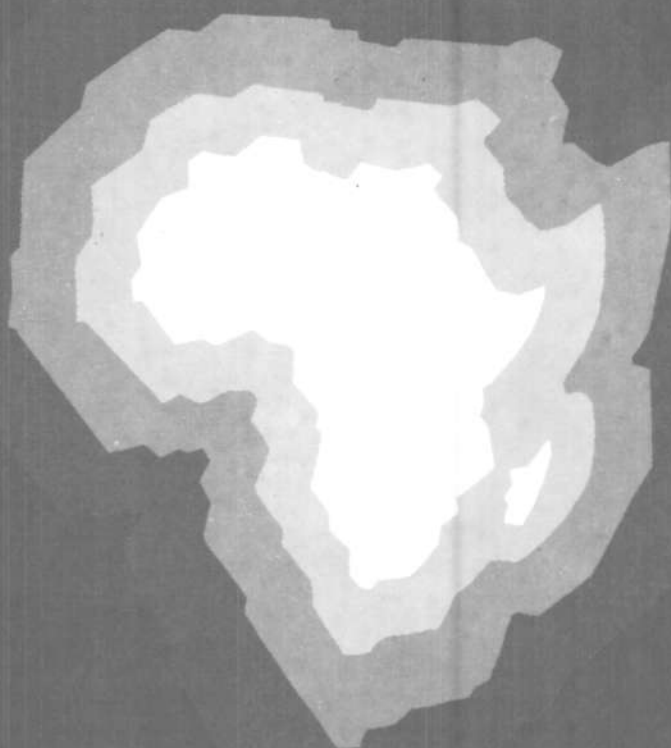


RURAL FINANCE PROFILES IN AFRICAN COUNTRIES VOLUME 1

edited by Mario Masini
for the FAO - FINAFRICA Working Group



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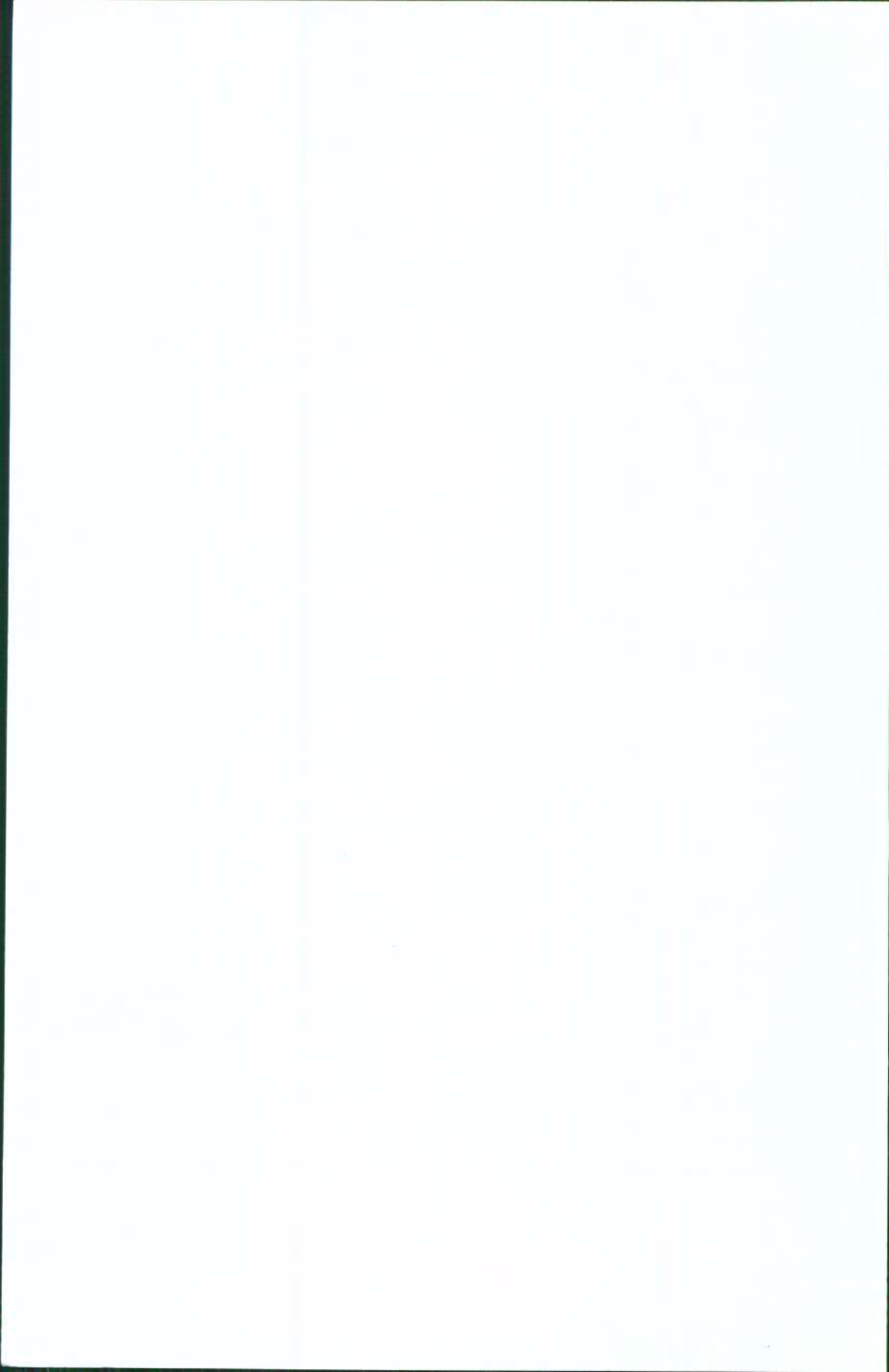
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PREFACE



In the vast majority of African Countries the hopes for a generalized improvement in the living conditions of the population are still related to improvements of the economic performance in the rural environment.

There is today a broader consensus for this view than was the case in the past. Efforts are under way to increase the amount of resources devoted to the rural environment in the form of technical assistance and physical inputs, including infrastructure. There are also strong pressures to improve the operating mechanisms which affect the performance of the rural economy, like the pricing system, marketing channels, extension. Financial institutions have been called upon to channel financial resources and to provide various services. However, there is widespread evidence that "orthodox" financial institutions did not get deeply involved in rural finance while "ad hoc" financial institutions did not survive the experience — they either went bankrupt or turned into administrative agencies with only an embryonic financial profile in their operations. In most cases there is also dissatisfaction with the volume of resources mobilized and with the quality of services provided.

FAO and Finafrica have decided to prepare a series of case studies — rural finance profiles or RPFs — with the purpose of helping to understand why financial institutions failed in assisting rural development. This knowledge should form the basis of a more effective technical assistance and of better framed economic and institutional policies at the country level.

The working-group tried to minimize the cost of acquiring information while at the same time maintaining acceptable standards of analysis and adherence to a uniform conceptual scheme. To this purpose it availed itself of experts with different levels and

quality of experience but provided them with an annotated checklist for the preparation of the RPFs (annexed to this preface). Work in the field consisted in short ad hoc missions or in the extension of other projects to cover the specific requirements of the RFP's. Five RFP's are presented in this volume while another set of case studies will be published in a new volume along with a preliminary set of conclusions and policy options.

The common conceptual framework of the case studies is based on three main assumptions: monetary control and broader financial policies are critical in explaining the performance of financial markets and the development of financial transactions in the rural environment; the specific pattern of funds flows within which rural financial institutions are called upon to operate is deeply affected by policies concerning pricing, taxation, provision of physical infrastructure, education inasmuch as these are primary factors of external financing requirements, debt repayment capacity, ability to generate — at least temporary — financial surpluses; institutional development is at the heart of the contribution of finance to rural development and cannot be achieved unless realistic and compatible goals are adopted along with appropriate structures and operating mechanisms.

Mario Masini

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ANNEX

AN ANNOTATED CHECK-LIST
FOR THE PREPARATION
OF RURAL FINANCE PROFILES



1. Main Features of the Economy

In this part the main features of the economy should be described along with factors affecting development and any general problem area that might be relevant for the remainder of the analysis.

2. Monetary Policy and Financial Development

Research items to be considered:

- Philosophy and actual performance in monetary control;
- Constraints deriving from “external” monetary authorities, participation in monetary unions, IMF guidelines;
- Financial development indicators: financial variables/GDP, deflated financial variables, level and structure of nominal and real interest rates, net external liabilities, structure of financial intermediation.

This paragraph aims at assessing the extent to which monetary and credit policies have led to a change in the intensity of financial processes relative to real processes in economic activity. This sets the general framework for understanding the development of rural finance.

The degree of control practiced on the money supply is relevant for explaining the growth of the financial system in nominal terms, i.e. in terms of deposits and loans without taking into account the effect of inflation on the purchasing power of financial instruments. Consideration of the processes through which money is created, on the other hand, can help explaining the allocative behaviour and the development of banking skills in the financial system. Finally, the interpretation of indicators for “real” financial development requires the consideration of mechanisms for external adjustments.

A trend towards financial deepening is deemed to produce favourable effects on real development. Ratios of financial to real variables, like money over GDP, or the value of financial stocks and flows deflated by price increases can be considered financial deepening indicators. It should be noted that positive and increasing variations of net external liabilities relative to GDP allow higher ratios of financial variables to GDP than would be the case when price increases are required to eliminate excess demand. Furthermore, when access to foreign sources of credit is semi-automatic, higher ratios of financial variables to GDP are attainable even when domestic interest rates and the foreign exchange rate are maintained at disequilibrium levels.

The level and structure (according to maturity and risk) of "real" interest rates (i.e. deflated nominal interest rates) is considered a critical factor in producing financial development.

3. Performance of Financial Institutions

Research items to be considered:

- Sources of funds: growth; classification by maturity, cost, sectors; debt/equity;
- Uses of funds: growth; classification by type of borrowers, sectors, loan size, contractual maturities, nominal and deflated interest rates; arrears; actual turnover;
- Structural features: branch networks, personnel (no. and type), size, technology, organization;

Profit performance: trends in profit formation; profit destination.

The study of sources of funds clarifies the degree of autonomy of financial institutions, the incentives they have to attract funds in free markets, their potential for growth, their philosophy in building asset portfolios with regard to risk, maturity, and required returns.

The analysis of portfolios of financial assets should reveal

the impact of lending policies on the relative availability of institutional credit for different sectors and classes of borrowers, the influence of external targeting on portfolio composition, the implicit effect of nominal interest rate decisions on credit and income distribution, the degree of credit discipline in meeting financial obligations on the part of borrowers, the possibility of offering attractive returns to depositors and other suppliers of funds.

The study of the structural features of financial institutions wants to supply information regarding the level of operating costs and operating efficiency on one hand, and on the other hand, information about the transaction costs born explicitly (through payment of fees, increased interest on loans, decreased interest on deposits) or implicitly (time and displacement cost, psychological discomfort, cost of delays, sub-optimal dimension of loans, fixed destination of resources obtained) by the customer of the bank.

Profit performance analysis should throw light on overall efficiency of financial intermediation, on the return afforded to resources destined as risk capital to financial intermediation and — in those cases where dividends are not paid and new sources of risk capital are not available — on the affordable rate of growth of assets for a stable debt/equity ratio in the financial institution.

4. Rural Credit Outside Financial Institutions

Research items to be considered:

- Credit “programs” run by non-bank specialized credit agencies: objectives; conditions applied; sources of funds; non-financial resources absorbed (e.g. personnel); arrears;
- Credit cooperatives: juridical structure; outstanding loans; number of members; loan repayment performance; sectors involved; relationships with “official” banking;
- Unofficial sector: trade credit; other private moneylending activities; rotating associations.

This paragraph deals with official credit programs run by specialized agencies that are not financial institutions and with finance within the so-called unofficial sector of the financial system.

An analysis of "credit programs" is necessary in order to assess the effective size of financial resources available to the economy, the degree to which non-banking mechanisms are adopted in allocating financial flows, the degree to which services relevant to bank lending are supplied by non-bank institutions.

The analysis of the unofficial sector again is useful in assessing the effective availability of credit to the economy. This analysis also helps to provide policy suggestions for exploiting the banking development potential of the so-called traditional or less advanced sectors of the economy. These sectors most often coincide with the rural environment and analysis of the unofficial financial system provides insights into micro-aspects of development which are basic for a successful savings mobilization policy.

5. Infrastructure for Rural Development and Pricing Policies

Research items to be considered:

- Infrastructure: transportation, seed selection and supply, other input supply, crop storage, irrigation, extension programs, crop purchase agencies, crop marketing agencies, crop insurance, land tenure and distribution, juridical and judicial framework for credit;
- pricing policies: inputs, output at farm gate, taxation.

Analysis is required to understand the broad factors — under the control of economic policy makers and politicians — that directly influence income formation in the rural sector. Those factors also directly affect the saving potential and the repayment capacity of farmers and other economic units in the rural environment.

Rural institutional infrastructures also affect the attitude of the public — in terms of loyalty, trust and perceived image — towards other government run programs and institutions, particularly in the financial field. Special attention should also be paid to the juridical and judicial framework for financial contracts.

6. Key Financial Institution(s) and an Overview of Rural Finance

Research items to be considered:

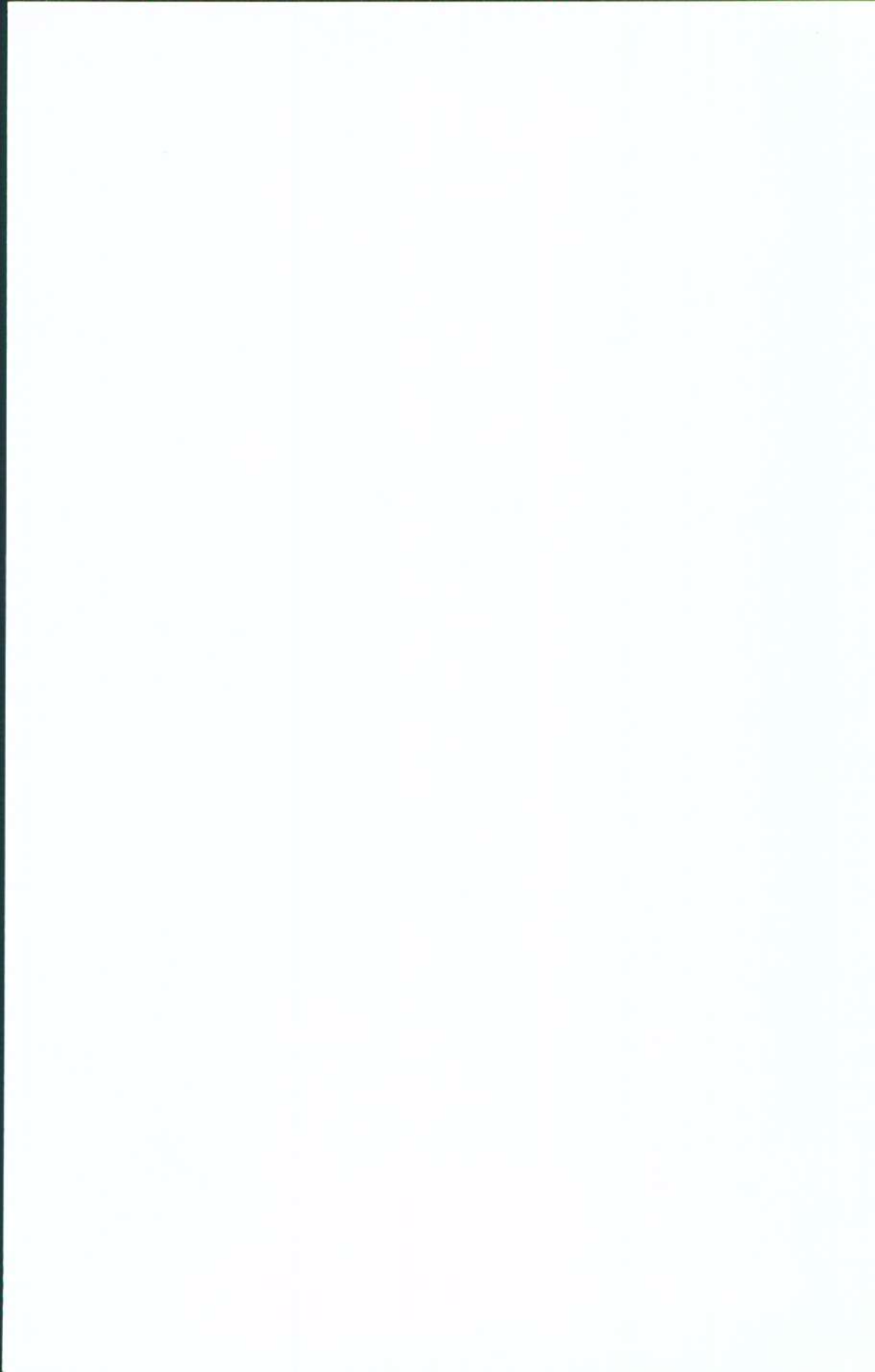
- Lending: nominal and real growth; distribution by sub-sector, type of beneficiary, size of loan, destination, maturity; interest rates; other conditions; arrears;
- Savings promotion: nominal and real growth of funds collected from free sources/markets; interest rates; maturities; savings schemes;
- Main institutions: type; size; number of personnel; number of branches;
- Key institution (s):
 - goals: size and growth, risk, profitability, customer composition;
 - sources of funds: liabilities structure (cost, maturity, sectors); debt/capital ratio; liability management and savings promotion;
 - asset management: real/financial asset ratio; loan portfolio composition (interest rate, sectors and types of borrowers, maturity); arrears;
 - design of financial instruments;
 - personnel and organization: hiring policy; critical tasks and skills required; number and distribution of personnel; distribution of responsibility and decision power; communication;
 - operating systems for: risk management, financial management, personnel management, skills development.

