



**TRANSFORMING MICROFINANCE IN KENYA**  
THE EXPERIENCE OF FAULU KENYA AND  
KENYA WOMEN FINANCE TRUST

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The Kenya Financial Sector Deepening (FSD) programme was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry, the programme's goal is to expand access to financial services among lower income households and smaller enterprises. It operates as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). In addition to the Government of Kenya, funders include the UK's Department for International Development (DFID), the World Bank, the Swedish International Development Agency (SIDA), Agence Française de Développement (AFD) and the Bill and Melinda Gates Foundation.



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# Abbreviations

<b>AMFI</b>	Association of Microfinance Institutions	<b>FSD</b>	Financial Sector Deepening
<b>ASCA</b>	Accumulating Savings and Credit Association	<b>GM</b>	General Manager
<b>CBK</b>	Central Bank of Kenya	<b>GTZ</b>	Gesellschaft fuer Technische Zusammenarbeit
<b>CEO</b>	Chief Executive Officer	<b>HR</b>	Human Resources
<b>CGAP</b>	Consultative Group to Assist the Poor	<b>ICT</b>	Information and Communication Technology
<b>DFID</b>	Department for International Development	<b>IFC</b>	International Financial Corporation
<b>DPFB</b>	Deposit Protection Fund Board	<b>KCB</b>	Kenya Commercial Bank
<b>DSOP</b>	Director Share Ownership plan	<b>KSHS</b>	Kenya Shillings
<b>DTM</b>	Deposit-Taking Microfinance Institution	<b>KWFT</b>	Kenya Women Finance Trust
<b>ESOP</b>	Employee Share Ownership Plan	<b>KWH</b>	Kenya Women Holding
<b>FAO</b>	Food and Agriculture Organization	<b>MFI</b>	Microfinance Institution
<b>FHI</b>	Food for the Hungry International	<b>MIS</b>	Management Information System
<b>FOSA</b>	Front Office Service Activities	<b>MoCDM</b>	Ministry of Co-operative Development and Marketing

# Abbreviations

<b>NBFI</b>	Non-Bank Financial Institution
<b>NGO</b>	Non-Governmental Organisation
<b>OECD</b>	Organisation for Economic Cooperation and Development
<b>OPIC</b>	Overseas Private Investment Corporation
<b>PPF</b>	Project Preparation Facility
<b>ROSCA</b>	Rotating Savings and Credit Association
<b>SACCO</b>	Savings and Credit Co-operative
<b>SASRA</b>	SACCO Societies Regulatory Authority
<b>TNA</b>	Training Needs Assessment
<b>UML</b>	Uganda Microfinance Limited
<b>UMU</b>	Uganda Microfinance Union
<b>USAID</b>	United States Agency for International Development
<b>WWB</b>	Women World Banking

## EXECUTIVE SUMMARY

This report examines the experiences of two micro-finance organisations in Kenya, Faulu Kenya Ltd (Faulu) and Kenya Women Finance Trust (KWFT), which both decided to transform into deposit taking microfinance institutions (DTMs).

The desire to grow, expand outreach and improve the quality of financial services to its target clients is a legitimate and fundamental goal for any financial institution. Growth allows financial intermediaries to enjoy economies of scale and paves the way for sustainability. A clear strategy to reduce funding costs is critical to achieve this objective. In 1989, the Bolivian non-governmental organisation (NGO) PRODEM took the initiative to scale up its activities and transform into the commercial bank – Bancosol. Since then, savings intermediation has provided the main rationale for the transformation of credit-only institutions worldwide. This is based on the fact that clients' deposits have two major advantages over other funding sources: they are remunerated at lower cost, and offer a hedge against foreign exchange risks since they are often denominated in local currency.

Both regional and international experience has demonstrated the importance of a clear national strategy for microfinance which aims at strengthening the policy environment and the regulatory framework. In the past, the absence of a proper legal framework (or other barriers) has prevented microfinance institutions (MFIs) from carrying-out deposit-taking business. Therefore, the role of governments has become crucial in removing obstacles and creating the appropriate legal environment. It is not surprising therefore that the majority of the 40 or so transformations recorded worldwide since PRODEM are in Latin America where the regulatory framework is the most advanced. The Microfinance Act of 2006 and the supportive Deposit Taking Microfinance Regulations of 2008 have together paved the way for institutional transformation in Kenya.

With the support of the Financial Sector Deepening (FSD) Kenya, Faulu and Kenya Women Finance Trust engaged in the process that led to their licensing as the pioneer deposit-taking microfinance institutions (DTMs) in Kenya. Both transformations were generally successful and have helped the two institutions to maintain their strategic positioning in the market. However, in both cases, the process required more resources and took much longer than expected. In addition, the transformations raised greater than anticipated organisational challenges. An in-depth-analysis included in this report highlights the areas of weakness in the transformation process. It identifies the main challenges and most importantly, draws lessons and formulates recommendations for other MFIs planning, or already in the process of transformation in Kenya and elsewhere.

There are several legal forms into which an NGO microfinance institution can transform (bank, DTM, etc.). However, this study will focus on the transformation from an NGO MFI into a deposit taking microfinance institution. Based on Microfinance Act 2006, the related regulations aimed at regulating deposit taking microfinance institutions, came into effect in May 2008. This opened a window of opportunity for institutions such as Faulu Kenya and Kenya Women Finance Trust to become deposit-takers. The Financial Sector Deepening (FSD Kenya) supported both institutions in their transformation. This study includes an overview of the Microfinance Act 2006, and how it contributed to enabling the process of transformation. It examines the experiences of Faulu Kenya and Kenya Women Finance Trust, with special focus on the planning and management, and the operational and structural aspects of transformation. The study concludes with a presentation of the strategic implications of transforming and the lessons learned from the experiences of the two institutions.



## Chapter 1

# EXPERIENCES IN TRANSFORMATION AND THE ROLE OF THE REGULATOR

The desire to serve clients better is the motivation for transforming from a non-governmental organization (NGO) or a non-regulated microfinance institution (MFI) into one which is regulated. To achieve a successful transformation into a deposit-taking institution requires easier mobilization of funding, greater outreach and a more efficient delivery of services than is common in a credit only MFI. Amongst the benefits of transformation are cheaper access to funds through deposits (in the long-term), increased governance, and greater competitive positioning. This will contribute towards achieving greater financial sustainability. Another key factor pushing NGOs towards transformation is the increased potential for equity investments. Over the last decade, there has been donor bias in funding towards for-profit institutions, based on the belief that these have a greater chance for long-term sustainability.

Although a successful transformation can bring clear benefits, a great deal of investment in terms of time and other resources is required. In some cases an almost a complete overhaul of the institution's organizational structure may be necessary. While transformation offers many opportunities, it is not the only option for successful NGOs to achieve long-term sustainability.

There are a number of factors which should be taken into consideration before making the decision to transform. These include the capacity to grow, readiness to share ownership, and a willingness to modify strategy and vision. Regional and global experience has demonstrated that a successful transformation is often closely linked to the regulatory framework regardless of the state of advancement or the strength of the microfinance sector. The willingness of the authorities to develop or amend the framework to better serve the sector is also important.

A well defined regulatory framework, a clear national vision, legal and policy environment are all pre-requisites to a successful transformation. In most countries, a tiered financial and regulatory approach has proved the most effective for enabling transformation, offering clear categorization of the institutions and providing a good basis for a roadmap. The tiered approach is also suited to the increasing demand for diversified microfinance products, as the industry changes from a primarily social development tool to a recognized economic development tool. A broader range of strong financial intermediation institutions is therefore needed.

### 1.1 GLOBAL AND REGIONAL EXPERIENCES

The first transformation to take place is still regarded as one of the most successful to date. The Bolivian NGO PRODEM took the initiative to transform into the commercial bank BancoSol in 1989. At the time, no one could have imagined that it would set an example for other NGOs around the globe (among them K-Rep in Kenya, ADEMI and ADOPEM in Dominican Republic). A little over a decade later, PRODEM launched a second transformation, to become a regulated Private Financial Fund, taking advantage of the developments in the regulatory framework.

In both cases, PRODEM's aim was to mobilize more funding through deposits, diversify its products and increase its outreach. Taking the steps towards transformation was not easy for PRODEM. As a pioneer, it had to educate the banking sector and the supervisory and regulatory bodies about microfinance: there were concerns that microfinance clients were too risky to be served by a formal financial institution, especially a bank. However, with the experience of both transformations, PRODEM was able to demonstrate that it is possible to succeed as a regulated entity with competitive market prices for financial products and services, in urban as well as rural areas.

One of the best known and well documented regional experiences is the transformation of Uganda Microfinance Union (UMU) into Uganda Microfinance Limited (UML). The developments in the regulatory framework, marked by the Microfinance Deposit-Taking Institution (MDI) Act of 2003, precipitated the decision to transform from an NGO to an MDI. The aim was to widen the scope of their activities and attract funding from international investors. The transformation of UMU into UML took approximately three years to complete and was nearly derailed by issues of ownership between the founding members and the investors. This drew attention to the importance of ownership and good governance. Indeed, most NGOs which transform experience difficulty in finding strategic investors who share their long-term vision and objectives.

### 1.2 TRANSFORMATION EXPERIENCES IN KENYA

Both regional and international experience of transformation has demonstrated the importance of having a clear national strategy for microfinance, aimed at enhancing the legal and regulatory frameworks as well as the policy environment. Not only does this make it easier for existing and potential players in the market to position themselves, it also encourages the international donors to invest in the development of the country. This is achieved through capacity building, equity and the provision of funds for on-lending. It is therefore no surprise that the majority of the 40 or so transformations recorded since PRODEM are in Latin America, where the regulatory framework is the most advanced. The African region has the least number of transformations, with many countries still struggling to supervise commercial banks, let alone MFIs.

As the first NGO in Kenya to transform into a regulated institution (bank in the 1990s), K-Rep had to educate the banking sector and the Central Bank of Kenya (CBK) about its proposed activities. K-Rep suffered from the lack of an appropriate microfinance regulatory framework in its request for a license from CBK. The decision to transform came at a time when the banking sector was going through a crisis characterised by a high level of non-performing loans. The licensing of an NGO was not seen as a priority. Complicating things still further, K-Rep wished to transform its existing microcredit programme into two complementary institutions under the umbrella of K-Rep Holding Limited. These included K-Rep Bank, a for-profit organisation, and K-Rep Development Agency, a capacity building organisation for financial services.

In addition to the challenges posed by the CBK, K-Rep faced more from its own Board members, who were sceptical of the added-value of the transformation. They feared that they would no longer have control over the institution should they open the company to new shareholders. They also worried that an increase in operations would cause K-Rep to drift from its core mission of poverty reduction and capacity building. Nevertheless, five years after it had written the concept paper outlining its strategy, K-Rep finally received its banking licence in 1999. It became the first commercial bank in Kenya to serve only low income clients, and the first NGO in Africa to transform into a regulated financial institution.

### 1.3 OVERVIEW OF THE KENYAN MICROFINANCE ACT 2006 AND THE RELATED DEPOSIT-TAKING MICROFINANCE REGULATIONS 2008

The Kenyan microfinance sector is one of the most vibrant in Sub-Saharan Africa. It includes a diversity of institutional forms and a fairly large branch network to serve the poor. However, microfinance activities have been regulated in Kenya only since 2006. The absence of regulation has allowed innovations to take place: institutions were set up easily without any barriers, such as minimum capital requirements. The microfinance industry has thrived in this environment.

