KENYA MICROFINANCE CAPACITY BUILDING PROGRAM

FINAL REPORT

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EXECUTIVE SUMMARY

During the 1990s, USAID played a major role in the development of microfinance in Kenya. Through sustained financial, technical and managerial support of the U. S government, individual microfinance institutions flourished and significantly evolved, achieving dramatic growth in client outreach and profitability. Likewise, the sector made substantial gains in institutional development by perfecting individual business models to meet the needs of economically disadvantaged Kenyans. USAID's efforts produced internationally recognized leaders, such as K-Rep Bank, one of the first credit-only institutions to receive a commercial banking license.

At the turn of the century, USAID Kenya began evaluating its approach to and engagement with the microfinance sector and, in particular, to individual institutions given worldwide trends and new methods endorsed by leading donor agencies. The question before USAID Kenya was: where and how to direct future levels of programmatic support and whether continued support of microfinance was needed at all.

In 2003, USAID Kenya commissioned a review of its portfolio of microfinance activities against the framework of possible interventions likely to advance the development of the sector (across the spectrum of financial services). The study identified four major growth constraints limiting the development of microfinance:

- An industry level enabling environment that promotes MFI growth and product diversity
- Access to growth capital
- Client-appropriate products, services and delivery systems
- Advanced training and consulting services that elevate human capacities to meet changing business needs.

USAID Kenya focused on the first two obstacles—enabling environment and access to growth capital. Working at the enabling environment in policy and regulations creates the conditions for institutional growth, which in turn promotes access to capital for MFIs to expand. As such, assistance was designed to benefit the Association of Microfinance Institutions and the Central Bank of Kenya. The new intervention was called the Kenya Microfinance Capacity Building Program, a 36-month activity, beginning in May 2004 and staffed by one long-term expatriate. AMFI received a full-time, Kenyan, advisor entrusted with transferring the skills and know how necessary to run an effective, sustainable and long lasting industry association. In addition, the Central Bank obtained support in building regulatory and supervisory capacity, needed to underpin the growth of sector while fulfilling its overall functions overseeing the financial system (promoting access, maintaining efficiency and ensuring stability).

Addressing the growth capital constraint, AMFI worked to ensure passage of the Microfinance Bill, which would allow leading and top-performing credit-only MFIs the opportunity to convert into regulated deposit-taking institutions, thus creating the conditions to grow through financial intermediation, a natural progression from donor subsidies. In addition, KEMCAP worked with the Development Credit Authority to open new avenues of debt financing to MFIs working directly with banks, through risk sharing, as a means to promote access to financial serves in under and unserved sectors of the economy (but not necessarily through MFIs).

Lastly, KEMCAP served as a catch-all for the mission to rapidly respond to other areas of need in finance or banking, namely: assisting the Coastal Development Authority with the design of a financial services scheme targeted to resource poor Muslim areas along the Kenyan coast; supporting the Kenya Maize Development Program in its efforts to launch a warehouse receipting system; advising the Kenya Business Development Program on an outgrower financing arrangement; delivering or brokering training on various topics, including HIV/AIDs in the workplace, credit analysis and risk management, and rural and agriculture finance; etc.

The Program built strong relationships and partnerships since inception while it continued evolving and expanding its scope.

Taken together, the USAID's investment in KEMCAP contributed to ground breaking changes necessary for the microfinance industry to expand the frontier of financial services.

- The **Association of Microfinance Institutions**, once managerially and financially dependent on donor finance is now a self-sustaining entity, no longer a USAID Kenya cooperative agreement recipient.

- The **Central Bank of Kenya** became a key partner for the microfinance industry, KEMCAP and USAID by supporting and implementing internationally-accepted best practices for the benefit of the ongoing growth and development of the financial sector.

- The **Microfinance Bill** was passed by Parliament and signed into law by the president.

- **Prudential Microfinance Regulations** were written for the Central Bank of Kenya and incorporated for implementation into **Bank Supervision**

- Important training and capacity building was delivered to the **Central Bank of Kenya** readying it for the safe and sound regulation of deposit-taking microfinance institutions authorized by the bill.

These crucial implementation actions were a result of USAID's investment in KEMCAP and will allow institutions to grow with a combination of financing options, including the once forbidden but now allowed source of funds – i.e. client savings.

Throughout the performance period, KEMCAP learned many valuable lessons. Those lessons include: flexible and responsive programming; long-term perspective and engagement; one-stop shop for financial services; and, public and private sector partnerships matter.

FLEXIBLE AND RESPONSIVE PROGRAMMING

KEMCAP was designed to assist the Association of Microfinance Institutions and the Central Bank of Kenya using an industry-building approach. The task order, however, offered a degree of flexibility to work in other areas when deemed necessary by USAID Kenya, even though doing so might not have directly supported the association or the Central Bank. Examples of working outside the industry included: supporting the Coastal Development Authority, facilitating HIV/AIDs in the workplace training for partner financial institutions, conducting bank training on topical areas, working with USAID Kenya funded commodity program in finance, etc.

Interventions outside the principal scope-of-work were important and contributed to the ongoing evolution of the financial services sector, having pushed the frontier of financial services beyond traditional areas of operations, and minimizing cost to USAID since KEMCAP leveraged ongoing work already underway with current programs (Kenya Maize Development Program and Kenya Business Development Services) or bringing in additional resources outside the task order to conduct trainings.

