Legal and Other Constraints on Access to Financial Services in Kenya

Survey results

Deregulation Unit

SPECIAL REPORT

KENYA INSTITUTE FOR PUBLIC POLICY RESEARCH AND ANALYSIS

KIPPRA in brief

The Kenya Institute for Public Policy Research and Analysis (KIPPRA) is an autonomous institute whose primary mission is to conduct public policy research, leading to policy advice. KIPPRA's mission is to produce consistently high quality analysis of key issues of public policy and to contribute to the achievement of national long-term development objectives by positively influencing the decision-making process. These goals are met through effective dissemination of recommendations resulting from analysis and by training policy analysts in the public sector. KIPPRA therefore produces a body of well-researched and documented information on public policy, and in the process it assists in formulating long-term strategic perspectives. KIPPRA serves as a centralized source from which the government and the private sector may obtain information and advice on public policy issues.

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Contents

Foreword vii

Preface viii

1 Introduction 1

1.1 Background 1

1.2 Purpose of the study 1

1.3 Methodology and scope 1

2 Overview of the financial services sector 2

2.1 Kenya's financial services sector 2

2.2 The Central Bank 2

2.3 Commercial banks 3

2.4 Non-bank financial institutions 4

2.5 The Kenya Post Office Savings Bank 4

2.6 Savings and credit cooperative societies 4

2.7 Micro-finance institutions 5

2.8 Development finance institutions 5

2.9 Mortgage finance companies and building societies 5

2.10 The capital market 6

2.11 The insurance industry 6

2.12 Forex bureaux 7

3 Commercial banks 7

3.1 Legal and regulatory framework 7

3.1.1 Ownership structure *7*

3.1.2 Capital requirement *7*

3.1.3 Liquidity ratio *8*

3.1.4 Cash reserve ratio *8*

3.1.5 Credit *8*

3.2 Current status 8

3.2.1 Branch network *8*

3.2.2 The sectoral distribution of deposits and credit *9*

3.2.3 Financial services offered by commercial banks *10*

3.2.4 Commercial banks and micro-finance *12*

3.2.5 Foreign exchange operations *13*

3.3 Constraints identified 13

3.3.1 Limited outreach *13*

3.3.2 Constraints in gaining access to savings facilities *13*

3.3.3 Constraints in gaining access to credit *14*

3.4 Recommendations 15

4 Non-bank financial institutions 16

4.1 Legal and regulatory framework 16

4.2 Historical background 16

4.3 Current status 17

4.4 Constraints identified 17

4.5 Recommendations 17

5 The Kenya Post Office Savings Bank 18
5.1 Legal and regulatory framework 18
5.2 Current status 19
5.3 Constraints identified 20
5.4 Comparison with postal banks in other countries 20
5.5 Recommendations 21

Savings and credit cooperative societies 22
6.1 Legal and regulatory framework 22
6.1.1 Types of cooperatives 23
6.2 Current status 23
6.2.1 Services savings and credit cooperatives offer 23
6.3 Constraints identified 24
6.4 Recommendations 25

7 Micro-finance institutions 25
7.1 Legal and regulatory framework 25
7.2 Characteristics of the micro- and small-enterprise sector 26
7.3 Current status 27
7.4 Other key players in the informal finance industry 28
7.5 Constraints identified 29
7.6 Recommendations 29

8 Development finance institutions 31
8.1 Overview 31
8.2 Industrial Development Bank 32
8.2.1 Current status 32
8.2.2 Constraints identified 33
8.2.3 Proposed changes 33
8.3 Industrial and Commercial Development Corporation 34
8.3.1 Recommendations 34
8.4 Agricultural Finance Corporation 35
8.4.1 Legal and regulatory framework 35
8.4.2 Current status 35
8.4.3 Financial services offered 36
8.4.4 Constraints identified 37
8.4.5 Recommendations 37
8.5 Comments 37

9 The mortgage market 38
9.1 Mortgage finance companies 38
9.1.1 Legal and regulatory framework 38
9.1.2 Current states 38
9.1.3 Constraints identified 40
9.1.4 Recommendations 40
9.2 Building societies 41
9.2.1 Legal and regulatory framework 41
9.2.2 Current status 42
9.2.3 Constraints identified 42
9.2.4 Recommendations 43

10 The capital market **43**
10.1 Legal and regulatory framework 43
10.1.1 Financial products *44*
10.2 Current status 45
10.2.1 Policy incentives *45*
10.2.2 Stock market *46*
10.2.3 Bond market *46*
10.3 Constraints identified 47
10.3.1 Constraints in the stock market *47*
10.3.2 Constraints in the bond market *48*
10.4 Actions being implemented 48
10.5 Recommendations 48

11 The insurance industry and pension funds **49**
11.1 Legal and regulatory framework 49
11.2 Current status 51
11.3 Constraints identified 52
11.3.1 The role of the life insurance industry *52*
11.3.2 Need for incentives *52*
11.3.3 Restrictions on investment *53*
11.3.4 Other pension fund managers *53*
11.3.5 Other issues raised by the insurance industry *54*
11.4 Recommendations 54

Bibliography **56**
Acts of Parliament 57

Appendix 1—Review panel for deregulation of financial services **58**

Appendix 2—Discussion of the Land Control Act, Cap. 302 ..... **59**
Issues *60*
Concluding remarks *61*
Recommendation *61*

List of tables

Table 1. Distribution of industry survey 2
Table 2. Population in the financial services sector 3
Table 3. Insurance industry members 6
Table 4. Distribution of commercial bank branches, December 1999 8
Table 5. Sectoral distribution of deposits and credit of commercial banks, 1993–1997 9
Table 6. Sectoral distribution of non-bank financial institutions' deposits and credit 18
Table 7. Growth in Postbank from 1978 to 1997 19
Table 8. Interest payments and minimum deposit requirements for Postbank accounts 20
Table 9. Provincial distribution of savings and credit cooperative societies 23
Table 10. Agricultural Finance Corporation branch network 36
Table 11. Assets of housing finance institutions 39
Table 12. Maturity profile of deposits and loans for mortgage finance companies 39
Table 13. Life and general insurance business, 1990–1997 51
Table 14. Insurance industry investments, 1990–1997 51

Abbreviations

AFC	Agricultural Finance Corporation
AIMS	alternative investment market segment
AMFI	Association of Micro-Finance Institutions
BBK	Barclays Bank of Kenya
CBK	Central Bank of Kenya
CDS	Central Depository and Settlement
CGAP	Consultative Group to Assist the Poorest
CMA	Capital Markets Authority
Co-op Bank	Co-operative Bank of Kenya
DFCK	Development Finance Company of Kenya Department
DfID	for International Development development finance
DFI(s)	institution(s)
EABS	East African Building Society
EADB	East Africa Development Bank
GoK	Government of Kenya
HFCK	Housing Finance Company of Kenya
ICDC	Industrial and Commercial Development Corporation
IDB	Industrial Development Bank
KCB	Kenya Commercial Bank
KPTC	Kenya Posts and Telecommunications Corporation
K-Rep	Kenya Rural Enterprise Programme
Ksh	Kenya shilling(s)
MFC(s)	mortgage finance company(ies)
MFI(s)	micro-finance institution(s)
MIMS	main investment market segment
MSE(s)	micro and small enterprise(s)
NBFI(s)	non-bank financial institution(s)
NGO(s)	non-governmental organization(s)
NHIF	National Hospital Insurance Fund
NSE	Nairobi Stock Exchange
NSSF	National Social Security Fund
PTA	Preferential Trade Area
Postbank	Kenya Post Office Savings Bank
ROSCA(s)	rotating savings and credit association(s)
Rs	Indian rupees
SACCO(s)	savings and credit cooperative society(ies)
T-bills	Treasury bills
USAID	United States Agency for International Development

Foreword

I am pleased to introduce this report, *Legal and Other Constraints on Access to Financial Services in Kenya: Survey Results*. The report has been prepared by the Deregulation Unit of the Ministry of Labour and Human Resources Development. The role of the Deregulation Unit is to research and develop specific proposals to government to improve the legal and regulatory environment for business, particularly small and medium-sized businesses. Deregulation is the removal of restrictive laws and regulations that create barriers to investment and impose unnecessary costs on the business—costs that are ultimately passed on to consumers in the form of higher prices. Deregulation has implications for Kenya's economic competitiveness.

The Deregulation Unit commenced work in 1996 in the Ministry of Planning and National Development. The Department for International Development (DFID) of the British Government provides technical and financial assistance to the unit. In the reorganization of the Government of Kenya in 1999, the Ministry of Labour and Human Resource Development became its reporting ministry.

The unit was relocated to the Kenya Institute for Public Policy Research and Analysis (KIPPRA) in February 2000. KIPPRA is an independent research institute whose primary mission is to conduct objective analysis of policy issues leading to policy advice. The Deregulation Unit continues to report to the Ministry of Labour and Human Resource Development.

The structure of the financial services industry is determined principally by regulations. This report, the result of a consultative, participatory survey process, highlights various deficiencies and weaknesses in current regulations. Stakeholders in the various sectors of the financial services industry were surveyed for their views on how the regulatory framework constrains the provision of financial services. The survey results therefore express the views and opinions of players in the financial services industry.

The Interim Poverty Reduction Strategy Paper has highlighted the importance of the availability of finance for the development of any economy. The role of the financial services sector is to provide to business the range of financial products it requires to enable it to expand and grow. Equally, the access to and the costs associated with these products need to be affordable. This report will serve as the starting point for the regulatory review of all aspects of the financial services industry by government in consultation with stakeholders.

The Government of Kenya is committed to promoting business confidence to stimulate economic growth. Only by the creation of greater economic activity and wealth can the attack on poverty be sustained. The financial services industry has a crucial role to play in the growth of the economy.

On behalf of the Government of Kenya, I recommend this report to all stakeholders in the financial services industry. I am confident that it will provide the base from which meaningful improvements in the regulation of, and consequently, the performance by the industry will be created.

Dr Kang'ethe W. Gitu, S.S.
Permanent Secretary
Ministry of Labour and Human Resource Development

Preface

The Kenya Institute for Public Policy Research and Analysis (KIPPRA) commenced operations in 1999. Its primary role is to provide high-quality analysis of key issues of public policy and to contribute to the achievement of national long-term development objectives by positively influencing the decision-making process. This is accomplished through effective dissemination of recommendations resulting from the analysis. KIPPRA also serves as a centralized source from which the government, agencies of government and the private sector may obtain information and advice on public policy issues.

KIPPRA was pleased to incorporate the activities of the Deregulation Unit from the Ministry of Labour and Human Resource Development in February 2000. The unit's role to research and develop recommendations to improve the legal and regulatory environment for business fits well with KIPPRA's own role of generating advice on matters of public policy. The Deregulation Unit is now one of five divisions in KIPPRA. The others are Macro, Productive, Social and Infrastructure Divisions.

KIPPRA acknowledges the support and assistance of the Department for International Development, DFID, of the British Government.

Legal and Other Constraints on Access to Financial Services in Kenya: Survey Results has been prepared by the Deregulation Unit in KIPPRA. Work on the report commenced in 1999. Further work was carried out in 2000, and the report has been updated for changes in the regulatory framework announced in the Finance Acts of 1999 and 2000.

The government is currently reviewing the regulatory framework on aspects of the financial services industry, particularly with regard to the availability of working capital facilities for exporters and small and medium-sized businesses. This is specified in the Interim Poverty Reduction Strategy paper. We hope that this report will assist this review process.

Finally, I would like to take this opportunity to thank all those who responded to the survey questionnaire. We in KIPPRA look forward to working with all stakeholders to develop an improved regulatory framework for providing financial services. Consequently, we look forward to making a contribution to reducing poverty in Kenya.

Mwangi S. Kimenyi
Executive Director
KIPPRA

1 Introduction

1.1 Background

This study was prepared by the Deregulation Unit in the Ministry of Labour and Human Resource Development; it was made possible by the support and assistance of the British Partnership Development Programme of the Department for International Development (DfID). The mandate of the Deregulation Unit is to develop proposals and recommendations to 'improve the legal and regulatory framework of business' with the aim of increasing employment in Kenya. This report was substantially completed by September 1999, although updates to June 2000 have been included.

Access to financial services has been identified as a major problem experienced by many in attempts to do business in Kenya. In particular, access to credit by micro and small enterprises (MSEs) from the formal banking sector has been cited as a major constraint to their development and growth. Various studies have concluded that while credit in formal banking institutions has grown steadily over the years, little of this credit has reached the MSE sector. On the other hand, research also indicates that this sector currently provides over 15% of employment countrywide and therefore should be assisted in its endeavours to operate and where possible to grow. Although micro-finance institutions (MFIs) have endeavoured to close the credit gap, their outreach efforts have been limited.

Accessibility to savings facilities has equally been a problem. Ngugi (1991) showed that 68% of savings among the rural households in Kenya are in non-financial form and never enter the formal financial sector. Otero and Ryne (1994) noted that the high propensity to save among the poor and MSEs in developing countries has remained untapped and beyond national efforts to mobilize resources for development.

Inadequate project finance because of the lack of sufficient long-term capital has also been a major source of concern. Mortgage finance is inaccessible to most people because of high interest rates. This has resulted in increased housing costs and growth in slums.

1.2 Purpose of the study

This study was motivated by the persistent inaccessibility of financial services experienced by MSEs despite various recommendations and interventions aimed at arresting the problem. Its main purpose was to identify the constraints that limit access to finance and to develop specific recommendations for the removal of legal constraints and further actions to address problems of a non-legal nature.

1.3 Methodology and scope

A survey was conducted using questionnaires and interviews. The study covered a sample size of 50 institutions of which 34 responded. Table 1 summarizes the distribution of the institutions surveyed and those that responded.

In addition, relevant literature and legislation on the subject were reviewed. Initial findings and recommendations were then presented for review to a panel of experts consisting of the following:

- Central Bank of Kenya
- Ministry of Finance and Planning
- Department for International Development
- Kenya Rural Enterprise Programme

Table 1. Distribution of industry survey

Institution	Surveyed	Responded
Central Bank of Kenya	1	1
Commercial banks	15	10
Non-bank financial institutions	6	4
Kenya Post Office Savings Bank	1	1
Savings and credit cooperative societies	4	1
Micro-finance institutions	2	2
Development finance institutions	3	2
Mortgage finance companies	2	2
Registrar of building societies	1	1
Building societies	2	1
Capital markets authority	1	1
Stock brokers and dealers	5	3
Fund management companies	2	2
Commissioner of Insurance	1	1
Insurance companies	4	2
Total	50	34

- Kenya Bankers Association
- Kenya Commercial Bank
- Barclays Bank of Kenya
- Kenya Post Office Savings Bank
- Housing Finance Company of Kenya
- Industrial Development Bank
- Co-operative Bank of Kenya
- Nairobi Stock Exchange
- Capital Markets Authority
- Association of Kenya Stockbrokers

A detailed listing of panel members is presented in appendix 1. Comments, recommendations and resolutions were obtained and have been incorporated in the body of this report.

2 Overview of the financial services sector

2.1 Kenya's financial services sector

The financial sector in Kenya is well developed; it consists of the institutions listed in table 2.

An overview of the main types of institutions follows.

2.2 The Central Bank

The Central Bank of Kenya (CBK) is regulated by the Central Bank of Kenya Act, Cap. 491. Under the Act, CBK has the power to make its own rules of conduct and procedures. It is not subject to the Companies Act or the Banking Act. CBK's main responsibilities, under the Act are to:

- formulate and implement monetary policy directed at achieving and maintaining stability in the general level of prices
- foster liquidity, solvency and proper functioning of a stable market-based financial system

Table 2. Population in the financial services sector

Type of institution	Number
Central Bank of Kenya	1
Commercial banks	55
Non-bank financial institutions	16
Kenya Post Office Savings Bank Savings	1
and credit cooperative societies	3168
Micro-finance institutions	various
Development finance institutions	8
Mortgage finance companies	2
Registrar of Building Societies	1
Building societies	4
Capital Markets Authority	1
Stock brokers and dealers	20/1
Nairobi Stock Exchange	1
Fund management companies	23
Venture capital companies Commissioner	various
of insurance	1
Insurance companies	38
Forex bureaux	48

Source: Central Bank of Kenya and Ministry of Co-operatives (return of an administered questionnaire), Commissioner of Insurance Report (1997)

- formulate and implement foreign exchange policy
- hold and manage foreign exchange reserves
- license and supervise authorized dealers in the money market
- promote the smooth operation of a payment clearing and settlement system
- act as a banker and adviser to and as fiscal agent of the government
- regulate the issue of notes and coins

The Act gives CBK powers to license, supervise and regulate the activities of commercial banks, non-bank financial institutions, mortgage companies and foreign exchange bureaux. The recent budget has also given CBK authority over building societies.

Financial institutions that do not currently come under the CBK umbrella are:

- development finance institutions (as these convert to banks, they will be included)
- the Kenya Post Office Savings Bank
- micro-finance institutions
- savings and credit cooperative societies

2.3 Commercial banks

Commercial banks are regulated under the Banking and Companies Acts. There are 55 commercial banks currently operating in Kenya, 9 of which dominate the banking system. They account for approximately 69% of commercial banking deposits. Most of the remaining banks are small and tend to concentrate on domestic and foreign trade, targeting well-established companies. Commercial bank lending primarily consists of short-term loans and overdrafts.

The Co-operative Bank of Kenya, one of the five largest, has traditionally served a different clientele from the other banks. It provides banking facilities to its member cooperatives and finances the cooperative movement through the provision of overdraft facilities and short- and medium-term

loans. The bank takes deposits from the public and also obtains loan funds from donors. Recently, it has expanded its operations to provide credit to the private sector.

The banking sector has faced several challenges. High interest rates have caused an increase in non-performing loans, which according to the recent budget report are estimated at 36% of total advances. In addition, five banks have collapsed since mid-1998. Expectations are high that government measures aimed at bringing down interest rates will reverse this trend and stimulate economic recovery.

2.4 Non-bank financial institutions

Non-bank financial institutions (NBFIs) are regulated under the Banking and Companies Acts. They are defined as 'a company other than a bank, which carries on financial business, where financial business means the acceptance from members of the public of money on deposit repayable on demand, and investment of money held on deposit at the risk of the depositor'.

The establishment of NBFIs was spurred by the government's policy of encouraging thrift institutions to develop to complement commercial banks. A two-tier legal and regulatory framework in the Banking Act, which outlined capital requirements, cash reserves and liquidity requirements as well as allowing these institutions to set interest rates before liberalization, facilitated their development.

Between the mid-1970s and the early 1980s, the sector grew rapidly, and by the mid-1980s, 40 NBFIs existed. Commercial banks, which at the time were required to observe credit ceilings, opted to establish NBFIs to serve as an additional market for their credit. Unfortunately, several NBFIs collapsed and this led CBK to adopt a universal banking policy, which is causing this segment of the financial services sector to disappear. Some NBFIs have had to convert to commercial banks while some subsidiaries of commercial banks have merged. By June 1998, only 17 NBFIs were in operation.