There is a clear recognition from the public and the Government that regulation of MFIs is necessary to establish the right environment for a market shifting from donor funded and poverty oriented institutions to for-profit organizations. Former credit-only institutions wanting to leverage deposits from the public can only operate successfully in the market if it is properly regulated. Both

financial institutions and depositors must be protected. Today, there are various forms of registration for institutions operating in the microfinance industry in Kenya. Table 1 gives an overview of the formal microfinance landscape and the regulations applying to each institutional form.

As a result of the implementation of the recently enacted deposit-taking SACCO Societies Act, a new formal institutional type 'Deposit-taking SACCOs' has been added to the current list of regulated institutions. The supportive regulations were effected in June 2010 and all the deposit-taking SACCOs were supposed to apply for licences by June 2011. Informal microfinance operators like money lenders, Rotating Savings and Credit Associations (ROSCAs) and Accumulating Savings & Credit Associations (ASCAs) are also part of the market.

#### The main principles of the Microfinance Act

**Scope:** Institutions involved in microfinance business. The DTM regulations state that any MFI willing to conduct deposit-taking business should apply for licence from the Central Bank of Kenya (CBK).

**Legal definition of a microfinance loan:** The Microfinance Act clearly defines a microfinance loan as a credit facility granted to an individual single end borrower (and his associates) whose maximum amount shall not exceed 2% of the MFI's core capital.

**Control for mission drift:** The DTM regulations state that MFIs licensed to conduct deposit-taking business should dedicate more than 70% of their portfolio to microfinance loans. At the same time, large exposures (loans between 2% and 5% of core capital) should represent less than 30% of the portfolio.

**Table 1: Microfinance regulatory framework in Kenya (December 2010)**

Institution	Number	Legal basis for regulation	Supervisory authority
Deposit-taking Microfinance institutions (DTM)	3	Microfinance Act	CBK
Credit only MFIs	200 in October 2010 (Economist Intelligence Unit 10/2010)	Discussions on-going between CBK and various industry stakeholders to develop regulations in line with international best practices. <sup>1</sup>	Registrar of Companies, NGO Council, various based on form of registration
Banks	6 (with a specialized focus on microfinance) and 6 with a microfinance department as of 2010	Banking Act	CBK
Savings and Credit Co-operatives (SACCOs)	Over 5000, of which nearly 230 offered front office services in October 2010 (Economist Intelligence Unit 10/2010)	SACCO Societies Act, 2008. This act applies only to an estimated number of 230 SACCOs with Front Office Service Activities (FOSAs).	SACCO Societies Regulatory Authority (SASRA) Non-FOSA (Front Office Service Activities) SACCOs supervised by the Ministry of Co-operative Development and Marketing (MoCDM).

<sup>1</sup> According to the Microfinance Information Exchange.

**Prudential ratios:** The DTM regulations have defined the following prudential ratios: (1) capital adequacy ratios including a core capital of 10% of total risk adjusted assets plus risk adjusted off balance sheet items, core capital of 8% of total deposit liabilities, total capital of 12% of total risk adjusted assets plus risk adjusted off balance sheet items; (2) a minimum liquidity ratio of 20%; (3) a limit on insider loans which should not exceed 2% of core capital and should be contained on aggregate within a ceiling of 20% of core capital.

**Reporting requirements:** deposit-taking MFIs must submit the following periodic reports and other disclosures to the CBK: biweekly liquidity information, monthly reports on capital to risk weighted assets, quarterly unaudited financial statements and annual audited financial statements.

**Protection of depositors:** although not included in the DTM regulations, the Microfinance Act states that all institutions should contribute to the Deposit Protection Fund. The Fund would prescribe the level of the contribution, and disclose the maximum balance per customer protected in case of insolvency.

**Sanctions:** Detailed and tough administration sanctions are listed in case of non-compliance with the capital adequacy standards without indicating the sequence of these sanctions. All the other offences are left to the appreciation and the discretionary power of the CBK.

#### 1.4 IMPACT OF THE MICROFINANCE ACT AND THE DTM REGULATIONS ON THE MICROFINANCE SECTOR AND INSTITUTIONS

The first consequence of the Microfinance Act and the supportive regulations is the emergence of a new player, the DTM, in the microfinance landscape in Kenya. In addition, the Act reinforces a clear policy orientation towards segmenting the sector. The three generally accepted categories are:

- Formal institutions: Banks and DTMs which are both regulated and supervised by CBK. It will also include deposit-taking SACCOs regulated and supervised by the SACCO Societies Regulatory Authority (SASRA).
- Semi-formal institutions: non-deposit-taking SACCOs which are supervised by the Ministry of Co-operative Development and Marketing (MoCDM). This category also includes credit-only MFIs (whose incorporation in the regulatory framework is currently under discussion by the CBK and a variety of industry stakeholders who will determine best practices.<sup>2</sup>
- Informal institutions: with no legal form of registration or supervision (ROSCAs, ASCAs, moneylenders, financial services associations, etc.)

The DTM regulations have been criticized by microfinance practitioners for being too stringent and very similar to mainstream banking regulations. Some feel this is not appropriate for the microfinance sector. For example,

the relatively higher license fee, the requirements for deposit-taking branch infrastructure, and the reporting and provisioning requirements are likely to discourage the setting up of DTMs. This is particularly likely for those which are community-based (see annex1 for detailed information on licensing fees and other requirements).

CBK has a limited regulatory capacity. It is generally accepted that this is why the Bank has decided to extend prudential regulation only to institutions which are big enough to endanger the stability of the overall financial sector (DTMs and banks). On the other hand, it is undeniable that the current regulation poses major constraints on the institutional capacities of microfinance providers wishing to mobilise savings. According to sources inside the CBK, nearly 15 institutions were expected to transform within two years, starting from the implementation of the Act.<sup>3</sup> By the end of 2010 only three had successfully completed the process and been granted a deposit-taking license. Faulu Kenya DTM Limited was licensed in May 2009, Kenya Women Finance Trust DTM Limited in April 2010, and Uwezo DTM Limited as a Community DTM in November 2010. Though over 30 more institutions had passed the initial stage of approval by the end of 2009<sup>4</sup> (approval of business name), compliance with CBK regulations is both time and resource consuming and they are yet to be licensed. This narrows the chances of effective institutional transformation.

The scope of adjustments required of former credit-only MFIs is wide: institutions have to move from a completely unregulated position to full prudential regulation. As a result, the pace of institutional reform is often too demanding and the transformation process too costly. In addition, DTMs cannot move up-market because the regulations oblige them to hold at least 70% microfinance loans in their portfolio. However, DTMs have the freedom to set higher interest rates in the absence of interest caps in Kenya. With time they will also be able to circumvent barriers of network expansion by using agency banking as a delivery channel. In this way they can offer financial services in a cost effective manner (agency banking guidelines for banks were effected in 2010 and those for DTMs are expected to follow soon).

The stringent requirements of the Microfinance Act and DTM regulations however, can be of great benefit if the transformation process is successful. The Kenyan microfinance market is very competitive: four specialized banks already provide microfinance services and more are expected to follow. It is therefore in their best interests for DTMs to upgrade the quality of their infrastructure so that they can offer depositors the same advantages as banks with whom they compete for customers.

The next two chapters examine how, with the support of FSD Kenya, Faulu Kenya and KWFT (Kenya Women Finance Trust) transformed from credit-only MFIs to DTMs.

<sup>2</sup> Microfinance in Kenya, country briefing: [www.mixmarket.org](http://www.mixmarket.org)

<sup>3</sup> Nyanjwa C., 2nd-4th of July, the status of the microfinance industry in Kenya", CBK's presentation at the 5th microfinance forum in Benin/Cotonou.

<sup>4</sup> Ibid

## Chapter 2

# FAULU KENYA LIMITED - THE EXPERIENCE OF TRANSFORMATION

## 2.1 BACKGROUND

Faulu began as a development project in 1991, initiated by Food for the Hungry International (FHI), a Christian international relief and development organization. It was registered as an NGO in 1994. Faulu's main objective was to provide credit to lower income households and micro-enterprises. With support from various donors, among them the Department for International Development (DFID) and the United States Agency for International Development (USAID), Faulu grew over the years to a level of near financial self-sufficiency. In order to have more access to commercial funding (which is easier for a limited liability company than for an NGO), they decided to incorporate into a private company with limited liability under the Companies Act in 1999.

While Faulu attained operational self-sufficiency in 2000, its portfolio deteriorated significantly in 2002 after it tried to enlarge its main target group - the lower income market - to include an upmarket segment. Faulu faced difficulties for two years and recorded a loss in 2004 due to high provisions for non-performing loans. In 2005 Faulu refocused on lower income households and microenterprises once more. Following this, it regained profitability and started growing rapidly. A switch to a more business oriented approach proved to be very successful and Faulu experienced an average annual growth in operations of 75% during the following two years. Encouraged by their growth, Faulu took the opportunity to issue a first microfinance corporate bond, and undertook steps to convert into a public limited company in 2004. The issue of a KShs 500 million 5-year bond (75% guaranteed by Agence Francaise de Développement) was successfully accomplished in 2005.

By 2007 when it was preparing for transformation, Faulu was one of the three largest microfinance institutions in Kenya. It had a network of 19 branches, 48 offices and a client base of about 76,000. Faulu's main competitors were other large MFIs that served the same market segment. Kenya Women Financial Trust was its most direct competitor, although it dealt only with women. The increasing profitability of MFIs serving the lower income market encouraged microfinance oriented banks such as Equity Bank, Family Bank and Cooperative Bank to take greater interest in the same segment. This led to a more competitive environment for Faulu.

Faulu realised that the ability of the microfinance oriented banks to provide a larger scale of products, including credit and savings, was key to their success. Its decision to transform was therefore based on three main reasons: increased competition, increased demand for a wider range of services, and the need to lower the cost of funds in order to serve the clients better. By deciding to transform Faulu also hoped to contribute to the development the microfinance sector by being a pioneer - the first MFI to transform into a DTM in Kenya.

## 2.2 PLANNING AND MANAGING THE TRANSFORMATION

In 2006, Faulu decided to establish itself as a full financial intermediary in order to provide a broad range of financial services. In the same year, with support from FSD Kenya, Planet Finance supported Faulu in a strategic planning exercise which entailed exploring the options available for transformation and making an institutional assessment. Based on this preparation, the Board of Directors decided to go ahead and transform into a DTM. As part of this decision, Faulu was to retain its grassroots oriented microfinance operation. A strategic transformation plan (2007-2011) was prepared by the management of Faulu that heavily leaned on the Planet Finance report. As part of this pre-transformation planning exercise and still with FSD support, MicroSave helped Faulu conduct a market survey. The aim was to help Faulu understand its clients' perception regarding the transformation, and identify the need for new credit and savings products.

### 2.2.1 The transformation plan

The transformation plan consisted of two phases: phase one focused on building the institutional capacity to meet the licensing requirements, including the establishment of a head office and a model branch. Phase two entailed establishing a national network of branches and other non-traditional delivery channels such as agencies and mobile banking.

The first phase focused on the following areas:

1. Setting up a new ownership structure;
2. Developing appropriate products and positioning Faulu as a fully fledged financial intermediary;
3. Building the capacity of the institution in readiness for licensing as a DTM;
4. Establishing appropriate information systems to meet the needs of the new institution (operational and reporting);
5. Establishing Faulu Kenya as a fully operational DTM.

Faulu launched the first phase in July 2007, with the hope of completing all the activities within 12 months. However, delays were encountered as the licensing process took much longer than expected. CBK finally granted Faulu a licence on 21st May, 2009.

The second phase focused on establishing a national network of branches. In 2009, Faulu Kenya was able to set up two bank branches and had managed to open 23 additional bank branches by December 2010. The plan was to open another two branches in 2011, bringing the network to 27. The second phase could then be completed.