This paragraph draws together all the elements concerning the rural sector developed in the previous parts of the study and analyzes in relative detail the main financial institution (s) involved in credit and deposit activities in the rural environment.

The paragraph should address the following problem areas: potential for growth of rural finance under effective savings mobilization policies vs. "rules" of growth under artificial finance; effective and ineffective layering of official and unofficial institutions in distributing rural finance; intended vs. realized allocation of credit; income distribution effects of alternative interest rate policies; effective risk and operating costs involved in performing financial intermediation in the rural environment.

KENYA

by ERIK SKÖN



1.

MAIN FEATURES OF THE ECONOMY

The Republic of Kenya, with a land area of 569.140 Km² is a country of contrasts in climate topography and agricultural systems. Despite its large land area, the diversity of ecological and climatic conditions in the country limit the amount of good quality agricultural land. Only about 7% can be described as high quality land, with adequate rainfall and good soils. Another 11% is of medium quality and an additional 4.5% is arable, but subject to periodic drought and crop failure. The remaining land area is suitable only for livestock, and even for this purpose potential is low with up to 60% of the total land area describable as semidesert.

In 1984 the population was estimated at about 19.5 million. The rate of growth is estimated at 4.0% per year, an extremely high population growth rate. This has caused increasing pressure on the limited supplies of arable land as wage employment opportunities are limited. In 1983 some 1.1 million were employed in wage employment. Of these 565.500 worked in the private sector and 527.800 in the public sector mainly for the Central Government and the parastatal bodies.

The Kenyan economy is fundamentally based on agriculture. Some 85% of the population still lives in the rural areas. In 1981 agriculture provided employment for nearly 70% of the working age population and it produces almost all of Kenya's food. As can be seen from Table 1 the main food crops marketed are maize and wheat. Of the cash crops coffee and tea are the main money earners. Also cattle for slaughter and dairy products bring considerable incomes.

Because of the critical links between agriculture and the rest

of the economy, agriculture's relatively disappointing performance in recent years has caused some concern. After showing vigorous performance in the years following Independence (4.6% per annum) growth has slowed noticeably in the last decade to an average 3.1% per annum between 1972-1983. There was a surge of growth after droughts in 1979 and 1980 as can be seen from Table 2. Severe drought again in 1984 devastated many parts of the country. In 1985 there was enough rainfall and a good crop. According to Table 2 the GDP of the primary sector (at constant 1976 prices) amounted in 1983 to 632 K£ million and accounted for 35% of the Kenyan economy.

TABLE I

Main Agricultural Commodities

	1980	1981	1982	1983 ¹⁾
PRINCIPAL CROPS				
<i>Production for Sale '000 Metric Tons</i>				
Wheat	204.6	214.4	234.7	242.3
Maize ²⁾	217.9	472.9	571.3	637.1
Rice Paddy	36.4	38.7	38.6	33.6
Pyretherum ext.	0.2	0.2	0.3	0.1
Sugar-cane ³⁾	3,972.2	3,822.0	3,107.7	3,188.1
Seed Cotton	38.1	25.5	24.4	25.8
Clean Coffee	91.3	90.7	88.4	95.3
Sisal	46.9	41.3	50.0	49.7
Tea	89.9	90.9	95.6	119.3
<i>Gross Marketed Production K£ '000</i>				
Wheat	17,670	17,869	22,071	26,922
Maize	10,390	23,645	30,777	48,952
Rice	2,843	2,897	2,899	2,679
Pyretherum	9,735	13,398	14,777	5,003
Sugar-Cane	29,520	30,877	29,408	34,342
Cotton	6,315	4,344	4,286	4,919
Coffee	118,856	102,471	122,866	166,247
Sisal	9,714	8,512	12,589	15,539
Tea	71,515	80,590	93,190	130,306
LIVESTOCK				
<i>Gross Marketed Production K£ '000</i>				
Cattle and Calves for slaughter	33,909	47,945	52,260	51,805
Dairy prod.	15,007	22,802	28,510	32,802

Source: Statistical Abstract, 1984, Central Bureau of Statistics.

1) Forecast/provisional

2) Deliveries to the Marketing Board, only

3) Including Cane delivered to the sugar factories for the production of white sugar.

TABLE 2

Real Variables in the Kenyan Economy

GDP ¹⁾	1978	1979	1980	1981	1982	1983 ²⁾
Primary sector, in %	37.8	36.0	34.4	34.7	34.6	35.1
Secondary sector, in %	19.9	20.4	21.0	21.0	19.8	19.8
Tertiary sector, in %	42.3	43.6	44.6	44.3	45.6	45.1
Total	100.0	100.0	100.0	100.0	100.0	100.0
Percentage increase	—	4.27	3.32	5.34	4.62	2.72
GDP per capita K£	—	95.38	94.94	96.35	96.01	96.01
<i>External Balance K£ million</i>						
Goods and services	—	-141.5	-317.2	-291.1	-179.4 ³⁾	-81.8
Transfers	—	-44.8	-11.5	-45.0	-74.0	-33.8
Current account	—	-186.3	-328.7	-336.1	-253.4	-115.6
Capital movements (excl. reserves)	—	253.8	252.8	236.3	148.4	180.7

Source: Statistical Abstract, 1984, Central Bureau of Statistics.

1) At constant (1976) prices

2), 3) Provisional

Government Revenue and Expenditure shs. million

	1982/83	1983/84	1984/85 ¹⁾	1985/86 ²⁾
Ordinary current Revenue	15,945	17,753	19,384	22,108
Expenditure (net)	20,684	23,356	25,783	29,781

Source: Annual report 1984/85, Central Bank of Kenya

1) Provisional

2) Printed budget 1985/86

The secondary sector accounts for 20% of GDP in 1983. Of manufacturing agro-industries constitute some 72%. Chemical Industries account for 15% and metals and engineering some 13%. Kenyan industrialization has been encouraged by heavy protection of domestic industry against foreign competition, largely in the form of nontariff barriers and government assistance to enterprises in the form of direct investment and loans. This constellation of policies produced a rapid growth of 10.5% per annum in real terms between 1972 and 1978. But, it has also created a sector strongly oriented to the domestic market and highly dependent on imported inputs. In the fourth plan period 1979-1983 the growth rate calculated amounts to 4.1% per annum. The rate is adversely affected by the decrease in building activity in 1982 and 1983.

The tertiary sector contributed some 45% to GDP in 1983. This is the fastest growing sector of the Kenyan economy with a growth rate of nearly 6% per year.

A special feature in the Kenyan economy are the Parastatals. They consist of some 147 Statutory Boards, 47 wholly government-owned enterprises, 36 companies in which Government and/or Statutory Boards have a minority interest. In terms of contribution to GDP and employment the Parastatals are equal in size to the Central Government. There are considerable variations in management standards and financial viability of Parastatals.

In exports the main commodities are coffee, tea and petroleum products. Coffee and tea represented 25.4% and 19.6% respectively of the Kenyan exports in 1983. Petroleum products accounted for 18.8% of the export. The volumes of coffee and tea exports were affected adversely by poor weather in 1979-1980 and 1980-1981 respectively. Since that there has been a recovery year by year. In 1982 tea experienced a good upswing from K£ 77.8 million to 123.4 million. Petroleum product export volumes declined sharply in 1981-1982, largely as a result of a rapid drop in Ugandan consumption following very rapid upward price adjustments in that country. Taken as a whole the dollar value of exports reached a temporary peak in 1980, reflecting higher export prices for refined

Petroleum, but declined in 1981-1982. This resulted from drops in both the volume and prices of exports.

Import restrictions were tightened in late 1978. As a result, import volumes declined 19% in 1979 and the nominal value of imports stabilised and the reserve position improved. Restrictions were eased and with increased liquidity, continued expansionary fiscal policy and exchange rate appreciation, import volumes rose again.

Through a number of devaluations of the shilling, tightening of monetary and fiscal policies as well as tariff adjustments, a fall in import volume and value was achieved in 1980. As can be seen from Table 2 the current account deficit had its peak in 1980-1981. Since then there is reflected a recovery for both 1982 and 1983. Still over the period 1977 to 1983 the Kenyan debt services ratio has risen from 7% in 1977 to 27% in 1983.

To improve management of Government finances the Working Party on Government Expenditures was set up by the Kenya Government. The Working Party has sketched out a budgetary scenario for the period to be covered by the fifth Development Plan 1984-1988. The aim is to progressively reduce the deficit in the Government budget, largely by allowing expenditures to fall relatively to GDP. In summary, the Working Party proposal would improve public sector savings, redress the imbalance between development and recurrent outlays (about 1/4 of GDP in 1983/1984), reduce Government investment in commercial enterprises and provide for improved project evaluation and budgetary controls.

2.

MONETARY POLICY AND FINANCIAL DEVELOPMENT

Monetary development during the plan period 1979-1983 has been characterized by an almost continuous decline in domestic liquidity (Table 3) caused by the deterioration of the overall balance of payments position.

With the slowdown in the growth of private financial assets, there has been competition for domestic bank credit. Based on information gathered in discussions with local bankers, the needs of the public sector, especially the Central Government, appear to have taken precedence.

The total public sector accounted for about 27% of the net domestic assets of the banking system at the end of 1978. At the end of 1982 the share had reached 43%.

Furthermore there was an accelerated growth in foreign debt, particularly in foreign debt of Central Government (Table 4). This growth seems to have been declining since 1983. In 1985 foreign debt increase of Central Government was only 3.1%. Expansion of credit to the private sector seems to have been rather irregular. It has grown on average by about 13% per year, or about the average pace of domestic prices (Table 4).

TABLE 3

Money Deepening Ratios

	1979	1980	1981	1982	1983	1984
Currency in circulation (% of GDP)	5.9	5.8	5.9	5.5	5.3	5.1
Deposit money (% of GDP)	30.2	25.0	24.5	26.1	23.6	24.3
Total money and Quasi money (% of GDP)	36.1	30.8	30.4	31.6	28.9	29.4
Nom % Δ	16.1	-1.1	13.3	16.1	4.9	12.9
Real % Δ	—	-13.9	0.7	-6.2	-9.6	3.8

Sources: Annual report 1984/85, Central Bank of Kenya
 Statistical abstract 1984, Central Bureau of Statistics
 Kenya 1985/1986, Newsprint International
 (Calculations by the author)

TABLE 4

Financial Deepening Ratios

	1979	1980	1981	1982	1983	1984
Total money % / GDP	36.1	30.8	30.4	31.6	28.9	29.4
Net domestic credit % / GDP	38.3	33.9	32.5	34.1	32.7	33.0
Δ Ext. liabilities % / GDP	1.9	1.0	1.1	3.8	1.7	0.4
Memo: % Δ Prices (Average index of consumer prices, Nairobi)	—	12.8	12.6	22.3	14.5	9.1

Sources: Annual report 1984/85, Central Bank of Kenya
 Statistical abstract 1984, Central Bureau of Statistics
 International financial statistics 1985, IMF
 (Calculations by the author)

Kenyan monetary policy has involved the use of changes in reserve requirements of the commercial banks, credit controls and interest rate adjustments (Table 5) to influence the expansion and allocation of credit. With tightening domestic liquidity in the aftermath of the coffee boom 1977, there have been a series of reductions in reserve requirements for banks in order to prevent

severe contraction of credit to the private sector. At times these measures have been combined with upper limits on the rate of expansion of credit to the private sector.

In order to protect agriculture, there have been requirements that a fixed proportion of Bank's deposits be in loans to that sector (17% at the time of writing this report).

Interest rate policy has been used more frequently in recent years. This has been a reaction to the decline in the level of domestic interest rates relative to those in the international markets and the inducement to capital flight this presents. It can also be viewed as an attempt to stem the flow of resources from banks with controlled rates to uncontrolled nonbank financial institutions. Lending rates were adjusted upwards in steps during 1980-1982 (Table 5).

Kenya does not have a history of strong inflationary periods. The economy has tended to be relatively open with demand pressures being vented through the balance of payments, while domestic price movements have reflected those in trading partners. There was, however, an upsurge of inflation in 1982 with prices rising by 22.3% and 14.5% in 1983 (Table 4). There were a number of factors responsible for this i.e.: the scarcity of maize as a result of drought and rising maize prices, upward adjustments in fuel prices and the effects of devaluation of the shilling during 1981. Price increases seem to have peaked in 1982 and decelerated thereafter. Based on average index of consumer prices in Nairobi the price increase was 22.3% in 1982, 14.5% in 1983 and as low as 9.1% in 1984. It should be noted these price statistics are based on information from Nairobi, only. Their usefulness for deflating financial variables is therefore limited and the results are difficult to interpret.

TABLE 5

Main Interest Rates

	1979	1980	1981	1982	1983	1984
Rediscount rate for treasury bills	4.60	6.03	10.12	13.48	15.12	not available
Loans, maximum	10.0	11.0	14.0	16.0	15.0	14.0
Savings account deposits, minimum	5.0	6.0	10.0	12.5	12.5	11.0
9-12 month time deposits	5.625	6.350	11.00- 12.25	13.375- 13.792	12.5- 13.0	11.75- 12.00

Source: Statistical abstract 1984, Central Bureau of Statistics
 Annual report 1984/85, Central Bank of Kenya

3.

PERFORMANCE OF FINANCIAL INSTITUTIONS

For the purpose of this study the functioning of the commercial banks and non-bank financial institutions (NBFI) is outlined and analysed. The role of the banks and NBFI in financing of agriculture has also been looked into.

3.1 OVERVIEW OF THE FINANCIAL SECTOR

Kenya has a comparatively well developed financial system rich in institutions and relatively deep in assets. The structure includes a Central Bank, 23 commercial banks, 41 non-bank financial institutions, 30 insurance companies, a Post Office Savings bank, a social security system, numerous pension plans, 6 industrial development banks, other specialized financial intermediaries, a stock exchange and over 1,300 savings and credit cooperatives.

The financial system continued to expand during 1984/1985 with the opening of two new banks and the licencing of four new non-bank financial institutions. The development of the branch network of commercial banks since independence is set out in Table 6.

Financial depth, as measured by the ratio of broad money (M2) to GDP, has in recent years been about 30% (Table 3), which can be deemed a reasonable level for a country at Kenya's stage of development and with its rich array of alternative financial assets.

Over the last 10 years the importance of commercial banks and NBFI in providing agricultural credit has increased. Of the 23

commercial banks, two of the largest banks, the Kenya Commercial Bank (KCB) and the National Bank of Kenya (NBK), are wholly Government owned. The Government also owns 40% of Grindleys Bank International (Kenya) Ltd.

