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FSA model review
Case of Kenya
(draft version)

CIDR

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ACRONYMS

| | |
|------|---|
| AGM | Annual General Meeting |
| BOD | Board of Directors |
| FSD | Decentralised Financial Services project |
| FSA | Financial Service Association |
| FSS | Financial Self-Sufficiency |
| IFAD | International Fund for Agricultural Development |
| KDA | K-Rep Development Agency |
| KFS | K-Rep Fedha Services Company |
| MC | Management Contract |
| NGO | Non-Governmental Organisation |
| OSS | Operational Self-Sufficiency |
| PAR | Portfolio At Risk |
| ROA | Return on Assets |
| ROE | Return on Equity |
| SPI | Social Performance Indicators |

I. EXECUTIVE SUMMARY

1. Identifying innovative and replicable mechanisms for providing rural finance services on a sustainable basis in the remote rural areas remains a challenge. The innovative Financial Services Association (FSA) model was developed in several countries of Western and Eastern Africa as an attempt to address this issue and develop a sustainable microfinance model suitable for the specific needs of the rural areas. The FSA project has been developed in Kenya by K-Rep Development Agency (KDA) since 1997. A total of 74 FSAs were progressively set up ; **59 FSAs now operate with the support of KDA** in 7 regions of Kenya covering 18 districts.
2. From year 2000, several studies and reviews in Kenya showed that the FSAs experienced problems that were mainly due to weak governance and management at the community level. The main conclusion was that FSAs, to become efficient and sustainable, required a stronger monitoring and training role from an external institution. KDA then launched an **innovative approach, based on a « Management contract »** signed between each individual FSA and KDA. 15 FSAs of two regions, Makueni and Kitui, have been under Management contract since June 2005 ; as of October 30th, 2006, 26 FSAs have signed a Management contract, most of them quite recently. To prepare for a sustainable support structure for the FSAs, KDA created K-Rep Fedha Service Company (KFS), a subsidiary of KDA, to become the service company in charge of Management contracts.
3. The present field review selected **6 sample FSAs** under management contract in the regions of Kitui and Makueni, this sample being representative of the variety of FSAs (in size, dynamism, and seniority in those two regions). Reviewing regions with stronger follow-up and support by KFS / KDA gives the opportunity to assess the first results of the “Management contract” approach and see how the FSA model in Kenya could evolve towards sustainability in the coming years.
4. With support of the FSD¹ fund in Kenya, KFS has launched since one year **a complete review of the FSA model** in order to improve the professionalism, quality of service and governance of FSAs under management contract. This holistic review should eventually enable FSAs to operate more professionally, with reliable information and management. Priorities are well defined : refining the products to better suit the clients’ needs ; improving the MIS and internal audit ; reinforcing capacities at all levels ; analysing risks.
5. The « Management contracts » signed by FSAs with KFS **bring dynamism and enthusiasm** at the local level (both Boards and staff). Setting targets for year 2006 has accelerated the growth of FSAs with potential, while improving confidence in FSAs which had previously encountered difficulties. In the FSAs visited most stakeholders – local Boards and staff, managers, regional branch managers – are engaged in efforts to progress ; they are aware of the sustainability challenge. Boards and managers have ideas and initiative, and can add value to the process if given a chance to participate.
6. Several **key organisational options** still need to be defined : what is the right size of an FSA, that can be manageable at local level ? Which pace of growth can be achieved while maintaining risks at an acceptable level? What will be the future structure of KFS at regional and central levels, depending on the institutional option chosen ?

¹ The Financial Sector Deepening Fund

7. **Risk culture** needs to be reinforced at all levels, and improving risk management is a clear priority. This includes operational risks – internal audit, liquidity management in particular. At this stage, controls are not yet efficient at the FSA level, the internal audit is not in place and the existing MIS system is weak. Liquidity management is an issue in all FSAs, implying risky practices (on-lending of current accounts). Defining a simpler, more efficient MIS, revising internal audit at all levels and enhancing liquidity management are key to the sustainability of the model. KFS is aware of it.
8. Risk management also cover **governance risks**. Governance issues include the risk of capture of the FSA by a few local interests ; Boards interpreting KFS’ involvement as a change in their role towards less participation and control, which would endanger FSAs and increase KFS’ workload ; dynamic Boards being reluctant to accept rapid changes on a short period of time and expressing frustration, with possible conflicts. KFS’ awareness of risks and involvement in the governance is likely to protect shareholders from such risks. KFS has planned to reinforce training and consultation of staff, shareholders and Boards in the near future; there is a clear need for such actions to implement changes efficiently.
9. The complete business model review will necessarily take time. Hurrying the process would be risky, since **managing growth and institutional changes** altogether (with limited human resources) is always a challenge. To achieve targets, FSAs may be induced to follow a rapid, unsecured growth track, with Boards and managers focusing on promotion rather on risk control. Fast growing FSAs may create branches and increase staff without having the ability to manage them; they may also pursue on-lending of current accounts. Moreover, it will be necessary to review products first, in order to increase membership and client satisfaction – in particular, the group lending methodology and loan products are not suited to all client needs, and are still a bottleneck for growth.
10. The growth and interest rate of most FSAs visited enable them to quickly be able to cover their operational costs. After adjusting for inflation, all **sustainability indicators**, including AROA and AROE, are well above those of the MBB peer group (Africa small). However, the cost for the support by KFS (depending on the institutional option chosen) and the cost of funds will probably increase in the future. It must also be kept in mind that Kitui and Makueni are provinces with good results and strong management by KFS – their performance does not reflect that of all regions of Kenya. These results are nonetheless encouraging as KFS extends its “management contract” model to other FSAs in Kenya.
11. The legal environment in Kenya is changing, as the **Microfinance Act** is expected to be passed by the end of 2006 ; it appears to be a rather generic and open law that gives room for different approaches and organisations.
12. A good institutional plan for FSAs would have to take into consideration : 1) scale or a critical mass for viability (division of risk, cost sharing, investment capacities), 2) a balanced governance complementing local ownership, community empowerment, effective peer pressure and professional credibility, efficient management, corporate culture for financial and social performance, 3) an option that fit into the new legal and regulatory framework for microfinance in Kenya.
13. Three main institutional options are offered for FSAs in Kenya :
 - (a) The FSAs belonging to the same district/or two neighbour districts form a share company where they are the founding and majority shareholders. This share company has a professional management and staff. It gets a licence as a “regional microfinance company”.
 - (b) All the viable FSAs of Kenya form a share company where they are the founding and majority shareholders. This company has a professional management and staff and gets a li-

cence as a “national microfinance company”. In this option, two organisational patterns could be envisaged : (1) a centralised institution with local outlets (the FSAs are both shareholders and outlets) (2) a decentralised model whose FSAs function more or less the way they will function under the new FSA offer but have in common an Apex Bank at national level with an appropriate governance and highly qualified banking staff.

- (c) KREP Bank forms a subsidiary for rural penetration, becomes a shareholder of FSAs and proposes to them a partnership contract where FSAs are windows for KREP product and services

II. OVERALL CONTEXT

1. Situation of the microfinance sector in Kenya

The microfinance sector in Kenya is composed of 32 institutions :

- 3 Commercial banks : KREP Bank, Equity Building Bank and Cooperative Bank
- 2 wholesale lenders : Jitegemee Credit and Oiko Credit Kenya
- Kenya Post Office Savings Bank
- 1 Insurance Company CIC Insurance providing micro insurance services
- And 24 retail MFIs.

These institutions have 841 outlets throughout the country, serving 2 073 363 savers and 493 682 borrowers. In 2005 the amount of loans disbursed was of 16 588 million KSH with an outstanding of 16 billion at 31 December 2005. The total staff is 4 222 (data from AMFI Kenya).

- ▷ Post bank is the largest deposit taking institution, providing savings services to 791 569 savers. Post bank does not provide loans.
- ▷ Equity bank serves 718 583 active savers and 147 288 active borrowers. The loan portfolio by end 2005 was at 8.3 billion KSH.
- ▷ KREP Bank serves 117 000 savers and 106 358 borrowers with an outstanding of 2.9 billion KSH.

The four banks (including Cooperative Bank) together serve 1 776 000 savers, i.e. 85 % of the total active depositors of the sector. They provide loans to 260 000 loaners i.e. 54 % of the total borrowers, concentrated on Equity Bank and KREP Bank as Postal Bank does not lend and co-operative bank lends to co-operatives and SACCOS more than to individuals.

Among the retail MFIs, the two largest are KWFT serving 78 524 savers and borrowers with an outstanding of 1.4 billion KSH and Faulu Kenya serving 40 000 borrowers with a portfolio of 1 billion KSH.

KDA, that is promoting FSAs in the rural Kenya, provides services to 61 000 members, with an outstanding portfolio of Ksh 146 millions as of June 30, 2006 and savings outstanding of Ksh 239 millions. KDA, with 59 FSA set up in the most remote rural areas, is therefore the third retail MFI in Kenya in terms of outreach and the fifth in terms of loan portfolio.

Up to a very recent period, all microfinance financial intermediaries were concentrated in the major towns of the country and are serving mostly micro and small entrepreneurs that could be classified as low income household heads.

A mapping exercise is being undertaken by DFID and seems to indicate that all towns except for the Northern, Eastern and Coastal regions are rather well covered, some localities such as Nairobi and Central (to a certain extent western) being close to saturation.

Hence, recently, microfinance banks are branching out up country and the retail MFI are aiming at reaching out to the rural areas.

In the rural areas, except from FSAs, one can find SACCOs, especially in cash crop areas (tea, coffee, dairy) and ROSCAs and ASCAs (SHG) in more remote areas.

It is said that there are some 4 000 SACCOs in Kenya servicing more than 2 million members. Among these, 800 may be based in the rural areas. It is quite difficult to quantify the number of ROSCAs and ASCAs that are functioning and even more so to quantify the number of people served. Nevertheless, the general assumption is that ROSCAs and ASCAs are many, espe-

2. Legal and Regulatory Framework

After nearly ten years of dialog and lobbying, in July 2006, the Microfinance Bill has been published. October 5, there was a first reading at Parliament. A second reading is due at end of October. The Microfinance Act is expected to be passed by the end of 2006.

Up to now, there were 7 different types of legal status for microfinance activities. With the Microfinance Act, all MFI should be formed as companies limited by shares, with a minimum of 4 shareholders each holding a maximum of 25 % of the share capital.

There are three types of Microfinance Institutions that could be licensed :

- MFI with national coverage
- MFI with regional coverage
- Subsidiary wholly owned by a bank.

MFI of national coverage would be required to have a minimum capital of 60 million Ksh, whereas regional MFI would be required to reach 20 million Ksh capital.

Though quite detailed in the content of the application format and on prohibited activities, as well as for governance (profile of directors), the Microfinance Bill of Kenya appears to be a rather generic and open one that gives room for different approaches and organisations.

On the other hand, this Microfinance Bill does not present any special accommodation for microfinance activities or microfinance clients. It is, at present, totally silent about operations in the rural areas. One can foresee some difficulties in integrating member owned/governed microfinance institutions, in regard of the governance : directors have to be approved by Central Bank against their professional/qualification background. Rural based institutions, with directors less formally educated could face challenges in getting approval.

In the same time, the new SACCO Bill is also very close to be passed. This bill is targeting the improvement of the governance and the management. The SACCOs will remain under Ministry of Cooperative, but a new supervisory body is supposed to be put in place to enhance oversight. The requirements for SACCOs are limited but it is thought that under this status, the institutions will also have limited potential for growth.

The enforcement of both Acts will certainly change the micro-finance landscape in Kenya, encouraging all actors to choose a form of institutionalisation, review their operations and organisations accordingly and review or define vision, mission and business plan.

Improved professionalism is expected at the end of the road.

Central Bank recognises the importance of providing access to financial services to the underserved, especially in the rural areas.

While traditionally solely involved in stability and supervision, Central Bank of Kenya has recently been given a role in promoting access to financial services.

After the Microfinance Act would be put in place, some time during the second semester of 2007, the Microfinance Policy will be formulated. It is probable that with some advocacy activities, rural microfinance and participatory micro-finance could find an appropriate position within the policy and the structuring of the financial sector.

This may involve setting tiers, thresholds, standards and code of conduct, especially for the more informal ones.

Ultimately, it will be crucial to take into consideration the capacity of Central Bank of Kenya to supervise this new microfinance sector. In this sense, networking, federation and mergers of smaller and more decentralised rural microfinance institutions would be key for a successful institution building process in a vast country like Kenya.