In practice, KEMCAP functioned as a market responsive and entrepreneurial consulting firm focused on core business activities with built-in flexibility necessary to advantage opportunities that offered exciting developmental prospects and outcomes in the areas of employment generation, wealth creation and poverty reduction.

LONG-TERM PERSPECTIVE AND ENGAGEMENT

Access to finance is the cornerstone to ongoing growth and development of economies, a universal truism across all countries of the world, the United States and Kenya included. The need for financial services change overtime, especially as economies expand and increase in sophistication. Therefore, most major economic growth activities financed by USAID require some degree of finance and banking expertise.

During KEMCAP, this crucial area of expertise was seen lacking in each of the commodity programs, which poses a constraint to upgrading the competitiveness of value chains supported by USAID. Given the importance of finance to economic expansion, it is vital for USAID Kenya to have a financial services program, neutral to the market and unbiased toward other firms funded by the mission, that serves to support USAID programs, especially activities in business or agriculture where information sharing is important.

A finance program can and probably should have other specific activities in addition to servicing other USAID activities. Such an approach requires a long-term perspective and a willingness to grow not only with activities supported by USAID but in other areas of the Kenyan economy requiring financial services assistance, because as the country develops, the need for finance increases.

ONE-STOP SHOP FOR FINANCIAL SERVICES

As part of a long-term perspective and engagement strategy, a financial services program can be designed that functions as a one-stop shop depending on need and level-of-effort. Functioning like KEMCAP, as a consulting firm and service provider, the program could be structured to serve a specific USAID agenda, such as passing the Microfinance Bill, supporting various USAID-funded activities, KBDS for example, while including flexibility in the contract to identify constraints and overcome those obstacles to economic growth through improving access to finance.

A one-stop shop could rely on various approaches – linking needs to local providers, sourcing experts from outside Kenya, or doing the work itself. The one-stop shop would have to employ a highly-qualified individual or two with a wide range of skills and experience. This is particularly true in a developed finance industry such as Kenya that displays characteristics of a sophisticated market and also one that is still very basic, having very high levels and poverty and associated problems.

PRIVATE AND PUBLIC SECTOR PARTERNSHIPS MATTER

Without the full support of the AMFI, the Central Bank of Kenya and the Ministry of Finance (Treasury), the Microfinance Bill would not have passed in 2007. Previously, the bill languished, moving in and out of non-ending debating circles since 1999. It wasn't until KEMCAP built relationships with these institutions, and then later, serving as the nexus to channel ideas, resources, and effort did the bill move from a good idea to a workable, best practice document to Kenyan law. This would not have been possible without committed public and private sector partners.

The relationships with these institutions required time to build and nurture – starting out as stand-offish ventures and ending as long-lasting and mutually beneficial partnerships. Trust is not easy to build in Kenya – with Kenyans and their institutions. Many want to do it 'the Kenyan way' – an approach that isn't always grounded in best practice. With both AMFI and the Central Bank, the alliances were tumultuous from the outset, necessitating patience and large expenditures of effort but now, at the conclusion of KEMCAP, both are on solid footing as evidenced in various correspondence sent to USAID Kenya from each partner.

Today and well into the future, these partners are critically important to USAID's work in moving the financial services sector forward, given how important both institutions are to ongoing and sustainable growth.

INTRODUCTION

For over twenty years, the United States Agency for International Development has been one of the leading donors supporting the effort to build and inclusive and competitive microfinance industry in Kenya. Its efforts have formed the catalyst, serving as the engine behind the massive growth of the industry, which serves millions of ordinary Kenyans. Kenya has two of the leading microfinance banks in the world – K-Rep and Equity – and a handful of pioneering non-bank MFIs also widely recognized throughout the globe. After working many years to build world-class institutions, USAID Kenya shifted its strategy to support the industry itself so that the industry would facilitate the continuous evolution of institutions, creating a healthy and competitive industry with many institutional forms geared toward meeting the needs of all Kenyans.

In 2004, USAID initiated a new activity, the Kenya Microfinance Capacity Building Program, designed to work strengthen the industry and key participants as means to facilitate ongoing growth.

With its focus on the industry, KEMCAP was created to:

- Strengthen the **Association of Microfinance Institutions** (AMFI), managerially and financially, so that it would become a self-sufficient, a stand-alone entity, able to survive and flourish in the absence of USAID technical and monetary support. It was also intended that USAID assistance would help AMFI better supply the evolving needs of its growing membership and the clientele it serves, ultimately benefiting Kenyans not having access to safe and readily available financial services.

- Partner with the **Central Bank of Kenya** to pass the **Microfinance Bill** and build its capacity to oversee institutions seeking deposit-taking licenses.

- Respond to **emerging market opportunities** identified important by USAID Kenya, such as **Development Credit Authority loan guarantees**.

In addition, after passage of the Microfinance Bill and during the last twelve months of implementation, KEMCAP was awarded a capacity-building component to further support the Central Bank of Kenya's in its effort to regulate deposit-taking institutions.

During the course of KEMCAP implementation, ground breaking changes have occurred in Kenya. A previously divisive industry, with an extremely weak association, coalesced to discuss and resolve common issues, debate and jointly lobby for legal and regulatory change. This new approach was the result of AMFI capacity building and partnership with the Central Bank of Kenya. AMFI is a strong institution as envisioned by USAID. It is financially and managerially self-sufficient, able to stand on its own and represent the needs of its expanding membership. AMFI is now seen as the voice of the industry and representative of its members' needs.