2.5 The Kenya Post Office Savings Bank

Founded in 1910, the Kenya Post Office Savings Bank (Postbank) is one of the oldest financial institutions in the country. After the collapse of the East African Community in 1978 it was incorporated under its own Act of Parliament, Cap. 493(B). Postbank's primary objectives are to mobilize deposits and to facilitate money transfers throughout the country. Its agency relationship with Kenya Posts and Telecommunications Corporation (KPTC) has been vital to facilitating its outreach to remote areas.

Small-scale savers form the bulk of the depositors for the bank, accounting for 80% of total funds. Their deposits are channelled through the Postbank network of offices in the country, which comprises 12 branches, 42 sub-branches, 354 post offices and 60 postal agencies.

As at 31 December 1997, the bank had 2.6 million accounts, nine products, and a deposit base of over Ksh 4.58 billion. It currently does not offer credit to its clients. A previous attempt to do this, by establishing Postbank Credit, failed.

2.6 Savings and credit cooperative societies

Savings and credit cooperative societies (SACCOs) are regulated under the Co-operative Societies Act and have played a vital role in providing financial services to Kenyans. The growth of SACCOs over the last 20 years has been spectacular. The number rose from 630 in 1978 to 3169 by the end of

1997. This rapid growth is an indication that SACCOs are meeting a demand that is not being met by other financial institutions.

SACCOs are currently organized as savings and credit associations whereby people with a common bond, for example, those who work together, save regularly, building sufficient deposits for lending within the group. Some of these savings and credit societies, such as the Harambee, Posta and Mwalimu SACCOs, are larger than some small commercial banks.

2.7 Micro-finance institutions

Development of micro-finance institutions (MFIs) in Kenya can be traced back to the late 1970s and early 1980s after it was determined that inaccessibility to credit from the formal banking sector was strangling the large, informal micro- and small-enterprise (MSE) sector. By 1998, there were over 86 NGOs and other organizations involved in providing micro-finance. These institutions have proved, through a relatively low default rate, that the economically active MSEs are credit worthy. Many MFIs, however, are still in the developmental stage and are currently facing pressure from donors to become self-sustaining.

Discussions are currently being held regarding the possibility of expanding the role of MFIs to take savings because of their outreach and successful track record with respect to credit. Some of the more sustainable MFIs may support deposit taking if the legal and regulatory framework is changed to accommodate such development. This is a key challenge that needs to be addressed to enable MFIs to provide more complete financial services to the MSE sector.

2.8 Development finance institutions

Development finance institutions (DFIs) were formed under individual Acts of Parliament to supplement the activities of the banks and other NBFIs and to promote development in specified sectors, such as agriculture, commerce and industry, tourism and housing. These institutions include:

- Development Finance Company of Kenya
- Industrial Development Bank
- Industrial and Commercial Development Corporation
- Agricultural Finance Corporation
- Kenya Tourist Development Corporation
- Kenya Industrial Estates
- East Africa Development Bank
- National Housing Corporation

DFIs have been the principal source of long-term project finance for Kenya. These institutions are funded primarily through loans and grants received from multilateral and bilateral development institutions, as well as from the Government of Kenya (GoK). Now, government allocations have been virtually eliminated, and without privatization foreign lenders are reluctant to continue their participation.

The adoption of a universal banking policy affects DFIs and has already resulted in the conversion of the Development Finance Company of Kenya and the Industrial Development Bank into banks.

2.9 Mortgage finance companies and building societies

Mortgage finance companies and building societies offer mortgage lending. The Banking and Companies Acts regulate mortgage finance companies. Two are currently operating in Kenya:

Savings & Loan (K) Limited and the Housing Finance Company of Kenya (HFCK). Savings & Loan, a wholly owned subsidiary of Kenya Commercial Bank (KCB), is the oldest mortgage finance company in Kenya; it has assets of approximately Ksh 5 billion. HFCK is a public company; its majority shareholders are the Government of Kenya and the Commonwealth Development Corporation. HFCK has assets in excess of Ksh 10 billion. Between 1965 and 1997, HFCK advanced more than Ksh 11.5 billion towards the development of housing and home ownership in Kenya.

Building societies are governed by the Building Societies Act. The first building society was started in 1959. Since then, 40 have been registered. By 1999, however, only 4 were operational. Of the rest, 4 are dormant, 11 are under receivership, 2 were taken over by Consolidated Bank, and the others are still waiting for their licences. The others ceased to exist between 1959 and 1989.

The four building societies that are still operational are East African, Equity, Family Finance and Prudential. The East African Building Society (EABS) is the largest, with assets of approximately Ksh 6.7 billion and over 35,000 account holders. Established in 1959, it has eight branches. The others are fairly small, with deposit levels of below Ksh 1 billion each, and they have not made a significant contribution to housing development or the provision of mortgage financing.

2.10 The capital market

The capital market is regulated by the Capital Markets Authority (CMA) Act, Cap. 485A. The Act gives CMA the mandate to promote and facilitate the development of orderly, fair and efficient capital markets in Kenya. It regulates the Nairobi Stock Exchange, 1 dealer, 20 stockbrokers, 18 investment advisers and funds management firms, and 6 depository institutions.

By December 1997, there were three markets within the capital market: the stock market, the bond market and the commercial paper market.

2.11 The insurance industry

The insurance industry comprises the Kenya Reinsurance Corporation, the East Africa Reinsurance Company, the Preferential Trade Area (PTA) Reinsurance Corporation, insurers, insurance brokers, loss assessors, insurance surveyors, loss adjusters, claims settling agents and risk managers. The members of the industry in 1994 are shown in table 3.

Table 3. Insurance industry members

Member	Number
Loss assessors	216
Insurance brokers	109
Insurers	39
Insurance surveyors	26
Loss adjusters	17
Claims settling agents	4
Reinsurers	3
Risk managers	3

Source: Commissioner of Insurance 1994

By 1997, there were 38 insurers with a premium income of Ksh 18.9 billion, out of which Ksh 15.3 billion was from general business, leaving the long-term business with only Ksh 3.6 billion or 19% of the total. Fifteen of these insurers dealt with general insurance only while the remaining 23 dealt with

both long-term and general business. In addition, 5 of the largest insurers accounted for 40% of the direct premium income.

2.12 Forex bureaux

Forex bureaux were not included in the study surveys and interviews. Review of the sector was based on available documentation and reports. A brief overview is presented here. Further review and analysis of this segment are not warranted at this time.

To operate a forex bureau, a licence must be obtained from CBK. Once acquired, the licence is not transferable and relates to a specific location. A forex bureau is restricted to buying and selling foreign exchange in cash. It can also buy travellers' cheques, personal cheques and bank drafts but it cannot engage in selling these instruments unless CBK specifically approves it to do so. In addition, new products can be introduced in the market only after consultations with CBK.

The growth in forex bureaux has been phenomenal following the liberalization of the financial sector in 1994, which saw the removal of restrictions on trade in foreign currencies. As of 30 June 1999, there were 48 forex bureaux, of which over 75% were in Nairobi. A forex bureau can transact up to US$5000 without seeking official authorization. The bureaux offer better exchange rates than banks, by 1 to 2% on the buying or selling rates. They also dispense cash quicker and levy no other charges.

The liberalization of the foreign exchange market has had a far-reaching impact on the economy. It has improved the efficiency of foreign exchange transactions, removed bureaucracy with accompanying corruption, provided an impartial tool of allocation of resources, and reduced trends to capital flight. Neither availability of foreign exchange nor currency depreciation features as a source of existing economic hardship in Kenya. This example should encourage more rapid deregulation, liberalization and privatization, which are thought to be necessary to boost the current economy.

3 Commercial banks

3.1 Legal and regulatory framework

The legal and regulatory framework within which commercial banks operate is set out in the Companies, Central Bank of Kenya and Banking Acts and in guidelines issued pursuant to these Acts. The key elements of the framework are summarized here.

3.1.1 Ownership structure

The Banking Act prohibits any person from having an interest of more than 25% of the capital of an institution, unless the owner is:

- another institution
- the government of any country
- a state corporation
- a foreign company licensed to carry on the business of a financial institution in its country of incorporation

3.1.2 Capital requirement

Commercial banks are required to:

- have a minimum paid-up capital of Ksh 200 million (to be increased to Ksh 500 million by 2002)
- observe a capital-to-deposits ratio of 8% at all times
- observe a capital-to-risk asset ratio of 8%

3.1.3 Liquidity ratio

Commercial banks are required to maintain a liquidity ratio (liquid assets to deposits) of 20%. For the purpose of this statutory requirement, liquid assets are defined as notes and coins, balances held at CBK, net balances with other banks in Kenya, demand deposits in convertible currencies with banks abroad, net of demand deposits due to banks abroad, Treasury bills (T-bills), and bonds of maturity not exceeding 91 days.

3.1.4 Cash reserve ratio

Commercial banks are required to maintain a minimum cash reserve of 13% of the bank's deposits with CBK.

3.1.5 Credit

Commercial banks are restricted from advancing:

- unsecured credit to employees or their associates; any of its officers or their associates; an entity in which any of the officers has an interest as agent, director, manager, shareholder or guarantor
- credit to any one person where the total credit exceeds 25% of the bank's equity. This is permissible only in transactions with a public entity, transactions between banks, or advances made against clean or documentary bills of exchange for payment outside Kenya for export
- credit against own shares as security

3.2 Current status

3.2.1 Branch network

As at December 1999, the banking sector consisted of 55 commercial banks with 635 branches, as shown in table 4. Nairobi Province accounts for 27.5% of the network, followed by Rift Valley Province with 21%. Western, North Eastern, Nyanza and Eastern provinces appear to have the

Table 4. Distribution of commercial bank branches, December 1999

Province	No of branches	Population (1989) ('000)	Population per branch
Central	96	3,116	32,458
Coast	81	1,829	22,580
Eastern	59	3,769	63,881
Nairobi	170	1,325	7,794
N Eastern	5	372	74,400
Nyanza	65	3,507	53,954
Rift Valley	132	4,982	37,742
Western	27	2,545	94,259
Total	635	21,445	

Source: Central Bank of Kenya (return of an administered questionnaire); Statistical Abstract, 1997, 1998a

poorest outreach. In general, branches are located at district headquarters. In some agriculturally rich areas, residents have to travel to divisional headquarters for access to financial services. In addition, the survey showed that well below 50% of the deposits raised in the rural areas are actually lent to rural borrowers, as they are not considered a good credit risk.

Overall, the banking sector is dominated by nine banks, which constitute 70% of the market share of total net assets and 69% of total deposits.

3.2.2 The sectoral distribution of deposits and credit

Total deposits with banks at the end of December 1997 amounted to Ksh 260 billion, having risen from Ksh 112 billion in 1993. Over 58% of deposits were from the private sector. More than 90% of these deposits were short term (refer to table 5) in nature. Approximately 88% of total credit had a maturity period of two years or less, indicating a dominance of trade finance. Total credit advanced amounted to Ksh 238 billion in 1997, up from Ksh 89 billion in 1993. The share of the private sector credit advances, excluding NBFIs and building societies, rose from 68% in 1993 to 79% by 1997. The increase in the share of private sector advances shows a decline in the need for government credit.

Table 5. Sectoral distribution of commercial banks' deposits and credit, 1993–1997

	Public sector		Private sector			
	Central govt.	Other public sectors	NBFIs	Building societies	Others	Total
			Deposits (Ksh '000)			
1993	6,782	12,595	6,453	417	85,642	111,889
1994	6,127	16,931	9,885	349	108,100	141,392
1995	6,760	16,609	5,555	811	138,893	168,628
1996	5,250	17,629	5,698	2,450	184,133	215,160
1997	3,619	18,559	3,814	2,136	232,093	260,221
			Credit (Ksh '000)			
1993	21,135	4,031	2,121	527	62,049	89,863
1994	38,088	5,683	1,896	12	82,593	128,272
1995	26,417	5,291	3,522	459	123,838	159,527
1996	42,576	5,647	3,939	31	154,844	207,037
1997	38,612	7,332	1,564	146	190,106	237,760

Source: Central Bank of Kenya Statistical Bulletin (1998b)
All figures are as of December of the specific year.

The total Kenya statistics appear to present a favourable picture regarding the accessibility of savings and credit by the private sector. However, the branch network and field survey results indicate that large segments have no access to financial services, as the bulk of credit goes to large enterprises in urban areas.

According to CBK's Statistical Bulletin of June 1998, out of total advances of Ksh 208 billion, only Ksh 20 billion or 9.6% was advanced to the agricultural sector. This is despite the sector's importance as the employer of approximately 70% of the country's total labour force, being a major contributor to the gross domestic product (26%) and a major foreign exchange earner, accounting for over 50% of export receipts.

3.2.3 Financial services offered by commercial banks

Major financial services offered by commercial banks include deposits and savings facilities, loans and advances, and foreign exchange services. Money transfer, merchant banking, and credit card services are also provided. On average, deposits form 80% of the source of funds and include savings, current accounts and fixed deposits.

I) SAVINGS ACCOUNTS

To open a savings account, most bank policies require the applicant to get two letters of introduction from customers of the bank. After opening the account, the account holder is required to keep a minimum deposit. Minimum deposits vary from bank to bank. Of all the respondent banks, one required a minimum non-interest-earning deposit of Ksh 500 and three required Ksh 1000. To earn interest a minimum balance of Ksh 5000 was required by two banks and Ksh 6500 by another. The latter charged a fee of Ksh 75 for deposits of less than Ksh 6500. Others required a minimum of from Ksh 20,000 to 50,000.

The minimum deposit requirement denies much of the population access to saving facilities. Further, the interest offered on savings deposits by about 60% of the respondent banks was either below the inflation rate (acting as a disincentive to save) or was marginally above the inflation rate, in some cases by only 1%.

II) CURRENT ACCOUNT DEPOSITS

To open a current account, applicants are required to obtain letters of introduction from two customers of the bank. They are also required to provide identification documents and two passport photos. Only three banks in the sample offered current account facilities without insisting on minimum deposits. Two banks required that a minimum of Ksh 100,000 be maintained in the current account. The rest required a minimum balance ranging from Ksh 1000 to Ksh 5000. Since the survey exercise, most of these banks have increased the minimum account balance requirement to Ksh 10,000. This requirement of minimum balances discourages many people from maintaining a current account, notwithstanding the fact that a current account is an important facility for money transfers and payment of bills through the cheque system. Bank cheques can be sold to people without current accounts, although the fees charged are high.

As at 31 December 1997, the demand deposits held by commercial banks stood at Ksh 46 billion compared with time and savings deposits of Ksh 210 billion. Although some banks pay interest on demand deposits, the bulk of this amount is available for use by the bank interest free. In addition to forgoing interest, the cheque clearing system also creates delays and associated costs. Currently, although the cheques are cleared and credited to the bank within 1 working day, the client account is not credited until after 4 working days. For upcountry cheques, crediting is done after 8 working days, which sometimes extends to 15 days because of weekends. An attempt, however, is being made to shorten this time frame to 2 days.

III) FIXED DEPOSITS

Fixed deposits form the bulk of commercial bank deposits. This service is generally the preserve of corporate clients and middle- to upper-income individuals. Like all other banking services, the poor and operators of MSEs who may wish to place their deposits with commercial banks for a fixed term or on call to get higher interest cannot afford the high minimum deposit.

About 38% of the respondent banks required a minimum of Ksh 50,000 for fixed deposits. The remaining 67% required a minimum deposit ranging from Ksh 100,000 to Ksh 250,000.

IV) CREDIT AND ADVANCES

The survey revealed the following types of credit being offered by commercial banks. Of the banks that responded:

- all provide overdraft facilities for working capital
- 80% provide bridge financing for mortgages
- 40% provide term loans for project finance
- 40% provide consumer loans including loans to purchase furniture or to pay school fees
- 30% provide automobile loans
- 10% provide hire-purchase loans
- 50% provide bridge financing for corporate loans
- 30% provide equity-related loans
- 60% provide foreign currency loans

Procedures for loan applications are basically the same in all banks. Information is requested on loan application forms that require the applicant to provide the following details: purpose of the loan, amount, capitalization of the applicant, sources of income, security to be offered, cash flow projections, and so on.

None of the respondent banks gave minimum loan size as a precondition for gaining access to credit. During the interviews, however, a general lack of enthusiasm for micro-credit was noted. The key reason given was the cost of processing such loans against the expected returns. The respondent banks felt that the cost of processing and monitoring micro-credit was higher than the interest to be earned from the loan.

In the 1980s and 1990s, with the assistance of donor funding, the main commercial banks launched several products aimed at MSEs and at rural or marginalized areas. The USAID/Rural Private Enterprise Project and the DfID/BBK (Barclays Bank of Kenya) Loan Guarantee Fund Programme are examples of such schemes. These initiatives, however, do not indicate commercial bank interest in developing the sector as a potentially profitable source of business.

V) SECURITY REQUIREMENTS

Contrary to various claims in the banking sector, the Banking Act and CBK do not require commercial banks to insist on collateral as a condition for making a loan. However, all respondent banks require all credit to be secured. Some unsecured credit is given, but on a very selective basis, and it is kept strictly confidential to avoid pressure from customers who would not qualify.

The security policies adopted are partly influenced by CBK's prudential guidelines on the classification of loans. The guidelines treat unsecured credit as a bad debt regardless of its payment history. Thus, other attributes of borrowers such as character or ability of the business to generate income are not recognized by the CBK guidelines.

According to the respondent banks, the security margins range from 20 to 40% and may take the form of cash, bank guarantees, legal mortgages, legal charges, assignment of receivables and inventory, fixed and floating debentures, pledges of shares and deposits, and personal guarantees. In general, the value attached to personal guarantees or letters of comfort is insignificant. Assignment of insurance proceeds is also obtained in cases where physical assets are taken as security.

Assignment of contract proceeds is obtained where a contract is financed or has issued guarantees relating to the contract. Commercial banks normally do not accept vehicle logbooks, chattel mortgages and agricultural land as security. Exceptions are allowed for select clients but only with approval from senior management. The Traffic Act and the Land Control Act were cited as the main constraints against accepting logbooks and agricultural land.

3.2.4 Commercial banks and micro-finance

I) UNATTRACTIVENESS OF MICRO AND SMALL ENTERPRISES

Low-income groups and micro and small enterprises (MSEs) find it difficult to get savings and credit from commercial banks. This situation, however, is not unique to Kenya; it exists worldwide. Although the demand for micro-credit is immense, the commercial banking sector does not find this market segment attractive for the following reasons:

- Bankers perceive MSEs as bad credit risks. The perception is that small-scale clients do not have stable businesses on which to base borrowing. Moreover, MSEs cannot satisfy the collateral requirements.
- Banks believe that small loans are costly. Commercial bank procedures are designed for large loans. Although it takes as much time and effort to process a Ksh 100,000 loan as a Ksh 10 million loan, the return on the larger loan is greater.
- MSE operators lack the education or cannot afford to employ qualified staff to prepare business plans.

Most banks therefore favour their large, well-established clients. Only three banks reported lending to MSEs through specialized programmes. These banks were KCB, BBK and the Co-operative Bank of Kenya (Co-op Bank).

