

**Microfinance Development in Kenya:
Transforming K-Rep's Microenterprise Credit Program
into a Commercial Bank**

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Abstract

The Kenya Rural Enterprise Programme (K-Rep), established in 1984, is one of the most innovative and successful microfinance schemes in Africa. It provides financial services to microenterprises excluded from the formal financial sector, thereby generating income and employment opportunities for low-income microentrepreneurs. K-Rep made 11,582 loans totaling KSh 347 million (approximately US\$5.9 million) in 1998.

K-Rep is in the process of institutional reorganization and diversification: it has changed its name to K-Rep Holdings Limited; split its commercial banking operations from its research and advisory services, creating K-Rep Bank; received a banking license in March 1999; and secured share capital in K-Rep Bank.

The transition from a microfinance NGO into two complementary institutions, one a commercial bank and the other a non-profit R&D and advisory organization, is an extremely challenging process to manage. This study is designed to facilitate K-Rep's transition by combining a comparative perspective from microfinance institutions in other countries with K-Rep's considerable research and extensive strategic planning to date.

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

The creation of K-Rep Bank also raises four critical operational issues: 1) How will K-Rep Bank mobilize voluntary savings, and what will be the relationship between voluntary and mandatory savings? 2) How can K-Rep Bank improve the efficiency while maintain the quality of its lending operations? 3) How can K-Rep Bank ensure sustainability? 4) What will be the relationship between K-Rep Bank operations and the microbanking operations of K-Rep Holdings Ltd.?

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

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CHAPTER I: EXECUTIVE SUMMARY

INTRODUCTION

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

In 1994, K-Rep decided to transform its microenterprise credit program into a commercial bank, to: 1) achieve institutional and financial sustainability through improved governance and increased profitability; 2) balance management time between profitable microfinance activities and complementary services that usually require some degree of subsidization; 3) gain access to additional sources of capital, particularly from client savings, thereby reducing K-Rep's dependence on donor funds, expanding K-Rep's market outreach, and recycling client savings to microenterprises rather than channeling them through traditional banks to finance wealthier sectors of the economy; and 4) offer additional financial services to microentrepreneurs and other low-income populations.

K-Rep has recently completed the process of institutional reorganization and diversification, which has entailed: 1) changing its name from Kenya Rural Enterprise Programme to K-Rep Holdings Limited; 2) splitting its microenterprise credit operations from its research and advisory services, creating K-Rep Bank Limited; 3) receiving a banking license in March 1999; and 4) securing share capital in K-Rep Bank.

The transformation from a microenterprise credit program into two complementary institutions, one a commercial bank and the other a non-profit R&D and capacity building organization, is a challenging process to manage. This study is designed to facilitate K-Rep's transition by combining a comparative perspective from microfinance institutions in other countries with K-Rep's considerable research and extensive strategic planning.

PROFILE OF K-REP HOLDINGS

K-Rep Holding's goal is to penetrate mainly rural, poor communities via the use of innovative products and delivery systems. It allows K-Rep to experiment with new financial products without the constraints of commercial banking regulations, as well as to promote outreach and coverage by assisting in the capacity building efforts of other microfinance institutions. K-Rep Holdings has two divisions, Microfinance Research and Innovations, and Microfinance Capacity Building. It is currently engaged in a broad spectrum of microfinance activities, including smallholder farmer credit, low cost housing finance, renewable energy technologies, health care financing, capacity building consultancies, and an information center. K-Rep Holding's most rapidly growing initiative is the creation of financial services associations, or FSAs (village banks).

PROFILE OF K-REP BANK

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

K-Rep has experienced substantial growth in the 1990s. The number of employees has increased four-fold, from 39 in 1991 to 152 in 1998, and the number of distribution outlets has grown from two area offices in 1991 to five area offices and sixteen field offices throughout Kenya by 1998. K-Rep lending has also grown dramatically over the past eight years, increasing almost eight-fold in the number of loans disbursed annually, and increasing twenty-four fold in the value of loans disbursed annually: K-Rep made 1,507 loans totaling KSh 14.3 million in 1991, which had grown to 11,582 loans totaling KSh 347.1 million disbursed in 1998. This disproportionate increase in value versus number of loans disbursed resulted in a tripling of the average size of a K-Rep loan, increasing from KSh 9,489 in 1991 to KSh 29,960 in 1998. Much of the growth in average loan size can be attributed to inflation, as the consumer price index roughly tripled from 1991 to 1998. Real growth in borrower business activity also contributed to the rise in average loan size. Loans outstanding increased significantly during this same period, growing seven-fold from KSh 32.5 million in 1991 to KSh 230.0 million in 1998. With the exception of 1994 and 1995, loan repayment rates (loan amount repaid ÷ loan amount due) have remained high at between 96 and 99 percent.

K-Rep gross income more than quadrupled from 1991 to 1998, increasing from KSh 39.9 million to KSh 180.8 million. While net income rose dramatically during the middle of this period, expansion of field operations caused net income to fall back to about the same level by the end of this same period: KSh 23.1 million in 1991 and KSh 23.9 million in 1998. Of special note is K-Rep's declining dependence on grant income: in 1993, grants comprised 87 percent of K-Rep's income, but grants had fallen to 32 percent of income by 1998. Most of this grant income has been replaced by income from credit schemes and miscellaneous income (primarily interest on treasury investments and income from consulting services).

The composition of K-Rep assets indicates a trend to hold ever larger portions of total assets in cash and treasury investments (treasury bills and fixed deposits): this figure totaled 16 percent of total assets in 1995, but had almost tripled to 44 percent of total assets by 1998. This is partly a symptom of K-Rep's difficulty in expanding credit operations while maintaining high portfolio quality during an overall economic downturn and depressed market conditions in Kenya.

STRATEGIC ISSUES

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

Commercialization and Corporatization of K-Rep Bank

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

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

In terms of future growth in average loan size, the microfinance market in Kenya seems to be relatively better serviced at the low end due to the large number of microfinance NGOs, while no commercial bank is yet offering credit products on a wide scale for what would normally be the high end of the microfinance market. Thus, there does not appear to be any reason for alarm in terms of K-Rep's strategic mission if K-Rep gradually increases its loan sizes. Rather, the challenge of larger loans is primarily operational.

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

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

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

OPERATIONAL ISSUES

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

Savings Mobilization

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

Cost-Effectiveness of Credit Operations

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

Ensuring Sustainability

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

REGULATION AND SUPERVISION ISSUES

Issuance of K-Rep's banking license raises regulation and supervision issues in three key areas related to CBK oversight of microfinance in Kenya: 1) regulation and supervision of K-Rep; 2) regulation and supervision of other potential microfinance banks; and 3) regulation and supervision of non-bank microfinance institutions. In each of these areas, the concerns are the same regarding the efficient and effective prudential regulation and supervision of microfinance banks in Kenya: 1) Are the CBK's commercial banking

statutory requirements and prudential norms and regulations appropriate for microfinance banks? 2) Can the CBK monitor and enforce these provisions in a cost-effective manner for microfinance banks?

