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Imp-Act **Working Paper 9**

The dynamics of competition in Karatina's financial markets: assessing the impact of microfinance in Kenya

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Summary

This paper is based on work conducted by *Imp-Act* – a three-year action-research programme aiming to improve the quality of microfinance services and their impact on poverty. Learning from the experiences of 30 microfinance institutions (MFIs) in four continents, *Imp-Act* is developing and encouraging the use of internal practitioner-focused impact assessment that can serve as a means to improve practice and service delivery, not only satisfy the needs of external stakeholders.

An important element of *Imp-Act's* work is assessing the wider impacts of microfinance, beyond the immediate financial effects on clients and their families. This paper addresses the reality that most impact-related research concentrates on the direct impact of microfinancial services on users. However, one of the less-discussed objectives of donor support to the entry of microfinance institutions into financial markets has also been to demonstrate to other players in the market how financial services can be provided profitably to poor clients. Additionally their impact on the market may be to enhance competition. Studies examining these claims are virtually non-existent. This paper seeks to address this gap, with a focus on microfinance in Kenya.

The study focuses on the town of Karatina in Central Kenya, an area of concentration for the Kenyan MFI industry. Evidence from this study suggests that MFIs have in fact been small players in the overall financial market; while they have demonstrated the existence of a small business market for loans they have not significantly developed products to appeal to a wider clientele. Indeed it appears to be macroeconomic influences that have forced the commercial banks to re-examine who their mass market is, and, in competition with Equity Building Society and the Savings and Credit Cooperative (SACCOs), it is this sector of the market that is most dynamic.

The research revealed that demonstration effects from group mechanisms appear strong – especially from managed Accumulating Savings and Credit Association (ASCAs) – with some better-off clients recognising the benefits of operating financial services for themselves. Competition for deposit accounts is strong and players such as the Equity Building Society and SACCOs are learning how to serve this market – and how to link loan products to their savings accounts. After conversion into formal financial entities, the MFIs may find that they are competing in a well-served market with high service standards and must be ready for this.

The paper concludes by setting out the challenges for local MFIs. These include the need for much more flexible products which respond to customer's needs; the need to justify their interest rates; avoidance of overly aggressive expansion strategies that risk provoking multiple membership and over-indebtedness; a greater understanding of the dynamics of their local markets; and finally collective action by MFIs to defend their strategic position and develop their competitive advantage in an increasingly competitive market.

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List of Acronyms

AMFI	Association of Microfinance Institutions
ASCA	Accumulating Savings and Credit Association
FOSA	Front Office Savings Account
K-REP	Kenya Rural Enterprise Programme
Kshs	Kenya Shillings
KWFT	Kenya Women Finance Trust
MFI	Microfinance Organisation
ROSCA	Rotating Savings and Credit Association
NBFI	Non-Bank Financial Institution
SACCO	Savings and Credit Cooperative
SMEP	Small and Micro Enterprise Programme

Exchange Rates: GBP 1 = approx. Kshs 115; US$1 = approx. Kshs 75

1 Introduction

The objective of donor-funded microfinance in supporting the entry of microfinance institutions (MFIs) into financial markets has been to have both a direct impact on poverty by providing services to poor clients, but also to demonstrate to other players in the market how financial services can be provided profitably to poor clients. While the direct impact on users has been the focus of much impact-related research, studies of the impact of their impact on financial markets themselves are virtually non-existent. This research therefore sets out to examine what effects MFIs have had within the financial market and this paper is the first of a series of such studies within the *Imp-Act* programme (see Johnson 2001).

Using neo-classically based infant industry arguments Hulme and Mosley argue that subsidies to MFIs are valid because developing the technology of lending to poor people involves imparting external knowledge (Hulme and Mosley 1996). When considering the shifting "frontier" of financial development von Pischke gives further indications as to how the broader impact of a particular project or financial organisation on financial development might be established. He asks whether project instruments are innovative; whether they have proved catalytic, novel or trivial; and whether they promote competition and reduce transaction costs (von Pischke 1991). The primary objective of this study is therefore to examine whether MFIs have influenced the provision of financial services to poor people more broadly. It proposes two domains in which such impacts may occur: first, on the behaviour of financial service providers, and second on the users themselves. There are two pathways through which impact may occur in these two domains:

- Competition effects: that is, the direct loss of a provider's clients to an MFI, with direct impacts on its profitability and performance and stimulating changes in behaviour.
- Demonstration effects: first, from MFIs to other financial intermediaries through demonstrating alternative products and methods of service delivery which other financial intermediaries then seek to copy or adapt; second, through the behaviour that MFI clients demonstrate which can in turn influence the behaviour of non-clients.

However, while this proposes that impact is caused by MFIs, we must bear in mind that the behaviour of MFIs and clients has also been changing as a result of the position they find themselves in the broader financial market.

The specific research questions are therefore as follows:

1 For the supply side and at the level of financial intermediaries
   - How do financial intermediaries explain their position in the financial market since the arrival of the MFI?
   - What changes in the provision of services by financial intermediaries has taken place and how do they explain this?

- How do MFIs explain their position in the financial market given the presence of other types of formal and informal financial service providers?
- What changes in the provision of services by MFIs has taken place and how do they explain this?

2 For the demand side or client level

- What financial services do people use to meet their livelihood needs and how has this changed with the introduction of MFIs, and in relation to other formal and informal service provision?
- Who uses the services of MFIs? What determines who uses the services in terms of their socio-economic characteristics, e.g. age, wealth, gender etc? What are the reasons people give for using/not using the MFI services available?

A series of ongoing studies has been investigating these questions in different types of financial market environment and using a comparative methodology to reveal how the behaviour of providers and users differs in these contexts. The first study examined provision in an area of Uganda where there were no MFIs.

This is the second study and has investigated a competitive environment in Karatina, Central Kenya. A further study is underway of the competitive financial market in Uganda in collaboration with MicroSave-Africa. Two further studies are also planned for India and Nepal. A final synthesis study drawing together the findings of all of these individual studies will be produced in 2004.

2 Methodology

The methodology for such a study is not straightforward for a number of reasons. First, methodologies for analysing local level financial markets in a holistic way in developing countries are limited, especially since large volumes of activity take place in the informal sector and are difficult to track. Second, formal procedures for impact assessment using quantitative data and control groups in turn raise a number of methodological problems such as sample selection and attribution problems.

The methodology chosen for this study was therefore primarily qualitative but also involved collecting available quantitative data. It involved investigation of the supply side through interviews with providers to collect data on products and prices, numbers of accounts and the value of funds deposited and lent. The demand side enquiry has used participatory qualitative methodologies drawn from the MicroSave-Africa market research toolkit. The most useful technique in this respect is the financial sector trend analysis which enables a structured discussion of changing use of providers over time with different groups of users (see Annex for more detail). This use of MicroSave-Africa tools to explore behaviour of clients on the demand side was also intended to be a means through which MFIs participating in the study could find out about the local financial market in which they were operating and consider any implications for their own service provision.

This study makes extensive use of data collected under a previous research project carried out in Karatina by the author from 1999–2001[1] and was supplemented by data collected during a two-week period in February 2003. Details of the methodology of the original study can be found in Annex 1. The research carried out in February 2003 undertook a rapid update on products using the Financial Landscape Analysis format of MicroSave-Africa to collect product data. This was supplemented on the supply side by interviews with managers and officials in 16 financial service providers found to be significant, mainly in terms of scale, in the earlier study. The demand side study involved the use of MicroSave-Africa market research tools with ten groups, covering financial sector trend analysis, relative preference rankings for loans and savings, and a focus group discussion on group formation and experience.

3 Financial markets in Karatina 1999–2001

3.1 The context of Karatina, Central Kenya

Karatina is a small town in Mathira Division of Nyeri District in Kenya's Central Province. Its location on the slopes of Mount Kenya means that it has fertile volcanic soils and good rainfall. Indeed, the First Report on Poverty in Kenya suggests that when rains are good then there is no absolute poverty in Nyeri District (Government of Kenya 1998). However, in recent years rainfall has been erratic with floods associated with the *El Nino* phenomenon in 1997 and poor rains in two subsequent seasons in 1998 and 1999. The industrial and service sectors are little developed and mainly informal. The research was carried out in three areas of Mathira Division selected to represent what were anticipated to be the key livelihood types: first, the sub-location of Chehe in the tea zone; second, the sub-location of Gatundu in the coffee zone; and third, Karatina Town where livelihoods are more heavily based on enterprise and employment. The tea and coffee zones are divided by altitude, with tea doing well on the cooler upper slopes, and coffee requiring the warmer lower slopes of Mount Kenya.

3.2 Karatina's financial markets: an overview of the supply side

There are a wide range of financial service providers in Karatina including banks and Non-bank financial institutions (NBFIs), parastatals, Savings and Credit Cooperative (SACCOs), MFIs, and informal sources of provision such as Rotating Savings and Credit Association (ROSCAs), Accumulating Savings and Credit Association (ASCAs) and moneylenders.

3.2.1 The formal financial sector and parastatals

Formal sector banks and NBFIs. Four of the five main banks with a national presence operate – Barclays, Kenya Commercial, National Bank of Kenya and Cooperative Bank. In addition there is a

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[1] This work was carried out under the Finance and Development Research Programme funded by DFID (see www.devinit.org/devfin for more details and also Johnson 2001; Johnson 2004).

building society[2], known as Equity. A small deposit-taking branch of Consolidated Finance closed in 2000. The commercial banks offer the expected range of current and deposit accounts, along with loans usually secured against land, shares or cash. In 1999, these accounted for 73 per cent of deposits by value, 55 per cent of outstanding loans, and 49 per cent of the number of savings accounts (see Table 3.1).