II) EXISTING MSE PROGRAMMES IN COMMERCIAL BANKS

Barclays has about nine small business loan schemes, of which two are fully donor funded and only one is fully BBK sponsored. Others are shared with the Kenya Women's Finance Trust, the Organisation of African Unity, the European Investment Bank, DfID, USAID and the Barclays Bank Development Fund. Not all of these schemes are available at all branches.

Kenya Commercial Bank runs MSE credit schemes funded by the bank and donors. Loan sizes range from Ksh 30,000 to Ksh 500,000. The total amount of funds under the KCB-sponsored scheme is Ksh 131 million. To date, seven schemes have been launched: the Graduate Loan Scheme, the Jua Kali Loan Scheme, the Women's Credit Scheme, the Small-Scale Enterprise Programme, the Lake Victoria Fishermen's Credit Scheme, the ILO/Kenya Youth Training and Employment Creation Loan Scheme, and the Loan Scheme for Small-Scale Tea and Coffee Farmers. These schemes are offered at selected branches of the bank.

The Co-op Bank runs two schemes for MSEs: a credit guarantee scheme with MFIs, funded by DfID, and a scheme targeting MSEs and poor households that is fully funded by the bank. The scheme for MSEs aims at mobilizing savings among the target population recognizing that the majority of low-income households manage their affairs with savings and do not necessarily demand credit. The scheme also provides loans to businesspeople who own and manage an enterprise and need the funds to expand their existing business and who are not solely reliant on the bank's capital for expansion. To avoid the risk associated with new businesses, the scheme does not finance start-up or businesses moving to new markets. Conventional security is not required. The borrower signs

a letter committing the assets (chattels) to the bank in the event of default, authorizing the bank to sell the assets without having to go to court.

Except for the Co-op Bank credit guarantee scheme, there appear to be no links between MFIs and commercial banks. One of the respondent banks indicated that it views MFIs as its competitors and has no intention of establishing a relationship with them. Others had a problem with the legal status of MFIs and the absence of a regulatory framework.

3.2.5 Foreign exchange operations

All respondent banks, with the exception of one, reported offering the following financial services under their foreign currency operations:

- spot buying and selling of foreign currency
- forward foreign exchange contracts
- export finance (denominated in either foreign or domestic currency)
- foreign currency accounts including current accounts, deposit accounts and loan accounts

Spot buying and selling of foreign currency is open to both customers and non-customers. A commission of 1 to 1.5% is charged on the shilling equivalent (for either a buying or a selling transaction). Forward foreign exchange contracts and export finance are restricted to the clients of commercial banks. Four banks in the sample gave a minimum of US$100,000 as the qualifying amount for forward contracts. The other banks did not have a limit, and any of their clients could have a forward cover if they required it. Export finance is generally not subject to a minimum amount requirement. The due diligence process, however, requires that besides meeting all the other credit requirements, applicants must demonstrate their ability to raise foreign currency.

Foreign currency accounts are available mainly in US dollars, pounds sterling, German marks and Dutch guilders. Accounts in other currencies may also be opened where an applicant demonstrates a specific need. A minimum of US$500 is required to open a foreign currency account and should be maintained throughout the operation of the account. The opening of a foreign currency account is subject to CBK approval.

3.3 Constraints identified

3.3.1 Limited outreach

The current branch network severely limits access to commercial bank services. Vast areas in this country are not covered by a commercial banking outlet of any kind. The current legal or regulatory framework does not cause this lack of outreach. The decision to open or maintain a branch is determined by its viability. In the past, government-owned commercial banks were required to open branches in areas that were not economically viable. As these banks become privatized they will be under pressure to close these branches. In addition, private commercial banks with branch networks have been closing their unprofitable upcountry locations. It is not realistic to expect banks to open branches at locations that they cannot justify economically.

3.3.2 Constraints in gaining access to savings facilities

Assessment of the impact of the gearing ratio on commercial banks showed that the ratio was not a constraint to their deposit mobilization. With a capital base of Ksh 39 billion, the banks can support deposits of up to Ksh 520 billion, which is far above the actual deposit amount of Ksh 250 billion.

Thus the banks can more than double their current deposit base with no additional capital requirement.

A large amount of money does not enter the banking system, owing not only to poor outreach but to other factors such as:

- introduction procedures needed to open an account
- minimum balance requirements and the imposition of high penalties when balances fall below requirements
- other charges such as ledger fees, transaction charges
- illiteracy

3.3.3 Constraints in gaining access to credit

Accessibility to credit in commercial banks is constrained by legal and regulatory factors as well as by stringent bank policies developed to counter risks associated with culture, attitude and cumbersome loan recovery procedures. Some of the identified legal and regulatory constraints are summarized below.

I) THE BANKING ACT

Banks with shares quoted on the Nairobi Stock Exchange cannot grant credit against their own shares. This creates a constraint to obtaining credit if this is the only form of collateral the borrower has.

The Act requires that provision for bad and doubtful debts must be made before a dividend or other distribution to shareholders is made. CBK guidelines require that adequate provisions be made for bad and doubtful debts. Such provisions are to include all unsecured loans even if there is little chance of their default. This is one of the constraints to developing non-collateral lending.

II) LAND CONTROL ACT

The Land Control Act was introduced in December 1967. Its objective was to control the transfer of agricultural land under the government's Africanization policy. It places severe restrictions on the transfer of land and thereby the ability of prospective borrowers to offer a first mortgage on agricultural land to financial institutions.

The Act constrains access to credit by people who own property. Currently, agricultural land is accepted as security on a very selective basis, mainly because of the conditions imposed by the Act and also by the instances of obstruction that lenders face when they try to realize their security.

The application procedures as stipulated by the Act and the appeal and decision-making processes are cumbersome and time consuming. According to the Act, the Land Board can refuse to consent to the disposal of land if it believes the prospective buyer is unlikely to cultivate, develop or use the land profitably. The Act also applies double standards because the same conditions do not apply to urban properties. Finally, the Act gives the Land Board too much discretion, which has become a major source of discontent and abuse. Appendix 2 is a detailed discussion of the Act.

III) TRAFFIC ACT

Motor vehicle logbooks are not acceptable securities for commercial banks. Some of the banks interviewed do not regard logbooks as security because it is difficult for lenders to transfer ownership of the repossessed vehicles.

IV) HIRE-PURCHASE ACT

The Hire-Purchase Act was cited as a constraint to providing consumer credit secured by the purchased merchandise. The Act requires the registration of all hire-purchase agreements of Ksh 300,000 or less to make the agreements enforceable by law. In addition, Section 12(1) allows the client to terminate the agreement by returning the goods to the seller at any time before the final payment falls due, so long as a written notice of termination is submitted. This provision is clearly unattractive. Therefore, lenders avoid hire-purchase agreements of amounts not exceeding Ksh 300,000.

Section 15(1) provides that, where goods have been sold under a hire-purchase agreement, and two-thirds of the hire-purchase price has been paid, the lender shall not enforce any right to recover possession of the goods from the hirer except by suit. This hinders the process of realizing collateral and discourages banks as well as vendors from providing hire-purchase credit.

V) CULTURE OF DEFAULT

All banks decried a default culture in society, which seems to have been institutionalized by bureaucratic court procedures and processes. In some communities, if a bank tries to realize its security, the community ensures that no one bids at the auction. Where outsiders buy the property, they are harassed until they sell the property at a low price. The culture of default also underscores a widespread misuse of cheques to such an extent that some people have acquired a habit of issuing cheques on inadequate cash. This abuse has far-reaching consequences in relation to providing and using banking services. First, cheques are widely mistrusted and cannot be used to pay bills. Second, the cheque-clearing process of as much as 15 days results. Third, to open a current account one is treated as untrustworthy and has to be recommended by first-class bank customers.

VI) SECURITY REQUIREMENTS AND LEGAL DOCUMENTATION

Security required to obtain credit is out of reach for many. In addition, legal and valuation fees, processing and government charges raise the already high cost of capital and add an additional burden of a lengthy and cumbersome bureaucratic process. This further marginalizes MSEs.

VII) SHORT-TERM NATURE OF LOANS

Commercial bank term lending is typically short term in nature. Evidence indicates that initial grace periods and extended repayment periods are attractive to customers. Banks are constrained in their ability to lend for longer terms primarily because of the relatively short-maturity profile of their deposit base and their desire to limit their liquidity risks. Banks require access to longer-term funds to meet their customers' capital project needs.

3.4 Recommendations

To enhance the accessibility of services from commercial banks, the following recommendations are made:

- The Land Control Act should be repealed (see appendix 2 for the justification of this recommendation).
- The Traffic Act needs to be amended to strengthen the disposal rights of institutions that use logbooks as security for loans. In particular, provision should be made where the Registrar would, on being satisfied that a notice has been served, cancel the original logbook and issue a

new one. The lender would further be entitled to statutory compensation from the borrower for the associated costs caused by the delay to deliver the logbook.

- Since bank shares, which are quoted in the Nairobi Stock Exchange, can be freely traded in the market it is recommended that Section 11(1)(a) of the Banking Act be amended to allow commercial banks to accept their shares as collateral.
- The hire-purchase mechanism should be revised to provide an alternative source of security for obtaining credit. Amending Section 12(1) to restrict the hirer from ending the agreement before the final payment could do this. In addition, Section 15(1) should be amended to allow the lender to enforce its rights even after two-thirds of the hire-purchase price has been paid.
- A credit rating agency should be introduced to report on defaulters and issuers of bad cheques. This measure will strengthen discipline in the use of cheques and loan repayments. This has been mentioned in the last two budget speeches, and the Banking Act will be amended to allow for the establishment of a credit reference bureau to be operated by the Kenya Bankers' Association. In addition, the Minister for Finance announced in the 2000/2001 budget speech an amendment to the penal code to make it a criminal offence to issue cheques against insufficient funds.
- Taking defaulters through the court process is lengthy and costly. It is recommended that this process be simplified and the number of judges increased so as to encourage banks to relax their lending criteria. The recent budget speech has outlined measures to address the current backlog.

4 Non-bank financial institutions

4.1 Legal and regulatory framework

Non-bank financial institutions, or NBFIs, are incorporated under the Companies Act and licensed and regulated under the Banking Act and the Central Bank of Kenya Act. Establishment of NBFIs was spurred by the policy to encourage development of thrift institutions to complement commercial banks in delivering financial services. The policy measures that helped to popularize the NBFIs were built into the Banking and the Central Bank Acts and included a requirement for paid-up capital that was 50% of what was required by banks, an exemption from the cash reserve ratio requirement, and lower licensing fees. This policy framework led to the establishment and growth of the NBFI sector, to the extent that by the mid-1980s there were 40.

To increase the stability of NBFIs, the capital requirement had been increased to Ksh 150 million by the end of 1999 and will be increased by Ksh 75 million per year to Ksh 375 million by the year 2002.

4.2 Historical background

The proliferation and growth of NBFIs has been one of the most striking developments in Kenya's financial sector. Unfortunately, many ceased trading because of either poor management or the panic that followed the collapse of a number of NBFIs in the mid-1980s. To address this crisis, the government took over the assets and operations of 9 banks and NBFIs and placed them under the umbrella of the Consolidated Bank of Kenya.

During the 1990s, 17 banks and NBFIs were liquidated after being seized by CBK. In spite of this turbulent history, Ndele (1991) concluded that NBFIs had lived up to the expectation of their

establishment and had experienced a period of phenomenal growth while competing favourably with banks in mobilizing savings and delivering credit. NBFIs were popular with borrowers because of their expeditious response to customer needs and less stringent loan approval procedures.

Over the years, however, certain measures taken eroded the main attractions of the NBFIs. In 1983, a directive required them to invest not less than 50% of their liquid assets in T-bills. This measure helped to divert NBFI resources away from the private sector to finance government borrowing. In the same year, the liquidity requirement was increased to 24%, further eroding loan funds.

In the wake of the financial crisis and with prompting from IMF, CBK adopted a universal banking policy, under which NBFIs are required to adhere to the same capital adequacy and prudence rules as commercial banks. This policy, which has been pursued since July 1994, brings NBFIs under tighter monetary control. CBK, however, argued that there was no need to maintain NBFIs separately and recommended that they convert into commercial banks. The following differences between commercial banks and NBFIs were noted:

- non-banks were not allowed to operate current accounts
- non-banks were not allowed to deal in foreign currency
- the share capital requirement for non-banks was lower by Ksh 50 million

The conversion is not automatic, and the normal CBK licence application and vetting process must be complied with. CBK is of the view that the conversion will not in any way hinder institutions from offering services.

4.3 Current status

Only 15 NBFIs are currently operational, 13 of which have their headquarters in Nairobi, 1 in Mombasa, and 1 in Nakuru; 8 are subsidiaries of commercial banks and the other 7 are independent. All respondent institutions offered savings and credit. Information provided indicates that NBFIs do not offer different services from the commercial banks. They are, however, more flexible when negotiating interest rates and faster when making decisions.

This segment is currently dominated by two institutions, which control 57% of the market in total net assets and 63% in deposits. The sector's deposits declined by 54% from Ksh 46.5 billion in 1993 to Ksh 21 billion by the end of 1997 (table 6). This trend is not surprising given the decline in the number of NBFIs.

The bulk of NBFI credit goes to the private sector. Like banks, NBFIs credit to the private sector rose from 65% in 1993 to 84% by the end of 1997.

4.4 Constraints identified

The NBFI sector faces similar constraints to those identified for commercial banks. A limited NBFI branch network is a major constraint to providing financial services. In addition, minimum balance and security requirements hinder access for the majority of Kenyans.

4.5 Recommendations

Driven by its universal banking policy, CBK has removed the slight flexibility that existed in the financial sector. The gap between the formal and the informal financial institutions is wide, making the prospects for small enterprises even worse. Research and studies indicate that MSEs that graduate from MFIs are left in a no-man's land and are likely to stagnate because of their inability to get credit from formal financial institutions.

Table 6. Sectoral distribution of deposits and credit of non-bank financial institutions (Ksh '000)

	Public sector		Private sector				Total
	Central government	Other public	NBFIs	Building societies	Banks	Private sector	
			Sectoral distribution of deposits (Ksh '000)				
1993	343	7,762	2,328	508	547	35,104	46,592
1994	480	6,959	2,981	454	537	40,847	52,258
1995	515	4,851	604	2	759	39,466	46,197
1996	403	5,295	815	52	1,708	30,036	38,309
1997	560	4,462	51	16	542	15,607	21,238
			Sectoral distribution of credit (Ksh '000)				
1993	18,605	359	-	2	150	35,941	55,057
1994	21,128	1,070	-	26	446	39,344	62,014
1995	7,223	83	-	2	27	41,599	48,934
1996	3,281	50	-	404	422	36,668	40,825
1997	4,346	19	-	0	0	27,797	32,162

Source: Central Bank of Kenya Statistical Bulletin (1998b)

As MSEs are the greatest generator of jobs and have the highest potential for increasing and sustaining economic development, the NGO-driven micro-finance institutions should not be relied upon as the sole driving force for this important sector.

It is therefore recommended that the current universal banking policy be moderated to allow for the continuation of a second-tier of financial institutions. Such institutions would provide a bridge between the formal and the informal financial intermediaries and provide a path for graduating micro-enterprises into small enterprises and MFIs into second-tier financial institutions.

5 The Kenya Post Office Savings Bank

5.1 Legal and regulatory framework

The Kenya Post Office Savings Bank (Postbank) is one of the oldest institutions in the country. It was founded in 1910 as a department of the East African Posts and Telecommunication Services. In 1978, it was established under Cap. 493B as an independent body with its own board of directors and management, responsible to the Minister of Finance.

The Act does not specify that Postbank must have any capital. The government guarantees the liabilities to depositors and any operating deficits, which can be charged to the Consolidated Fund. Its capital base comprises grants and retained earnings. Consequently, its equity base is very low, amounting to about 5% of its deposits.

Under the Act, the bank enjoys tax-free status of all the interest accruing on all savings accounts and exemption from payment of the Corporation Tax and other forms of taxation.

The main objective of Postbank is to provide the means and opportunity for people to save. Under the provisions of the Act, the bank established an agency relationship with the Kenya Posts and Telecommunications Corporation (KPTC), which provides additional outlets through which its financial services are offered.

The Act restricts investments of mobilized funds to interest-yielding securities or any other form of investment that the Postbank board may approve. The Act also prohibits the bank from giving

credit. In its Development Plan 1998–2000, the government has urged that Postbank be reoriented from taking deposits only to also providing secondary financial services such as extending credit. To achieve this, the Act would have to be amended to allow Postbank to engage in other financial activities. The reorientation has not happened, as issues between the Central Bank, the Treasury and Postbank remain unresolved.

In 1991, the Post Office Savings Bank Act was amended to allow for the establishment of a subsidiary company that would offer full-fledged banking services. This led to establishing Postbank Credit Ltd, which opened for less than three years before it failed as a result of mismanagement and a poor credit policy. Postbank, however, blames the failure on loopholes in the amended Act, which assigned all powers of appointment of managers to the Ministry of Finance.

5.2 Current status

Currently, Postbank's balance sheet shows an equity of Ksh 270 million made up of grants, capital reserves and retained profit. This figure is, however, misleading as the assets include a staggering amount of nearly Ksh 1 billion of unresolved amounts, which represent accumulated losses recoverable from the Consolidated Fund. This account was transferred from the profit and loss in 1982. Without this transfer, the balance sheet would show an accumulated loss of Ksh 667 million. Postbank has grown steadily over the years, as table 7 indicates.

Table 7. Growth in Postbank from 1978 to 1997

	1978	1997
Accounts	700,000	2.6 million
Number of products	1	9
Agency service outlets	200	490
Deposit base	Ksh 196 million	Ksh 4.58 billion

Source: Postbank (data obtained from the return of an administered questionnaire)

The nine products Postbank offers are savings accounts, salary accounts, save-as-you-earn accounts, premium savings accounts, fixed deposit accounts, premium bonds, Visa card (local and international), and money transfer services. Postbank is also planning to start a safe-card account.

Of the total service outlets, 54 are Postbank branches, 345 are in post offices and 91 are in agencies of post offices.

The interest paid on the ordinary savings account of 5% (table 8) is lower than that given by other financial institutions by approximately 8%. Nevertheless, the ordinary savings account still dominates, accounting for 91% of the total deposits. Postbank has a very simple process of opening accounts—presentation of the national identification card and two passport-size photographs is all that is required.

Since Postbank had not been allowed to provide credit, the surplus funds were invested as follows:

	%
Government securities	28
Balances with banks	30
Fixed assets	10
Other assets (Consolidated Fund & staff loans)	32
	100

Table 8. Interest payments and minimum deposit requirements for Postbank accounts

Accounts	Interest (%)	Minimum deposit
Ordinary savings	5.0	500
Save-as-you-earn	11.0	500
Call deposits	8.0	10,000
Time deposits	15.5	10,000
Premium savings	17.5	50,000

Source: Postbank (data obtained from the return of an administered questionnaire)

The bank has received several requests from customers and international agencies such as the World Savings Bank Institute, the German Savings Bank and the Swedish Savings Bank Association to serve the MSE sector. A feasibility study undertaken by the bank shows that it can diversify into such operations profitably. The bank has also entered into an agreement with the African Housing Fund (which has since folded) and Citibank to serve their customers regarding loan repayments and cashing cheques for a commission. Indications are that other organizations may want to contract such services to pay salaries to their staff.