**Table 2: Faulu Kenya's milestones in the transformation process**

Date	Milestones
December 2006	Strategic transformation plan approved by the Board of Directors
September 2007	Selection of MIS (Management Information System)
April 2008	Opening of pilot branch in Mombasa
July 2008	Submission of application to the Central Bank of Kenya
24 Dec. 2008	Letter of intent of the Central Bank of Kenya for the approval of the license
February 2009	Data migration into the new ICT (Information and Communication Technology) system
April 2009	Opened second branch in Kitale
21 May 2009	Faulu Kenya Deposit Taking Micro-finance Ltd became the first licensed Deposit Taking Microfinance institution in Kenya
July 2009	Identified locations for banking branch constructions and engaged contractor
September 2009	Engaged in pilot with Postal Corporation of Kenya for agency services.
September 2009	Launch of the savings products
December 2009	Entered into agreement for provision of M-PESA Service for customers

### 2.2.2 Managing and funding the transformation

Faulu's initial estimate of the total costs of the first phase of the transformation was slightly over KShs 300 million. Half of this budget went to the acquisition of a new core banking system. FSD Kenya provided KShs 75 million, representing 22% of the total. In addition, Faulu used KShs 100 million of retained earnings and covered the other costs with loans obtained from the Overseas Private Investment Corporation (OPIC) and the Deutsche Bank.

The actual costs of this first phase were more than double the original estimate, reaching KShs 667 million. About KShs 230 million was spent on the MIS, KShs 340 million on branch construction/renovation, and KShs 97 million on consultancy, rebranding, legal, training and other costs. To cover them, Faulu secured loans of KShs 350 million and KShs 450 million from Citibank and Standard Chartered Bank/International Finance Corporation (IFC), respectively.

This phase of the transformation was managed by a team comprising all heads of departments. It was coordinated by Faulu's Internal Audit Manager, Ms Anne Kimari, who was appointed the Transformation Manager. The rationale

for appointing someone from within Faulu was to ensure familiarity with the company and provide guidance on the needs of the organization and proper co-ordination of the process. The transformation process consisted of different stages. The preliminary stage entailed internal discussions to weigh up the pros and cons of transforming. The type of institution to transform to, and how to organize the transformation were also considered. This stage took place in 2006. As soon as the decision was taken to transform, Faulu approached Financial Sector Deepening Trust (FSD Kenya) for support. Subsequently, a number of consultants were identified and contracted to provide specialised support in various areas during the transformation process. Although some of the internal changes and consultancies started in 2007 during the preparation phase, the major part of the transformation work was undertaken in 2008. The feasibility study for the transformation was developed, approved and implemented in the same year.

During this time, Kenya encountered both economic and political challenges which directly affected Faulu's operations and consequently the process of the transformation. In early 2008, post-election violence broke out in Kenya and Faulu, like most other MFIs was unable to operate for several weeks. Many of its clients had to cease their activities, as they closed or lost businesses. This in turn led to reduced liquidity in the MFIs as loans went into arrears. As a consequence there was a significant increase in the portfolios at risk. This was followed by severe drought in most parts of the country, and in mid-2009 flooding in the North Rift region. Each had a major negative impact on Faulu's agricultural finance portfolio (constituting about one-third of the total).

### 2.2.3 Technical support during the transformation

The use of external consultants to help strengthen internal capacity was a significant factor in Faulu's successful transformation. Each department was supported by an external consultant. MicroSave was competitively selected as the lead transformation consultant.

The following consultants contributed to the development of the departments within Faulu:

- Internal audit: Banconsult supported the internal audit department in becoming compliant with the CBK audit requirements for DTMs.
- Banking operations: A team of local banking experts who had previously worked in a leading local bank (Kenya Commercial Bank) was involved in system-based process mapping and the training of the pilot branch staff in banking operations.
- Human resources: Namconsult was engaged to improve the internal communication and the HR department.
- Risk management: Dr. Joachim Bald (subcontracted by MicroSave) supported the department in risk and treasury management.

**Table 3: Faulu's institutional data before and after transformation**

	Number of branches	Number of clients	Number of outstanding loans	Outstanding loans portfolio (KShs)	Average outstanding loan size (KShs)	Number of depositors
Before Transformation (Dec 2006)	45 (including satellite offices)	68,434	57,877	1.32 billion	22,847	Voluntary - Nil Compulsory 68,434
After Transformation (Dec 2010)	93 (25 banking branches, rest marketing units)	226,307 (346,088 accounts)	105,733	2.820 billion	26,346	Voluntary 104,626 Compulsory 121,671

- Legal department: Tom Onyango helped with putting together all the documents required for the DTM licensing.
- Business development: MicroSave was responsible for: market research and product development, piloting and roll-out of new and refined products, positioning in the market, pricing, process mapping, development of delivery channels for services, and development of related manuals.
- ICT department: PriceWaterhouseCoopers provided support in the selection of the Information and Communication Technology (ICT) system (see section 2.2.6);
- Corporate affairs: MicroSave worked together with Imagine Works on Faulu's rebranding. A retainer contract directly with Imagine was put in place for any further support post-project. In addition, Faulu also benefitted from exchanges with other organizations in the sector. The Association of Microfinance Institutions (AMFI) provided an exchange platform for all the institutions that were going through transformation and invited CBK to some of their workshops. The Consultative Group to Assist the Poor (CGAP) also provided a number of sessions on transformation. Additionally, Faulu also benefitted from meetings with Equity Bank where ideas were exchanged and lessons learned.

Some Board and senior management members made exposure visits to the Philippines to leading institutions such as CARD Bank, Bangko Kabayan and Bank Ryakat (BRI) in Indonesia, BancoPostal and Lemon Bank in Brazil, and BancoSol, Crecer and Prodem in Bolivia in South America. Although most of the exposure visits were relevant to the participants and effectively helped build their capacity, the delays in the registration process meant that the knowledge could not be immediately applied to the transformation process.

## 2.3 OPERATIONAL TRANSFORMATION: UPGRADING AND SYSTEMIZING

### 2.3.1 Human resource management

It is not possible to transform an institution without overhauling the organizational structure and in most cases, changing the mind-set of the existing employees. Proper management of personnel is therefore a crucial element of a successful transformation.

A number of changes were made within the organizational structure; new departments were created and others merged. A new level of General Managers was introduced. The diagnostic undertaken by Planet Finance prior to the transformation helped identify the key institutional competencies that needed to be improved during the transformation process. Improvement of Faulu's human resource capacity came in two forms: recruitment of new staff and training of existing personnel. The need for extra capacity was driven by both organic growth in the credit business and the specific requirements for licensing by CBK.

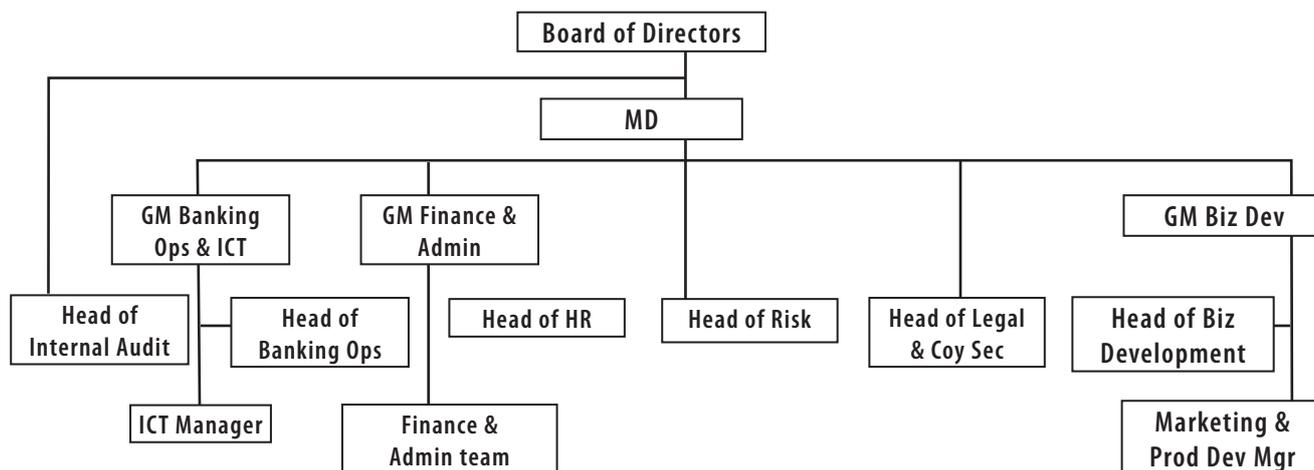
### 2.3.2 New recruitments

A number of new recruitments were made during the transformation, largely due to growth of business rather than the transformation itself. The only recruitment that was necessary in order to comply with CBK requirements was Head of the risk department. Three general manager positions were created, two of which were external appointments.

### 2.3.3 Training

A Training Needs Assessment (TNA) was carried out and a programme subsequently developed, managed by a team leader. A series of training sessions have been provided for the staff. These included product related training (credit and savings), new business processes, new MIS, and the balanced scorecard. Gaps in key competences were identified in risk

**Figure 1: Faulu’s organizational chart**



MD: Managing Director; GM: General Manager; HR: Human Resources; Biz Dev: Business Development; Coy Sec: Company Secretary; Prod Dev Mgr: Product Development Manager; Ops & ICT: Operations and ICT

management, reporting, internal auditing and treasury management. Faulu’s Board consisted of a mix of profiles: banking, business and human resources. Three new directors were identified to enhance the Board’s skill set in line with the regulatory requirements.

One of the main tasks of the human resources department during the transformation process was to keep a continuous flow of communication and information for the staff. Bi-monthly communication magazines, Mdaraja for an internal audience and Mteja for clients, were initiated to inform everybody of the changes which were taking place. A number of changes also took place in the department. A communication manager was recruited to take charge of developing the staff communication strategy. The institutional assessment and training needs assessment showed that there was need for a performance manager as well as a change manager, who would also be in charge of communication. Faulu made use of an external consultant to rationalise and re-organise its human resources in line with the new business requirements.

**2.3.4 Challenges in managing the staff in changing times**

Change management was necessary within Faulu on two levels: i) the credit business was undergoing rapid expansion, and ii) new banking operations had to be put in place. Faulu had to recruit a number of staff with banking knowledge and experience to support the deposit-taking operations. Conflicting cultures emerged between existing staff who were specialists in credit operations, and new staff. New staff who had a banking background felt superior to existing staff since their skills were needed for this phase of the transformation. The existing staff felt that they had made Faulu what it is, and that it was unfair to bring in new staff at higher levels.

Faulu decided to separate the tasks of the existing credit staff and the new banking operations staff. The new organizational chart therefore keeps

the business development activities and the banking operations activities separate from each other. The credit business is now included in the business development activities while the business development officers now report to regional managers. The banking operations officers on the other hand report to the banking operations manager. By separating these two responsibilities, Faulu was able to avoid the situation in which a banking operations manager needed to supervise a business development officer, without having the knowledge and or experience in credit operations, or vice versa.

**Table 4: Changes in the personnel of Faulu during the transformation**

	No of employees	No of senior management	No of loan officers	No of client advisors (savings products)
Before Transformation (Dec 2006)	308	8	170	16
After Transformation (Dec 2010)	832	13	513	82 (personal loan officers)

**2.3.5 Financial management**

Being able to attract savings has a major impact on financial management. One of the most important changes in financial management was the establishment of a treasury management function. Together with the Asset and Liability Committee, this was to ensure proper management of liabilities (deposits). Faulu contracted technical support for establishing the

treasury management function. The consultant, Dr. Joachim Bald, supported the development of a comprehensive risk management framework and programme. This is a document combining the policies and procedures and the operational manual. He also trained the relevant personnel in the finance department to take on this role. To enhance this capacity further, Faulu recruited an experienced Finance and Treasury Manager from the banking sector.