3. The evolution of the FSA model in Kenya

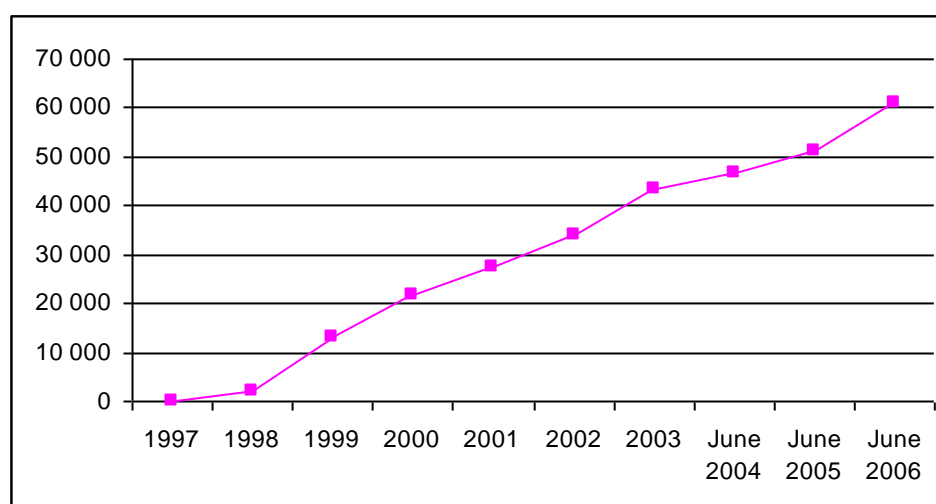
3.1 The story of Kenyan FSAs

Identifying innovative and replicable mechanisms for providing rural finance services on a sustainable basis in the remote rural areas remains a challenge. The innovative Financial Services Association (FSA) model was developed in several countries of Western and Eastern Africa as an attempt to develop a sustainable microfinance model suitable for the specific needs of the rural areas. FSAs operate in non-banked rural communities that would not be viable for many other forms of financial services organisations.

An FSA is established at community level : it is owned and managed by community members that buy shares in the FSA; it provides credit and savings services to its members. The FSA model is characterised by simple systems and procedures, a narrow range of financial services and a relatively lower cost, due to the absence of a complex support structure.

The FSA project has been developed in Kenya by K-Rep Development Agency (KDA) since 1997. It experienced a strong growth (see chart below), as a total of 74 FSAs were progressively set up. Since November 2005, 59 of these FSAs³ are still supported and supervised of KDA. They are located in 7 regions of Kenya covering 18 districts : Lower Coast, Taita Taveta, Western Region, Nyanza, Bomet, Makueni and Kitui.

Chart 1: Growth in number of shareholders (1997 – 2006) – all FSAs



The FSA model made the assumption that after an initial period of rapid growth FSAs would stand on their own individually, as effectively governed and managed institutions. From year 2000, several studies and reviews in Kenya showed that the FSAs experienced significant problems (including delinquency issues) that were mainly due to weak governance and weak management at the community level. The main conclusion was that FSAs, to become efficient and sustainable, required a stronger monitoring and training role from an external institution specialising in microfinance.

³ On the 74 FSAs initially set-up, 3 were closed in Nyanza region, two others merged. 11 FSAs in the remote region of North Kenya were left out of KDA support, due to difficult access and rising security problems (in Marsabit district for instance, 3 FSAs closed and 2 maintained some activity on their own).

KDA therefore decided to try and launch an innovative approach, based on a « Management contract » signed between each individual FSA and KDA. FSAs of two regions, Makueni and Kitui, have been under the Management contract approach since June 2005. As of October 30th, 2006, 26 FSAs have signed a Management contract, most of them quite recently ; only 15 (in Makueni and Kitui) have been under MC for more than one year. Several other FSAs are in discussion and are likely to sign a MC by the end of the year (in Lower Coast, Bomet, Taita districts).

KDA decided to prepare for a sustainable support structure for the FSAs that would be separated from the Ngo activities ; it therefore created K-Rep Fedha Service Company (KFS), a subsidiary of KDA. KFS has one central office and two branches in the main regions under Management contract, Kitui and Makueni. KFS now is the service company in charge of the Management contracts.

Table 1 : FSAs by region and under management contract

| Region | Number of FSAs | Nb of FSAs under MC |
|-----------------|----------------|--|
| Lower Coast | 15 | <i>11 soon (could start in Dec 06)</i> |
| Taita Taveta | 9 | 1 |
| Bomet | 7 | 1 (+2 by dec 06) |
| Western | 8 | 7 (starting Nov 06) |
| Nyanza | 6 | 0 |
| Kitui | 8 | 8 (June 05) |
| Makueni | 9 | 9 (June 05) |
| Total MC signed | 62 | 26 |

Finally, in 2006 KFS received support from the FSD⁴ fund to launch a complete review of the FSA model. The objective is to improve the professionalism, quality of service and governance of FSAs under management contract. The on-going holistic review of the business model is adequate and should eventually enable FSAs to operate more professionally, with reliable information and management. The transformation of the FSA model is on the right track, with well defined priorities: refining the products to better suit the clients' needs ; improving the MIS and internal audit ; reinforcing capacities at all levels ; analysing risks.

3.2 Scope of the present Field review

In 2004, IFAD Rural Finance Thematic Group decided to carry out an in depth review on the FSA model to built on the experience of FSAs so far gained. In early 2004 a desk review of experiences in several countries was carried out as the first step of the proposed technical review. This Field technical review of FSAs in Kenya is part of the second step, which also includes a Field review in Benin and aims at internalising lessons learnt and elaborating a plan of actions on key issues such as governance and sustainability.

The FSAs in Kenya operate in 7 regions, with strong differences in environment and performance. In some areas (Bomet, Nyanza) FSAs face serious problems of management and delinquency.

The mission assumed that such weaknesses were already well documented by KDA and several other studies in Kenya ; and that studying the results achieved by the innovative Management contract approach defined by KDA/KFS could bring solutions to difficulties experiences by FSAs, and be potentially replicable to other countries. 6 sample FSAs were selected in both regions under Management contract, this sample being representative of the variety of FSAs in size, dynamism, and seniority: three FSAs in Makueni (Mukuyuni, Kathonzweni, Nunguni) and three in Kitui (Itoleka, Mutitu and Kakeani) (see table 3, summary data for sample FSAs).

In this report, a few significant consolidated figures for all FSAs in Kenya will be presented. However, global figures for FSAs are difficult to analyse due to the strong disparities ob-

⁴ Financial Sector Deepening

served between FSAs and regions. It is thus assumed that a close analysis of the sample FSAs – and the overall organisation being implemented in the two regions of Makueni and Kitui – can give a more accurate taste of what can be achieved in Kenya with a stronger support by KDA / KFS. Several comments will be based on examples deriving from meetings with elected members of governing bodies (Board, Supervisory Committee, Credit Committee), staff members (manager and cashier), shareholders and non-shareholders, borrowers and non-borrowing members at the community level. The detailed analysis of FSAs, including the financial analysis will also be mainly based on the sample FSAs.

Table 2: Summary of key data – FSAs in Kenya

(Source : KFS ; 1 USD = Ksh 72)

| | as of June 30, 2006 |
|---|---------------------|
| Number of FSAs | 59 |
| % FSAs in areas with density < 100 p.p. km ² | 19 |
| Nb of shareholders | 60 999 |
| Aver. nb of shareholders / FSA | 1034 |
| Nb of shares | 309 092 |
| Share capital (in Ksh) | 92 727 481 |
| in USD | 1 287 882 |
| Av. nb of shares per shareholder | 5,1 |
| Av. share capital / FSA (in USD) | 21 829 |
| Nb loans outstanding | 15 364 |
| % borrowers / shareholders | 25,2% |
| Total outstanding loan portfolio (in Ksh) | 145 952 172 |
| in USD | 2 027 113 |
| Average loan balance (in USD) | 132 |
| Total balance of vol. savings accounts (Ksh) | 238 819 269 |
| in USD | 3 316 934 |
| Nb of transfer services (MFT) users | 25 666 |
| Amounts transacted through MFT (in USD) | 23 631 863 |
| Nb of delinquent loans | 2 825 |
| PAR at 1 day | 18,41% |

Table 3 – Summary of key data – sample FSAs in Kitui and Makueni

| as of Sept 30, 2006 | MAKUENI | | | KITUI | | |
|--|-----------|-------------|-----------|-----------|-----------|-----------|
| | Mukuyuni | Kathonzweni | Nunguni | Itoleka | Mutitu | Makeani |
| Date of creation | 2000 | 2004 | June 2005 | 2000 | May 2003 | Dec 1999 |
| Nb of shareholders | 1 796 | 1 766 | 1 731 | 1 338 | 1 784 | 552 |
| Share capital (Ksh) | 3 002 850 | 3 707 640 | 3 187 800 | 2 386 511 | 3 728 400 | 902 400 |
| Nb loans outstanding | 391 | 562 | 599 | 442 | 960 | 82 |
| % borrowers / shareholders | 21,8% | 31,8% | 34,6% | 33,0% | 53,8% | 14,9% |
| Total outstanding loan portfolio (Ksh) | 4 740 194 | 7 298 820 | 4 864 038 | 5 142 553 | 8 377 203 | 1 261 866 |
| Average loan balance (Ksh) | 12 123 | 12 987 | 8 120 | 11 635 | 8 726 | 15 389 |
| PAR at 1 day | 9,9% | 5,4% | 0,0% | 3,8% | 0,9% | 0,8% |
| Nb voluntary saving accounts | 1 198 | 1 959 | 784 | 861 | 90 | 377 |
| % saving accounts / shareholders | 67% | 111% | 45% | 64% | 5% | 68% |
| Total balance voluntary savings | 4 051 421 | 13 585 257 | 6 195 908 | 1 533 808 | 661 336 | 585 507 |

Source : KFS (Statistics report) & Balance sheets as of Sept 30th, 2006

III. INSTITUTIONAL ANALYSIS

1. Support by KDA / KFS

One key specificity of the FSA model in Kenya is the strong support provided to FSAs by KDA initially and now by KFS, a specialised subsidiary of KDA.

▷ Organisation

At this stage, KFS is a subsidiary of KDA, with two levels :

- headquarters (with one General Manager and one Operations Manager),
- two regional branches. In Makueni, the regional branch employs (in addition to Managers at FSA level) one Branch Manager and one office administrator / accountant ; Kitui regional branch is managed by one Branch manager and one Business development officer.

Under this model, managers at FSA level are no longer hired and supervised by the FSA, but are hired and employed by KFS.

KFS has 30 staff, including all FSAs managers. At both headquarters and regional levels KFS staff seem dedicated, active and aware of the weaknesses of the FSAs and the challenges yet to address.

The evolution of the organisation will depend on the institutional option chosen in the future (national, or regional MFI for instance). However, it seems already clear that in any case, the support function at regional level will need to be reinforced, at least with a full-time internal auditor. Management fees charged to FSAs to cover the cost of KFS support are therefore likely to increase, so as to take into account all costs - at present, management fees are set at a relatively low level⁵. For the period January-September 2006, management fees collected from FSAs were sufficient to cover the manager's salary in 4 FSAs out of 8 in Kitui, and in 6 out of 9 in Makueni.

Moreover, KFS will have to define which regions in Kenya will join the final scheme. There seems to be a good potential for Kitui and Makueni, but it is probably early to see whether all regions can eventually become sustainable – the answer to this question will depend on the ability to resolve delinquency in some areas (Bomet) and turn around a critical number of FSAs per region.

▷ KFS competencies / human resource

KFS is a subsidiary of KDA involved in microfinance only. The separation from other “development” activities is a clear choice made by KDA, to ensure a strong specialisation/professionalism of KFS in microfinance.

A choice was made to recruit staff with good educational and financial background, at all levels : headquarters / regional branches / FSA managers. A strong focus is made by KFS on training staff at regional and FSA level, especially in accounting / financial matters. KFS can therefore become a strong partner to FSAs, with good technical competencies in microfinance.

⁵ FSAs under Management Contract pay to K-Rep a fixed charge of Kshs 4,000 per month and 15% of income generated from loans, savings and money transfer transactions; as well as 0.5% of income generated from fixed deposits and 5% of other incomes.

