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Rural Financial Services in Kenya: What is Working and Why?

by Betty Kibaara

This paper was chosen through an open call for research in rural finance, whereby the selected individuals were invited to Rome, Italy, to share their results during the conference and to discuss key issues in shaping the rural finance research agenda as well as ways of strengthening the ties between research, policy and practice.

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Abstract

Access to rural financial services has a potential to make a difference in agricultural productivity, food security and poverty reduction. However, an efficient, sustainable and widely accessible rural financial system remains a major development challenge in most Sub Sahara African countries. In the late 1990's, most mainstream commercial banks closed down the rural branches in order to cut costs and improve profits. Since then, a number of non-traditional financial institutions have emerged to fill the gap created by the mainstream banks which locked out low income and irregular earners. The study looks at the emerging and innovative rural finance models in the rural Kenya.

Key Words: rural finance, agricultural credit, Agricultural Finance Corporation, credit voucher system, village banks, market day loans, beach banks

Introduction

Agriculture contributes 23.9 percent of the national Gross Domestic Product (GDP) and 60 percent of the total export earnings. In addition, 80 percent of the population derives their livelihood from agriculture. However, agriculture has experienced low productivity in the past decade. The Poverty Reduction Strategy Paper (PRSP) prioritized agriculture and rural development sector as one of the key sectors that needs urgent intervention. In order to attain the targeted five percent annual growth in this sector, financial systems, extension services, rural infrastructure, marketing and distribution systems need to be

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addressed. Promoting an efficient, sustainable and widely accessible rural financial systems remains a major development challenge in most sub Sahara African countries. With about 73% of Africa's population living in the rural areas and experiencing a high incidence of rural poverty, improved rural finance is crucial in achieving pro-poor growth and poverty reduction goals. However, the development of rural financial systems is hampered by the high cost of delivering the services to small, widely dispersed customers; as well as a difficult financial terrain – characterized by high covariant risks, missing markets for risk management instruments and lack of suitable collateral (Onumah, 2002).

Lack of working capital and low liquidity limit the farmer's ability to purchase productivity enhancing inputs like seeds, fertilizers and pesticide. In spite of the relatively high adoption rates of inputs like fertilizers, the quantities used are low and therefore, hybrid variety crops that are dependent on fertilizers may not attain their potential production (Nyoro, 2002). The average production efficiency levels are higher among producers who have access to formal credit (Awudu and Richard, 2001). Access to credit results to higher technical efficiency in maize production in Kenya (Kibaara, 2005).

Kenya has not developed a comprehensive rural financial services strategy. The rural financial sector is governed by the Banking Act, Building Society Act and the Post Bank Act. The proposed SACCO Societies Regulatory bill 2004 is still to be debated in parliament. Through the Economic Recovery Strategy for Wealth and Employment Creation (ERSWC) the government has identified poor access to farm credit and financial services as a contributing factor to the decline in agricultural productivity. The Strategy for Revitalizing Agriculture (SRA) proposes to encourage an orderly development of micro-finance institutions through the enactment of facilitative legislation, encourage

commercial banks to set up operations in the rural areas by providing appropriate incentives, encourage banks to lend to agriculture by reviewing and repealing legal provisions that have undermined lending to the sector, recapitalize and streamline the management of Agricultural Finance Corporation so that it can perform its function of providing affordable credit to farmers (Republic of Kenya, 2004). As a follow up on SRA, the Agricultural Sector Co-ordination Unit (ASCU) has fast tracked the rural financial services by establishing a thematic group on inputs and rural financial services with an overall objective of developing an Integrated Farm Input Strategy.

Rural financial services refer to financial services extended to agricultural and non-agricultural activities in rural areas; these include money deposit/savings, loans, money transfer, safe deposit and insurance. Demanders/beneficiaries of rural financial services are mainly households, producers, input stockists/suppliers, traders, agro-processors and service providers. Rural financial services help the poor and low income households increase their incomes and build the assets that allow them to mitigate risk, smoothen consumption, plan for future, increase food consumption, invest in education and other lifecycle needs. In spite of the importance of a savings account, 77 percent of Kenyan households have no access to a bank account (Kodhek, 2003). In the late 1990's, most mainstream commercial banks closed down some rural branches in order to cut costs and improve profits. The non-traditional financial institutions have emerged to fill the gap created by the mainstream banks which locked out low income and irregular earners.

The primary objective of this study was to examine the evolving models of rural financial service providers with a broad aim of understanding models that are working, why they are working, characteristics, opportunities and constraints. The study seeks to

answer the following research questions; Are there success cases in the provision of rural financial services? What are the characteristics of rural financial service providers? What are the challenges and opportunities? How can the success cases be replicated and up-scaled? Who is accessing rural financial services and at what cost?

This study utilized data from primary and secondary sources. Secondary data was gathered during the discussions with stakeholders from the rural finance. Primary data on the emerging models were gathered purposively from 15 districts in Kenya. The rural financiers were interviewed using a structured checklist that covers the history of the organization, operations, outreach, costs, performance indicators, financial services provided, socio-economic characteristic of the client, requirements, use of loans, transaction charges, default rates, sustainability, constraints, opportunities among others . In addition, the study uses supplementary data from the Tegemeo Agricultural Monitoring Project Analysis (TAMPA) panel data. This is cross-sectional household panel (2000 and 2004) comprising of 1540 rural households.

The Role of Rural Credit in Increasing Agricultural Productivity

Credit is an important input into the production system and it contributes to increased food productivity. Households that received credit for maize production had a higher productivity averaging 7.65 bags per acre as compared to 6.5 bags per acre among households that did not receive credit (Table 1). Access to credit increases the farmers' working capital enabling the farmers to buy productivity enhancing inputs such as good quality seeds, fertilizers and chemicals.