TABLE 6

Growth of the Branch Network of Commercial Banks

	1963	1971	1983
<i>Nairobi and Mombasa</i>			
Full-service branches	29	51	74
Sub-branches	1	10	28
<i>Non-Metropolitan</i>			
Full-service branches	26	58	87
Sub-branches	42	100	53
<i>Total</i>			
Full-service branches	55	109	161
Sub-branches	43	110	81

Notes: Information for 1963 and 1971 is taken from Abdi 1977, and for those years sub-branches included mobile branches. The 1983 data on sub-branches do not include mobile branches.

Source: Agricultural Credit Policy Review, 1985, World Bank.

The Cooperative Bank of Kenya is registered jointly under the Banking Act and the Cooperative Societies Act. The majority of the other banks are foreign owned or multinationals. The banking sector is currently dominated by KCB, Barclays Bank and Standard Bank. These three banks accounted for over half of the total loans outstanding as at June, 1983. The four largest banks, including NBK, accounted for 65% of the total deposits and 63% of the total credit.

One of the most pregnant forces in Kenya financial markets has been the recent growth of NBFI. There can be seen several reasons for this. First, the legal framework of the Banking Act, in essence, has sheltered the specialized NBFI by restricting the activities of commercial banks in the areas of hire-purchase finance and the financing of property.

Second, the regulatory policies of the Central Bank have

been less restrictive for NBFI on lending rates and credit controls. And third, NBFI have been able to attract large deposits, partly because of higher deposit interest rates. Of the 41 NBFI, 12 are affiliated with commercial banks. 17 NBFI have been licenced since January 1982. Three NBFI have started affiliated banks. NBFI have incentives to start banks because there are certain services that NBFI cannot offer: they cannot operate current accounts using cheques as a means of payment, and they cannot engage in foreign exchange transactions. An amendment of the Banking Act has recently been passed according to which no NBFI shall directly or indirectly own any equity shares in a bank.

There are several features of the evolving financial market structure and financial institutions operations which the Central Bank has tried to influence through the regulatory framework. The relevant features of the market structure are the prominence of multinational financial institutions, many of them small and specialized, with only a few banks broadly involved in all sectors of the economy and most with geographical presence limited to major urban areas, mainly Nairobi and Mombasa. Until recently there has been little price and quality competition among the financial institutions, and most institutions offer only a limited range of financial services. Although more competition has now been introduced into the system through the rapid growth of the NBFI, there is also reason for concern about the financial viability of some of NBFI and sectoral allocation of credit by NBFI. In response to the above risk the Central Bank has recently been considering proposals to introduce a Deposit Protection Scheme. A proposal under consideration would fully insure the first 100,000 Shs of deposits and cover 75% of the next 900,000 shs. According to the Banking (Amendment) Act the scheme shall be funded mainly by the banks and NBFI. The amount of contribution shall not be less than 100,000 Shs nor exceed 0.4 per cent of the bank's deposit liabilities. The contribution of a bank to the Fund can be raised in case the affairs are conducted in a manner detrimental to its own interest or to the interest of the depositors. This way the

Central Bank being the chief administrator will be able to use the Fund as a whip on bankers not performing up to standards. The Fund is no doubt needed, but the question is to what extent the well established banks are willing to pay for the good of the banking industry as a whole.

3.2 REGULATIONS OF THE FINANCIAL SECTOR

Under the Banking Act (Cap. 488) and the Central Bank of Kenya Act (Cap. 491), the Central Bank has authority to licence, regulate and inspect the commercial banks and NBFI. The Ministry of Economic Planning and Finance and the Central Bank share the functions of monitoring the commercial financial sector and establishing monetary and economic targets and policies. The Banking Act specifies a number of requirements, covering such areas as adherence to licencing conditions, minimum capital requirements, restrictions on unsecured lending and limits on individual loans etc. to be monitored by the Central Bank by inspection. In addition, the Central Bank administers a set of flexible policy instruments that are adjusted periodically to changing economic conditions. These instruments fall into five categories:

- 1) interest rate guidelines, which set the minimum deposit rates and maximum lending rate,
- 2) the discount rates,
- 3) the reserve requirement, which has usually been set in terms of a liquid asset requirement, but occasionally has also specified a cash ratio,
- 4) selective credit controls over the expansion and sectoral allocation of credit,
- 5) foreign exchange restrictions, which include control of import licencing.

The Government's fifth Development Plan 1984-1988 clearly identified the need to review the regulatory framework of NBFI and to reformulate the policy directives to Commercial Banks,

particularly with regard to their agricultural lending. In 1984 IMF carried out a study with the Central Bank on NBFI, the results of which have now been transformed into practical regulations through the Banking (Amendment) Act increasing capital requirements and control in general of NBFI.

3.3 INTEREST RATE POLICY

Before independence, the interest rate structure in Kenya was determined by agreement among the larger multinational banks. Since its establishment in 1966, the Central Bank has set interest rate guidelines for minimum deposit and maximum lending rates. Between 1966 and 1980, however, the interest rate structure was adjusted only once, marginally in 1974. The real interest rates were low or slightly negative over most of the period (Table 7). The basic motivation for maintaining low interest rates, as in many other countries, has been the desire to stimulate investment. The possible distortions resulting from these policies were largely ignored in the belief that savings were largely insensitive to interest rates and the Central Bank could influence the sectoral allocation of credit through other mechanisms. Higher variable inflation and more active Government policy have led to more frequent adjustments in the interest rate schedule in recent years. Interest rates were adjusted upward in 1980 and have been adjusted on almost an annual basis ever since. Real interest rates have been positive on deposits and loans since early 1984. The spread between the maximum lending rate for commercial banks and minimum rate paid on savings accounts has also been decreasing with the post-1980 interest rate adjustments. Before 1980, the nominal spread was about 5% and in 1984 about half of that.

The low level of interest rates in the past introduced economic and structural distortions in the economy. In the first place, negative real borrowing rates subsidized borrowers at the expense of savers. While the average effective interest rate charged on loans

may have been slightly above the official maximum (because of additional fees and charges added by banks), the average real interest rate on commercial bank loans remained negative or very low over the 1970s. The real interest rate on savings with commercial banks and the Post Office Savings Bank (POSB) ranged from about 1.9% to about 12.3% at various times between 1976 and 1984, thus penalizing savers. Second, indications are that financial institutions' deposits are positively correlated with changes in real interest rates, and some Kenyan bankers seem to agree, but there has been little incentive in recent years for savings mobilization. Financial policies may have underestimated the potential of domestic savings mobilization and seem to have ignored the importance of the relationship between the saver and the banker as it affects the saver's access to banking and credit services. Third, the maintenance of interest rates below the equilibrium level resulted in non-interest rate rationing of loans, which in a young developing nation like Kenya was a very tricky task for the local bankers. With an excess demand for loans, bankers tend to favor the larger and less risky loans, a factor which often disadvantages smaller and/or agricultural borrowers. Also, this situation often results in credit decisions being subject to political pressures, as prospective beneficiaries of the interest subsidies attempt to gain access to scarce credit. This fact was admitted by local bankers, who, no doubt, are doing their best to fight the problem. Furthermore, in this situation of interest rate ceilings and excess loan demand, there is little incentive for banks to compete for clientele. This poses a particular problem in the rural areas where the small market makes the provision of banking services more expensive.

The difference of interest rates structure between commercial banks and NBFI contributed to structural distortions in the financial markets. NBFI currently pay more for deposits, because they can not operate non-interest bearing current accounts, they are therefore allowed to charge a higher effective interest rate and pay substantially higher rates for longer time deposits. In addition, and particularly relevant to agricultural investment, the structure of

TABLE 7: Trends in Nominal and Real^{a)} Interest Rates, 1976-1984 (as of December 31)

	1976	1977	1978	1979	1980	1981	1982	1983	1984
<i>Commercial Banks</i>									
Savings deposits									
(minimum)									
Nominal	5.0	5.0	5.0	5.0	6.0	10.5	12.5	12.5	11.0
Real	-4.9	-7.7	-7.6	-3.4	-6.8	-2.6	-9.8	-2.0	1.9
Loans and advances									
(maximum)									
Nominal	9.0	10.0	10.0	10.0	11.0	14.0	16.0	15.0	14.0
Real	-9	-2.7	-2.6	1.6	-1.8	1.4	-6.3	.5	4.9
<i>Post Office Savings Bank</i>									
Deposit - Nominal	5.0	5.0	5.0	5.0	6.0	10.0	10.0	11.0	11.0
Real	-4.9	-7.7	-7.6	-3.4	-6.8	-2.6	12.3	-12.3	1.9
<i>Hire Purchase Co and Merchant Bank</i>									
Time deposits -									
Nominal	5.0 to 8.0	5.0 to 8.8	5.0 to 8.0	5.0 to 8.0	8.0 to 11.0	8.0 to 12.0	13.3 to 16.3	14.0 to 16.5	13.0 to 14.5
Real	-4.9 to -1.9	-7.7 to -4.0	-7.6 to -4.6	-3.4 to -.4	-12.8 to -1.8	-4.6 to -0.6	-9.0 to -6.0	-.5 to 2.0	3.9 to 4.9
Loans (maximum)									
Nominal	10.0 to 12.0	10.0 to 12.0	10.0 to 12.0	10.0 to 12.0	10.0 to 14.0	10.0 to 14.0	up to 16	20.0	19.0
Real	-1 to 2.1	-2.7 to -.7	-2.6 to -.6	6.6 to 3.6	-2.8 to 1.2	-2.6 to 1.4	-6.3	5.5	9.9
<i>Agric. Finance Corporation</i>									
Development loans (maximum)									
Nominal	9.0	9.5	9.5	9.5	10.0	13.0	13.0	13.0	13.0
Real	-9	-3.2	-3.1	-1.1	-2.8	.4	-9.3	-1.5	3.9
Seasonal Credit loans (maximum)									
Nominal	10.0	10.0	10.0	10.0	11.0	12.0	12.0	14.0	14.0
Real	-1	-2.7	-2.6	1.6	-1.8	-6	10.3	-.5	4.9
Inflation Rate	9.9	12.7	12.6	8.4	12.8	12.6	22.3	14.5	9.1

a) Nominal rates adjusted for inflation.

Source: Central Bank, Economic and Finance Review. (Calculations by the author)

rates favoring NBFI has resulted in these institutions gaining an increasing share of total deposits; however, most of NBFI do not have the capacity to lend directly to farmers.

There are further distortions introduced by the development banks (AFC and CBK) and the commercial financial institutions. Because the development banks are largely dependent on aid agencies and Government funds, their cost of funds has been lower, and the Government has mandated lower lending rates and restrictions on additional fees charged by publically-sponsored credit programs. Interest rates charged by AFC, for example, have been consistently 1% to 2% below the maximum commercial lending rates. Given that commercial financial institutions levy additional charges, such as commitment fees, and also have indirect methods of raising the effective interest rates on loans (e.g. requiring borrowers to hold compensating balances on deposit), the actual difference between effective commercial lending rates and rates for AFC lending or rates on other specialized agricultural credit schemes is significant. Although subsidization of interest rates has been motivated by broadly recognized development and social objectives, as in many other developed countries, this policy instrument has rarely proven to be the best means of targetting special subsidies. It has also had the effect of encouraging built in inefficiencies in favored sectors, leading to unsustainable enterprises in the long run. In tight credit markets, such as has been the case in Kenya in recent years, the disparity between commercial and public-supported institutions' effective interest rates has intensified the competition for cheap funds, with the intended target group of poor or new borrowers often losing to the more influential and established borrowers.

Many of the other financial sector regulations have been introduced to compensate for problems created by the interest rate ceilings. For commercial financial institutions, for example, foreign companies operating in Kenya are limited in their domestic borrowing to keep them from benefitting from the low interest rates. The recent policy debate in Kenya has tended to focus almost

exclusively on the level of interest rates rather than on the structure of interest rates or the differential treatment of financial institutions. It should be noted that there has been recent progress in setting nominal rates so that real rates are positive or closer to being positive. Introducing more flexibility in interest rate guidelines leading to progressive liberalization is one important step the Government could take to meet its agricultural credit objectives.

3.4 RESERVE REQUIREMENTS

There have been significant fluctuations in the liquidity position of the Kenya banking system which mirror the swings in the economy. The use and effect of the reserve requirement has varied during different periods of time. It was used as a tool for controlling the supply of domestic credit during the coffee boom years of the late 1970s. Increasingly in recent years, it has been used to require financial institutions to carry a significant amount of Government debt.

Compliance with the reserve requirements has been a particular problem for NBFI. These requirements were only extended to NFBI in 1974, and NBFI licenced under the Building Societies Act have remained exempt from this requirement. Because NBFI do not maintain accounts at the Central Bank, NBFI were allowed to count current account deposits at commercial banks as liquid assets (liquid assets for NBFI include cash, balance at local banks and Treasury bills). However, from January 1, 1981, all NBFI were required to hold 50% of the required liquid assets in Treasury bills. During 1981 and 1982, the average holding for NBFI were consistently above the reserve requirement of 20%. NBFI had more trouble meeting the liquidity requirement when it was raised to 24% in February 1983. At the end of March 1983, four of the 29 NBFI were holding less than 15% of their deposit liabilities in liquid assets.

Since the reserve requirement was increased for both banks

and NBFI in February 1983, all financial institutions have had to cut back on new lending to customers. The increase in the reserve requirement was coupled with an additional requirement that NBFI purchase Treasury bills equivalent to the amount of their parastatal deposits. The liquidity situation in the commercial financial sector has remained tight, limiting new lending activities.

3.5 AGRICULTURAL LENDING REQUIREMENTS

The Central Bank has tried to encourage financial institutions to become more involved in the agricultural sector and expand out of trade finance. It has tried to achieve this through establishing agricultural lending targets. In 1975, the Central Bank issued a directive to commercial banks to lend 17% of their deposit liabilities to agricultural lending; banks were expected to comply with this directive by June 1976. A similar lending requirement, but at 10% was extended to NBFI in 1980. The definition of "agricultural credit" given in the Central Bank guidelines emphasizes primary production and includes direct lending to farm enterprises, agricultural cooperatives and indirect lending to parastatals for onlending (i.e. to the Kenya Tea Development authority, Pyrethrum Board, Cotton, Lint and Seed Marketing Board, etc.) or for direct production (i.e. to the Agricultural Development Corporation and National Irrigation Board, etc.). Loans to buyers of farm produce, input suppliers and agro-industries were specifically excluded. The 1980 directives stated that financial institutions could also include the purchase of Government guaranteed paper, such as the AFC promissory notes issued to help finance NSCS in 1980/1981. The definition was expanded in April 1982 to include explicitly Cereals and Sugar Finance Corporation (CSFC) promissory notes. Lending to the National Cereals and Produce Board (NCPB) operations has also been included by financial institutions to meet their quotas.

Tables 8 and 9 summarize Central Bank data on aggregate

agricultural lending by commercial banks and NBFI, respectively. The data show that between 1976 and 1980, the aggregate ratio of agricultural lending to net deposit liabilities of commercial banks fluctuated between 13% and 17%, but rose gradually to the range of 19% to 21% in the period since 1980 to the present. Compliance has been uneven, with the average ratio being heavily influenced by the lending of a few large banks and the Cooperative Bank of Kenya.

The smaller banks with offices only in Nairobi and Mombasa and serving a specialized, often multinational, clientele have had difficulties in meeting the quota requirement. Similarly, in the aggregate, NBFI have met the 10% requirement. By March 1983, the aggregate ratio was 13%. As with commercial banks, however, this reflects the lending activities of several of NBFI with specialized agricultural programs.

TABLE 8

Trends in Commercial Bank Agricultural Lending (K sh million at end of year)

Year	Lending to agriculture	Net deposit liabilities	Lending ratio (%)
1976	922.4	6,880.3	13
1977	1,364.0	10,125.1	13
1978	1,575.2	11,108.5	14
1979	1,779.9	12,576.1	14
1980	2,097.6	12,105.9	17
1981	2,317.3	13,486.9	17
1982	2,995.4	17,153.3	17
1983	3,811.9	19,449.8	23
1984	3,636.5	22,159.4	19
1985 (June)	4,109.4	22,494.2	21

Source: Central Bank of Kenya: Economic and Financial Review.