The Central Bank of Kenya is a close USAID partner, willing to collaborate on issues important to the US government, particularly in the ongoing safe and sound expansion of banking and microfinance in Kenya. Not only did KEMCAP and the Central Bank partner to pass the Microfinance Bill, but at the request of the bank, KEMCAP produced a best practice version of the bill that was used to lobby for changes with the Ministry of Finance, the Attorney General's office and the microfinance industry. KEMCAP also produced the complete set of deposit-taking microfinance regulations for the bank supervision department.

Given the success of the partnership, the bank sought advice from the program on research, regulatory and supervisory issues outside the realm of microfinance. The Central Bank, at the conclusion of KEMCAP, is interested in expanding access to financial service outside of urban areas, a key concern to USAID Kenya. The Central Bank is a critical factor in the ongoing evolution of the sector and a key partner to USAID.

The remainder of the report will chronicle the implementation of KEMCAP from start to finish, document lessons learned, detail the budget framework, and detail project deliverables and materials.

Implementation Chronology

2004

- May — KEMCAP started and located within the Association of Microfinance Institutions
- June — Work initiated on AMFI's first strategic, operational and marketing plans
- August — Partnership begun with KMDP and Cooperative Bank on maize warehouse receipting, a finance mechanism
- September — Partnership with the Coastal Development Authority undertaken to support design of $500,000 USAID cooperative agreement designed to support the finance of Muslim communities along the Kenyan coast
- October — Cooperative Bank employees complete study tour to Uganda on maize warehouse receipting
- November — Performance Standards convened for the microfinance industry at the Kenya School of Monetary Studies
- December — Diagnostic of AMFI completed

2005

- January — Delivered a three-day workshop on Microfinance and HIV/AIDs: Designing Options for Strategic and Operational Change
- February — Conducted DFID Output to Purpose Review on Opportunity Malawi Bank with two Kenyan consultants
- March — Completed a Transformation Plan for SMEP and delivered a presentation to its board of directors, outlining steps needed to prepare for conversion to a deposit-taking microfinance bank
- May — Drafted and submitted paper to the Coastal Development Authority called, "Recommendations for Facilitating Financial Services in Resource Poor Areas Along the Kenyan Coast"
- May — Prepared paper titled, "Evaluation of Credit Worthiness of the SME Sector in Kenya"
- May — June Facilitated on-site sectoral review of candidate banks for potential DCA loan guarantee
- June — Facilitated aftercare assistance to workshop participants from the Microfinance and HIV/AIDs: Designing Options for Strategic and Operational Change
- July — Organized a training workshop on advanced credit analysis and risk management for DCA partner banks and MFIs
- August — KEMCAP enters into partnership with the Central Bank of Kenya and holds the first industry workshop on the draft Microfinance Bill
- September — Prepared report on warehouse receipt financing for Cooperative Bank, outlining steps necessary to complete a transaction, and a corresponding financial model

2005 (continued)	
• September	DCA loan guarantee signed with K-Rep Bank for SME lending focused on women owned and/or operated businesses
• September	Brokered DAI vice president and former banker to teach a credit risk class at the School of Applied Microfinance in Kenya
• September	Two CBK employees sponsored and sent to School of Applied Microfinance Training
• October	KEMCAP contract modification approved to add Kenyan national as advisor to AMFI
• November	KEMCAP convenes an Annual General Meeting and helps reconstitute AMFI's board of directors to fit the evolving needs of the institution
• December	CBK requests KEMCAP to re-work the draft Microfinance Bill based on international best practices and create prudential regulations to attend the bill
2006	
• February	Completed analysis of the draft Microfinance Bill and reworked it into a framework of internationally-accepted best practices
• March	Delivered BASIS Rural Agriculture Finance to USAID Kenya, its commodity programs, and financial sector partners, including the MFIs, commercial banks, CBK, Ministry of Finance, Ministry of Agriculture, Ministry of Livestock, etc.
• April	Consensus building workshop on the Microfinance Bill held by AMFI for MFIs and other industry participants
• May	KEMCAP and KBDS partner to develop a lending scheme for smallholder avocado farmers
• June	Numerous materials and documentation produced for the lending scheme on behalf of KBDS and Equity Bank
• June	Position paper and list of amendments prepared for AMFI on the Microfinance Bill
• July	New strategic plan and financial model created for AMFI and approved by its board of directors
• July	Lobbying plan and budget for passage of the Microfinance Bill prepared for AMFI
• August	Stakeholder's Forum for passage of the Microfinance Bill held
• August	Kenya Rural Agriculture Finance Assessment finalized
• September	Two DCA loan guarantees closed with Fina Bank and Kenya Commercial Bank for SME lending
• September	DAI vice president and former banker to teaches a credit risk class at the School of Applied Microfinance in Kenya for a second time
• September	Two CBK employees sponsored and sent to School of Applied Microfinance Training
• October	Delivered a paper and presentation on finance opportunities for rural finance in Kenya, specifically on maize warehouse receipting
• November	Capacity building plan prepared for bank supervision department and approved by the CBK's governor
• December	Microfinance Bill passed by parliament and signed into law by the president
• December	Initial drafting of thirteen microfinance prudential regulations completed
2007	
• January	Peer review workshop held with CBK employees to solicit feedback on draft prudential regulations
• February	First-ever AMFI directory launched
• March	CBK microfinance regulations finalized and gazetted
• April	AMFI holds workshop on impact of CBK microfinance regulations on transforming institutions
• April	CBK conducts workshop for the industry on the microfinance regulations, compliance and transformation
• April	Assessment of Development Credit Guarantees in Kenya completed
• April	KEMCAP granted eight-month no-cost extension through January 2008
• May	Through AMFI, industry prepares and submits its detailed position on CBK microfinance regulations
• June	KEMCAP task order modified to include capacity-building component for the CBK