Table 1: Maize Productivity and Access to Agricultural Credit, 2004

| Agricultural credit | Mean Yield in bags ¹ per acre | Standard Deviation |
|---------------------|--|--------------------|
| Received | 7.88 | 6.45 |
| Did not receive | 6.50 | 6.08 |

Source: Tegemeo household survey, 2004

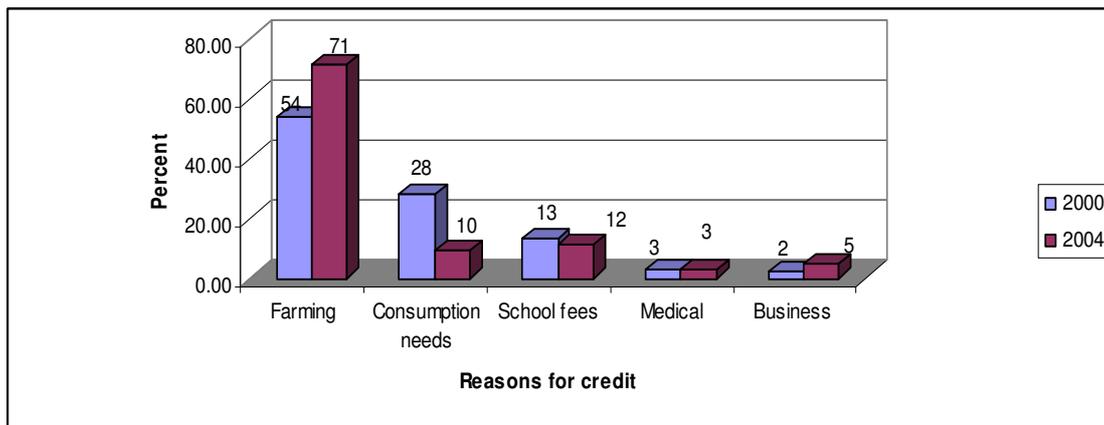
These results were subjected to *Levene test of equality of variance* and an evaluation of t-statistics shows that there is an overall statistical significant (at 1% significance level) difference between maize productivity among households with and without credit.

Demand and Supply of Rural Credit

Data from the 2004 Tegemeo survey shows that only 39% of the households sought credit and 82% of these actually received credit applied for. The main reasons for trying to access credit were farming, consumption needs, school fees, medical and business. Figure 1 compares levels of demand for credit in 2000 and 2004. Credit for farming purposes remains the most dominant need because majority of the rural households, derive their livelihood from agriculture. Demand for agricultural credit has increased from 53.71% in 2000 to 71.15% in 2004. However, 62% of those that sought agricultural credit did not actually receive. Most farmers do not get the required credit partly due to the risky nature of rain-fed agricultural farming.

Figure 1: Reasons for seeking credit

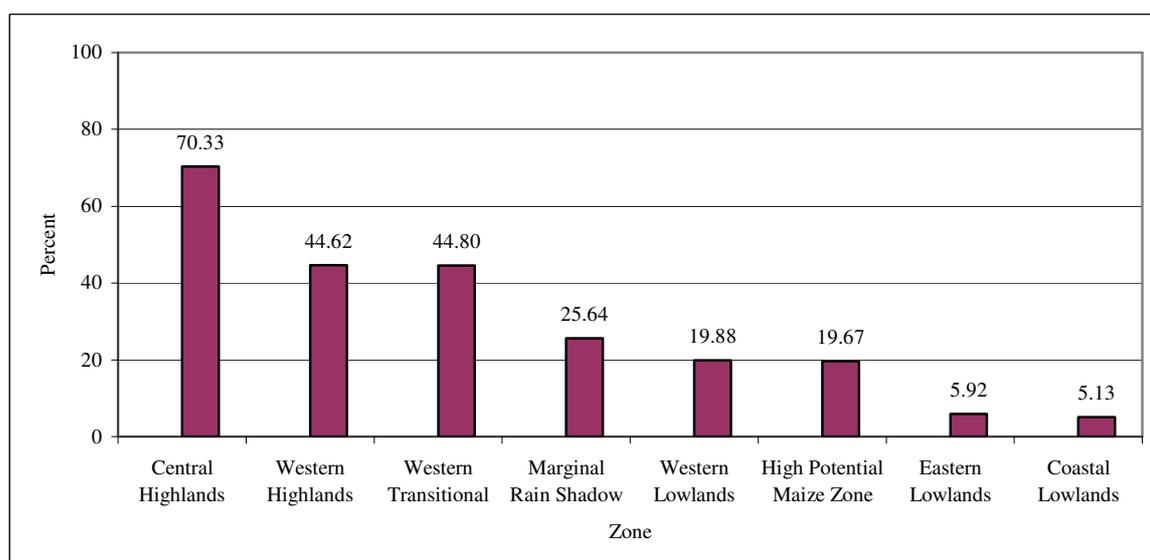
¹ Bag weighs 90 kilograms



Source: Tegemeo household survey, 2000 and 2004

Access to agricultural credit in Kenya is skewed towards the more productive agro-ecological zones (Fig 2). Households in the high potential areas have more access to credit as a result of embedded credit component for the perennial crops such as sugar, coffee and tea.

Figure 2: Percent of rural households that obtained credit by region in 2004



Source: Tegemeo household survey, 2004

Supply of Agricultural Credit

The supply of agricultural credit is dominated by commodity based credit providers/companies who promote Tea, Sugarcane and horticultural crops production. Provision of credit by the commodity based credit providers has increased from 53.5% in 2000 to 62.7% in 2004 (Table 2). This shows that the role of contracted farming in provision of embedded services such as credit for agricultural inputs has become increasingly important. The savings and credit co-operatives (SACCOs) remain a significant supplier of agricultural credit and especially in the Central Highlands and Western Transitional zones. However, the SACCOs market share has slightly declined from 25% in 2000 to 20.6% in 2004 partly because of spillover effect of wrangles and mismanagement of SACCOs.

Table 2: Source of Agricultural Credit

| Source of credit | 2000 | 2004 |
|-------------------------------------|-------|-------|
| Commodity Based Credit Providers | 53.5% | 62.7% |
| SACCOs | 26.0% | 20.6% |
| Informal money lenders ² | 12.1% | 9.9% |
| Local trader/input stockists | 6.8% | 3.9% |
| AFC | 0.4% | 1.3% |
| Commercial banks | 0.6% | 1.0% |
| MFIs/ NGOs | 0.6% | 0.5% |
| | 100%% | 100% |

Source: Tegemeo household survey, 2000 and 2004

Jointly, the informal money lenders and local traders/input stockists are more important than the formal commercial banking institutions, providing 20% of the agricultural credit to the rural households in Kenya. The government owned Agricultural Finance Corporation has increased its agricultural credit provision from 0.4% in 2000 to 1.3% in

² Informal money lender includes shylocks, self help groups, merry-go-rounds, community associations

2004. This gain is partly attributed to financial revamp by the government and the current restructuring of the institution. Provision of agricultural credit through the mainstream commercial banks has increased slightly as a result of recent innovative products associated with retail banking such as loans to tea and dairy farmers. In addition, there is reduced bureaucracy, excess liquidity as investment opportunities are thinned following the reduction of government/treasury bills which was estimated to contribute 50% of the bank's income. However, the commercial bank's contribution to agricultural credit is insignificant. The Micro Finance Institutions (MFIs) provide agricultural credit to a mere 0.6% of the rural households. MFIs have been in existence for the last 20 years, focusing on the economically active poor/entrepreneurs and have played a pivotal role in helping the low-income earners access non-agricultural loans.