TABLE 9

Trends in NBFIs Agricultural Lending (K sh million at end of quarter)

Year	Lending to agriculture	Net deposit liabilities	Percentage ratio
1981 June	429.6	3,884.1	11
Sept	519.4	4,433.0	12
Dec	532.4	4,576.0	12
1982 March	563.8	4,643.0	12
June	729.9	4,905.6	15
Sept	659.1	5,348.8	12
Dec	769.2	6,157.4	12
1983 March	787.5	5,919.0	13

Source: Central Bank of Kenya

It is not clear whether the introduction of agricultural lending quotas has induced a greater involvement of these institutions in agriculture than might have occurred otherwise. Although periodic Central Bank circulars and other Government policy statements have sought compliance with these quotas, many of the financial institutions are in fact not meeting the quota requirement. While aggregate agricultural lending has indeed increased, the pressure to do so may have in financial institutions resulted in classifying new loans or reclassifying existing loans as agricultural which, only marginally, conform to the Central Bank definitions. Since most of the commercial financial institutions do not inspect loan usage and admit to a high incidence of loan diversion, the amount of credit reportedly going into the agricultural sector is probably overstated in the Central Bank statistics. Furthermore, many of the financial institutions are not willing to lend directly to farm enterprises because they do not have the branch network to service rural loans, lack the expertise and do not like to incur individuals. In the last several years, an increasing portion of new agricultural lending by these institutions has been in the form of loans to agricultural parastatals. Commercial bank credit to other approved intermediaries has risen steadily over the last six years from 9% of total agricultural

sector credit in 1979 to 28% at the end of 1984.

The Central Bank has considered several proposals to reformulate the agricultural lending requirements, including: (a) upgrading the status of the agricultural lending quota from a guideline to a directive in order to increase the Central Bank's leverage to enforce compliance; (b) increasing the level of quota; (c) requiring that a certain percentage of the agricultural credit be lent to small farmers; (d) to require that financial institutions not meeting the targets lend to agricultural intermediaries, such as AFC, which would onlend funds in the agricultural sector.

3.6 CENTRAL BANK MONITORING CAPACITY

In addition to the issues raised by the types and level of the regulations used in the financial sector, there is the problem of insufficient monitoring and inspection capacity in the Central Bank. Bank inspections have been rare; many banks have not been inspected for years. Of more concern perhaps is the largely unregulated growth of NBFI. While an effort was made to inspect the new NBFI in 1982, an adequate inspection and monitoring system has not been established yet.

3.7 INTERACTION OF MARKET STRUCTURE AND REGULATIONS

The evolving market structure of the financial sector and the policies and practices of banks and NBFI, together with the financial sector regulations reviewed above and their influence on these, will have an important impact on the extent to which the financial institutions can and are willing to expand lending to the agricultural sector. The present financial market structure is not particularly conducive to increasing the direct involvement of commercial banks and NBFI in agricultural sector lending, because of the growing importance of small, specialized banks and NBFI. The three

largest banks at present run all but three of the 67 rural branches outside the major banking centres (i.e. Nairobi, Mombasa, Kisumu, Nakuru and Eldoret). Most of the new, smaller banks do not plan to open rural branches despite the Central Bank's policy objective that commercial banks open one rural branch for every two branches in urban areas and the fact that Government charges lower annual taxes for rural branches. Currently, liquidity problems, coupled with declining interest margins and high costs in agricultural lending, have intensified competition for deposits but tended to reinforce conservative banking practices, particularly in rural areas and for new clients.

3.7.1 *Commercial banking sector*

There are several salient trends within the commercial bank sub-sector. One is that the concentration in the banking sector, while still significant, is declining. In 1976, the four largest banks (KCB, Standards, Barclays and the National Bank of Kenya) controlled about 80% of both total deposits and total loans. While a decline in concentration will be beneficial if it leads to greater competition among and greater access for more borrowers, the fact that institutions located primarily in Nairobi and one or two of the secondary cities (i.e. Mombasa, Kisumu, Eldoret and Nakuru) are gaining an increasing share of total resources (deposits) suggests that potential benefits from competition are not likely to be realized by rural borrowers.

Most banks are not anxious to expand services in rural areas, since the cost to benefit ratio of increasing branch banking in rural areas is perceived to be higher than for new branches in urban areas. The larger commercial banks in Kenya have been represented in the major agricultural areas for many years and have the established institutional capacity to serve many rural areas with the existing branch network. These banks have experience in dealing with agriculture and serve some segments of the agricultural sector fairly efficiently. The larger banks have experimented with both

sub-branches and mobile units. There are about 50 sub-branch units currently operating in the rural areas. These commercial banks claim that they have had poor results with mobile banks (rural savers do not like to see their money disappearing down the road in a van; also the security and operating costs of such a mobile unit have been very high). While the more permanent sub-branches are seen to have the greatest potential to generate new business and increase the access of rural people to banking services, these small rural branches are perceived as being only marginally profitable. However, since many banks do not have a fully decentralized cost accounting system and are not measuring the full benefits derived from the new flow of funds from the rural areas (where small, non-interest bearing deposits are generated) to the urban areas, it is possible that the profitability of rural branches has been underestimated. In addition, banks have not been particularly aggressive in recruiting rural deposits, reflecting perhaps the lack of competition among financial institutions in the rural areas. Thus, a more systematic testing of the economics of rural branches could be considered to determine the full costs and benefits to banks of such services and to identify measures which might improve the profitability of rural banking services.

The ability of the commercial financial institutions and particularly banks to do term lending has been constrained by the wide swings in the liquidity position which mirrors general macroeconomic conditions in the economy. During most of 1983 and early 1984, there was very little excess liquidity in the financial system because of the higher reserve requirements imposed in early 1983 and the loss of foreign exchange reserves because of the trade deficit. The liquidity situation has improved recently because of an increase in the foreign assets, partially as a result of the IMF loan and partially because of the ability of the Central Bank to restrict consumer good imports. This improvement in the liquidity position of the financial system, however, does not change some underlying forces that will continue to constrain term lending by the commercial banks such as: (a) a gradual shift in the share of

total resources toward NBFI, which benefit from higher deposit and lending rates; and (b) a decline in the average maturity of commercial bank deposits.

The data in Table 10 compare the growth in deposits of commercial banks and NBFI. These data show that liabilities of the commercial banks in real terms were about the same in 1981 as in 1977, but decreased in 1982 and again in 1983. Conversely, the liabilities of NBFI have substantially increased.

TABLE 10

*Trends in the Real Value of Bank and Non-Bank Liabilities*¹⁾ (K £ million in constant 1977 prices)

	1977	1978	1979	1980	1981	1982	1983 ²⁾
Total liabilities of banking system	635.2	641.1	715.9	650.5	636.4	607.3	571.6
Total liabilities of non-bank financial institutions	138.8	168.1	202.8	232.7	251.7	270.5	288.5
Line 2 as percent of line 1	21.8	26.2	28.3	35.8	39.6	44.5	50.5

1) Deflated by average price increases in Nairobi.

2) Provisional

Source: Economic Survey, 1984, Ministry of Finance.

The ability of the commercial banks to generate a larger deposit base will depend on the general economic environment, but it can be argued that the savings base will probably not grow substantially unless the interest rate structure is adjusted to allow banks to offer greater incentives to savers and to cover the costs of new services to attract deposits.

3.7.2 *Non-bank financial institutions*

The recent growth of the non-bank financial institutions has had both positive and negative effects on the financial system; the implication of those effects on future agricultural lending by the financial sector is difficult to assess. NBFI have, in general, been subject to a lesser degree of regulation and monitoring by the Cen-

tral Bank to date; and the rapid and relatively unregulated growth of NBFI has been the cause of increasing concern about the financial stability of some of the new and smaller NBFI. One NBFI was placed under official receivership in late 1984 by the High Court of Kenya and there may be panicky withdrawals from other NBFI. Lending by non-bank financial institutions has more than trebled over the last four years. With the February 1983 Government increases in the minimum reserve level and the requirement that NBFI hold 50% of the required liquid reserves in Treasury bills, the risky financial practices of some of these institutions have become more apparent. The aggregate statistics for NBFI, as monitored by the Central Bank, show an advance to deposit ratio of about 85% in December 1982 and March 1983. Only a small part of the total liabilities of NBFI is in capital and reserves. Since there is not yet deposit insurance in Kenya, lack of effective enforcement of prudent banking requirements raises instability and the risk of loss to depositors. On the positive side, NBFI have introduced more competition in Kenya's financial system. By virtue of their higher interest rate structure, NBFI have been able to successfully mobilize funds and have been willing to lend to enterprises not normally funded by commercial banks, i.e. riskier projects and term lending. The smaller NBFI are able to offer more personalized services than larger banks, partly again as a result of their more lenient cost structure and specialized nature.

TABLE II

Commercial Bank Agricultural Credit Outstanding (1974-1984)

A) Distribution by Loan Maturity

		Short 0 to 2 years (% t)	Medium 2 to 5 years (% t)	Long 5 years (% t)	Total %	Total (K SH (Mill.))	Annual % Growth	Inflation rate %
As at end of Dec	1974	65	33	2	100	456.6	—	
	1975	72	25	3	100	749.1	56.0	
	1976	75	22	3	100	913.0	28.0	9.9
	1977	73	23	4	100	1,352.0	48.0	12.7
	1978	71	24	5	100	1,563.1	15.5	12.6
	1979	67	29	4	100	1,774.5	13.5	8.4
	1980	68	29	3	100	2,078.2	17.0	12.8
	1981	70	21	9	100	2,306.4	11.0	12.6
	1982	68	21	11	100	2,821.3	18.3	22.3
	1983	81	14	5	100	3,811.9	26.0	14.5
	1984	74	15	11	100	3,636.4	(4.6)	9.1

B) Distribution by Type of Enterprise

		1) Small scale (% t)	2) Large scale (% t)	Coop Societies (% t)	Agri- cultural boards (% t)	Total %	Total (K SH Million)
As at end of Dec	1974	23	52	14	12	100	456.6
	1975	23	51	13	13	100	749.1
	1976	27	47	9	17	100	913.0
	1977	23	38	15	24	100	1,352.9
	1978	19	47	23	11	100	1,563.1
	1979	17	53	21	9	100	1,774.5
	1980	18	51	21	10	100	2,078.2
	1981	22	44	20	14	100	2,306.4
	1982	20	41	15	24	100	2,821.2
	1983	16	32	16	36	100	3,811.9
	1984	19	35	18	28	100	3,636.4

1) Includes farms with 50 ha or less

2) Farms with over 50 ha.

Source: Central Bank, Economic & Finance Review

TABLE 12

Non-Bank Financial Institutions NBFI

Credit Allocation to Private Sector (December 1978 to 1984) (K SH million)

Distribution of credit Outstanding (%)	1978	1979	1980	1981	1982	1983	1984
Agriculture	5.0	5.0	4.0	6.0	11.6	12.7	11.4
Manufacturing	13.0	12.0	13.0	12.0	12.3	12.6	12.9
Building and construction	6.0	11.0	10.0	13.0	10.8	8.7	9.0
Housing	30.0	28.0	34.0	33.0	30.8	29.2	25.3
Export	.5	1.0	1.0	1.0	.7	1.2	1.5
Import	4.0	3.0	3.0	2.0	2.6	1.4	1.4
Domestic trade	15.5	9.0	12.0	12.5	13.3	13.1	14.1
Others 1)	26.0	31.0	23.0	20.0	18.0	21.1	25.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
K Sh million	2,406.0	2,936.0	4,136.0	5,210.0	6,710.2	7,978.4	10,323.7
Growth %		22.0	40.9	26.0	28.8	18.9	29.4
Inflation %		8.4	12.8	12.6	22.3	14.5	9.1

1) Other business and personal including hire purchase.

Source: Economic and Financial Review, Central Bank of Kenya.
(Calculations by the author).

TABLE 13

Non-Financial Institutions: Selected Assets (1975-1984) (K SH million)

Year (December)	Investments		Loans, Advances and Bills		Total assets
	Public sector	Private sector	Public sector	Private sector	
1975	17.35	57.64	15.52	1,002.10	1,643.14
1976	17.86	53.45	1.25	1,355.95	1,943.46
1977	5.74	56.16	12.70	1,715.59	2,776.41
1978	41.07	183.93	12.81	2,221.70	3,774.79
1979	33.56	164.05	38.51	2,770.86	4,934.78
1980	231.79	146.16	33.95	3,989.90	6,388.86
1981	423.35	121.07	35.43	5,087.74	7,801.09
1982	580.76	131.25	117.83	6,578.96	10,256.07
1983	1,788.67	159.10	78.73	7,819.30	12,536.26
1984	1,881.76	232.65	70.83	10,091.07	17,326.77

Source: Central Bank of Kenya, Economic and Financial Review.

3.8 CONCLUSIONS

Factors in both the evolving market structure and present regulatory framework are likely to constrain the growth of commercial agricultural lending in the medium term future. The first one is the general liquidity squeeze resulting from recent balance of payments problems. The combination of public sector/parastatal credit demands and the required purchase of Treasury Bills and rather high reserve requirements continue to place a significant burden on the financial system. This situation may, however, change in case the expected coffee boom materializes. Coffee prices are in an upward trend after frost in Brazil and Kenya has got substantial stocks of coffee, appr. 90,000 tons, which she hopes to be able to sell on lifting of the coffee quota system. Second is the progressive squeezing of the interest rate margin which makes banks increasingly reluctant to undertake high cost and highrisk lending like agricultural lending in general. Many NBFIs do not have an active or permanent presence in rural areas and lack expertise for agricultural loan evaluation.

Agricultural credit management and financial sector regulations are stated to be areas of priority policy attention for Government in the Fifth Development Plan (1984-1988). The diagnosis of the overall problems of financial regulations is clear and widely accepted. The plan points to: (a) the increasing liquidity problems of the financial sector, (b) recognized low to negative real rates of interest, which have had an adverse effect on domestic savings mobilization as well as encouraged an inefficient allocation of resources among sectors. As such, the plan states that Government anticipates lower requirements for Government borrowing from the banking system over the plan period and that it intends to pursue a more flexible interest rate policy with the objective of maintaining positive real interest rates. The Government has made significant progress toward meeting these objectives. In particular, the Government borrowings have been gradually reduced in 1984 and 1985, and real interest rates have been positive for savers and

borrowers since early 1984.

Judging from both the monitoring efforts of the Central Bank and from the evidence of actual lending practices of the commercial financial institutions, the combination of financial regulations to date have had a limited impact on stimulating new, effective agricultural lending. It seems that the most important force driving credit allocation in recent years has been the differential interest rate structure for commercial banks and NBFIs which resulted in NBFIs attracting a significant share of new deposits. NBFIs have traditionally specialized in lending for hirepurchase or construction and have now moved into some manufacturing ventures. With the exception of a few NBFIs that have always specialized in agriculture, most NBFIs have little interest or institutional expertise in agricultural lending and do not operate rural branches.

4.

RURAL CREDIT OUTSIDE FINANCIAL INSTITUTIONS

Agricultural credit in Kenya is available through a number of institutions in the organized credit market and individuals operating in an informal market. While the commercial banks and NBFIs were dealt with in chapter 3 and the main agricultural credit institutions will be covered under chapter 6, this chapter will highlight some agricultural credit channels in addition to those. Cooperatives and marketing boards are covered.

COOPERATIVES

The agricultural Cooperatives had a turnover in 1984 amounted to 2,926 million shs. The number of societies was 1,515 and the number of secondary societies or unions was 57. The membership of the agricultural cooperative societies amounted to 1,182,030 in 1984.

The agricultural cooperatives administer a number of credit schemes for the benefit of their members. To the extent these credit schemes contain loans to members and savings they will be dealt with in chapter 6 together with the Cooperative Bank of Kenya. Supply of farm inputs on credit is commented upon under this chapter.

For the purpose of the report two on the spot case studies were carried out. The Kenya Grain Growers Cooperative Union (KGGCU) in Nakuru was visited and also the Muranga Farmers District Cooperative Union (MFDCU).

KGGU was established in December, 1984 through a merger of Kenya Grain Growers Cooperative Society and Kenya Farmers

Association (KFA). The KGGCU, being recently set up, it is still in the process of organizing itself and its operations.