Financial intermediaries with **parastatal and government** origins comprise the PostBank which, while not having a branch in Karatina, offers its basic savings account via the Post Office. The Agriculture Finance Corporation (AFC) closed its office in Karatina in 1999 and consolidated its operations in Nyeri. However its lending volume in the area has been extremely low in recent years as it has a huge portfolio of bad debts. The Industrial and Commercial Development Corporation (ICDC) is a successful parastatal which in this area mainly offers commercial sector loans for between Kshs200,000[3] to Kshs1m and also operates from Nyeri. Kenya Industrial Estates (KIE) has a Karatina office where it offers its individual lending programme for the informal sector with loans of Kshs300–500,000. Finally the Joint Loans Board – run by the Ministry of Trade and the Local Authority – is virtually moribund as it has very little new money and recovery rates are very low; loans in the programme average Kshs50,000. Apart from ICDC, the parastatal sector became increasingly insignificant in the 1990s due to emphasis on restructuring and liberalisation. However, significant reform has yet to be undertaken. Apart from the Post Office for which deposit data was not available,[4] none of these organisations mobilised deposits. On the loans side they accounted for only a very small proportion – 4 per cent – of the value of outstanding loans.

3.2.2 The SACCO sector

The next main sector of financial institutions is the **cooperative sector,** or savings and credit cooperatives (SACCOs). In Kenya SACCOs are referred to as rural or urban – with urban SACCOs referring to employee-based cooperatives. Here we refer to the basis of the common bond and highlight three types – those based in cash crops, employment, and a new and growing set of SACCOs mainly based in the transport sector among *matatu* (public taxi) owners. In Kenya an employee-based SACCO operates with members buying shares on a regular basis – usually monthly directly from their salary. These shares can only be withdrawn on leaving the SACCO, and loans are usually taken as a multiple of shares. In rural SACCOs, a single share is usually bought to join with non-withdrawable deposits being made as deductions from income on a regular basis, e.g. tea or coffee payments.

There are two SACCOs in Karatina which are based on the common bond of being tea farmers. The first is Mathira Tea Grower's SACCO which was established in 1990 and started offering "front office services", i.e. basic deposit accounts to non-members as well as members, from 1997. In 2000 the Nyeri District Tea Growers SACCO, which also had members in the area, also opened an office in Karatina.

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2 Building Society registration originally required lending for long term housing purposes but during the 1990s the Central Bank treated this registration as little different from that under the Banking Act. However, it cannot operate cheque accounts.

3 GBP=approx.Kshs115; US$=approx. Kshs75

4 Data for savings held by the Post Office were not available because accounts are held centrally and not on a branch basis.

These two SACCOs are competing for the membership of the approximately 6,000 tea farmers in the Division.

The coffee cooperative system has been in a state of transition in the late 1990s. The division was served by the so-called "giant Mathira" Coffee Cooperative – a coffee marketing cooperative of some 25,000 smallholder coffee farmers. The marketing side was split in 1997 into 13 small cooperative societies which manage between one and four coffee factories each. Further, as a result of government directives, the Union Banking Section of the District level marketing cooperative has been transformed into an independent Nyeri Farmer's Society SACCO which has a branch in Karatina. The combination of low international coffee prices and this re-organisation has been the cause of relatively low lending volumes in the past three years, since many farmers have had insufficient income from coffee to repay past loans, and the re-organisation has provided opportunities to avoid doing so as the links between the factories and the SACCO weakened.

There are four small employee-based SACCOs in and around Karatina with between 50 and 300 members each, which are based in the medium sized institutional employers such as the Town Council and Tumutumu Hospital and Schools. Alongside these is the Nyeri District Teacher's SACCO which caters mainly for primary school teachers in the district and which opened a front office in Karatina in 2002. However other national employers run SACCOs based in Nairobi, of which their staff in the Karatina area are members. These include Securicor, who have their own "Nyati" SACCO; the Office of the President's *Harambee* SACCO, which is the largest in the country with over 1 million members; SACCOs based in other government ministries; and the Secondary school teachers SACCO – *Mwalimu* SACCO.

SACCOs based on the common bond of transport and businesses developed in the 1990s. Transport SACCOs have grown up around associations of *matatu* owners operating particular routes. In Karatina there are four that have an obvious presence although one has its headquarters in Nyeri. There are two business SACCOs: one operated by the Nyeri Chamber of Commerce (Biashara SACCO) and another somewhat unusual SACCO set up in Karatina by a local stockbroker where the common bond is ownership of shares in the Nairobi Stock Exchange.

The SACCO sector as a whole accounted for 17 per cent of the value of deposits, 18 per cent of the value of outstanding loans and 39 per cent of the number of savings accounts in 1999. This sector therefore accounted for a relatively high proportion of the number of savings accounts but a low proportion of deposits by value, suggesting much lower average deposits than the banking sector and the fact that SACCOs – especially those based in cash crops – tend to deal with poorer clients.

Table 3.1 Savings and loans performance of financial institutions in Karatina, Kenya 1999 & 2003 (Kshs'000s)

	Deposits				Members/savings accounts				Loans				Loan/deposit ratio	
	1999	*per cent of total*	**2003**	*per cent of total*	**1999**	*per cent of total*	**2003**	*per cent of total*	**1999**	*per cent of total*	**2003**	*per cent of total*	**1999**	**2003**
Formal sector:														
Banks[1]	1,148,593	*73*	1,093,703	*65*	24,543	*24*	17,374	*23*	429,995	*55*	537,099	*55*	37	49
NBFIs[2]	113,973	*7*	160,000	*10*	25,663	*25*	21,000	*28*	70,995	*9*	82,000	*8*	62	51
Parastatals[3]	0		0	*0*	0	*0*	0	*0*	29,961	*4*	29,961	*3*		
Sub-total	1,262,566	*80*	1,253,703	*75*	50,206	*49*	38,374	*51*	530,951	*68*	649,060	*67*	42	52
MFI sector:														
Mainstream MFIs[4]	18,629	*1*	24,947	*1*	1,958	*2*	2,911	*4*	28,411	*4*	50,500	*5*	153	202
Management service MFIs[5]	43,184	*3*	26,628	*2*	10,329	*10*	5,790	*8*	82,050	*10*	29,919	*3*	190	112
Sub-total	61,813	*4*	51,575	*3*	12,287	*12*	8,701	*12*	110,461	*14*	80,419	*8*	179	156
SACCOs:														
Cash-crop SACCOs[6]	168,449	*11*	235,102	*14*	37,283	*36*	25,250	*34*	53,495	*7*	112,662	*12*	32	48
Employee SACCOs[7]	90,150	*6*	147,343	*9*	2,277	*2*	2,048	*3*	80,117	*10*	114,257	*12*	89	78
Transport/Business SACCOs[8]	12,560	*1*	13,373	*1*	396	*0*	396	*1*	11,448	*1*	12,170	*1*	91	91
Sub-total	271,159	*17*	395,818	*24*	39,956	*39*	27,694	*37*	145,060	*18*	239,088	*25*	53	60
TOTAL	1,576,909	*101*	1,676,149	*101*	102,449	*100*	74,768	*100*	786,471	*100*	968,567	*100*		

Notes:
1. Data for one bank in 2003 was not available so its numbers of accounts and volumes have been assumed to have changed comparably to the other banks.
2. Data for these institutions is incomplete.
3. Data for Post Office Savings was not available as balances are not held at a branch level.
4. Mainstream MFI's deposits are in the main mobilised by the MFI but deposited in the bank so are excluded from total deposits
5. These totals have been estimated based on averages from a sample of groups of one of the organisations.
6. Data for some of these institutions was estimated in 1999.
7. For 2003 data on small SACCOs for which updated information was not collected, deposit growth has been assumed at approx 10 per cent per year; with membership unchanged
8. For 2003 data on transport/business SACCOs was not collected – deposit growth at 5 per cent per year and static membership has been assumed.

3.2.3 The NGO microfinance sector

The **NGO based microfinance sector** can be split into two sub-categories. First are what can be called the "mainstream" MFIs which have donor or other external support. The biggest of these programmes in Karatina is Kenya Women Finance Trust where it has based its Mountt Kenya Region Branch. They are followed by Faulu, and the Small and Micro Enterprise Programme (SMEP), whose origins lie in the National Council of Churches of Kenya. Finally, K-REP was originally an NGO-based MFI that was registered as a bank in 1999, but is treated here as part of the MFI sector. While Faulu and SMEP have local offices in Karatina, their headquarters for the region are in Nyeri.

A further microfinance model is known as the **managed ASCA** model and this is operated mainly by three organisations from their base in Karatina: Partnership for Productivity; Women's Enterprise Development Institute (WEDI) and Small Enterprise Development Institute (SEDI). In this model, women form groups and lend their own savings to each other in the form of a revolving loan fund (RLF) which is essentially an Accumulating Savings and Credit Association (ASCA) model. They meet monthly and the role of the NGO is to provide management services to the group. These organisations are entirely independent of donor funding. The model is termed the managed ASCA model, as the organisations act as managers for women's own ASCAs. The model is characterised by high interest rates on short term advances – called *gubasho* – at 10 per cent per month. However, longer term loans are also offered at much lower rates for a period of a year or more. A key feature of this model is that the high interest on these short-term loans accumulates in the women's fund and is used to pay out dividends at the end of the year which can be quite high – 20 to 60 per cent of savings – but this of course depends on the overall performance of the fund. If the fund does perform well, then these dividends also substantially reduce the net interest rate being paid on loans.

The managed ASCA model does face problems (see Nthenya et al. 2002, and Box 4.1 below); in particular, in the context of poor macroeconomic performance of the Kenyan economy, repayment has been poor and this has resulted in the stagnation of the fund. It has been difficult to establish its financial performance. The ability of the ASCA managers to enforce repayment can be limited, costly and face objections from the members themselves.

Table 3.1 indicates that the mainstream MFIs accounted for approximately 1 per cent of deposits by value, 4 per cent of outstanding loans and 2 per cent of savings accounts. By contrast, estimates for the managed ASCA organisations suggest that they accounted for 3 per cent of deposits by value, 10 per cent of loans outstanding and 10 per cent of the number of savings accounts. This is somewhat surprising, as the managed ASCA model is little known. It is fully sustainable – indeed it grew out of the need for local NGOs operating with women's groups to survive after donor funding was withdrawn. The excess of loans over deposits (see loan to deposit ratio in Table 3.1) reflects the accumulated margin in the fund between interest earned and paid on loans. According to these figures its outreach is greater than the mainstream MFIs – who have developed with considerable donor funding although their operations in the Mount Kenya Region are in general now financially self-sustaining.