2007 (continued)		
•	July	Banker and Commodity Program Forum held for USAID funded programs, banks, MFIs and other industry participants
•	July	Three CBK employees attend Boulder Microfinance Training Program
•	August	Three CBK employees attend Federal Reserve training in Atlanta on credit risk analysis
•	August	Two CBK employees attend a Harvard University course on Financial Institution's for Private Enterprise Development
•	September	DAI vice president and former banker to teaches a credit risk class at the School of Applied Microfinance in Kenya for a third time
•	September	Four CBK employees attend School of Applied Microfinance Training
•	October	Two CBK employees attend SEEP annual conference in Washington DC
•	October	CBK sponsored Transformation Forum, Phase I, for microfinance industry
•	December	Five CBK employees complete study tour of Mexico and Bolivia
•	December	SEEP Frame Tool training delivered for MFIs
•	December	CBK sponsored Transformation Forum, Phase II, for microfinance industry
•	**2008**	
•	January	KEMCAP ends

THE ASSOCIATION OF MICROFINANCE INSTITUTIONS

The partnership with AMFI was very slow to begin. The Chief-of-Party originally located inside the association. The executive director was not open to collaboration but the board, led by the Chief Executive Officer of K-Rep Bank, considered USAID support as critical to improving the performance of the association. AMFI, at the time, was a recipient of a USAID cooperative agreement. The association, under the executive director's stewardship, was not compliant with the agreement and the executive director had no intention of amicably resolving issues with the board or USAID. As a result of the executive director's recalcitrance, the Chief-of-Party relocated to another office, and, at the same time, the board began searching for a new executive director, allowing for USAID and KEMCAP to re-think its strategy during AMFI's transition.

It was concluded that that KEMCAP should hire a new local advisor to support the association, devoting his full-time and attention to AMFI, allowing the Chief-of-Party ample time to build the relationship and work with the Central Bank of Kenya, in addition to responding to other emerging opportunities. The contract was modified in 2005 and a Kenyan advisor had hired and placed at the association. KEMCAP, through its advisor administered the association on a daily basis until the board was reconstituted and a new executive director hired. Since then, KEMCAP helped produced necessary strategy documents, attended by operational plans and other functional materials. The relationship between the board and the executive director was strengthened, leading to incremental improvements in managerial and financial performance.

AMFI's new board and executive director significantly contributed to the passage of the Microfinance Bill; however, the most visible accomplishment resulting from the restructuring was the never before seen inclusive style of leadership provided to the industry. New and experienced leadership created the platform for the range of positive changes felt both inside and outside the association. Inside the association, AMFI was able to become managerially and financially self-sustaining – a deliverable under the KEMCAP contract. Outside the association, it prioritized items of time-bound importance to its members, starting with passage of the microfinance bill and building solid relationships with other industry participants and luminaries, including the Central Bank of Kenya, the Ministry of Finance, the Attorney General's Office, Parliament, etc. Sequencing priorities, AMFI assisted its members on issues underpinning conversation under the bill to deposit-taking microfinance status, an expensive and arduous process for institutions.

At the conclusion of KEMCAP, AMFI is able to operate as a business that supports the growth and development of microfinance for years to come. The association now has:

- Qualified, experienced and well known people in key positions.
- Proper systems in place to gauge and respond to client needs.
- Requisite mechanisms to monitor and counter risk.
- Essential planning and control systems to manage performance

THE CENTRAL BANK OF KENYA

Early, during the implementation period, KEMCAP began working to build a solid partnership with the Central Bank of Kenya. First, KEMCAP was assigned to work with the rural finance department by senior bank management. The relationship did not rapidly progress. The bank had a limited understanding microfinance since it was not involved in supervision. But as KEMCAP and the association began aggressive lobbying of the Microfinance Bill, the Central Bank began to take notice because one day it would, assuming the bill passed, assume supervisory authority over deposit-taking microfinance institutions.

In mid 2005, the Central Bank restructured, eliminating the rural finance department while creating the microfinance division as a unit under bank supervision. With this change, the partnership with KEMCAP began. The Central Bank requested KEMCAP that facilitate an industry meeting to begin discussions on transformation, regulation and supervisory issues. Following the meeting, the bank requested that KEMCAP advise it on the draft microfinance bill and begin work on the attendant regulations.

During the period beginning in September 2005 and through the passage of the bill in December 2006, KEMCAP worked closely with the bank, relocating to a desk inside the microfinance division. KEMCAP redrafted the bill based on international best practices; the Central Bank lobbied the KEMCAP version of the bill with the Ministry of Finance, the Attorney General's office, Parliament and the industry. KEMCAP then produced thirteen regulations based on the final version of the bill that was eventually adopted by all stakeholders. Numerous workshops were held with the industry using those regulations as a guideline for gearing individual institutions toward the process of licensing, compliance and supervision.