According to information received during the visit KGGCU has been appointed sole agent by National Cereals and Produce Board (NCPB) to handle wheat throughout Kenya. KGGCU has got 44 selling stores and 2 storage warehouses. It also supplies farm inputs for grain growers.

While KFA had only 10,000 members the KGGCU will have a much larger membership.

KGGCU provides credit in kind under three schemes, namely:

- 1) Monthly credit sales for farm inputs. The credit sales are to be cleared on monthly basis. However, interest will not be charged until after 60 days after the month of delivery. Security (charge over land, chattels, irrevocable orders for crops payments etc.) based on prudent judgement case by case.
- 2) Seasonal credit for farm inputs, to be recovered on delivery of produce, or normally after 6 months. Security according to need.
- 3) Credit for farm-machinery like tractors, harvesters, and implements. The farmer is supposed to make a 40% downpayment on purchase of machinery. For the rest, credit up to 2 years can be given. Security through the new machinery.

Rate of interest charged by KGGCU has up to now been bank rate of interest +2% or at the time of writing the report 16%. The rate of interest is being reconsidered and will be lowered to either bank rate or bank rate less 2% or 12-14%. How this will be possible in practice is difficult to assess. Most certainly it will increase demand for credit.

As at the end of December, 1985 Shs 342 million was outstanding as follows:

1) Monthly credit sales	307 Mill. Shs
2) Seasonal credit	25 Mill. Shs
3) Machinery	10 Mill. Shs
	<u>342</u> Mill. Shs

The arrears amounted to 265 million. Shs or 77.5%. Arrears are being recovered continuously and a provision of 53 mill. Shs was made in the balance sheet of December 1984. The revolving of funds is extremely slow. The lower rate of interest will no doubt call for more finance to the credit schemes.

Also the *local agricultural cooperative societies* supply farm inputs on credit terms to their members. Basically the credit sales are to be recovered from the subsequent payment to members. Statistics at national level are not available but to deem from the statistics collected in Muranga District (Table 14) the volume of credit sales through local agricultural cooperatives is considerable. Credit sales under the Cooperative Production Credit Scheme (CPCS) have mainly been introduced in coffee, dairy and pyrethrum societies. As long as it is a matter of supplying inputs on credit for cash crops, recoveries are rather secure as the member normally will have to deliver his crop to his cooperative society.

TABLE 14

Statistics on Credit Sales in Muranga Farmers' District Cooperative Union Ltd. (MFDCU) 1984/1985 Financial Year (K SH million)

	Amount outstanding at 1/10/1984	Credit sales during fin. year	Recoveries during fin. year	Outstanding balance at 30/9/1985
16 coffee societies/ 81,000 active members/ payment to members 1983/1984 coffee crop 615.6 K Shs mill.	8.7	91.1	81.9	17.9
Current debts				12.9 (72%)
Overdue debts (= debts which have not been recovered from the subsequent payment to members)				5.0 (28%)

Source: MFDCU/Banking Section.

To secure adequate farm input supply to members the Ministry of Cooperative Development is supporting development

of the cooperative stores activity through various donor sponsored programmes. At the time of writing this report the DANIDA sponsored Farm Input Supply Scheme was in operation. It covered 36 cooperative societies and 23 unions. The scheme provided grants for construction of stores and a revolving fund for financing the stores operations.

MARKETING BOARDS

Farmers growing tea, pyrethrum, coffee and cotton often obtain seasonal or medium term credit from the respective monopoly marketing organizations. Cash crop loans take up most of the funds, and farmers growing food crops have little access to credit.

INFORMAL MARKET

Not much is known about the informal market, but significant amounts of money seem to change hands, especially within the extended family system. Many of these family members earn a living elsewhere in urban areas and remit regular sums to help maintain their holdings.

5.

**INFRASTRUCTURE FOR RURAL DEVELOPMENT
AND PRICING POLICIES**

The record of Kenya's agricultural development over the last twenty years, despite its unevenness, is remarkable. A fairly well developed system for farm input supply, extension advice and commodity marketing has made an invaluable contribution to this growth.

In this report some main aspects of farm input supply and commodity marketing will be highlighted.

5.1 ROAD NETWORK

An adequate road network is of critical importance to agricultural development. In Kenya the government has improved highway facilities extensively. Trunk and primary roads have received priority. But also special purpose roads e.g. settlement, sugar, tea and rice roads have been constructed. The 54,000 Km highway network comprises some 25,000 Km of trunk, primary and secondary roads, 26,000 Km of minor roads and 3,000 Km of special purpose roads. The length of paved roads has increased from a little over 1,000 Km in 1960 to 6,700 Km in 1983.

Some 85% of the classified road network consists of gravel or earth roads. In addition there are between 85,000 and 100,000 Km of unclassified rural tracks.

5.2 FARM INPUT SUPPLY AND PRICING

Use of improved inputs is wide-spread in Kenya. Compared to many other countries, Kenya's input delivery systems function well in most areas for most inputs. The structure of input marketing is marked by the participation of a range of large and small parastatals, cooperatives, private companies and small scale traders. The main problems in input supply are i.a.: disruptions in national supplies of fertilizer, localized shortages, slow development of infrastructure to serve smallholders and late arrivals of fertilizers. The Government has taken an active role in promoting input use and regulating input delivery through pricing and import control policies, encouragement of cooperatives, support for research and extension and direct provision of some inputs.

Kenya uses between 160,000 and 200,000 tons of *fertilizer* per year. Technical knowledge of fertilizer use is still limited in many areas. Promotion remains weak both through the extension service and through sales outlet. Kenya's fertilizer market is characterized by a diversity of supply channels and strong involvement of commercial distributors and importers. At present Kenya Grain Growers Cooperative Union (KGGCU) handles about half the fertilizer imported to Kenya. Other major suppliers are MEA, cooperatives and Kenya Tea Development Authority (KTDA). All fertilizer is currently imported, usually in bags. To assist the Government in a period of foreign exchange shortage, substantial quantities of fertilizer have been provided under bilateral programmes.

In fertilizer pricing the key issue is the extent and form of price controls. The Government is concerned with keeping prices to producers as low as possible. Anomalies in the pricing system, and particularly inadequate margins, have at times had the additional undesired effect of decreasing supplies in the rural areas. This counteracts the benefits of low prices.

Kenya has a solid experience also in the production and distribution of improved *seeds*, and for key crops (maize and wheat) use of improved seeds is high. The introduction of hybrid maize

seed throughout the country and its rapid uptake has been a dramatic experience. Significant credit is due to the Kenya Seed Company (KSC), which mounted an aggressive campaign to interest smallholder farmers, working through the extension service and through a network of small shopkeepers. Today, KSC estimates that about half of Kenya's 1.2 million ha in maize is covered by hybrid or improved seed. Statistics on use of improved seed for other crops are, however, not as good. It is estimated 50% of wheat producers use improved seeds, while improved bean, potato and vegetable seeds are available but cover only a small proportion of cropped area. Pricing is the principal issue in seed supply, particularly for maize. Retail stockists margins have deteriorated in recent years, from 9.4% in 1975 to 7.2% in 1985, threatening the viability of the seed distribution system.

Kenyan farmers spend nearly as much on *agricultural chemicals* as on fertilizers, over K£ 12 million in 1983. Chemicals are especially critical for coffee and cotton production. 65% of agrochemicals go to coffee alone. Free from import and price controls, chemicals are widely available, usually in ample supply. The marketing system is based on private wholesalers, KGGCU, cooperatives and smallscale stockists. Promotion in the press and at retail sales point is keen.

Livestock production makes a substantial contribution to GDP. Much of Kenya's livestock is currently grass-fed, even in the high potential areas, but as population growth exerts more pressure on limited land supplies farmers are increasingly turning to zero-grazing, production of *fodder crops and feeds*. Livestock *health services* are currently provided mainly by the Government e.g. dipping against tickborne disease, vaccinations, veterinary services, artificial insemination and sale of drugs and medicines. Both the costs and the quality of these services are emerging as major issues. Subsidies for livestock services totalled some K£ 14.5 million last year, a substantial burden in this time of scarce public funds. Government funding problems and problems in management of livestock services have led to unreliable delivery, shortfall in medi-

cines, understrenght dips etc.

5.3 AGRICULTURAL COMMODITY MARKETING AND PRICING

The Government effects decision making in the agricultural sector through its pricing and marketing policies. The level of Government intervention in pricing and marketing is comparatively high. Many pricing and marketing controls stem from the colonial period. After independence, these controls were largely retained, and the scope of the marketing boards enlarged to include smallholder producers as well. Thus, the pricing and marketing system has developed, to a great extent in response to the needs of large-scale farmers, rather than smallholder producers. Smallholder producers sales to marketing boards have increased since independence and amount to about 55% of total sales to marketing boards.

Market controls have particular importance for key domestic foodcrops as maize, wheat, and rice. The controls are clearly established by law, and the Government has wide authority in this area. Maize is marketed through both an official and a parallel marketing system. The official system, which handles about 50% of marketed maize, is controlled by the National Cereals and Produce Board (NCPB), a Government Parastatal. NCPB has a legal monopoly on the purchase, distribution and import of maize. NCPB's operations are substantial, with 41 depots and some 400 buying centres. NCPB also works through cooperatives and, to a limited extent, licenced private traders as purchasing agents. The margins, purchases and sales prices of NCPB are set by the Government. In addition there is a flourishing parallel market made up of thousands of small traders in small amounts of maize in local markets. This trade is regulated on a local basis by the administration. It is especially important for smallholders, and it handles about 70% of maize smallholder production.

NCPB is also responsible for regulating *wheat* marketing.

Because wheat is grown primarily by large and medium scale farmers, there is no parallel market in wheat. NCPB uses local branches of KGGCU as agents. *Rice* is the third most important cereal crop. It is almost exclusively grown on irrigated fields under the direction of the National Irrigation Board (NIB). NIB acts as NCPB's agents, collecting rice, processing it and passing it on to wholesalers on behalf of NCPB.

Coffe and Tea, the major export crops, are also handled through marketing boards. Coffee is marketed through the cooperatives (smallholders) and the Kenya Planters Cooperative Union (KPCU). KPCU processes, stores, grades and markets coffee on behalf of both the cooperatives and the estates, under authority granted by the Coffee Board of Kenya. Performance of coffee cooperatives is on average good.

Smallholder tea production, accounting for 60% of total tea production, is handled by the Kenya Tea Development Authority (KTDA), which collects, processes and markets tea at auctions. KTDA performance in marketing has been good. Estates are responsible for marketing their own tea production.

Government price controls have had the greatest impact on foodstuffs. Major problems have been low official prices, inadequate producer incentives and parastatal losses. Official prices are set for a range of domestically consumed agricultural commodities e.g. maize, wheat, sugar, beef, milk and cotton. For export crops producers receive world market prices adjusted for quality of deliveries less marketing costs, and in some cases taxes.

Kenya's performance in maintaining an adequate exchange rate has been mixed, although on the whole favourable. Recent exchange rate adjustments have been beneficial for the agricultural sector and also as import and export parity prices are used as a basis for setting prices in the Annual Price Review.

With a few exceptions, most agricultural crops are not heavily taxed in Kenya, except for local county council taxes levied in the course of marketing. Coffee and sugar are the major exceptions to low taxes on agricultural products. In the 1981/1982 coffee crop,

taxes, levies and cesses totalled approximately 9.3% of the value of the crop.

TABLE 15

Summary of Pricing and Marketing Arrangements

Commodity	Pricing System	Marketing System	Major Problems
<i>FOODCROPS</i>			
<i>Maize</i>	<p>Producer price, distribution and milling margins, and retail price for maize meal set by Government.</p> <p>Enforcement good in commercial market channels, sporadic in rural markets (except for 1980/1981 shortage periods).</p>	<p>Government monopoly established by law and held by NCPB, except for legal intra-district trade on a limited basis (less than 10 bags)</p> <p>NCPB handles up to 30% of marketed production. Parallel market operates extensively in rural areas.</p>	<p>Low official price levels in some years and erratic price adjustments. Panterritorial pricing decreases incentives. Price controls benefit mainly urban dwellers at expense of rural. Insufficient price margins for NCPB. Market controls introduce distortions and costs, and adversely affect smallholders.</p>
<i>Wheat</i>	<p>Producer prices, margins, and retail price for flour set by Government. Enforcement is good, as wheat grown mainly by large and medium scale farmers on commercial basis.</p>	<p>Government monopoly established by law and held by NCPB, who controls entire Market. KFA^{*)} acts as NCPB agent.</p>	<p>Inefficiencies in NCPB and possibly KFA. Actual KFA costs not known.</p>
<i>Beans</i>	<p>Incentive price set by NCPB, but prices otherwise not controlled.</p>	<p>NCPB handles small amounts, except for 1982, when high incentive price resulted in large purchases.</p>	<p>High prices led to large NCPB purchases with result of storage problems. Significant exports, in 1983, some at a loss.</p>
<i>Rice</i>	<p>Producer prices margins, and retail prices set by Government. Enforcement is good, although there is a parallel market in rice in urban areas.</p>	<p>Government monopoly established by law and held by NCPB.</p>	<p>Low producer prices in some years required subsidies to producers on irrigated schemes. Demand greater than supply, but partially met through food donations. Inefficiency of NCPB.</p>
<i>Other Foodcrops</i> (Millet sorghum, vegetables etc.)	<p>Prices market determined.</p>	<p>Largely sold on local markets. NCPB handles small amounts of some crops.</p>	<p>Marketing services need improvement, some problems in supply and quality, especially for fruits and vegetables.</p>

^{*)} Taken over by KGGCU.

TABLE 15 (continued)

Commodity	Pricing System	Marketing System	Major Problems
<i>Industrial</i>			
<i>Crops</i>			
<i>Sugarcane</i>	Producer prices, factory and distribution margins, and retail prices set by Government. Enforcement is good.	Cane marketed through cooperatives or directly to factories. Government has wholesale sugar monopoly, operated through KNTC. Many private retail distributors.	Policy of low consumer prices resulted in insufficient producer prices and factory margins, and subsidization of producers. High rates of taxation. Industry in financial crisis due to prices and resultant supply problems. Improvements in cane marketing needed.
<i>Cotton</i>	Producer prices & ginning margins set by Government. Enforcement is good.	Government has monopoly through Cotton Board. All cotton handled by cooperatives.	Weak cooperatives and financial Management of Cotton Board. Late producer payments, high deductions.
<i>Oilseeds</i>	Prices market determined. NCPB sets incentive prices for own purchase.	Free market, NCPB and cooperatives handle oilseeds as well.	Improved market. Information and market channels needed.
<i>EXPORT CROPS</i>			
<i>Coffee</i>	Prices determined in reference to world price, less marketing board and cooperative charges. Producer price about 70% of world price.	Producers market through cooperative KPCU handles all cooperative and estate coffee on behalf of the Coffee Marketing Board. Auctions are held in Nairobi.	Marketing system fairly efficient. Need to improve quality of smallholder coffee processing to raise returns. High and variable cooperative levels reflect variable efficiency.
<i>Tea</i>	Prices determined in reference to world price, less processing and marketing costs. Final producer price linked to quality.	KTDA collects, processes, and markets all small-holder tea; estates have own factories. Tea Board holds auctions in Mombasa.	System is efficient. KTDA prices linked to quality.
<i>Pyrethrum</i>	Prices set by Government and related to pyrethrum content. Prices have been as low as 25% of world price.	Pyrethrum Board has monopoly in marketing and exports. Cooperatives handle marketing to Board.	Low producer prices leading to declines in production. Pyrethrum Board inefficient. Late payments to farmers.

TABLE 15 (continued)

Commodity	Pricing System	Marketing System	Major Problems
<i>Livestock and Dairy</i>			
<i>Livestock and Beef</i>	Retail beef prices set, but only enforced for lowest grades.	Market competition, KMC has monopoly on exports. Livestock Marketing Branch (LBM) of MOALD buys livestock in distress sales.	Low retail beef prices have encouraged demand, let to drop in carcass weighs. KMC in financial difficulties as it cannot compete. High costs of LMB operations.
<i>Milk</i>	Producer prices set by Government with dry season price differential. Enforcement only in commercial channels. Prices in rural markets seasonally determined.	KCC has monopoly milk collection and processing. Seasonal rural markets.	Low and sporadically adjusted milk prices have decreased supplies. Local market prices often more attractive. Improved collection systems for smallholders needed. High costs of KCC.