3.2.4 The informal financial sector

Next is the **"informal" financial sector** with **informal group based systems** and **moneylenders** both being in evidence. Karatina abounds with group based financial arrangements, called *giteti*, and these also fall into two categories. Rotating Savings and Credit Association (ROSCAs) are the most common, and although the model operates in slightly different ways the main mode is one in which members save on a regular basis and one member takes the pot of money in the order in which their names are balloted. These systems thrive especially in and around the open-air vegetable market. Women here may be members of a number of these ROSCAs. The oldest ROSCA found to be in operation was one which started in 1976 and the ballot of members determining the order of payouts has never been changed, with replacement members simply taking over the number of a leaving member. What is perhaps more unusual about these ROSCAs is that in some cases, members do not know each other. The money is collected by a "collector" and as members drop out for whatever reason they are replaced by people who are introduced to the collector. Since the group never actually meets, it is only the collector who may actually know all of the members.

Fewer in number but still numerous are independent ASCAs, in which members save and lend the fund to each other. Interest is accumulated into the fund and used to pay out a dividend. Some of these systems are time-bound with a fixed point at which members expect the pot to be paid out including the dividend.

It is common for local people to deny the existence of **moneylenders** in Karatina and many Kenyans believe money lending to be illegal. However the Moneylenders Act was repealed in 1987 and the activity does not require a license. Seven moneylenders were interviewed in the course of this research. Some are quite well known and have been operating their businesses since the 1970s. Others are quite new entrants who have moved to the area with their jobs and whose main market is their work colleagues. Informal credit in the course of trade relationships was examined but there was no evidence of systematic trade credit arrangements. Goods may be provided on credit between wholesaler and retailer, or retailer and customer but the basis of these arrangements is personal knowledge of the trustworthiness of the client and terms negotiated on a case-by-case basis.

3.2.5 Conclusions from the supply side

The 1999 survey showed that, as would be expected, the formal sector banks dominated the market in terms of deposits and loans by value. However when it comes to the number of accounts[5] it is clear that the SACCO sector plays a significant role. This particularly reflects the role of the coffee sector. The data on the microfinance sector suggests that the managed ASCA model is a more significant player than the mainstream MFIs. However, managed ASCAs are similar to SACCOs in that they are user-owned or mutual forms of finance. ASCAs are not registered under the cooperatives act but as financial intermediaries, operating in very similar ways. If the data for these is put together with that for the

[5] Customers may hold accounts in a number of financial intermediaries but this is not accounted for in the data.

SACCO sector it becomes clear that mutualist finance accounts for almost half the number of savings accounts (49 per cent) while accounting for 20 per cent of deposits by value and 28 per cent of the value of loans outstanding.

3.3 Karatina's financial markets: an overview of the demand side

On the demand side a two-stage survey was undertaken. A random household survey of 150 households spread equally across the three key livelihood types in the area – tea farming, coffee farming and town-based enterprise and employment – collected basic household level information on livelihood profiles. This data was then used to identify a purposive sub-sample of 68 in-depth individual interviews, based on location, age, sex, and marital status, in order to investigate both quantities and explanations of financial service use. The data has been pooled to analyse overall levels of use, in order to contrast findings with the supply side data and explore the use of informal financial services not captured on the supply side. The original data collection sought to investigate explanations for financial service use and hence prioritised explanation over quantification. The key findings and their explanation are summarised here.

This sample indicates the importance of ROSCAs, which were used by 48.5 per cent of respondents, compared to 45.6 per cent for bank accounts and 33.8 per cent for rural SACCOs, i.e. tea, coffee or dairy based (see Table 3.2). As borrowers, informants were most likely to have borrowed from a rural SACCO (19.1 per cent) or a friend or relative (17.6 per cent), with only 7.4 per cent having borrowed from the bank.

Table 3.2 Frequency of use of financial services by type (per cent of respondents; N=68)

	Savings accounts	Loans	Ratio of borrowers to savers
Banks/ Building societies	45.6	7.4	16.2
Rural SACCOs	33.8	19.1	56.5
Employee SACCOs	10.3	8.8	85.4
Parastatal	0	1.5	N/A
Post office	8.8	N/A	N/A
MFI [1]	7.4	7.4	100
NGO managed ASCA	5.9	7.4	125.4
Independent ASCA	8.8	5.9	67.0
ROSCA	48.5	48.5	100
Insurance group	39.7	N/A	N/A
Moneylender	N/A	0	N/A
Loan from friend or relative	N/A	17.6	N/A

N/A – not applicable
Note 1: MFI savings accounts are in this case compulsory savings to access loans.
Source: own data

This data indicated that users were likely to benefit from a wider range of savings services than sources of loans.[6] Individuals used a mean of 2.46 savings mechanisms, 1.38 in group-based mechanisms and 1.09 in formal sector savings accounts. Women used significantly more group savings mechanisms than men – a mean of 1.86 compared to 0.88, though there was no significant difference in their use of formal sector savings accounts. In particular, women were significantly more likely to use ROSCAs than men[7] but the use of ROSCAs was similar, irrespective of poverty levels. Rural SACCOs were much more likely to be used by men over 40 and people educated to primary school level or less, and those living in the tea and coffee zones. 14.7 per cent of respondents did not use any type of savings service.

By contrast the mean number of loan sources, excluding ROSCAs, was 0.85 with 35.3 per cent having not borrowed at all. Borrowing from rural SACCOs was again more likely to be by those over 40 and less educated. Borrowing from friends and relatives on the other hand was more likely to be by those who were younger, educated to secondary level and above, and male.

A notable feature of Table 3.2 is the ratio in the final column between saving in a source and borrowing from a source. The proportion of savers in a bank who have borrowed is 16.2 per cent compared to rates of over 50 per cent for SACCOs, and in the region of 100 per cent for ROSCAs, ASCAs and MFIs. This suggests that if loans are required then it is unlikely to be the bank from which they are obtained.

3.4 Explaining Karatina's financial markets

This brief overview of both provision and use suggests the following key points. First, while the formal sector appears dominant in terms of volumes of savings, when it comes to numbers of accounts, this is more or less equally split between the formal sector and the mutual sector, i.e. SACCOs and ASCAs. Since this sector handles 20 per cent of deposits by value and 28 per cent of outstanding loans by value, the implication is – as would be expected – that the "mutual" sector is serving poorer clients than the formal sector. When the information from users is added to the picture, it becomes clear that informal group-based systems, especially ROSCAs, are extremely important mechanisms for financial intermediation. ROSCAs can also be classified as mutuals in that they are user-owned and managed.

Second, on the loans side, it was found that only 7.4 per cent had borrowed from a bank. This figure was lower than the frequency of borrowing from SACCOs, and friends and relatives. Five out of a total of 52 documented loan sources were banks, none of which involved land as formal collateral.[8]. Two of these were from a special microfinance programme within one of the banks, two were from a building society

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6 Respondents were asked to report the places in which they had saved in the last two years and the sources from which they had taken loans over the last five years.

7 Logistic regressions confirmed this. These were used to test for the socio-economic characteristics most strongly associated with the use of particular financial services where there was adequate data.

8 One of these loans did involve the deposit of a title deed at the bank, but it was not formally charged as the loan was relatively small at KShs 30,000 (approx. £300), the lodging of the title deed served to underline the importance of repayment although the land could never have been sold by the bank. As one moneylender, who had taken titles in the past in the same way explained, someone would always eventually return to reclaim a title deed.

and one was a bank overdraft. The only loan in the sample that had involved the mortgaging of land was to a parastatal.

Third, the data here also indicates that, although Karatina is one of the areas in which the MFIs have been longest established, their total activity is small even in comparison to local NGO programmes of ASCA promotion and management.

The "mutual" sector therefore appears to require further consideration. The term mutual refers to both formally registered SACCOs and informal group-based systems as they are both user-owned mechanisms. While the importance of SACCOs in part reflects the historical position of coffee as a cash crop in the area, there are new areas of SACCO development in the transport and business sectors. Moreover, there were widespread reports that both ROSCAs and ASCAs had also increased in numbers in the period since 1997: particularly that their use had increased among men, while in the past they have mainly been associated with women.

This trend can be explained by the following factors. First, it is important to note the general deterioration in the Kenyan economy since 1997, precipitated both by drought, poor economic management and the absence of aid flows. Against this background lump sum payments that men used to receive from coffee or other business ventures have declined. This has driven them into ROSCAs and ASCAs that enable flows of income to be converted into lump sum payments required for school fees, investments and so on.

Second, borrowing from the banks is seen by users as increasingly difficult. Government fiscal policy has used treasury bills to finance spending and this has been an important factor in producing high and volatile bank lending rates during the 1990s. These have acted as a disincentive to borrowers when business opportunities are higher risk. In this context borrowers have become increasingly wary of mortgaging land for fear they might lose it.

Third, mutually based financial mechanisms, such as managed ASCAs, offer products with characteristics that are more appropriate to the circumstances people face. In mutuals, the member's entitlement to a loan is very clear and based on savings. Second, members set the interest rate on loans, which can be as high as 10 per cent per month in an ASCA. Members know that not only will the interest rate not change without them knowing or voting for it, but also that the interest they are paying will accrue to them as dividends at the end of the year. Third, when circumstances arise which result in repayment difficulties, members know that they will have a range of options in dealing with the situation. In SACCOs, loan products include school fees and emergency loans. In informal groups, members have the opportunity to voice their opinions, and may gain the confidence to negotiate an alternative payment schedule; in some cases the member may be given an additional loan to overcome the circumstances; the member can also rely on the social networks that arise in the group for support – whether that support is financial or social and whether from the group or individuals. Finally, when borrowing, the member is usually risking only her existing savings; future income, from salaries or cash crops; or possibly household items, so land is not at risk.

