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Improving public policy making for economic growth and poverty reduction

Enhancing the Role of Development Finance Institutions in Kenya's Development Process

Development finance is vital in the implementation of government development strategy. For example, when the government earmarks the private sector as the engine of economic growth in the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC), it expects the private sector to expand and grow in order to create wealth and alleviate poverty. However, growth of private sector is dictated by, among other things, the ability to grow business and investment. While short-term financing meets some needs of the private sector, development finance is required for long-term investment and economic growth.

Kenya's financial sector has a wide range of products, institutions and markets but there are glaring gaps in development finance. Commercial banks have not managed to supply long-term capital, and the stock market has remained shallow and thin, limiting long-term resource mobilization by firms. This is despite the efforts put in the revitalization of the stock market. The corporate bonds market is in its youthful stage of development, and has attracted only a handful of firms. Therefore, deliberate efforts must be made to adequately develop institutions for mobilizing long-term capital in Kenya. Development Finance Institutions (DFIs) are a viable option given the prevailing market condition.

After independence, the Kenya government created DFIs as a deliberate effort to fill a development financing gap. Like in other Sub-Saharan African, the DFIs were specifically established to alleviate perceived market failures in the provision of long-term credit and equity to industrial as well as agricultural enterprises. The DFIs were expected to spearhead the Kenyanization process by enhancing local participation in the economic development process. These institutions focused on development of specific activities by serving as channels for mobilizing long-term capital to finance prioritized activities.

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The Industrial and Commercial Development Corporation (ICDC) facilitated industrial and economic development by supporting the establishment and expansion of industrial, commercial and other undertakings of enterprises. It provided long-term industrial loans, management guidance, and also offered continued assistance to small African businessmen through a Revolving Funds Programme. The Agricultural Development Corporation (ADC) besides being responsible for purchasing large-scale farms from British farmers and leasing them to Kenyan farmers also made substantial direct investments for the government in productive agricultural enterprises. The task of the Kenya Tourist Development Corporation (KTDC) was to develop tourist facilities and services in the tourism sector. The Kenya Industrial Estates (KIE) assisted in promoting, establishing and expanding owned small scale industrial enterprises through its industrial estates programme. This entailed construction of factory buildings for rental, with attached administrative and technical services blocks providing such services as business development services. The industrial estates acted as incubators for small enterprises to mature and grow into bigger firms. The Development Finance Company of Kenya (now called Development Bank of Kenya) and Industrial Development Bank (IDB) provided term loans and/or equity to medium and large scale industrial enterprises and also tourism enterprises in co-operation with other DFIs in Kenya.

However, unlike some countries, Kenya has not managed to reap significant benefits from DFIs. For example, in South Africa, the Industrial Development Corporation has evolved from being a leading industrial player at national and regional levels to being the first South African DFI to have its mandate extended to the rest of the African continent.

In Kenya, DFIs have faced several constraints that have made them unable to fill the development financing gap. Despite the poor performance, however, the role of DFIs in the development process as spelt out in various development strategies over time is still vital. For example, in the industrialization by 2020 strategy, the government outlines its commitment to enhance provision of long-term finance and improve credit availability by restructuring the institutions. In the Economic Recovery Strategy for Wealth and Employment Creation, the government recognizes the need to strengthen DFIs in order to facilitate local investment and provision of credit, especially to micro and small enterprises. Even so, the

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government has often failed to fully support the relevant institutions in ensuring that the objectives of such strategies are met. Also, no expected deliverables from DFIs are pointed out.

Nevertheless, it is important to note that the government has initiated measures to support DFIs. While development of a strategy for DFIs is underway, the government has resumed budgetary allocations to these institutions. For example, the Kenya Industrial Estates received financial assistance in the year 2001 through the Medium Term Expenditure Framework (MTEF) for on-lending activities. In 2003/2004, the government provided funding for the Agricultural Finance Corporation (AFC) to the tune of Ksh 520 million for lending to farmers.

Constraints Facing DFIs

a) *Ownership structure*

The government has in the past exerted control on management of Development Finance Institutions by appointing board members and chief executives. The appointments are often based on political considerations rather than merit, making it difficult to take action against non-performing managers. This has made these institutions prone to political interference in both management and investment decisions, therefore preventing them from developing into viable commercial entities.

b) *Poor performance of projects*

Development Finance Institutions have in the past offered a wide range of products, including business development services, working space, equity participation, long-term capital and technical assistance. Through their financing programmes, these institutions filled the gap that banking institutions and financial markets were not able to cater for. Although the projects financed were viable, their performance was affected by the downturn of the economy and an unfavourable business environment. Also, a substantial number of bad investments were made through undue political interference. The DFIs consequently accumulated huge non-performing loans.