### 2.3.6 Management information systems

Faulu had been using the FAO/GTZ (Food and Agriculture Organization/ Gesellschaft fuer Technische Zusammenarbeit) developed Microbanker system for loan tracking. This clearly needed upgrading. A Board committee was established to supervise this process. With FSD Kenya's support, Faulu identified and engaged PriceWaterhouseCoopers to support them in selecting and configuring a suitable management and information/core banking system. A competitive tender process was launched and the Emerge T24 solution was selected in June 2007. The software had to be customised to meet Faulu's requirements and this was completed in December 2008. Data migration into the new system was completed in February 2009, although due to a high number of bugs, improvements to the system continued until the end of 2009.

Understandably, Faulu encountered a number of difficulties and delays in implementing the system. Some activities had to be temporarily suspended and some transactions had to be recorded manually for a short time. The process was made more complicated by having a number of new staff (mostly hired to cope with the growth in credit business). New employees had to become familiar with the new system as well as the internal policies and procedures.

### 2.3.7 Product mix

Through a competitive process, Faulu identified MicroSave Consulting Ltd to spearhead its market research and product development. The firm helped them to carry out a survey of the market to understand customer needs and refine its existing credit products. The survey identified five credit products:

- Business loans.
- Consumer loans.
- Agricultural loans.
- Salaried loans.
- Top up facility included for business and agricultural loans only.

Faulu also used the research findings to develop savings and money transfer products. The savings products were tested, refined and eventually launched following licensing and approvals from CBK. At the start of the deposit-taking business, Faulu's existing credit clientele opened accounts, though there was

minimal activity in these. From November to mid December 2010 Faulu conducted a marketing exercise on television. The new clients generated by this activity now represent the bulk of savings business for Faulu.

In addition to the market research and the initial support in product development, MicroSave trained twelve managers in these two areas to enable the organisation to undertake similar work in future. In recognition of the importance of market research and product development, Faulu created a new business development unit with its own manager.

### 2.3.8 Marketing, re-branding and positioning

In the process of the transformation, Faulu realised the importance of making their institutional changes visible to the public, and a new mission statement, vision and core values were drawn up. A new company logo and corporate identity have also now been adopted. The internal launch of the new brand was an important step in the re-branding. Communicating the rationale behind Faulu's new image to the staff was equally important. As part of this endeavour, a competition was organized to identify a staff member who could best demonstrate/explain the new brand. Although MicroSave was involved in the first steps of the re-branding, most of work was undertaken by Imagine Works. The re-branding was a definite milestone, and one of the key success factors of the transformation, both for the staff and the public. Faulu is satisfied with the results.

A marketing promotion was also held to attract more clients who would eventually become lenders. The promotion, dubbed *Vukisha Uvuke* (which means 'cross the bridge to success and help others to cross with you'), resulted in an increase of clients from 170,000 to 225,000 between March and June 2009. Encouraged by both the favourable results from the market study and product development exercise, Faulu decided to reinforce the research and product development unit. In the third quarter of 2009 one of the three research officers was promoted to research manager.

Figure 2: Faulu's old logo



Figure 3: Faulu's new logo



## **2.4 STRUCTURAL TRANSFORMATION: CREATING FAULU KENYA DTM, ATTRACTING INVESTORS AND STARTING OPERATIONS**

### **2.4.1 Creating Faulu Kenya DTM and attracting investors**

Faulu established itself as a company limited by share capital in 1999 in order to obtain debt funds from the market. In 2004 the institution decided to go a step further and become a public limited company, issuing a bond to raise additional funds for operations. Once this was accomplished, the main challenge was to identify new, like-minded shareholders/investors. Ideally, incoming shareholders would not only share Faulu's social objectives, but also the Christian faith of its current investors. The new Microfinance Act limits individual shareholding to 25% of the total share capital. The Act gives transforming institutions four years to comply with this requirement following licensing. Faulu has started negotiations with international development-oriented financial institutions that share its social vision and mission, and are comfortable with its Christian faith. Although various discussions began during the transformation period, no new shareholders have yet come on board.

To inform and attract potential investors Faulu prepared a restructuring strategy, an information memorandum and a shareholder agreement. Deloitte and Touche had carried out a valuation of the company in 2008 which was reviewed by chartered accountants De Chazal Du Mée (DCDM) in 2009. In line with its social mission and to provide incentives to its employees and directors, Faulu plans to establish an employee share ownership plan (ESOP) and a director share ownership plan (DSOP) as part of the restructuring of the ownership arrangement. Draft plans have been developed and will be finalised and implemented in due course.

### **2.4.2 Starting deposit-taking operations**

Faulu received the letter of intent for the approval of a deposit-taking licence on 24th December 2008. The Central Bank of Kenya issued them with the licence on 21st May 2009. Faulu's pilot branch was opened in Mombasa in April 2008. By the end of 2010, Faulu had set up a network of 25 branches. However, the CBK requirements, particularly concerning the security measures, made the costs were extremely high, and the whole process was much more difficult than expected.

## Chapter 3

# THE TRANSFORMATION EXPERIENCE OF KENYA WOMEN FINANCE TRUST

### 3.1 BACKGROUND

By start of 2009 when Kenya Women Finance Trust (KWFT) embarked on the transformation into a deposit-taking institution in earnest, it was the largest non-bank microfinance institution in Kenya, serving 250,000 women only clients.

KWFT first realised it needed to transform ten years earlier. The business model had become inadequate and the institution was not able to grow in its current form. The Chief Executive Officer attended several conferences and seminars to consider the options. The thought of transforming brought into question the very nature and identity of the organization, what it wished to accomplish, and with what means. In the late 1990s development for women was generally thought of in terms of financial support. KWFT however, was convinced that empowerment of women was only possible through a combination of both financial and non-financial instruments.

KWFT joined the Women's World Banking (WWB), a network of financial institutions for women covering some 28 countries by 1982. In this initial strategic planning stage, WWB gave KWFT valuable insights and a platform to exchange ideas about the empowerment of women. Exchanges with sister organizations, and trips in Latin America provided examples of different transformation possibilities.

The first step in this transformation journey was to decentralize. This was crucial to develop the business and expand the client base. The process began in 2000, and led to the creation of what is today a network of more than 210 offices throughout Kenya. The second step was to develop its products. However, KWFT's legal form then was limiting and, it soon became clear that it needed to be transformed in order to offer a wider variety of products and services.

KWFT had a competent Board of Directors composed of bankers, financial analysts, entrepreneurs, marketing and human resources experts, and lawyers. The bankers were in the front-line, proposing a transformation in which KWFT would evolve towards becoming a bank. A preliminary analysis found this strategic option extremely costly. It also threatened to force the institution to go beyond its scope of concentrating on women clients.

In early 2006, with the support of FSD Kenya, KWFT contracted a South African consultancy, Genesis Analytics to explore various transformation strategies. The study confirmed that transforming into a commercial bank would be costly. The Microfinance Act, passed in late 2006, presented an alternative strategic option for KWFT. While not granting the full benefits of transforming into a bank, the Act provided a chance for the organization to mobilize deposits and grow.

The final decision to create a for-profit deposit-taking MFI was made in 2008. The Deposit-taking Microfinance Institution (DTM) was to be owned by a holding company named Kenya Women Holding (KWH) and was to be known as Kenya Women Finance Trust Deposit Taking Microfinance Institution (KWFT DTM).

### 3.2 PLANNING AND MANAGING THE TRANSFORMATION

KWFT's Board prepared a detailed transformation plan which was organized in four phases over three years. The formal licensing of KWFT as a for-profit deposit taking financial institution, regulated by the Central Bank under the Microfinance Act, was expected to take six months.

#### 3.2.1 The transformation plan

There were several dimensions to the evolution of the new institution: capacity building, human resources management, cultural adaptation and geographic development. These were integrated into a strategic transformation plan that was developed with the assistance of Deloitte and Touche Consulting Ltd.

The first phase was to change KWFT into Kenya Women Holding, which kept the same legal form as a not-for-profit company limited by guarantee, and to establish KWFT DTM as a private company limited by share capital. As part of this process, it was necessary to conduct an analysis identifying human resource gaps, develop prospectuses, contact potential shareholders, and create a strategy for growth. The second phase of transformation involved developing its licensing strategy. This required a new institutional analysis which took into consideration the CBK licence requirements for a deposit taking institution.

The licensing requirements necessitated human resource changes, audit review mechanisms, and a risk management strategy and policies. A geographic strategy for establishment of branches, a governance review and institutional procedures were also needed. At the end of the second phase, KWFT was in a position to implement all requirements. The main focus for the first two phases was capacity building. According to growth projections, KWFT's assets were expected to increase significantly once the transformation process began. This meant that institutional capacity also had to increase.

The aim of the third phase was to obtain the deposit taking license. All planning and analysis in the second phase had to be implemented and tested before handing in the licence application. Finally, the fourth phase was to expand the network for banking operations (with and without branches) and provide extra services to the target group.

#### 3.2.2 Managing and funding the transformation

According to KWFT's initial budget, the estimated cost of the first phase of transformation was about KShs 113 million. FSD Kenya was to fund 52% and the balance was to come from KWFT itself. KWFT planned its budget

**Table 5: KWFT's milestones in the transformation process**

Date	Milestones
February 2007	Strategic transformation plan approved by the Board of Directors
August 2008	Submission of application to the Central Bank of Kenya
December 2008	Letter of intent of the Central Bank of Kenya for the approval of the license
April 2010	KWFT DTM received the license for a deposit taking microfinance institution in Kenya
May 2010	Opening of pilot branch
May 2010	Launch of the savings products

in detail. The projected incomes were expected to grow by KShs 80 million, covering 70% of all costs of the transformation. However, as indicated in section 3.3.2 below, the real costs, as well as the timeframe were significantly underestimated.

KWFT was fully responsible for implementation of the transformation plan. Deloitte and Touche Consulting Ltd was engaged for a period of seven months from October 2007 to April 2008, during which all four transformation phases were to be covered, subject to the DTM licence being granted by the Central Bank of Kenya.

### 3.2.3 The technical support during the transformation

The licensing process actually lasted 18 months, three times longer than expected. KWFT hired the services of the Deloitte and Touche Consultancy Ltd to provide specialised support in all functions where needed. However, Deloitte Consulting, is not specialized in microfinance and therefore needed time to acquire knowledge, especially at the beginning of the assignment. This caused some delays.

## 3.3 OPERATIONAL TRANSFORMATION: UPGRADING AND SYSTEMISING

To transform successfully, KWFT needed to hire and train staff, set up offices, and enhance its hardware, software, and ICT capacity. In effect, this meant a cultural revolution within the organization.

### 3.3.1 Human resources management

A number of changes were happening in human resources at the same time. Apart from the transformation process, KWFT's regular business was expanding rapidly. They therefore had to increase personnel in order to cope with the increased business and to meet the high regulatory requirements from the Central Bank Kenya. KWFT had to reconsider every position within the organization, weighing up current capacity against the future needs of the organization. KWFT was proud of its employee ownership, and integrating the new personnel presented significant challenges. Entry level staff had always been encouraged to develop gradually into management positions. This is the first time staff members were recruited externally for management positions.

Most of the new personnel were recruited to support the growing business. In order to meet the regulatory human resources capacity requirements and to accommodate the new changes, the organization hired almost 800 employees in the two years between 2008 and 2010, almost doubling staff numbers (from 914 to 1709).