A further finding of the research concerns the role of land as collateral. Land registration and titling was initiated in Kenya in the 1950s and aimed at creating a land market that would support the financial market. The evidence from this research further supports the view that this has not happened. Social constraints include the safety-net role of land and the fact that the agreement of wives and other family members is required via the Land Board before men can formally use land as collateral, which brings a complex myriad of family and lineage relationships into the transaction. In addition, with increasing demand for land and hence smaller plot sizes, land cannot necessarily secure loans of significant size.

4 Karatina's financial markets: key developments between 1999 and 2003

4.1 Savings services

In the period 1999–2000, banks decided to raise their minimum deposits and move their business towards a high net worth customer base – primarily the business market and salaried individuals. By mid-2000 minimum balances on deposit accounts had risen from approximately Kshs500 to Kshs2000 or above, the highest being Kshs10,000. If a customer's savings were less than the minimum balance then she would incur monthly charges to the account of approximately Kshs200. This led to customers letting their accounts fall into disuse. Indeed if a customer returned to the bank months later having left a balance of between Kshs1,000 and 2,000, she could find that her savings were virtually gone. This led to much resentment and distanced the banks from the mass market since even low-level salaried government employees, earning in the range of Kshs7000–10000 per month, could no longer afford to leave the minimum balance in their accounts untouched.

By the time of the research in early 2003, this had started to change. All the main banks had lowered their minimum deposits back down to between Kshs 500–1000 and Barclays had introduced a product simply called the "Bank Account" which allowed withdrawals during the month to take the account down to zero, although it still incurred a service charge of Kshs250 per month. These revised products have been accompanied by aggressive marketing campaigns with bank officials visiting businesses and individuals around the town on a door-to-door basis.

A range of factors has precipitated this re-orientation. All the banks were chasing high net- worth individual customers who were increasingly scarce, given recession and retrenchment in both public and private sectors. At the very top end of the banking market, corporate business has also developed new financing mechanisms such as the bond market. Hence with pressure from both sides, the banking sector has had to reconsider where the main market in Kenya is and reorientate itself towards the mass of farmers and low paid employees.

The data collected in 2003 was not as comprehensive as that collected in 1999 but is displayed in a similar format, to give it a comparable basis. The data does however indicate that the total number of formal sector savings accounts, both current and deposit, was approximately 38,000 in 2003. This suggests

a fall of 12,000 or 24 per cent compared to the 1999 figures. However, this is not reflected in a decline in the overall nominal value of deposits, which are at similar levels and hence have fallen in real terms. This can in part be explained by the fact that there were a lot of dormant accounts with low balances in 1999.

The distribution of accounts between banks has also changed. It is the commercial banks that have in the main suffered a decline in account numbers, although those that have deposit accounts tailored towards poorer people have tended to maintain or increase their numbers of clients. Hence, the Cooperative Bank with its *Haba na Haba* account – an account with a lower minimum balance, no fees for deposits and low fees on withdrawals – and Equity, have tended to gain in this shift. Equity is in fact the dominant player by far in terms of numbers of accounts and is only rivalled, in terms of client numbers, by the Nyeri Farmer's SACCO. Equity presents an interesting story and throughout the period when the main banks were raising their minimum balances, not only kept its balance constant but was gradually orienting itself towards being a microfinance bank targeting small savers and borrowers.[9]

Over this period SACCO front office services (FOSAs) have also developed products very similar to those of the banks. In Karatina there are now three SACCOs with branches offering these in the main street where there were none in 1999. The FOSAs now offer computerised services, can give their customers chequebooks even though these cheques are not part of the clearing system, and offer services such as school fees cheques. It is difficult to gauge the numbers of accounts which might have moved from the banks to the FOSAs. This is because many SACCOs have front office accounts for members through which dividends, loans etc are paid but which they may not actually use in the way they would a bank or NBFI savings account, e.g. having their salaries paid through them. However, approximate figures suggest that the number of accounts moved is 5,000 since 1999. This suggests that the FOSAs have been making some inroads into the deposit accounts market and may have captured some 15 per cent of these accounts.

The individual clients whom the banks and SACCOs are mainly chasing are salaried employees and tea farmers since these are the people who have regular incomes in the area. As a result, the SACCOs are also changing their bylaws to extend their common bonds to include these people. This means that they are increasingly attempting to position themselves positively in relation to this market.

4.2 Loan services: learning to lend

4.2.1 Formal sector loan products

A survey of loan products soon reveals that the unsecured lending market is now a key area of interest for banks. Most of the main commercial banks now have personal unsecured lending products such as the Barclayloan. Customers are usually eligible for these when they have been receiving a salary or other regular income through their current or savings account for approximately six months, and some of the banks now link these loans to the sale of deposit accounts in their marketing information. This further

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9 See Coetzee et al. (2002), for an account of Equity's re-birth and re-orientation towards microfinance.

reflects the re-orientation of the banks, described above, towards this middle-range market in that it has now recognised that these are the customers to whom it also needs to be able to lend without the cumbersome process of lending against collateral. Loan products are available up to a maximum of Kshs 600,000 (£5,000). In addition, this has been assisted by the development of credit-scoring techniques that enable decisions to be made quickly. However, these decisions are not usually made locally but applications are sent to Nairobi despite the fact that most of these banks are now online. This is probably to protect the integrity of the credit-scoring process so that local staff cannot bias the system. Earlier attempts to introduce such systems online at branch level failed for these reasons.

Overall these developments have raised the nominal value of lending by approximately 22 per cent, at a time when there has been a 17 per cent increase in the price index suggesting an increase of 5 per cent in real terms. This appears to have raised the loan to deposit ratio from 37 per cent in 1999 to 49 per cent in 2003, which while not substantial is not insignificant either given the state of the economy.

For Equity, aiming at the lower end of the market, unsecured lending is up to a ceiling of Kshs 50,000. But collateral needed for loans above this amount is a pragmatic process and may for example include the deposit of a title deed without it being formally charged. They have introduced a range of products including medical, education, salary advances, farm input and business loans. These have meant that they are also the only formal sector organisation which is really competing at the bottom end of the market with the tea and coffee SACCOs especially for advances (see next section).

4.2.2 SACCO loan products

The main longer-term loan products (1–3 years) available in SACCOs have not changed. Loans are still based on a multiple of savings, must be guaranteed by 2–3 other members and related to cash crop income for tea and coffee farmers. The main development on the lending side is the introduction of advances against regular income payments e.g. salary for teachers or tea payments, where this payment is received through a FOSA account. However, this is more risky than the usual SACCO loan products since repayments for these loans are not deducted at source, hence customers can move their pay point while there is an outstanding debt. Aggressive competition between the FOSAs and Equity in particular over this segment of the market had produced some problems of this nature. However, these organisations are now acting more cooperatively to ensure that debts have been cleared, either by contacting the manager or asking for the client to bring a letter to confirm outstanding balances have been cleared before accepting the account.

Data for SACCOs suggests that the number of accounts in this sector is approximately the same as in 1999. However, given the poor performance of the coffee sector in the last few years, the coffee SACCO has a high proportion of non-performing loans. Since its conversion from a Union Banking Section of the Nyeri Farmers District Cooperative Union into a SACCO, the membership level is approximately half the number of accounts as many farmers have not been able to afford the membership share contribution.

4.2.3 MFI loan products

The main development in the products of the mainstream MFIs has been the introduction of additional products in three out of the four main players. These have introduced a combination of school fees, emergency and medical loans usually at similar interest rates and very similar terms and conditions for amounts up to Kshs 50,000 for up to one year, with similar repayment frequencies to the main working capital loan products. K-REP is the only organisation not to have done this; rather it has been experimenting with going up-market towards individual lending against collateral, from which it has had not dissimilar experiences to the main banking sector of much poorer repayment performance than in their familiar microfinance market.

In the period 2000–2001 MFIs were in the main attempting to increase their productivity by replenishing groups since many had fallen to below 20 members. Now, all are tolerant of smaller groups, having realised that new members in these groups can disrupt their performance. Three have also gone further to introduce a specific product for small groups of as few as five members though starting loan sizes for these groups is at least Kshs 50,000. Experience with these small groups has so far been mixed. One MFI reported that this seemed to attract people who were intent on defrauding the MFI since it was much easier for them to form the group with the intention of defaulting on the loan. Another MFI reported that those who did not fit into the normal groups but wanted larger loans often found it difficult to find other women who wanted similar sized loans and ended up forming a new group with women who were happy with much lower loan sizes.

The changing product mix of the mainstream MFIs has reflected a new interest in listening to clients and responding to their needs, in part in response to competition from other MFIs. This has been accompanied by a concern to improve service quality and customer care. All the MFIs interviewed reported initiatives or intentions to cut their application to disbursement times, and some have paid attention to the quality of records reaching the group on a weekly basis, along with emphasis on the honesty and integrity of staff.

Mainstream MFIs have increased their membership in Karatina by 48 per cent in the period 1999–2003. The outstanding loan value of the MFIs as a whole has increased by 77 per cent while the average outstanding loan balance is Kshs23,000 compared to Kshs20,000 in 1999, a nominal increase of 15 per cent in a period when prices increased by at least 17 per cent.[10] These figures indicate that there has been no overall increase in outstanding loan value in real terms.

4.2.4 Developments in the managed ASCA model

Managed ASCAs appear to have fewer members: approximately 6,000 compared to a 1999 estimate of 10,000.[11] This lower figure can probably be explained through a combination of factors. First, the earlier

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10 The New Kenya Overall Price index indicates that prices rose by 17.3 per cent between December 1999 and June 2002, (see CBK Statistical Bulletin June 2002).

11 Derived from an estimate of the number of groups operating in Mathira division out of the total number of groups these agencies ran and an estimated group size of 30 members.

figures may have been an overestimate since it was difficult to delineate groups in the Mathira area from the full total of the organisations' groups and therefore the basis of the figures is not necessarily entirely comparable. Second, a number of staff members have split off from the bigger MFIs since the last survey to form their own MFIs. It was not possible to collect data from all of these smaller organisations during the recent research. As a result, these figures are undoubtedly an underestimate, and a significant proportion of the difference could be accounted for by these organisations having taken groups with them when they split from the larger ones. If these organisations accounted for some 100 groups, then this would reflect approximately 3,000 clients and suggest that overall use was more or less stable.