Characteristics of the Households that Received Agricultural Credit

The Tegemeo household survey 2004 shows that 92.30% of households that received credit had at least one family member belonging to a group (self help, producer, co-operative). Among households that did not receive credit, only 67% were in some form of groups. Household assets act as collateral for loan repayment. Table 3 shows that households that received agricultural credit were better off than those that did not.

Table 3: Characteristics of households that received credit, 2004

| Indicator | Received Agricultural Credit | |
|--|-------------------------------------|-----------|
| | Yes | No |
| % of households that received agricultural credit | 32% | 68% |
| Households that Belongs to a group | 92.30% | 67.60% |
| Asset Value in Ksh ³ | 264,678 | 170,994 |
| Annual Household Income in Ksh | 189,037 | 147,469 |
| <u>Incomes by Quartiles in Ksh</u> | | |
| <i>Lowest</i> | 24,818 (23%)* | 25,227 |
| <i>Second lowest</i> | 76,356(33%)* | 76,221 |
| <i>Third lowest</i> | 141,988(33%)* | 142,774 |
| <i>Highest</i> | 399,107(39%)* | 384,170 |
| % engaged of household head in off-farm activities | 36% | 34% |
| Education level | | |
| <i>No formal education</i> | 16% | 23% |
| <i>Primary</i> | 52% | 52% |
| <i>Secondary</i> | 23% | 19% |
| <i>Post secondary</i> | 6% | 5% |
| Gender of the Household Head | | |
| <i>Male -headed</i> | 32.90% | 67.06% |
| <i>Female-headed</i> | 27.50% | 72.54% |

Source: Tegemeo household survey, 2004

*The values in bracket shows the percentage of households that received agricultural credit within the quartile

Emerging Models of Rural Financing

This section details selected emerging rural finance models such as Community Owned Rural Finance Model, Private Commercial Bank Led Model, Government Led Rural Finance Model, Credit Guarantee-Input Supply Model and the Beach Banking Model.

³Ksh =Unit of Kenyan currency (i.e Kenya shillings), 70 Ksh=1 US Dollar

Community Owned Rural Finance Model

The community owned rural finance model is owned and managed by the rural community with assistance from the donor agency. The community forms registered associations. Membership is through purchase of shares in the associations. The objective of this model is to reduce poverty through improved access to financial services mainly in the low population density areas with high incidences of poverty such as parts of Eastern and Western Lowland regions. The main beneficiaries are the low and medium income population who has few alternatives to financial services. Examples of this model are Financial Service Associations and the church based Mbeu Savings and Credit Association.

Financial Service Associations

The Financial Services Associations (FSA) are also referred to as '*village banks*' and are mainly promoted by K-rep development agency. The association is registered as a self help group under the Ministry of Culture and Social Services. Membership is acquired through purchase of at least one share at a cost ranging from Ksh. 300 to Ksh. 400. For the model to be operational, it requires a minimum of 300 shareholders. The community contributes towards the share capital and setting up of a physical financial transaction structure that acts as a 'banking' hall. The cost of setting up a physical structure ranges between Ksh. 100,000 and Ksh. 400,000. The donor agency contributes towards institutionalization (building, furniture, insurance, audit fee) and capacity building. The agency has a clear exit strategy. The FSA is run by a board of directors comprising eight members who are elected annually in a general meeting. The agency monitors the

activities of the FSA and has formed Regional Management Companies (RMC) to provide management expertise. RMC charge a fixed rate of 15% of the net revenue (though this may vary between FSAs). The day to day activities are run by lean and low income earning staff members from the community.

The main financial services offered are; compulsory savings, voluntary savings, fixed deposit, money transfer, business loans, agricultural loans, education loans, emergency loans and safe deposit. The financial services are open to the non-shareholders at a higher fee. Each FSA operates a bank account with a link mainstream bank located in the nearest town center where surplus money is deposited and money transfer is transacted. Members interested in borrowing loans are required to be members of a primary group. Six primary groups form a secondary group. The group members scrutinize the borrower and also guarantee to repay the loan in case of default. The borrower is loaned three times the amount of accumulated shares. The loan attracts an interest rate ranging between 3% and 7% per month on reducing balance, depending on the loan type, repayment and credit history. The loans are insured at a small fee averaging Ksh. 80 per month. The monthly revenue per village bank averages Ksh. 100,000 and the expenditure is about Ksh. 50,000. This shows the FSAs are making some reasonable amounts of profit.

The number of FSAs have grown by 105% from 34 (1999) to 70 (2005). The FSAs have registered a 2233% growth in number of savers from 3000 in 1999 to 70,000 in 2005. The rural poor have mobilized a total of Ksh.82 millions through shareholding. As at December 2005, the value of savings was Ksh. 1.3 billion while cumulative disbursed loan was Ksh. 524 million (Table 4).

Table 4: Financial Service Association Statistics, 1999-2005

| Year | No. of shareholders | Shares capital in Ksh. Millions | loans in Ksh. Millions | No. of savers | Saving in Ksh. Millions | Average savings/member (Ksh) | Average loan/member (Ksh) |
|------|---------------------|---------------------------------|------------------------|---------------|-------------------------|------------------------------|---------------------------|
| 1999 | 12,958 | 7 | 9 | 3,833 | 8 | 2,087 | 4,284 |
| 2000 | 21,686 | 17 | 38 | 10,620 | 49 | 4,614 | 5,685 |
| 2001 | 27,377 | 30 | 101 | 16,137 | 125 | 7,746 | 7,011 |
| 2002 | 33,978 | 36 | 163 | 19,369 | 264 | 13,630 | 8,506 |
| 2003 | 42,148 | 48 | 236 | 25,199 | 438 | 17,382 | 8,660 |
| 2004 | 52,925 | 67 | 329 | 35,372 | 677 | 19,139 | 8,590 |
| 2005 | 58,897 | 82 | 524 | 70,683 | 1,354 | 19,156 | 7,215 |

Source: K-rep development Agency

The cumulative average savings per member is Ksh. 19,000. In addition, the amount of loan averages Ksh. 7,215. The proportion of clients that obtain loans as a percent of the total clients is 38%, re-enforcing the finding that the rural folks have a higher demand for a save haven for their money rather than for credit/borrowing.