Throughout the process of working together, the Central Bank gradually realized that it required additional assistance outside the framework of what KEMCAP was able to offer within the framework of the USAID task order. Specifically, the bank recognized that microfinance supervision was different than its approach and methodology used with commercial banks. As a result, with the help of KEMCAP, the bank prepared a request for additional finance from USAID Kenya to help prepare it for eventual supervision of the newly created sector. The request was submitted in early 2007 and subsequently approved. A series of trainings and study tours were sourced on various topics for microfinance and bank supervisors, including the deposit protection fund employees. Midway through 2007, microfinance was rolled into bank supervision, with the Central Bank adopting a holistic approach. The deposit protection fund is responsible for oversight of the new sector, providing deposit insurance to savers.

Capacity building culminated in a study tour to Bolivia, considered by many as the cradle of microfinance supervision, and to Mexico which shares many parallels to Kenya in the area of credit unions (SACCOs). The Central Bank is preparing a final report on its trip and when completed, it will be forwarded to USAID.

DEVELOPMENT CREDIT AUTHORITY

In mid 2004, USAID requested KEMCAP provide assistance to Cooperative Bank on a DCA specifically for maize warehouse receipting, working together with the Kenya Maize Development Program. Cooperative Bank, after fully understanding the financing mechanism and based on its internal risk management considerations, withdrew from the lending scheme. The agreement was cancelled by USAID. KEMCAP and KMDP marketed the warehouse receipting system to other banks and Equity Bank later began implementing the scheme in a slightly different form. Incremental improvements to the scheme continue today.

In addition to warehouse receipting, KEMCAP provided oversight to the portfolio of guarantees in Kenya. KEMCAP also marketed new deals and placed three transactions at K-Rep, Fina Bank and Kenya Commercial Bank. Below is a list of DCAs that KEMCAP successfully managed.

Bank Name	**Guarantee Value**	**Begin / End**	**Purpose**
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 SME, MFI, NGO—with an emphasis on warehouse receipting for smallholder maize farmers
K-Rep Bank	$ 800,000 $3,200,000	9/2002 – 9/2007 9/2005 – 9/2010	SME 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

KEMCAP was asked by USAID to prepare a DCA analysis, reviewing the current portfolio of guarantees and providing recommendations for the future. In the paper, KEMCAP concluded that promoting access to financial services at all levels is and will continue to be a challenge. Financial service institutions display different characteristics. Matching those characteristics and adapting behaviors and practices to specific market segments within SME niches or rural agriculture finance commodities can only be met with customized solutions. Loan guarantees are not a panacea to designing and delivering solutions. The DCA is an important tool but one that must be used selectively and monitored closely to ensure that it is affecting necessary and desired changes.

Furthermore, USAID Kenya's initial track record with the DCA guarantee program has been excellent. All banks should be considered successes for various reasons, unique to each institution. It is apparent, however, that DCAs with Kenyan partner banks realize dramatic initial gains and then in certain areas, where change could affect additionality, taper off or come to standstill. While gains still occur without direct intervention, accomplishments could be significantly maximized with the addition of hands-on, external consulting.

The overall impact on the behavior of the financial sector as a whole, resulting from loan guarantees to individual banks, is not well understood. This represents an enormous opportunity. Banks, themselves, want to build a protective moat around their business and product lines. Once success is widely disseminated, financial products are quickly commoditized as competitors enter the market. That role and responsibility of regularly dispersing and sharing information rests with a neutral third party. Financial institutions will not perform the task themselves; they do not consider it in their interest.

Loan guarantees are a vital component of any strategy used to promote access to financial services. By mobilizing bank liquidity and resources, loan guarantees provide a stimulus to incite private sector development leading to broad-based economic growth and an overall acceleration of wealth creation and stability. It is this premise that governs and justifies the long-term focus on loan guarantees that is now necessary but only on a selective basis and under the right conditions and engagement.

The recommendations contained in the paper included:

- *Clearly define and articulate a strategy underpinned by quantifiable milestones, deliverables and results.* USAID Kenya's Strategic Objective 7 clearly defines and articulates a strategy. For the purpose of expanding access to financial services, on a tactical level, the objectives should be more definitive. S07 could be used to further animate more precise goals and associated tactics specific to expanding the frontier of financial services. From there, quantifiable milestones, deliverables and results can be derived.

- *Move from a passive to active management approach.* While reporting on usage and impact is important, it does not go far enough, especially at this stage of involvement with DCAs in Kenya. Generally, banks progress very rapidly with a new DCA, internalize gains and then stagnate in areas where additional achievement is possible. Working closely with banks on a one-on-one basis will ensure much greater gains are realized.

- *Engage the whole financial sector; segment it; and grade it, matching profiles and performance criteria to mission strategy.* To date, only have a handful of institutions have been approached. The needs of the entire sector should be better understood so that it can be properly engaged in order to achieve USAID objectives. This recommendation centers on a systematic approach that involves profiling the sector from top to bottom, segmenting it, grading it, matching the analysis to desired USAID objectives and then implementing it.