Source: Kenya agricultural sector report 4629-KE
1984 World Bank

6.

**KEY FINANCIAL INSTITUTIONS AND AN OVERVIEW
OF RURAL FINANCE**

In this chapter the operations of the Agricultural Finance Corporation (AFC), the Co-operative Bank of Kenya (CBK) and the Co-operative Union Banking Sections (UBS) will be outlined and analysed.

6.1 BACKGROUND AND OVERVIEW

The Government has been directly involved in promoting agricultural credit through the established and continuous funding of AFC and CBK. The credit institutions were explicitly set up to cater for the financing needs of sectors of population which did not have adequate access to other sources of commercial credit and to meet the term financing needs of the agricultural and cooperative sectors which the commercial financing institutions were not able to satisfy. While CBK initially was set up to deal with cooperative societies and unions the UBS was set up to serve the individual cooperative members with loans and later savings services. The operational focus of AFC has changed since the 1960s when land purchase and large-scale development dominated lending. Since the early 70s AFC has become increasingly involved in smallholder credit schemes. CBK was established to provide full banking services for the cooperative movement. It was registered under the Cooperative Societies Act in 1965, and later in 1968, also licenced under the Banking Act. Membership includes national cooperative organizations, district cooperative unions and primary socie-

ties. CBK lending activities support a host of agricultural production, marketing and processing activities. UBS were originally set up to, on behalf of the member societies, administer the Cooperative Production Credit Scheme (CPCS) to cooperative small-scale farmers. To finance the CPCS the Cooperative Savings Scheme (CSS) was later initiated. The first UBS were set up in coffee growing cooperatives in the late 1960s.

The policies and practices of AFC, and CBK are largely influenced by Government by the fact that:

- 1) their Boards of Directors are appointed by Government (AFC) and include several representatives of key ministries.
- 2) their oversight ministries, MOALD in the case of AFC and MOCD in the case of Co-operative Bank, have played a predominant role in defining lending programs and conditions, and are to varying degrees involved in loan decisions.
- 3) Government funds are a major source of financing for these credit institutions AFC is 100% financed through aid agency funded projects and other Government budgetary support, while CBK's funds are about 30% to 40% from the Government and the rest from co-operative deposits. Government funds have been lent to AFC and CBK at subsidized rates in order to provide these institutions with margins to cover the higher costs of developmental lending. Lending rates to farmers and cooperatives have been held below commercial bank maximum rates.

The UBS were set up as sections within district Cooperative Unions. The operations are governed by the Co-operative Societies Act through MOCD. The Co-operative Production Credit Scheme is to a very high degree financed through savings mobilized under CSS. However, UBS are also administering other loan schemes to members being financed through CBK with government donor agency funds. Both CPCS and CSS are government initiated schemes.

The lending activities of these institutions have expanded rapidly over the 1970s. AFC and CBK's credit outstanding together represents close to 50% of total institutional agricultural credit out-

standing. AFC's loan portfolio, excluding separately funded Government seasonal Credit Programs, increased in nominal terms between 1974 and 1984 from K Sh 263 million to about 1,100 million. In addition, seasonal credit outstanding as of October 1984 on AFC's administered portion of NSCS was about K Sh 600 million. CBK's loans outstanding expanded from about K Sh 33 million in 1974 to K Sh 630 million in June 1983. Total for Governments total investment in the credit Programs of these two institutions, including aid agency-financed Credit Schemes, was approximately K Sh 2,000 million by mid-1983. Outstanding balance of CPCS-loans in UBS was at end of September 1984 347 million Sh and the balance of members savings at the same date amounted to K Sh 515 million.

6.2 THE AGRICULTURAL FINANCE CORPORATION (AFC)

6.2.1 *Original objectives and evolving demands*

A number of the institutional constraints under which AFC is labouring at present are due to the fact that its legal, policy and operational framework has not evolved with the growing and changing demands on the institution. Historically, AFC was conceived as a Government Statutory Board under the tutelage of the Ministry of Agriculture to assist in the implementation of agricultural development policies through the provision of credit and farm services. Under the AFC Act of 1969, its functions are defined as assisting in the development of agriculture and agricultural industries by making loans to farmers, co-operative Societies, incorporated group representatives, private companies, public bodies, local authorities and other persons engaged in agriculture or agricultural industries. It has been the primary source of terms credit for agricultural investment. AFC has been called upon by the Government to focus its lending activities increasingly on the small and medium-scale farmers. AFC's activities are limited to

lending and advisory services related to lending. It does not handle deposits or perform any related banking functions.

6.2.2 *Management structure*

The AFC Act provided for a dominant role of the Ministry of Agriculture in appointing the management of the corporation and determining its lending priorities and policies. The Board consists of six to eight members, four to six of whom are nominally appointed by the Ministry of Agriculture and Lands Development (MOALD), plus the Permanent Secretary of MOALD and the Permanent Secretary of the Ministry of Planning and Finance. Of those appointed by the Ministry of Agriculture, two are appointed by virtue of their experience in banking and financial matters. The corporation was explicitly exempted under its Act from the provisions of the Banking Act and the Companies Act, and the Board of Directors was given supreme policy-making authority in addition to extensive latitude to exercise influence in the day-to-day operations of the corporations. The General Manager is appointed by the Board, but with overriding approval authority of the Ministers of Agriculture, Planning and Finance and the Office of the President. The powers and responsibilities of the General Manager, according to the Act, are those specifically delegated by the Board. Historically, the Board has retained important prerogatives in the area of senior staff appointment, approval of large-scale loans (over K Shs 100,000) and review and approval of loan foreclosures. Regular involvement of the Board in day-to-day operational management decisions was criticized in the report and recommendations of the Presidential Commission for Review of Statutory Boards (known as the Ndwegwa Report), which recommended in 1979 that parastatal boards remove themselves from involvement in line operations and focus more on providing leadership in policy matters. To date, the AFC Board has interpreted its broad policy mandate fairly conservatively. The total number of staff in AFC is 1,016 of which 196 are loan officers and 74 accountants. The

organizational structure is outlined in chart 1. The finance department and the two regional offices are headed by assistant general managers.

6.2.3 *Lending and financial policies*

The total assets of AFC represent some 5% of the total assets held by the commercial banks. Over the past decade AFC has administered a number of specialized lending schemes many of which required tailored credit assistance, special lending terms and conditions, and separate accounting and reporting requirements. The generally weak performance of these schemes, both in terms of AFC's management and borrowers' performance, are most certainly due to a combination of factors e.g. inadequate assessment of farmer financing needs and financial viability of proposed loan types, non-adherence to lending objectives as specified, and lack of proper loan follow-up and enforcement of collection procedures. At this stage of development it would be important to further clarify AFC's lending objectives and restructure loan policies in support of development of operations and achievement of financial objectives.

According to the general provisions of the AFC Act, the corporation was expected to eventually become self-sustaining. However, what was meant to be a self-sustaining level of operations and how this level was to be reached were not defined, either in terms of total capital, levels of lending or income objectives. The Act inferred that this level would be considered attained once AFC's reserve fund exceeded 10% of the amount of funds invested by the Government in AFC, after which time, the Board was to direct the net income toward redemption of Government loans to AFC. The corporation was specifically exempted from the Banking Act and the Companies Act, and AFC's Board was therefore vested with full authority to establish AFC's financial objectives and to achieve these objectives.

The financial tools available to the Board in this regard were

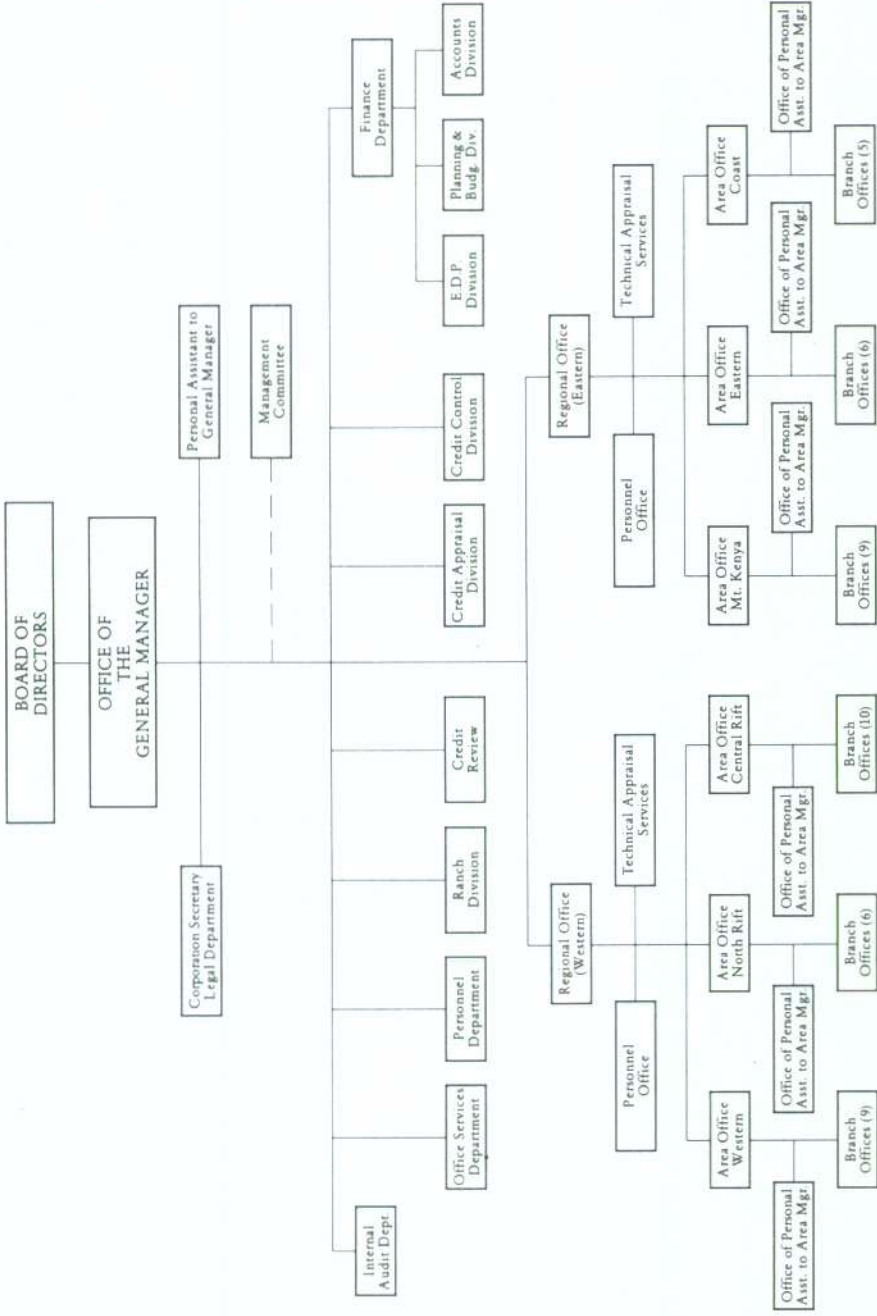
not only the determination of lending policies, as discussed above, but also the authority (with the approval of the Minister of Planning and Finance and in consultation with the Minister of Agriculture—both represented on the Board) to set: (a) the onlending rates from Government to AFC (on Government and aid agency provided funds), (b) the level of AFC interest rate to farmers, (c) levels of additional charges which AFC could levy on its borrowers in respect of loan applications, security evaluations, etc.

Up to the present, AFC's interest rates have been maintained below the prevailing banking sector rates with the view to stimulating agriculture investment and directing subsidies to special target groups, such as the small farm sector. As of December 31, 1984, AFC was charging 12% on long-term (10 to 20 years) land purchase loans, 13% on medium-term agricultural/livestock development and equipment loans, and 14% short-term (one year) seasonal crop credit loans under the Government's NSCS. Commercial bank maximum lending rates at that time were 14% and NFBI were charging 19% (hire-purchase companies and merchant banks) and 16% (building societies). Because AFC loans are both cheaper and for much longer terms than commercial loans, AFC interest rate subsidy has resulted in intense competition for AFC funds. This competition has been felt by AFC in terms of pressures to lend to influential elements of the society, thus crowding out smaller borrowers without other access to commercial loans.

6.2.4 *Loan appraisal and administration*

AFC has well established loan appraisal, processing and collection procedures. These are carefully spelled out in credit manuals, and formalized in a series of operation forms and inputs to ease loan administration. However, the quality of actual loan appraisals is rather weak, loan administration appears to be rather cumbersome and at times involves delays, and follow-up and collection procedures are unevenly enforced.

AGRICULTURAL FINANCE CORPORATION
STRUCTURAL CHART (JANUARY 1986)



AFC has evolved with a high degree of centralization of loan decision-making and administration. The loan approval authority is at present:

- | | | |
|------------------------------|-------|-------------|
| a) Branch Manager | up to | 10,000 Shs |
| b) Assistant General Manager | up to | 50,000 Shs |
| c) General Manager | up to | 100,000 Shs |
| d) Board of Directors | over | 100,000 Shs |

Similarly, while it is the loan officers and Branch Managers responsibility to issue reminder notices to delinquent borrowers and to make recommendations for appropriate actions, decisions and legal follow-up are the responsibility of the credit Control Division, the General Manager and the Corporation Secretary. The Board is also involved in final decisions regarding foreclosure of loans, approval of the public advertisement of foreclosure properties to be auctioned and all write offs. All loan disbursements are authorised and cheques issued from Nairobi and borrower loan statements are issued from Nairobi with copies to the branches.

6.2.5 *Financial performance*

The AFC's loans program encompasses loans for:

- a) Land purchase,
- b) development,
- c) working capital,
- d) seasonal credit.

In addition a number of special projects are being administered by AFC e.g.:

- a) The new seasonal credit Scheme (NSCS)
- b) ranch loans,
- c) Group Farm Rehabilitation loans,
- d) Narok Agricultural Development Project

The NSCS is the largest Government-funded specialized credit Scheme ongoing at present. It is directed at financing commercial maize and wheat production and is one of the Government's

major programmes in support of food self-sufficiency objectives. To qualify, a farmer must have an acreage of not less than 5 acres under wheat and/or maize.

AFC's loan portfolio has expanded rapidly over the last decade. The amount of loans outstanding (including unmatured principal, accrued interest, arrears of principal and interest) increased from about K Sh 263 million at the end of AFC's FY 1974 (March 31) to K Sh 1,168 million as of March 1986 (draft accounts). AFC's audited financial statements for 1974 through 1982 are provided in Table 16 - 17. In addition, AFC has also managed on an agency basis about 95% of the Government funds for NSCS which was introduced in 1980 to replace the GMR scheme. From 1980 to October 1984, AFC has disbursed a total of about K Sh 1,100 million in seasonal loans.

The overall quality of AFC's portfolio is difficult to assess; bad debt provisions which currently represent about 8% of portfolio outstanding are substantially underestimated, and write offs have been strictly limited to cases of death or borrower disappearance. In general, field supervision of poor performing loans is not systematic, and due to staff shortages in some branches and poor organization of staff in others, some borrowers go without being visited by an AFC loan officer for years. The loan recovery rate as of April 1984 was only 50%, i.e. principal and interest collections equalled about half of amounts due. AFC is in the process of introducing a computer program to age arrears. Tentative figures suggest that over 90% of the principal arrears are over three months due (the point at which commercial banks initiate foreclosure proceedings) and that at least a third of principal arrears have been outstanding for more than one year. Total arrears on the NCSC loans as of October 1984 amounted to about K Sh 430 million.

Details of AFC's loan portfolio as of the end of 1982 are given in Table 19. The loan portfolio is broken down into a number of lending schemes according to source of finance and the size of the loan. Up until 1983, AFC classified all loans of K Sh 20,000 or less as small-scale; the small-scale loan size limit has recently been

increased to K Sh 50,000. Over the period 1979-1982, the small-scale portion of the portfolio has represented between 20% to 25% of the total. However, the loan size is not necessarily related to farm size or income and thus it is difficult to determine the distribution of loans by these characteristics. AFC is currently in the process of recoding loan files to allow for such analysis by farm size and type of enterprises.