Mbeu Savings and Credit Association

Mbeu savings and credit association is another example of a community owned rural finance model. It is promoted by the Catholic Diocese of Embu in conjunction with a foreign donor (who contributed Ksh. 17 million) who has a clear exit strategy. The association became operational in 2001 and targets beneficiaries in Embu and Mbeere Districts. It uses the basic principles of FSA; however, the only deviation is that it does not set up a fortified financial transaction structure such as a 'banking hall'. The loan officers take the financial services to the people using motor cycles. The secondary groups meet under big trees, church compound or a shopping center to collect money and make financial transactions such as compulsory Ksh. 200 monthly saving, voluntary saving, loans and money transfers- for school fees. The model has also provided a

channel for remitting contributions towards the National Hospital Insurance Fund (NHIF). The association penetrates deep into the interior where many financial providers have not succeeded or have not considered viable for banking business. In this model, the members do not have to incur two-way transport cost to the nearest town to access financial services thus saving time and scarce financial resource because the officers take the services to the people. All loans attract a 12% p.a interest rate and additional 2% for loan insurance premium.

A recent study shows that 60% of households in the remote Mbeere Districts of Kenya deposit their savings with Mbeu Savings and Credit Association (Kibaara, et al., 2006). Households that save with Mbeu savings association live below the poverty line and earn \$0.66 per day as compared to those that bank with commercial bank who earns \$1.16 per day (Table 5).

Table 5: Where do Mbeere District Households save?

| Where save? | Mbeere | Mean Annual Household income In Ksh. | Daily earning (in dollar/day) |
|-------------------------------------|--------|--------------------------------------|--------------------------------|
| Mbeu savings and Credit Association | 60% | 108,676 | 0.66 |
| SACCOs | 12% | 161,825 | 0.99 |
| Commercial bank | 28.8% | 190,439 | 1.16 |

Source: Kibaara et al, 2006

The association has seen a tremendous growth in membership, shares and loans. There is a 550% growth in membership from 1140 members in 2001 to 7408 in Feb 2006. In addition, there is a remarkable increase in shares, from Ksh. 1.7 million in 2001 to 30.2 million in Feb 2006. Loans increased from Ksh. 0.12 million in 2001 to Ksh. 22.48 million in Feb 2006. The tremendous increase in membership, shares and loans implies that the association is on the path of growth. Cumulative average saving per member is

Ksh. 4,077. Only 30% of the members borrowed loans averaging Ksh. 10,000. This again is an indication that most rural households are mainly interested in other financial services and not only on loans/credit. The Mbeu model can be replicated and scaled up in other regions of the country at low costs. However, the model faces key challenges such as insecurity, poor infrastructure, lack of policy and regulatory framework and management issues.

Private Commercial Bank Led Model: a Case of Emerging Indigenous Banks

Commercial banks are potentially an important source of rural financial services. However, most mainstream banks have undergone major restructuring such as closing branches in the rural areas to cut down on costs and improve profits. This has left a gap in provision of rural financial services which has partly been filled by the emerging indigenous banks such as Equity bank. The private commercial bank led model works on the principle of taking banking services closer to the people. The bank financial services to rural clients make up 68 percent of clients in Equity bank but with only 28 percent of the total deposit volume, given the relatively lower average savings account size of rural clients (CGAP, 2004). Although the bank covers a wide range of clients, the majority of its clients are low-end salaried workers, and micro and small businesses. In addition, the rural farming community can access supervised short term loans for horticulture, dairy, coffee and tea farmers.

The bank has captured a market niche in the banking sector in Kenya among the low income earners by addressing the perceived exorbitant price and attendant charges of loan and savings products. The bank has given incentives to its clients as such affordable

operating balance on the deposit account i.e. Ksh. 400; Ease of opening a bank account and all that is needed is a national identity card and the opening deposit. The bank uses a digital camera to take free passport photographs. Unlike other banks, there is no ledger or maintenance fee. In addition, withdrawal charges of Ksh. 50 are affordable to the low income clients. The interest on loan ranges between 1% and 1.5 % per month or 12% to 18% per year.

The number of branches has increased by 55% from 20 in 2004 to 31 in 2005. The customer base increased by 33% from 413,000 clients in 2004 to 560,000 clients in 2005, this constitutes 22% of all the total deposit accounts in Kenya. Customer deposits grew by 76% from 5.1 Ksh. billion in 2004 to 9 billion in 2005. The loan portfolio has also grown by Ksh. 97% from Ksh 3 billion in 2004 to Ksh 5.9 Billion in 2005. Profit has increased by 130% from Ksh. 218 million in 2004 to Ksh 501 million in 2005. The ratio of borrowing clients to total clients is 21% an indication that bank client's financial needs are greater than other access to loans. Average loan per client is Ksh. 42,942 while savings Ksh 16, 071. Equity bank has focused specifically on the outreach component of mobile banking services, and on improving service efficiency and proximity for clients.

Mobile Banking under Equity Bank

Mobile banking comes in many variants such as a Grameen loan officer visiting a Grameen group on a motorcycle, an automated teller machine visiting a remote village to pay out pension and provide savings facilities. Mobile banking has been widely accepted in many countries such as South Africa, Vietnam, Thailand, Indonesia, West Africa and Bangladesh as an innovative and low-cost distribution system of improving financial

services in remote areas where there are no formal banks. In most cases the benefits outweigh the costs(Coetzee, et al., 2003).