The view that the use of the managed ASCA model was increasing despite these survey results was heavily underscored by financial sector trend analyses carried out in the recent round of research. In this it became apparent that there were two trends occurring. First, the splitting of staff from the original ASCA organisations meant that these staff members were looking for new areas to provide services – usually areas not necessarily covered well by the existing organisations although they would often take a number of groups with them when they left their previous organisation. Second, it also became apparent that people had learnt from the model and were implementing it themselves. This is consistent with the evidence of the 1999–2001 research which also found an increasing use of independent ASCAs. In one case in Nyeri, members of a managed ASCA group have actually set up their own women's organisation using a similar model.

The proliferation of this model is evidence of the low barriers to entry involved in its replication on the supply side and its attractiveness to users on the demand side. On the supply side, it requires knowledge of the model and the printing of some stationery along with sufficient funds to enable a free service to be offered to groups for a period of three months when they are first recruited. For the providers, this is usually facilitated by paying a small commission to a loan officer when she recruits a group and only paying her a salary once the group is actually paying fees. While the figures above reflect the outreach of the model in Mathira alone, estimates for mid-2001 suggested that the model was reaching some 29,000 across Central Province and reaching as far as Nyahururu and Nanyuki moving north from Karatina and Njoro moving southwards.

On the demand side, the extensive take-up of this model is due to the small size of savings and loans that it can deal with, the ease with which loans are accessed at meetings and the ability to negotiate repayment. This makes it useful to a wider range of clients, in particular those in rural areas such as farmers, and those with less steady income streams. The ability to negotiate is key; as pointed out above for mutuals in general, when people face livelihood shocks they need to be able to use their social networks to either find funds to repay, delay repayment or even negotiate a new loan. User-owned groups offer this possibility and directly contrast with the mainstream MFI model. In the user-owned model the group can allow delays in repayment or a new loan because it is allowing its own funds to be held for longer. In the mainstream MFI model the MFI uses the group to enforce repayment of its own funds and there is little scope for negotiation as it is the other group members who are forced to pay for the member who cannot.

However, one of the groups in this model illustrated well the problems that can arise in it and which have been pointed out elsewhere – see Box 4.1.

Box 4.1 A managed ASCA group at Giakaibei

This group was formed in 1999 and all the members came from one village. They started by each contributing Kshs120 per month and then taking loans from the fund – *gubasho* – paying 10 per cent every month in interest. Many of the members are in other *gubasho* groups, which have increased in popularity in the area because of people's need for money to pay for necessities such as school fees, and also as a means to repay their loans in other groups. One woman explained that she had been to a group the day before, and was using her loan to pay off an existing one. However, tea is the main cash crop in this area and it is difficult for the members to repay when they are not doing business and don't have multiple sources of income. As a result, default has been rising in the group.

The group pays the ASCA manager 1 per cent of the fund per month, and this has been rising, along with the value of the fund. While the members think that the monthly fee is too high, they feel they have to keep the ASCA manager because it is his responsibility to follow up the defaulters. It is very difficult for the women to do this because they are often related to the defaulters.

The group was dissatisfied with the ASCA manager because they claimed that he did not adequately follow the defaulters to get their money back. As a result the group was "stuck" because they felt that they still had to pay the service fee but were not getting the service that they deserved.

This problem has been developing in managed ASCA groups over the last few years. It arises because the default problem has become quite widespread with the poor economic circumstances in which members have over-extended themselves. The fee paid allows for a limited amount of follow-up by the ASCA manager – usually follow up letters to the client and a visit to their home. However, since the other women members often do not want to get involved in forcing their relatives to repay, they do not exert pressure on the member. After a certain stage if the member is not paying, the ASCA manager needs to hand over to an advocate, but the costs of this are high and are eventually incurred by the client rather than the ASCA manager. However, the women themselves may also resist the member being taken to court and can do this because it is in turn their money that is being reclaimed. Throughout this stage it is likely that the woman is paying very slowly and this may only be covering the administrative costs of collecting this money from her and hence the money does not reappear in the group's funds.

Part of the problem here is that there is no clear agreement between the ASCA managers and the groups about the service on offer. When the ASCA manager is selling his services, he often claims that he will follow the defaulters, but realistically this also requires the cooperation of the other members. In addition, it is clear that the managed ASCA expansion has been at a time when women have been borrowing beyond their debt capacity and it will indeed take time for them to repay.

Some groups are prompted to renegotiate the fee once the money for loans on the table at each meeting falls since it is from this money that the manager is paid. Other ASCA managers have reduced the interest rates charged on loans and introduced more flexible repayment schedules in order to help the women repay and keep money circulating in the group for other members.

Some of the managed ASCA operators have been attempting to address these problems through adjustments to the model. One has introduced a medium-term loan of up to 10 months at 10 per cent fixed rate paid in equal monthly instalments. In some cases groups have requested a reduction in their

monthly interest rate to five per cent fixed rate per month. Another has introduced a more flexible repayment schedule. These adjustments are necessary for the survival of the model since once members get into repayment difficulties the whole group risks seizing up, as the example above shows. Lower interest rates mean that the loan fund does not grow as fast and produces lower dividends. However, now that there is a wide range of providers of these services, their own survival depends on them being able to adapt the model quickly so that funds continue circulating. In addition, one provider has noted that members have been returning to repay loans since the new government came to power after the December 2002 general election.

4.3 Interest rates: the troubling question

Figures 4.1 and 4.2 schematically represent the situation with respect to nominal interest rates in 1999.

Figure 4.1 shows deposit interest rates. In SACCOs and ASCAs the return on savings is the annual dividend. As indicated above these can be very high on ASCAs if the ASCA performs well and members are charging themselves high interest rates on their loans. However, in many SACCOs interest rates are not dissimilar to the banks. SACCO loan interest rates tend to be lower and hence dividends are also lower. Tea, coffee and teacher's SACCOs were paying 5 –7 per cent, comparing very positively with bank deposit rates, many of which require high levels of balances for loan eligibility.

Figure 4.2 represents the overall situation with respect to loan interest rates in 1999. While there are a mixture of methods for quoting rates in the market: i.e. declining and flat; annual and monthly, Figure 4.2 uses calculations of effective equivalent declining balance interest rates in order to present them on a comparable basis. Table 4.1 details these rates for particular institutions in 2003.

The main change in rates has been in the banking sector where base rates have fallen significantly. All other lending rates in the market have remained virtually unchanged. In 1999, commercial bank base rates were in the range of 20 to 25 per cent at the beginning of the year, falling to 15–18 per cent by the end of the year. In 2002, these had fallen a little further to 14–18 per cent by the end of the year. Treasury Bill rates which have been the main underlying determinant of bank base rates underwent further falls in the early part of 2003 to 7–8 per cent by February. It is important to remember that actual lending rates operate at a premium over this depending on risk. While corporate borrowers may negotiate margins of as little as 1 per cent over base, small borrowers are more likely to face premiums in the range of 6–9 per cent.

The MFIs in this market have been quoting their interest rates in terms of flat rates – mostly annual flat rates – and during the late 1990s these were in general lower than the bank base rates and certainly lower than the bank lending rate which was close to 30 per cent. Since few customers are aware of the difference, MFIs have been generally perceived to be cheaper than the banks. This is now changing; since bank base rates are falling, some clients are now aware that banks are quoting lower rates than the MFIs. With this development, MFIs are likely to start coming under much heavier pressure from clients regarding interest rates.