Regulation and Supervision of K-Rep

Capital Adequacy

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

Asset Quality

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

Management Quality

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

Earnings

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

Liquidity

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

Regulation and Supervision of Other Microfinance Banks

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

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

Regulation and Supervision of Non-Bank Microfinance Institutions

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

CHAPTER II: INTRODUCTION

OVERVIEW

The Kenya Rural Enterprise Programme (K-Rep), established in 1984, is one of the most innovative and successful microfinance schemes in Africa. It provides financial services to the poor who are typically excluded from the formal financial sector, thereby generating income and employment opportunities for low-income people. In 1998, K-Rep made 11,582 loans totaling KSh 347.1 million (approximately US\$ 6.0 million), and mobilized 13,202 savings accounts totaling KSh 86.7 million (approximately US\$ 1.5).¹

K-Rep has recently completed the process of institutional reorganization and diversification. This has entailed:

- Changing its name from Kenya Rural Enterprise Programme to K-Rep Holdings Limited, with dual registration as both a not-for-profit company without share capital and limited by guarantee under the Company's Act, and as an NGO under the Non-Governmental Organisations Co-ordination Act.
- Splitting its microenterprise credit operations from its research and advisory services, creating K-Rep Bank Limited.
- Receiving a banking license in March 1999.
- Securing share capital in K-Rep Bank from K-Rep Holdings, K-Rep employees (KWA - Staff Association), Shorebank Corporation, African Development Bank, Netherlands Development Finance Company (FMO), Stichting Triodos-Doen (Dutch NGO), and the International Finance Corporation.

The transformation from a microenterprise credit program into two complementary institutions, one a commercial bank and the other a non-profit R&D and capacity building organization, is a challenging process to manage. This study is designed to facilitate K-Rep's transition by combining a comparative perspective from microfinance institutions in other countries with K-Rep's considerable research and extensive strategic planning to date.²

The results of this EAGER/PSGE project³ should provide guidance to other African NGOs attempting to become commercial banks, and commercial banks in Africa that are entering the microenterprise sector. Microenterprise development focuses on income

¹ Using the January 1999 exchange rate of US\$1.00 = KSh 58.

² For studies of BancoSol's transition to a bank in Bolivia, see Glosser (1994) and Mosley (1996). Patten and Rosengard (1991), Christen et al (1995), Microbanking Bulletin (1998) and Morduch (1998) provide general overviews of the microfinance sector.

³ Equity and Growth through Economic Research/Public Strategies for Growth and Equity.

generating investments for low- income microenterpreneurs, thereby generating economic growth while at the same time improving equity in the distribution of this growth.

KEY ISSUES

The following key strategic, operational, and regulatory issues have been prepared jointly with K-Rep and USAID/Kenya.

1. Strategic Issues

- How will K-Rep Bank's need to be commercially viable and institutionally self-sustaining affect its current microbanking mission and market niche?
- What are the potential complementarities and contradictions in the respective missions of K-Rep Bank and K-Rep Holdings?

2. Operational Issues

- How will K-Rep Bank mobilize voluntary savings, and what will be the relationship between voluntary and mandatory savings?
- How can K-Rep Bank improve the efficiency while maintaining the quality of its lending operations?
- How can K-Rep Bank ensure sustainability?
- What will be the relationship between K-Rep Bank operations and the microfinance operations of K-Rep Holdings?

3. Regulatory Issues

- Are the Central Bank of Kenya's commercial banking statutory requirements and prudential norms and regulations appropriate for microfinance banks?
- Can the Central Bank of Kenya monitor and enforce these provisions in a cost-effective manner for microfinance banks?
- What should the Central Bank of Kenya's role be in the regulation and supervision of non-bank microfinance institutions?

METHODOLOGY

This study is a joint effort of researchers at the Harvard Institute for International Development and K-Rep Holdings. The methodology combines primary field research with a review and synthesis of previously published documents.

This study evolved as follows:

- Key issues were identified in October 1998.
- At the same time, preliminary field visits were made to Juhudi groups in K-Rep's West Nairobi (Kawangware) branch and to Chikola groups in K-Rep's East Nairobi (Thika) branch.
- The final design of the project was presented to a Research Supervision Committee in November 1998 consisting of Kenyan academicians and policymakers.
- From the West Nairobi area office, six credit officers were selected at random and a survey of borrowing groups was designed. This survey was administered in January through March of 1999.
- Financial data on K-Rep past operations was also collected and interpreted starting January 1999.
- Meetings with officials at the Central Bank of Kenya were conducted in February 1999.
- The draft final report was presented to the above-noted Research Supervision Committee, as well as to the EAGER All-Africa Conference, "Africa in the Third Millennium: Trade and Growth with Equity," both in October 1999.

DISCLAIMERS

Due to limited resources and the desire to meet K-Rep's strategic needs, this study will concentrate on providing applied policy research for the specific case of K-Rep's transition to a commercial bank. While this study will place K-Rep's transition within the context of the microfinance sector in Kenya, it will not attempt to perform an in-depth survey or analysis of Kenya's or East Africa's microfinance sector.¹ In keeping with EAGER/PSGE objectives, this study will provide policy inputs without attempting to provide technical assistance to K-Rep.

¹ Dondo (1999) offers a comprehensive review of the status of microfinance in Kenya, while Aryeteey (1997) and Gurgand et al (1994) provide an introduction to microcredit efforts elsewhere in Africa.

CHAPTER III: PROFILE OF K-REP

BACKGROUND¹

K-Rep is a microenterprise development organization with the objective of promoting the participation of low-income people in the development process. Its main focus to date has been on expanding the financial services available to those who have traditionally been neglected by the formal banking sector.

K-Rep was established in 1984 by World Education Inc., a United States based private voluntary organization, with funding from the United States Agency for International Development (USAID). In 1987 it was locally incorporated as a Kenyan Non-Governmental Organization (NGO). Initially K-Rep was designed to be an intermediary NGO that provided on-lending, training, and technical assistance to local NGOs. Concerns about sustainability and effectiveness of its NGO clients prompted K-Rep to change its approach and start its own direct lending program in 1990.

INSTITUTIONAL EVOLUTION

Overview

K-Rep experienced substantial growth in the 1990s. The number of employees increased four-fold, from 39 in 1991 to 152 in 1998. The number of distribution outlets also increased dramatically, growing from two area offices in 1991 to five area offices and sixteen field offices throughout Kenya by 1998.

Since 1993-94, K-Rep began to separate its financial services (lending and savings mobilization) from its non-financial services (research, training, technical assistance, innovations, and consultancy), and established two divisions for that purpose. These two divisions formed the basis for K-Rep's eventual separation of its commercial banking operations (K-Rep Bank) from its research and advisory services (K-Rep Holdings).

K-Rep has learned from doing. Its two direct lending products, Juhudi and Chikola, both started out as hands-off group lending schemes loosely modeled after the Grameen Bank in Bangladesh. Over time, the model was adapted to Kenyan conditions. In 1994, K-Rep ceased all wholesale lending to NGOs due to increasing arrears, and combined the administration of Juhudi and Chikola loans for greater operational efficiency. It adopted a 'minimalist' credit approach, emphasizing financial services.²

Below is a description of the evolution of Juhudi and Chikola.

¹ For details on K-Rep's background and the evolution of its direct lending schemes see Mutua (1994), Dondo (1997), and Pederson and Kiiru (1997).

² Studies of group lending programs include Ghatak and Guinnane (1999) and Rai and Sjostrom (1999). Mutua et al (1996) describes the history of group lending in Kenya.

Juhudi

The following are the main features of Juhudi lending:

- Borrowers are organized into groups of 4 to 8 members (*watano*) and 3 to 8 *watano* groups are combined to form a larger association (*kiwa*). The average *kiwa* size is 25.
- Borrowers are required to contribute to a savings account that is jointly operated by the *kiwa* and K-Rep. The proportion of required savings to amount borrowed increases with loan size. For example, the borrower is required to deposit 5 percent as savings for a loan of KSh 15,000, while for a loan of KSh 50,000, the borrower is required to deposit 20 percent as savings.
- In addition to the mandatory savings, borrowers must also pledge physical collateral to the *kiwa* to protect against default. Such a pledge must be accompanied by a legal affidavit.
- In case of default, the defaulting borrower forfeits his/her savings plus interest earned. If the defaulting borrower's savings are insufficient, *watano* members forfeit their savings in equal proportion to cover the balance. If even the *watano* savings are insufficient, the *kiwa* takes responsibility for the sale of pledged securities outlined in the affidavit.
- Juhudi loans are typically made for six months or more, and repayments are made weekly at the *kiwa* meeting.