The concept of mobile banking involves taking banking services to the rural areas using an equipped mobile van. This is done 2-3 times in a week. Other requirements of a mobile bank include; permanent premise, motor vehicles, at least two banking staff and two security personnel. Currently, the bank has 52 mobile units that contribute an estimated 15% of the bank's business. For sustainability, one mobile unit requires to at least 1500 clients. Most mobile Equity banks have a clientele base of up to 3000 members. These mobiles are demand driven and in most cases, some have converted into fully fledged branches in less than one year. The mobile bank charges an addition to a fixed monthly charge of Ksh. 50. In most cases most branches handle between 250-300 transactions per day. Mobile banking services are beneficial to clients because most save money that could have been used on transport. For example a client residing in Siakago pays Ksh. 160 (2 way) for transport to access financial services in Embu District(about 40 Km). However, with the mobile bank in Siakago Town in Mbeere District, the same client is charged an extra Ksh. 50 to access his financial services via the mobile bank. In addition to convenience, the clients also save traveling time. The estimated cost of running a mobile unit is Ksh. 70,000 per month and mobile unit generate an estimated monthly profit of Ksh. 100,000. Lack of quality infrastructure remains a major obstacle in determining the success of mobile banking.

Government Led Rural Finance Model: a case of AFC

This is a government owned model that provides credit services mainly to large scale farmers with an objective of promoting food production in the country. In Kenya, the

model works through the Agricultural Finance Corporation (AFC). There are 31 AFC branches country wide. The corporation has been instrumental in the implementing many government and donor supported programs such as mechanization of the agricultural sector, livestock development programs, the Guarantee Minimum Return, the Seasonal Crop Credit and the Emergency Livestock Off-take Program. Since early 1990's, the corporation started experiencing operational difficulties due to poor governance, political interference and effects of economic liberalization that led to subsequent collapse of some agricultural marketing bodies. By 1992, the non-performing loan portfolio reached 89% (AFC, 2005). The government and other donors stopped funding AFC and the recovered money was used for recurrent expenditure. AFC officially stopped lending from 1997 to 2001.

The National Rainbow Coalition (NARC) government pledged to improve access to rural credit and financial services from 2003. Since then, the government has implemented some of its pledges as stated in the Strategy for Revitalizing Agriculture (SRA). The government has restructured AFC by writing off bad debts and refinancing. The corporation has resumed lending for seasonal crop credit and value addition loans at 10% and 15% respectively. As at 2004/2005, the corporation had advanced a total of one billion Kenya shilling to 5253 farmers. Seasonal loans account for 52% of the total loans, while development accounts for 48%.

Table 6: AFC Development and Seasonal Credit in Ksh, 1996 to 2005

| Year | Total development ⁴ loans (SS, LS, ranches) | | Seasonal crop ⁵ credit | | Total loan (Dev+ Seasonal) | | Average loan/beneficiary In Ksh | |
|---------------|--|----------------|-----------------------------------|-------------------|-------------------------------|-------------------|------------------------------------|--------------------------|
| | No. | Amount in 000' | No. | Amount in 000' | No. | Amount in 000' | Small scale ⁶ | Large scale ⁷ |
| 1995/96 | 112 | 202,877 | 831 | 142,228 | 943 | 345,105 | 96,364 | 2,111,223 |
| 1996/97 | 283 | 290,863 | 0 | | 283 | 290,863 | 40,307 | 1,590,458 |
| 1997/98 | 133 | 87,941 | 0 | | 133 | 87,941 | 133,333 | 675,357 |
| 1998/99 | 105 | 157,872 | 0 | | 105 | 157,872 | 150,000 | 1,544,333 |
| 1999/00 | 117 | 130,728 | 0 | | 117 | 130,728 | 236,667 | 1,190,722 |
| 2000/01 | 56 | 112,638 | 0 | | 56 | 112,638 | 182,500 | 2,510,182 |
| 2001/02 | 1 | 225 | 0 | | 1 | 225 | 225,000 | 0 |
| 2002/03 | 590 | 90,772 | 0 | | 590 | 90,772 | 100,824 | 635,017 |
| 2003/04 | 2314 | 187,030 | 2077 | 338,612 | 4391 | 525,642 | 15,464 | 503,452 |
| 2004/05 | 2663 | 497,991 | 2580 | 537,624 | 5243 | 1,035,615 | 152,023 | 499,591 |
| Average loans | | | | | | | 133,248 | 1,126,034 |

Source: AFC SS=small scale LS=large scale

Prior to 2002, the corporation advanced 98% of the development loans to the large scale farmers. But after 2003, lending to large scale farmers averages 36%. AFC's average loans to small scale farmer averages Ksh. 130,000 while the large scale averages Ksh. 1.1 million.

Prohibitive loan transaction costs remains a challenge to small scale farmers, for example if AFC was to lend a supervised seasonal credit to a small scale borrower amounting to Ksh. 11,000 to plant maize on one acre, the loan transaction costs before repayment of interest would be Ksh. 8,715 (Ksh. 2500 application fee, Ksh. 6050 conveyance fee and Ksh. 165 commitment⁸ fee). Labor productivity is the other challenge, 64% of the current staff is composed of non-technical (support) staff, leading to labor inefficiencies. This is an indication that the staff restructuring is still not efficient

⁴ Dairy, poultry, pigs, farm infrastructure, farm mechanization etc

⁵ Seasonal credit loans –specifically for production of marketed wheat, maize and potatoes

⁶ Small scale loans have a maximum loan ceiling of Ksh. 200,000 and a minimum of Ksh. 50,000

⁷ Large scale loans with a minimum loan of Ksh. 200,000 and a maximum of Ksh. 3 million

⁸ Commitment fee is 1.5% of the loan amount

and the support staffs should be reduced. Finally, AFC is not financial sustainable in the long run because it solely depends on the government budget.

Stockists Credit Guarantee System

The credit guarantee system is a model that strengthens the lending and borrowing capacity between the commercial manufacture of agricultural input and the input stockists. The rural stockists/shopkeepers are an important source of credit for agricultural inputs to the rural areas. Data from the 2004 Tegemeo survey shows that rural stockists provide between 4 % and 7% of agricultural credit in-kind. The rural stockists face challenges such as lack of the required capital to meet the input requirements of the producers, lack of knowledge on inputs and business skills. This has contributed to low usage of agricultural input that translates to low agricultural productivity. The overall objective of the guarantee system is to improve agricultural productivity and incomes of smallholder farmers in Western Kenya. The central strategy is to strengthen commercial linkages between enterprises in the private sector distribution system, i.e. input supply companies, regional wholesalers and rural stockists- from whom farmer's access inputs – in order to increase the range and quantity of inputs available to end users. This will increase the smallholder farmers' sustainable access to and use of agricultural inputs. The program was piloted in 2005 in Western Kenya.