TABLE 16

Agricultural Finance Corporation (AFC) Balance Sheet (year ended March 31) (%)

	1974 %	1975 %	1976 %	1977 %	1978 %	1979 %	1980 %	1981 %	1982 %
<i>Assets</i>									
Loans for farmers	89.5	94.3	96.9	90.6	93.3	92.4	94.0	82.4	90.0
Provision for doubtful debts	5.7	6.2	6.2	6.0	6.0	6.1	6.1	5.3	7.0
Sub-total	83.8	88.1	90.7	84.6	87.3	86.3	87.9	77.1	83.0
Other loans and deposits	7.1	6.8	4.4	7.2	8.2	8.3	7.6	15.1	8.2
Fixed assets	1.9	1.8	1.5	1.4	1.4	1.4	1.1	1.1	1.1
Development house Phase II	—	—	—	—	0.1	0.7	1.3	2.2	2.5
Farm properties in possession	0.1	0.1	0.0	0.1	0.0	0.1	0.1	0.1	0.1
Current assets:									
Deferred expenditure	—	—	—	—	—	—	0.1	0.0	0.1
Debtors	3.3	1.1	1.6	1.6	1.0	0.9	1.5	4.1	3.2
Bank and cash balances	3.7	2.1	1.8	5.1	2.0	2.3	0.1	0.3	1.8
Livestock at cost	0.1	—	—	—	—	—	—	—	—
Sub-total	7.1	3.2	3.4	6.7	3.0	3.2	1.7	4.4	5.1
Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Current liabilities									
<i>Liabilities</i>									
Deposits at call	0.7	0.1	0.0	0.0	0.0	—	—	—	—
Land and tractor private deposits	0.9	1.6	1.1	1.0	0.5	0.3	0.3	0.2	0.2
Creditors and accrued charges	1.9	1.8	1.7	1.6	1.9	2.4	6.6	16.1	14.0
Bank overdraft	—	—	—	—	—	—	0.9	2.6	1.6
Taxation	—	—	—	—	—	—	—	1.2	3.3
Sub-total	3.5	3.5	2.8	2.6	2.4	2.7	7.8	20.1	18.5
Loans and grants:									
Irredeemable interest bearing loans	27.2	23.5	18.8	15.9	14.9	12.5	24.6	25.2	27.6
Revolving funds	—	—	—	—	—	—	0.1	0.1	0.1
Interest free grants	16.0	13.9	11.3	9.6	9.0	7.7	6.5	9.4	9.1
Redeemable loans	51.3	58.4	66.4	69.8	69.6	71.9	54.4	42.8	42.1
Sub-total	98.0	99.3	99.3	97.9	95.9	94.8	93.4	98.1	98.0
General reserve	2.0	0.7	0.7	2.1	4.1	5.2	6.6	1.9	2.0
Total liabilities	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: AFC audited financial statements.

TABLE 17

Agricultural Finance Corporation (AFC) Income Statements (year ended March 31) (%)

	1974 %	1975 %	1976 %	1977 %	1978 %	1979 %	1980 %	1981 %	1982 %
<i>Income</i>									
Interest receivable	84.8	82.0	81.0	85.1	79.2	83.0	83.3	91.0	85.0
Other income:									
Agency commission	9.5	11.5	13.3	9.5	14.3	11.2	11.2	3.7	10.5
Application and legal fees	2.1	3.1	3.3	3.3	4.0	3.4	2.2	2.7	2.0
Rent	2.7	2.2	1.6	1.5	2.0	1.8	2.0	1.9	1.8
Profit on sale of fixed assets	0.3	0.4	0.5	0.2	0.4	0.1	0.4	3.0	0.3
Miscellaneous	0.6	0.8	0.3	0.4	0.1	0.5	0.9	0.4	0.4
Sub-total	15.2	18.0	19.0	14.9	20.8	17.0	16.7	9.0	15.0
Total income	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<i>Expenditure</i>									
Interest payable:									
Irredeemable loans	19.0	15.4	12.0	9.1	8.3	6.8	8.6	9.0	6.9
Redeemable loans	26.1	25.4	24.1	23.9	23.8	21.4	17.3	16.2	13.1
Deposits	0.4	0.3	—	0.1	0.3	—	—	—	—
Sub-total	45.5	41.1	36.1	33.1	32.4	28.2	25.9	25.2	20.0
Other expenditures:									
Board members' fees and allowances	0.1	0.1	—	—	—	—	—	0.2	0.2
Staff costs	33.3	32.4	28.9	24.3	24.8	23.2	20.0	23.6	25.3
General administration	12.2	16.4	13.2	12.9	13.0	15.0	12.8	17.2	13.7
Bad and doubtful debts	0.3	17.9	17.4	8.6	4.3	10.6	13.9	4.9	15.1
Bad debts written off	—	—	—	0.7	—	0.9	0.3	—	—
Misappropriation	(0.4)	0.2	—	—	—	—	—	—	—
Depreciation	3.9	4.1	3.2	2.9	3.1	2.8	3.7	3.9	4.4
Sub-total	49.4	71.1	62.7	49.4	45.2	52.5	50.7	49.8	58.7
Total expenses	94.9	112.1	98.8	82.5	77.6	80.7	76.6	75.0	78.7
Net profit for the year	5.1	(12.1)	1.2	17.5	22.4	19.3	23.4	25.0	21.3
Taxation								15.3	19.4
Profit after taxes								9.7	1.9
Total expenditure	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: AFC audited financial statements.

TABLE 18

Agricultural Finance Corporation

New Seasonal Credit Scheme Status as of October 31, 1984 (K Sh million)

	1980	1981	1982	1983	October 30 1984
Amount disbursed	201.8	351.5	220.2	183.6	153.6
Interest accrued					12.2
Principal arrears	51.6	127.7	70.6	70.5	
Interest arrears	2.7	8.1	4.5	7.0	
Interest on arrears	21.9	41.7	16.6	83.8	
Total arrears	76.2	177.5	91.7	83.3	
% Principal arrears of amount disbursed	26	36	32	38	

Source: AFC MIS 805-0, October 31, 1984

AFC's financial statements show a marginal profitability, as measured by net income (before taxes) to total assets. However, because uncertainties about income receivable (interest income from loan and agency commission on NSCS loans) are not adequately provided for and because AFC has not written off irrecoverable loans, the marginal profitability of 2.6% reported in 1982 is questionable. All other cost trends indicate that at present levels of interest rates and high arrears, AFC is bordering on being a deficiary operation. By subsidizing AFC's borrowing rates (which have decreased from an average of about 3.7% interest expense to average loans outstanding in 1975 to 2.7% in 1982), Government has allowed AFC's net interest margin to expand from 3.8% in 1975 to about 9.0% in 1982. This cushion has been absorbed by rapidly rising staff and general administration costs which both doubled in nominal terms between 1979 and 1982. A portion of this increase went into critically needed reinforcement to branch operations. Staff and general administration costs, as a percent of average loans outstanding, were 5.4% in 1982. Total operating expenses (excluding financing costs) were equivalent to 8.1% of the average portfolio value in 1982, thus leaving a .9% difference between the net interest margin of 9.0% and the cost of total operations. AFC's

liquidity position has also deteriorated to serious levels; the ratio of current assets to liabilities has decreased from a healthy position of 2.58% in 1977 to an extremely precarious one of 0.26% in 1982. These trends have continued in 1983 and 1984 to the point that AFC's income cannot support the present level of operating expenditures.

TABLE 19

Loan Statistics as per Branch as at 31.12.1985

34 Schemes	1 Number of loans	2 Disbursed amount (Shs)	3 Unmatured principal (Shs)	4 Principal and interest arrears (% of 2)
Totals:	187,609	3,256,502,028.46	1,528,287,446.14	44.4

Source: AFC

TABLE 20

*Agricultural Finance Corporation (AFC)*Operating Ratios and Financial Performance Indicators^{a)} (all expressed as percentages)

	1975	1976	1977	1978	1979	1980	1981	1982
1. Interest receivable to average loans outstanding	7.50	7.60	8.80	8.20	9.20	9.40	9.70	11.70
2. Interest receivable to total income	82.00	81.00	85.10	79.20	83.00	83.30	91.00	85.00
3. Interest receivable to total income excluding agency fees receivable for seasonal credit ^{b)}	92.70	93.50	94.00	92.20	93.50	93.80	94.40	95.00
4. Interest expenses to average loans outstanding	3.70	3.40	3.40	3.40	3.10	2.90	2.70	2.70
5. Net interest margin	3.80	4.20	5.40	4.80	6.10	6.50	7.00	9.00
6. Staff costs and general administration to average loans outstanding	4.50	4.00	3.90	4.20	3.70	4.40	4.40	5.40
7. Increase in bad debts provision to average loans outstanding	1.60	1.60	.90	6.40	1.30	1.60	.50	2.30
8. Total expenses (excluding interest expenses) to average loans outstanding	6.50	5.90	5.20	4.70	5.80	5.70	5.30	8.10
9. Net profit (before taxes) to total assets	(1.03)	.10	1.70	2.10	2.00	2.50	2.30	2.60
10. Total assets to total debt	1.04	1.03	1.03	1.03	1.03	1.09	1.25	1.24
11. Current assets to current liabilities	.92	1.20	2.58	1.24	1.17	.20	.22	.26
12. Bad debt provision to loans outstanding	6.50	6.40	6.60	6.50	6.50	6.50	6.50	7.70
13. Principal arrears on total portfolio outstanding	9.40	10.50	13.00	11.50	11.50	14.50	10.00	11.00
14. Interest arrears on total portfolio outstanding	3.20	3.00	3.70	3.40	3.70	4.40	12.00	15.00
15. Total arrears	12.60	13.50	16.70	14.90	15.30	18.90	22.00	25.00

a) Government seasonal credit loans excluded from total loans.

b) Agency fees have not yet been received by AFC.

Source: AFC audited financial statements, 1974-1982.

6.2.6 *Conclusions*

AFC experienced rapid growth in its lending activities over the last decade, but because institutional capacity has not kept pace with increasing demands of its complex and evolving mandate, AFC today is facing problems of rising arrears, poor financial control, inadequate staffing capacity, and other organizational management problems. There is growing concern about its financial stability, and sample reviews of its loan portfolio suggest that AFC is not achieving the stated development objectives of serving the

small and medium-scale farmers and increasing access of this group of farmers to institutional credit. Rather, institutional weaknesses have resulted in misuse of loan funds and pressures on AFC to lend subsidized development resources to persons who should have the possibility to finance such investments from other sources; a large portion of these funds are not being repaid and willful defaulters are not being systematically foreclosed upon.

6.3 THE CO-OPERATIVE BANK OF KENYA (CBK)

6.3.1 *Original objectives and evolving demands*

CBK was set up in 1965 to serve as the Central Bank for the cooperative movement. It was registered under the Co-operative Societies Act in 1965, and started operating in 1968.

It was also subsequently registered under the Banking Act in 1968, and as such, is subject to the same regulations as other commercial banks.

At the time it was established, the stated objective of CBK was to mobilize funds generated by cooperatives through Co-operative Production Credit Scheme (CPCS) launched in late 1969 with funds from SIDA, DANIDA and cooperative membership shares. CPCS was designed to be largely self-financing since the credit scheme was combined with an integrated savings program. By the mid-1970s, the lending activities of CBK had increased and diversified significantly with the addition of a number of Government and donorfinanced smallholder credit schemes and through the expansion of CBK's own lending activities financed by cooperative deposits, and as well as by an increase in the membership share capital. CBK started with only 161 cooperatives in the late 1960s; by the end of 1982 there were an estimated 1,400 cooperative societies representing about 1.5 million individuals.

The history of CBK's institutional development is similar in many respects to that of AFC. While CBK was created to provide

both savings and credit services (as opposed to AFC, whose function remains to that of providing loans), like AFC, its policies and operations were largely influenced by the Government through its management structure and the legal framework of the Cooperative Societies Act which reserved a major role for MOCD. In addition a large portion of its funds have come from the Government. The current institutional and financial problems of CBK reflect the fact that CBK's institutional capacity has not kept pace with the growing services and demands placed on it by the Government to implement numerous and complicated lending schemes. Also, its mandate in general, and the demands of the specialized lending schemes in particular, have resulted in conflicts with its financial objectives as a bank.

6.3.2 *Legal and policy framework*

Although CBK is registered under both the Banking Act and the Cooperative Societies Act, its management and operating policies have been influenced predominantly by the fact of its status as a cooperative society. It has been subject to significant control by its parent Ministry, MOCD. This arrangement has had the effect of limiting CBK's ability to carry out its intended banking functions in an efficient manner. CBK's institutional resources have been stretched too thinly over the requirement of its own lending programs plus those delegated to it by the Government. Its lending policies, which have been determined in accordance with complex and often competing objectives, have not resulted in a satisfactory financial performance.

MOCD has exercised a major decision-making role in nearly every aspect of credit decisions through its role on the CBK's Board of Directors and through its supervisory controlling functions within cooperative societies and missions at the field level.

Many of these problems inherent in the structure of CBK's relationship to MOCD and the potential conflict of social and financial objectives in the lending decisions have been recognized

by the Government, and important measures have been taken to begin to address these issues. Major changes in the Government policy towards CBK were announced in July 1983 by the Minister for Cooperative Development which were intended to give CBK a greater degree of management autonomy. Specifically, CBK was exempted from certain provisions of the Cooperative Societies Act (sections 23, 24 and 85). These exemptions provide that: (a) CBK can now select its own accounting staff, design its accounting systems and choose its external auditor without prior approval by MOCD; (b) the annual bank audit is no longer filed with CCD and CBK is responsible before the regulations of the Banking Act; and (c) CBK is no longer subject to the specific rules established by the Minister for Cooperative Development governing the detailed operations, nor is it subject to the discretionary rulings of the Commissioner as provided for in Section 85 of the Cooperative Societies Act. While the Minister and Commissioner retain important roles on CBK's Board of Directors, these exemptions formalize the management independence of the bank and increase the relative importance of the Banking Act regulations in policy and operations.

6.3.3 *Management and organization*

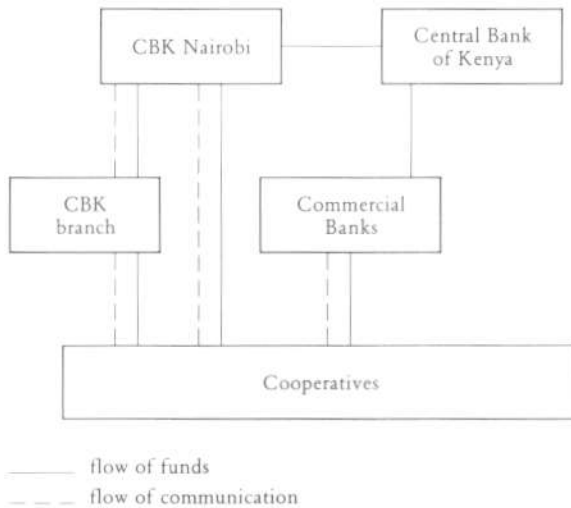
At present, CBK's capacity to carry out independent loan appraisals and to administer and collect loans efficiently is limited. Granting CBK greater autonomy in decisionmaking would substantially reduce the lengthy and cumbersome loan application/approval process, and reinforce the banker-client relationship between CBK and its borrowers. However, even with this simplification of loan administration, CBK's staff resource, procedures, and accounting and loan monitoring systems need to be strengthened if CBK is to perform the role envisaged.

CBK is a small institution with about 332 staff members (as of the end of June 1985) and with four branches outside of Nairobi. For this reason cooperatives in areas with no CBK-branch will nor-

mally, in addition to the CBK-account, also operate an account locally with a commercial bank. In Nairobi, Kisumu, Mombasa, Meru and Nakuru areas the cooperatives bank directly with CBK. Senior staff are considered fairly strong for a financial institution of this size, but these are few in number (about 30 at a management or supervisory grade) and they are concentrated in Nairobi.

Corporate planning is done on an ad hoc basis with input from senior management and responsibility for operational decisions, divided between different units reporting to different managers. Under the present system of organization, there are several sections carrying out loan appraisals.

CHART 2: Operational contact net-work of CBK



Source: Cooperative Bank of Kenya Ltd.