Each *kiwa* is also encouraged to make regular contributions to an Emergency Fund. K-Rep is not a signatory on the Emergency Fund. The purpose of this fund is to provide for short-term bridge loans to members who are having difficulty making a repayment and to pay for *kiwa* expenses.

K-Rep opened its first Juhudi branch in September 1990 in Kibera, Nairobi's largest slum. The branch experienced quick initial growth and a high repayment rate. Initially, K-Rep was enthusiastic in recruiting borrowers and forming groups quickly, but it soon realized that relying exclusively on peer selection makes for fragile groups. Some group members were not genuine business operators, as they had claimed. Further, the groups were responsible for deciding the initial loan's size, and it was discovered that initial loans were often too large or too small for the microenterprise's investment.

Consequently, K-Rep made some changes to its lending methodology. It emphasized training borrowers on how to appraise loans, and involved the credit officer in actively monitoring the borrowers to ensure that they were indeed business operators. K-Rep also learned to spend time up front with borrower groups explaining the lending mechanism clearly.

Chikola

The main features of Chikola lending are:

- Chikola groups are 20 members on average, smaller than typical Juhudi groups.
- Repayments are made monthly and loans are for 12 months or longer.
- Chikola members save in a joint account and these savings may be forfeited in the event of a default.

Members must pledge physical collateral to the group (just as in the Juhudi scheme) to protect against default.

To expand outreach and coverage, K-Rep made its first Chikola loans in June 1991. Unlike Juhudi loans, Chikola lending is directed to preexisting and registered rotating savings and credit associations (ROSCAs).

The Chikola lending scheme initially was quite different from Juhudi. K-Rep made a group loan and let the group members decide on how to on-lend the funds internally. Repayments were made by a standing order at the bank where the Chikola group had an account. Chikola lending was therefore much cheaper than Juhudi lending, as all costs of group formation, loan disbursement, and collection of repayments were delegated to the group.

However, declines in Chikola repayment rates led K-Rep to change its methodology. Now the Chikola scheme has come to closely resemble Juhudi. K-Rep has introduced checks and balances to ensure the stability of Chikola groups. K-Rep is now a signatory on the Chikola savings accounts. Loans are no longer made to the group, but instead are made to individuals within the group. A K-Rep credit officer now visits the Chikola group meeting to follow-up on repayments.

Transformation to Holding Company and Commercial Bank

In 1994, encouraged by precedents such as Prodem's conversion to Banco Sol in Bolivia, K-Rep decided to transform its microenterprise credit program into a commercial bank,¹ in order to:

- Achieve institutional and financial sustainability through improved governance and increased profitability.

¹ K-Rep also considered alternative institutional options, such as a non-bank financial institution (NBFIs) or a cooperative. However, the advantage of a lower capital requirement for NBFIs was eliminated when the Central Bank of Kenya increased it the same level required of commercial banks, and the cooperative form was unattractive due to fear of excessive government interference.

- Balance management time between profitable microfinance activities and complementary services that usually require some degree of subsidization.
- Gain access to additional sources of capital, particularly from client savings, thereby reducing K-Rep's dependence on donor funds, expanding K-Rep's market outreach, and recycling client savings to microenterprises rather than channeling them through traditional banks to finance wealthier sectors of the economy.
- Provide additional financial services to microentrepreneurs and other low-income populations.

Five years transpired between K-Rep board's decision to transform the NGO's Financial Services Division into a regulated financial institution, and Central Bank of Kenya (CBK) issuance of a commercial banking license to K-Rep Bank. The delay was caused by: difficulties in reaching a shareholder agreement due to the internal requirements of each investor, particularly the multilateral financial institutions; CBK regulatory impediments (see Chapter V); and financial stress within Kenya's banking system.¹

K-Rep is now formally split into two institutions: K-Rep Holdings Limited, which, as noted in Chapter II, has a dual registration as both a not-for-profit company without share capital and limited by guarantee under the Company's Act, and as an NGO under the Non-Governmental Organisations Co-ordination Act; and K-Rep Bank Limited, licensed by CBK as a commercial bank. K-Rep Holdings owns 32 percent of K-Rep Bank, and the K-Rep Group Coordination Office facilitates interactions between the two institutions.²

KEY ACTIVITIES OF K-REP HOLDINGS

K-Rep Holding's main goal is to help K-Rep fulfill its mission by complementing K-Rep Bank's primarily urban, commercial financial activities via the deeper penetration of mainly rural, poor communities with innovative products and delivery systems. It allows K-Rep to experiment with innovative financial products without the constraints of commercial banking regulations, as well as to promote outreach and coverage by assisting in the capacity building efforts of other microfinance institutions.

K-Rep Holdings has two divisions, Microfinance Research and Innovations (MFRI), and Microfinance Capacity Building (MFCB). It is currently engaged in a broad spectrum of microfinance activities, including:

- Smallholder Farmer Credit – A pilot project to increase access to credit facilities as one way of improving farm productivity, and thus, farmer income.

¹ In mid-1998, five small banks were placed under CBK management due to lack of liquidity, followed by a run in December 1998 on the National Bank of Kenya, the country's fourth largest bank.

² K-Rep Holdings maintains a registration under the Companies Act so that it may own shares in K-Rep Bank; an NGO is not allowed to own shares in a bank.

- Low Cost Housing Finance – A pilot project to develop mechanisms through which financial and building technology services can be combined to assist the poor in acquiring affordable shelter through home ownership.
- Renewable Energy Technologies – A pilot project to develop and test private sector credit mechanisms to finance household solar systems.
- Health Care Financing – An initiative now under development to offer low income communities a means to finance their health care requirements.
- Capacity Building Consultancies – Advisory services to microfinance institutions both in Kenya and abroad (Ghana, Somalia, Ethiopia, South Africa, Swaziland, Namibia, Zambia, Zimbabwe, and Uganda).
- Arifu MSE and Microfinance Development Information Centre – Established in 1994, it now has a stock of over 2,400 books, articles, and reports, as well as five data bases (literature, institutions, projects and programs, experts, and K-Rep publications).

K-Rep Holdings' most rapidly growing initiative is its Financial Services Association (FSA) Project. Known unofficially as village banks, FSAs are rural savings and credit institutions owned, financed, and managed by village members. Implementation began in November 1997, and as of 31 August 1999, 21 FSAs had been formed, with 5,803 members, KSh 3.7 million in shares, and KSh 6.2 million in loans.

FSAs have been established in remote rural areas not reached by other microfinance programs, often in villages with poor infrastructure, low population density, and limited economic potential. The challenge will be to sustain these FSAs past the start-up phase, and to integrate them into K-Rep Bank's financial network (see Chapter IV).

FINANCIAL TRENDS UNTIL THE LICENSING OF K-REP BANK

K-Rep lending has grown dramatically over the past eight years, increasing almost eight-fold in the number of loans disbursed annually, and increasing twenty-four fold in the value of loans disbursed annually: K-Rep made 1,507 loans totaling KSh 14.3 million in 1991, which had grown to 11,582 loans totaling KSh 347.1 million disbursed in 1998. This disproportionate increase in value versus number of loans disbursed resulted in a tripling of the average size of a K-Rep loan, increasing from KSh 9,489 in 1991 to KSh 29,960 in 1998. Much of the growth in average loan size can be attributed to inflation, as the consumer price index roughly tripled from 1991 to 1998. Real growth in borrower business activity also contributed to the rise in average loan size (see Figure 1 and Statistical Annex).