The credit guarantee system involves the following parties; the donor, agricultural input stockists/wholesaler, a local non-governmental organization (NGO) in this case Agricultural Market Development Trust (AGMARK) and an input manufacturing company. To increase the creditworthiness of the input stockist, the donor through the

NGO offers seven business training modules at a cost of Ksh. 500 each. As at January, 2006, 138 stockists had been trained. The NGO avails the list of trained stockist to the input company. The input manufacturing company then enters into agreement with the trained stockist to supply inputs on credit. The donor guarantees to pay 50% of the defaulted loan and the company will absorb the balance. The guarantee fund worth over US \$40,000 (Ksh 2.9 million) is held by the donor. As at January, 2006, five companies had received a revolving credit⁹ guarantee enabling them to extend credit valued at Ksh. 866, 364 to two wholesalers who in turn guaranteed 50 new stockists who have received inputs worth Ksh. 3.6 million on credit. There has been an excellent repayment rate, with only one defaulter, amounting to Ksh. 222, 285. The organization has already paid for 50% default though the process of repayment is lengthy, taking approximately 2-3 months. A recent study shows that the effect of the credit guarantee has trickled down to the farmers. Stockists affiliated to the credit guarantee system are doing better than the non-affiliated stockists in credit provision; about 34% stockists gave credit to farmers compared to 29% of the non-affiliated stockists (AGMARK, 2006).

The \$40,000 credit guarantee fund is limited and can only guarantee limited beneficiaries. On the other hand, the 'free things mentality' among the people is a problem towards repayment of credit, which might slow down repayment rates.

The model could be replicated and scaled up to other parts of the country where many stockists need empowerment in business skills and credit services. The trained stockist are now more attractable to banks and other financial institutions and can therefore benefit from the upcoming wholesaling and group lending financiers such as the AFC.

⁹ Credit inform of fertilizer, seeds, crop protection chemicals and animal feeds.

Credit Input Supply Voucher System: Rice Production in Ahero Irrigation Scheme

The credit voucher system is a model of providing agricultural inputs on credit to farmers. The principle involves provision of input using a combination of a credit voucher and cash (where vouchers cannot be used). The vouchers reduce the likelihood of credit diversion to other life cycle needs. The credit vouchers are staggered during the production period. The model involves a number of actors i.e. the donor, a micro finance institution, SACCO, input stockists, government, and buyer of the agricultural output. The credit voucher system otherwise referred to as ¹⁰Mkulima loan is being piloted in Ahero rice scheme since March 2005.

The donor guarantee to pay 50 % of any defaulted loans. The MFI-SAGA Thrift and Enterprise Promotion Limited (STEP) is a rural financial organization that facilitates the delivery of financial services to people living in the Kenyan districts¹¹ around Lake Victoria region. It comprises of SAGA SACCO and SAGA Thrift and Enterprise Promotion Limited (STEP), the later manage the affairs of the SACCO. SAGA operates a Front Office Service Activities (FOSA). Members buy shares from the SACCO at Ksh 25 with a minimum of 4 shares per month (Ksh 100 per month). The shareholder can then access loan and savings products. All loans attract an interest rate of 2% per month with a rebate of 0.5% on timely repayment. The 1.5% of the interest earned is shared equally between the SACCO and the management company –STEP.

The farmers who are members of the SACCO get mkulima loans up to three times the amount of shares held in the SACCO. The loan attracts a 2% monthly interest rate or 24% p.a. In addition, the beneficiaries pay an insurance fee of 2% of the loan amount.

¹⁰ Mkulima refers to a farmer loan

¹¹ Kisumu, Bondo, Busia and Rachuonyo

No tangible collateral is required. All loans are secured by SACCO members and guarantors savings. The 75% of the mkulima loans is disbursed via the credit vouchers and 25% through cash vouchers. **Cash vouchers** covers, *transplanting, weeding and harvesting* and credit **vouchers** include but not limited to cost of *ploughing/ rotavation, seeds, fertilizers, chemicals and gunny bags*. During the 2005 crop production year, the organization disbursed a total of Ksh. 6.7 million to 617 farmers in Ahero rice irrigation scheme.

The farmers obtain the vouchers from MFI-SAGA and submit the vouchers to the stockists for the supply of the inputs/services, the stockists then remits the vouchers to the MFI for payments. The disbursement of the vouchers is staggered over the production period and the loan officers supervise the farmers to ensure that the inputs and cash are not diverted. The loan for irrigated rice is repaid using the balloon payment method. The farmer is expected to contribute towards the cost of production by meeting the labor and transport costs. The maximum loan is Ksh. 17,500 per acre of rice and Ksh. 20,000 for horticultural crops. On average each farmer gets a loan of Ksh. 10,630.

Rice yield ranges between 20-30 bags per acre and yields an estimated net profit of Ksh. 8,600 /acre. Given that most farmers cultivate 4 acres, then majority of farmers take home between Ksh. 30,000 and Ksh. 120,000 as net profit for each growing season. The 'high interest rate' does not deter the farmers from borrowing. Decomposition of the cost of capital as a fraction of overall cost of production reveals that the cost of capital accounts for only 7% of the total cost of production. Farmers in the scheme are now better off economically and there is a spill over effect in the business community which is now more vibrant.

The government has contributed to the revival of the once dead Ahero scheme by reviving the scheme in 2005 following a Ksh. 20 million intervention that saw installation of two pumps (with a capacity to handle 600 liters of water per second) and rehabilitation of 10 kilometer irrigation canals. The cost of water amounts to Ksh. 3,100 per acre and it is paid in advance to the National Irrigation Board (NIB) by the micro-finance institution before planting. The output market prices are negotiated before planting.

Beach Banking Model

This is a model that serves the unbanked fishermen along the Lake Victoria beaches.

This model involves a SACCO and a micro finance institution (in this case, MFI-SAGA Thrift and Enterprise Promotion Limited) which oversees the management of the SACCO at a fee recovered from paid up interest rates. Members in the SACCO (in this case fishermen along the beach) buy shares which are used as collateral for leveraged loans. A share is valued at Ksh 25 with a minimum of 4 shares per month (Ksh 100 per month).