5.3 Constraints identified

The bank is not properly capitalized, primarily depending on grants and retained earnings to leverage the deposits. The capital base is only about 2% of deposits. In addition, the unresolved amounts due from the Consolidated Fund cause concern over Postbank's solvency. The liquidity of the bank (cash and other liquid investments) is unsatisfactory at Ksh 2.7 billion, compared with Ksh 4.3 billion of savings deposits.

The bank has lost customers because of its inability to provide credit. Delays in remittances from KPTC are also substantial, which delays investment.

There are some indications of overstaffing. The accounts for the period ending December 1997 show that staff costs increased by a staggering 35% from 1996 and represented 43% of the gross income. Staff cost is nearly double the interest and other payments to deposit holders.

5.4 Comparison with postal banks in other countries

I) Tanzania Postal Bank

The Tanzania Postal Bank offers the following financial services:

Savings	ordinary savings
	save-as-you-earn (SAYE)
	fixed deposits with maturity varying up to one year
Finance	import–export finance
	loans against pay-as-you-earn (PAYE)
	loans to micro and small enterprises
	loans to corporate customers
Services	trading in T-bills
	trading in securities
	international operations (bureaux de change)

II) MALAYSIA POST OFFICE SAVINGS BANK

The Malaysia Post Office Savings Bank Act 1948 was repealed in 1974 to give the bank more flexibility and to enable it to compete effectively with other financial institutions. The main change in the new Act was the requirement to promote the interests of its depositors and other customers. The new services introduced after this change were:

- housing loans for low-income members of the society, provided at a subsidized interest rate ranging from 8.5 to 11%
- current account services

While the bank does not operate under the Banking Act of Malaysia, the Act gives general guidance on how surplus funds should be invested. Investment in government securities should not be less than 60% and loans to customers should not exceed 20%.

After the bank reorientation, the branch network increased from 15 in 1979 to 511 branches in 1997. As at December 1995, account holders increased to 10.7 million with a deposit base of US$2.1 billion. Total profit for that year was US$20 million. The bank has invested in three subsidiaries including a commercial bank, a unit trust management company, and a merchant bank. In addition, the bank, which is 100% government owned, is planning to sell 30% of its shares to the public through the stock exchange.

5.5 Recommendations

Postbank, with its excellent outreach to small-scale savers, has tremendous potential for extending other financial services to its current clientele. This potential can be achieved by converting from the main objective of encouraging savings for national development to that of promoting the interest of its clients. It is unfair that savings of Ksh 4.7 billion should be mobilized from the poor to invest in government and other securities while the depositors cannot get credit and other services available to those who save with other financial institutions.

To achieve this objective, Postbank proposes that the Kenya Post Office Savings Bank Act, Cap. 493B, be amended to include the interests of clients regarding savings, credit and other services. In addition, an arrangement should be reached under which CBK will supervise the lending scheme of Postbank. The bank should, however, be allowed to operate outside the Banking Act. The reform should explore further the possibility of the bank insuring small depositors with the Deposit Protection Fund.

The financial status of Postbank needs to be improved to enable it to take up these new responsibilities. The financial restructuring should, among other things, seek a reimbursement of Ksh 1.0 billion in guarantees from the government. The new responsibilities would also require a radical change in the management style and staffing to increase professionalism and efficiency in delivering services. Overstaffing should be critically evaluated. A feasibility study should be undertaken with the assistance of independent consultants, to develop a restructuring process that would include financial structure, management, staffing and the future relationship with the KPTC agency or its successor. The study should also explore the alternative of joint ownership of the postal network between KPTC or its successor and Postbank.

6 Savings and credit cooperative societies

6.1 Legal and regulatory framework

The cooperative movement in Kenya dates back to 1931 when the first ordinance was enacted to regularize the operations of cooperatives in the country. The following decade witnessed increased state intervention in the sector with the eventual enactment of the Co-operative Ordinance Act of 1945, the predecessor of the current Co-operative Societies Act, Cap. 490, of the laws of Kenya (as amended in 1997).

Savings and credit cooperative societies (SACCOs) are registered and regulated under the Co-operative Societies Act. For registration, the Act requires a primary society to consist of at least 10 persons and to have the following objectives:

- promotion of the welfare and economic interests of its members
- incorporation in its bylaws of the following cooperative principles:
  - voluntary and open membership
  - democratic control of membership
  - economic participation by members
  - autonomy and independence
  - education, training and information
  - cooperation among cooperatives
  - concern for the community in general

SACCOs are accorded the same treatment as producer or marketing cooperatives, and to qualify for registration they are not required to raise any capital. Also, a SACCO needs no licence to commence trading, whether offering back-office or front-office services (banking services). Once registered, the SACCO has to operate according to the following aspects of prudential management of societies as provided for in the Act:

- No member other than a cooperative society shall hold more than one-fifth (20%) of the issued and paid-up capital of any cooperative society.
- Books of account must be kept and audited every year by an external auditor appointed at the annual general meeting.
- The Registrar can carry out an inquiry or inspection of a cooperative society at the expense of the society.

The Ministry of Co-operative Development has developed guidelines that contain detailed operational requirements for the SACCOs to follow. The societies also prepare and submit monthly reports to the ministry. In addition, in conjunction with the Rural Banking Project, an inspection team has been put in place, which monitors whether the societies are operating under sound banking principles.

Section 43 of the Act prohibits a cooperative society from giving loans to non-members, unless the bylaws of the society provide for giving such a loan. Therefore, the law gives SACCOs the leverage to develop a policy framework for lending to non-members. In rural areas a cooperative society may receive deposits and loans from persons who are not members on such conditions as its bylaws or rules under the Act may prescribe.

In addition to giving loans to its members, a cooperative society is allowed to invest or deposit its funds in:

- the Kenya Post Office Savings Bank
- banks licensed under the Banking Act
- the stock of any statutory body in Kenya or in any limited company incorporated in Kenya
- any other manner approved by the society at a general meeting

6.1.1 Types of cooperatives

Three types of cooperatives are recognized in the Act: primary cooperatives, cooperative unions and apex cooperatives. SACCOs fall in the category of primary cooperatives.

Before the 1990s, only employer-based SACCOs were operational in the country with employment as the common bond. This system locked out a large number of people who were self-employed. An amendment to the Act recognized the possibility of forming a SACCO on a base other than employment. This development ushered in a new category, referred to as rural SACCOs. Their activities derive from agricultural produce being marketed through an organized system such as marketing cooperative societies. The reforms also ushered in the formation of SACCOs among informal sector operators engaged in public transport, textiles and commerce. Informal sector SACCOs are referred to as 'rural' and employer-based SACCOs are referred to as 'urban'.

6.2 Current status

Cooperatives can provide financial services to their members through existing product or marketing societies, SACCOs, and the Co-op Bank. Members also have the opportunity of saving with their marketing societies through banking sections of the district cooperative unions, which maintain savings accounts for their members.

As at 31 December 1997, there were 6,300 registered cooperative societies out of which 3,169 were SACCOs, with a membership numbering 4.85 million. Table 9 shows the distribution of SACCOs by province. The data provided in this table are misleading because the urban SACCOs also serve many employees of public institutions and government ministries whose SACCO headquarters may be in Nairobi but where many of its members are working in other urban and rural bases throughout the country.

Table 9. Provincial distribution of savings and credit cooperative societies (SACCOs)

Type	Central	Coast	Eastern	Nairobi	North Eastern	Nyanza	Rift Valley	Western
Urban	266	316	92	1249	8	109	28	72
Rural	13	4	11	–	–	8	58	–

Source: Ministry of Co-operative Development (data obtained from the return of an administered questionnaire)

As at 31 December 1997, savings through SACCOs stood at Ksh 29 billion and the outstanding loans amounted to Ksh 22 billion. The loans to deposits ratio was 74%, which demonstrates the effectiveness of the SACCOs as a financial intermediary.

6.2.1 Services savings and credit cooperatives offer

The services that SACCOs that responded to the questionnaire offer are the sale of shares, and deposit and credit facilities. Shares can be sold only to SACCO members, as defined by the Act. The minimum monthly share contribution is Ksh 400. The societies can take deposits from members and

non-members with no limitation. A popular feature of rural SACCOs where alternative savings facilities are not available is taking deposits from non-members.

Interest paid on deposits with SACCOs is pegged at 3% below the commercial bank rate paid. One of the respondent SACCOs with an outreach of over 2000 clients (including members) operates a mobile bank for farmers who are unable to travel to the SACCO bank because of the distance involved.

Credit provision is restricted to SACCO members at an interest rate of 1% per month. The loan size is determined by the amount of shares that an applicant has; it is usually three times the amount of the shares. Other members of the SACCO provide additional security for the loan repayment, in the form of a guarantee The maximum loan size to an individual is limited to 5% of the society's total share capital and reserves.

One respondent SACCO noted that it had not considered opening credit to non-members because it had not yet satisfied credit demand among its members. The findings in a Kenya Rural Enterprise Programme (K-Rep) study noted similar sentiment among the nine SACCOs covered.

The respondent SACCOs offer credit for development, education, consumer needs, and for health-related and emergency loans. For SACCOs included in the K-Rep study, advance crop credit was very popular among tea farmers. The study noted lack of funds as the main limitation of the scheme.

Other types of financial services that SACCOs offer include money transfers (for SACCOs offering front-office services), insurance cover and business training for members.

6.3 Constraints identified

The 1997 amendments to the Co-operative Act, Cap. 490, enabled SACCOs to make investments without approval from the Ministry of Co-operatives. This has greatly removed bureaucracy from the day-to-day operations of the societies but has increased the risk of making unsound investments. Already some SACCOs have suffered in the recent bank crisis.

The law is silent on the requirement of returns that the societies should prepare for monitoring compliance with the requirements relating to prudence as laid down in the Act. This omission has potential dangers for SACCOs because early warning signs may be missed.

The Ministry of Co-operatives is ill equipped to develop guidelines for SACCOs or to carry out effective supervision. Countries where SACCOs are allowed to take deposits and offer banking services place them by law under the auspices of the Central Bank and the Ministry of Finance. For example, credit unions in Burkina Faso are licensed and regulated by the Central Bank.

The need to streamline the regulatory framework for the benefit of developing SACCOs was advanced by one of the respondents to this survey. It argued that SACCOs should be regulated just like other financial institutions.

The Commissioner of Co-operatives also agreed and stated that 'there is a need to develop separate legislation for the management of these societies as they need specialized supervision. Such a law should specify steps to be taken before a registered society is allowed to operate front-office services. It should also discourage societies from investing accumulated savings outside their primary (core) activities without being too prescriptive in the qualification and operational requirements, such as those provided in the Banking Act. Such a law should open a relationship with Central Bank but *not* bring such societies under the direct supervision of the Central Bank. The law should also encourage collaboration among SACCOs while discouraging competition.'

A major threat to the continuation of SACCOs as providers of financial services is the lack of an appropriate regulatory framework. The management structure prescribed in the Act is not appropriate for SACCOs offering banking services. The management committees, which are given executive powers of the society, usually have no knowledge of banking. Hence giving such a team executive power to transact quasi-banking services does not ensure professional management. The near collapse of the mainstream crop marketing cooperatives is an indication of what can happen to promising SACCOs.

Most SACCOs charge an interest rate of 1% per month on loans. This restricts accessibility of loan funds from other sources and thereby creates a credit gap. Success of the non-employer-based SACCOs, especially in the rural areas, is marred by poor management because they are unable to hire high-calibre management staff.

6.4 Recommendations

As noted above and supported by the Commissioner of Co-operatives, a separate regulatory framework is needed to govern SACCOs. This recommendation should be explored further in conjunction with consideration of a separate regulatory framework for MFIs. The role of the Ministry of Co-operative Development should be reduced to registering SACCOs. The Ministry of Finance should license their operations in consultation with the Central Bank. In drafting the legislation, care should be taken to ensure that regulations do not constrain SACCO growth. The new Act should be able to address the management, operation and supervision of SACCOs and all other matters that are necessary to ensure the success of institutions that provide financial services as their main activity.

7 Micro-finance institutions

7.1 Legal and regulatory framework

Most micro-finance institutions, or MFIs, are registered as NGOs and coordinated by the NGO Coordination Act, 1990. Some MFIs are incorporated under the Companies Act while others operate under the auspices of umbrella organizations like churches and voluntary agencies.

NGOs are defined as a 'private grouping of individuals or associations, not operated for profit or for other commercial purposes but which have organized themselves nationally or internationally for the promotion of social welfare, development, charity, or research through mobilization of resources'. The NGO Act under Section 3(1) has established an NGO Coordination Board. Its functions are:

- to coordinate the NGO work, maintain a register, review annual reports and advise the government on the role and activities of the NGOs
- to conduct regular reviews of the register to determine the consistency with the reports submitted by the NGOs
- to provide policy guidelines to NGOs for harmonizing activities with the national development plan of Kenya
- to approve the code of conduct prepared by the council of NGOs for self-regulation of the organizations and the activities

NGOs have to be registered and are issued a certificate of registration, which is valid for 60 months and is renewable. The certificate is conclusive evidence of authority to operate throughout Kenya or

parts of the country specified therein. The Act provides that a registered NGO shall by virtue of its registration be a body corporate. The board can deregister an NGO for various violations of this Act.

The Act also establishes a National Council of Voluntary Agencies, which acts as a collective forum of all the voluntary agencies registered under this Act. The council adopts a code of conduct and other regulations as may facilitate self-regulation by NGOs on matters of activities, funding and programmes. The Act, therefore, does not recognize the existence of MFIs and their special role as financial intermediaries or provide a regulatory framework to coordinate their activities and guard against specific financial malpractice.

MFIs have formed the Association of Micro-Finance Institutions (AMFI), which among other things seeks to develop and implement self-regulatory features for the industry. It draws its members from institutions that are committed to developing a micro-finance industry to serve poor and low-income people.

The association's mission is to:

- develop the micro-finance industry in Kenya and facilitate the development of its member institutions
- promote micro-finance systems and approaches, which are to be followed and understood by practitioners, the government and donors
- facilitate the institutionalization of micro-finance projects and programmes
- provide members with access to information and expertise that increases their knowledge
- provide a forum for the exchange of ideas

7.2 Characteristics of the micro- and small-enterprise sector

In Kenya, micro and small enterprises (MSEs) are defined as those employing not more than 50 employees. According to the Gemini MSE 1993 survey (Parker and Torres 1994), enterprises with more than 50 workers play an insignificant role in job creation. Indeed, this population is non-existent outside of commercial and industrial areas. Enterprises with 11 to 50 workers also play a minor role, comprising only 1% of enterprises nationally. It is the enterprises with 1 to 10 workers that make up 99% of the enterprise population.

The MSE sector includes the micro self-employment endeavours and small enterprises that are remarkably dynamic, operating a vast array of activities from both rural and urban locations. The 1993 survey estimated that there were more than 900,000 enterprises, employing 2 million people. By 1996, the sector's employment, excluding those engaged in small-scale farming activities, had increased to 2.24 million people.

Given that 99% of enterprises have fewer than 10 workers, graduation of these enterprises into medium enterprises with more than 50 workers would take a very long time. Instead, it is the less noticeable but very important transformation of 1-worker enterprises into 3-to-5-worker enterprises, or of 3-to-5-worker enterprises into enterprises with 6 to 10 or 11 to 50 workers that plays the leading role in creating jobs.

Certain size categories within the micro-enterprise population appear to offer special development potential. This is particularly true of enterprises in the 3-to-5-worker category. Not only does this category make up 20% of the enterprise population, it also provides one-third of the sector's jobs nationally.

Enterprises starting in the 3-to-5-worker category use markedly more start-up capital than smaller enterprises, suggesting that they start with more business assets than simply their labour, whether it

be land, materials or equipment. Although two-thirds of these enterprises remain in the 3-to-5-worker category, a sizeable percentage of the remaining one-third grow into 6-to-10- or 11-to-50-worker enterprises.

According to the Gemini study (Parker and Torres 1994), women make up 46% of the Kenyan MSE entrepreneurs and 40% of the sector's total employment. Women's enterprises start smaller, grow slower, and end smaller than do men's enterprises, with two-thirds remaining 1-worker concerns. In aggregate, women-owned enterprises generate 26% fewer jobs per year than do men-owned enterprises. Women entrepreneurs have different credit-use patterns than do men, using less start-up capital and little formal credit, relying instead on informal credit. Similarly, women are more likely to join savings groups as a means of financing their enterprises. Women-run businesses are more likely to rely on unpaid and unskilled workers and are more likely to work from their homes. If working outside the household, women typically have fewer formal tenure arrangements and are more likely to work out of temporary structures and without utilities than similar enterprises managed by men.

The Gemini study (Parker and Torres 1994) revealed a clear dominance of agriculture-related activities in the MSE sector. Despite the omission of primary agricultural activities from the survey, agriculture-related enterprises were by far the most numerous of any group of activities, making up the bulk of commercial enterprises and one-third of manufacturing businesses. Moreover, this group of activities is a key provider of income and employment for women.

A common factor that constrains the growth of MSEs in Kenya is their tendency to start new businesses more often than expand within the same business. The typical entrepreneur in a rural shopping centre will be running a very poorly stocked shop beside a butchery, a tea kiosk, a bar and a small *shamba*. Demand for expansion capital within the same line of business can be regarded as one of the indicators of business growth.

Such businesses with good growth potential, which can viably use credit of between Ksh 500,000 to Ksh 3 million, are considered as the 'missing middle' between informal MSEs served by MFIs and medium-sized formal businesses with access to bank credit.

Policy-makers should consider several key points that when developing strategies. First, strategy should focus on assisting enterprises within the MSE sector, rather than on assisting larger enterprises. Second, any strategy that can reach this sector can also reach rural businesses and home-based enterprises. Third, female entrepreneurs face a different set of constraints than do their male counterparts.

7.3 Current status

Development of the micro-finance industry traces back to the late 1970s and early 1980s when organizations registered under the NGO Act were formed. The mission of these organizations was to provide financial services, particularly credit, to MSEs with development potential that had hitherto been constrained by the inaccessibility of credit from the formal banking sector.

There are many NGOs and other organizations involved in providing micro-finance directly or indirectly throughout the country. Evidence in the literature on the supply of credit by these institutions abounds. Aleke-Dondo (1994) estimated the supply of credit to the MSE sector at about Ksh 2 billion in the period 1983 to 1990. The study revealed that of this amount, small enterprises received Ksh 1.3 billion, while Ksh 700 million went to micro-enterprises.

More recent estimates of the volume of credit based on 24 organizations indicate that the advances to MSEs amounted to Ksh 11.5 million in 1990, Ksh 211 million in 1991 and Ksh 241 million in

1992. Although based on only 24 institutions, these estimates reveal that the volume of credit to the sector has been increasing over time. This assertion is further corroborated by evidence in Oketch, Abaga and Kulundu (1995) where some 54,403 loans amounting to Ksh 847 million were disbursed to MSEs by 50 organizations (which included MFIs, Kenya Commercial Bank and Barclays Bank of Kenya).