Currently, some DFIs have put in place various measures to deal with the non-performing loans. For example, some have initiated debt recovery strategies, established debt recovery units, reorganized their debt registries, improved management information systems, regularized release of loan statements, negotiated debt settlement, or have taken legal action against the debtors as a last resort.

c) *Funding*

DFIs rely on diverse sources of funding, including the government, bilateral and multilateral donors and also local institutions such as commercial banks and contractual savings institutions. The

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funding from the government is in form of loans and grants from the Consolidated Fund with approval from Parliament. The government guarantees most of the foreign credit. With the advent of Structural Adjustment Programmes in early 1990s, DFIs lost priority in government financial support. Also, due to perennial default of loans by the DFIs, the government ceased to provide guarantee for foreign loans. This has limited the funding options of most DFIs and their funding has dried up over time. The institutions have strived to get funds from other sources without much success. Given that DFIs have weak asset position, poor performance record, and are faced with various management problems, it has been very difficult for most of them to raise funds from the market. This has constrained the financing of their activities, as internally generated funds have not been sufficient.

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d) Regulatory issues

Development Finance Institutions in Kenya have been established through various Acts of Parliament. In addition, these institutions are answerable to their parent ministries and are also regulated by the State Corporations Act. This leads to multiplicity of reporting and bureaucracy, slowing down the decision making process. Furthermore, the State Corporations Act is not conducive for commercial orientation as it puts unnecessary controls and also denies these institutions powers to raise funds independently. For example, section 5 (2) of the Act provides that the power of a state corporation to borrow money in Kenya or elsewhere shall be exercised only with the consent of the Minister and subject to such limitations and conditions as may be imposed by the Treasury in respect to state corporations generally or specifically with respect to a particular state corporation.

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Policy Recommendations

a) Ownership structure

The ownership structure of DFIs should be changed for them to achieve efficient management, improved governance, and curb political influence. The continuum of ownership ranges from purely public-owned to purely private-owned.

Purely public-owned DFIs would be able to meet the social welfare objective in the development agenda. However, they are more susceptible to political influence, mismanagement and poor governance. Public ownership coupled with the performance contract management style would make it possible for these institutions to deliver more efficiently. However, sustainability in terms of financing may be an issue if the institutions are not engaged in some level of commercial activities.

Privately-owned DFIs may fail to meet the initial objective especially due to the tendency to concentrate more on private returns rather than social returns. Diverting from the core activities may have its own repercussions on the development agenda that these institutions are expected to drive, unless there are alternative sources of long-term capital. However, privately-owned institutions are more likely to be financially sustainable due to the commercial orientation.

The government could consider a mixed ownership structure for DFIs in Kenya. This would mean reducing government shareholding in DFIs and allowing the private sector to have majority ownership, preferably of 51 percent. This will open up the institutions for more public scrutiny, which helps in monitoring their operations, and ensure efficient management and commercial orientation. It also enhances the performance and sustainability of the institutions, therefore enabling them to meet their objectives. The private ownership element will cater for the commercial activities, therefore enabling the DFIs to become financially stable. The public ownership element will enable the institutions to pursue the social development agenda.

This structure, however, requires cleaning of the institutions' balance sheets in order to be able to attract potential investors. Cleaning the balance sheets will help the institutions meet the listing requirements if the shares are to be floated. The government could consider taking up the debts owned by these instutions, or the institutions could remove the non-performing loans from their books but with efforts to follow up the debts. Writing off of the debts may be considered as a last resort especially if the debtors have since closed down and efforts to follow them bear no fruits.

b) Financing of projects

Efficient investments contribute in sustaining the DFIs. This means that DFIs must put in place adequate systems for monitoring and evaluating projects to help them reduce the information gap and enhance allocative efficiency. The challenge though is how to balance social and private returns in deciding on the investment projects. As vehicles for development, DFIs must ensure that they meet their objectives, which are generally geared towards enhancing social welfare. With social welfare as an objective, and given the current focus on employment creation, DFIs should target labour-intensive firms for job creation and produce high quality products to achieve a competitive edge. They should also spread their activities to the marginalized areas in order to ignite economic activities.

The government could complement the activities of DFIs by providing a favourable environment for businesses to flourish, since performance of firms has implications on the performance of DFIs. In particular, there is need to provide adequate infrastructure where workspaces are provided in order to attract private firms.

In some cases, lack of graduation of firms is attributed to inability to penetrate the market. The government should support micro and small enterprises by offering a ready market for their goods. The deliberate efforts being made to promote entrepreneurship by giving micro and small enterprises an opportunity to tender for government supplies should be encouraged. However, only entrepreneurs who are properly skilled and making standard products should be allowed into the government tendering and supply systems.

Development Finance Institutions (DFIs) could collaborate with Micro Finance Institutions (MFIs) in supporting business growth. Since MFIs have a good record of having interacted successfully with, microenterprises they could, for example, work closely with the Kenya Industrial Estates in providing workspaces for enterprises. The enterprises will receive the technical and other business development services from their facilities to develop entrepreneurial capabilities. Growth-oriented businesses will of course surpass the financing limits of MFIs, and this would be the time for the DFIs to intervene and provide the financial support to facilitate graduation of firms. Such an approach would therefore guarantee survival of enterprises.