- *Use DCA as a last resort only.* As part of an overall strategy to expand financial services in Kenya, DCA is an important tool but not the most important one. With the sector profiled as described above, the favored approach involves working directly with a bank to solve a market imperfection as a means to increase access (a USAID objective). DCA is only necessary as a last resort, when the financial institution is the best selection for the intervention, the product is a right match for the specific bank, other approaches have been exhausted and a stimulus is required. Then, as noted above, if a DCA is viewed as the proper incentive, an active hands-on engagement is preferred.

- *Widely share innovations, including success and failures, with the financial sector, donors and others using simple and inexpensive media channels.* Most financial institutions do not share product information with other financial organizations for fear of increased competition and commoditization. But this is (or should be) the ultimate goal of USAID. The adoption of new practices is growing in Kenya as incentives are aligned with the changing realities of the marketplace. Targets of opportunity are increasing. All of which should be shared. Through regular email updates, newsletters, and organized informational exchanges, innovations could more rapidly spread through the financial community and be readily adopted – ultimately benefiting ordinary Kenyans on an increasing scale.

RURAL FINANCE

KEMCAP was called upon to work in rural finance in the following areas: warehouse receipting with Cooperative Bank and KMDP; a BASIS Rural Agriculture Finance training delivered to USAID Kenya and partners; materials and a structured finance product designed for KBDS and Equity bank to facilitate access for avocado growers, enhancing the competitiveness of the value chain; and an analysis of rural agriculture finance (RAF) in Kenya produced.

The RAF paper outlined a number of conclusions. Foremost, access to RAF is and will continue to be a challenge. Each sector displays different characteristics that can only be met with customized solutions. However, there are common threads that cut across agriculture as a whole. Ultimately, shared characteristics drive design and functionality of solutions to improve the lives of target groups and other beneficiaries. The primary challenge of RAF access is one of capacity. The capacity issue must be addressed on three levels: borrower, institutional, and developmental.

Borrowers must be able to manage the financial products necessary to grow a business. On a related concern and an often cited problem, borrowers must be able to effectively manage a business, especially as it grows. The high cost of credit and the unforgiving low-margin environment associated with agriculture makes poor management a destructive and debilitating force. This dilemma is further exacerbated when credit is directed to small-scale producers, dependent on farming as a livelihood. Capacity building is an important activity to enable success.

USAID is doing this very well through its programs in maize, dairy and horticulture. The programs were designed to offer business development and extension services. The programs were not designed to overcome financial access issues, including financial product design, working with financiers, building institutional finance capacity (banks and MFIs), etc.

Institutional capacity focuses on the ability of financiers to both innovate and develop. Innovation is a process that creates solutions to reach customers in new and profitable ways. However, innovation must translate into action in order to move ideas from the conceptual phase and into functional products. Institutional capacity to both innovate and develop new products remains week in the RAF context. Without activities addressing this concern, it is difficult to foresee beneficial products entering the market and succeeding.

Developmental capacity examines the myriad of projects working in targeted RAF sectors. Many of these projects are designed with technical expertise in production and market linkages but lack dedicated expertise in finance and do not have the needed know-how and savvy to work with financiers. Any concerted effort to extend RAF must bridge this gap by providing an interface between production issues and financial solutions.

Creating (and funding) dedicated finance capacity within each of the USAID-funded Kenya commodity programs is not an appropriate application of scarce resources. Lessons learned and innovations must be shared throughout the sector and among all donor-funded interventions, including those of USAID. Maize, dairy, horticulture and BDS (essentially a commodity activity) programs do not work well together and share information. First, each is occupied with its own agenda. Second, the programs consider one another competition for the mission’s time and programming commitments (money).

It makes more sense for a separate activity to work with USAID-funded activities and perhaps one or two others (DFID) that offer opportunity for demonstration. This standalone finance activity would be neutral to each program and commodity, working with all as necessary and sharing information through the most appropriate dissemination channels. This neutral activity could also be tasked with monitoring and reporting on success, an area that often seems exaggerated.

Likewise, by addressing capacity constraints at the different levels of RAF participation, new interventions can be introduced in an environment that offers an optimal chance for success. Furthermore, program capacity development can be internalized in a manner that contributes to better practices in both RAF and the target sectors as a whole.

Secondary level challenges in RAF are endemic to Kenya. The legal and regulatory environment poses a significant hurdle to improving growth and development. It is difficult to enforce contracts, which a party may choose to break at will. Therefore, contracts must be drawn with properly aligned incentives or mechanisms that increase the likelihood of repayment. Operating like this, increases costs significantly.

Contract uncertainty necessitates market-based assurances. This negative feature inhibits production-related finance, increasing both risk and cost. In the absence of a contractual vehicle that is enforceable under the rule of law, assuring the financier of a commodities market and price, it is difficult to extend finance. This hurdle extends beyond the reach of RAF-focused activities and it is the reason we did not focus on legal and regulatory obstacles (these problems require political solutions, a long and hard road to navigate in Kenya).

Beyond capacity development and a focus on relevant broad-based and customized solutions, markets demand further incentives to participate in activities. At this point, it is often necessary to examine the viability of credit guarantees and grants. These types of inducements are valuable tools for instigating demonstrations and helping institutions through the learning process associated with new endeavors. These instruments are valuable tools to be used wisely and sparingly but both facilities are important to expanding the frontiers of RAF.