Nonetheless, it is still necessary to reinforce competencies at all levels in internal control and risk management (see below). Regional branches will need to be reinforced, at least with internal auditors. Moreover, a “technical” approach is not sufficient to manage efficiently FSAs; a good balance between financial and social approaches is needed. KFS will therefore need to reinforce training and expertise of its staff in governance issues (see below).

Lessons learnt - Kenya FSA model (1)

An external partner for FSAs needs to bring strong competencies in microfinance – the degree of experience and specialisation in microfinance will be essential selection criteria.

The external partner should have (or be able to develop) strong competencies in finance/accounting/audit, which are usually areas of weaknesses for FSAs, as well as the ability to follow the set up of a reliable MIS.

However, a ‘technical’ approach is not sufficient in the FSA model, and attention should be paid to maintaining a good balance between financial and social performance (including maintaining a good governance).

▷ Impact of Management Contracts

The « Management contracts » signed by FSAs with KFS bring dynamism and enthusiasm at the local level (both Boards and staff). Since June 2005 the two regions under management contract, Kitui and Makueni, have experienced a growth well above that of other regions.

Table 4: Makueni and Kitui: growth since June 2005

| Region | Makueni | | | Kitui | | |
|------------------------------|----------------|----------------|-------------|----------------|----------------|-------------|
| | 30th June 2005 | 30th June 2006 | Change(%) | 30th June 2005 | 30th June 2006 | Change(%) |
| No of FSAs | 8 | 9 | | 8 | 8 | |
| Nb of Shareholders | 6 737 | 10 348 | 54% | 4 873 | 6 916 | 42% |
| Nb of shareholders / FSA | 842 | 1 150 | 37% | 609 | 865 | 42% |
| Sharecapital (Kshs) | 9 675 300 | 22 042 800 | 128% | 7 607 700 | 13 191 181 | 73% |
| No of loans Disbursed | 6 754 | 14 196 | 110% | 4 918 | 9 237 | 88% |
| Loans Disbursed (Kshs) | 50 225 303 | 145 514 171 | 190% | 46 608 256 | 87 409 509 | 88% |
| No of loans outstanding | 1 831 | 3 671 | 100% | 1 515 | 2 332 | 54% |
| Loans outstanding (Kshs) | 14 745 140 | 39 100 341 | 165% | 11 826 471 | 24 320 459 | 106% |
| Average loan balance (Ksh) | 8 053 | 10 651 | 32% | 7 806 | 10 429 | 34% |
| No of Deliquent loans | 29 | 277 | 855% | 42 | 170 | 305% |
| Delinquency rate % | 0,9% | 3,7% | | 2% | 5% | |
| Net Aggregate Savings (Kshs) | 8 369 904 | 32 563 515 | 289% | 5 160 926 | 19 240 102 | 273% |

It is difficult to estimate to which extent the growth observed in Kitui and Makueni this year is linked to the management contracts. Nonetheless, setting targets for 2006 has probably accelerated the growth of FSAs with potential, while improving confidence in FSAs which had previously encountered difficulties. However, delinquency rates deteriorate over the period.

In the FSAs visited most stakeholders – local Boards and staff, managers, regional branch managers – seem to do real efforts to progress ; they are aware of the sustainability need. In one FSA, the MC seems to have a strong effect on Board members who express their satisfaction to be “supported” to address delinquency issues ; increasing membership brings enthusiasm.

In FSAs that are not yet under Management contract, it should be avoided however to put pressure on Boards to sign the contract: if Boards are reluctant to sign, forcing them into the contract may result in future frustrations and conflicts.

▷ **Risks linked to growth**

With the support of FSD, KFS is in the process of reviewing the whole business model for the Kenyan FSAs - including key issues such as MIS, loan methodologies, product refinement and risk analysis. This complete business model review will necessarily take time as it will imply pilot testing, discussing changes with staff and Boards at FSA level, training stakeholders, etc.

Hurrying the process would be risky, since managing growth and institutional changes altogether (with limited human resources) is always a challenge. Putting pressure at all levels to boost growth, at the same time, may be difficult to manage. The workload seems already heavy at all levels – managers, regional branches, headquarters ; the staff often admit to be under pressure. In FSAs with a potential for growth, it may be tempting for the FSA to grow too quickly – and pilot testing of products or MIS may prove difficult at the same time.

In this context, rapid growth means increased risk. The internal audit is not yet in place, and the MIS needs improvement ; existing controls are not yet strict enough to secure the system; however in several FSAs visited, current accounts are on-lent.

To achieve targets, FSAs may be induced to follow a rapid, unsecured growth track, with Boards and managers focusing on promotion rather than on risk control. From June 2006 (see table above) FSAs in Kitui and Makueni have grown a lot, increasing the number of shareholders by more than 30% on average ; loan disbursement almost doubled, with average loan balance increasing by over 30%. Meanwhile, delinquency rates are slightly increasing, even if the PAR at 1 day is still very low.

Fast growing FSAs may create branches and increase staff without having the ability to manage them. The targets set by KFS for FSAs seem achievable at this stage, according to discussions with staff and boards. Attention should be paid however to keeping things under control.

Lessons learnt - Kenya FSA model (2)

The « Management Contract » model (contract signed between the FSAs and a specialized technical service provider as KFS) is still new in Kenya, and has been implemented for one year only in two regions.

At this early stage, the Management Contract seems to have at least two positive effects:

- It brings enthusiasm to FSAs (both local staff and boards), including in less dynamic FSAs. Setting targets together with Boards and staff boosted growth for most FSAs. However, growth can be risky if uncontrolled, since several key tools (MIS, audit system) need to be revised at the same time.
- The MC also brings more professionalism to FSAs: in the MC, the FSA manager is hired and supervised by KFS ; KFS provides training at Board and staff level, especially on accounting and financial matters.

However, MC do not seem to impact positively on delinquency rates – the reasons for delinquency are complex, and partly linked to the products themselves (see below).

2. Ownership & governance

2.1 Ownership

▷ Ownership in the FSA model

Shares are an essential part of the FSA model and a significant difference with co-operatives. The FSA is a for-profit organisation which has the objective to pay a high return to its shareholders. It is assumed that introducing a profit-related incentive (through dividends and rise in share value) can increase membership and support the growth of the FSA ; growth in share capital in turn enables to mobilise loan capital. The link between voting rights and size of shareholding should also be a potential answer to governance problems often encountered by co-operatives, which often suffer from poor governance and unrepresentative local management. The risk of capture by dominant interest is mitigated by a ceiling in the number of voting rights per person (10 rights as a maximum). Finally, it is expected that a strong equity base can enable FSAs to develop linkages with the banking sector.

▷ Growth in membership

In sample FSAs, the share capital is the first financial resource for lending – therefore growth in membership is key. All FSAs have been created when they could gather a significant number of members (over 400). The growth in membership has been strong, however all FSAs encountered difficulties to mobilise enough funds for lending and are trying to reinforce membership to avoid risky practices such as on-lending of savings. Since the beginning of Management contracts (June 1st, 2005), KFS has put strong emphasis on the need to increase membership. All stakeholders in the FSAs seem aware of this necessity and doing real efforts of promotion.

▷ Who are the members and what is their motivation?

On average, each FSA member has 5 to 7 shares, with an average share capital per member around Ksh 2,000. In the FSAs and muunganos (groups of clients) visited, the number of “large” shareholders is around 10 per FSA (with significant number of shares, over 30 shares). Women are a strong proportion of shareholders in all FSAs (from 40% to 53%).

In all FSAs, the initial share price was 300 Ksh (about 4 \$). According to FSA rules, dividends can be granted from the 3rd year of existence. The surplus of the year is divided in theory in two parts : 40% for dividends, and 60% to increase the share value. The allocation of the surplus is voted by the AGM; the new price of the share being discussed and voted during the AGM (in the range between current value and value + surplus allocation).

Except in the youngest FSAs, the value of shares has increased from 300 to above Ksh 400, and dividends have been distributed every year – including in one FSA which encountered difficulties and had to reduce the dividend to Ksh 5 in 2005.

In one FSA, the current share value raised from Ksh 300 to Ksh 470 in 2006 (+57%), and dividends have been distributed on a regular basis (from 40 to 70 Ksh per year); dividends are actually mentioned by members in this FSA as being a clear expectation when they buy shares, together with the perspective of lending higher amounts. In other FSAs, members tend to consider shares mainly as a means of accessing loans. Big shareholders (with more than 30 shares) would mention access to loans as their priority, even if some are aware of a potential benefit on shares. Very few sales of shares have been noted, since the expectation of a larger loan remains the essential motivation.

Lessons learnt - Kenya FSA model (3)

Shares are an essential part of the FSA model and a significant difference with co-operatives ; introducing a profit-related incentive can increase membership and support the growth of the FSA, provided that risks of capture by a few local interests are kept under control.

To encourage membership, FSAs need to maintain an attractive reward on shares. Emphasis needs to be given on dividends and share value, so that getting a loan would not be the only motivation of new shareholders.

It seems that in Kenya, after a first generation of shareholders motivated by ownership, new shareholders would expect only loans as a reward for shares. When access to loans is the sole motivation of shareholders it becomes a source of frustration for many, since they expect to borrow 4 times the amount of their shares, and can not do so because of shortage in loan capital.

The distribution of dividends should therefore be maintained and if possible increased, even if it may imply for FSAs reaching financial targets at a slower pace.

2.2 Governance

▷ Theoretical governance

The organisational structure of FSAs, similar to that of private companies, includes :

- an Annual General Meeting (AGM) of members,
- a Board of 8 directors elected by the AGM, (evolving to 5 in Kitui – see below),
- an Audit Committee (2 people) and Credit Committee (3 people),
- a Manager + FSA staff (usually one or several loan officers, a cashier and a clerk).

Key policy decisions, long term strategy and supervision of staff (except for the Manager) are under the responsibility of the Board. The Board is elected by the AGM and accountable to the AGM. The AGM is the final decision making body, in particular for setting the price of shares and deciding on annual dividends.

In the previous arrangement, the manager and its staff were hired and supervised by the FSA Board. Under the new Management contract, the Manager working in the FSA is hired, paid and supervised directly by KFS, while the staff is hired and remains under the responsibility of the FSA.

▷ Rules in practice

There is a constitution model for FSAs, but it remains of large scope. Apart from rare cases no written rules or bye-laws were available in FSAs. Some rules are well known and expressed spontaneously by Board members and some shareholders : limitation in loan amount, limitation in number and duration of Board mandate, obligation of Board members to step down if they default. However some Boards, Managers and members seemed to be hesitating on several key issues, such as the link between shares and voting rights. There is a need to formalise the rules and practices of the FSAs, possibly by adding written bye-laws and/or updating the constitution.

▷ Effective role and skills of the Board

Board members often include a majority of educated people – retired teachers most of the time (at least 2 BoD members in each FSA visited). Most members are involved in many social activities in the community. Most Boards members were elected to “represent” a specific area covered by the FSA. At least 2 Board members are women – a rule of FSAs ; most women

members seemed to be of a lower level of education, and less involved in the FSA management.

Most Board members expressed a high level of motivation, and would have ideas and initiatives to discuss. No Board members had loans in arrears in the FSAs visited. KFS plays an active role in maintaining the governance, ensuring that AGM are held and accounts approved, therefore offering protection for shareholders.

All Boards met are aware of the fact that they could not manage efficiently the FSAs without KFS' active support, which in fact is the case at this stage; they are aware of the need to achieve sustainability. In most FSAs decisions are proposed by the Manager, and the Board would rely on her / him to adapt the FSA rules and products. In two FSAs however the roles of Manager and Board seem more balanced, with Boards appearing more active/interested in defining the FSA policies. Management contracts seem to have been well accepted in the FSAs: all Board members met mentioned the training sessions proposed by KFS as helpful ; they expect external support, especially on delinquency problems.

KFS regional managers spend time visiting FSAs, and meetings are organised on a quarterly basis for Board members at regional level ; one FSA Board member has been elected by all Boards and will represent the FSAs of each region at the KFS headquarter meetings. In FSAs with more mature Boards feelings were expressed however that changes should be validated through a dialogue with the Board. This is probably due to the fact that in 2006 most FSAs have experienced changes and pressure to grow and solve delinquency, without yet a complete system in place, and with still a limited support structure at regional level. Reinforcing KFS regional level and maintaining regular discussions between KFS/manager and Board about future improvements / pilot testing will be needed to avoid potential conflicts and frustration.