To help curb non-performing loans in Development Finance Institutions, MFIs could act as intermediaries for DFIs in channeling funds to micro and small enterprises, since MFIs the do no face the problem of loan repayments. The social capital approach in the loaning process by MFIs has been a success. This means that DFIs would be assured of loan repayment and financial sustainability. This means that the government could adopt a deliberate policy to ensure that all funds targeted to micro and small enterprises, including those from the donor community, are channeled through DFIs.

Strengthening debt recovery efforts at institutional level is important in order to reduce the level of non-performing loans. These effortsshould be complemented with establishment of a strong credit bureau and strengthening of the commercial court system.

c) *Funding the DFIs*

Maintaining adequate flow of funds is important for DFIs to sustain their activities and contribute significantly to development. However, DFIs must demonstrate the ability to repay and ensure that the funds are affordable.

The alternative financing products include:

- Floating a long-term bond. Presently, the bonds market has a maturity of up to 10 years, making it a potential source of long-term capital. A major drawback, however, is that the market suffers from short-term nature. Investors demand higher expected returns, which would make funds from DFIs very expensive. Floating short and medium term bonds may, on the other hand, constrain DFIs from matching the long-term demands. It is important that the bonds market is vibrant and liquid enough to attract investors.

- Floating shares through the stock exchange. The stock market provides a cheaper source of financial capital, which, coupled with public scrutiny, compels the institutions to perform. Restructuring assets of DFIs is vital in order to meet the basic listing requirement. The alternative is to place the DFIs in the hands of a strategic private investor.

- Government allocations: Despite budget constraints, the government could continue allocating funds to DFIs for development purposes because these institutions are channels for financing development and the government can use them to achieve specific development objectives.

- Pension funds: The investment policy of pension funds could be reviewed to allow DFIs access contractual savings from such institutions as the National Social Security Fund, the National Hospital Insurance Fund, and pension and provident funds. Previously, DFIs have accessed such funds. Since these are long-term funds, they are better diverted to long-term gestation projects instead of being invested in short-term securities. However, this requires efficient management and lending practices among the DFIs.

- Revolving fund to sustain DFIs financing: For the revolving fund to be well endowed, the principal amount of loans repaid by the clients should always be put back into the fund to ensure continuous availability of lending funds. This, however, requires instituting effective debt recovery measures.

- Establishment of a common resources pot to allow pooling of risks, and strengthen the negotiation position with potential financiers. The advantage is that the various sector-specific DFIs can draw funds from the pool for on-lending. It also enables the DFIs to concentrate on ensuring the funds are allocated efficiently and effectively. One of the institutions caould take the responsibility of mobilizing the resources and sharing them among the DFIs. The institutions, however, are expected to strengthen their operational base to ensure that the resources are utilized efficiently and repaid.

d) Regulatory framework and legal status of DFIs

In order to integrate DFIs into the development process, it is important that a policy framework is developed to clearly define the responsibilities and financing strategies of the DFIs. Such a framework needs to place the institutions under one supervisory authority to eliminate multiplicity of reporting and bureaucracy.

In addition, there is need to clearly define in the government development strategies what is expected of DFIs in terms of deliverables. Though such strategies are short to medium term, it is also important to focus on long-term development goals to accommodate the role of DFIs because the lending from these institutions is of a long-term nature.

e) Other restructuring measures

Rigorous internal restructuring of the institutions is important to enhance efficiency. This means ensuring that the DFIs remain focused in their activities, rationalizing the branch networks, and getting rid of non-core activities/non-strategic assets.

Although the economy has developed farther compared to the period when DFIs were being established, there are various factors that still remain a priority. These factors include the need to ensure the competitiveness of local firms, graduation of firms, diversification to marginalized areas and sectors, and the need for adequate infrastructure. Therefore, the identified priority areas and the development agenda could guide the restructuring at sector level.

DFIs should adequately equip workspaces and facilitate access to technology. They should work closely with relevant ministries and institutions and support key industrial activities, which are core in achieving the development agenda. For example, if the government identifies value adding to the agricultural products as the main activity, support should be skewed towards agro-based manufacturing firms and all relevant institutions mobilised towards that activity.

DFIs can play a major role in igniting productive economic activities in marginalized areas. Financing could target tapping regional potentials. However, this requires the government to provide basic services such as security and infrastructure, and working closely with regional development authorities in realizing the priority areas.

In dealing with such emerging development issues as housing, DFIs could focus on provision of low-cost housing for the low-income groups, again working very closely with municipal councils, research institutions, private sector developers and mortgage institutions.

Further, it is also important to establish a DFI focusing on infrastructure development. This would facilitate the private public partnership strategy that the government is taking up at the moment.

About KIPPRA Policy Briefs

KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

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