KWFT's policy of relying on internal promotions and networking to fill staffing needs was an integral part of the organization's culture, yielding both confidence and loyalty. It was therefore a shock for some employees to find new external staff with different backgrounds being hired for middle or senior positions. People with a banking background, and therefore a more profit-oriented approach were hired for the branch operations. This was different from the more social attitude of most of the existing employees. In order that everybody in the organization shared the same business values, KWFT

**Table 6: KWFT's institutional data before and after transformation**

	No of Branches	No of clients	No of outstanding loans	Total outstanding loans portfolio (KShs)	Average disbursed loan size (KShs)	No of depositors
Before transformation (Dec. 2008)	167 non-deposit taking branches	238,554	247,532	6.7 billion	Group loans: 38,098 Individual loans: 303,000	Compulsory: 238,554
After transformation Start (Dec. 2010)	200 non-deposit taking 7 deposit taking branches	440,628	434,597	12.9 billion	Group loans: 37,672 Individual loans: 250,000	Voluntary: 138,169 Compulsory: 416,813

put all new employees through an orientation training which focused on their main operations and target group. The new management structure included five new senior management staff working with the CEO, bringing the total number to twelve.

All new recruits, regardless of position, are sent to the field units to assist in and conduct loan business with clients. This is considered fundamentally important and is designed to instil the core business values and mission of KWFT. All senior management hired in the transformation process underwent this process, something the staff considered a very important part of working with KWFT DTM. Managers who came from a banking environment, hired during the transformation process, soon learnt that microfinance is distinct from pure profit-oriented banking business. Once they started work, they were able to teach banking in turn to those staff members who came from a microfinance background. The new management worked closely with staff who had been with the organisation before the transformation, and each was able to exchange information about their own areas of expertise. This helped maintain direction, and avoid mission drift.

This human resources change, although stressful, has been a success. No single member of staff, whatever their role or responsibility, left the organization due to the transformation process. Effective communication played a key role. The KWFT senior management and the Board travelled to every branch and office, discussing and explaining the steps and procedures that were going to take place. They strived to convince every person that the organization was going in the right direction and had the resilience to succeed in its new form. With the new organisational structure in place, the transformation process

in terms of human resources was complete. Training is an on-going activity of the human resources department. Prior to the transformation, the human resources unit comprised two staff members. A training arm has now been added, bringing this to four.

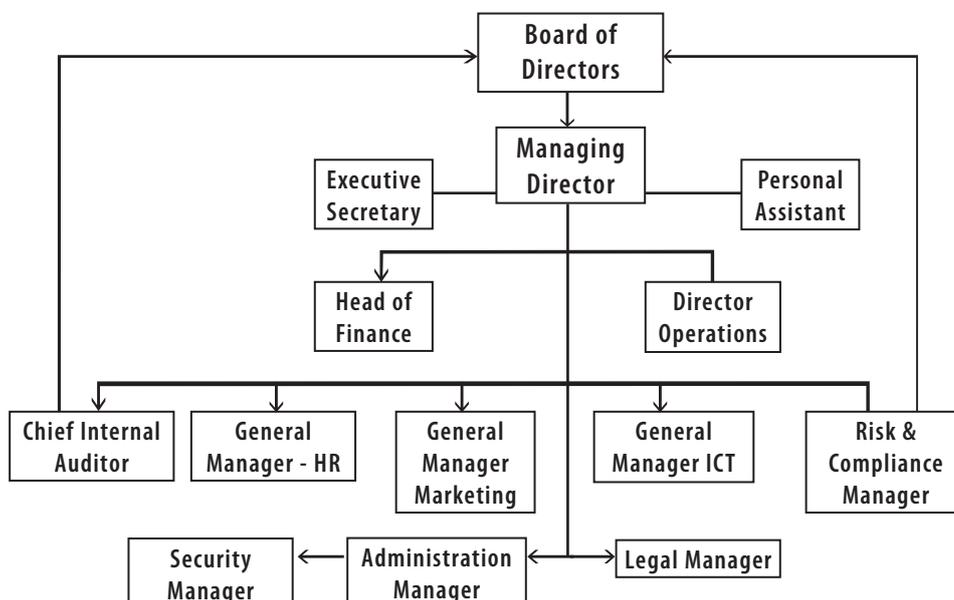
**Table 7: Changes in the personnel of KWFT during the transformation**

	No. of employees	No. of senior management	No. of loan officers	No. of client advisors (savings products)
Before Transformation (Dec. 2008)	914	7	697	0
After Transformation (Dec. 2010)	1709	12	1262	98

**3.3.2 Financial management of the transformation**

KWFT has managed to maintain good portfolio quality and strong growth during the transformation process. The organization’s portfolio at risk (less than 30 days) is currently lower than 2%, and never went above 3% since late 2007. This is remarkable considering that the organisation more than doubled its number of active loans and tripled the volume of its loans in the same time period.

**Figure 4: KWFT’s organizational chart after transformation**



The transformation has cost approximately KShs 600 million. FSD Kenya funded 25% while the bulk of the difference was made up by KWFT itself. Some funding support was also received from the Ford Foundation. The costs of the various components varied. The changes in ICT, and development and implementation of policies and procedures for all departments to fulfil the regulatory requirements for a DTM, were the most expensive.

Investment in infrastructure does not necessarily give an immediate or direct return. An institution wishing to transform must have large reserves, and strong, sustained growth. Before considering transforming, an organization must have a realistic business development plan and anticipate to create sufficient growth during the process, in order to be able to pay all the costs of transformation.

KWFT DTM has enjoyed strong growth throughout the transformation process: business has grown by about 100% every year since 2007. In readiness for the transformation, the organization created a reserve. It relied on loans to fund the microfinance activities, putting aside profits for investment in the transformation. The debt load is considered to be sustainable as all the costs are capital investments, and are expected to yield returns over time.

The transformation resulted in the creation of separate departments for finance, information and communication technology (ICT), Human Resource Management and administration. In the past, all four areas were combined in one department which fell under the direct responsibility of the General Manager.

### 3.3.3 Management information systems

The organisation anticipated that ICT would be a difficult area to manage. KWFT had a centralized ICT system before the transformation process, and the main task was to upgrade the system in order to fulfil the regulatory requirements. KWFT was already using the ICT system Temenos (T24) but needed an upgrade to be able to cope with the necessary changes in procedure. They also needed to equip the deposit-taking branches with new software and expanded capacity. The upgrade and transition into use of the new system posed a number of challenges. The ICT system became unreliable for a number of months due to problems in the database and the system upgrade. When the system went live, a number of bugs were detected. This was a particularly stressful time for all staff. It became clear to everybody that the information from the system was not adequate and a manual system had to be run in parallel. The system is now stable and KWFT is optimistic about resolving the remaining bugs.

The equipment for a countrywide infrastructure was extremely costly, and to this day, the organization is networked only to the level of the regional offices and the new branches. The microfinance offices will all be networked in the near future. ICT maintenance was an important consideration in deciding

which system to use. T24 maintenance requires expertise which is not always available in Kenya. For more specialized maintenance experts are drawn from South Africa or India which adds to the cost.

### 3.3.4 Product mix and branch operations

KWFT DTM has built competence in developing products that seek to address the needs of the whole family. Its marketing strategy is to touch all aspects of family life and includes products such as consumer credit for water tanks or housing projects, loans for energy (notably solar), and agricultural development (both land cultivation and fisheries). To promote the well-being of the family, loan products ameliorate everyday life, health, and financial growth.

The transformation process has embraced this strategy. Adding the savings to its activities allowed KWFT DTM to boost its core credit business. Moreover, a savings product directly addresses the needs of the family. Women in particular benefit from transactional accounts, giving them greater financial independence. They can access the family savings for everyday purchases or invest in one-off goods and services which help to improve family life. Long-term savings products for example, give clients the opportunity to provide for health and school expenses. KWFT DTM is also investigating micro-insurance products, an area which the new Microfinance Act allows.

The transformation process regarding products is divided into three stages:

- Develop and make available products that are being used by other banking businesses, to capture part of the market. Given that 99% of savings products in the Kenyan market are identical, KWFT DTM will convince its current loan clients to open savings accounts with them to simplify loan disbursements. Cheques, which had to be deposited in banks, have been the preferred method of disbursement. Opening an account with KWFT DTM eliminates this need.
- Develop specific products to cut out a niche where KWFT has a competitive advantage. A market study was undertaken to inform savings products development. These new products were introduced in the market in the third quarter of 2010 following licensing.
- Develop products for the full cycle of human life (birth and maternity, healthcare, death provisions, etc.). These products are expected to be made available by the end of 2011.

The marketing department was not changed much by the transformation process, and participated actively in development of new products. The process is on-going, and obtaining the deposit-taking licence is just one step in building a much wider and stronger organization.

### 3.3.5 Marketing, re-branding and positioning

The most visible aspect of transformation in the marketing department was changing the organization's logo. The acronym of KWFT was maintained to

provide continuity. This was also stressed by uniting the letters. Gold was added to the brown to emphasise the vast amplification of services.

**Figure 5: KWFT's old logo**



**Figure 6: KWFT's new logo**



### 3.3.6 Creating KWFT DTM

KWFT provided both financial and non-financial activities. It was decided that the financial activities would transform into the newly created KWFT DTM and the non-financial activities remain within Kenya Women Holding (KWH). KWH has an autonomous Board and CEO together with its own staff. Its roles and responsibilities include ensuring that KWFT's mission and vision are maintained.

After the creation of KWH, the majority of KWFT's activities turned into KWFT DTM (which obtained its licence in April 2010). KWFT DTM was created to hold and manage the previous KWFT loan portfolio, find new business, and invest profitably. Currently KWH is the only shareholder of the DTM. The dividend earned by KWH will be used to further women's empowerment. KWFT DTM has its own Board of Directors which makes all relevant policy decisions and oversees the business.

#### Governance

The governance structure of KWFT DTM is independent from that of KWH. It has its Board and management staff who work toward accomplishing the for-profit organization. As an internal requirement, two-thirds of Board members must be women. Furthermore, to impede mission drift, powers have been split between the Board and shareholders.

There are currently nine Board members, five of whom were already in KWFT before its transformation. The other four have been appointed to manage the expanded and new responsibilities, especially in the banking operations, and to meet CBK's requirements regarding the required skill set.

#### Attracting investors

KWH currently owns 100% of the for-profit KWFT DTM. As per the microfinance regulations, CBK gave KWFT DTM (like any licensed DTM) four years to make the transition to a maximum of 25% shareholding by each shareholder. KWH intends to own 25% of the organization within the required time. It will do so by diluting its shareholding through inviting other shareholders instead of divesting. The organization is seeking social, long-term, responsible investors, not speculators. These investors are expected to bring not just funds, but ideas for future growth and commitment to the organization's mission and values.

KWH will seek to maintain a strong degree of ownership by Kenyan organizations. The KWH Board has decided that no less than 65% of KWFT DTM will be owned by Kenyans, leaving a maximum share of 35% for foreign investors.

### 3.3.7 Starting deposit-taking operations

The Central Bank of Kenya has very stringent requirements for deposit-taking branches under the microfinance regulations. KWFT DTM had nevertheless established seven licensed branches by the end of 2010 and was preparing another three in January 2011. The cost of setting up a new branch is estimated at between KShs 20 and 22 million. Most of this cost relates to stringent security requirements which are, almost identical to bank standards. An international standards safe room with a fire-proof safe is required. Closed-circuit cameras and security personnel are also required by CBK. These high security standards were considered unnecessary as the funds held by the branches are insured. This creates a double-cost for the volume of funds held, even though this is not as high as in traditional banks.

There are three types of branches within the KWFT DTM network: small, medium and large, according to the volume of loans and savings capacity in the area of responsibility. Small branches have between 10 and 12 staff; medium between 13 and 17; and large are not expected to exceed 20 staff members. These numbers do not include loan officers, who are placed in unit offices in the field. They do not normally work within branches except for reporting and credit committee purposes. Most loan officers work directly with clients in the villages.