The model operates eight service points otherwise referred to as 'Beach banks' along Lake Victoria beaches in Kisumu and Bondo District. The motivation behind this innovation is to contribute towards poverty alleviation among the fisher folks. Kenya earns about Ksh 6.9 billion annually from fishing. However, with such large amounts of money, there has been insignificant impact of fishermen's physical and economic lifestyle, what a paradox? Most of the fishermen along Lake Victoria have been exploited by the middle men and others squandered their hard earned cash due to lack of banking institutions.

The service points have front offices that operate like conventional banks, providing saving and credit products. It has a current membership of 3,000 clients with a total savings of Ksh. 15 million. The beach 'banks' contribute 36% (Ksh. 15 million out of Ksh. 42 million) of the total savings in MFI-SAGA. On average each beach 'banker' has a savings of Ksh. 5000.

About 55% of the beach bank savers are female fish mongers and the rest are fishermen. Previously, most of the female fishmongers were constrained by lack of capital for business development. However, the beach banks have facilitated, women to access loans thus reducing financial dependency on fishermen.

The beach 'bank's offer a variety of loan products, the *market day loans* are a special loan facility, a very short-term loan for business people dealing with fast moving goods with quick returns. The loan is processed within the same day and is payable within 5 days with a 2% interest rate. The leverage ratio is 1:2. In addition, a borrower pays a 2% insurance premium incase of death. This product is popular among fishmongers and traders. This is one of the most innovative rural finance product developed by MFI-SAGA. The market day loans account for 62% of the total beach 'bank' loans. Members can borrow as low as Ksh. 200 per visit and in addition; they can borrow a number of times in a day. The cumulative average loan amount disbursed to the beach bankers is about Ksh 18,152. The ratio of borrowers to savers is 30%.

Insecurity remains a big challenge for the success of the beach 'banks'. There have been cases where the service points have been broken into and large sums of monies stolen. In addition, the migratory nature of the fishermen reduces the business activities thus affecting the performance of the beach 'banks'. The beach 'banks' have a potential

for expansion, currently only reaching 3,000 fishmongers against a potential of 12,000 in the lake region.

A Comparative Analysis of the Models

The following section gives a comparative analysis of the described models of rural finance i.e. clientele outreach, interest rates, financial sustainability, economic status of the targeted clients, loaned amounts and cost of lending. Table 7 outlines a comparative description of these models. Rural financing models are designed to meet different objectives; the Government led model and credit input guarantee credit voucher system are designed to increase food production in the country. The emerging indigenous bank model is mainly for expansion of rural financial services. The community based owned model and beach banking models are mainly designed for poverty reduction.

Compared to other models of financing, the emerging indigenous banks have the greatest outreach in the rural areas partly associated to mobile banking, affordable rates and reduced bureaucracy. The community based owned models have the second largest clientele outreach partly because of the group masses. However, this model has a great potential for outreach. AFC has the lowest client outreach but there exist potential for greater outreach under the group lending.

Estimated annual household income generated from Tampa 2004 household survey shows that AFC clientele are above the poverty line as defined by the dollar a day (averages US \$1.4 per day). Although the emerging indigenous banks have a greater clientele outreach, the model is mainly reaching the middle income group who are slightly above the poverty level (averages \$ 1.2 per day). The community owned rural finance model, the credit input guarantee voucher system and the beach banking models

reach the rural poor in the low land regions. The beneficiaries earn a range US \$ 0.5 to US \$0.8 per day. This implies that any policy that promotes development of the community owned models is most likely to have a greater impact in improving access to rural financial services.

The community based own models provide the lowest amounts of loans averaging from Ksh. 7000 to Ksh. 10,000 per beneficiary per year, an indication that the models serve the poor in the community. The beach banking disburses slightly higher amount of loans partly because of the market day loans.

The government led model and the emerging bank provide relatively higher loan amount. The results show that across these models, the proportion of rural borrowers as a proportion of total no of bankers ranges between 30% and 39%, reinforcing the fact that most households prefer to have access to a saving facility rather than a borrowing facility. This is also supported by Tampa household survey 2004 on agricultural credit, which showed that only 39% of the households tried to obtain any credit.

The unit cost of lending ranges between Ksh. 0.02 and Ksh 0.5. AFC lending is the most costly; each shilling loaned out incurs an expense of Ksh 0.5. The community owned models are low cost models. Insurance on loans ensures recovery of loans in case of the death of the beneficiary. Results show that all the rural financiers apart from AFC insure the loans at 2% of the loaned amounts.

Table 7: A Comparative Analysis of Selected Models

| Indicator | Government led Model: AFC | Commercial Bank Model | Community Owned Model: | | Credit Input Guarantee Voucher system | Beach banking model |
|--|---------------------------|-----------------------|----------------------------------|-------------------|---------------------------------------|---------------------|
| | | | FSA | Mbeu | | |
| Objective | Food production | Profit making | Poverty reduction | Poverty reduction | Food production | Poverty reduction |
| Interest rates per annum | 10% | 12% to 18% | 20% to 34% | 12% | 24% | 24% |
| Outreach (no. of clients) | 5,200 | 380,800 | 70,000 | 7,400 | 617 | 2,700 |
| Mean annual HH income Ksh | 260,489 | 227,103 | 159,130 | 159,130 | 99,317 | 99,317 |
| Per capital income ¹² (US \$) | 1.4 | 1.2 | 0.8 | 0.7 | 0.5 | 0.6 |
| Average loans per client | 320,000 | 42,942 | 7,215 | 10,000 | 10,000 | 18,153 |
| Insurance on loans | No | Yes | Yes | Yes | Yes | Yes |
| % loaned members | N/A | 21% | 38% | 30% | N/A | 30% |
| Unit cost of lending 1 Ksh | 0.5 | 0.22 | 0.13 | 0.08 | 0.09 | 0.02 |
| Average Savings per client | N/A | 16,071 | 19,000 | 4,077 | 3,635 | 5,797 |
| Sustainability | Low | High | Average | Average | Average | High |
| Source of funds | Government | shareholders | shareholders/loan interest/donor | | shareholders/loan interest | |

Source: Author's computation

¹² * Annual household income and dollar per day computed from TAMPA household survey, 2004

The interest rates vary across the models. AFC has the lowest interest rate of 10% per annum. FSAs have the highest interest rates ranging from 20% to 34% per annum. The interest rates by FSA are set by the shareholders, the interest rates are highest partly because of lack of alternative to other financial institutions, to increase monthly revenue as the FSA attempts to move towards sustainability and finally earned interest is paid as dividends at the end of the year.