RAF is a vital component of any strategy that addresses the large proportions of underdeveloped sub-Saharan Africa. By mobilizing liquidity and resources, RAF promises a way to incite private-sector development leading to market-based capitalist economies and an overall acceleration of wealth creation and stability. It is this premise that governs and justifies the long term focus on RAF that is now necessary.

FLEXIBLE AND REPONSIVE PROGRAMMING

USAID Kenya treated emerging opportunities as a catch-all in the event the mission wanted specific work completed that was not necessarily related to KEMCAP’s core activities.

For example, KEMCAP:

- Provided consulting services to the Coastal Development Authority (CDA), designing an activity to support the finance of Muslim communities and unemployed youth along the coast.
- Delivered a workshop on Microfinance and HIV/AIDs in the workplace.
- Conducted a DFID Output to Purpose Review on Opportunity Malawi Bank
- Drafted a paper on for the CDA on “Recommendations for Facilitating Financial Services in Resource Poor Areas along the Kenyan Coast.”
- Prepared a document titled, “Evaluation of Credit Worthiness of the SME Sector in Kenya.”
- Facilitated aftercare assistance to workshop participants from the Microfinance and HIV/AIDs workshop.
- Organized a training workshop on advanced credit analysis and risk management for DCA partner banks and MFIs.
- Worked in the area of rural agriculture as outlined above.
- Brokered DAI trainer for the School of Applied Microfinance held annually in Kenya.
- Completed an assessment of DCA credit enhancements in Kenya.

Flexibility in the task order created opportunities to provide assistance that contributed to the ongoing evolution of Kenya’s financial sector without a major deployment of USAID resources. In a program geared toward consultancy and partnership, like KEMCAP, it makes sense to create space and flexibility necessary to respond to emerging opportunities.

LESSONS LEARNED

FLEXIBLE AND RESPONSIVE PROGRAMMING

KEMCAP was designed to assist the Association of Microfinance Institutions and the Central Bank of Kenya using an industry-building approach. The task order, however, offered a degree of flexibility to work in other areas when deemed necessary by USAID Kenya, even though doing so might not have directly supported the association or the CBK. Examples of working outside the industry included supporting the Coastal Development Authority, facilitating HIV/AIDs in the workplace training for partner financial institutions, conducting bank training on topical areas, working with USAID Kenya funded commodities in agriculture finance, etc.

Interventions outside the principal scope-of-work were important and contributed to the ongoing evolution of the financial services sector, pushed the frontier of financial services beyond traditional areas of operations, and minimized cost to USAID since KEMCAP leveraged ongoing work already underway with current programs (Kenya Maize Development Program and Kenya Business Development Services) or bringing in additional resources outside the task order to conduct trainings.

In practice, KEMCAP functioned as a market responsive and entrepreneurial consulting firm focused on core business activities with built-in flexibility necessary to advantage opportunities that offered exciting developmental prospects and outcomes in the areas of employment generation, wealth creation and poverty reduction.

LONG-TERM PERSPECTIVE AND ENGAGEMENT

Access to finance is the cornerstone to ongoing growth and development of economies, a universal truism across all countries of the world, the United States and Kenya included. The need for financial services change overtime, especially as economies expand and increase in sophistication. Therefore, most major economic growth activities financed by USAID require some degree of finance and banking expertise.

During KEMCAP, this crucial area of expertise was seen lacking in each of the commodity programs, which poses a constraint to upgrading the competitiveness of value chains supported by USAID. Given the importance of finance to economic expansion, it is vital for USAID Kenya to have a financial services program, neutral to the market and unbiased toward other firms funded by the mission, that serves to support USAID programs, especially activities in business or agriculture where information sharing is important.

A finance program can and probably should have other specific activities in addition to servicing other USAID activities. Such an approach requires a long-term perspective and a willingness to grow not only with activities supported by USAID but in other areas of the Kenyan economy requiring financial services assistance, because as the country develops, the need for finance increases.

ONE-STOP SHOP FOR FINANCIAL SERVICES

As part of a long-term perspective and engagement strategy, a financial services program can be designed that functions as a one-stop shop depending on need and level-of-effort. Functioning like KEMCAP, as a consulting firm and service provider, the program could be structured to serve a specific USAID agenda, such as passing the Microfinance Bill, supporting various USAID-funded activities, KBDS for example, and including flexibility in the contract to identify constraints and overcome those obstacles to economic growth through improving access to finance.

A one-stop shop could rely on various approaches – linking needs to local providers, sourcing experts from outside Kenya, or doing the work itself. The one-stop shop would have to employ a highly qualified individual or two with a wide range of skills and experience. This is particularly true in a developed finance industry such as Kenya that displays characteristics of a sophisticated market and also one that is still very basic, having very high levels and poverty and associated problems.

PRIVATE AND PUBLIC SECTOR PARTERNSHIPS MATTER

Without the full support of the AMFI, the Central Bank of Kenya and the Ministry of Finance (Treasury), the Microfinance Bill would not have passed in 2007. Previously, the bill languished, moving in and out of non-ending debating circles since 1999. It wasn't until KEMCAP built relationships with these institutions, and then later, serving as the nexus to channel ideas, resources, and effort did the bill move from a good idea to a workable, best practice document to Kenyan law. This would not have been possible without committed public and private sector partners.