However, between 1993 and 1994, the average loan size doubled, and then increased another 25 percent between 1994 and 1996. This was due to a dramatic growth of K-Rep business, supported by K-Rep's expansion from one branch in 1990 to five area and eleven field offices by 1995. In addition, average loan size began to increase rapidly, as credit officers found it easiest to expand their portfolios by making larger loans. This resulted in increasing delinquency rates due to over-crediting, borrower misapplication of funds, and poor credit officer monitoring of their clients. It also led to higher group desertion rates because many members felt uneasy co-guaranteeing large loans. K-Rep has intentionally reversed the trend of increasing average loan size, in order to refocus on a clientele of lower income people in what it calls "back to basics." The average loan size had fallen to KSh 24,834 by June 1999 (see Figure 1 and Statistical Annex).

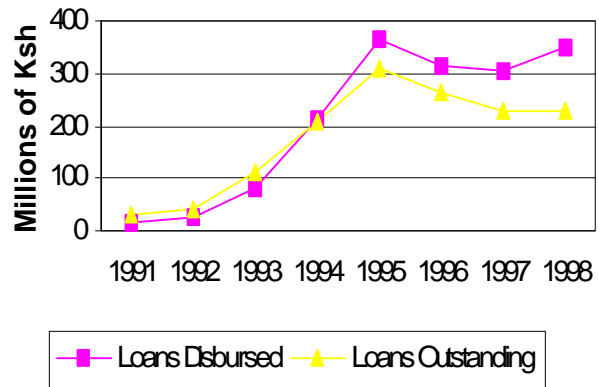
Loans outstanding increased significantly during this same period, growing seven-fold from KSh 32.5 million in 1991 to KSh 230.0 million in 1998. With the exception of 1994 and 1995 (see preceding paragraph), loan repayment rates¹ have remained high at between 96 and 99 percent (see Figure 1 and Statistical Annex).

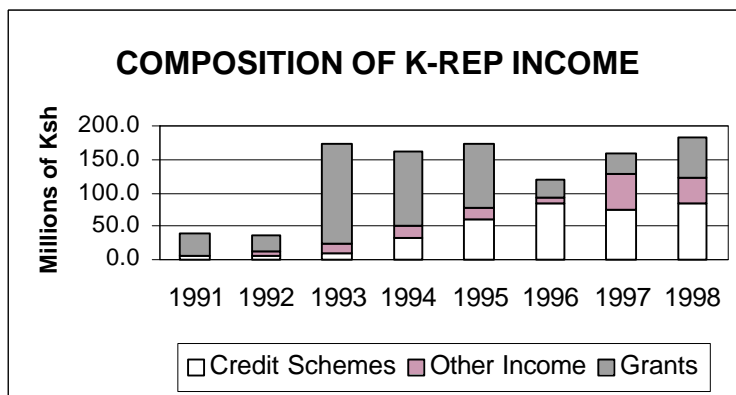
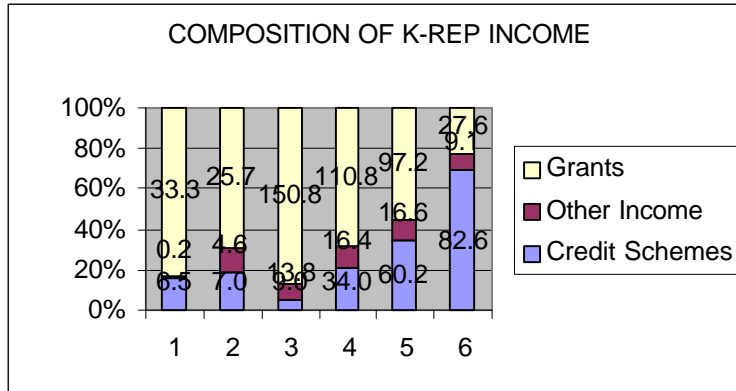
K-Rep gross income more than quadrupled from 1991 to 1998, increasing from KSh 39.9 million to KSh 180.8 million. While net income rose dramatically during the middle of this period, expansion of field operations caused net income to fall back to about the same level by the end of this same period: KSh 23.1 million in 1991 and KSh 23.9 million in 1998 (see Statistical Annex). Of special note is K-Rep's declining dependence on grant income: in 1993, grants comprised 87 percent of K-Rep's income, but grants had fallen to 32 percent of income by 1998 (see Figure 2). Most of this grant income has been replaced by income from credit schemes and miscellaneous income (primarily interest on treasury investments and income from consulting services).

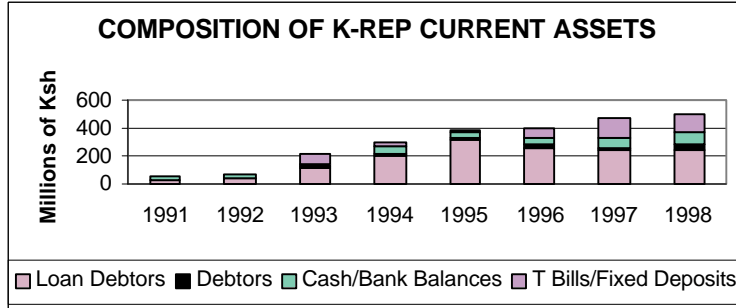
The composition of K-Rep assets indicates a trend to hold ever larger portions of total assets in cash and treasury investments (treasury bills and fixed deposits): this figure totaled 16 percent of total assets in 1995, but had almost tripled to 44 percent of total assets by 1998 (see Figure 3 and Statistical Annex). This is partly a symptom of K-Rep's difficulty in expanding credit operations while maintaining high portfolio quality during an overall economic downturn and depressed market conditions in Kenya.

¹ Loan amount repaid ÷ loan amount due.

GROWTH OF KREP LENDING







CHAPTER IV: STRATEGIC AND OPERATIONAL ISSUES

INSTITUTIONAL TRANSFORMATION

The transformation of K-Rep from a microenterprise credit program into two complementary institutions, one a commercial bank and the other a non-profit research and capacity building organization, is a challenging process to manage. This institutional change not only entails legal and organizational modifications, but also has long-term strategic and operational implications.

STRATEGIC ISSUES

The creation of K-Rep Bank raises two key strategic questions:

- How will K-Rep Bank's need to be commercially viable and institutionally self-sustaining affect its current microbanking mission and market niche?
- What are the potential complementarities and contradictions in the respective missions of K-Rep Bank and K-Rep Holdings?

Commercialization and Corporatization of K-Rep Bank

The experience of microfinance NGOs elsewhere that try either to attain commercial viability as NGOs, or to transform themselves into banks, is that financial pressures compel them to make larger loans than they had made previously. Some of the larger loans go to old customers whose financing needs have increased as their businesses have grown, some are for old customers whose businesses do not warrant ever increasing loan sizes, and some go to completely new more up-market entrepreneurs. The motivation is clear: the more lent per loan officer, the lower the cost per unit lent. Thus, this is one way to reduce lender transaction costs.

While this has not necessarily led to a deterioration of loan portfolio quality, it has led to a re-examination of the microfinance institution's mission, and that institution's current market niche. Some see this as a natural institutional evolution that parallels the growth of a microfinance institution's borrowers, and they see a need to fill a gap that still remains between informal credit markets and traditional retail commercial banking. Proponents of this viewpoint also claim that there are numerous other NGOs to service the smaller end of the microenterprise market, while these NGOs do not have the capacity to finance the relatively large microenterprises. Others are concerned that this trend creates a financing gap for the smaller-scale microentrepreneurs, especially potential new borrowers, as well as creates greater credit risk for the microbank because of more concentrated lending activities.