The regional offices include the back office for both savings business carried out in the branches and credit business carried out in the units. The branch/unit structure is expected to change as more branches are opened, though reporting and back office functions will remain in the regions. The architectural layout of the branches accommodates this change, with the ground floor being used for savings business and the first floor for credit.

It is still early days and, as might be expected, the savings business is not yet optimal. According to the business plan, approximately KShs 3 billion deposits were expected to be mobilised by the end of 2010. However, this has proved ambitious. The total voluntary savings collected to end of the year were KShs 460 million while compulsory savings grew to KShs 5.6 billion. Although the delay in receiving the deposit-taking licence significantly contributed to this (the licence was expected by end of January but was actually received in April), it has been more difficult to attract savings than hoped. However, performance is expected to improve markedly as more branches are opened.

The fact that loans are no longer distributed in the form of cheques but are now credited to the client's deposit account is an important modification in operations. It has created not just a shift in procedure, but also requires an

evolution in client perception. Clients need to be reassured that their money will be available in a bank account and can be accessed by going to the teller at the branch, using a card at an automated teller machine (ATM) or through mobile banking. It will take time to build the trust necessary for the client to be totally comfortable that a physical cheque is not needed, and that KWFT is not keeping the loan for itself.

The operations department has been significantly changed as part of the transformation. There are now three General Managers in the regions reporting to the Director with whom responsibility for operations now rests. In future Branch Managers will report solely to the General Manager in their region. However, during the transition phase, Branch Managers will also

report to the Director of Operations. Two new management staff members, a Head of Liabilities and Head of Credit will be required. The three General Managers were internally promoted from their previous positions as Regional Managers. The Director of Operations and the Branch Managers were hired externally from the banking sector.

Despite the challenges of transformation, KWFT DTM has grown considerably. Growth is expected to be sustained through the introduction of new products and opening new of business places. KWFT DTM has been conservative in its procedures, taking the time necessary to consider all options before acting, and exercising caution to ensure that the systems work before proceeding. This prudence has served the institution well and it has maintained its growth and position of leadership in the market.

## Chapter 4

# STRATEGIC IMPLICATIONS OF TRANSFORMATION

Although both Faulu Kenya and KWFT suffered setbacks and delays in their transformation, this has been successfully achieved in both institutions. Indeed, neither institution lost positioning in the sector. On the contrary, both continue to be leading examples for other MFIs and microfinance providers. The transformation has allowed them to increase both their outreach and the number of products and services available to their clients.

However, it is undeniable that transformation is a stressful process for any institution. A thorough feasibility study which examines the capacities, cost implications and environment in which it will operate is essential before deciding whether it is the right option for an organisation. Transformation involves a complete makeover of organisational, cultural and operational structures. This can be met with resistance not only by those within the organization, but also outsiders such as its clients. As these two case studies have demonstrated, change occurs at every level. If the change is not properly managed there is a risk that the organisation could take several years to recover and result in lost opportunities for growth and development.

Below are some of the key areas which institutions should consider prior to engaging in a transformation process:

### 4.1 PLANNING

Know your institution and its capacity for growth. Do not overestimate the potential of your organisation. It is preferable to undertake a progressive transformation - in several phases - leaving time for adjustment at each phase, than to hurry through the process. Detailed strategic planning is important before embarking on the transformation process.

### 4.2 SUSTAINABILITY

Transformations are very costly, both in terms of financial and operational resources. The process itself can be a long one and is often full of obstacles. Before considering a transformation, it is therefore important to have a history of strong growth good prospects of sustaining it throughout the process.

### 4.3 HUMAN RESOURCES

Taking on a transformation from a credit-only microfinance institution into a DTM requires developing new areas of expertise, especially in the area of deposit-taking. As experienced by both Faulu and KWFT, staff capacity can be enhanced either by training existing personnel or recruiting new personnel with the required skills. This should be accompanied by a detailed training plan for existing personnel, and an integration plan for new staff to ensure that both can work together in harmony.

### 4.4 GOVERNANCE

A good governance culture is necessary prior to beginning a transformation, since it helps to ensure transparency. Moreover, once transformed, the organisation will be subject to even greater scrutiny, which may become

cumbersome if the management is not used to strong governance structures. The DTM regulations have specific governance requirements which must be met before licensing. It might be necessary to re-organise the Board to realise the required skills.

### 4.5 COMMUNICATION

Effective communication is a crucial component of any transformation process. Change is always associated with risk, and for this reason it is important to have a good communication strategy before, during and after the transformation. It is very important to keep members of the organisation and the public constantly informed and assure them that their interests are protected throughout the process.

### 4.6 OWNERSHIP

In order for a transformation to succeed, it must be embraced by all members of the organisation: staff, management, Board of Directors and financial partners. All must be aware of and agree on the objectives that the institution plans to achieve through the transformation, the expected benefits and the investment the process will need. The top management has to be committed to ensure that the organisation will not back out at the first sign of difficulty, and that all staff are involved and feel part of the process.

Moreover, transformation means a change in the shareholding structure. With the 25% maximum single shareholder regulatory requirement, transforming into a DTM necessitates bringing on-board new shareholders. Their objectives may not be closely aligned to those of the existing shareholders. Transformation also implies dilution of control as each new shareholder has a right to participate in decision-making. Faulu Kenya and KWFT continue to struggle to find like-minded shareholders who share their strategic mission, vision and core values. NGOs considering transformation must make a decision about the type of investor they are looking for (strategic or financial), and draft comprehensive terms of reference well in advance. These should include a clear exit strategy for financial partners who might not envisage a long term commitment.

### 4.7 MISSION DRIFT

Most people who are opposed to the transformation of an NGO fear that a profit driven institution will drift away from its core mission of serving poorer populations. For some, the focus changes to the need to remain commercially viable and maximize shareholder returns. The fear is that, in order to ensure financial sustainability, MFIs increase the average size of their loans, not taking into consideration that the risks of default are also greater. This can mean that overall performance is harmed. There is therefore a need for a post-transformation period strategy which clearly stipulates how the institution will maintain its original mission. This should be shared with all stakeholders, shareholders, management and members of staff.

Chapter 5

# LESSONS, RECOMMENDATIONS AND CONCLUSIONS

The table below summarizes the lessons learned from the transformation experiences of Faulu Kenya and KWFT. It is highly recommended that any institution thinking about or preparing to transform into a deposit-taking microfinance institution studies this very carefully. Transformation is a

complicated, lengthy and expensive process. The decision to undertake such a change should only be taken after all the advantages and disadvantages have been thoroughly scrutinised.

**Table 8: Lessons learned from the transformation of Faulu and KWFT**

Area	Lessons learned
Planning and managing the transformation	<ul style="list-style-type: none"> <li>▪ It is necessary to have a full time transformation manager, who is not engaged in other responsibilities.</li> <li>▪ The transformation manager should have a thorough knowledge and understanding of the organization.</li> <li>▪ Technical support by consultants who have knowledge of both microfinance and banking is useful.</li> <li>▪ Commitment of the management and the Board of Directors is crucial to ensure a successful transformation.</li> <li>▪ Effective and constant communication with all stakeholders (shareholders, Board, management, staff and clients) is crucial and should be embedded into the transformation plan.</li> </ul>
Operational transformation	<ul style="list-style-type: none"> <li>▪ Human Resource and communication with staff and clients is extremely important to reduce tensions.</li> <li>▪ Training of personnel is important and should be well timed. When organized too early the learning effect is reduced since it cannot be put into practice immediately.</li> <li>▪ The transformation process will create unrest among personnel. It is pivotal to have a frequent and transparent communication with all personnel. It should be emphasized within the organization that the transformation presents opportunities to develop and grow within the institution. Effective communication will minimise staff turnover.</li> <li>▪ Usually, any transformation takes longer and costs more than initial estimates. This needs to be remembered while planning. The strategy should ensure that the institution has sufficient resources to cover the process – it is better to over-budget than under-budget. Availability of financial resources needs to be guaranteed before embarking on the process, otherwise it will stall halfway, wasting time and money. While continued growth of the institution (profits) would be ideal to finance the transformation, this may not be possible. Therefore sufficient reserves or alternative funds need to be available from the start.</li> <li>▪ Rebranding is an important tool to show the public, clients and staff that the institution has indeed changed.</li> </ul>
Organisational structure	<ul style="list-style-type: none"> <li>▪ A change in organisational structure becomes inevitable as the institution starts the deposit-taking business. Positions related to this which did not exist before such as liability manager, treasury manager and branch manager need to be created.</li> <li>▪ At the governance level, the regulations are likely to require the appointment of Board committees which did not previously exist. New skills, and therefore probably new directors, will also have to be introduced at the Board level to meet the regulatory requirements.</li> <li>▪ The choice of new investors must be made carefully and introduced gradually. This will minimize the risk of mission drift and avoid pressures for profit maximization before the transformation is completely accepted, both internally and externally.</li> </ul>
Structural transformation	<ul style="list-style-type: none"> <li>▪ Setting up a “bank” branch has proven to be time consuming and very costly.</li> <li>▪ CBK’s requirements for a DTM branch infrastructure are similar to those for commercial banks. The set-up of a branch network is therefore extremely expensive.</li> <li>▪ In reality, implementing branchless banking seems to be more challenging than had been envisaged.</li> </ul>

Area	Lessons learned
ICT/MIS	<ul style="list-style-type: none"> <li>▪ Prior to choosing an ICT/MIS, the organisation should obtain references from other institutions with similar structures, business models operating in similar environments.</li> <li>▪ A detailed analysis of the available solutions is advised before investing in ICT/MIS.</li> <li>▪ Strong project management is a key component of an ICT/MIS deployment and this should be assured at the start.</li> <li>▪ A testing period should be planned and contingency plan developed for accessing client data and continuing operations should the system fail completely.</li> </ul>
Donors/Partners	<ul style="list-style-type: none"> <li>▪ More often than not, transformations, take longer and are more costly than expected. It is necessary to maintain trust in the implementing partner and continue support until the transformation process is complete.</li> <li>▪ A transforming MFI must choose its financial partners carefully and make sure that candidates share the same strategic vision for the transformation.</li> </ul>
Regulatory environment	<ul style="list-style-type: none"> <li>▪ The current CBK requirements, especially with regard to branch security and prudential ratios, are not adapted to the microfinance business in Kenya. To encourage other organizations which are performing well to transform, a review of actual risks for DTMs would be necessary to lower some of the requirements and therefore costs.</li> <li>▪ The challenge in transformation is not in meeting the regulatory capital requirements but in realising the related costs to comply with the non-capital requirements. Key among these is investment in ICT/MIS and the establishment of a deposit-taking infrastructure.</li> </ul>

## RECOMMENDATIONS

Drawing on Faulu and KWFT experiences, we make the following recommendations for successful transformation in Kenya.