I) IMPACT OF MFI OPERATIONS

Despite the number of MFIs and their commendable effort to provide credit to MSEs, the impact of these interventions is minimal. Oketch, Abaga and Kulundu (1995), for instance, found that only about 6.7% of total MSEs, which were estimated at 910,000 by the Gemini survey of 1993 (Parker and Torres 1994), had used credit between 1990 and 1994. Further evidence from the survey of MSEs by K-Rep (Kagira and Maganjo 1998) and Gemini (Parker and Torres 1994) indicated that the gap between supply and demand for credit is still wide. No analysis regarding the credit worthiness of this demand, however, is available, and therefore it is not clear that the full amount would or should be lent were it available. The survey found that as many as 71% of the sample depended on profits from their business and 22% depended on previous savings to finance additional investments. Only 7% had used external funds.

II) SERVICES OFFERED

MFIs offer credit and in some cases savings facilities. The respondent MFIs offer business loans, which include working capital and project finance, consumer loans, education loans and loans for purchase of shares in the stock market. Access to credit is eased by the absence of stringent collateral requirements, where only a group guarantee and some cash contribution is sufficient to get credit facilities.

The bulk of MFI funding is dependent on donors, but funding has not matched the rise in the demand for credit in the MSE sector. Of the two MFIs surveyed, one depended on donor funds entirely, while the other had bank loans accounting for 7% of its funding. The reasons for the low use of bank facilities were lack of acceptable collateral from the MFIs, their informal nature, and the fact that they operate in an unregulated environment, which makes it difficult for commercial banks to assess the MFIs' financial capability with certainty.

7.4 Other key players in the informal finance industry

Without access to commercial sources of funding, micro-entrepreneurs rely on informal sources of funds, which carry either no cost or a higher cost than formal financial institutions. Micro-entrepreneurs raise the majority of their start-up funds through savings or loans from family members.

Another important source of finance is buying merchandise on credit. MSEs also tap traditional rotating savings and credit associations (ROSCAs) to finance business requirements. ROSCAs are groups of people who agree to make regular contributions to a fund, which is given in whole or in part to each contributor in turn. The key problem with this type of funding base is that its availability does not coincide with the business demands for such funds. The scheme also carries considerable risk if a group breaks up before all contributors have had an opportunity to borrow.

Moneylenders are also sources of short-term emergency loans. They lend money at very high interest rates for a short period ranging from a day to a year. Most loans are for less than one month. Money-

lending rates may range from 10 to 60% per month. In some countries, moneylenders are registered; in Kenya they are not.

Despite the number and variety of players in the market, research indicates that the credit needs of MSEs are still largely unmet. This situation, however, is not unique to Kenya, and it is important to note that the gap between supply and demand of credit may be due to a genuine lack of credit worthiness.

7.5 Constraints identified

Financing of credit activities by MFIs from deposits is not acceptable under the law, as MFIs cannot take deposits from the public unless they are licensed as a commercial bank under the Banking Act. Together with other operating requirements that banks are supposed to observe, this represents an insurmountable barrier, beyond the reach of MFIs with the exception of K-Rep, which was given a banking license in 1999.[1]

Because they operate with minimal capital, relying almost wholly on donor funding, and operating mostly with inexperienced and poorly trained staff, the sustainability of most MFIs is questionable. Sustainability refers to the ability of an institution to generate enough funds to cover its operations and to fund the growth required for its continuing existence. It is essential that the micro sector, which gives so much hope for the future development of private enterprise in Kenya, be supported by a sustainable financial system able to identify, nurse and support the growth and expansion of their clients' businesses.

The banks and financial institutions that have ventured into donor schemes for small business lending have found that such schemes have high administration, monitoring and reporting costs. Specific conditions in the use of funds give rise to extra reporting requirements, which sometimes require additional investment in information systems and staffing. Sector-specific schemes also complicate processing and approval, thus increasing costs. To motivate banks and financial institutions that obtain donor funds for micro-credit, a wider spread in the interest rates and loan guarantee schemes has been used.

7.6 Recommendations

The development of an MFI industry in Kenya has reached a critical stage. The role that MFIs play in providing credit to MSEs and the reluctance of other financial institutions to get involved has led CBK to support the development of the industry. The recommendations below address the constraints identified and suggest the way forward in terms of new legislation for MFIs that may wish to mobilize deposits. Also discussed is the need for institution building for MFIs that may not meet the necessary regulatory requirements that new legislation would establish.

Only K-Rep has developed sufficiently to operate as an MFI bank under the existing legal and regulatory system. The others will have to remain as informal institutions. Such institutions, however, need a self-regulatory system to enhance their image and character, so that they continue to attract funding from traditional donor sources and the formal financial sector.

The main recommendations of this report follow:

[1] Discussions with key players in the MFI sector has revealed that many MFIs do effectively take deposits while not legally being allowed to do so. Such deposits normally take the form of member contributions, which are deposited with the MFI in a group account.

I) ESTABLISHMENT OF MICRO-FINANCE BANKS

While it is neither possible nor desirable to regulate all micro-finance institutions, some MFIs would like to graduate into the formal sector so that they can take deposits from the public. This is not possible under the current banking regulations because they do not meet cash and liquidity requirements or capital base. There is therefore a need to explore an option that would set up a regulatory system for MFIs. The following example from South Africa merits consideration in this context.

The South African Mutual Banks Act of 1993 was an attempt to create a banking category that had less stringent capital-adequacy prerequisites but similar risk-management requirements. It also attempted to involve communities in banking by including a provision for local boards for branches of mutual banks.

The main provisions of this Act follow:

- A mutual bank may accept deposits and grant loans, advances or other credit.
- Such a mutual bank must meet capital adequacy requirements by maintaining unimpaired reserve funds of up to 8% of its risk exposures.
- It must maintain a minimum reserve balance with the Reserve Bank of South Africa equal to 5% of its short-term liabilities.
- It must avoid portfolio concentrations in excess of a certain percentage without making a specific report to the Registrar of Mutual Banks.
- It must provide detailed monthly and quarterly returns, showing the bank's various risk exposures and the manner in which it complies with capital adequacy and liquidity requirements.
- The Registrar may require applicants for mutual bank status to establish a relationship with a commercial bank (referred to as a 'guardian bank') to assist the applicant with technological and infrastructure support, management and general advice.

Such amendments to the Banking Act may facilitate the formation of second-tier institutions with less stringent conditions than those for commercial banks. The amendments should still allow MFIs to operate under realistic prudential guidelines to guard against gross abuse but at the same time allow them to retain sufficient flexibility to encourage further innovations in informal credit mechanisms. Such second-tier institutions, sometimes called rural banks or micro-finance banks, have assisted in providing micro-credit successfully in Ethiopia, Bolivia and Indonesia.

II) SECURITIZATION OF AN MFI PORTFOLIO

To address the constraint of an insufficient funding base, securitization of the MFI credit portfolio is an option worth exploring and developing. Securitization is an innovative attempt to link micro-enterprises with capital markets and presents an alternative structure for MFIs that may wish to continue their credit activities without having to obtain a banking licence.

The process establishes a special purpose corporation, the key objective of which is to raise funds from the capital market and money market through issue of corporate bonds and commercial paper. The funds raised in this manner would be used to finance the rapid growth of MFIs.

Regulatory authorities, AMFI and donor agencies currently supporting programmes in the MFI sector should explore the possibility of establishing such an institution. Broad-based ownership through the stock market should also be explored because of the rating attribute that this mode of incorporation would lend to the corporation. In promoting this initiative, the experience of ACCION International and its affiliate Fundación Ecuatorial de Desarrollo (FED), where the two

are piloting a similar project in Ecuador, will prove valuable. The Consultative Group to Assist the Poorest (CGAP)[2] should also be included in the consultations.

III) INSTITUTIONAL CAPACITY AND IMAGE

The Association of Micro-Finance Institutions (AMFI) should be developed. To facilitate this, donor funding of MFI activities should be confined to AMFI members. Member MFIs would be required to observe best-practice standards and procedures, which would improve their credit worthiness and allow them to borrow funds for on-lending.

AMFI could also consider setting up a borrower's database for credit reference.

IV) THE CENTRAL BANK OF KENYA AND MICRO-FINANCE AND RURAL BANK DEPARTMENT

Many different types of institutions presently provide micro-finance; some are:

- government agencies that have been receiving funding from the government and lending to micro-enterprises at subsidized interest rates
- banks and NBFIs that set aside limited resources normally supplemented by donors to finance micro-enterprises.
- NGO MFIs sponsored by donors
- SACCOs

The environment under which MFIs operate is diverse in size and area of concentration. MFIs also lack clear ownership, shareholders and regulations. To address this, CBK has established a division charged with the responsibility of promoting their development. This department can play a critical role in coordinating efforts to develop micro-finance generally.

Specifically, CBK will encourage banking institutions with micro-finance portfolios to expand such operations and in cooperation with AMFI will also assist in drafting self-regulations for non-deposit-taking MFIs and explore ways in which MFIs can play a greater role in financing the needs of the informal sector. It will also play a key role in spearheading the development of a policy and regulatory framework for MFIs.

V) DONOR FUNDS

Currently, continued donor support to MFIs is essential. AMFI could highlight specific issues in the MFI sector and assist in focusing donor support. CGAP could advise and guide AMFI on best practices for AMFI member to comply with. By tying donor funds to institution-building measures, MFIs may reach a level of sophistication that would make them viable partners in business, acceptable to formal institutions such as commercial banks.

8 Development finance institutions

8.1 Overview

Development finance institutions (DFIs) were formed by statute to supplement the activities of banks and other NBFIs and to promote development in specified sectors, such as agriculture,

[2] CGAP is a micro-finance programme with multidonor effort whose goal is to significantly expand very poor people's access to quality financial services from sustainable or potentially sustainable micro-finance institutions. For more information on publications by CGAP see its Web site: http:www.cgap.org.

commerce and industry, tourism and housing. Development finance institutions are regulated by individual Acts of Parliament. The existing DFIs are:

- Agricultural Finance Corporation (AFC)
- Development Finance Company of Kenya (DFCK)
- East Africa Development Bank (EADB)
- Industrial and Commercial Development Corporation (ICDC)
- Industrial Development Bank (IDB)
- Kenya Industrial Estates (KIE)
- Kenya Tourist Development Corporation (KTDC)
- National Housing Corporation (NHC)

DFIs have been the country's principal sources of long-term finance for industrial and other business development activities. These institutions are funded primarily through loans and grants received from bilateral and multilateral development institutions and donors, as well as GoK. The government, once a major source of funds, has eliminated its budgetary allocations.

The new universal banking policy includes DFIs and DFCK and IDB have already been converted into banks. Some of the DFIs listed above exist on paper only, incurring huge losses and paying their operating costs through proceeds from the sale of assets. Others are virtually dormant. In this report, we have concentrated on three: IDB, ICDC and AFC, as the main DFIs with a significant role in this sector.

8.2 Industrial Development Bank

The Government of Kenya owns 49% of IDB's share capital; ICDC, the National Bank of Kenya, the Kenya Reinsurance Corporation and Kenya National Assurance hold 12.75% each. The government created IDB to further economic development by assisting in promoting, establishing, expanding and modernizing medium- and large-scale industrial enterprises, including mining, agro-industries, engineering, tourism, and transport and shipping. Specifically excluded in its sphere of operation are enterprises that are purely involved in commerce, real estate and farming activities.

IDB provides the following financial services:

- medium- and long-term finance
- direct equity investment
- guarantees for loans from other sources
- underwriting of security issues, shares, stocks and promissory notes

The bank gives minimum loans of Ksh 3 million and will not take controlling interest in any enterprise, limiting its maximum exposure to 49%. The bank cannot normally commit itself to more than 50% of the total project cost, and the aggregate investment in one enterprise cannot exceed 20% (equity not exceeding 10%) of the bank's unimpaired capital and reserves.

8.2.1 Current status

Apart from equity and accumulated reserves and grants from the government, IDB's main sources of finance have been foreign lines of credit. Lenders include the World Bank, the German Development Bank, the Africa Development Bank, the European Development Bank, and other foreign-denominated lines of credit from Saudi Arabia, India, Korea and China. The Government of Kenya has guaranteed most of these advances.

Total sources of funds for the bank as at 31 December 1997 were Ksh 1.8 billion made up thus:

	Ksh (million)
paid-up share capital	258
reserves	465
grants	97
foreign lines of credit	547
write-off reserve	433
	1800

Of the total, only Ksh 880 million or 49% was invested in projects. The bank's profitability was Ksh 30 million, the equivalent of 4% of its capital and reserve base.

The government no longer invests in IDB because of the GoK move to stop investing in parastatals. In addition, GoK will no longer guarantee lines of credit. To address this problem, IDB tried to mobilize deposits but the response has not been very successful. Customer deposits have never exceeded Ksh 100 million and these have been declining. Although some success has been achieved in obtaining tied credits, IDB has continued facing difficulties in securing credit from foreign financiers, who have continued to demand government guarantees or the privatization of IDB to qualify for funding. Treasury has in recent years shown reluctance in extending this support. Nevertheless, IDB is still playing its development role, albeit in a small way compared with its past performance. In 1997, the bank approved investments in 10 projects for a total sum of Ksh 365 million compared with 16 projects totalling Ksh 495 million in 1996. The projects are well spread among the sectors of the economy including, tourism, engineering, mining and horticulture.

8.2.2 Constraints identified

Without government guarantees, IDB is finding it difficult to mobilize sufficient financial resources. In addition, the rapid depreciation of the shilling against hard currencies over the 1980s and 1990s caused the IDB loan portfolio to deteriorate rapidly. During this period, the value of the shilling depreciated from Ksh 21 to more than Ksh 70 to the dollar.

In 1991, to ameliorate this situation, the government agreed to assume the exchange exposure after freezing the rate as at 1 July 1989. However, this was not effected until June 1997, by which time the bank had realized high exchange losses, which eroded its balance sheet.

8.2.3 Proposed changes

In 1998, IDB was granted a banking licence to enable it to widen its services to include hire-purchase and leasing operations, stock and insurance brokerage, and investment and merchant banking services. It has already acquired premises in Bima House, where it intends to start providing selected commercial banking services. The bank will continue to cofinance projects with other financial institutions, and it will promote loan syndication services. Operations will continue being conducted in local and foreign currencies.

The commercial banking wing will assist the bank in accelerating the mobilization of local currency to minimize the exchange risk associated with foreign currency funds. To supplement long-term lending the bank will, to a limited extent, undertake short-term lending activities including provision of working capital and trade finance. Apart from limited liability companies, the bank will also extend its services to individuals and partnerships.

In pursuit of the government's undertaking in its Development Plan 1998–2000 to privatize strategic enterprises gradually, IDB management has explored various options for privatizing the bank. It has

recommended that both direct and indirect government shareholding in IDB be reduced to a maximum of 25%.

The management has further recommended that the bank's share capital be increased from the present Ksh 400 million (of which only 257.6 million is paid up) to Ksh 1 billion. This would satisfy the CBK requirement of a minimum of share capital of Ksh 500 million and give the bank the funds it badly needs to expand its operations.

If the proposal to privatize IDB is agreed, the government should allow the bank to identify and attract both local and foreign shareholders, as well as bilateral and multilateral lenders who will support the bank's developmental role.

Without deliberate government intervention and a reduction of government shareholding, IDB will find it increasingly impossible either to borrow or to attract new shareholders. Reputable institutions like the World Bank, the International Finance Corporation, the African Development Bank, and several other investment and import–export banks have categorically stated that they would favourably consider participating in IDB as shareholders or lenders, but only when it has been substantially privatized.

8.3 Industrial and Commercial Development Corporation

The Industrial and Commercial Development Corporation (ICDC) plays an important role in providing credit. In 1996, the corporation received 841 loan applications from its Nairobi and regional offices compared with 624 applications in 1995. It approved loans amounting to Ksh 364 million to 497 applicants, compared with Ksh 164 million to 233 applicants during the previous year. This is a high conversion rate for a DFI. ICDC is, however, having a problem with the quality of its portfolio as indicated by the high provisions made in 1996.

As at June 1996, the corporation in its efforts to privatize its equity investments had divested 27 of its companies, through pre-emption rights, competitive bidding and liquidations. The disposal of more companies is still being actively pursued.

ICDC was not able to respond to the questionnaire, or to make time available for an interview for this study.

8.3.1 Recommendations

While ICDC did not participate in this study, the central role that it has in developing commerce and industry warrants further comment and analysis.

Although the government has adopted a policy of divesting itself of parastatals, it should consider retaining the DFI concept. It is recommended that two such organizations be kept to specialize in industry, commerce, tourism and agriculture. We recommend that both ICDC and the Agricultural Finance Corporation be restructured to carry out these development roles. This can be achieved by selling government shares to give the controlling interest to local and international finance institutions.

The objective of this strategy would be:

- to continue with the current plan of spearheading investments in industry, commerce, tourism and agriculture
- to tap the resources of international development institutions and retain a specialized institution that can be an avenue for mobilizing project resources

- to give government an avenue to provide specific incentives for economic development outside the private sector, without retaining the powers of hiring or firing—functions that can be done more effectively by the board, which would be appointed by the shareholders, with the government being represented as a shareholder.

The above can be achieved by relaunching ICDC under a new statute.

8.4 Agricultural Finance Corporation

8.4.1 Legal and regulatory framework

In 1969 the Agricultural Finance Corporation (AFC) was reconstituted under the Agricultural Finance Act, Cap. 323, with wider powers and the responsibilities of the land agricultural bank. As a statutory body, AFC falls under the Office of the President and works in close consultation with the Ministry of Finance and Planning and the Ministry of Agriculture and Rural Development. The running of AFC is entrusted to a board of directors, which in turn administers the corporation through the managing director.

The functions of the corporation are to assist in developing agriculture and agricultural industries by making loans to farmers, cooperative societies, incorporated group representatives, private companies, public bodies, local authorities, and persons engaged in agriculture or agricultural industries. The corporation is not subject to the Companies Act or the Banking Act.

The AFC Act authorizes the corporation to borrow money or obtain credit either in Kenya or abroad subject to approval by the Treasury. The corporation can invest any surplus funds, after disbursing approved loans, with any public body. The Act, however, prohibits the corporation from borrowing an amount that would result in the corporation's total indebtedness, exceeding Ksh 300 million or a larger amount that the Treasury may, by notice in the Kenya Gazette, determine.

Parliament can also allocate the corporation loan capital from the Consolidated Fund. The government is paid interest at a rate to be determined by the Treasury. The corporation's board determines the terms and conditions of lending, including the interest rate, the security and the repayment terms. The interest rate has to be approved by the Minister of Finance.

The corporation may approve a loan to reduce or discharge an existing first mortgage if in the opinion of the board the terms of the mortgage are onerous. The loans can be made for a period of up to 30 years and can be secured by a first mortgage on land that the borrower owns. However, the board can waive the need for a first mortgage in favour of a registered memorandum of the loan under the Chattels Transfer Act, which would secure the loan and the interest on it by movable property.