Each Board has two sub-committees : the Audit committee (2 people) and Executive Credit Committee (3). There is a strong consensus (both at Manager and Board level) on the fact that audit committee members encounter difficulties in playing an efficient role, due to their lack of accounting skills and to a complex MIS. Audit committee members spend an average one to two days per month on what should be simple checks focusing on a control of flows (cash counts and registration of vouchers in the general ledger). Credit committees seem even less efficient, and review rather formally each loan application form.

BoD members receive Ksh 300 to 400 per sitting, and no performance-related allowance yet. One FSA has adapted the amount to take into account the increasing role of BoD members.

▷ **Evolution of the Board**

KFS rightly intends to reduce the number of BoD members to 5 and define a performance-based, higher allowance for active Boards. In Kitui, KFS modifications in the BoD composition and role have been introduced in 4 FSAs to date:

- the number of BoD members has been reduced from 8 to 5, to enable higher allowance to be paid to each member ;
- BoD meet quarterly, instead of monthly ;
- audit and credit committees – which were often inefficient in their task – have been suppressed.

The objective is to reinforce the BoDs and improve the overall professionalism of the FSA by recognising that audit and credit committees do not function properly.

Nonetheless, these changes can have side effects in FSAs with weaker governance, where all internal control is now delegated to the Manager and to the Branch manager. Since in Kitui, FSAs are distant and roads are bad, it seems unlikely – and not advisable - that complete internal controls of FSAs can be performed by the Branch staff. It seems thus risky to leave managers in charge of everything at the FSA level – access to the safe, control of the docu-

ments -; their motivation, and the fact that they are now better paid and employed by KFS, are not sufficient guarantees to prevent fraud. Moreover most Board members have a sufficient level of education and could be able to better monitor internal controls, if the MIS is adapted.

The evolution of the Boards' structure and role should therefore be carefully monitored, to avoid negative side effects (the BoD being less and less involved in the FSA) or potential conflicts between Boards and managers.

Lessons learnt - Kenya FSA model (4)

Through Management contracts, the technical partner (KFS in Kenya) can induce changes in the governance structure, to cope with the weaknesses of FSA governance.

One key objective is to reinforce the BoDs: reducing the number of BoD members and defining a performance-based allowance for active Boards seem to be good options – but not yet fully implemented in Kenya.

However, the Kenyan experience shows that such changes must be done through enhanced dialogue with Boards, to avoid possible side effects (“hands off” Boards, possible frustration of Boards resulting in conflicts with managers).

It seems important to maintain a role of control at the Board level, since in rural, remote areas internal audit can not rely on external control only.

▷ **Governance risks**

The risk of a few influent people taking control of the FSA is limited by the internal FSA rule stating that no shareholder can hold more than 10% of the shares. However, it is possible that a group of people, or a family, may together take control of the Board. A risk could also be that an individual causes the bankruptcy of the FSA, by defaulting big loans. The risk division rule in FSAs states that no single borrower can have loans exceeding 10% of the FSA capital ; but 5 people altogether, for example from the same family, are always able to borrow 50% of the capital, and could be able to cause major damages to the FSA.

Lessons learnt - Kenya FSA model (5)

Various experiences in community-based financial systems world-wide have shown that governance risks exist (capture by a few local interest, conflicts between staff and boards...). The question is how to mitigate them. A close follow-up of governance risks is needed in prevention. The role of a professional partner (as KFS in Kenya) seems necessary to ensure that governance does not drift over time.

The experience in Kenya is not long enough to provide lessons on possible solutions. Such actions may include :

- Defining the risk management as including not only operational and financial risks, but also governance issues ;
- Enhancing the communication with Boards, and reinforcing the legitimacy of board members when they prove efficient and dedicated ;
- Formalising clear rules, and defining more restrictive rules if needed (restricting division ratio to 5% for instance in Kenya case?);
- Pursuing training of Boards and members on the FSA's mission and rules.

2.3 FSA management and internal organisation

▷ Human resource

Since Management contracts were signed managers have been appointed, paid and supervised by KFS. In most FSAs (4 out of 6) new managers were hired, since former managers had been involved in past delinquency / fraud issues. Under the MC, a new rule states that managers can not take a loan from the FSA. New managers seem to have a higher education level than before (college / university graduates, specialising in various subjects : HR, accounting, marketing), and training by KFS has focused on reinforcing their financial skills.

The remaining staff at FSA level are still hired and paid at by the FSA, though it seems quite clear in all FSAs visited that the manager is the real “boss” of all staff. The level of qualification of the staff at FSA level is high for rural communities, since they have at least a secondary-level diploma, and sometimes additional skills (preliminary accounting diploma).

The number of staff differs from one FSA to another, mainly due to the level of activity and number of “branches” created by the FSA to cover new areas (one FSA has 3 branches). Moreover, the number of office staff (bookkeeper and cashiers) could probably be reduced or support a higher activity level in some FSAs, should a new, simpler MIS be used.

Table 5 : HR organisation at FSA level

| | Makueni | | | Kitui | | |
|--------------------|----------|-------------|----------|----------|-----------|----------|
| | Mukuyuni | Kathonzweni | Nunguni | Itoleka | Mutitu | Kakeani |
| Manager | 1 | 1 | 1 | 1 | 1 | 1 |
| Assistant Manager | | | | | 1 | |
| Loans Officers | 2 | 2 | 2 | 3 | 2 | 1 |
| Cashiers | 1 | 3 | 1 | 1 | 3 | 1 |
| Bookkeeper | 0 | 0 | 0 | 0 | 1 | 0 |
| Back officer clerk | 1 | 0 | 1 | 0 | 0 | 0 |
| Watchmen | 1 | 0 | 2 | 2 | 5 | 0 |
| Total | 6 | 6 | 7 | 7 | 13 | 3 |
| excluding watchmen | 5 | 6 | 5 | 5 | 8 | 3 |

All Managers, and most staff members, seemed motivated and dynamic, and aware of challenges and targets set by KFS. Skills and knowledge of financial issues vary among staff. Staff recruitment and turnover is generally not a problem. Some FSAs have been able to hire and train a higher number of staff, and appoint them to new branches.

Salaries are broadly fixed, with few incentives based on performance (less than a half month salary, if targets are met). KFS intends to implement a new incentive system ; it is actually advisable that a higher part of the salary of most staff, especially loan officers and managers, would be linked to performance.

A Manager gets 12,000 to 15,000, which represents an increase compared to pre-MC situation (when he/she would get less than Ksh 10,000 a month, with additional travel allowances). Staff get between Ksh 2000 and 5000 per month, according to position and experience – a senior loan officer or cashier earning 5000. This is low compared to “educated” positions in rural areas (school teachers earn from Ksh 5,000 to 20,000 a month) but seems however attractive due to the lack of job opportunities, especially in more remote areas. However, in other FSAs where competition is rising, it may be necessary in the near future to increase salaries to avoid staff turnover. Finally, one issue in the future may be the apparent gap between the manager and staff salary, even if the real difference appears to be less (staff receive travel allowances, while KFS human resource policy provides for a global salary with no per diem).

A pending issue mentioned in two FSAs by Board members is the difference in status between the Manager, employed by KFS, and the staff, employed by the FSA. “Tensions” have been mentioned and it seems rather difficult to maintain two categories of staff, while reinforcing the role of the Manager in the FSA; KFS is aware of this. If KFS would take over the FSA staff, there would be a need to clarify and formalise the internal organisation and job descriptions at FSA level, and do an analysis of productivity in details (see below, productivity ratios).

▷ **Decentralisation and FSA “branches”**

Several FSAs in Kitui and Makueni have created branches to cover new areas with no access to financial services. From discussions with managers and Branch managers, the creation of branches seems to raise at least three questions :

- Ability for the Manager to manage a larger team, with frequent travels to branches being necessary at least for controls,
- Adaptation of MIS and internal audit to include reconciliation of all branches at FSA level,
- Legitimacy of the FSA Board for all branches, and ability to maintain a good governance.

KFS is in the process of setting rules and procedures for the creation of branches, which seems necessary as FSAs tend to develop more and more branches. The criteria for creating a branch should be a potential for growth and a minimum number of members (200 to 250, according to managers), with the objective of creating independent FSAs in most cases.

However, defining conditions on which branches can be maintained or should be turned into independent FSAs will be necessary as well, as FSAs are not necessarily in favour of letting branches become autonomous – the creation of branches is assumed to be positive for the profitability and image of the FSA, and risks are not well understood at FSA level. Up to now, the creation of branches has been a rather spontaneous evolution, and the ability to manage extensions will be a key element constraining growth for several FSAs.

▷ **MIS and internal audit**

In theory, controls are performed both at the audit committee and manager level, as well as by KFS branch managers :

- at local level, the MIS is complex and accounting-based (rather than suited for management), with too many documents that need copying information several times - KFS staff mentioned the fact that to register a new member, it is presently necessary to copy the name of the shareholder up to 8 times -, which contributes to errors in books. This results in lengthy, uncompleted checking, since audit committees and managers spend most of their time correcting errors and filling documents. Discrepancies exist between balance sheet figures and monthly statistics filled in the FSAs – notably on portfolio figures.
- Audit committees are usually unable to perform complete controls, both because of inadequate MIS and because of insufficient financial background and/or experience in most cases. Controls are long (1 to 2 days), unreliable, and focus only on accounting issues. Physical controls of passbooks and unexpected audits seem to be lacking.
- FSAs managers do cash counts and seem to spend lots of time updating books. Delays seem to be frequent : none of the FSAs visited had general ledgers updated on a daily basis. When branches have been created difficulties are greater, since each branch keeps a general ledger.
- It is difficult for KFS regional staff to control managers. In areas as Kitui, with bad roads and long distances, it seems impossible to check very frequently the FSA and do unex-

pected audits. Furthermore a simple audit methodology based on simple, management-oriented MIS is lacking.

KFS is well aware of these weaknesses, and these conclusions led to the current process of revising the MIS and controls. This process is under way :

- The new MIS should be implemented early in 2007. Some options need to be clarified (choice of a software, computers being used only at regional level or also in the largest FSAs whenever electricity is available). Simple, reliable manual MIS should be maintained at FSA level (except maybe in rare cases with easy road access), since it is difficult in most cases to find local human resources for maintenance.
- The internal audit function will according to KFS include hiring at least one full-time internal auditor at Branch level, which is highly advisable. However, the respective roles of the internal auditor and of local stakeholders (managers and Boards) in controls still need to be defined. Considering practical difficulties (distances / roads), it seems impossible to organise a complete control system based solely on the branch internal auditor.
- It seems necessary to maintain local controls at both manager level, and Board level (to control the Manager). Regular cash counts and simple checks could be done by Board members and should be refined based on the new MIS, so that the role of the internal auditor at regional level could focus on 1) verifying that local checking are properly done and that procedures are followed, rather than doing the controls directly, 2) doing unexpected controls and complete audit (including physical checks) with sample client accounts.

▷ **External Audit**

An external audit is commissioned by KFS on a yearly basis ; external auditors are in charge of preparing the financial accounts and assessing the quality of accounting, with sample checks (on shares, loans and savings).

Most FSAs in Kenya (all in Kitui and Makeni) have been audited by external auditors in 2005. All 59 FSAs followed by KFS/KDA will be audited in 2006, and all accounts will be closed as of Dec 31st to harmonise practices (moreover closing on Dec 31st will be required under the Microfinance Bill). In 2005, some frauds have been discovered thanks to external auditors, who also made useful recommendations in each Letter to management. However, discrepancies in some FSA accounts did not prevent external auditors from certifying the accounts. KFS say they have implemented a stricter rule concerning errors noticed by external auditor : no AGM will be held in an FSA until all discrepancies noticed by external auditors have been analysed and solved.

Lessons learnt – Kenya FSA model (6)

As in any MFI, implementing an efficient organisation, building a reliable MIS and effective internal control system are key to the sustainability of the model.

The on-going revision of the business model in Kenya is not finished: a new MIS still needs to be tested, and there is no reliable internal control at this stage. As in any MFI, the investment needed is important, both in budget and time, and should not be underestimated.

In the “Kenyan model”, compared to the classical FSA model, the support of an external, professional partner can clearly reinforce such tools (by providing guidance on the implementation of tools and new functions, and training staff adequately).

IV. PRODUCTS & CLIENTS

Preliminary note : In 2006 KFS, with support of DFS, has been through a systematic review of the FSA « business model ». The review includes lending methodology, products and client perception, MIS, systems and risks. The work on product refining and product diversification is just over, and KFS will now start testing some improvements proposed.