Figure 4.1 Deposit interest rates by intermediary and term

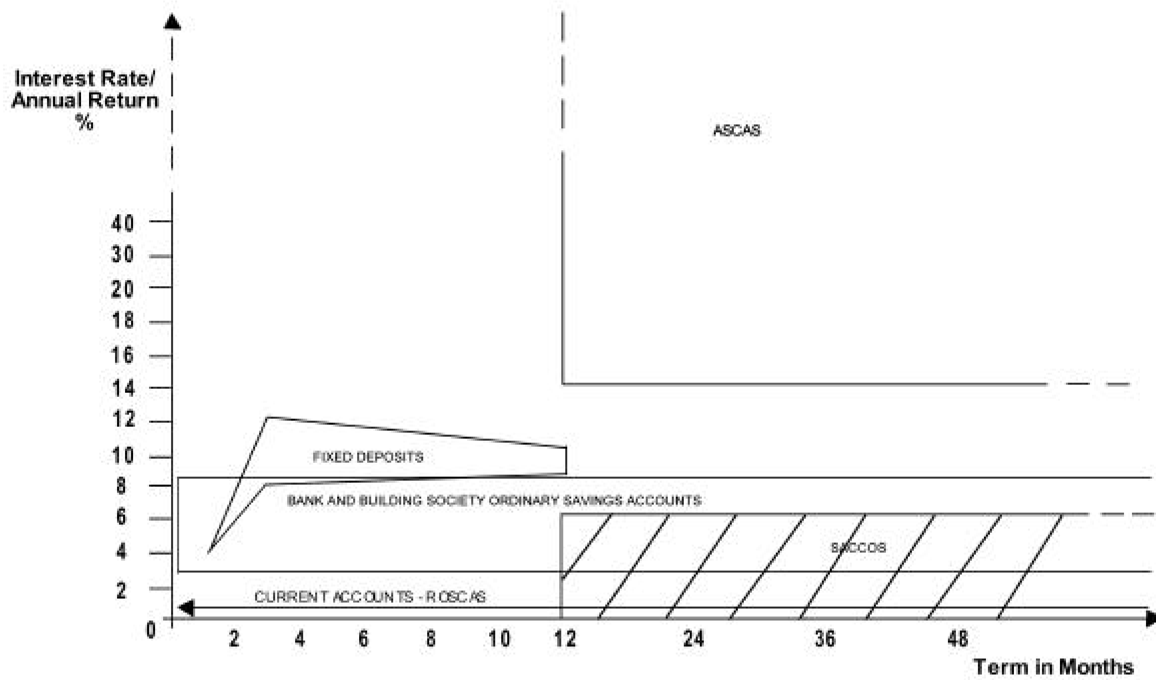

Figure 4.2 Loan interest rates by intermediary and term

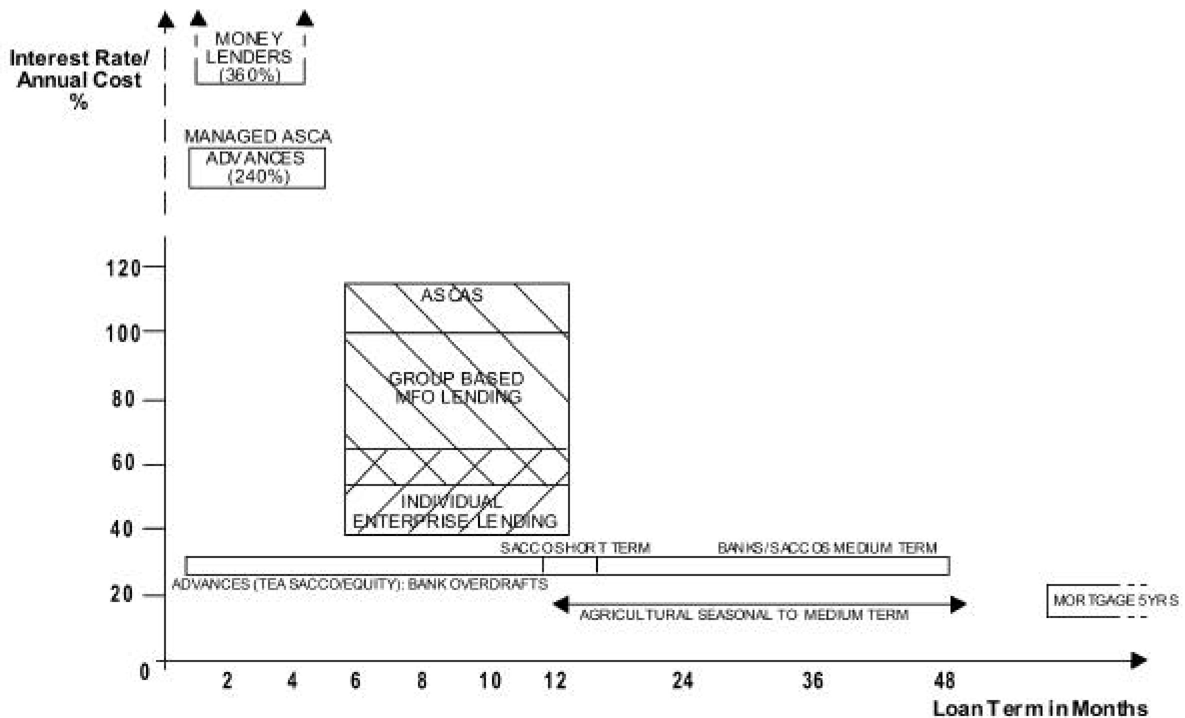

Table 4.1 Interest rates quoted and effective 2003

Financial intermediary	Interest rate quoted	Equivalent annual declining balance interest rate*
KWFT	22 per cent flat per annum	82 %
K-REP	18 per cent flat per annum	69 %
Faulu	22 per cent flat per annum	102 %
SMEP	22 per cent flat per annum	66 %
Cooperative Bank – Biashara loan	2.5 per cent flat per month	61 %
Equity	1.5 per cent flat per month	N/A
	2 per cent per month reducing	N/A
Employee SACCO	12 per cent declining per annum (for a 3 year loan)	49 %
Managed ASCA	10 per cent per month on outstanding balance	>240 %
Bank (model case)	25 per cent declining per annum	41 %

*Effective annual rates have all been calculated for a loan of Kshs20,000 over a year and include the effect of fees levied and compulsory savings where these are part of the product. They will inevitably change when calculated for different amounts over different periods.

In this respect it is surprising to note that Equity has recently introduced a mixture of quoted interest rates. For those products that it quotes at a flat rate, the interest rate is in fact higher than it was previously when rates were quoted in declining balance terms. Indeed when the Cooperative Bank introduced its *Biashara* loan product, it also used a flat rate pricing mechanism. In fact there are no regulations under banking law that prices have to be quoted in a particular way.[12] Equity argues that clients want to know what they will pay, and indeed flat rate pricing in this way can offer greater transparency. However, customers are becoming more knowledgeable in the market and starting to realise that interest paid over the period of the loan does not decline with the amount of the loan. It is likely that interest rates will become a much more sensitive issue for the MFIs in the future, especially given the political nature of interest rates in Kenya.[13] This is a challenge that the microfinance industry needs to collectively consider how to address.

4.4 Multiple membership and default

Multiple membership and borrowing has long been an issue in Karatina for MFIs (See Oketch and Wachira 1996). Findings from the first round of research in Karatina suggested that MFI borrowers had their own businesses, were educated to secondary level, and were based in the town. Key informant

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12 In the UK the requirement is for financial products to be advertised using a standardised price called the Annual Percentage Rate (APR) is a result of the Consumer Credit Act rather than banking regulations.

13 The 'Donde Bill' was tabled in 2000 to limit interest rates on loans to 4 per cent over the Treasury Bill (TB) rate, and ensure that the banks paid 70 per cent of the TB rate on deposits. The bill's passage into legislation was controversial and never finalised. But the important point here is that the bill represented a backlash against some of the banks in the wake of their high interest rates and reported high profit levels in a context of overall poor macroeconomic performance. A more cynical interpretation is that it represented an attempt by many politicians at self-preservation as their debts spiralled out of control.

research demonstrated the overlapping social networks that were put into play when MFIs form groups in an area (see Box 4.2). In addition, one of the market-based groups interviewed during the recent research operated as a basis for joining other MFIs.

Box 4.2 Social networks and multiple membership

A Faulu group was formed in June 1999. By December 1999 it had 21 members, of whom six were also in K-REP, one was in K-REP in Nanyuki and had only recently moved to Karatina, and one was in KWFT. The group was formed from a nucleus of three members who were in K-REP and who were also members of independent ASCAs. This nucleus of three decided that they wanted to join Faulu as well. So they recruited a couple of other members of their ASCA and then used their social networks to recruit the others. Three of the members are close relatives brought in by one of the original three.

Reasons for joining multiple MFIs and groups (*gubasho*) are mixed. Some argue that loan sizes are too small in the MFIs to undertake the project they want. Others argue that many have over-extended themselves, have been running from group to group to get money during the last few years of economic difficulty, and have ended up having repayment problems. A noticeable issue during this round of research was the negative impacts on households of such multiple borrowing, which resulted in large debts and an inability to pay. Four out of the ten focus groups reported effects such as divorce and more serious consequences on the health and welfare of the households concerned, arising from the impact of repossession of household items, civil jail and the related stress of default.

The overall trend of the past few years can be summarised as follows: as economic conditions became more difficult in the late 1990s, people sought more sources of finance and joined groups. For some this resulted in a process of juggling loans and repayments from one organisation to another. Where people faced livelihood shocks or their businesses did not do well this was then likely to result in a cascade of default as the implications of not paying in one group spilt over into another.

By mid-2001 the MFIs recognised that there was a problem and began to collaborate in sharing lists of poor payers and defaulters as up to that time it was not hard to default in one MFI and then move on to join, or even form, a group in another. As borrowers realised that they had overextended themselves they cut back, and members in some of the groups interviewed reported that they had reduced their membership – often back to one organisation.

It is important to put these trends into context. First, the economy was in general performing poorly due to a mixture of poor rainfall and macroeconomic mismanagement. Second, the MFIs were attempting to expand their membership during this period and were doing so elatively aggressively. At times this involved MFIs poaching groups that had recently been formed by another. As is explained above, the social networks and style of product mean that the working capital loan is manageable by a particular stratum of business people with the social networks to be able to form and manage group-based finance.

It is important to consider the implications of poor economic performance for the number of business people who can manage a strict loan product in a difficult economic environment. With retrenchment in both the public and private sectors, there has been an expansion of the informal business sector and increased competition. This means that some of the more dynamic business people who may be more established have also seen their own margins fall and sought to move into new business areas – this in turn produces its own risks. Box 4.3 offers a case study of default arising from the risks of entering into a new and unknown business area.

Box 4.3 The risks of scaling up and changing business

Wambui had been a member of an MFI group since 1999. She was doing well in her business and had a lot of respect and trust among other women and ran a number of independent ASCAs for them. She took a large loan (Kshs350,000) from an MFI using a plot as collateral to buy a *matatu* (public taxi) which required a deposit of Kshs250,000, and to send her daughter to the US for studies.

She was introduced by a friend to a firm in Nairobi through which she could buy a *matatu* by putting a deposit down of Kshs250,000 and this was apparently the lowest deposit for which one could obtain one. It was supposed to arrive in about three weeks. She kept visiting the company but nothing happened until she realised that she had been deceived. She is in default with the loan, but the plot has not yet been repossessed and her MFI group is not functioning.

The implications of this experience are as follows:

First, MFI expansion plans should be set within an awareness of the general economic environment. Aggressive MFI expansion at a time when the economy overall is performing poorly is likely to lead to problems for both existing and new borrowers. The displacement impact of new businesses is inevitably greater at such a time and may lead to attempts by existing borrowers with relatively successful businesses to diversify into areas that in turn expose them to new risks.

Second, MFIs should cooperate when expanding into new areas to ensure that the pace of expansion is measured and competition between them is not overly aggressive. People are not necessarily aware of their debt capacities and group-based compulsory savings systems are a very crude indicator of debt capacity. Even though Karatina is an area in which MFIs have been operating for some time and many are shrewd financially, as the evidence above indicates, people tended to join a number of groups and then often resorted to juggling repayments, sometimes with problematic effects. Some business people are prepared to pay the price of others' default for continued access: one woman explained that her loss of Kshs20,000, due to the default of another group member, would not deter her from accessing loans. Nonetheless, it is only the better-off who will be able to afford these losses and hence such losses are also likely to undermine the expansion of the model.