Until recently, the trend at K-Rep had been increasing average loan sizes: although the total value of loans disbursed declined 16 percent from 1995 to 1997, the average loan

size grew 55 percent during this same period (see Chapter III). This trend alarmed K-Rep management, as it appeared that default rates had been higher for the larger loans in K-Rep's portfolio. However, the average K-Rep loan has decreased dramatically over the past year and a half due K-Rep's policy to refocus its attention on lower-income borrowers. This "back to basics" measure was taken both to better achieve K-Rep's mission, and to improve credit risk management. Under this program, K-Rep retrained all of its credit officers regarding K-Rep's original development philosophy and the fundamental principles of microfinance. K-Rep also implemented new internal control instruments, which intensified management supervision of credit officers and increased the amount and frequency of loan delinquency tracking. K-Rep was convinced that the organization could separate its microfinance activities into a commercially sustainable bank because of the demonstrated financial viability of its credit operations, and that going "upmarket" would not be necessary to ensure K-Rep Bank's financial survival.

In terms of future growth in average loan size, the microfinance market in Kenya seems to be relatively better serviced at the low end due to the large number of microfinance NGOs, while no commercial bank is yet offering credit products on a wide scale for what would normally be the high end of the microfinance market. Thus, there does not appear to be any reason for alarm in terms of K-Rep's strategic mission if K-Rep gradually increases its loan sizes. Rather, the challenge of larger loans is primarily operational, as discussed below.

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

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

The most important synergy between K-Rep Bank and K-Rep Holdings is the Bank's integration, or adaptation and commercial replication of K-Rep Holdings' microfinance innovations. This could greatly enhance K-Rep Bank's outreach and coverage. The challenge will be to make use of banking products and delivery systems developed by K-Rep Holdings in a financially viable manner.

Of special note at present are the Financial Services Associations (FSAs) now being supported by K-Rep Holdings (see Chapter III). While some of these FSAs will inevitably fail, those that survive past the start-up phase offer K-Rep Bank an innovative way to service remote rural areas. The cost of expanding K-Rep Bank's physical delivery system to geographically isolated, sparsely populated, economically low-potential locations is prohibitive. However, K-Rep Bank can link these village banks to the formal financial system in two ways: it can absorb the excess liquidity of FSAs that have surplus funds, and it can provide a line of credit to those FSAs with excess demand for loans. This would allow the FSAs to serve as true financial intermediaries, while extending K-Rep Bank's network in a low-cost, low-risk manner.

The area most likely to cause confusion in terms of overlapping and competing functions is the simultaneous delivery of microcredit via both K-Rep Bank and K-Rep Holdings. To avoid such a conflict, K-Rep Holdings and K-Rep Bank are currently working in different geographical areas and targeting different clients. Unfortunately, this has had the unintended effect of making it more difficult for K-Rep Bank to benefit from K-Rep Holdings' innovations. Thus, this could still happen if K-Rep Bank and K-Rep Holdings were to provide communities similar products with different terms and conditions. This might occur, for example, where K-Rep Holdings was experimenting with microfinance in communities already serviced by K-Rep Bank, or as a result of K-Rep Bank's efforts to integrate the FSAs into its distribution network.

OPERATIONAL ISSUES

The creation of K-Rep Bank raises three critical operational questions:

- How will K-Rep Bank mobilize voluntary savings, and what will be the relationship between voluntary and mandatory savings?
- How can K-Rep Bank improve the efficiency while maintain the quality of its lending operations?
- How can K-Rep Bank ensure sustainability?

Savings Mobilization

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

This is the main obstacle to K-Rep Bank's need to mobilize savings from the public: the possible perception that savings as voluntary deposits might be treated like savings as collateral. There are two responses to this constraint:

- Rely primarily on non-borrowers as the source of voluntary savings. In fact, the bulk of voluntary savings in other microfinance programs has come from the local community, not microenterprise borrowers. K-Rep market surveys confirm that the largest untapped source of microsavings is from the community at large, not K-Rep borrowers.

- Experiment with eliminating the mandatory savings requirement as a condition of borrowing, perhaps as part of new terms and conditions for individual loans to microentrepreneurs who have “graduated” from group borrowing. Field survey results indicate that while mandatory savings might serve as an incentive to repay loans in theory, these mandatory savings accounts are seldom used as an enforcement mechanism in practice. Even the emergency funds created by group borrowers to compensate for missed loan payments as an alternative to tapping into group savings are not used very often.

The result of mandatory savings as a condition of borrowing is to raise the effective interest rate – it is more like a tax on borrowing, rather than either a form of collateral for group borrowing or microcredit funds mobilization. If the risk of lending increases somewhat without compulsory savings, perhaps K-Rep Bank could increase the interest rate on its loans slightly to compensate.

K-Rep has encouraged “voluntary savings” in the past, in excess of the standard amounts that are required as collateral. But the procedure to withdraw these “voluntary savings” is complicated because of the group structure of the accounts. To withdraw “voluntary savings”, a member must present a reason for withdrawal to the group, get their approval and obtain the signature of two of the group officials. To make savings easily accessible and to encourage non-borrowers to save, K-Rep Bank will need to establish individual level savings accounts for “voluntary savings” with unlimited, unrestricted access.

Cost-Effectiveness of Credit Operations

Over the past fifteen years, K-Rep has developed a successful methodology for delivering credit to entrepreneurs who previously did not have access to formal credit institutions, and ensuring that most of these loans are paid back on time and in full. As K-Rep Bank adapts its microfinance activities to commercial banking operations, this new bank will have to balance its need for continued effective credit risk management with its desire for more efficient credit delivery and collection systems. Over time, K-Rep Bank must increase the amount lent per credit officer, by increasing either value (making larger loans) or volume (making more loans). The key is to achieve economies of scale in a manner that balances the greater credit risk of larger loans with the higher transaction costs of smaller loans. This will entail a re-examination of current credit operations, to determine which attributes are intrinsic to K-Rep’s success to date, and which characteristics can be modified for increased cost-effectiveness.

For example, K-Rep’s group lending methodology reduces credit risk through loan pooling, portfolio diversification, and mutual liability. It also saves on operational expenses for field activities that are delegated to the group, such as verification of business status and the value of pledged collateral. However, K-Rep keeps all accounts on an individual basis for the purpose of tracking loan disbursements and repayments, and ages its arrears on an individual basis as well. Not only does this negate cost savings to be derived from group rather than individual record keeping, but redundancy actually increases the cost as group records are also maintained. As K-Rep Bank increases the

volume and dispersion of its lending operations, it is unclear whether nominative credit data should be reported to the head office and the CBK, or whether it would be more cost-effective to report either aggregates from individual accounts or group status summaries. Such a change would have to be negotiated with the Central Bank of Kenya.

K-Rep Bank is already experimenting with individual loans of larger sizes for both its old customers and new customers, although it plans to maintain group lending for small loans. K-Rep Bank should continue to monitor carefully the repayment performance of its individual borrowers. It is possible that, given good credit histories and a strong incentive to repay for continued access to credit, that loan quality will remain high. However, K-Rep Bank should take care not to destroy its groups as the most successful members graduate to individual loans. This can best be achieved by allowing such graduates to continue to borrow a small amount from their group to maintain solidarity, while at the same time borrowing the excess required in the form of an individual loan. This strategy would allow K-Rep to reconcile the dilemma that borrowers should graduate to preserve group balance and efficacy, while their very graduation could destroy the group.

Ensuring Sustainability

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

Operationally, this will entail:

- Aggressive efforts to track and contain operational expenditures, especially where redundancies do not enhance profitability.
- The development of new back-office (bookkeeping and reporting), front-office (teller and customer service), and overall (asset-liability management) systems for high-transaction, low-value individual savings accounts.
- Optimization of K-Rep's credit risk management techniques to preserve the most important incentives to repay while eliminating lending terms and conditions that K-Rep and its customers might have outgrown.