Therefore, the following description of products gives an idea of the situation in October 2006, but is likely to evolve rapidly. On-going pilot testing will be mentioned below.

1. Loans

1.1 Loan products

The « **normal loan** » is the first product offered by FSAs, representing 70 to 80% of all loans in sample FSAs according to managers – this assumption seems realistic from discussions with members.

It is a group-based loan, with two levels of groups. Members form small joint-liability groups (KCM) of 5 to 10 people, which then are united in larger groups known as “Muunganos”. There will be 3 to 4 KCM per Muungano, i.e. 25 to 30 members. Muunganos meet weekly and each member brings Ksh 20 as compulsory KCM group savings, pledged as a guarantee for loans in last resort.

All loans are share-based, and the maximum amount is usually four times the amount of shares, with a ceiling. A tangible security (typically a cow, or a goat) will be required as well. The loan application process usually takes one to two weeks, according to FSA managers and Boards.

Table 6 : Normal Loan – characteristics

| | Mukuyuni | Kathonzweni | Nunguni | Itoleka | Mutitu | Kakeani |
|-----------------------------------|--|--|---|---|---|--|
| Loan ceiling | Max 4 X shares Limit = 10% of share capital (300 000 Ksh) | Max 4 X shares Limit = 10% of share capital | Max 4 X shares Limit = 10% of share capital | Max 4 X shares Limit = 10% of share capital (250 000 Sh) | Max 4 X shares Limit = 160 000 Ksh | Max 4 X shares Above 100 000 require approval of region branch KFS |
| Interest rate (/month, declining) | 3% | 3% | 4% | 1-10 000 : 5% 11 - 50000 : 4% > 50000 : 3% | 1 st loan, < 6000 : 6% < 25000 : 4% < 25000 : 3% | < 10 000 and 1 st loan : 6% < 24000 : 5% < 48000 : 4% > 48000 : 3% |
| Max loan duration | 18 months | 18 months | 24 months | 18 months | 18 months | 18 months |
| Additional fees | LAF : 150 Ksh | LAF : 150 Ksh From 9/06 : Life insurance : 62 Ksh for loans over 10 000 | LAF : 150 Ksh (up to 15,000) 200 (<30,000), then 0.75% of loan | LAF : 100 Ksh Affidavit : 100 Ksh for loans > 10 000 | LAF : n.a. | LAF : 100 Ksh Life insurance : 100 (200 for loans over 20,000) |
| Compulsory savings (group level) | Ksh 20 / week | Ksh 20 / week | Ksh 20 / week | Ksh 20 / week | Ksh 20 / week | Ksh 20 / week |

The average loan amount ranges from around Ksh 8,000 (in Nunguni) to Ksh 15,000 (Ka-keani). The amounts and duration of loans are progressive, up to around 150,000 over 18 months to two years in practice in most FSAs. Up to date, the maximum amount of normal loans was first limited because of shortage in loan funds encountered by FSAs.

Interest rate varies from FSA to FSA, with several levels of interest according to loan amounts in Kitui. Interest rates could be simplified and harmonised to ease understanding of effective cost, both for staff and clients (see below, Interest rate analysis).

- ▷ The second type of loan is **emergency loan**, that clients seem to appreciate - in most cases it is the only type of loan that can be cumulated with a normal loan. It usually bears an interest of 10% per month declining (6% in one case), and is limited to 2000 to 3000 Ksh, on a short period (1 to 3 months).

Other loan products (available in some FSAs in Makueni, more rarely in Kitui) are :

- ▷ Agriculture loan : two-month grace period, interest rate 2% declining.
- ▷ Education loan, called “Masomo” loan : borrowers save money (in the “Masomo” account) and can borrow up to two times the amount saved ; the money will be sent directly to the school. Interest rate is 2%, maximum duration one year.

In most FSAs visited clients can not borrow two different types of loans at the same time, except for the « emergency loan » that can be added to a normal loan.

2. Voluntary Savings

▷ Current accounts

Current accounts represent a huge proportion of the voluntary savings collected by the FSAs today : the percentage of current accounts out of total voluntary savings is over 90% in all FSAs visited except one (84%), where fixed savings are slightly more developed.

It is a highly flexible product, with very few restrictions. Actually, in an FSA located in a poorer area, clients seem to be very much willing to use the savings facility of the FSA, and the proportion of savings accounts to members exceeds 100%.

Average balances of voluntary savings across FSAs on savings accounts generally in the range of KShs 1 – 5,000. Although it is in some cases to be a shareholder of an FSA in order to open a savings account (requiring the purchase of a share), there are no conditions such as minimum balances or ledger fees. Several FSAs have opened accounts to “associates”, i.e. non-shareholders. No interest is usually charged on the client, though it is a costly product for the FSA.

▷ Fixed deposits

Fixed deposits are not yet much developed in FSAs – especially in Kitui, where it seems to have been only recently introduced. Most FSAs propose fixed deposits accounts for a fixed term of minimum 3 months, carrying a small interest per year.

Voluntary savings rely on trust, and in some of the FSAs visited the question of physical security of the building and safe has been an issue. In fast-growing FSAs the decision was made to invest in a larger building (shareholders contributing to the cost), reinforce security measures and change old safes. However, developing more attractive products could meet a demand and would enable FSAs to increase their financial autonomy.

▷ Education accounts, called “Masomo” savings

Masomo savings are not much developed – clients can save and obtain a “masomo loan” to cover school fees. School fees represent a huge expense for most families in Kenya, especially

at secondary level (the cost is over 20,000 Ksh per year), and masomo savings and loan could meet a larger demand, if they are correctly adapted to it.

As a conclusion, introducing some restrictions on current accounts (or charging an interest) and proposing attractive longer-term savings products could be an option for FSAs, to raise more savings that could possibly become an internal resource to increase loan funds.

3. Other products

Other services offered to clients include money transfers, cheque clearing, payment of salaries. However, they are not yet well developed and represent a marginal part of the income of FSAs (around 4% in Kitui and 6% in Makueni as of September 30th, 2006). To be profitable, such products would need to be much more developed, which would probably require to focus on a few services of interest to customers.

4. Are products adapted to demand?

Several comments can be made, based on client comments and discussions in the FSAs visited:

- ▷ The lending methodology is constraining for a client : need to form a joint-liability group, weekly meetings, compulsory savings, security, shares, etc. This methodology has several advantages : it reduces default thanks to group pressure and peer selection, it offers guarantees in case of default. However, multiplying conditions to access loans is also costly for borrowers and may discourage part of target clients.
- ▷ “Normal loans” are well adapted to small businesses and trading activities, or to families with diversified activities (or when a member of the family is employed in a factory in Mombasa or Nairobi) that can generate regular earnings. They are too rigid and less adapted to farming activities.
- ▷ Conditions to access loans and limits in loan size have also been used as tools to reduce demand for credit when the FSA encounters liquidity problems. It has probably discouraged clients with bigger activities who need higher amounts – introducing with caution individual lending could enable FSAs to reach a new segment of clientele.
- ▷ Interest rate conditions seem in line with that of competitors and can not be lowered much. Developing products suited to finance a wider range of activities (by adapting the maturity/grace period to the activity) could enable FSAs to remain competitive. However, fixed amounts for compulsory savings and loan application fee imply that the APR is higher for small borrowers (see below, Interest rate analysis).
- ▷ Developing voluntary savings would be useful both for clients and for FSAs. The focus on lending has prevented FSAs from developing attractive savings products. Collecting fixed deposits can enable FSAs to on-lend part of it, and therefore develop loans as well.

5. Product refining and diversification

KFS is aware of the limits of existing services and products offered by FSAs, and product refining and diversification is planned in the short-run.

The main decisions taken by KFS seem adequate to adapt products and services :

- improve the flexibility of loans,
- develop individual loans (pilot test in Makueni),
- increase the interest on fixed deposits,

- introduce new products (micro-leasing will be pilot tested in Makueni, market-day loan has been tested with success in one FSA)
- enable poorer clients to save only (in two FSAs) at weekly meetings.

Lessons learnt – Kenya FSA Model (7)

The FSA model is often driven by credit products. To reach a large panel of clients, it appears necessary in Kenya to extend the range of services offered by FSAs – in particular, savings products are of interest to the poor, and can enable FSAs to increase their loan fund.

Strict conditions to access loans and limits in loan size have also been used by Kenyan FSAs as tools to reduce demand for credit when they encounter liquidity problems. It has probably discouraged clients with larger activities who need higher amounts – introducing with caution individual lending could enable FSAs to reach a new segment of clientele.

As for savings, introducing some restrictions on current accounts (or charging an interest) and proposing attractive longer-term savings products could be an option for FSAs, to raise more savings that could possibly become an internal resource to increase loan funds.

To adapt products, there is a need for the external partner to develop and use regularly client follow-up tools.

V. SOCIAL PERFORMANCE

The following analysis of social performance is limited - a complete review of social performance indicators would require a mission in itself. However, a recent survey on client perception in Kitui and Makueni⁶, as well as discussions with clients and staff from FSAs and KFS, provide some insights in the FSAs' social mission and performance.

We will follow here the four dimensions of social performance as described in the Social Performance Indicators (SPI) defined by CERISE⁷.

KFS may in the future include some social performance indicators in the monitoring of FSAs, so as to emphasise the social performance of the network.

1. Dimension 1 : Outreach to the Poor and the excluded

Outreach to the rural population is an achievement of the FSA program in Kenya. All FSAs supported by KFS / KDA cover a total of over 60,000 members in rural areas where few or no financial services are available to the population. In Kenya at large, 19% of FSAs are operating in areas with density below 100 p.p.km², with certainly a high poverty incidence.

In the regions of Kitui and Makueni, the poverty level differs from one place to another – depending mainly on access and water – the eastern part of both regions is much dryer. Competing MFIs have started very recently to operate in the regions of Kitui and Makueni – entering small towns and developing groups in neighboring areas. However, consistent with observations from field visits and interviews with clients, the indications are strong that the FSAs are serving a market which has either limited or no access to alternative formal financial systems in these two regions.

⁶ Client Perception Report for Kitui & Makueni FSAs, Final Report, KDA, Feb 2006.

⁷ <http://www.cerise-microfinance.org/publication/impact.htm>

The average loan balance in FSAs is currently of Ksh 9,500 (USD 132), much lower than the average loan balance of MFIs in Southern Africa (USD 427, according to MBB) and just above the average in the “Africa – small ” peer group (USD 89). The “depth indicator” (measured as the average outstanding loan size compared to GNI per capita - around USD 530 in Kenya) would be of an estimated 25% - well below the average of African MFIs (89%), and the average of the MBB peer group (59%)⁸.

2. Dimension 2 : Adaptation of the services and products to the target clients

The FSA model constitution states that the association will offer services to the rural community as a whole, « starting from the poorest in the community ». Indeed, the “normal loan” indirectly targets a poor or medium-poor population, since group lending constraints (frequent meeting, compulsory savings, limited and progressive loan amounts) will discourage the better-off. Current accounts services offered by FSAs are also theoretically convenient to the poor, with no minimum balance requested.

However, the range of services offered by FSAs is very limited ; the “normal loan” is adapted only to a part of the rural population, with regular earnings. Moreover, the lending methodology may discourage two categories of the rural population, due to the numerous constraints of group lending (see “Products and clients” section) :

- Potential clients with bigger businesses, or the more well-off part of the population is probably not interested in accessing small loans with such constraints. Individual loans would clearly be more adapted to this client segment.
- In other countries, it has been demonstrated that very poor clients are often excluded by group lending methodologies.

The “loan-driven” orientation of FSAs may also discourage poorer clients, who do not always wish to get indebted but favour flexible, small savings. KFS’ decision to pilot test weekly voluntary savings for clients that do not need loans is a justified attempt to reach poorer clients.

In any case, refining the products and lending methodology should enable FSAs to attract a much wider clientele and increase their local outreach.

3. Dimension 3 : Improvement of clients’ social and political capital

Participation of shareholders in the FSA management is one of the key components of the model. In several cases, Boards seem motivated and can bring ideas and initiatives. Moreover, KFS plays an active role in ensuring that AGM are correctly organised, that accounts are presented to shareholders, and that the remarks of external auditors are taken into account.

There seems to be a sense of “ownership”, at least in some FSAs with stronger participation. In most FSAs that needed to finance a new building, raising funds in the community proved to be rather easy.