- A progressive transformation approach: it is preferable to undertake a progressive transformation, in several phases, leaving time for adjustment at each phase.
- Prudent planning: transformations are very costly in terms of time, finances and human resources. The process is often long and full of obstacles. Before considering a transformation, it is important to plan adequately and commit the required resources. These include a full-time transformation manager who has a good understanding of the institutional culture, and preferably several good external consultants with a track record in banking and microfinance.
- Readiness to develop new areas of expertise: a successful transformation will need the development of new expertise within the organization, especially in the area of deposit-taking. The experience of Faulu and KWFT demonstrates the importance of training existing staff and recruiting new employees within a short timeframe. There is need to identify capacity gaps and draw for a clear plan on how these are to be filled. Proper implementation of the training and integration plan is essential to ensure that both existing and new staff can work together in harmony.
- Governance: a very strong commitment towards good governance is essential for a successful and transparent transformation. Once complete, the organisation will be subject to even greater supervision of Central Bank of Kenya (CBK). This would become cumbersome and unproductive if the Board and management lacked commitment to strong governance principles.
- A good communication strategy: change is always associated with risk, and it is important to have a good communication strategy before, during and after the transformation. Both the members of the organisation and the public need to be informed and reassured throughout the process that their interests are being protected.
- Ownership from all stakeholders: the transformation should be embraced by all members of the organization (staff, management, and the Board of Directors). All must be aware of and agree on the objectives that the institution plans to achieve throughout the transformation. They must also be clear about the expected benefits and the investment required to transform successfully. The top management and the staff must be committed, to ensure that they will not back out at the first sign of difficulty. NGOs considering transformation must draft clear terms of reference (ToR) and know in advance the type of investor they would like to attract - strategic or financial. The ToR should include a clear exit strategy for financial partners, who may not envisage a long term commitment.
- Mission Drift: there must be a clear strategy detailing how the institution will maintain its mission of serving the target group following transformation. This should be shared with all the stakeholders (shareholders, partners, members of staff and clients).

## CONCLUSION

Transforming into a deposit taking institution is a huge task. Organisations which believe it is their future must have a solid past. They need to start from strong foundations, continue to be well organized and flexible enough to keep aspirations focused when difficulties arise. They will also need determined leadership, dedication, excellent communication and a great deal of patience. For those that have all these requirements, the risks and rewards still need to be carefully weighed up. Investing in staff training throughout the organisation, particularly in the use of new MIS, mobilising and managing deposits, and developing and marketing new products is crucial.

Both Faulu Kenya Ltd and Kenya Women Finance Trust have transformed successfully. Although their journey was often difficult and protracted, they have eventually arrived at a place in which they believe they can thrive. Our review of the Microfinance Act and the supportive DTMs regulations concludes that the current legislation is very stringent, both in licensing procedures and

branch infrastructure establishment. Credit-only MFIs seeking a DTM licence should therefore prepare a detailed and prudent strategy, dedicating sufficient human and financial resources to the transformation process. At the same time, they must concentrate on continued business growth in order to make the profits needed to help finance part of the process. Transformation is extremely expensive and a detailed strategy to manage the finances throughout the process will be essential.

In the two cases under review in this report, the transformation process took longer than expected and cost far more than initial estimates. Their experiences show that transformations are long and complicated processes which call for ownership from all stakeholders. They also highlight the importance of a clear communication strategy to ensure that the interests and incentives of all parties are aligned. Those contemplating transformation have a great advantage: they can be better prepared as a result of the pioneering experiences of Faulu Kenya Ltd and the Kenya Women Finance Trust.

## Annex

# CRITICAL ANALYSIS OF THE MICROFINANCE ACT AND THE SUPPORTIVE REGULATIONS

Structured in three sections, this report analyses the legal framework that regulates Deposit-Taking Microfinance institutions (DTMs) in Kenya. The first section summarizes the main provisions of the Microfinance Act. The second section delivers a comparative analysis of the Microfinance Act and the Banking Act. The last section draws the implications of the Microfinance Act for the microfinance sector in general and the potential for institutional transformation in particular.

## 1.1 THE MICROFINANCE ACT

Although the Kenyan microfinance sector is one of the most vibrant in Sub-Saharan Africa with a diversity of institutional forms and a good infrastructure to serve the poor, microfinance activities were not regulated until 2006. The absence of regulation allowed innovations to take place. Institutions were set up easily without any barrier like minimum capital requirements. In this environment, the microfinance industry has developed and managed to attain reasonably high outreach.

During the last two decades, banks focusing on microfinance have entered the market through a greenfielding strategy (e.g. Co-operative Bank) or an institutional transformation approach - Equity Bank and Family Bank have transformed from building societies and K-Rep Bank from an MFI NGO. These institutions offer fully-fledged banking services to micro and SME clients. A high number of NGO MFIs are also serving the same market segment. The NGO MFIs considered various possibilities of expanding their businesses but they were not allowed to collect deposits and therefore had to rely either on expensive funding sources (borrowings) or unreliable subsidies and grants.

The endeavour to regulate MFIs is a clear recognition by the public and the Government that some efforts are required to set up the rules of the game in a market shifting from donor funded and poverty oriented institutions to for-profit organizations. Indeed, the presence of banks in the market and the desire of former credit-only institutions to leverage deposits from the public are a fundamental reason to implement and enforce prudential regulations in order to prevent the institutions' failure and protect depositors. Against this background, the Microfinance Act was enacted in 2006 and the supportive Deposit-Taking Microfinance regulations effected in 2008.

By end of March 2011 there were varied forms of registrations for institutions operating in the microfinance industry in Kenya. Table 9 gives an overview of the formal microfinance landscape and the regulations applicable to each institutional form.

As a result of the implementation of the recently enacted SACCO Societies law, a new formal institutional type of deposit-taking institutions is in the process of being added to the current variety of regulated institutions. Informal microfinance operators like money lenders, Rotating Savings and Credit Associations (ROSCAs), Accumulating Savings & Credit Associations (ASCAs), and village banks are also present in the market.

### The main principles of the Microfinance Act and the supportive regulations

**Scope:** The law applies to microfinance institutions which are involved in deposit-taking business. The DTM regulations state that any MFI willing to

**Table 9: Microfinance regulatory framework in Kenya**

Institution	Number	Legal basis for regulation	Supervisory Authority
Deposit-taking microfinance institutions (DTM)	5	Microfinance Act 2006 and the supportive DTM regulations 2008.	Central bank of Kenya (CBK)
Credit only MFIs	About 200 in October 2010 (Economist Intelligence Unit October 2010)	Unregulated; discussions on the way between the Ministry of Finance and the industry stakeholders to develop regulations in line with international best practices. <sup>5</sup>	Ministry of finance
Banks	6 with a specialized focus on microfinance (microfinance departments) as of December 2010	Banking Act	CBK
SACCOs	Over 5,000 of which nearly 220 offer Front office savings services (FOSA) in October 2010 (Economist Intelligence Unit October 2010)	SACCO Societies Act 2008 and the supportive SACCO Societies regulations 2010. This legislation only applies to an estimated number of 220 SACCOs operating FOSAs.	Sacco Societies Regulatory Authority (SASRA)

<sup>5</sup> According to the Microfinance Information Exchange

conduct deposit-taking business should apply for licence with the Central Bank of Kenya (CBK). Credit-only MFIs are not under the scope of the DTM regulations and neither are the SACCOs as outlined in Table 9.

**Legal definition of a microfinance loan:** The Microfinance Act clearly defines a microfinance loan as a credit facility granted to an individual single end borrower (and his associates) whose maximum amount shall not exceed 2% of the MFI's core capital.

**Control for mission drift:** This is provisioned for in the DTM regulations. MFIs licensed to conduct deposit-taking business should dedicate more than 70% of their portfolio to microfinance loans. At the same time, large exposures (loans between 2% and 5% of core capital) should represent less than 30% of the portfolio.

It is often argued by academic and practitioners in many countries that the implementation of a prudential regulation leads to increasing costs for former unregulated (non profit) institutions. In many cases, these institutions have to adjust their MIS, build the internal support functions for deposits mobilization and comply with stricter reporting requirements. It is possible that the regulation costs exceed the benefits, in which case institutions are tempted to change their lending policy and strategic mission. It might indeed sound reasonable to target a higher market segment and avoid the heavy transaction costs borne on tiny loans if the change in regulatory regime does not produce the expected effect on costs and profitability. But with a minimum ratio of 70% of microfinance loans, the DTM Act ensures that MFIs are not going to shift focus from the micro segment.

**Prudential ratios:** The Act has defined the following prudential ratios: (1) Capital adequacy ratios including a core capital of 10% of total risk adjusted assets plus risk adjusted off balance sheet items, core capital of 8% of total deposit liabilities, total capital of 12% of total risk adjusted assets plus risk adjusted off balance sheet items; (2) a minimum liquidity ratio of 20%; (3) a limit on insider loans – should not exceed 2% of core capital and should be contained on aggregate within a ceiling of 20% of core capital.

**Reporting requirements:** The deposit-taking MFIs must submit the following periodic reports and other disclosures to the CBK: bi-weekly liquidity information, monthly reports on Capital to Risk Weighted Assets, quarterly unaudited financial statements and annual audited financial statements.

**Protection of depositors:** although not provisioned for in the DTM regulations, the microfinance Act of 2006 provided that all institutions should contribute to the Deposit Protection Fund. The Fund would prescribe the amount of the contribution and discloses the maximum balance per customer that is protected in case of insolvency.

**Sanctions:** The legislation details tough sanctions are listed in case of non-compliance with the capital adequacy standards. All the other offences are left to the appreciation and the discretionary power of CBK.

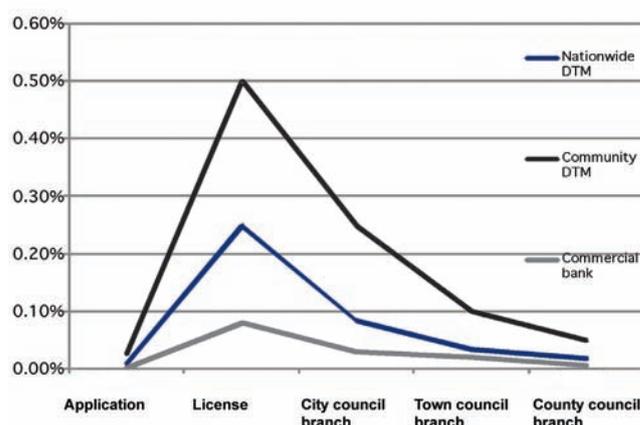
## 1.2 COMPARATIVE ANALYSIS BETWEEN THE BANKING ACT AND THE MICROFINANCE ACT

In Kenya, formal MFIs are regulated under two legislations: the Microfinance and the Banking Acts. Implementation of the SACCO Societies Act started in June 2010 when the related regulations took effect. Regulations for credit-only MFIs, principally NGOs, are still under formulation.

This section compares the Microfinance and Banking Acts to account for two major facts detailed in Table 10. First, institutions which are governed under both legal texts are allowed to collect deposit from the public, as such they are subject to prudential regulation with regular on-site visits from the CBK, and stringent reporting requirements. The second reason stems from the critic (justified or not) who argue that the Microfinance Act and the supportive regulations are too stringent and similar to a banking regulation, thus not appropriate for the microfinance sector. The aim of this comparative analysis is to build a basis for an objective judgment after reviewing the key elements of the regulatory regimes of deposit taking MFIs and banks offering microfinance services in Kenya.

The Microfinance Act and related regulations have set up entry barriers for institutions planning to undertake deposit-taking business by fixing the minimum capital amount and license fees. As suggested in the figure below, the license fees are high, relative to size for the community based DTM compared to nationwide DTMs and Banks. The rationale for this might be that the CBK is less keen to take on the supervision burden of institutions which do not pose significant danger to the stability of the overall financial sector, therefore seeking to limit the number of such institutions.