K-Rep has been doing this for several years, which is why it has been profitable. The challenge will be to maintain profitability while incurring a changing cost structure due to the introduction of new products and compliance with a different regulatory regime. K-Rep Bank should adhere to its plans to seek inspection certificates for its agencies at an expeditious but prudent pace, so they can become full branches. This will allow K-Rep Bank to consolidate its commercial microfinance activities, as well as seek new business opportunities via the introduction of fee-based services such as wire transfers.

CHAPTER V: REGULATION AND SUPERVISION ISSUES

OVERSIGHT OF THE MICROFINANCE SECTOR IN KENYA

In March 1999, the Central Bank of Kenya (CBK) issued a commercial banking license to K-Rep's West Nairobi Branch. This decision marked the beginning of a new era for financial sector development in Kenya, as it was the first banking license ever issued by the CBK to a microfinance institution. Furthermore, in the 1999/2000 Budget Speech, the Minister for Finance announced CBK plans to:

- Establish a division within its Banking Department to monitor operations of microfinance institutions and to assist them in their development.
- Encourage microfinance institutions to coordinate their operations and cooperate with the formal banking sector.
- Assist the newly formed Association of Micro-Finance Institutions (AMFI) to streamline their legal and regulatory framework, as well as their accounting practices.

The issuance of K-Rep's banking license raises three sets of issues related to CBK oversight of the microfinance sector in Kenya:

- The regulation and supervision of K-Rep itself.
- The regulation and supervision of other potential microfinance banks in Kenya.
- The regulation and supervision of non-bank microfinance institutions in Kenya.

Each set of issues will be dealt with separately, as K-Rep is already well into its transformation from an NGO to a bank having successfully dealt with pre-licensing regulatory challenges that prospective microfinance banks will have to confront, and the ramifications of failed non-bank microfinance institutions are quite different from the consequences of bank failures.

REGULATION AND SUPERVISION OF K-REP

K-Rep's banking license raises two key questions regarding the efficient and effective prudential regulation and supervision of microfinance banks in Kenya:

- Are the CBK's commercial banking statutory requirements and prudential norms and regulations appropriate for microfinance banks?

- Can the CBK monitor and enforce these provisions in a cost-effective manner for microfinance banks?

The CBK's general mission regarding the banking sector is clear, and has three principal components:

- Control the activities of banks for efficiency, fairness, and safety.
- Avoid banking crises by protecting depositors, ensuring access to credit, and maintaining the smooth functioning of the payments system.
- Mitigate moral hazard without introducing market distortions.

For that purpose, the CBK conducts periodic on-site examinations and requires banks to report the following:

- Income statements and balance sheets, due 15 days after the end of each month.
- Liquidity ratios, reported every 10 days - the minimum liquidity ratio is 20%.
- Quarterly capital/asset ratio reports - the minimum is 7.5% for total capital, or 4% for core capital.¹
- Quarterly audited financial statements within three months of the end of each period.

The CBK should certainly regulate and supervise microfinance banks as part of its general mission, including K-Rep Bank. Microfinance banks mobilize savings from the public and allocate credit to the public just like any other bank, and could very well also strive to provide liquidity and payments services.

Thus, microfinance banks could also be subject to risks of public concern that justify government regulation and supervision by the central banking authority, including:

- Bank runs and liquidity crises caused by loss of public confidence.
- Negative externalities (contagion) of other bank failures and a possible systemic collapse.
- Vulnerability to market failures caused by asymmetries of information by both the bank in terms of the creditworthiness of its borrowers, and the bank's customers in terms of the bank's soundness.

¹ The CBK has proposed raising the gearing ratio from 7.5% to 8%.

The question therefore is not: Should the CBK regulate and supervise microfinance banks in Kenya? Rather, it is: What special characteristics of microfinance banks might justify adjustments in the way the CBK carries out its regulatory and supervisory responsibilities? While a bank is indeed a bank, whether big or small, complex or simple, some adaptations of current practices might be necessary for CBK to fulfill its mission without incurring exorbitant costs itself or imposing unreasonable burdens on microfinance banks. The guiding principle should be flexibility, not leniency: identification of equally rigorous criteria and standards for measuring a common performance objective differently.

There are five key features of microfinance banks that might warrant such adaptations:

- **Client Base:** Borrowers are low-income entrepreneurs working in the informal sector, rather than traditional, registered, formal businesses.
- **Lending Methodology:** Loan decisions are character based and backed by little if any conventional collateral, rather than the result of sophisticated analysis of financial statements supported by pledges of formal security.
- **Cost of Lending:** Transaction costs of lending are relatively high, somewhere between traditional bank lending and informal credit markets.
- **Loan Portfolio Composition:** Credit is comprised of a high volume of small, short-term loans with strong geographic concentrations, in contrast to a standard retail banking loan portfolio profile.
- **Funding Base:** Deposits are largely from community-based savers, rather than from highly mobile and somewhat speculative short-term investors.
- **Structure and Governance:** Bringing banking services to a widely dispersed, relatively remote clientele usually results in a decentralized structure and weak institutional infrastructure, rather than the centralized structure and bureaucratic governance of most retail branch banking.

The implications of these unique characteristics of microfinance banks for CBK prudential regulation and supervision fall into five main categories, in keeping with the five components of the CBK's CAMEL bank oversight methodology: capital adequacy, asset quality, management quality, earnings, and liquidity. The following discussion raises issues for further study and evaluation by the CBK, in consultation with K-Rep Bank.¹ It is premature to offer specific criteria and standards to assess the soundness of microfinance banks in Kenya, given the lack of historical data on the subject and in light of the overall transformations now taking place in Kenya's banking sector.

¹ For a review of how K-Rep has prepared for the regulatory and supervisory challenges associated with becoming a bank, see Mutua (1998).

Capital Adequacy

Problem

While the Central Bank of Kenya requires that commercial banks should maintain capital (equity and long-term debt) at least equal to 7.5 percent of risk-weighted assets, this might be an insufficient safety net for sudden losses for a microfinance bank. The microfinance market can be much more volatile than traditional banking markets, and there are many examples of loan portfolios that have deteriorated with alarming speed when internal systems began to break down or there were significant changes in the external environment. Lack of geographic, sectoral, and loan size diversification increases vulnerability to these shocks. Moreover, generally weak management, coupled with bank supervisors' unfamiliarity with the special characteristics of microbanking operations, decreases the likelihood of early problem identification and thus, increases the magnitude and complexity of bank decapitalization when finally detected.¹

Recommendation

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

An alternative risk management measure might be to require a majority of a microfinance bank's owners to be commercially oriented and able to raise additional capital quickly; the more common profile is non-profit or community-based organizations less concerned about preserving their capital and/or less able to generate additional capital contributions in a timely manner should their microfinance bank begin to fail.

Asset Quality

Problem

Conventional determination of asset quality, and loan provisioning based on loan classifications, are not very helpful when dealing with microfinance loans. When risk is determined by security coverage, exposure is overstated since most microfinance loans are not backed by formal collateral – there is no direct relationship to repayment performance. When risk is determined based on an aging of arrears, exposure is understated because of the relatively short maturities of microfinance loans – often, many loans should have been completely paid off before they are even rated “not current.”

¹ Unlike many microfinance NGOs in Kenya, K-Rep Bank operates throughout the country and in all sectors, so is relatively more diversified and able to absorb geographic or sectoral shocks.

Recommendation

The CBK should require microfinance loans to be classified by time overdue in keeping with the prevalent repayment period for a microfinance bank's loans, and loan provisioning implemented using a rules-based, non-discretionary system based on historical performance and periodic sampling of arrears, and regardless of collateral pledged. CBK's acceptance of current uncollateralized (group guaranteed) loans up to KSh 300,000 without provisioning is a reasonable beginning. Likewise, write-offs should be automatic according to pre-determined rules.