However, in some FSAs there is still some confusion for shareholders on the difference between co-operatives and FSAs, and on the FSA rules. Regular training will be necessary to maintain the feeling of “ownership” for local communities, which is a comparative advantage of FSAs vis-à-vis competitors. Once again, external support is necessary to protect shareholders and avoid governance risks ; a good balance between external support and local management is needed.

⁸ Source : MBB 2004 Benchmark Tables.

FSAs have internal policies encouraging participation of women (representation at Board level). Women are strongly represented among clients, with differences among FSAs ; their higher participation in some FSAs is linked to the fairly good adaptation of the FSA products to women activities, and does not reflect a specific targeting strategy.

4. Dimension 4 : Social responsibility of the MFI

- ▷ Social responsibility towards the staff : training is a strong, positive component of KFS' support for Managers and FSA staff. At present, the staff met in FSAs and at KFS seem motivated and satisfied with conditions of salary – though FSAs expect KFS to hire directly all of the staff in the future. Human resource policies can be improved with clearer, formalised salary grid and training plan in the future. Introducing a performance-related part in the salary can add to the staff motivation in the future, at all levels.
- ▷ Social responsibility towards the clients : impact studies are rather new for FSAs ; KFS has used a review of client perception and product adaptation in 2006. Using regular, standardised tools to estimate client satisfaction will need to be put in place as a follow-up of product refinement. A closer look could be given as well to “social” aspects of lending (group cohesion, reality of joint-liability, functioning of peer pressure...) to improve lending methodologies.

VI. FINANCIAL PERFORMANCE

1. Loan Portfolio Quality

- ▷ Loan portfolio analysis

Table 7 : Loan portfolio quality of sample FSAs

| as of Sept 30, 2006 | MAKUENI | | | KITUI | | |
|-------------------------------|-----------|-------------|-----------|-----------|-----------|-----------|
| | Mukuyuni | Kathonzweni | Nunguni | Itoleka | Mutitu | Takeani |
| Number of loans outstanding | 391 | 562 | 599 | 442 | 960 | 82 |
| Nb of delinquent loans | 38 | 175 | 0 | 7 | 42 | 16 |
| % of late loans | 9,7% | 31,1% | 0,0% | 1,6% | 4,4% | 19,5% |
| Total outstanding loans (MOS) | 5 164 693 | 6 391 571 | 4 864 137 | 5 142 373 | 8 252 402 | 1 313 732 |
| Outst. balance of late loans | 467 752 | 346 116 | 0 | 192 953 | 76 280 | 10 849 |
| PAR at 1 day | 9,1% | 5,4% | 0,0% | 3,8% | 0,9% | 0,8% |

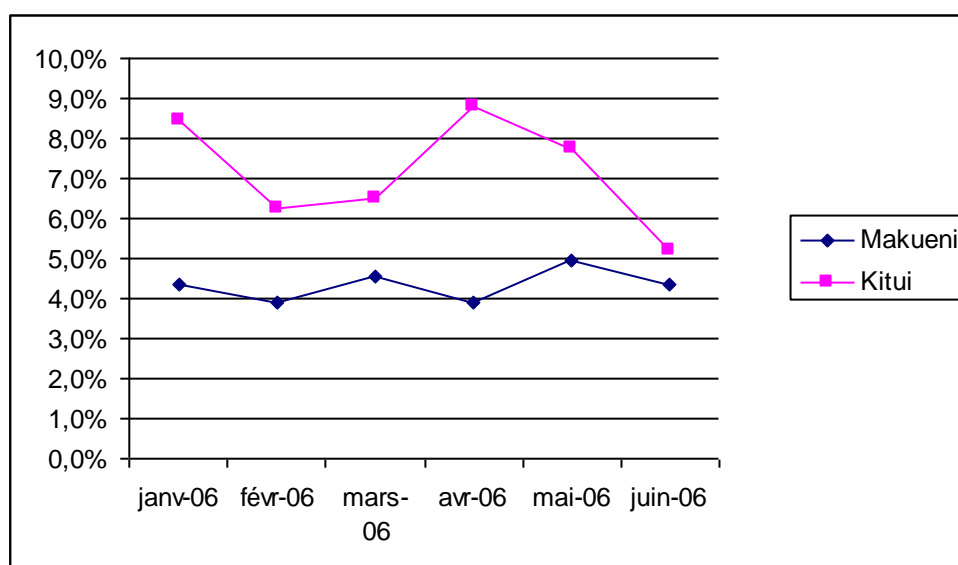
Source : FSA Monthly statistics & Defaulters listing and aging 1 month

In the Makueni (9 FSAs) and Kitui (8 FSAs) districts, the respective average PAR was of 4.4% and 5.2% as of June 30th, 2006 :

Table 8 : Loan portfolio quality – regional level

| as of June 30, 2006 | Makueni | Kitui |
|-------------------------------|------------|------------|
| Number of loans outstanding | 3 671 | 2 332 |
| Nb of delinquent loans | 277 | 170 |
| % of late loans | 7,5% | 7,3% |
| Total outstanding loans (MOS) | 37 825 639 | 23 492 676 |
| Outst. balance of late loans | 1 650 204 | 1 226 419 |
| PAR at 1 day | 4,4% | 5,2% |

At regional level, trend analysis indicates as well that delinquency is under control in Makueni but not decreasing ; in Kitui, where the PAR was higher, the situation seems to be on a rather favourable trend in the first semester of 2006.

Chart 2 : Trend in PAR at 1 day – regional level (1st semester 2006)

Among FSAs visited, two FSAs out of 6 have PAR at 1 day exceeding 5%, but with delinquency rates dropping after one month. This tends to demonstrate that both FSAs still have a good capacity to recover loans the three months following delay.

No Board members were defaulters in the FSAs visited, which is a good indicator as in community-based financial systems, defaulting board members are usually a major cause for delinquency.

Analysing the reasons for defaulting would require more in-depth analysis but discussions with FSA boards, managers and clients indicate that at least two reasons could be further investigated :

- clients are used to having a few days delay, and more strictness in applying repayment rules could improve the PAR;
- adaptation of loan products is another issue. In dryer areas of Makueni, many clients depend on farming activities to repay their loans. Refining products to better suit the clients' seasonal revenue could improve reimbursement.

▷ **Delinquency follow-up and management**

Doubtful debts are being provisioned in all FSAs, however currently there is no write-off policy. KFS plans to introduce it, which is advisable.

In all FSAs visited, both managers & board chairmen were aware of the target set by KFS to keep PAR at 1 day under 5%, and efforts are clearly done to achieve this. However, the will to achieve target could induce also practices such as rescheduling. In several FSAs it was very clear that no rescheduling would be done, whereas in others managers admitted that it had been possible to “extend the duration of loans”, esp. agriculture loans in Makueni. Such examples, if any, are probably very occasional, however it would be advisable to check on possible rescheduling. A more formal and transparent policy concerning rescheduling should be stated.

Since delinquency seems to be mostly short-term, more strictness in loan repayment might be needed. To do so, a more efficient information system is necessary to enhance reactivity. Muunganos can react quickly (they meet each week and should check on late payments),

however if they don't, at the FSA level managers can not complete and check the General ledger before the end of month, which enables for a whole month delay before any action is taken.

The effort being pursued under Management contracts may not be sufficient in itself, and a thorough understanding of delinquency issues is needed, all the more because rapid growth may also have a negative impact on repayment rate in 2007.

Improving the MIS and loan follow-up as well as refining products may thus be needed to improve delinquency control. In the product refining process, there is also room for adapting penalties and incentives to improve repayment on time. In most FSAs penalties for late loans are set at a very high level (1% or 0.5% per day depending on the FSA), which implies that in many cases the cumulated penalties due by the defaulter are higher than the late loan balance itself. There is a general consensus amongst boards and staff at all level to say that this level is high, and that the penalty policy is unsatisfactory. A positive incentive has been introduced in Makueni : members can take back 25% of compulsory savings at the end of the loan is they have repaid on time ; however, the rule does not seem to be clearly understood or practised by clients.

Lessons learnt – Kenya FSA model (8)

Keeping delinquency low is a key element to achieve sustainability. FSAs of several regions of Kenya experience unsatisfactory repayment rates, and KFS's ability to turn such FSAs around will be decisive for the future of the model.

The example of Kitui and Makueni regions shows that the effort pursued under the Management contracts is not enough in itself – a thorough understanding of delinquency issues is needed (causes may include product being not tailored to the needs, and a need for more “strictness in loan management”). Improving the MIS and loan tracking as well as refining products can contribute to decrease delinquency.

2. Financial results

The following analysis refers to the financial statements of the FSAs visited in Makueni and Kitui, presented in Annex II and III.

2.1 Sustainability

▷ At FSA level

Revenues derived from loans, including penalties, are the principal source of income for the FSAs (ranging from 69 to 89% ; 81% on average in Makueni, 88% in Kitui). Penalties are high, representing up to 13% of income at Mukuyuni.

Thanks to commercial interest rates, the growth of most FSAs visited in Kitui and Makueni enables them to quickly cover their operational costs, including management fees paid to KFS; Nunguni, a fast growing FSA created in June 2005, achieved impressive results in slightly more than one year.

The OSS (including management fees) reaches over 160% on average in both Kitui and Makueni. Nunguni, a young and fast growing FSA (launched in June 2005) already enjoys a 242% OSS. Their result are clearly above the average MBB peer group (Africa small).

However, to estimate the future self-sufficiency at FSA level, we have to take into account the impact of inflation. The following table shows that after adjusting for inflation (assuming average inflation rate of 11% in 2006) the FSS is still above 100% (with positive AROA and AROE) for dynamic FSAs, but the other ones are not yet fully sustainable. However, all indicators, including AROA and AROE, are well above those of the MBB peer group.

It must be kept in mind nonetheless that Kitui and Makueni are provinces with good results and strong management by KFS – and their performance does not reflect that of most FSAs in other regions of Kenya. These results are however encouraging for the future if KFS extends its “management contract” model to other regions.

Table 9 – Profitability and sustainability ratios

| As of Sept 30th, 2006 (in Ksh) | Makueni | | | Makueni all FSAs | Kitui | | | Kitui all FSAs | MBB peer group |
|--------------------------------------|-------------|-------------|-------------|---------------------|------------|-------------|------------|-------------------|-------------------|
| | Mukuyuni | Kathonzweni | Nguni | | Itoleka | Mutitu | Kakeani | | |
| OSS inc.Mgt fees | 229% | 119% | 242% | 169% | 167% | 231% | 167% | 163% | 98% |
| Adjusted op. cost - adj. inflation | 1 193 976 | 2 037 933 | 1 165 768 | 12 180 736 | 1 155 858 | 1 582 675 | 289 382 | 6 772 038 | |
| FSS (adjusted for inflation) | 117% | 91% | 137% | 106% | 94% | 124% | 86% | 98% | 80% |
| Adj. Op. income (adj. for inflation) | 205 456 | -189 538 | 428 026 | 773 458 | -71 088 | 374 031 | -41 553 | -119 908 | |
| ROA | 6,6% | 3,4% | 7,7% | 5,9% | 5,9% | 10,0% | 3,4% | 5,2% | |
| Adj. Return on Assets (AROA) | 1,7% | -2,2% | 3,5% | 0,9% | -1,0% | 3,4% | -1,4% | -0,2% | -6,50% |
| ROE | 14,5% | 5,6% | 14,9% | 10,9% | 8,7% | 15,4% | 7,5% | 9,5% | |
| Adj. Return on Equity (AROE) | 3,8% | -3,6% | 6,8% | 1,6% | -1,4% | 5,2% | -3,1% | -0,4% | -10,60% |

Nonetheless, estimating the future self-sufficiency of the whole model would imply to take into account three key factors :

- Loan losses in two FSAs have a strong impact on results (23% of all expenditures for Itoleka and up to 46% of for Kathonzweni, i.e. the equivalent of all salaries, BoD and AGM expenses). The break-even of FSAs depends on their ability to monitor delinquency over years.
- The cost of fund is rather low: today FSAs pay an interest on very limited amounts of fixed deposits (except for one FSA which received an additional loan from KDA). In the future FSAs may have to borrow more, and/or develop a more aggressive policy for savings remuneration in areas where competition is rising.

▷ At regional branch level

It is possible to compare, for 2006, the level of financial self-sufficiency budgeted and achieved as of September 30. The FSS in 2006 would be of 27% at this level according to the business plan. Achieved FSS as of September 30, 2006 is actually higher in Makueni and lower in Kitui, compared to business plan figures.