**Figure 7: License fees as a % of minimum capital**



**Table 10: Non-prudential regulation**

	<b>Microfinance Act</b>	<b>Banking Act</b>
Scope of the law	Limited to deposit-taking MFIs only	Central bank of Kenya (CBK)
Supervisory authority	CBK	CBK
License fees	<ul style="list-style-type: none"> <li>▪ KShs 5,000 when applying for setting up a deposit-taking MFI (nationwide or community based) and opening a branch;</li> <li>▪ KShs 150,000 and 100,000 on the granting of a license respectively for a nationwide and community institution (with a yearly renewal);</li> <li>▪ License and annual renewal fees per branch within: <ul style="list-style-type: none"> <li>• City Council – KShs 50,000</li> <li>• Municipal council – KShs 20,000</li> <li>• County council – KShs 10,000</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ KShs 5,000 when applying to conduct a banking business or opening a branch as an institution;</li> <li>▪ KShs 40,000 on the granting of a license with a yearly renewal;</li> <li>▪ License fees and annual renewal fees per branch within: <ul style="list-style-type: none"> <li>• City Council – KShs 150,000</li> <li>• Municipal council – KShs 50,000</li> <li>• County council – KShs 30,000</li> </ul> </li> </ul>
Minimum capital requirement	<ul style="list-style-type: none"> <li>▪ KShs 60 million for nationwide DTMs.</li> <li>▪ KShs 20 million for community based DTMs</li> </ul>	<ul style="list-style-type: none"> <li>▪ Commercial banks: KShs 500 million by end of 2010, but set to increase to KShs 1billion by 2012.</li> <li>▪ KShs 200 million for non-bank financial institutions.</li> </ul>
Prohibited activities	Activities restricted to credit, savings and remittances. DTMs cannot issue cheques or offer other banking services.	Banks can offer a diversified range of products. They can issue and process cheques.
Depositor protection	Not provisioned in the Microfinance (DTM) regulations 2008 but included in the Microfinance Act, 2006. This has now been made an amendment to the regulations.	Banks must annually contribute to the Deposit Protection Fund a sum determined by the Minister of Finance, which will be at least KShs 100,000 and no more than 0.4% of average total deposit liabilities during the preceding twelve month period.
Reporting requirements	<ul style="list-style-type: none"> <li>▪ Biweekly: Liquidity report;</li> <li>▪ Monthly: <ul style="list-style-type: none"> <li>• Capital adequacy report;</li> <li>• Compliance report;</li> <li>• Activity report.</li> </ul> </li> <li>▪ Quarterly: <ul style="list-style-type: none"> <li>• Unaudited financial statements;</li> <li>• Place of business report.</li> </ul> </li> <li>▪ Annually: <ul style="list-style-type: none"> <li>• Audited financial statements;</li> <li>• Maturity analysis of assets and liabilities;</li> <li>• Returns to the Deposit Protection Fund Board (DPFB);</li> <li>• Return on the distribution of credit by sector.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ Biweekly: Liquidity report;</li> <li>▪ Monthly: Capital adequacy report;</li> <li>▪ Quarterly: Risk classification of assets and provisioning; loans/advances performance report; report on advances to person/group exceeding 25% of core capital; report on advances to employees, shareholders, and Directors and their associates; exposure to 50 largest borrowers; maturity analysis of assets and liabilities.</li> <li>▪ Annually: Audited financial statements, including balance sheet with assets and liabilities, profit and loss account, and other disclosures.</li> </ul>

The application and operational requirements of institutions seeking a DTM license are similar to those for banks e.g. the branch. They include items like windows and glass walls reinforced with metal grills or made of anti-burglar or bullet proof glass, alarm system connected to police or security firm, existing and well documented emergency plan, a standing fire proof safe, etc. The cost of such infrastructure is extremely high for DTMs when expressed as a percentage of their core capital or the amount of cash transacted in these branches. The DTM regulations have now been amended to allow for agency banking following this provision for commercial banks. In the limit of these guidelines, banks and DTMs could delegate some of their activities to agents in order to compensate for the great cost of setting up a large nationwide branch-network. CBK has provided guidelines for agency banking but the decision as to whether to employ this as a delivery channel is left to each institution. The Board of Directors of banks and DTMs shall select credible agents and ensure that risks associated with agency banking are properly identified, documented and mitigated. The Board should also monitor agent activities to ensure compliance with the Banking Act or the Microfinance Act, the Guidelines on agency banking and the agency contract. Like is the case with other aspects of operations, CBK will provide oversight to these too.

Reporting and disclosure requirements are more or less the same for both institutional forms. DTM and banks are subject to public disclosure of financial information. They have to publish their annual balance sheet and profit and loss accounts in the Kenyan Gazette or in two nationwide newspapers. In addition, banks are required to openly display information on business hours, audited accounts, current banking license and tariffs, names of senior officers and certificate of contribution to the Deposit Protection Fund at their headquarters and branches.

The risk weights used for the calculation of capital adequacy ratios are the same for banks and deposit-taking MFIs. Some of these ratios do not conform to Basel-II standards. For example, the Microfinance and Banking Acts assign a zero weight to advances or credit facility extended to any organization for Economic Co-operation and Development (OECD) or the central government without differentiating on individual country risk. The minimum capital requirements range between 8 and 12 % and are more or less in line with international standards. The minimum core capital calculated as a percentage of total risk weighted assets is more restrictive for DTMs (10%) than for banks and NBFIs (8%). The ratios related to large risk exposures on both individual and aggregate basis are also more restrictive for DTMs. The limitations on insider and external lending are also stringent compared to banks. Insider loans are capped (on single and aggregate terms) at 2% and 20% of the DTM's core capital while they are respectively set at 20% and 100% of the bank's core capital. A ratio of 5% of the institution's core capital applies for the maximum risk exposure on a single client (and his affiliates) in DTMs against 25% core capital in Banks. The liquidity ratio is however the same for banks and DTMs. Table 11 provides the details on these.

### 1.3 RULES FOR LOAN CLASSIFICATION AND PROVISIONING OF NON-PERFORMING LOANS (NPLS)

In determining the amount of potential loss for a specific loan or the aggregate loan portfolio, DTMs and banks are guided by the rules on loan classification and minimum provisioning percentages as specified in the next Table 12.

The loan classification is much stricter for deposit-taking MFIs compared to that for institutions regulated under the Banking Act. Credit facilities are

**Table 11: Prudential rules**

Ratio	Microfinance Act and DTM regulations	Banking Act
1. Minimum core capital (1)	10% of total risk adjusted assets plus risk adjusted off balance sheet items	8% of total risk adjusted assets plus risk adjusted off balance sheet items
2. Minimum core capital (2)	8% of total deposit liabilities	8% of total deposit liabilities
3. Total capital	12% of total risk adjusted assets plus risk adjusted off balance sheet items.	12% of total risk adjusted assets plus risk adjusted off balance sheet items.
4. Definition of large exposure	Credit facility ranging between 2% and 5% of the institution's core capital	Any Credit facility above 10% of the institution's core capital
5. Restriction on total higher risk exposure	Max 30% of the institution's core capital	Max 50% of the institution's core capital
6. Limitation on insider lending	Max 2% of core capital on a single insider and 20% of core capital on aggregate	Max 20% of core capital on a single insider and 100% of core capital on aggregate
7. Limitation of risks taken on a single client	Loans to a single end-user borrower should not exceed 5% of the institution's core capital	Max 25% of the institution core's capital
8. Liquidity ratio	Minimum 20 % of liabilities	Minimum 20 % of liabilities

**Table 12: Loan classification**

Classification	Microfinance Act and DTM regulations	Banking Act
Normal	Performing loan (up to date in payments of principal and interests)	Performing loan (up to date in payments of principal and interests)
Watch	1 - 30 days in arrears	31 – 90 days in arrears
Substandard	31 – 60 days in arrears	90 – 180 days in arrears
Doubtful	61 - 90 days in arrears	>180 days in arrears
Loss	>90 days in arrears	Any doubtful loan where the security has either been sold or discounted to zero value

considered non-performing when they are not serviced after 30 days in the microfinance sector against 90 days in the banking industry. This corresponds to the substandard loan category. According to the Microfinance Act, doubtful loans are credit facilities in arrears between 61 days and 90 days and they will be considered a loss after 90 days. However, the Banking act, classifies loans as doubtful if they are in arrears for more than 6 months and would move them to loss if the underlying collateral has been sold or has a zero discounted value.

The provisioning requirements (see Table 13) are restrictive for deposit-taking MFIs. The minimum provisioning percentages applying to the watch and substandard categories are higher than those applied to banks. Only one loan class (doubtful) out of five has a lower provisioning requirement, with a minimum percentage of 75 % for DTMs against 100% for banks. But, if this percentage is related to the number of days in arrears, the Microfinance Act remains more restrictive. The only argument that could justify this difference between the Microfinance Act and Banking Act is the fact that microfinance clients are perceived riskier than bank's clients in the sense that they often don't have the collateral which is a key element in provisioning calculation, and typically the loans have shorter loan terms and more frequent repayments. However, in a market where specialized microfinance banks are competing with deposit-taking MFIs targeting clients with the same inherent characteristics, these differences in regulatory regimes certainly disadvantage the DTMs in terms of costs and profitability.

**Table 13: Minimum provisioning percentages for NPLs**

	Microfinance Act and DTM regulations	Banking Act
Normal	1%	1%
Watch	5%	3%
Substandard	25%	20%
Doubtful	75%	100%
Loss	100%	100%

## 1.4 IMPLICATIONS OF THE MICROFINANCE ACT AND THE SUPPORTIVE REGULATIONS FOR THE SECTOR AND THE INSTITUTIONAL TRANSFORMATION

### 1.4.1 At the sectoral level

The first implication of the Microfinance Act is the emergence of a new type of player in the microfinance landscape in Kenya. In addition, the Act reinforces a clear policy orientation towards the tiering of the sector. The following segmentation of the sector in 3 categories is generally accepted:

- Formal institutions (regulated and supervised): banks and DTMs which are both regulated and supervised by CBK and the deposit-taking SACCOs regulated and to be supervised by the SASRA.
- Semi-formal institutions: non-deposit taking SACCOs (supervised by the Ministry of Co-operatives and Market Development) and credit-only MFIs whose incorporation in the regulatory framework is currently under discussion.
- Informal institutions (with no legal form of registration or supervision): Village banks, ROSCAs, ASCAs, moneylenders, etc.

Within the DTMs, there is a classification between nationwide and community based institutions. As demonstrated, the relative higher license fees and infrastructure requirements are not in favor of supporting the setting up of community based DTMs. Beside the indisputable rationale of extending prudential regulation only to institutions which are big enough to endanger the stability of the overall financial sector, the intended (or unintended) preference for larger institutions (DTMs and Banks) that we draw from this review of the legal microfinance framework might simply be explained by a limited regulatory power and capacity of the CBK.

### 1.4.2 Potential for institutional transformation

According to information from CBK, nearly 15 institutions were expected to transform within two years following the implementation of the Act. By end of March 2011, about three years later, only five DTMs had been licensed.

Even though about 30 institutions had passed the first stage of approval by the end of 2009 (approval of business name), there is a general consensus in the microfinance industry that the current regulations are very stringent regarding licensing procedures, branch infrastructures, reporting standards and provisioning requirements, not to mention the related transformation cost. Compliance is time and resource consuming, thus narrowing the path for institutional transformation.

The scope of adjustments required of former credit-only MFIs is huge, especially when they are moving from being unregulated to a mainstream banking type of regulation. As such, the pace of institutional reforms is very demanding and the transformation process unsurprisingly costly. In addition, DTMs do not have a possibility to move up market because the law controls for

mission drift by obliging them to hold at least 70% microfinance loans in their portfolio. However, they have a freedom to set higher interest rates because of the inexistence of interest caps in Kenya. They can also circumvent barriers of network expansion by using agency banking as a delivery channel for offering financial services in a cost-effective manner.

The stricter requirements of the Microfinance Act and the related regulations should not be purely regarded as a threat but be seen to hold great benefit if the transformation process is successful. In a competitive market where four specialized banks already provide microfinance services and even more are expected to downscale, it is in the DTMs' interest to offer the same level of confidence as banks to their depositors having in mind that they are all competing for the same customers.