Management Quality

Problem

Many central banks have mandatory organizational structures and staffing requirements for commercial banks that are inappropriate for microfinance banks. These tend to be overly complex, highly centralized bureaucratic structures, while a key to the success of microfinance banks is simplicity in organization and operations to maximize the quality of service to their customers and ensure the financial viability of their bank.

The same holds true for reporting requirements. Standard statistical reports are usually designed for banks with a wide variety of extremely diverse and sophisticated services, while most microfinance banks offer a limited range of simple products. Thus, many reports and reporting categories either do not apply to microfinance banks, or are irrelevant for ensuring the quality of a microfinance bank's management.

Recommendation

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

Earnings

Problem

If microfinance banks are free to set their interest rates to cover all costs (funds, operations, losses), then standard indicators of profitability such as return on assets and return on equity should also be appropriate for microfinance banks. In fact, many microfinance banks generate higher returns than commercial banks in percentage terms.

Recommendation

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

Liquidity

Problem

Microfinance banks like K-Rep Bank which are not part of a larger commercial bank have special challenges in asset-liability management, especially regarding exposure to a relatively high level of seasonal liquidity risk. These stand-alone microfinance banks have no immediately accessible “life-line” of liquidity credits. Moreover, loss of savings for the low-income clientele of microfinance banks is calamitous for poor families in the absence of any publicly funded social safety net.

Recommendation

At a minimum, microfinance banks should be subject to the same reserve and liquidity requirements as general commercial banks. The CBK might also consider making these requirements even more stringent for microfinance banks, given their relatively greater exposure to liquidity risk and their more limited access to possible sources of quick liquidity injections. This is entirely within the CBK’s critical responsibility to protect savings mobilized from the public at large. However, higher reserve requirements would increase the cost of doing business for a microbank, as it would reduce the loanable funds portion of its deposit base.

REGULATION AND SUPERVISION OF OTHER MICROFINANCE BANKS

The CBK should examine carefully its licensing standards for the establishment of other microfinance banks in Kenya, particularly in regard to minimum capital requirements. There is no obvious relationship between size and quality in banking, and the CBK should minimize regulatory barriers to entry for small, local microfinance banks. This does not entail compromising standards for safety or soundness, but rather, simply not making size or scale of activity part of the criteria for determining risk. The issue of barriers to entry for new microfinance banks is especially important in light of the CBK’s recent increase in the minimum paid-up capital required to start a new bank to KSh 500 million.

The CBK should also consider its permission for K-Rep Bank to open a branch in a poor neighborhood close to its clientele as a precedent for other microfinance banks; there should be no more geographic restrictions that prevent banks from opening branches in poor areas because of security risks. The informal sector and microfinance thrive in poor neighborhoods, and a key competitive advantage of a microfinance institution is the extension of its delivery system as close as it can get to its intended clientele.

Finally, the CBK should consider creating positive incentives to conform with its CAMEL bank soundness requirements by the active dissemination of transparent CAMEL criteria and standards for microfinance banks. It is rather difficult for a microfinance bank to alter behavior for improved performance if evaluation measurements are not clear.

REGULATION AND SUPERVISION OF NON-BANK MICROFINANCE INSTITUTIONS

Should the CBK regulate and supervise non-bank microfinance institutions (MFIs)? No. MFIs are not allowed to accept deposits from the public, and protection of these deposits would be the principal reason for central bank oversight. In addition, the task of regulating and supervising the numerous MFIs in Kenya would impose a tremendous financial and administrative burden on the CBK, diverting scarce resources from CBK's primary mission of ensuring the safety and soundness of Kenya's banking system. Finally, without dramatic and substantial modification of current operations, CBK regulation and supervision of MFIs would most likely stifle rather than foster the growth of microfinance in Kenya.

Instead, the CBK's efforts to create an enabling environment for the microfinance sector in Kenya should focus on two areas:

- Allowing commercial banks to diversify their lending by going downmarket and providing banking services to microentrepreneurs and family savers, without any implicit or explicit regulatory or financial penalties or disincentives to engage in microfinance.
- Removing any barriers to entry unrelated to prospective bank soundness for those who would like to create an entirely new microfinance bank, or for MFIs that would like either to transform themselves into microfinance banks, or to split their operations into non-profit activities and banking activities.

If the microfinance sector in Kenya would like to improve the performance of MFIs short of imposing formal CBK prudential regulation and supervision, there are two popular approaches that have been tried in a number of countries:

- Self-regulation, which can range from a voluntary code of conduct to sector-wide licensing requirements and performance standards. While attractive in theory, the problem with this model in practice is enforcing compliance.
- Establishment of an apex or a second-tier MFI as a conduit for financing first-tier MFIs. While not itself a regulatory agency, this institution could require that certain performance standards be met as a condition for receiving funds, just like any other creditor. A potential weakness of this model is the tendency for such an apex institution to behave as a government-supported monopoly, crowding out market-based funding sources for MFIs.

If an MFI wants to accept funds from the public, however, it should only be permitted to do so after it has received a banking license from the CBK. Non-bank microfinance institutions, that is, MFIs not subject to CBK statutory requirements and not obliged to meet CBK prudential norms and regulations, should not be allowed to mobilize savings from the public – the risk is simply too great for their depositors.

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STATISTICAL ANNEX

1. K-Rep Consolidated Income and Expenditure Statement

K-REP CONSOLIDATED INCOME AND EXPENDITURE STATEMENT

(all figures in Ksh)

ITEM	1991	1992	1993	1994	1995	1996	1997	1998
Income								
Financial Services	6,470,626	7,022,669	9,017,140	34,000,535	60,162,496	82,633,778	73,162,654	84,889,533
Other	178,606	4,549,394	13,762,405	16,425,165	16,602,973	9,050,515	54,743,500	37,667,810
Subtotal	6,649,232	11,572,063	22,779,545	50,425,700	76,765,469	91,684,293	127,906,154	122,557,343
Grants	33,264,546	25,738,209	150,825,076	110,750,755	97,203,899	27,550,987	31,461,750	58,250,724
Total	39,913,778	37,310,272	173,604,621	161,176,455	173,969,368	119,235,280	159,367,904	180,808,067
Expenditure								
Financial Services	n.a.	n.a.	n.a.	25,865,617	51,121,455	51,322,105	69,592,046	77,472,644
Other	n.a.	n.a.	n.a.	36,097,926	43,528,981	41,131,244	78,291,938	79,408,731
Total	16,821,754	29,142,629	37,662,947	61,963,543	94,650,436	92,453,349	147,883,984	156,881,375
NET INCOME	23,092,024	8,167,643	135,941,674	99,212,912	79,318,932	26,781,931	11,483,920	23,926,692

2. K-Rep Consolidated Balance Sheet

K-REP CONSOLIDATED BALANCE SHEET

(all figures in Ksh)