However, the support cost by KFS is likely to rise in the future if the structure at regional and/or central level is to be reinforced (with internal auditors at regional level, for instance); this will also depend on the final organisational structure chosen for the FSA model in Kenya.

Table 10: Makueni and Kitui regional branches – Estimated self-sufficiency in 2006

| Regional Branch | Makueni budgeted | Makueni as of Sept, 06 | Kitui budgeted | Kitui as of Sept, 06 |
|--|---------------------|---------------------------|-------------------|-------------------------|
| Estimation, 2006 (source : BP) | | | | |
| Income from FSAs | 1 895 911 | 1 745 889 | 1 906 570 | 1 116 469 |
| All operating costs - including regional office | 4 637 181 | 3 099 224 | 4 802 281 | 3 263 252 |
| OSS | 41% | 56% | 40% | 34% |
| Headquarter costs (cost allocation : 1/7 per region) | 1 452 410 | 1 590 921 | 1 452 410 | 1 590 921 |
| FSS - adjusting for all support costs | 31% | 37% | 30% | 23% |
| Add. Cost - Adjustment for inflation | 907 436 | | | |
| FSS - adjusting for inflation and support costs | 27% | | | |

* Costs = estimation Business plan, year 2 (2006) ; balance sheet Makueni = estimation Business plan

2.2 Efficiency and productivity

Table 11: Efficiency and productivity ratios

| As of Sept 30th, 2006 | Makueni | | | Kitui | | |
|--|----------|-------------|---------|---------|--------|---------|
| | Mukuyuni | Kathonzweni | Nunguni | Itoleka | Mutitu | Kakeani |
| Yield (interest & fees from loans / portfolio) | 24,7% | 20,0% | 27,0% | 18,8% | 22,2% | 13,4% |
| Adm. expense (inc mgt fees) / net loan portfolio | 8,7% | 9,9% | 8,7% | 6,0% | 4,8% | 6,5% |
| Operating expenses (inc mgt fees) / net loan portfolio | 12,9% | 21,3% | 13,6% | 12,6% | 10,1% | 11,7% |
| Adjusted operating exp. / net loan portfolio | 25,2% | 27,9% | 24,0% | 22,5% | 18,9% | 22,9% |
| Operating Cost per Active Client (in USD) | 19 | 22 | 14 | 15 | 12 | 19 |
| Nb of active loans per Loan Officer | 196 | 281 | 300 | 147 | 480 | 82 |
| Average Outstanding Loan Size (in USD) | 168 | 180 | 113 | 162 | 121 | 214 |

Ratios of efficiency must be analysed with caution, since the costs at FSA level (even including management fees paid to KFS) do not yet include the full cost of support by KFS, which will be correctly estimated only when the final business model and structure are in place.

All FSAs except one have an “operating expense over loan” ratio higher than the yield on portfolio, as should be expected. However, after adjusting for inflation it appears that only two FSAs have a really efficient structure. Reviewing the organisation (number of staff according to growth potential) to improve efficiency is probably possible in the near future.

The number of active loans per loan officer is still lower in most FSAs than the “target” of 350 to 400 borrowers per loan officer mentioned by managers. There is room for improvement in productivity.

Key lessons learnt – Kenya FSA model (9)

Thanks to commercial interest rates, the growth of most FSAs enables them to quickly cover their operational costs, as well as a portion of support costs. However, delinquency may have a strong impact on results; maintaining low delinquency rates in all FSAs (and closing or turning around FSAs with high delinquency rates) is key for the future of Kenyan FSAs.

Adjusting for inflation and all support costs (which depends on the institutional option chosen) is necessary to estimate the real financial self-sufficiency of the model.

3. Risk Management

A comprehensive risk-management approach needs to be reinforced at most levels (boards and FSA staff / managers / regional branches of KFS).

Improving the MIS will certainly enable to reinforce risk management at operational levels, but governance risks need to be taken into account as well (see above, Governance).

4. Asset-Liability & Liquidity Risk Management

FSAs have a policy to use only net equity (equity less fixed assets) for lending. This was set by KDA as a prudential measure, until the security of savings could be ensured in all FSAs.

However, in all FSAs visited, it appears that savings are occasionally or regularly used for lending. In one case current accounts were on-lent, which obviously bears a high risk in case of default. KDA is aware of the situation, and decided to refinance some FSAs (including K.) where pressure for lending is high, in order to avoid on-lending of current accounts.

- ▷ At this stage, staff and board members in FSAs have a limited ability to manage liquidity issues. A simple spreadsheet to follow cash flows and anticipate on money shortage for lending (especially at seasonal peaks for loans) would be necessary in the new MIS to be defined, and all stakeholders in FSAs could be trained to use and analyse it.
- ▷ In secure FSAs, rules may be adapted to authorise on-lending of part of fixed deposits.
- ▷ In the future, eligibility criteria may also be set by KFS to define which FSA could access refinancing. Such criteria may include the age of the FSA, sound financial situation including low PAR, and quality of cash management.

5. Interest Rate Analysis

▷ Estimation of APR

Nominal interest on loans is usually 3% declining, and 4% in more recent FSAs.

Since application fees and compulsory savings are set not in percentage of the loan but in fixed amounts, the APR for the client differs with the amount lent and the duration of the loan. For this reason, clients borrowing the smallest amounts will be disadvantaged, whereas borrowers with big loans will have an APR near to the nominal interest rate.

The following table shows that the APR of « normal loans » (still representing the wide majority of the portfolio) ranges from 36.6% to 68.8% for Mukuyuni FSA (nominal interest rate 3%) and from 49.6% to 82.8% for Nunguni FSA (interest rate 4%). It must be kept in mind that this APR calculation takes into account upfront fees and compulsory savings, but not the shares that a member will initially buy (the value of the shares varying with time, and giving right to annual dividends). This is thus a minimum APR.

Table 12: Variation of effective interest rate for two FSAs, according to amount and duration of loan

| Amount of loan | 2 400 | 5 000 | 8 000 | 20 000 | 100 000 |
|-------------------------------|--------------|--------------|--------------|---------------|----------------|
| nb. shares necessary | 2 | 4 | 6 | 17 | 84 |
| Loan application fee | 150 | 150 | 150 | 150 | 150 |
| Compulsory savings | 20 sh/ week | 20 sh/ week | 20 sh/ week | 20 sh/ week | 20 sh/ week |
| Duration (in months) | 6 | 6 | 9 | 12 | 18 |
| Nominal monthly interest rate | 3% | 3% | 3% | 3% | 3% |
| Nominal annual interest rate | 36% | 36% | 36% | 36% | 36% |
| APR Mukuyuni FSA | 68,8% | 50,3% | 43,7% | 38,8% | 36,6% |

| Amount of loan | 2 400 | 5 000 | 8 000 | 20 000 | 100 000 |
|-------------------------------|--------------|--------------|--------------|---------------|----------------|
| nb. shares necessary | 2 | 4 | 6 | 17 | 84 |
| Loan application fee | 150 | 150 | 150 | 200 | 756 |
| Compulsory savings | 20 sh/ week | 20 sh/ week | 20 sh/ week | 20 sh/ week | 20 sh/ week |
| Duration (in months) | 6 | 6 | 9 | 12 | 18 |
| Nominal monthly interest rate | 4% | 4% | 4% | 4% | 4% |
| Nominal annual interest rate | 48% | 48% | 48% | 48% | 48% |
| APR Nunguni FSA | 82,8% | 63,2% | 56,4% | 55,0% | 49,6% |

A recent study on products and client satisfaction⁹ in the two districts of Makueni and Kitui – where competition is rising - stated that such rates are in line with competition. Examples in the field of loan products proposed by KWFT confirm this analysis.

Actually, most discussions with members in the FSAs visited did not focus on the interest rate level but rather on the terms and conditions to access loans (group constraints, loan amount). Regular clarifications on the role of interest rates in ensuring the sustainability of the FSAs will however be necessary to avoid misunderstandings.

▷ **Yield (revenue from loans / net outstanding loans)**

Since the APR will vary from FSA to FSA, and depends on the amount and duration of the loan, it is difficult to estimate the yield gap for FSAs, i.e. the difference between theoretical and actual revenues from loans.

However, estimating an average APR at 50% (which is probably low), the yield gap seems to be above 10% in all FSAs visited¹⁰, implying that there is room for improving the efficiency in loan and liquidity management.

Table 13: Estimated yield gap – 6 FSAs

| as of Sept 30th, 2006 (in Ksh) | Makueni | | | Kitui | | |
|--|-----------|-------------|-----------|-----------|-----------|-----------|
| | Mukuyuni | Kathonzweni | Nunguni | Itoleka | Mutitu | Kekeani |
| Est. theoretical interest (APR) | 50% | 50% | 50% | 50% | 50% | 50% |
| Net outstanding loans at end of period | 4 740 194 | 7 298 820 | 4 864 038 | 5 142 373 | 8 377 203 | 1 257 447 |
| Theoretical interest & fee income (annual) | 2 370 097 | 3 649 410 | 2 432 019 | 2 571 187 | 4 188 602 | 628 724 |
| Theoretical interest & fee income (9 months) | 1 777 573 | 2 737 058 | 1 824 014 | 1 928 390 | 3 141 451 | 471 543 |
| Actual interest & fee income as of Sept 30 | 1 169 201 | 1 462 919 | 1 315 440 | 966 242 | 1 856 368 | 168 012 |
| Yield gap | 608 372 | 1 274 139 | 508 574 | 962 148 | 1 285 083 | 303 531 |
| in % of net loans | 12,8% | 17,5% | 10,5% | 18,7% | 15,3% | 24,1% |

6. Business Planning

KFS has been in 2005 through the process of defining a business plan for the period 2005 - 2014. According to these estimations, the whole “FSA company” (FSAs + support structure, including regional offices – one per region - and headquarters) would reach sustainability (before adjusting for inflation) in less than 5 years, by year 2009.

The results achieved in Makueni and Kitui in 2006 are in line with the estimation made in the business plan, confirming that the model seems realistic for those two regions, at least in the short run.

However, it is difficult to take these projections for granted at this stage, for three main reasons :

- the final “business model” is not yet in place ; the adaptation of the products and services, the accuracy of the MIS, the quality of risk management are key issues for the future of FSAs,
- the institutional option (regional / national...) to be chosen in the coming years impacts on the organisational structure,

⁹ Client Perception Report for Kitui & Makueni FSAs, Final Report, KDA, February 2006.

¹⁰ CGAP’s Appraisal Format for MFIs estimated that a « normal » yield gap should be under 10%

- the central issue for many FSAs remains delinquency, in regions that are not yet under management contract – cost estimations for Kitui and Makueni are probably realistic, but the situation in other regions is much more delicate to estimate. In a national scenario, KFS would also have to define which regions in Kenya would be able to join the institution.

There will therefore be a need to update these financial projections in one year time, to take into account possible changes in cost structure and revenues. This review may be an opportunity to build a business plan on a bottom-up approach, with a stronger participation from stakeholders (especially managers and FSA Board members).

VII. INSTITUTIONALISATION STRATEGIES FOR FSAs IN KENYA

1. Perception of the FSA in the Microfinance Sector

1.1 Perception of the FSAs by the FSAs themselves

The FSAs see themselves as “formal” microfinance institutions, owned by the shareholders and operated by KREP (or at least strongly supported by KREP). They consider themselves as part of KREP and are deriving from that a strong sense of belongingness, pride and trust.

Nevertheless, some shareholders believe that FSAs function like a co-operative, on the base of “one man one vote” and consider “merry go rounds” as their competitors at village level.

There are very few opportunities for neighbouring FSAs to meet and exchange experiences and therefore little inter actions and information among FSAs, though increasing interest to know more about the performance of other FSAs in the same district and in other parts of Kenya. For the moment being, FSAs do not see themselves as a “movement” or a “network” or even “outlets” of KDA.

There has been an attempt to form a “Federation” of FSAs in Taita Taveta a few years ago that was not very successful, while it is hard to tell if it is due to inappropriate methodologies or lack of co-operation culture among individual FSAs. All the lessons from this recent experience may not have thoroughly drowned yet.

1.2 Perception of the FSAs by other stakeholders in the microfinance sector

Leading MFIs look at FSA as SACCOs or ROSCAs, community based organisations that could penetrate more easily the rural areas. They are seen as either potential competitors or as potential retail partners that the MFI could complement through training and lending (wholesale – retail relation).

AHFI, the Association of MFI, also considers FSAs as member based organisations, closer to SACCOs and expects FSAs to transform into SACCOs once the SACCO Law will be issued. Central bankers see FSAs as a blend of SACCO and MFI, registered under (welfare) societies Act, which operations are unclear to them. They call them “village banks”.