5 Discussion

The background and changes to the financial market in the period 1999–2003 have been presented above. This section seeks to answer more specifically the research questions set out at the beginning of the paper and to draw out the implications for MFIs in Kenya. These questions aim to examine the impact of the MFIs as financial service providers in the financial market as a whole through two pathways; as **competitors** to other financial service providers, and as **demonstrators** of alternative means of provision. This consideration of impact is not concerned with the direct impact of services on users, which is the key concern of most impact studies, but with the wider impacts that many analysts expected would also be a product of subsidised MFI development.

5.1 What impacts have MFIs had on other financial service providers?

Outside of Nairobi, Karatina and the Mount Kenya Region more generally, is a relatively wealthy part of the country, which has been a key focus of mainstream MFI operations. The area has attracted MFIs for a number of reasons. It is one of the richest areas of the country agriculturally and its people are well-known for their business acumen. It is also easily accessible from Nairobi.

Despite their concentrated presence in Karatina, the evidence above suggests that the mainstream MFIs established with donor funds have captured only a very limited segment of the financial market as a whole. In serving the small-scale business sector the MFIs have helped fill a gap in provision, as this was clearly a sector with few financial services directed towards it in the early 1990s.

During the period 1999–2003 the mainstream MFIs have undergone a process of transition to financial self-sustainability. The main organisations are no longer in receipt of donor grants and this has forced them to expand, become more efficient and find new sources of loan funds.[14] It is clear that they have risen to this challenge. KWFT and Faulu, for example, have more than doubled their outreach over the period. Expansion strategies have involved new geographic coverage as well as expansion within existing areas.

However, the product has remained the core working capital loan delivered through a group mechanism. While additional products have more recently been introduced, and adjustments to terms and conditions on existing products also made – for example longer loan terms, smaller groups, greater flexibility in repayment frequency – the suitability of this product to other segments of the market has been very limited. Indeed, when I first arrived in Karatina in 1999 and found that many people were members of more than one MFI, I initially concluded that the "market" was saturated. However, the evidence presented here demonstrates that they have captured only a small proportion of the entire market and suggests that it is the product design and its delivery mechanism that limits its outreach.[15]

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[14] A key source has been borrowing from the banks using compulsory savings as collateral. With such cash collateral, they have been able to borrow at rates similar to, or in some cases below, commercial bank base rates.

[15] A number of practitioners familiar with Karatina argue that it is full of "sharp operators" that is, opportunists who will take loans and default if they can. While this may indeed present challenges for MFIs, it can also be seen as a good testing ground.

By comparison, it is the managed ASCA model and Equity that have exhibited some dynamism. The managed ASCAs demonstrate wider outreach, even if their coverage has shrunk in the last couple of years. The model can handle smaller loan sizes than mainstream MFIs for whom Kshs 5,000 tends to operate as a lower limit. Due to its monthly format it also fits better with clients whose income streams are less regular. In terms of outreach to the mass of Kenyans who fit such a profile, it offers a model with good potential. Its costs of operation are low and if some of the incentives and credit management can be improved upon, it offers significant potential to reach out to many more.

While the problems of the managed ASCA model have been pointed out above, the proliferation of providers, creating competition, may also have unleashed more rapid adaptation of the model to the economic environment in which it is operating. It has also become clear that there have been clear demonstration effects from managed ASCAs to people running their own ASCAs under the realisation that this way they can also keep the interest for themselves (see Box 5.1 below). MFIs show little awareness of the managed ASCA model and tend to believe that they are targeting a different market segment i.e. those with businesses. This is to an extent the case in that the managed ASCA model tends to cater to smaller loan sizes which are not necessarily enough for business people, but ASCA technology was also being increasingly used by members from their target market. This was apparent when some MFI members told us that they had also formed their own independent ASCAs.

While MFI clients may be interested in forming their own ASCAs, it is also likely to be these clients – those with small businesses – who the banks will target in their efforts to move down-market although the main commercial banks have not yet designed products that would necessarily reach them – apart from Cooperative Bank with its *Biashara* loan (see below).

However, Equity Building Society is now a prime mover, focusing on people with small businesses, with the largest number of accounts and flexible lending policies, i.e. no collateral, for loans under Kshs50,000. Equity has in a sense discovered its mission by identifying itself as a microfinance provider (Coetzee et. al. 2002)

Observation of a small town such as Karatina and its financial intermediaries over this period brings out a very interesting – but perhaps obvious – finding. The organisations that have responded fastest to the situation on the ground are those that are headquartered locally or, like Equity, have a relatively limited area of operation. The managed ASCA organisations are the product of local dynamics and SACCOs – though learning from their peers elsewhere – are able to respond to the local situation. Equity has not yet grown to a size where it is out of touch with these dynamics. Indeed, the branch manager's "open door" policy, enabling anyone to easily talk to him, has been one of the factors that have helped them to re-orientate their business and understand local conditions. This has more recently been supplemented by more formal market research and product development work. By contrast, the changing features of bank and mainstream MFI products are designed and developed for countrywide coverage and as a result take time to develop and are more inflexible once they have arrived. The evidence above also makes it clear that the key influences on the banking sector and the readjustment of its products to a middle-range market have been primarily *macroeconomic*. The decline in Treasury Bill rates has meant that banks have

again had to start learning how to lend to customers rather than the government. As explained above, the trends in salaried employment and business have also forced the banks to re-orient their savings accounts to a middle range clientele and earn the all-important fees that these accounts generate.

Mainstream MFIs have played an important role in serving the business sector. They have also raised the profile of lending to this sector, but in a very broad way by making it apparent to bankers that it is possible to lend to this segment through the public profile of the MFIs – particularly K-REP, now that it has converted to being a bank. However, the group-based methodology of MFIs is not easily replicable by formal sector financial intermediaries and these therefore have to learn how to lend in ways that are appropriate to their organisational capacities and constraints. This is effectively a question of moving from a collateral based lending model – which has proved increasingly ineffectual in a climate of increasing corruption, but also faces inherent constraints as explained above in terms of land – to an approach in which the lender is sufficiently confident about the borrower's income sources. If other financial intermediaries begin to be successful in this, then the group guarantee approach used by MFIs is likely to become increasingly unpopular because of the costs it transfers to other borrowers.[16]

Prior to these developments, the Cooperative Bank was one of the few of the commercial banks to be well positioned with products to serve the poorer market in the form of the *Haba na Haba* savings account detailed above and the *Biashara* loan account. It does appear to be making progress with the *Haba na Haba* account but has not yet become a market leader in Karatina.

On the supply side, it is mainly Equity that can be said to have clearly focused on the lower end of the market and started learning to serve it. Being able to term this "microfinance" seems to have in itself provided a rationale, focus and further motivation. While Equity experimented a little with group lending in Karatina in 1999 this did not yield good results. Its definition of microfinance is therefore not associated with a narrow understanding of group-based lending or demonstration effects from the mainstream MFIs. Rather, it has been engaged with donors and a wider discourse about how to move beyond this rather narrow view of microfinance, and is attempting to develop individual loan products and mechanisms for unsecured lending.

The larger local SACCOs are also eager to enter these markets. In the current vacuum surrounding SACCO legislation, many are moving quickly to enter what they see as potentially lucrative markets attempting to attract salaried customers in particular. In addition, recognising that salaried workers in an area such as Karatina are often also farmers, attempting to offer services that cater to both these needs is important. A number of SACCOs expressed an interest in lending to small-scale business. While SACCO legislation is vague and there is no supervisory body, they may start to make moves into this area, although this will require awareness of the possible pitfalls.

This evidence suggests that MFIs have little room for complacency with respect to their market position for either loan or savings products. They await the Microfinance Bill to set the regulatory

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[16] This author is not aware of any studies of members' losses due to others' default within group based systems not just in Kenya but for MFIs anywhere.

requirements for registration as deposit-taking institutions. While they may not necessarily convert, the incentive to do so is likely to be strong as they currently face constraints in raising adequate capital to expand quickly. Meanwhile, competition for deposit accounts is strong, and players such as Equity and the SACCOs are learning how to serve this market. By the time the MF bill is passed and the MFIs have converted, they may find themselves competing in a well-served market with high service standards. Although K-REP has already converted to a bank and is beginning the preparations for banking premises in Nyeri, it does not anticipate offering banking services for another two years or so and appears, to an extent, to be constrained by the cost of fulfilling banking requirements for its premises. Currently the SACCOs operating FOSAs do not face such constraints.

The main conclusion of this section is therefore that MFIs have had only very limited demonstration or competition effects on other players in the financial market. Rather, it is becoming increasingly clear that there are a number of ways in which the wider dynamics of the financial market are having, and are likely to continue to have, significant impact on the MFIs. The changing macroeconomic environment has put pressure on the formal sector financial intermediaries to change their strategy and consider how to tailor their products to the middle-income market. In doing this they are finding new ways to lend primarily based on assessment of income flows. These clients are facing expanding options in terms of loan sources, which is especially significant, given that MFI clients often have multiple identities, for example, as business people, farmers and sometimes employees. In addition, the familiarity and abundance of group-based financial systems in this area means that they are also prepared to set up groups to respond to their financial needs and recognise the advantages of doing this. Finally, as MFIs move towards providing individual loans, it will become clearer to the formal sector how to start designing products appropriate to this market.

The MFIs are not competing on the savings side at the moment but may do so if they convert under a new Microfinance Bill. In this case they will be competing in an already competitive market.

5.2 What impact have MFIs had on the behaviour of financial service users?

The research also considered whether MFIs have had effects on the behaviour of financial service users. The evidence above suggests that mainstream MFI outreach has been predominantly to the small business community, although according to the initial research the characteristics of those able to borrow indicate that these business people tended to be educated at least to secondary level, and based in Karatina town. MFI clients were both men and women and were reasonably evenly split.