Financial Sustainability and Clientele Outreach

Most of these models have an external source of funding; in most cases the donor has a clear exit strategy. However the issue of financial sustainability remains a big challenge.

AFC is mainly supported through a budgetary allocation and in some cases the donor. Given its current form, the corporation has low sustainability and low outreach. However, the implementation of group lending will most likely improve outreach, but the issue of sustainability will be uncertain because it will depend on the ability to recover loaned amount to the registered groups. Figure 3 demonstrates an outreach and sustainability frontier.

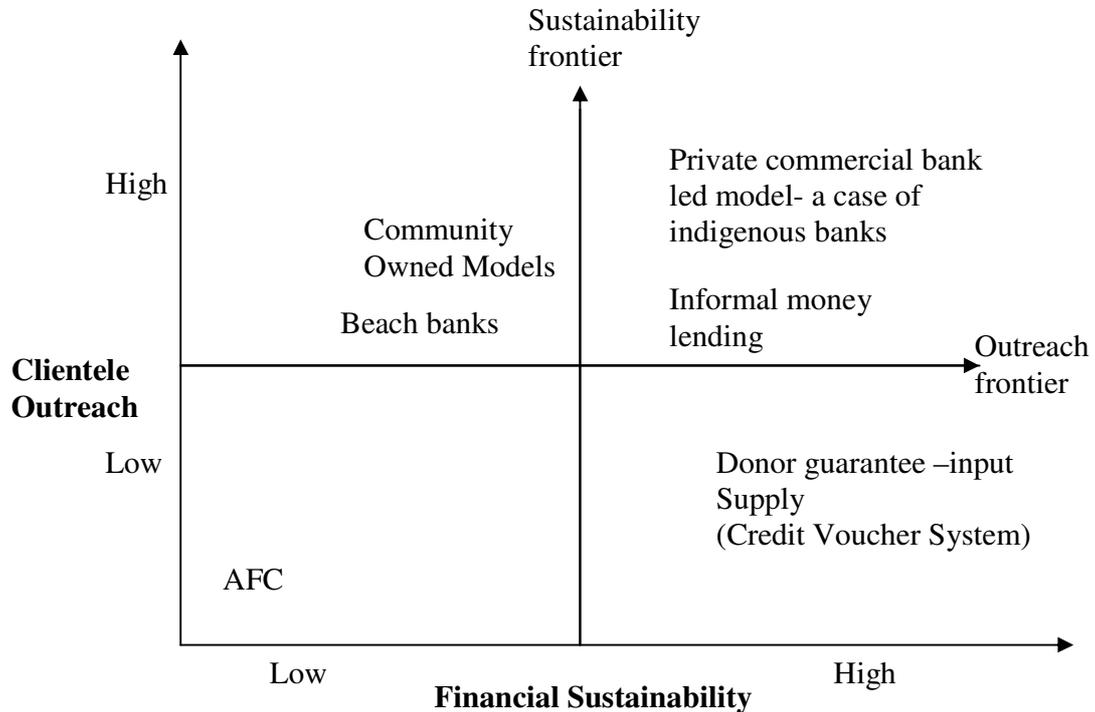
The community owned models have a high outreach and low sustainability. Some attempts made to move towards sustainability are; piloting of regional management companies by FSA and withholding dividends on interest rates by Mbeu savings and credit association. Financial sustainability will require an increase in shareholding membership and improved management.

The emerging indigenous banks demonstrate the high outreach and high sustainable model because the operating expenses are sourced mainly from the local shareholders capital and earned interests. The rapid expansion is demand driven.

The credit guarantee–input credit voucher system has high sustainability as evidenced by the fact that the MFI promoting the voucher system has expanded to Bunyala irrigation scheme without the donor guarantee. However, outreach is low because in Kenya, the proportion of irrigated land is very low. The development of irrigation scheme would provide an opportunity for the expansion of the voucher system.

The Managed Sacco-beach ‘banking’ model has high sustainability because it lends from the voluntary and compulsory savings from local shareholders. Currently, it has low outreach because of the few service points. There is a potential for expansion to cover 12,000 beach bankers. The informal models have high sustainability and high outreach.

Figure 3: Outreach and Financial Sustainability Frontier



Future Scenario of Rural Financing

This section looks at the future scenario of rural financing. Given this background, most likely, the mainstream banks will concentrate on the niche markets in the urban centers. The emerging indigenous banks will continue to expand in the rural areas.

The AFC will most likely to transform itself in order to survive. Wholesale and group lending will enable the corporation to reach more clients reach at lower costs.

The MFIs will continue to serve the middle and upper income earners and will be transforming themselves into commercial banks. They will be profit motivated. Their transaction charges will go up as they go national.

The rural SACCOs, ROSCAS, self-help groups will continue serving the rural people and will transform themselves into community based micro-credit units. This will most likely reduce unemployment in the rural areas. We are likely to see some form of urban-

rural migration as some skilled workers will probably move to the rural areas to work in the community based micro-credit units. The credit guarantee works on limited scale and may not address the needs of the masses in the future

Key Findings and Policy Implications

Most households in the rural areas borrow credit for farming. However, most farmers seeking agricultural credit do not get due to risks related to rain-fed agriculture. Provision of agricultural credit is skewed toward the productive region and it's mainly provided by the commodity based credit providers and co-operatives. Therefore any intervention that strengthens the performance of the above will improve access to rural credit.

Different models of rural financing have evolved over time and proportion of clients that borrow accounts for less than 40% of the banking clients. This is an indication that the promoters of rural finance should consider provision of other financial services not just credit.

The government is still involved in provision of agricultural credit. Although the new group lending mechanism has a potential of reaching a greater outreach the question of financial sustainability still remains. Should the tax payers continue to support state finance institutions as the expense of higher priority social programs?

The community owned models have wide outreach and lower cost. Policy intervention whose objective is to increase financial service should strengthen the community owned model.

The emerging indigenous commercial banks that are attempting to conduct businesses in the rural areas are making profit. There still exist a potential for growth. On the other hand, the microfinance institutions have been insignificant contribution in provision of

credit to the rural Kenya. There is need to design innovative products suitable for the rural population.

A successful credit system and especially in agriculture requires a concerted effort in production process. The government and other stakeholders in the sector should ensure provision of all the support services such as agricultural extension, marketing and general infrastructure.

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