To all, FSAs are the organisations that KREP has set up in the rural areas and are the “alternative financial services” to go deeper into the rural areas, to reach underserved communities.

1.3 FSAs seen by KDA

KDA is the development arm of KREP when it was transformed into a bank. KDA’s role is to identify new needs, design and pilot test new products that could be extended by KREP Bank. In this sense, FSAs are in a way, the “product” for KREP Bank to penetrate the rural areas and downscale its operations in a cost effective way.

Initially, KDA thought that FSAs would be able to operate autonomously after some years and KREP Bank would wholesale to them. Nowadays, KDA is developing a new long term service through KFS (KREP Fedha Session) : the management contract, providing FSAs with professional managers for a fee. This evolution in the relationship between the individual FSAs and KFS is too recent to have clearly determined a vision of service or of longstanding cooperation and alliance.

KDA sees the FSAs as member owned, member managed and member financed Micro-Finance Institutions that are operated professionally and financially sustainable. KDA firmly considers FSAs as non SACCOs and aims at anchoring them to the microfinance sector.

Nevertheless, KDA considers empowerment of the shareholders and the communities as part of the mission of the FSAs and their contribution to rural development. Participation is therefore an important element of the mission.

1.4 Communicating the specificities of FSAs

It appears to all stakeholders in the microfinance sector in Kenya that a clear communication on the FSAs to highlight their specificities and differentiate them from other member based financial intermediaries (SACCOs and ROSCAs) will be needed.

This communication should be both internal and external :

- ▷ Internal Communication targeting the FSAs' shareholders, FSAs board members, staff and managers : the substance of this communication could derive from the various studies conducted in 2006 in the frame of the "FSA transformation project". It could be seen as a mean to build internal capacity in self evaluation and positioning in the Microfinance market.
- ▷ External communication in the direction of non members, other microfinance institutions, microfinance banks, regulatory authorities, donors and investors : this could be derived from the "new FSA model" : operations, products, segment of market, target institutional model. This communication would serve as advocacy for rural finance.

2. Developing an institutional strategy for the FSAs in Kenya

A good institutional plan for FSAs would have to take into consideration :

- Scale or a critical mass for viability: division of risk, cost sharing, investment capacities.
- A balanced governance complementing local ownership, community empowerment, effective peer pressure and professional credibility, efficient management, corporate culture for financial and social performance.
- That can fit into the new legal and regulatory framework for microfinance in Kenya.

The three main options may be :

- (a) The FSAs belonging to the same district/or two neighbour districts form a share company where they are the founding and majority shareholders. This share company has a professional management and staff. It gets a licence as a "regional microfinance company".
- (b) All the viable FSAs of Kenya form a share company where they are the founding and majority shareholders. This company has a professional management and staff and gets a licence as a "national microfinance company". In this option, two organisational patterns could be envisaged : (1) a centralised institution with local outlets (the FSAs are both shareholders and outlets) (2) a decentralised model whose FSAs function more or less the way they will function under the new FSA offer but have in common an Apex Bank at national level with an appropriate governance and highly qualified banking staff.

In both cases, opening the capital of the FSA microfinance companies to external investors would bring added value. Among potential investors, KREP Bank should be seen as a natural partner, bringing both professionalism and credibility.

- (c) KREP Bank forms a subsidiary for rural penetration, becomes a shareholder of FSAs and proposes to them a partnership contract where FSAs are windows for KREP product and services

ANNEX 1 : Documentation

1. ASF - Desk review, Rapport final, IFAD, Feb 2004.
2. Verhagen K., FSAs in East Africa, Microfinance driven by shareholder value, IFAD, Sept 2000.
3. Mbole F., K-Rep Development Agency's Management Contract, an Alternative Management Approach for FSAs, KDA, Sept 2004.
4. Client Perception Report for Kitui & Makueni FSAs, Final Report, KDA, Feb 2006.
5. Johnson S., Malkamaki M., Mukwana P., Wanjau K., One Step Beyond : Challenges and Opportunities in Promoting Quality Financial Services in Remoter Areas, MicroSave, oct 2002.
6. FSA Uganda, case study, DFID, oct 01.
7. FSAs : The Story So Far, Helms B., Pearce D., CGAP, feb 2001.
8. Tounessi M., FSAs : A Microfinance Innovation in Benin, IFAD, 2000.
9. FSAs in Uganda, A Mid-Term Review, MicroSave, April 2000.

ANNEX II : INCOME STATEMENTS AS OF SEPT 30th, 2006 SAMPLE FSAs IN KITUI AND MAKUENI

Income Statement - FSAs visited and regional total - Makueni

| as of Sept 30th, 2006 (in Ksh) | Makueni Mukuyuni | | Kathonzweni | | Nunguni | | Total Makueni | |
|--|---------------------|-------------|------------------|------------|------------------|------------|-------------------|------------|
| Income | | | | | | | | |
| Interest & fee income (LAF) from loans | 986 967 | 71% | 1 385 685 | 75% | 1 242 209 | 78% | 9 580 177 | 74% |
| Loan penalties | 182 234 | 13% | 77 234 | 4% | 73 231 | 5% | 969 218 | 7% |
| Other operating income | 230 231 | 16% | 385 476 | 21% | 278 354 | 17% | 2 404 799 | 19% |
| Total operating income | 1 399 432 | 100% | 1 848 395 | | 1 593 794 | | 12 954 194 | |
| Expenditures | | | | | | | | |
| Salaries & wages | 130 686 | 39% | 168 577 | 27% | 187 002 | 46% | 1 521 011 | 39% |
| BoD and AGM | 51 746 | 15% | 127 981 | 21% | 25 768 | 6% | 435 115 | 11% |
| Other op. expenses | 153 656 | 46% | 326 043 | 52% | 193 332 | 48% | 1 925 520 | 50% |
| Total operating expenses | 336 088 | 100% | 622 601 | | 406 102 | | 3 881 646 | |
| Financial exp. (int. on KDA loan) | 0 | | 7 000 | | 0 | | 104 708 | |
| Provision for bad debt | 20 914 | 5% | 595 413 | 46% | 0 | 0% | 1 575 664 | 27% |
| Other provisions (audit, depreciation...) | 48 254 | | 62 932 | | 50 199 | | 374 039 | |
| Total expenditures | 405 256 | | 1 287 946 | | 456 301 | | 5 936 057 | |
| Net profit / loss before MC fees | 994 176 | | 560 449 | | 1 137 493 | | 7 018 137 | |
| Payment for mgt fees to KFS (<i>% of profit</i>) | 205 493 | 21% | 267 309 | 48% | 202 788 | 18% | 1 740 889 | 25% |
| Profit/loss after management fees | 788 683 | 56% | 293 141 | 16% | 934 705 | 59% | 5 277 249 | 41% |

Income Statement - FSAs visited and regional total – Kitui

| as of Sept 30th, 2006 (in Ksh) | Kitui Itoleka | | Mutitu | | Kakeani | | Total Kitui | |
|--|------------------|-----|------------------|-----|----------------|-----|------------------|-----|
| Income | | | | | | | | |
| Interest & fee income (LAF) from loans | 926 976 | 85% | 1 484 674 | 76% | 160 912 | 65% | 5 111 566 | 77% |
| Loan penalties | 39 266 | 4% | 371 694 | 19% | 7 100 | 3% | 758 920 | 11% |
| Other income | 118 528 | 11% | 100 338 | 5% | 79 817 | 32% | 781 644 | 12% |
| Total Income | 1 084 770 | | 1 956 706 | | 247 829 | | 6 652 130 | |
| Expenditures | | | | | | | | |
| Salaries & wages | 176 250 | 60% | 408 056 | 76% | 30 500 | 51% | 1 103 008 | 60% |
| BoD and AGM | 52 510 | 18% | 46 041 | 9% | 3 748 | 6% | 167 250 | 9% |
| Other op. expenses | 64 854 | 22% | 80 007 | 15% | 25 739 | 43% | 561 457 | 31% |
| Total operating expenses | 293 614 | | 534 104 | | 59 987 | | 1 831 715 | |
| Financial exp. (int. on KDA loan) | | | | | | | 105 674 | |
| Provision for bad debt | 106 301 | 23% | 0 | 0% | 4 419 | 5% | 760 312 | |
| Other provisions (audit, depreciation...) | 58 437 | | 40 032 | | 30 647 | | 278 690 | |
| Total expenditures | 458 352 | | 574 136 | | 95 053 | | 2 976 390 | |
| Net profit / loss before MC fees | 626 418 | | 1 382 570 | | 152 776 | | 3 675 740 | |
| Payment for mgt fees to KFS (<i>% of profit</i>) | 191 130 | 31% | 274 132 | 20% | 53 064 | 35% | 1 114 469 | 30% |
| Profit/loss after management fees | 435 288 | | 1 108 438 | | 99 712 | | 2 561 271 | |

Source : KFS.

ANNEX III : BALACE SHEETS AS OF SEPT 30th, 2006 SAMPLE FSAs IN KITUI AND MAKUENI

| Summary Balance Sheet As of Sept. 30th, 2006 (in Ksh : 1 USD = 72 Ksh) | Makueni | | | Kitui | | |
|--|-------------------|-------------------|-------------------|------------------|-------------------|------------------|
| | Mukuyuni | Kathonzweni | Nunguni | Itoleka | Mutitu | Kekeani |
| Assets | | | | | | |
| Fixed assets | 144 065 | 810 972 | 1 656 719 | 409 123 | 542 364 | 39 958 |
| <i>Loans</i> | <i>4 740 194</i> | <i>7 298 820</i> | <i>4 864 038</i> | <i>5 142 553</i> | <i>8 377 203</i> | <i>1 261 866</i> |
| <i>less provisions</i> | <i>20 914</i> | <i>591 913</i> | <i>0</i> | <i>106 301</i> | <i>0</i> | <i>4 419</i> |
| Net loans | 4 719 280 | 6 706 907 | 4 864 038 | 5 036 252 | 8 377 203 | 1 257 447 |
| Fixed deposits in bank | 3 500 000 | 0 | 1 000 000 | 1 200 000 | 0 | 0 |
| Cash & equivalent | 3 469 526 | 1 110 391 | 4 679 498 | 708 249 | 2 043 778 | 1 599 499 |
| Other current assets | 44 000 | 70 000 | 0 | 23 760 | 150 000 | 0 |
| Total assets | 11 876 871 | 8 698 270 | 12 200 254 | 7 377 384 | 11 113 345 | 2 896 904 |
| Equity and Liabilities | | | | | | |
| Share capital | 2 912 700 | 3 886 200 | 3 615 000 | 2 478 817 | 3 445 500 | 755 500 |
| Share premium | 622 278 | 261 590 | 0 | 955 140 | 619 680 | 131 710 |
| K-Rep Grant | 130 000 | | 140 000 | 130 000 | 130 000 | 80 000 |
| Retained earnings | 1 613 442 | 58 423 | 206 127 | 340 656 | 1 093 934 | 241 171 |
| Surplus for the period | | 771 089 | 998 394 | 875 341 | 1 802 198 | 115 104 |
| Building fund | 167 701 | 221 661 | 1 303 375 | 232 583 | 127 480 | 700 |
| Total Equity | 5 446 121 | 5 198 963 | 6 262 896 | 5 012 537 | 7 218 792 | 1 324 185 |
| Savings | 5 429 335 | 4 726 255 | 5 828 995 | 3 049 618 | 6 682 942 | 582 119 |
| K-Rep loan | 0 | 700 000 | 0 | 60 517 | 1 500 000 | 0 |
| Proposed dividend | 0 | 0 | 0 | -158 992 | 0 | 0 |
| Provisions | 90 301 | 35 000 | 40 001 | 112 100 | 27 000 | 62 500 |
| Other liabilities | 82 254 | 167 969 | 44 717 | 60 470 | 0 | 30 236 |
| <i>Suspense a/c</i> | <i>828 860</i> | <i>-2 129 916</i> | <i>23 646</i> | <i>-758 866</i> | <i>-4 315 389</i> | <i>897 865</i> |
| Total liabilities | 6 430 749 | 3 499 307 | 5 937 359 | 2 364 847 | 3 894 553 | 1 572 719 |
| Total Equity & liabilities | 11 876 871 | 8 698 270 | 12 200 254 | 7 377 384 | 11 113 345 | 2 896 904 |

Source : KFS.