The Act allows the corporation to recall a loan in case of default or if the loan has not been applied for the intended purpose. In case of default the corporation may, after due demand notice, without recourse to any court, take possession of or sell by public auction the mortgaged land upon such terms and conditions as the board may consider proper. The corporation is also allowed to bid for the land in a public auction.

8.4.2 Current status

Until the government's policy of allocating funds to parastatals from the Consolidated Fund was discontinued, AFC was the leading credit provider to the agriculture sector. With an outreach of 49 branches through out the country (table 10), the corporation was making a substantial contribution to agricultural development.

Table 10. Agricultural Finance Corporation branch network

Central Rift	North Rift	South Rift	Western	Nyanza	Eastern	Coast	Mt Kenya
Eldama	Eldoret	Bomet	Bungoma	Kisii	Kajiado	Garissa	Chogoria
Kabarnet	Iten	Kericho	Busia	Kisumu	Kiambu	Garsen	Embu
Maralal	Kapenguria	Kilgoris	Kakamega	Migori	Kitui	Kilifi	Karatina
Naivasha	Kapsabet	Molo	Kimilili	Oyugis	Limuru	Mombasa	Kerugoya
Nakuru	Kitale	Narok	Turbo	Siaya	Loitoktok	Ukunda	Marsabit
Nyahururu					Machakos	Voi	Meru
					Mandera		Murang'a
					Ngong		Nanyuki
					Thika		Nyeri
					Wajir		

Source: Agricultural Finance Corporation (data obtained from the return of an administered questionnaire)

Total AFC funds as at December 1997 stood at Ksh 2.2 billion, of which Ksh 130 million was in the form of grants. Loans to farmers stood at Ksh 3.6 billion, representing 74% of total assets. Most of the branches have not been advancing loans since the early 1990s but concentrate on debt collection. According to the balance sheet, AFC has a huge accumulation of interest and taxes payable, which it has not been able to service.

8.4.3 Financial services offered

As Kenya's largest single agricultural credit institution, AFC assists in developing agriculture and agricultural-based industries by making short-, medium- and long-term loans. Their maturity ranges from 1 to 30 years. The loans are classified as small-scale (less than Ksh 100,000) or large scale (greater than Ksh 100,000).

The corporation operates a wide range of loan types as follows:

- ***new seasonal crop credit loans*** for financing maize and wheat farming to farmers with at least 5 acres under crop in areas gazetted as high potential
- ***other seasonal crop production loans*** for financing cereals, cotton and potatoes
- ***mechanization loans*** for financing the purchase of tractors, vehicles and other agricultural machinery and equipment
- ***water development loans*** for financing irrigation and livestock development; the specific items financed are water tanks, wells, boreholes, equipment, pumps, irrigation equipment, small dams, and the labour and transportation related to installing the equipment
- ***livestock development loans*** for financing dairy and ranch development, pasture improvement and the keeping of poultry, sheep, goats, bees, and so on
- ***loans for plantation crops*** for financing farming of tea, coffee, sugarcane, pyrethrum, cashew nut, citrus and mango
- ***farm purchase loans*** for the purchase of farms including permanent improvements. The minimum size of a piece of land to be purchased is 2 acres. The title deed for the farm being purchased is charged as security. All applications must be supported by a sale agreement, Land Control Board approval, and land rate clearance certificate, where applicable

8.4.4 Constraints identified

AFC must have ministry approval to revise its interest rates. This creates a delay, and the corporation finds that it can not change rates in time to reflect market conditions. For example, in recent years the corporation charged 12% per annum while banks were charging over 20%. When the rates were finally increased to this level, the market had moved to over 30%. This situation creates excessive demand for loans. In addition, the lagging rates constrain AFC's ability to borrow needed loan funds from other sources for on-lending. Loans for reducing or discharging an existing onerous first mortgage potentially expose funds to abuse of refinancing expensive loans that generate no economic benefits and encourage corruption.

Section 15(1) restricts the corporation to seeking and getting its funds from government and donors. This requirement has constrained activities because these funds have not been adequate.

AFC is experiencing a high default rate. Its balance sheet shows repossessed land valued at Ksh 14.5 billion. This is more than double the amount of outstanding loans.

8.4.5 Recommendations

Agriculture continues to be a dominant sector in contributing to the GDP (about 27%) and employment. In view of this, the following recommendations are made to address the constraints identified above:

- As a first step towards revitalizing AFC, the repossessed land needs to be sold immediately. The government needs to resolve the administrative procedures hindering its disposal.
- Following restructuring of the financing of the corporation, the next step should be to repeal the AFC Act and allow the corporation to sell shares.

8.5 Comments

It can be argued that Kenya needs to retain some of its DFIs, as institutions involved in mobilizing foreign and local currency resources for financing long-term projects to improve economic development and support the policy to transform the country into a newly industrialized nation by the year 2020. Export-led industrial growth, to which Kenya is strongly committed, requires a high level of long-term industrial financing. Purchasing fixed assets, which yield returns over long periods, do as well.

There is an argument that long-term industrial financing can best be provided by DFIs, which can be used as intermediaries for donor and other development agencies to mobilize funds. DFIs have assisted in developing most sectors including manufacturing, tourism, agriculture and housing. Their exit would certainly open a gap in the provision of long-term funds. Even within the current liberalization regime, some measures should be taken to repackage these institutions so that they continue to play their strategic role in the new environment. It is clear that poor management has been largely responsible for destroying the credibility of DFIs. It is unfortunate that poor management has discredited the role these institutions have played and can continue to play.

In its Development Plan 1997–2001, the government has undertaken to facilitate access by DFIs to funds from savings institutions such as the National Social Security Fund (NSSF), the National Hospital Insurance Fund (NHIF), pension provident funds, and SACCOs, and channel these savings into long-term industrial investment lending. Savings from these institutions have, in the past, been invested heavily in government bonds and T-bills. Since the government is committed to reducing its borrowings to only about 5% of the gross domestic product, the excess savings will be available to finance industrialization.

In addition, the government has undertaken to encourage CBK to explore modalities through which it can directly provide financing for priority industries. The government therefore needs to design appropriate incentives to induce these savings institutions and other profit-taking enterprises to advance or deposit their surplus funds with strategic DFIs for long-term financing.

9 The mortgage market

Two types of housing finance institutions serve the mortgage market in Kenya: mortgage finance companies and building societies.

9.1 Mortgage finance companies

9.1.1 Legal and regulatory framework

The Banking Act defines a mortgage finance company (MFC) as 'a Company other than a financial institution which accepts from members of the public, money on deposit repayable on demand, and is established for the purpose of the acquisition, construction, improvement, development or alteration of land and for no other purpose'. Similarly an MFC must lend only for purchase, construction, improvement, alteration and adaptation of land.

The Banking Act allows only MFCs to grant loans or advances without a maximum limit but the MFC must always have a first mortgage over land. In addition, it may take other types of security. Following are the legal provisions that the Banking Act requires MFCs to observe:

- An MFC must place at least 75% of its loan portfolio in residential property.
- An MFC must use only security allowed by CBK in deciding the amount that may be lent.
- The institution can take other types of security but cannot use these to increase the amount lent.
- The minimum period of a loan may be prescribed by CBK.
- CBK can specify the maximum interest rate per annum (which must include all fees, charges, additions, etc.) that an MFC can charge.
- CBK can specify both maximum and minimum interest rates (including all inducements, additions, etc.) on deposits in MFCs.

In practice, however, CBK does not exercise the powers conferred by these sections.

9.1.2 Current status

I) INVESTMENT TRENDS

An analysis of the assets of HFCK, Savings and Loan, and EABS in table 11 shows that the majority of investment is mortgages and estate development, which account for about 53% of their total assets. It therefore appears that these institutions are leaving an excessive proportion of their assets (47%) outside their core business of mortgage finance. The explanation given for this is that, while the demand for housing is extremely high, the cost of a mortgage is beyond the reach of most people because of the high interest rates. The other problem is the current practice of allocating public land to intermediaries to sell to the mortgage companies, making land a speculative item rather than what it should be – a tool of development.

Table 11. Assets of housing finance institutions (Ksh million)

Asset	1994	1995	1996	1997
Mortgages	6,431	6,855	8,577	10,702
Estate development	405	694	553	505
Current assets	4,783	4,424	7,682	7,262
Total assets	11,619	11,973	16,812	18,469

Source: HFCK and EABS annual accounts (1994, 1995, 1996, 1997)
HFCK dominates the mortgage market, with its share of assets being 71% or over Ksh 7.6 billion in 1997.

II) DEPOSIT AND LOAN MISMATCH

Further analysis shows that these institutions overwhelmingly rely on public deposits, which are predominantly short term in nature. Statistics from CBK on the maturity profile of deposits and loans in MFCs clearly show the threatening problem of deposit-to-loan mismatch (table 12):

Table 12. Maturity profile of deposits and loans for mortgage finance companies

Maturity in years	1996		1997	
	Ksh billions	%	Ksh billions	%
		Deposits		
Up to 2 years	7.7	74.0	8.3	72.3
2–5 years	2.7	26.0	3.2	27.7
Over 5 years	0.0	0.0	0.0	0.0
Total deposits	10.4	100.0	11.5	100.0
		Loans and advances		
Up to 2 years	0.1	1.0	0.1	1.2
2–5 years	0.6	7.5	0.8	7.8
Over 5 years	7.3	91.5	9.0	91.0
Total loans	8.0	100.0	9.9	100.0

Source: Central Bank of Kenya (data obtained from the questionnaire completed by the CBK)

While no deposits had a maturity period of over 5 years, loans maturing in over 5 years accounted for over 90%. Loans showing a term of less than 5 years are reaching their maturity. The common term of mortgage loans is 15 years.

III) OTHER FINANCIAL SERVICES OFFERED

In addition to lending for the purchase and construction of commercial properties and plots in urban areas, mortgage finance companies provide a host of other related services:

- various savings accounts, including ordinary savings accounts, deposit accounts, children's accounts, provident or pension funds, and fixed-term deposit accounts
- 10 different types of housing development bonds with special tax advantages designed to channel funds into housing
- bearer certificates of deposit
- undertaking of bridge financing required for the completion of a housing project that an MFC has agreed to support after completion
- valuations of undeveloped plots, extensions and repairs, as well as valuations on behalf of companies that purchase or rent houses for employees or give housing allowances to staff
- professional opinion on the suitability of the location, design and pricing of the houses to be built

- undertaking of mortgage insurance arrangements on behalf of clients, including life insurance for borrowers, so that family members are protected and guaranteed ownership if a tragedy occurs
- setting up of a fund to enable employees to enjoy reduced mortgage interest rates for a company that wants to pass this benefit on to its employees (this product is, however, being threatened by the newly enacted Retirement Benefits Act, which will prohibit direct investment of pension funds in the mortgage market)

9.1.3 Constraints identified

Lack of a legal framework for establishing a secondary mortgage market limits the options for obtaining alternative sources of finance, although the Capital Markets Authority has indicated that housing bonds can be traded on the stock market. The current limit of Ksh 300,000 that attracts the waiver of withholding tax is considered inadequate to stimulate sufficient investments in these instruments.

The current practice in which a pension fund can enter into an arrangement with a mortgage company to provide mortgages to pension contributors at subsidized interest rates is being outlawed by the new Retirement Benefit Act, Section 38. This will precipitate a crisis because a fair amount of the outstanding mortgage facilities is based on pension fund schemes.

The Sectional Properties Act, which is meant to facilitate the issuance of titles for individual flats in a block of flats, is not yet operational. This constrains mortgage companies from financing the construction of flats.

Registration of properties is a cumbersome procedure, sometimes taking several months. The problem is more prevalent with municipal council land.

9.1.4 Recommendations

To address the mismatch between deposit and loan and to ensure that increased funds are provided for mortgage development, a secondary mortgage market is required. This can be achieved by encouraging the start up of an investment company with the main objective of developing the mortgage market. Such a company could purchase part of a portfolio of an MFC for use as security in raising long-term funds through the bonds market, which in turn would be invested back into the mortgage market to purchase additional assets.

The investment company would use the mortgage repayments to repay the bonds. The MFCs would be able to mobilize long-term funds by selling the existing portfolio to the investment company while earning extra transaction fees and charges and also spreading risk. Homeowners could benefit from increased mortgage duration periods and reduced interest rates, further enabling many potential homeowners to qualify for mortgages, thereby increasing the demand for mortgage finance, improving the quality and quantity of housing, and finally stimulating the construction industry.

Potential investors like pension funds and life insurance companies would get an opportunity to invest in long-term financial instruments that match their long-term resources. The capital market would diversify its tradable instruments. Development of a secondary mortgage market would be beneficial to investors, borrowers, financial institutions, homeowners and society in general.

To enhance the flow of the existing sources of long-term funds to finance the housing sector, the amount of housing bond that qualifies for withholding tax exemption should be raised from Ksh 300,000 to Ksh 1.5 million (the average cost of a housing unit for lower income groups).

The Retirement Benefit Act should be amended to facilitate investment by pension fund schemes in the mortgage market.

The Sectional Property Act should be amended to address the question of head title and individual flat titles. In addition, the title registration process should be streamlined to reduce time delays. This will require the authority concerned to conduct an audit of the entire process and determine where the bottlenecks occur. Other trust landowners like Nairobi City Council should create titles for large chunks of land whose holders do not have title, to facilitate development of housing units.

9.2 Building societies

9.2.1 Legal and regulatory framework

A building society, as defined in the Building Societies Act, means 'a society formed for the purpose of raising subscriptions from members to make advances to members, secured by land and registered in accordance with the Building Societies Act'.

Thus, a building society is 'a society of a special kind, formed and regulated under a particular Act of Parliament for special purposes'. The rights and liabilities of its members depend upon the contract into which they have entered, the terms of which are to be found in the rules of the society. A building society cannot be involved in banking or insurance, nor can it run unit trusts.

To be registered, a society is required to have 10 members who are ready to raise a share capital of Ksh 5 million. The members are generally of two classes:

- investing members, who merely pay their subscriptions and other contributions into the society and receive interest, dividends or bonuses; investing members may withdraw from the society on such terms as the rules prescribe
- borrowing members, who obtain an advance from the society on mortgage of freehold or leasehold estate and may at any time redeem their securities

A share in a building society is different from a share in a limited liability company. The share capital of a building society is fluid. Members of a society may withdraw their share but cannot transfer it to another person, whereas company shareholders may simply sell their share to someone else.

Since the Act, building societies are required to develop rules and regulations, which they submit to the Registrar together with the application for registration. The rules define the classes of shares:

- investment shares, which include fully paid shares and savings shares
- borrowing shares
- preferential shares (which most societies do not issue)

Investment shares receive dividends as may be payable in acccrdance with the rules. The board may at any time suspend the issue of shares, and may, upon not less than three months' notice in writing, cancel the holding and redeem such shares. Fully paid-up shares are usually reserved for founder members, who also form the board. Savings shares are reserved for other members of the public who invest with the building society. The shareholders are supposed to commit themselves to saving the agreed amount every month.

The rules give the board power at any time and without notice to limit the amount that may be withdrawn in any month. Subject to the foregoing and to the provisions of these rules, a member holding an investment share may withdraw the whole or any part of the net amount outstanding to the credit of the share account in the manner prescribed in the Act.

Borrowing shares are issued to applicants for new mortgage loans to qualify for membership of the society. They need not have been saving with the society before this. What is of interest to the society is the ability of the borrower to repay the money. Borrowing shares vary from one society to the other. One society stated the amount as Ksh 3000; another, Ksh 5000. The borrower share does not earn interest or dividends and cannot be withdrawn throughout the loan period.

Other than the share contribution, modem building societies raise deposits from members of the public for on-lending to society members. In Kenya, building societies are permitted to collect deposits and to raise funds by issuing loan stock.

Following the provisions of the Act, the societies must issue the following rules on deposits:

- The society may receive deposits or loans at interest from its members or from other persons to be applied to the purposes of the society at such rates of interest and upon such conditions as the board may from time to time determine.
- No deposits shall be received except upon condition that not less than one month's notice may be required before repayment or withdrawal.

The rules further state that the society may make advances to members out of its funds upon the security of land, with or without additional collateral or guarantees, and upon such terms and conditions as shall be prescribe by the board.

Because building societies are allowed to collect deposits, the Act requires that the Ministry of Finance license them only on recommendation of CBK.

9.2.2 Current status

In 1959, the East Africa Building Society (EABS) was the first such to be registered. Today only 4 are operational; 4 are dormant, 11 are under receivership and 2 were taken over by Consolidated Bank in 1989. The remaining 9, which were registered between 1993 and February 1998, are still waiting for their licenses to be processed. Considering the above statistics, it appears that the building societies have had a turbulent past and have thus made minimal impact in providing financial services.

An analysis of the audited accounts for four building societies revealed that the societies provide deposit accounts, savings shares and mortgage loans. In total, mortgage loans amounted to Ksh 1.5 billion with Ksh 1.1 billion of this being accounted for by EABS.

In 1997, savings mobilized by the four building societies amounted to Ksh 335 million. The societies depended mainly on deposits and housing bonds to finance their mortgage business. EABS mobilizes funds through the following instruments: fixed deposits, savings accounts, bearer certificates, and housing bonds. Of these four categories of deposit, fixed deposits account for 48% of total liabilities; bearer certificates and housing bonds follow in that order.

9.2.3 Constraints identified

The law that guides the registration and operations of building societies is the main reason for the various weaknesses noted in the societies. For instance, saving shareholders do not have equal status with other shareholders, introducing uncertainty to the holders of such shares. Further, the Act is silent on the rights of the investors in the savings share category. The holders of fully paid-up shares have leeway to exploit the situation to the detriment of the savings shares and the depositors.

One of the main constraints to the growth of building societies is the requirement of at least 10 founder members for registration. They must raise a share capital of Ksh 5 million and form a board of directors. Mobilizing this number of people to start a new business is no longer feasible in Kenya, as the trend is now in favour of family businesses with one person as the driving force in the enterprise.

9.2.4 Recommendations

It is recommended that the Building Society Act be amended as follows:

- Allow CBK to play a more active role in fostering the development of building societies. The role of the Registrar of Building Societies should be reduced to mere registration of a society while CBK regulates their trading activities. An amendment should require the building societies to file regular returns with CBK to facilitate regular monitoring. The Minister of Finance has addressed this issue through the 2000/2001 budget speech, in which he announced that since the societies have emerged as financial intermediaries, proposals will be brought to Parliament to bring building societies under the regulatory control of CBK. To ensure this, various amendments have been proposed to the Building Societies Act as well as to the Mortgage Companies Act to provide for key prudential ratios and also to give the CBK legal authority to supervise building societies.
- The Act should contain provisions that would give holders of savings shares voting rights.
- Share capital requirements should be raised to safeguard deposits.

