to assist the troubled microfinance sector. Industry needs were overwhelming and immediate. Together, with the industry and other important partners, a response to the crisis was created. It is anticipated, that the industry response to which KARF is a key participant, will improve the situation and lead to actions that mitigate future crisis (future electoral violence) by equipping financial institutions with proper tools and access to specialized networks.

KARF shifted its focus and resources to assist the microfinance industry and it is expected that project will be involved over its contractual life. KARF does not expect it will substantially impact realization of its deliverables, although the project is not what it functioning as it was originally designed.

Second, KARF was forced to delay its entry into rural finance. This reality is understandable given that most of the country outside the major cities was unsafe. Travel and trade was severely restricted.

Rural finance work will slowly commence in the third quarter of the fiscal year. However, it must be recognized that the effect on financial innovation (product development through piloting and testing) will be cumulative and the end result will be less positive had the crisis not happened. The net impact is greater in KARF's circumstances since the project has a short three-year lifespan. With an increased project duration, e.g. five years, the impact of the crisis would be less.

Third, the crisis postponed implementation of the RAF market assessment. The will delay data collection and, ultimately production of the assessment. The assessment was expected to help inform innovation and geographic coverage of the financial sector. Interested parties – the public and private sector alike – must operate in a semi-vacuum until the report is finalized. This might be in the third year of KARF implementation.

Unrelated to the crisis, the partnership with the CBK, FSD Trust and others will lead to a more comprehensive and useful document.

Fourth, KARF will achieve its goals but differently than originally envisioned. Due to the changed environment, more emphasis will be placed on rural finance and less on value chain finance. This is driven by the response to the post-election crisis the impact on the microfinance sector. Contractual benchmarks will be achieved but the bulk of the numbers attained will come from rural impact not value chain or agriculture finance. This change in orientation, again, is a result of necessity and responding to crisis.

ANNEXES

ANNEX A:
TECHNICAL DOCUMENTS

Workplans/PMPs

- KARF Workplan and PMP (Life-of-Project, Including Year 1 Detail)

Quarterly/Final Reports

- Quarterly Report, October 1, 2007 – March 30, 2008

Post-Election Violence

- AMFI Extraordinary Board Meeting Post-Election Violence Document
- Literature Review on Microfinance Disaster Reponses
- Microfinance Post-Election Way Forward Paper

Financial Services

- KBDS Avocado Value Chain Lessons Learned

ANNEX B: WORKSHOPS/TRAININGS/FORUMS

Workshops

- Three-day SEEP Frame Tool for AMFI Membership

Industry Forums

- MFI Emergency Post-Election Crisis Meeting (KARF, AMFI and FSD Trust)
- AMFI Extraordinary Board Meeting on Post-Election Crisis
- First Industry Forum on the Impact of Post Election Violence on Microfinance Providers and Potential Responses
- Second Industry Forum on the Impact of Post Election Violence on Microfinance Providers and Potential Responses

ANNEX C:
PARTNERSHIPS AND COLLABERATIONS

	Name:	Activity:
1.	Association of Microfinance Institutions	Post-election crisis response
2.	FSD Trust	Post-election crisis assistance and funding/RAF Market Assessment
3.	USAID Office of Development Credit	Post-election crisis liquidity facilities and new DCAs
4.	Equity Bank	Post-election crisis liquidity DCA (new)
5.	Oiko Credit	Post-election crisis liquidity DCA (new)
6.	K-Rep Bank	Water DCA (new) and SME DCA (existing)
7.	Faulu	Micro health DCA (new)
8.	Jitigemee Trust	Debt/equity DCA (new)
9.	Fina Bank	SME DCA (existing)
10.	Kenya Commercial Bank	SME DCA (existing)
11.	Cooperative Bank of Kenya	Multiple DCAs (existing)
12.	World Bank	K-Rep water DCA
13.	USAID Kenya Office of Public Health	Water DCA
14	Kenya Business Development Services	Avocado value chain
15.	Ideal Matunda	Avocado value chain
16.	Central Bank of Kenya	RAF market assessment

ANNEX D:
BUDGET

	Budget	Inception to Last Period	Current Bill Amount	Cumulative Bill Amount	Remaining Amount	Percentage Billed
Labor	1,002,301	71,755	24,325	96,080	906,221	9.59%
Withholding	-	(3,588)	(1,216)	(4,804)	4,804	0.00%
ODC	914,323	76,173	18,404	94,577	819,746	10.34%
G&A	83,203	6,908	1,675	8,583	74,620	10.32%
TOTAL	1,999,827	151,248	43,187	194,436	1,805,391	9.72%