ITEM	1991	1992	1993	1994	1995	1996	1997	1998
Assets								
Current Assets								
Stocks	0	57,030	247,046	0	0	0	0	0
Loan Debtors	32,530,448	38,585,260	109,582,245	205,704,443	309,877,930	263,657,947	237,742,153	243,269,995
Debtors	1,906,075	2,862,290	13,478,153	10,666,944	12,399,334	18,422,214	24,102,461	38,786,561
T Bills & Fixed Deposits	0	0	68,468,237	28,539,534	11,520,123	73,016,606	143,631,540	122,647,339
Cash & Bank Balances	25,860,366	24,192,704	25,564,584	62,083,099	48,248,436	51,021,458	65,597,326	95,015,986
Subtotal	60,296,889	65,697,284	217,340,265	306,994,020	382,045,823	406,118,225	471,073,480	499,719,881
Fixed Assets								
Freehold Land & Buildings	5,300,005	5,829,785	9,140,712	9,730,570	17,468,470	21,500,000	16,000,000	40,135,625
Motor Vehicles	356,290	1,075,164	4,181,600	4,668,079	4,668,079	2,568,974	2,546,999	3,602,400
Furniture & Fittings	316,495	546,710	2,445,465	4,103,162	5,230,614	3,110,988	3,704,226	4,143,105
Office Equipment	194,876	6,331,024	7,862,137	12,884,136	16,556,664	15,784,853	19,547,920	18,166,791
Capital Work in Progress	0	0	0	0	0	0	10,309,274	38,808,161
Subtotal at Cost/Valuation	6,167,666	13,782,683	23,629,914	31,385,947	43,923,827	42,964,815	52,108,419	104,856,082
Less Depreciation	867,661	7,952,898	1,276,375	4,298,904	8,196,885	3,345,690	7,440,750	11,235,832
Subtotal at Net Book Value	5,300,005	5,829,785	22,353,539	27,087,043	35,726,942	39,619,125	44,667,669	93,620,250
TOTAL ASSETS	65,596,894	71,527,069	239,693,804	334,081,063	417,772,765	445,737,350	515,741,149	593,340,131
Liabilities								
Current Liabilities								
Creditors	3,243,910	795,282	1,525,592	6,028,104	17,884,419	22,727,472	19,462,633	25,546,795
Loan Repayable Within 1 Year	0	600,000	1,448,000	5,413,237	650,000	0	0	0
Financial Services Members' Savings	975,714	0	4,391,128	3,331,581	460,760	42,236	0	13,915,395
Staff Funds	1,584,824	2,902,297	4,837,161	286	16,692,636	24,582,334	35,991,780	45,969,891
Bank Overdrafts	0	0	14,644,616	10,113,344	1,004,464	0	51,068,529	54,524,424
TOTAL LIABILITIES	5,804,448	4,297,579	26,846,497	24,886,552	36,692,279	47,352,042	106,522,942	139,956,505
Equity								
Restricted Funds	5,484,568	6,188,168	20,633,630	21,627,683	14,857,011	27,274,393	51,807,842	89,116,314
General Funds	2,959,024	7,267,786	17,167,669	36,831,044	48,352,143	24,405,019	7,922,939	-14,726,456
Program Loans Funds	51,348,854	51,923,536	170,165,692	249,643,354	317,378,902	341,918,910	344,840,899	374,541,501
Capital Reserve	0	0	442,430	442,430	442,430	4,786,986	4,646,527	4,452,267
Long Term Loans (Secured)	0	1,850,000	4,437,886	650,000	50,000	0	0	0
TOTAL EQUITY	59,792,446	67,229,490	212,847,307	309,194,511	381,080,486	398,385,308	409,218,207	453,383,626
TOTAL LIABILITIES & EQUITY	65,596,894	71,527,069	239,693,804	334,081,063	417,772,765	445,737,350	515,741,149	593,340,131

3. K-Rep Juhudi and Chikola Program Development

K-REP JUHUDI AND CHIKOLA PROGRAM DEVELOPMENT

(all monetary figures in millions of Ksh except averages)

ITEM	1991	1992	1993	1994	1995	1996	1997	1998
Loans Disbursed								
Number	1,507	1,939	4,331	5,149	11,137	6,200	5,958	11,582
Value	14.3	23.2	83.5	211.0	363.7	315.0	305.9	347.1
Average	9,489	11,965	19,280	40,979	32,657	50,814	51,343	29,969
Loans Outstanding (Value)	32.5	38.6	109.6	205.7	309.9	263.6	230.1	230.0
Loan Quality								
Repayment Rate (%) [Loans repaid/Amount due]	99.0	97.5	95.5	93.0	93.0	98.6	96.1	96.8
Loan Provisions (Cumulative) [Excluding institutional loans]	n.a.	n.a.	n.a.	n.a.	15.0	22.9	39.4	46.7
Loan Write-Offs	0	0	0	0	0	0	0	0
Savings Mobilized [Juhudi and Chikola]								
Number	2,337	2,850	5,429	5,189	12,451	15,148	10,956	13,202
Value	2.4	5.2	13.6	19.4	55.3	52.1	99.2	86.7
Average	1,027	1,825	2,505	3,739	4,441	3,439	9,054	6,567
Total Employees	39	44	80	94	113	123	130	152
Total Offices								
Head Office	1	1	1	1	1	1	1	1
Area Offices	2	2	4	6	5	5	5	5
Field Offices	0	0	0	7	11	14	15	16

FIELD SURVEY ANNEX

FIELD SURVEY RESULTS

A field survey was conducted in January through March 1999 to understand the role of the groups in reducing defaults to K-Rep. Six credit officers were selected at random in the West Nairobi area office. Five of these credit offices handled Juhudi groups and one handled Chikola groups. The survey was administered by the credit officer at each group meeting. Total repayments collected by the credit officer at that meeting were then broken down into sources of repayment. These sources included regular payments by group members, prepayments, pay-off of arrears, payments from other group members' contributions, payments from the group savings accounts, and payments from collateral.

Survey responses indicated that repayments by K-Rep borrowers are irregular. Prepayments were recorded in 43 percent of the 136 Juhudi group meetings, and late payments were recorded in 29 percent of the meetings. This is in keeping with a K-Rep directive where borrowers must balance their accounts by the end of the month, but are allowed substantial latitude for weekly repayments within the month. It suggests that K-Rep could experiment with moving from weekly to bi-weekly or even monthly repayments with the Juhudi groups, thereby lowering costs and potentially maintaining as high a repayment rate as before. In the Chikola group meetings, which are held monthly, only 2 of the 19 responses indicated either a prepayment or a late payment.

The survey also suggested the importance of K-Rep's group lending in reducing the risk of default. In 18 percent of the Juhudi group meetings, repayments from individuals were augmented by voluntary contributions from other group members (presumably to assist an individual who was having temporary difficulty in making repayments). In 4 percent of the Juhudi group meetings, the Emergency Fund was accessed either to give internal loans to group members or to fund group level expenses. The group level savings account was accessed in only 7% of the meetings and appears to be used as a last resort.

FIELD SURVEY QUESTIONNAIRE

GROUP NAME _____

CREDIT OFFICER _____

Date of meeting _____

Number in attendance _____

For CO: Please complete questions 1 - 4 before the meeting

1. Number of loans outstanding from KIWA to K-Rep: _____
2. Total amount of loans outstanding from KIWA to K-Rep: Ksh. _____
3. Required weekly installment due from KIWA to K-Rep: Ksh. _____
4. KIWA savings account balance: Ksh. _____
5. Total collection from the KIWA at the meeting: Ksh. _____
6. Sources of collection
 - a. Total amount prepaid: Ksh. _____
 - b. Regular payments made directly by the members: Ksh. _____
 - c. Payment from the emergency fund: Ksh. _____
 - d. Payment from Watano voluntary contributions: Ksh. _____
 - e. Payment from Watano savings account: Ksh. _____
 - f. Payment from KIWA voluntary contributions: Ksh. _____
 - g. Payment from the KIWA savings: Ksh. _____
 - h. Payment from Individual's security/collateral: Ksh. _____
 - i. Arrears from previous meetings paid off today: Ksh. _____
 - j. From other sources (specify) _____ Ksh. _____
- TOTAL** (a) to (j) {Should be equal to total collection} Ksh. _____
7. a. Total contributions for the emergency fund: Ksh. _____
 - b. Total amount deposited into emergency fund account: Ksh. _____
 - c. Amount of emergency fund loan repaid since last meeting: Ksh. _____
8. Total deposits into the KIWA savings account: Ksh. _____
9. New loans given by K-Rep today: Ksh. _____
10. Number of KIWA members _____ any dropouts? _____

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