10 The capital market

10.1 Legal and regulatory framework

The Capital Markets Authority Act, Cap 485A, sets out the legal and regulatory framework under which institutions of the capital market operate. The Act, which came into force on 15 December 1989, provided for the establishment of the Capital Markets Authority (CMA) as the regulatory body. The principal objectives of the authority as outlined under Section 11(1) of the Act are:

- development of all aspects of capital markets with particular emphasis on removing impediments to, and creating incentives for, long-term investments in productive enterprises
- facilitation of the existence of a nationwide system of stock brokerage services so as to enable wider participation of the general public in the stock market
- creation, maintenance and regulation (through implementation of a system where market participants are self-regulatory as much as possible) of a market in which securities can be issued and traded in an orderly, fair and efficient manner
- protection of investor interests
- operation of a compensation fund to protect investors from financial loss arising from the failure of a licensed broker or dealer to meet his contractual obligations

The Act gives CMA the following powers, duties and functions:

- to implement government policies and to advise the Minister of Finance on all aspects of the development and operation of the capital market

- to license capital market intermediaries and to conduct inspection of books of account and records
- to publish findings of malfeasance by a licensed intermediary or any public company, the securities of which are traded on an approved securities exchange
- to suspend or cancel the listing or trading of any securities for the protection of investors
- to grant compensation to any investor who suffers pecuniary loss resulting from the failure of a licensed broker or dealer to meet their contractual obligations
- to act as an appellate body for appeals from securities exchange actions by aggrieved parties
- to regulate and oversee the issue and subsequent trading in both primary and secondary markets of capital market instruments
- to do all such other Acts as may be incidental or conducive to the attainment of the objectives of the authority or the exercise of its powers under the Act

CMA has further been given power under Section 12 of the Act to formulate rules, in consultation with the Minister of Finance, as may be necessary to ensure an orderly, fair and efficient capital market.

The Act restricts foreign ownership of stock brokerage firms to 51% and investment adviser firms to 30%. Further, brokers are restricted from dealing.

The Act provides for the approval and licensing of the following institutions in the capital market: a securities exchange, stock brokers and dealers, investment advisers and unit trusts (currently inactive).

10.1.1 Financial products

The Capital Markets Authority Act provides for trading of the following capital market instruments: stocks and shares, bonds (corporate, Treasury and municipal). The authority has developed guidelines for issuing these products.

I) SHARES

Primary issue of shares at the Nairobi Stock Exchange (NSE) is a preserve of companies that meet the conditions for listing, as provided by NSE and approved by CMA. Some of the requirements that an issuer must meet are as follows:

- fully paid-up capital of not less than Ksh 20 million
- only one class of voting shares, which shall be the shares offered at the exchange
- not less than 20% of its paid-up share capital held by not less than 300 shareholders
- a profitability trend during the last 3 years immediately preceding the application of listing
- occupation in substantially the same businesses and under substantially the same management and shareholder control for the 3 years before the application

The CMA (Foreign Investors) Regulation No. 2 of 1992 provides that the shares purchased by foreign investors shall not exceed 40% in aggregate of the share capital of the issuer or listed company. The regulations also limit the shares to be purchased by single or joint foreign investors to not more than 5% of the total number of shares on offer.

In response to the special requirements of the market, the equity segment has been reorganized into the main investment market segment (MIMS) and the alternative investment market segment

(AIMS). MIMS will adapt the current listing requirements of NSE with appropriate changes to reflect the reorganization of the market.

Requirements for this market are:

- fully paid-up share capital of Ksh 50 million and net assets of Ksh 100 million before the public offering
- only one class of voting shares, which shall be the shares offered at the exchange
- at least 20% of the shares to be held by not less than 300 shareholders excluding employees of the company, following the public shares offering
- a profitability trend in at least three of the last five completed accounting periods preceding the date of the offer
- the latest audited and financial statements (not more than 3 months old) to comply with international accounting standards

II) BONDS

In practice, the issue of Treasury bonds and municipal bonds is backed by the name of the issuer. For corporate bonds, CMA has issued guidelines to be observed by all issuers. As in the case of shares, issuance of corporate bonds is the preserve of large companies that are able to meet the following conditions:

- paid-up share capital and reserves of Ksh 50 million, which should be maintained throughout the debt period. In the event that the issuer does not have the prescribed minimum paid-up capital and reserves, the issue should be backed by a financial guarantee obtained from a bank or any other approved institution
- record of 2 years of profitability in at least two of the last three accounting periods preceding the application for the issue
- total indebtedness, including the new issue of bonds, that does not exceed 40% of the company's net worth (or gearing ratio of 4:10) as at the date of the latest audited balance sheet
- funds from operations to total debt for the three trading periods preceding the issue to be maintained at a weighted average of 40% or more
- size of issue restricted to a minimum of Ksh 50 million and minimum issue lots of Ksh 100,000
- offer period restricted to 10 working days or such other period as CMA may approve

Although the Act has not provided for the trading of commercial paper in the capital market, CMA has issued guidelines similar in every respect to those applicable to a bond issue. The only difference is that for commercial paper, the minimum denomination is restricted to multiples of Ksh 1.0 million.

10.2 Current status

10.2.1 Policy incentives

Some incentives have been provided to encourage the development of capital markets including tax exemption for 10 years for approved venture capital funds. It is hoped that this will encourage the emergence of registered venture capital funds that will provide funds for new or expansion enterprises with good growth potential. Eventually the original promoters would exit by offering

shares on the stock exchange. In this way, the market would expand and ventures could have access to risk capital, which would help promote industrialization.

Incentives were also provided for both licensed dealers and insurance companies to encourage their participation in the market. Under the new policy, insurance companies will not be taxed on capital gains arising from trading in listed securities, which in effect puts them on the same standing with other institutional investors. The dealers in listed securities will also be exempted from tax on gains arising from trading in securities.

In addition, foreign brokerage and fund management firms will be allowed to participate in the domestic market through partnership with locally registered companies. This participation is expected to facilitate the transfer of skills and technology into local brokerage and fund management companies. This international exposure will also encourage portfolio investment in the domestic market and help position Kenya globally within competitive financial markets.

10.2.2 Stock market

By December 1999, 57 companies were listed at NSE. Companies that constitute the NSE 20 share index accounted for 83% of market turnover, 56% of market volume and 79% of market capitalization. Market concentration remains high. The top 10 companies accounted for 69% of total market capitalization in 1997 and 67% in 1998 and 1999.

The market for equities declined in 1998 and 1999 compared with 1997. Shares traded have declined by 30% in 2 years from 143 million in 1997 to 111 million in 1998 and 101 million in 1999. Turnover also declined during the same period, moving from Ksh 6.1 billion in 1997 to Ksh 4.58 billion (a decline of 25%) in 1998 before making some recovery in 1999 to settle at Ksh 5.07 billion (an increase of 10%). The NSE index weakened substantially by 11% in 2 years, moving from 3115 points in 1997 to 2962 in 1998 and standing at 2760 at the close of 1999.

Foreign turnover, which stood at Ksh 2.32 billion in 1997, declined by 50% to 1.16 billion in 1998 and by a further 3% to Ksh 1.12 billion in 1999. The ratio of foreign turnover to the market was 36.2% in 1997, 35.1% in 1998 and 21.7% in 1999. Much of foreign turnover in 1998 and 1999, however, represented net outflows as foreigners liquidated their positions owing to poor market performance and an unstable, declining shilling exchange rate.

The main structural challenge facing the market rises from the limited supply of securities and the substantial controlling interest in a number of the listed company shares, which are not available for trading. A significant proportion of tradable shares is also held by institutional investors such as insurance companies and pension funds, who rarely trade them because the supply of shares is limited..

10.2.3 Bond market

Equities have dominated the market and preceded the emergence of the corporate debt market. This segment of the market originally faced the constraints of no guidelines to regulate the issue of these instruments and high volatility in interest rates. CMA has since developed guidelines, and the first issue of East Africa Development Bank (EADB) bonds took place in 1996.

Originally, the guidelines restricted the issuance of commercial paper to listed companies. This restriction has since been reviewed and any company, provided it complies with the minimum conditions set out in the guidelines, may issue commercial paper. It is now expected that companies seeking to issue corporate bonds will list the instruments on the stock exchange.

The government introduced Treasury bonds in 1997 to shift short-term T-bills to long-term debt. The bonds were issued in tranches of Ksh 5 billion in each quarter. The Treasury and EADB bonds have provided unrivalled trading activities in the stock market with bond turnover recording Ksh 15.1 billion in 1997. This is nearly 2.5 times more than the amount recorded in the equities market during the same period.

The bond market is dominated by Treasury bonds, which increased from 3 in 1997 to 22 in 1999. Corporate bond listings are still limited. The 3-year EADB bond was redeemed in 1999 and a new 4-year bond was issued. Although guidelines are in place for corporate bonds, interest volatility continues to be a deterrent. Short-term commercial paper is preferred because of the lower risk premium.

Turnover in the bond market has declined substantially from Ksh 15.1 billion in 1997 to Ksh 8.1 billion in 1998 (45%) and further to Ksh 6.9 billion (15%) in 1999. It is interesting to note that bond turnover continues to decline amid more issues of Treasury bonds.

10.3 Constraints identified

10.3.1 Constraints in the stock market

The NSE listing requirements disqualify many medium-sized enterprises from seeking capital through the stock market. This is not unique to Kenya; it is true of most stock markets. Following recommendations by stakeholders, the eligibility constraint faced by medium-scale companies in gaining access to the market has now been addressed to some extent.

The alternative investment market segment has been launched and is tailored to facilitate access of medium-sized companies to the market. Proposed requirements include:

- fully paid-up capital of not less than Ksh 10 million and net assets of Ksh 20 million
- a minimum of 25 investors
- at least 20% of the paid-up capital after listing held by not less than the prescribed minimum number of investors, excluding employee and family holdings
- no investor to hold more than 3% of the shares above
- operation in substantially the same businesses and under substantially the same management and shareholder control for 2 years before the application

Restricting foreign investment was cited as a major constraint to the inflow of foreign funds to the stock market.

Brokers are restricted from dealing. There is opposition to this restriction from some brokers who argue that the regulation restricts dynamism in the market by not allowing them to buy shares that receive no offers during normal trading.

The Companies Act stipulates that a company shall issue a share certificate within 60 days after the date on which a transfer is lodged. To shorten this period, any company seeking a listing at the stock exchange has to undertake to effect share transfers within a period of 30 days. But 30 days is considered excessive, and it has been argued that liquidity and the level of business could be enhanced if a central depository and settlement (CDS) system were put in place. A CDS system would also reduce the risk of loss. A CDS system provides custodial services and acts as a bank for securities.

While the Capital Markets Authority Act allows a registered stock exchange to make its own rules, CMA has to approve such rules. Although this requirement is normal, brokers complain that some NSE rules have taken nearly 5 years to receive approval.

Several issues have been raised regarding the level of disclosure to be made in prospectuses. Most investors feel that the current level of disclosure is inadequate and that potential investors may be misled. On the other hand, there are those who think that the disclosure requirements are too complex and cumbersome. Many companies are afraid to apply for listing because of the fear of exposing past tax liabilities.

10.3.2 Constraints in the bond market

The main constraints to the development of the corporate bond market are the stringent issue requirements. Examples are the requirement that the minimum paid-up capital of the issuer be Ksh 50 million and the minimum value of the bond issue be Ksh 50 million.

Rating of debt also needs to be addressed before corporate debt can be developed as an effective market.

Local authorities, with a history of municipal bond default, attributed the absence of municipal bonds in the market to poor financial management. Nairobi City Council, for example, has defaulted on Ksh 200 million worth of bonds held by the National Social Security Fund.

10.4 Actions being implemented

The Capital Markets Authority is encouraging the entry of at least one rating agency to the market. In addition, to encourage the development of credit ratings, the government has allowed the costs of such a rating agency to be tax-deductible.

Establishing a CDS system has also been given high priority. The Central Depository and Settlement Corporation was incorporated in 1999. Seven shareholders: the NSE, stockbrokers, KCB, Apollo Insurance, Jubilee Insurance, Citibank and International Finance Corporation (IFC), have signed a shareholders agreement.

CMA, with financial assistance from the World Bank, commissioned a firm of consultants to draft an enabling bill to provide for creating the Kenya central depository system. The Central Depositories Bill was passed by Parliament in August 2000.

A critical challenge facing the market is the need to increase the supply of securities and the development of new financial instruments. CMA has identified the following measures, which could alleviate the situation:

- new private sector listings and privatization of parastatals
- review of the minimum public share issue for listing at NSE from the current level of 20% to 25% or higher
- encouragement of regional listings
- encouragement of securitization or issuance of asset-backed securities such as mortgage bonds

10.5 Recommendations

- It is essential for a stock exchange to be able to react rapidly to changing market conditions and new products. Section 21 of the CMA Act should be amended to allow a registered stock exchange to make or amend its rules after giving CMA sufficient notice to comment.

- The CMA disclosure rules should be amended to place the burden of disclosure on the issuer to ensure that material information, whether or not it is specifically required, is disclosed. The amendment should provide for sufficient penalties on the part of the issuer and its advisers to discourage wilful non-disclosure of significant information to potential investors.

- The CMA rules should be amended to require listed companies to disclose their dividend policy in the prospectus.
- There is pressure by some brokers to have Section 16A of the CMA Act (which prohibits brokers from buying shares in their own name) amended to allow brokerage firms to combine brokerage and dealing. They argue that the authority should develop a mechanism for monitoring the activities of brokers instead of banning them from dealing. Greater trading by brokers would enhance market liquidity and the proposed amendment should be introduced.
- The restriction of foreign investment in the capital market needs to be revisited, especially in view of the role that foreign direct investment could make as a catalyst for development.
- The conditions for issue of corporate bonds and commercial paper need to be relaxed to allow medium-sized companies to raise long-term capital.
- CBK should work with CMA to establish a rating agency, which is a necessity for developing bond and commercial paper markets.
- CMA needs to develop a legal and regulatory framework for unit trusts and merchant banks. This recommendation notes the initiatives already under way and urges their completion.

11 The insurance industry and pension funds

11.1 Legal and regulatory framework

The Insurance Act, Cap. 487, regulates the insurance industry. The Commissioner of Insurance is responsible for the general administration of this Act and the performance of all duties and functions assigned to the commissioner under the Act.

Members of the insurance industry include Kenya Reinsurance Corporation, East Africa Reinsurance Company, PTA Reinsurance Corporation, insurers, insurance brokers, loss assessors, insurance surveyors, loss adjusters, claims settling agents and risk managers. Currently the insurance industry cession rates are 18% for Kenya Re, 10% for PTA Re and 5% for Africa Re.

The insurance industry has formed a self-regulating body, the Association of Kenya Insurers (AKI), which has developed a code of conduct for its members. AKI is, however, not recognized by the Insurance Act and therefore is not able to enforce its self-regulatory mechanisms if a member refuses to cooperate.

The commissioner may, by notice in writing, require a member of the insurance industry to supply information about insurance business. The commissioner may also call upon the insurer to submit for examination all reinsurance treaties and any other reinsurance contracts entered into by the insurer. In addition, an investigation can be ordered if the commissioner has reason to believe that an offence has been committed, that insurance affairs are being conducted in a detrimental manner, or that an insurer may be unable to meet its obligations.

The commissioner has powers under the Act to require that an insurer conducting long-term business who has not issued a new policy for 12 months, transfer the business or amalgamate it with another insurer.

A person must be registered by the commissioner to operate an insurance business in Kenya. Only an incorporated company, where at least one-third of the controlling interest is local, can qualify for registration. At least one-third of the board of directors must be Kenyan citizens. In addition, a

company to be registered must have a paid-up capital of not less than Ksh 100 million in respect of general insurance and a further Ksh 50 million in respect of life insurance.

An insurer can be registered to transact any or all of the 4 classes of long-term insurance business: bond investments, industrial life assurance, ordinary life assurance, and super-annuation business. It may also be licensed to transact any or all of the 12 classes of general insurance business: aviation, engineering, fire (domestic), fire (industrial and commercial), liability, marine, motor (private), motor (commercial), personal accident, theft, workmen's compensation, and miscellaneous business.

The Act requires the insurer to maintain deposits with CBK of Ksh 1.0 million in respect of long-term business and Ksh 500,000 in respect of general business. These deposits cannot be refunded as long as the insurer remains in that business.

An insurer carrying out long-term business shall keep at all times admitted assets of not less than the aggregate value of its admitted liabilities plus Ksh 1.0 million. An insurer conducting general business shall keep at all times admitted assets of not less than the aggregate value of its admitted liabilities plus Ksh 10 million or 15% of its net premium income.

Subject to the above, the insurer shall, with sufficient consideration of security, liquidity and income, invest the assets of the company in Kenya in such manner as the insurer thinks fit as long as it is not in shares of another insurer. In addition, the admitted assets of an insurer carrying on long-term insurance business shall be invested and kept invested in the following manner:

a) 20% of the total admitted assets in one or more of the following securities:
- government
- prescribed statutory bodies
- local authorities

b) not less than 45% of the total admitted assets in one or more of the following:
- securities in (*a*) above
- mortgage on immovable property, debentures and shares of public-quoted companies, legal charges, loans on life assurance policies, deposits in financial institutions licensed under the Banking Act
- any other prescribed securities

c) the balance in such investments in Kenya as the insurer chooses; the deposit in any one institution is not to exceed 5% of the assets related to long-term business or 10% of general business

The admitted assets of an insurer carrying on general insurance business shall be invested and kept invested in the following manner:

d) 10% of the total admitted assets in one or more of (*a*) above

e) not less than 20% of the total admitted assets in one or more of (*b*) above

f) the balance in such investments in Kenya as the insurer chooses

An insurer is prohibited from investing directly or indirectly in a private company other than an institution licensed under the Banking Act. In addition, an insurer, in long-term insurance business shall not invest more than 5% of its total admitted assets in shares or debentures of any one company or group of companies. Similarly, an insurer shall not invest more than 10% of its total admitted assets related to general business in any one company or group of companies. An insurer shall not invest in more than 15% of the subscribed share capital of any one company.

11.2 Current status

As at 31 December 1997, there were 38 insurers with a premium income of Ksh 18.9 billion, out of which Ksh 15.3 billion was from general business and Ksh 3.6 billion or 19% from long-term insurance business. Fifteen of the insurers dealt only with general insurance while the remaining 23 dealt with both long-term and general business. The 5 largest insurers accounted for 40% of direct premium income. In addition, there were 491 registered agents in the industry.

Analysis of gross premium income indicates that the insurance industry has grown rapidly because of an increase in general business. Long-term business did not exhibit growth. In fact, several leading long-term insurers were classified as closed funds and were required to transfer their funds to other insurers or to amalgamate. These included Old Mutual, Cannon Assurance Limited, Prudential Assurance Company Limited and Norwich Union Life Insurance.

In 1995, the insurance industry was shocked by the collapse of Kenya National Assurance Limited, which in 1991 was the largest insurance company, representing 18% of the total assets held by the industry.

Gross direct premium written by long-term insurance business is a direct reflection of the long-term savings trend in a country. This trend, however, is not encouraging, as shown by table 13.