It is clear from the above evidence that one of the key demonstration effects for users has been of the managed ASCA model, rather than the mainstream MFI model, since there is evidence that people are independently setting up their own ASCAs and in some cases have seen this as a direct contrast to the MFI methodology as they recognise the benefit of keeping the interest for themselves. One group of relatively well-educated MFI borrowers had indeed taken the course of building up their own fund, then withdrawing their funds from the MFI to boost this fund and continue with their own revolving loan fund (See Box 5.1).

Box 5.1 From ROSCA to MFI to ASCA

This ASCA consisted mainly of professional people in Karatina: accountants, teachers, bank clerks, doctors, nurses and a small number of small business owners. Its origins were in a burial committee that formed when a mutual friend died. As one member of the group reported, all his friends on the committee were from outside Karatina and succeeded in organising the funeral without any assistance from his family who were 170km away in Nyahururu. They then met after the funeral and organised a fundraising event for the family. After that, they thought that since they had done this very successfully and none of them had relatives near by, they should meet again. A financial "merry-go-round" developed out of this.

Later they also joined an MFI and started taking loans. They did this for around two years continuing to build up their own savings fund as well as saving with the MFI. When they had built up a significant fund of savings they decided to turn this into their own business fund and withdrew the savings from the MFI, producing a fund of over Kshs1m. They now borrow from the fund at per cent per cent declining balance per year, recognising that they can set the interest rate as it is appropriate to them. However, with the poor economy it is difficult to invest all of the available funds in their businesses and related ventures. As a result they have been investing some of this fund into Treasury Bills.

5.3 Implications for MFIs in Kenya

Negotiability and flexibility: It has been pointed out above that managed ASCAs, and mutuals more generally, offer some important features which clients favour. One of the key features is negotiability – the ability to renegotiate loans when problems strike. While most of the mainstream MFIs have now introduced emergency loans as an addition to their product range, these still operate within the relatively rigid group methodology. The overwhelming request from clients is for flexibility and this will become more important in product design.[17] The future is therefore in products that enable clients to tailor loan terms and conditions to their own circumstances which is what ASCAs allow through negotiation.

In the past, being a good banker involved judging risk and negotiating broadly defined products, such as loans and overdrafts, with customers to meet their needs. The challenge of reaching the mass market through scale requires standardised approaches which must build flexibility into product design.[18]

Interest rates: The microfinance mantra has been that it is availability rather than price that is key to providing credit to poor people. However the mainstream MFIs using group-based lending have begun to recognise the importance of new products and service quality in an increasingly competitive market. While their prices have always been higher than those of the banks, the ordering of interest rates concealed this to customers. This ordering is now changing with quoted bank rates falling below those of the MFIs flat rates. This, along with increased awareness and experience of MFI borrowing among users, is likely to bring pressure on the MFIs to lower interest rates. Since other players such as Equity are also entering this market it is likely that competition based on price will now start to emerge.

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[17] It is interesting to note that even in the UK mortgage market increased flexibility without penalties e.g. repayment holidays, options for overpayment and so on, have become a more common feature of products in the last five years.

[18] The huge growth in credit card use in some developed countries may also reflect the need for such flexibility.

It is unlikely that MFIs can cut their rates significantly in the short term, and this therefore suggests the need for a combined initiative by the MFI sector on this issue. Such an initiative would find ways to educate and train clients about the nature of the service, for example pointing out that MFIs take the service to the client. It would seek to ensure that the MFIs collectively provide consistent messages to their clients about interest rates and raise their profile in terms of what is distinctive and different about their services.

Expansion strategies: It has been suggested above that MFIs may need to take greater care in planning their expansion strategies. The research was mainly undertaken when the economy was performing poorly and it is to be hoped that this situation is now changing. Despite this, aggressive expansion can lead to multiple membership and over-indebtedness, both because it is easiest for borrowers in one MFI to join another group, and because the savings component is not a good indicator of debt capacity. This risks a negative backlash for all MFIs as default affects good borrowers as well as bad, and risks deterring new borrowers through losses within groups that are seen as unacceptably high. As expansion takes place into more fragile business environments this poses a greater potential risk.

Understanding of the market: One of the most notable features of carrying out interviews with officials in such a range of financial intermediaries was their own reaction to the idea of competition. There were few managers who could see beyond their own market segments to where the future potential opportunities and threats lay. Most felt that they were doing well in their own segment. Of course, there is a possible response bias here in that they wanted to appear confident in what they were doing. However, the segmentation was apparent also from the lack of knowledge of many players about other key players in the sector and their performance. While this is at one level perhaps symptomatic of the fact that the market is strongly segmented and providers have little to fear from other parts of the market, the current evolution of the market suggests that medium-term developments are likely to present increasing challenges and that this segmentation will erode over time.

Collective action by MFIs: The relationship among MFIs in Kenya has been characterised by competition rather than cooperation and it is only recently that the Association of Microfinance Institutions (AMFI) has been functioning more effectively as a forum for discussion. The dynamics outlined above suggest that this cooperation is now a necessity. The sector needs to start to act collectively if it is to defend its progress and make space for itself in an increasingly competitive market.

Such collective action would be a new departure for the MFI industry in Kenya. However, at present it is not well understood compared to other sectors such as banks or SACCOs and their survival may depend on presenting themselves as offering distinctive products and services and reaping the benefits that a better understanding of their operations by the public might offer. In doing so, the sector would have to identify its competitive advantage and attempt to build on this. Part of that package might be codes of conduct for consumer protection, which would educate clients about interest rates and their own debt capacity. It is important that in pursuing expansion strategies MFIs do not compete against each other in ways that lose sight of the overall objective, that is, to expand the provision of financial services to poor people.

Annex: Methodology of the study

Methodology of the study of Karatina's Financial market 1999-2001

The methods used in the fieldwork comprised surveys and semi-structured interviews with providers, users and key informants. First, a supply-side survey was undertaken which involved: (a) in-depth interviews with 37 formal sector financial service providers and (b) the identification and interview of informal sector providers ranging from groups to moneylenders. Cross-sectional data on prices and volumes was collected along with details of products and services. Open-ended questioning explored trends and informants explanations of changing provision.

Second, a two-stage demand-side survey was undertaken. A random household survey of 150 households spread equally across the three key livelihood types in the area – tea farming, coffee farming and town-based enterprise and employment – collected basic household level information on livelihood profiles. This data was then used to identify a purposive sample of 68 individuals for in-depth interviews, based on location, age, sex, and marital status, in order to investigate both quantities and explanations of financial service use. This in-depth data was used for doctoral research purposes (see Johnson 2003).

Individual interviews were critical to ensuring accurate data collection. This avoids the assumption that financial management is carried out by the household head on behalf of the household. In fact, income pooling is a rare situation in households in this area, and men and women manage their own income in relation to their expenditure responsibilities. Indeed the sampling was purposive in order to ensure representation of both married and single women, and married households were split into younger and older around the median age of male household heads. Further, respondents were interviewed by a researcher of the same sex in order to ensure the greatest level of confidence was built with interviewees. This proved important since men were much more likely to divulge sensitive information, such as their polygamous state, to another man than to a woman; and women were much more likely to explain the "secret" groups to which they belonged to other women.

Data from the supply side was compiled to establish overall market dimensions and a detailed understanding of the products on offer. Quantitative data analysis of first round household and second round individual interview data was carried out. While the 68 individual interviews were purposively chosen, the data was pooled to examine patterns of use of financial services. Since data was not available to weight these categories for the whole sample the data collected from this sub-sample is not randomly representative of the whole population. While sub-sample numbers were small the research faced the trade-off between breadth and depth in the face of limited research resources. Since the overall objective was a detailed qualitative understanding of financial service use decisions, the objective of depth of explanation was prioritised over quantification. This data was analysed in depth for the author's doctoral thesis (Johnson 2003) and is only made very limited use of in this report. However, Table 3.2 appears both to corroborate the supply side findings regarding bank and rural SACCO use, as well as other secondary sources available which, for example, report the extensive use of ROSCAs in Central Kenya (see for

example (Kimuyu 1999)). Qualitative data was analysed to explain patterns and relationships thrown up by the quantitative analysis and these explanations are summarised in section 3.4.

Methodology of the February 2003 re-visit

The methodology of the follow-up research involved:

1 A supply side component which involved interviewing managers and officials in 16 financial intermediaries about; their product mix, completing the Financial Landscape Analysis matrix; data on numbers of accounts and values of deposits and loans (as at end 2002); their understanding of the local market and their main competitors, and their response strategies. This work in Karatina was complemented by interviews with six financial intermediary managers based in Nairobi head offices.

2 A demand side component involved focus group discussions with 10 groups. These in turn involved 62 women and 13 men. Four were MFI groups, two were managed ASCA groups and four were not members of MFIs, though individuals within the groups were in some cases. With these groups we carried out three financial sector trend analyses; two relative preference rankings on loans; two relative preference rankings on savings and three focus group discussions on group formation and experience. The Financial Sector Trend Analysis tool was particularly useful. Details of these exercises can be found in MicroSave-Africa's *Participatory Rapid Appraisal – A Toolkit*, May 2002.

This study benefited hugely from the earlier research carried out by the author in the area which meant that she had a detailed knowledge of the intermediaries operating, their products and the overall trends underway. Given the complexity of the market it would have been difficult to understand the full range of services available in two weeks.

However, the financial sector trend analysis was the most useful tool for this study. It allows an exploration of user's views of changing use by having them indicate to what extent a service was used 10 years ago, five years ago, one year ago and this year. This allows a structured discussion of the influences on people's service use. Because it is a considerable time since the MFIs came into the area, it was not possible to use the financial sector trend analysis to understand what clients did before the MFIs arrived.

The relative preference rankings may be more useful when used by an MFI wishing to understand its product relative to others in the market, but for the purposes of this research tended to reveal the limited understanding of the products available in the market and their terms and conditions. While for example, all groups said that interest rates were the most important in their choice of product, the ranking revealed that their knowledge of these was in practice limited.

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