The relationships with these institutions required time to build and nurture – starting out as stand-offish ventures and ending as long-lasting and mutually beneficial partnerships. Trust is not easy to build in Kenya – with Kenyans and their institutions. Many want to do it 'the Kenyan' way, an approach that isn't always grounded in best practice. With both AMFI and the Central Bank, the alliances were tumultuous from the outset, necessitating patience and large expenditures of effort but now, at the conclusion of KEMCAP, both are on solid footing as evidenced in various correspondence sent to USAID Kenya from each partner.

Today and tomorrow, these partners are critically important to USAID's work in moving the financial services sector forward, given how important both institutions are to ongoing and sustainable growth.

ANNEXES

ANNEX A: BUDGET

	BUDGET (in USD)
WORKDAYS ORDERED	1,191,303.93
OTHER DIRECT COSTS	818,006.00
G & A COSTS	68,968.35
CEILING FEE	0.00
CEILING PRICE	**2,078,278.28**

Note: at the writing of this report, the budget modification request and other approvals had not yet been processed. As a result, DAI only shows the total budget in this annex.

ANNEX A:
TECHICAL DOCUMENTS

KENYA MICROFINANCE CAPACITY BUILDING PROGRAM
TECHNICAL DOCUMENTS
CONTRACT NO. GEG-1-00-02-00011-00
TASK ORDER NO. 804
MAY 2004 – JANUARY 2008

Quarterly/Final Reports

- Quarterly Report, May 17 – September 30, 2004
- Quarterly Report, October 1 – December 31, 2004
- Quarterly Report, January 1 – March 30, 2005
- Quarterly Report, April 1 – June 30, 2005
- Quarterly Report, July 1 – September 30, 2005
- Quarterly Report, October 1 – December 31, 2005
- Quarterly Report, January 1 – March 31, 2006
- Quarterly Report, April 1 – June 30, 2006
- Quarterly Report, July 1 – September 30, 2006
- Quarterly Report, October 1 – December 31, 2006
- Quarterly Report, January 1 – March 31, 2007
- Quarterly Report, April 1 – June 3, 2007
- Quarterly Report, July 1 – September 30, 2007
- Quarterly Report, October 1 – December 31, 2006
- Final Report, May 2004 – January 2008

Microfinance Act 2006 and Central Bank

- Memo from the Director, Financial Institutions Supervision
- Deposit-Taking Microfinance Bill, 2005
- Brief from Andrew Mullei, March 1, 2006
- Best Practices Analysis of Proposed Kenyan Microfinance Bill and Regulations, May 2005
- Proposed Changes to the Deposit Taking Microfinance Bill 2005, February 2006
- Kenya Gazette Supplement, Acts 2006, January 2, 2007
- Regulation 1: Licensing New Deposit-Taking Microfinance Institutions
- Regulation 2: Capital Adequacy
- Regulation 3: Risk Classification of Assets and Provisioning
- Regulation 4: Liquidity Management
- Regulation 5: Prudential Returns
- Regulation 6: Publication of Financial Statements and other Disclosures
- Regulation 7: Mergers, Amalgamations, Transfer of Assets and Liabilities
- Regulation 8: Appointment, Duties and Responsibilities of External Auditors

- Regulation 9: Prohibited Business
- Regulation 10:Place of Business

- Regulation 11:Corporate Governance: Duties, Responsibilities and the Code of Conduct for Directors, Chief Executives, Management and Other Employees
- Regulation 12:Supervisory Enforcement Actions and Corrective Orders
- Regulation 13:Proceeds of Crime and Money Laundering
- Central Bank of Kenya Capacity Building Plan, November 2008

DCA

- Assessment of Development Credit Authority Guarantees in Kenya, April 2007
- Office of Development Credit, Concept Document for DCA Loan Portfolio Guarantee and Loan, Bond, or Portable Guarantee
- Trip Report: Uganda Development Credit Authority Exposure Visit, October 2004

SME Sector Analysis

- Evaluation of the Creditworthiness of the SME Sector in Kenya, June 2005

AMFI

- AMFI, Strategic Business Plan, 2005-2009, October 2004
- AMFI Diagnostic, December 2004
- AMFI Update
- Unsolicited Proposal, Strengthening Long-term Microfinance Support Services and Creating Incentives for Rural Development, April 2005
- AMFI, Strategic Plan, 2006-2010, July 2006
- AMFI Member Directory, February 2007
- CBK Position Paper on CBK Microfinance Regulations, May 2007

Warehouse Receipts and Other

- Warehouse Receipt Financing, September 2005
- Paper and presentation on for Rural Finance in Kenya for the 2nd National BDS Donor Conference, October 2007

Coastal Development Authority

- Recommendations for Facilitating Financial Services in Resource Poor Areas along the Kenyan Coast, May 2005
- CDA/CMDP—Coast Development Program, Key Findings: CBO Capacity Assessment, April 2005

AVO-Loan Product – KBDS Collaboration

- KBDS Equity AvoLoan Brochure
- KBDS Avo Process Flows
- AvoLoan Credit Manual, June 2006
- KBDS Scope of Work, Development of Information Systems for Avocado Market Linkages, November 2007

- KBDS AvoIS Assessment Plan

SMEP Transformation
- SMEP: A Generic Transformation Plan, March 2005

RAF Assessment
- Assessment of Rural Agricultural Finance in Kenya, July 2006

Other
- DFID Output to Purpose Review on Opportunity Bank Malawi, February 2005