Table 13. Life and general insurance business, 1990–1997

Ksh millions	1990	1994	1997	Annual growth (%)
Long-term	1,511	1,910	3,570	15.5
General	4,362	10,336	18,864	23.2
Long-term percentage	25.7%	15.6%	15.9%	

Source: Commission of Insurance (annual reports of 1990, 1994 and 1997)

The slow growth in long-term business and the closings discussed above indicate that this segment of business is losing its impact on mobilizing long-term savings in the country. Table 14 shows the trend of investments by the insurance industry between 1990 and 1994:

Table 14. Insurance industry investments, 1990–1997 (Ksh millions)

	1990	%	1994	%	1997	%
Government securities	3,387	28.27	7,319	28.37	14,858	40.49
Bank deposits	2,862	23.90	7,896	30.60	8,222	22.41
Secured loans	2,720	22.70	2,303	8.93	2,486	6.77
Land and buildings	1,976	16.50	3,116	12.08	5,470	14.91
Shares	778	6.50	4,639	17.98	5,361	14.61
Other securities	223	1.86	480	1.86	258	0.70
Debentures	32	0.27	47	0.18	39	0.11
Total	11,978	100.00	25,800	100.00	36,694	100.00

Source: Commission of Insurance (annual reports)

The format for the 1997 annual report is different and therefore the groupings are slightly different. Other assets not included as investments for 1997 had a value of Ksh 20,963 million and included shares not quoted on the stock exchange, outstanding premiums, amounts due from reinsurers, accounts receivable, cash in hand and current accounts. The value of these assets for 1990 and 1994 was not available.

Table 14 shows that the investment in government securities is diverting funds from other areas. Between 1990 and 1994, investment in government securities had stabilized at about 28% while bank deposits increased from 24 to 30%, which indicates an increase in funds available for investment in the private sector. This trend was reversed in 1997 when investment in government securities increased to over 40% and bank deposits declined to 22%. This is explained by the availability of high-yielding T-bills, which were earning up to 27% at their peak in mid-1998. This trend will be reversed as yields on T-bills fall. The decline in secured loans from 22% in 1990 to 7% in 1997 can be interpreted as an indication of less long-term investment by the private sector, because of either the high cost of money or strong competition for funds.

11.3 Constraints identified

11.3.1 The role of the life insurance industry

The life insurance industry in Kenya is still in its infancy. It is not a popular form of investment for the general public, and the market is limited to a small section of the population, mainly employees in the formal sector. Promoting the life insurance business leads to generating long-term funds, which supplement the national economy by providing investment in capital and long-term projects.

From a national point of view, a thriving life market:

- provides a long-term source of finance
- directly and indirectly provides employment for a large number of people
- protects families
- encourages savings, which in turn promotes economic development

11.3.2 Need for incentives

Certain incentives are required to mobilize substantial long-term savings in individual and group pension schemes. In the past, the individual enjoyed tax relief of Ksh 2 per Ksh 20 of premium, subject to a maximum relief of Ksh 1,200 per annum. While this relief was very small compared with the average income of the middle class, it demonstrated the government's appreciation of the need to give incentives to encourage long-term savings through life insurance. Unfortunately, instead of increasing the relief the government has discontinued it and therefore discouraged this form of savings.

Many developing countries offer much better tax incentives through life insurance than Kenya does. A good example is India, where the government uses tax incentives to encourage life insurers to mobilize savings. The government allows tax relief of Rs 80,000 (Ksh 128,000) per annum for life, health and retirement schemes. Up to Rs 40,000 per annum (Ksh 64,000) of this is for life insurance only. This policy has dramatically changed savings patterns and has placed India among the countries with the highest savings ratios. Consequently, the Life Insurance Corporation of India is the largest investor in the India Stock Exchange.

While it is true that some developed countries have reduced the tax benefits offered to the life assured, it cannot be denied that those countries in the past offered attractive tax packages, which played an important role in mobilizing savings.

Currently, pension fund contributions still realize tax benefits. Pension fund contributions are at present limited to 30% of taxable earnings, subject to a maximum limit of Ksh 210,000. The insurance industry considers the monetary limit of contribution at Ksh 210,000 per annum to be restrictive and limits high wage earners from contributing more to these funds.

In Kenya, individual pension funds do not qualify for any incentives. This amounts to discrimination since benefits from an individual pension scheme are fully taxable, whereas under group schemes, part of the benefits are not taxable. In other countries, private pension funds are given the same incentives as corporate pension funds.

11.3.3 Restrictions on investment

In addition to a lack of incentives, the Insurance Act is too restrictive as to the type of investments that the insurance industry can make. For example, an insurance company must invest a minimum of 10% of its total life business assets in government bonds with a maturity of 2 or more years.

The Insurance Act also limits to 30% the proportion of life funds that can be distributed as dividends to policyholders or shareholders. Section 46(5) of the Act was amended to allow long-term insurers a free hand in deciding the percentage of the surplus of their statutory long-term fund to declare as dividends to shareholders. The Finance Act of 1996, however, again restricted the amount available for distribution to 20% of surpluses in the statutory fund. This pendulum swing of policies is seen by the insurance industry as a major constraint to foreign investment.

Section 50 of the Act sets out the proportions to be invested in various types of investments, hence providing a compulsory diversification. The section requires that if securities held in one of the mandatory sectors fall below the prescribed minimum, stocks in the buoyant sector have to be sold to purchase those from the poor sector. This requirement denies the industry the opportunity to maximize profits.

Similar compulsory diversification is not required of bank or self-administered pension funds. This is not treating banks and insurance companies equitably.

Thus, while the insurance industry should be a major source of long-term finance for private sector development, it is encumbered by the slow growth in long-term business caused by the lack of incentives and the overly restrictive Insurance Act.

11.3.4 Other pension fund managers

Others involved in the pension market include banks and pension-fund management companies. These have an unfair advantage over the insurance industry. Their operation in this area is not subject to the provisions under the Insurance Act of 1987, which includes certain restrictions on investments of the fund as well as allowing extensive supervisory powers by the Commissioner of Insurance. The following restrictions are placed on pension funds managed by insurance companies vis-à-vis those managed by non-insurance entities:

- The commissions payable to intermediaries (brokers and agents) are fixed by the Insurance Act for insurance-based pension funds whereas there is no similar restriction on funds managed by other entities. Consequently, non-insurance entities may, and often do, pay higher commissions and offer other inducements.
- A premium tax of 1% is applicable to insurance-based pension funds whereas there is no similar requirement for pension funds managed by other entities.

Both these requirements restrict competition between pension funds managed by insurance companies and those managed by other entities. The rationale for these provisions in the Insurance Act is difficult to comprehend. They have a negative impact on mobilizing long-term savings and on the entire industry from developing new products.

The current Retirement Benefits Act, which became law in 1997, restricted management of pension funds by insurance companies and necessitated their setting up management companies to conduct this line of business.

11.3.5 Other issues raised by the insurance industry

The industry is finding it increasingly difficult to bear the trend of awarding large settlements for motor vehicle accident cases. This phenomenon, which is relatively new to Kenya, has been witnessed in many other countries in the past. Some countries are taking remedial measures by incorporating a structured compensation system for motor vehicle accidents, workers' compensation and personal accident liabilities.

The liberalization allowing investments outside Kenya is a welcome move, although such investment is currently not accepted as admitted assets. In addition, the requirement that the commissioner sanction such investment also places insurers at a disadvantage because of time delays.

Section 19(9)(b) of the Income Tax Act, Cap. 470, introduced in the Finance Act 1992, prohibits carrying forward losses incurred by companies that underwrite long-term business. This is inequitable because during start-up, costs often exceed income, and without exception, life assurance companies suffer losses during their first 5 to 10 years of operation because of the front-end strain. Indeed, during the first years, the shareholders have to fund these losses. This prohibition represents another disincentive to the life and long-term insurance business.

Stakeholders in the insurance industry would prefer that after Kenya Re is privatized the current placing of treaty reinsurance should be restricted to a locally registered and incorporated reinsurer.

Health maintenance organizations have for a long time operated as insurance companies but have been incorporated under the Companies Act. These organizations need to be regulated to ensure that they remain solvent and able to meet their obligations.

The Retirement Benefits Act should provide for an option of allowing members to contract out of NSSF. Once members have chosen this option, they should be allowed to transfer their fund balances to the new scheme.

11.4 Recommendations

The Commissioner of Insurance is responsible for the general administration of the Insurance Act and the performance of all duties and functions assigned to that office under the Act. This administrative set-up places too much power in an individual for an industry that operates in a very dynamic environment. The stakeholders in this industry would prefer the industry to be regulated by an Insurance Regulatory Authority to be managed by a board. Current examples of this are the Capital Market Authority and the Retirement Benefits Authority. The board would be responsible for formulating policy and guiding the Commissioner of Insurance on all matters pertaining to the development of the insurance industry.

One of the primary roles of the insurance industry is to mobilize savings for investment in other sectors of the economy. Currently the commercial banks specialize in providing short-term loans and working capital finance. This type of finance is not suitable for capital projects, and commercial banks do not provide longer-term loans. In the past, development finance institutions provided a source for such funding, but as these are being transformed into banks, the gap to fill for long-term finance will widen. A thriving long-term insurance industry could be the source of such funds. Therefore, the long-term segment of the business needs to be revitalized.

Providing tax and other incentives to encourage the public to take out life insurance can do this. In addition, making the insurance business more profitable will encourage competition and enable the industry to develop industry-driven incentives through its products.

The measures recommended here should be considered towards achieving these objectives:

- It is proposed that life premium tax relief be reintroduced. To make it tax efficient and to encourage savings through life assurance, it is suggested that it be tied to 10% of the insured person's gross income. Such an incentive would make savings through life insurance policies attractive and reverse the current declining trend. The insurance industry argues that reduced tax revenue in the short term will be more than compensated by taxes that the insurers pay in the long term and other revenue generated from businesses. Such revenues, however, will emerge over time.
- In relation to pension funds, the Retirement Benefits Act should be amended to remove the restriction on the insurance industry from managing such funds. This will enable the industry to compete directly with the other fund managers without having to set up subsidiary companies to do so, thus reducing costs and duplication of efforts.
- Contributions to pension funds are limited to 30% of the employee's taxable earnings, subject to a maximum limit of Ksh 210,000 per annum. It is recommended that the maximum not be capped, allowing for the full 30% as a deduction. In addition, the total lump sum payable on retirement should be exempt from tax.
- The Insurance Act should be amended to provide standard incentives for both corporate and individual pension funds. As discussed in other parts of this report, small enterprises employing three to five people are the largest providers of jobs. These employees should also be encouraged to plan for their retirement through individual pension schemes.
- It is recommended that Section 50 of the Insurance Act (which prescribes the areas of investment of surplus funds by insurance companies) be repealed to treat insurance companies in a like manner as pension fund managers. The only prudential policy to be applied should be limited to strict monitoring of the admitted assets, proper gearing and maintenance of stable liquidity ratios. The industry should be deregulated to enable investing surplus funds in the assets that generate the best returns.
- Section 48 of the Insurance Act requires that the Commissioner of Insurance approve investment in overseas securities. The liberalization of foreign exchange has removed such controls from all other investors, who can invest up to US$500,000 without regulatory approval. This requirement puts the insurance companies at a disadvantage. Section 48 of the Act should be repealed.
- The Association of Kenya Insurers should be recognized by law to enable it to enforce higher professionalism in the industry through self-regulation. Law in Uganda and Nigeria recognizes similar associations.

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Chattels Mortgage Act, Cap. 28. Revised edition 1981 (1962)
Companies Act
Co-operative Societies Act, 1997
Finance Act
Hire-Purchase Act, Cap. 507. Revised edition 1982 (1970)
Income Tax Act
Industrial and Commercial Development Corporation Act, Cap. 445. Revised edition 1983 (1962)
Industrial Development Bank Act
Insurance Act, Cap. 487. Revised edition 1988
Kenya Post Office Savings Bank Act, Cap. 493B 1978
Land Control Act
Non Governmental Organizations Co-ordination Act
Pensions Act, Cap. 189
Provident Fund Act, Cap. 191. Revised edition 1982 (1962)
Retirement Benefits Act, 1997
State Corporations Act, 1987, Cap. 446
Traffic Act, Cap. 403
Unit Trust Act, Cap. 521. Revised edition 1991 (1967)

Appendix 1

Review panel for deregulation of financial services

The following attended the Review Panel Meeting held at the Safari Club on 30 March 1999. They also gave feedback on the draft resolutions agreed at that meeting. Their assistance and advice are gratefully appreciated.

Mr Salim Abdalla
Deputy Risk Management Director
Barclays Bank of Kenya Ltd

Mr Tom Chemjore
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Mr David Ferrand
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SSJKE Division
Ministry of Planning & National Development

Mrs W Karingithi
Head, Deregulation Section
Ministry of Planning & National Development

Mr J K Kihumba
Chief Executive
Nairobi Stock Exchange

Mr J M Kitili
Deputy Director, Banking Supervision Dept
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A N Koigi
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Mrs C Kola
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National Bank of Kenya

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Personal Assistant to the MD
Co-operative Bank of Kenya

Mr S M Ngaine
Chairman
Association of Kenya Stockbrokers

J K Njenga
Chief Manager, Advances
Housing Finance Company of Kenya

Mr Nyanjwa
Micro-Finance Department
Central Bank of Kenya

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Consultant, Deregulation Section
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Mr M Wekesa
Deregulation Section
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Appendix 2

Discussion of the Land Control Act, Cap. 302

The Land Control Act, Cap. 302, is an Act of Parliament for controlling transactions in agricultural land. It went into effect on 12 December 1967.

Under the Act, agricultural land is defined as any land that is not within a municipality, township or market. The Minister of Planning and National Development (now the Ministry of Finance and Planning) can declare an area in a city or municipality as agricultural land by notice in the Gazette. The minister can also establish a land control board for every land control area or, where the land is divided into divisions, for each division.

The following transactions are void unless the land control board for the area or division in which the land is situated has given its consent in respect of that transaction:

- the sale, transfer, lease, mortgage, exchange, partition or other disposal of or dealing with any agricultural land that is situated within a land control area
- a division of such agricultural land into two or more parcels to be held under separate titles
- the issue, sale, transfer, mortgage, or other disposal of or dealing with any shares in a private company or cooperative society that for the time being owns agricultural land situated within a land control area

The restrictions do not apply to transmission of land by virtue of the will or intestacy of a deceased person unless that transmission would result in the division of the land into two or more parcels to be held under separate title.

An application for consent in respect of a controlled transaction shall be made to the appropriate land control board within 6 months of the making of the agreement for the controlled transaction. Any extension of the 6 months duration can be extended only by the High Court.

The land control board shall either give or refuse its consent to the controlled transaction and, subject to any right of appeal under the Act; its decision shall be final and conclusive and shall not be questionable in any court.

In deciding whether to grant or refuse to consent in respect of a controlled transaction, a land control board shall:

1 Consider the effect that the grant or refusal is likely to have on the economic development of the land concerned or on the maintenance or improvement of standard of good husbandry within the land control area

2 Act on the principle that consent ought generally to be refused where:

- the person to whom the land is to be disposed of:
  - is unlikely to farm the land well or to develop it adequately
  - is unlikely to be able to use the land profitably for the intended purpose owing to its nature
  - already has sufficient agriculture land
- the person to whom the shares of a private company owning agricultural land (which is the subject of a controlled transaction) are to be transferred:
  - already has sufficient shares in a private company or cooperative society owning agricultural land
  - would, by acquiring the shares, be likely to bring about the transfer of the control of the company or society from one person to another and the transfer would be likely to lower the standard of good husbandry on the land
- the terms and conditions of the transaction, including the price to be paid, are markedly unfair or disadvantageous to one of the parties to the transaction
- in the case of the division of land into two or more parcels, the division would be likely to reduce the productivity of the land

3 Refuse consent in all cases in which land or shares in a private company owning land are to be disposed of by way of sale, transfer, lease, exchange or partition to a person who is not:

- a citizen of Kenya

- a private company or cooperative society, all of whose members are citizens of Kenya
- a group of representatives incorporated under the Land (group representatives) Act
- a state corporation

Where a land control board refuses to grant consent in respect of a controlled transaction, the applicant may, within 30 days of the board's decision being delivered or posted, appeal to the Provincial Land Control Appeals Board for the province in which the land in question is situated.
The person whose appeal has been dismissed by a Provincial Land Control Appeal Board may, within 30 days of the copy of the board's decision being delivered or posted, appeal to the Central Land Appeals Board. The decision of this board is final and conclusive and shall not be questionable in any court.
The President may, by notice in the Gazette, exempt any land or shares, or any class of land or shares or any controlled transaction, or any person in respect of a controlled transaction, or some classes of controlled transaction, from all or any of the provisions of this Act.
A mortgage of land in favour of the following bodies is exempted:

- the Land and Agriculture Bank of Kenya
- the Agricultural Finance Corporation
- the Agricultural Settlement Trust
- the Commissioner of Income Tax
- Lands Limited

Issues

This Act is a major constraint for rural borrowers who wish to use their land as collateral to secure a loan. The following points are put forward in support of this argument.

1. Currently, financial institutions accept agricultural land as security on a very selective basis. They all give the conditions imposed by this Act as the main reason that they reject title deeds for agricultural land as viable collateral for loans. In addition, they cite the obstruction by communities to allow lenders to seize such collateral.

2. The composition of land control boards does not guarantee the sufficient level of expertise required to make decisions on when to sell, transfer, lease, mortgage, or subdivide land into separate titles.

3. The application procedure, the decision-making process, and the appeals procedure are all cumbersome and time consuming. Processing loans therefore takes too long and borrowers are not able to obtain funds when they need them.

4. The Act assumes that property owners in rural areas are incapable of making rational decisions in relation to agricultural land. While it is accepted that the original motivation for the Act was to protect and enhance African control over agricultural land, it is argued that the Act has outlived its usefulness and now constitutes a significant barrier to economic development and poverty reduction.

5. To refuse consent to dispose of land because the prospective buyer is unlikely to farm the land well or to develop it adequately or to use the land profitably for the intended purpose implies the ability to see into the future.

6. The Act discriminates against agricultural land, as similar limitations are not put on urban land.

7. The Act does not provide guidelines on what is considered to be enough land. The absence of objective criteria and guidelines introduces subjectivity and the possibility of abuse of power.

8. When are shares in a private company or a cooperative society owning agricultural land sufficient to deny consent to a transaction? There are no such restrictions for private companies or cooperative societies in urban areas.

9. What competence does a land control board have to determine when a transfer of shares would lower the standard of good husbandry of the land?

10. The Act does exempt specified bodies regarding mortgages. If the Act cannot be repealed, it should be amended to provide that financial institutions be similarly exempted.

11 Finally, the Act gives land control boards too much discretion. Without objective criteria scope occurs for corruption and abuse of power.

Concluding remarks

The strength of opinion on this issue from respondents to the survey questionnaire was overwhelming. None of the other issues considered in this report generated opinions held with anything approaching the same conviction. Indeed, the Deregulation Section has yet to encounter any issue on which such an overwhelming consensus was so evident.

Recommendation

We support and fully endorse the recommendation to repeal this Act. It introduces distortions and is a major barrier to the ability of landowners to provide collateral for loans that they need. The impact that the repeal of this Act would have on access to credit is immense.

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