6.3.4 Funding

The deposits of CBK equal some 3% of the total deposits held by the commercial banks and NBFI. CBK has four main sources of funds: share capital, deposits, Government loans, and foreign

donor loans and grants. The original share capital of K Sh 255,800 for the Cooperative Bank was contributed by the cooperative movement. This was supplemented by two Government loans in 1969 and 1972. Total share capital had increased to about K Sh 554 million by the end of June 1985.

TABLE 21

Deposits at CBK (1978 to 1985) (K Sh million)

	1978/79	1979/80	1980/81	30.06.1985
Current accounts	167.7	221.2	233.6	297.8
Savings accounts	27.9	28.9	42.8	200.0
Fixed deposits	16.1	28.4	42.5	180.6
Short call deposits	113.8	194.9	62.3	126.2
Other deposits	8.0	—	4.8	0.1
Total	<u>333.5</u>	<u>472.7</u>	<u>386.0</u>	<u>804.71</u>

In early 1983, deposits represented about 63% of total sources of funds. Because of the short-term nature of these funds, CBK's deposit-based lending is limited to loans under five years.

During the mid-1970s, CBK increasingly became the lending channel for specialized Government and donor-financed small-holder credit schemes. These schemes were financed mainly on a loan basis, although there are small grant elements attached to some.

6.3.5 *Loan portfolio analysis and financial performance*

CBK's lending operations expanded at a rapid pace over the period 1974-1985 from K Sh 33 million to about K Sh 634 million. Growth has been in erratic spurts, reflecting mainly the introduction of new donor and Government-financed specialized credit schemes. The number of loanees reached through these programs has also increased dramatically. Estimates for CPCS, the oldest and largest scheme, indicate that farmer coverage increased from about

100,000 in 1982 to over 470,000 by the end of 1982. Available data for all the other specialized schemes indicate that the number of farmers reached under these schemes grew from about 20,000 in the early 1970s to about 85,000 in 1982.

Details of the portfolio as of November 30, 1985, are summarized in Table 22. About 50% of the outstanding portfolio (including unmatured principal plus principal and interest arrears) represents loans financed by CBK's own funds. Loan repayment performance has been poor across-the board, with principal arrears (as a percentage of total principal due) equal to about 60%. As of November 1985, total principal and interest arrears amounted to about K Sh 384 million. This has left an insufficient amount of funds revolving in the scheme to have a sustained impact. In general, loans financed out of CBK's own resources appear to have performed as poorly as the other specialized credit schemes. A review of non-performing loans account for about 1/3 of total loans/advances outstanding to CBK.

In comparison with the total share capital of CBK, the largest non-performing loan is equivalent to about 80% of CBK's share capital.

Bad debt provisions are low (2% of total loans outstanding); provisions are not based on historical performance and substantially overstate the realizable value of the portfolio and income receivable. CBK does not have a policy of writing off loans, even though principal arrears on some lending schemes are over 90% and have been outstanding for more than a year. Unlike AFC, CBK does not require land titles or tangible security for many of its loans, hypothecation of stock forms the basis security in most cases. This raises an important issue about the recoverability of loan security in cases of foreclosure. Often cooperatives in default on loan payments are those experiencing difficulties in marketing or processing sufficient quantities of produce to cover their costs and service debt and/or the cooperatives which have already liquidated their stock by selling them to Government marketing boards or other cooperative marketing/processing organizations.

In neither case does CBK have direct access to the stock. CBK's explanation for the low level of provisions is that many of the loans are covered by Government guarantees.

TABLE 22

The Cooperative Bank of Kenya Ltd.
Loans System. Summary of Scheme Lending
 Date: 30.11.1985

Approved	Scheme released	Repayment	O/S Principal	O/S Interest	Arrears total	Deposit amount
Bank's own funds, 17 schemes						
434,993,549.15	402,191,880.00	131,791,041.00	270,400,839.00	47,265,667.00	208,947,882.00	70,610,623.10
Government/donor scheme lending, 43 schemes						
469,367,582.00	374,367,544.00	90,875,613.00	283,491,931.00	33,327,039.00	175,713,772.00	326,272,259.30
Grand total						
904,361,131.15	776,559,424.00	222,666,654.00	553,892,770.00	80,592,706.00	384,644,654.00	396,883,152.40

Source: CBK

The extent of irrecoverable loans and realizable security is not known at present. The collection arrangements for most of the loans, particularly those for seasonal crops, are cumbersome through intermediaries or indirect channels (e.g. marketing boards) as mentioned above. Loan recoveries are being pursued vigorously in Kisumu and Nakuru. So far the results are reported to be good.

Close to one-third of the total loans outstanding are either Government guaranteed or disbursed on an agency basis by CBK for the Government. However, all loan funds, both Government guaranteed and financed from CBK's own sources, have been lent to clients approved by MOCD together with recommendations from MOALD and other Government institutions. It would be difficult to ascertain which loans were approved on the basis of other criteria. As CBK has not been able to apply normal banking criteria in evaluating loan applications or to refer loans considered to be poor risks, it could be considered that CBK bears little, if any, financial responsibility for losses incurred.

6.3.6 Financial status

The present financial status of CBK is difficult to evaluate realistically. CBK's audited financial statements (Table 24 and 25) show a positive net income before taxes of K Sh 7.7 million in 1982¹⁾, equivalent to a marginal return, on assets of 0.7%. However, because of the deficiencies in CBK's accounting policies, particularly for bad debt provisions and write offs, these financial statements cannot be considered an adequate representation of the financial position of the bank. Thus, an analysis of operating and financial performance indicators on the basis of available accounts is not particularly meaningful. The serious arrears position raises questions about the solvency of the Cooperative Bank.

1) 1982 for comparison reasons with AFC

TABLE 23

Cooperative Bank of Kenya Balance Sheet (year ending June 30) (%)

	1974	1975	1976	1977	1978	1979	1980	1981	1982
<i>Assets</i>									
Cash and short-term funds	75.2	27.5	72.1	81.8	56.3	12.4	24.1	14.4	29.4
Advances and other accounts	24.2	71.7	27.4	17.8	40.9	80.4	64.9	68.0	54.5
Investments	0.2	0.3	0.1	0.1	1.8	6.6	1.8	1.7	1.3
Subsidiary company	—	—	—	—	—	—	8.6	15.3	13.5
Fixed assets	0.4	0.5	0.4	0.3	1.0	0.6	0.6	0.6	1.3
Total assets	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<i>Liabilities and Capital</i>									
Current deposits									
and other accounts	91.1	63.7	83.4	88.9	80.7	72.1	67.0	53.1	62.4
Taxes payable	0.4	0.8	0.4	0.8	0.5	0.6	0.4	0.3	0.3
Dividend payable	0.4	0.8	0.4	0.1	0.4	0.3	0.5	0.5	0.4
Liabilities for acceptances	—	—	—	—	—	0.3	0.5	—	—
Long-term loans	2.2	24.6	11.5	7.1	13.4	18.9	25.5	39.8	31.3
Total deposits and liabilities	94.1	89.9	95.7	96.5	95.0	92.4	94.1	93.8	94.4
Grant	—	—	—	0.3	0.4	0.5	0.2	0.4	0.4
Share capital	5.3	9.3	4.2	3.1	4.2	6.1	5.1	4.8	4.5
Reserves	0.6	0.8	0.1	0.1	0.4	1.0	0.6	1.0	0.7
Total equity capital	5.9	10.1	4.3	3.5	5.0	7.6	5.9	6.2	5.6
Total liabilities and capital	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: CBK audited financial statements.

TABLE 24

Cooperative Bank of Kenya Income Statement (year ending June 30) (%)

	1974	1975	1976	1977	1978	1979	1980	1981	1982
<i>Income</i>									
Interest receivable on loans	48.5	53.1	64.3	28.7	41.1	74.4	91.2	95.1	84.7
Interest receivable - other investments	51.5	46.9	35.7	71.3	58.9	25.6	8.8	4.9	15.3
Gross income	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
<i>Expenditure</i>									
Interest paid: Long-term loans	4.0	10.9	17.1	9.3	10.7	12.7	17.8	29.8	28.5
Deposits	33.3	43.8	21.4	34.1	33.2	22.3	23.1	24.7	31.0
Staff and general administration ^{a)}	21.3	14.1	21.4	16.3	15.9	32.8	30.4	28.1	24.0
Board of management	5.0	3.1	4.3	3.1	1.9	1.6	1.4	0.9	0.7
Provision for doubtful debts ^{a)}	—	—	4.3	2.3	5.1	—	—	—	—
Depreciation	—	1.5	2.9	1.6	1.9	2.0	2.6	2.8	5.0
Total expenses	63.6	73.4	71.4	66.7	68.7	71.4	75.4	86.3	89.2
Net income before taxes	36.4	26.6	28.6	33.3	31.3	28.6	24.6	13.7	10.8
Taxes	15.2	12.5	15.7	16.3	12.6	13.6	11.7	6.6	6.0
Income after taxes	21.2	14.1	12.9	17.0	18.7	15.0	12.9	7.1	4.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

a) Financial statements for 1979-1982 do not provide details on provision for doubtful debts or a breakdown of staff and general administrative costs.

Source: CBK audited financial statements.

TABLE 25

Cooperative Bank of Kenya

Operating Ratios and Financial Performance Indicators (all expressed as percentages)

	1975	1976	1977	1978	1979	1980	1981	1982
1. Loan interest receivable to average loans outstanding	6.5	5.9	4.2	4.2	7.7	6.9	9.8	10.9
2. Loan interest receivable to total income	48.5	64.3	40.2	41.1	74.4	91.2	95.1	84.7
3. Interest expense to average advances outstanding	6.6	3.6	6.3	4.5	3.6	3.1	5.6	7.7
4. Interest paid on current deposits and accounts	4.4	.6	.9	1.5	2.0	1.2	3.1	3.5
5. Interest paid on long-term debt	2.9	3.6	3.1	3.0	4.3	3.2	3.7	6.3
6. Net interest margin	(.1)	2.3	(2.1)	(.3)	4.1	3.8	4.2	3.2
7. General expenses (excluding interest expenses) to average advances outstanding	1.7	3.0	3.4	2.5	3.8	2.6	3.3	3.8
8. Net profit before taxes to total assets	1.7	.7	.8	1.2	1.9	1.1	.9	.7
to average total assets	1.4	1.0	1.0	1.2	1.8	1.3	.9	.8

Sources: Cooperative Bank of Kenya (Calculations by the author)

TABLE 26

Cooperative Bank of Kenya

New Seasonal Credit Scheme Status as of June 30, 1983 (K Sh '000)

	1980	1981	1982 ^{a)}	1983
<i>Production Credit</i>				
Disbursements	20,653	32,929	6,940	330
Repayments	7,873	6,434	1,630	
Arrears:				
Interest	1,363	2,736	773	
Principal	12,779	26,493	5,310	
Total arrears	14,142	29,229	6,083	
% principal in arrears	62	80	77	
<i>Produce Buying</i>				
Disbursements	10,723	9,014	2,529	
Repayments	6,658	6,826	75	
Arrears:				
Interest	585	165	50	
Principal	4,066	2,188	2,454	
Total	4,651	2,353	2,504	
% principal in arrears	38	24	97	

a) Repayments were delayed due to NCPB's financial problems, therefore arrears are substantially overstated.

Source: Cooperative Bank of Kenya.

6.3.7 *Conclusions*

The foregoing review of the operations and performance of the Cooperative Bank reveals similar institutional and policy problems to those affecting AFC. There are also a series of other constraints which arise out of CBK's special and complicated relationship with the Ministry of Cooperatives Development. As in the case of AFC, CBK's lending activities have been largely predetermined by the lending requirements of specialized loan schemes; the multiplicity of different schemes with often substantially different loan criteria, terms and conditions has rendered loan administration extremely complicated for CBK and has contributed to confusion among cooperatives. The respective roles of CBK and MOCD in serving the cooperative sector have not been clearly delineated. Traditionally, MOCD has been involved in loan decisions at all levels, including the formulation of lending policies and the design of cooperative credit schemes, preparation and review of loan application, loan approval decisions through the participation of MOCD on CBK's Board of Directors and loan approval committee, and cooperative loan utilization, accounting and collection. The extensive involvement of MOCD in credit decisions and processing has contributed to an unnecessarily cumbersome application and credit delivery system, and it has also been an important factor preventing CBK from establishing a direct lender-borrower relationship with its clients. On top of these complications are the highly varied problems of the cooperative sector, including the difficulties of cooperative organization, management and member cohesion; the shortage of qualified accountants and managers, the inherent complexities of cooperative business, and the vulnerability of smallholder cooperatives to politicization and self-serving management.

The combination of these factors has had the effect of impeding CBK's development as a viable bank for the cooperative movement. CBK's staff resources remain extremely limited; operational decisions are still centralized in Nairobi, and its field level

presence is thin and concentrated in a few branches in the major secondary cities. The involvement of numerous parties (MOCD, external aid agencies and other Government interests) in loan eligibility criteria, loan approval decisions, collection mechanism and the presence of Government guarantees on many lending schemes has reduced CBK's incentives to take a very active interest in recovery of loans.

6.4 THE COOPERATIVE UNION BANKING SECTIONS (UBS)

6.4.1 *Background and overview*

During the latter half of the 1960s the government introduced the Cooperative Production Credit Scheme to bring financing services to small-scale cooperative farmers, which otherwise did not have access to credit. The scheme was introduced on a step-by-step procedure where the cooperative had to prove its ability to handle one step before it was eligible for the next one. In practical terms the exercise normally started from updating of the books of accounts and formalization and recovery of old debts owned by the members to their societies. When this stage was reached and it was considered the administrative capacity of the society was adequate for giving loans to members, the cooperative society could be recommended by MOCD for a loan from the CBK to be disbursed under CPCS terms to members/farmers. The first loan to the society funded by CBK was normally a very small one and it was taken as a pilot project. On good recovery performance the cooperative societies were recommended for further loan funds from CBK to be disbursed under CPCS to members/farmers. The scheme was first introduced in viable coffee areas and later in pyrethrum, dairy and settlement societies. To secure recovery the member/farmer was given a loan up to a maximum of 2/3 of his average earnings from the society during 3 previous years. As security the member/farmer hypothecated his crop proceeds to the

society and provided two loan guarantors. When a society had proved its ability to administer CPCS and further had good management and a proper payment calculation system (MT-system) it could, on the approval of MOCD, introduce the Cooperative Savings Scheme (CSS). Members'/farmers' payments were credited to savings accounts. Also other deposits and withdrawals could be made from the savings accounts. To allow members/farmers to participate in CSS a low minimum deposit was set. Further a slightly higher rate of interest was paid on savings than in commercial banks.

The administration of these two schemes were normally centralized at district union (= secondary coop. society) level in a section called UBS. Later when also other loan schemes to members were introduced e.g. SPSCP, IADP etc. also these loans were administered in the same section in areas where UBS were in operation. (In other areas a credit section was set up for loans' administration). UBS can be said to be the retail units in cooperative credit and savings as they are serving individual members/farmers. CBK is the corporate banking organization for the cooperative movement as it is mainly serving the cooperative organizations.

Today there are 16 UBS in operation. CPCS loans outstanding amounted to 303.9 million shs. at the end of December 1984. CSS balances were at the same time 583.1 million shillings, which equals about 2% of the deposits held by the commercial banks and NBFI.

6.4.2 *The Cooperative Savings Scheme (CSS)*

Development of CSS over the period 1982-1984 is outlined in Table 27 below:

TABLE 27

The Cooperative Savings Scheme 1982-1984

	1982	1983	1984
Savings balances K shs. Million	365.7	442.5	583.1
Growth, K shs. Million		76.8	140.6
Growth %		21.0	31.8
Inflation %		14.5	9.1
Number of accounts	422,481	449,307	454,174
Average balance per account K shs	865	985	1,284

Source: Ministry of Cooperative Development
(Calculations by the Author).

The deposits in CSS were growing at a nominal rate of 21% in 1983 and 31.8% in 1983 and a real rate of 6.5% and 22.7%. Average balance per account increased, although still being a meagre 1,284 Shs at end of 1984. As total membership of agricultural cooperative societies in 1984 was 1,184,000 the coverage of CSS was 38.4% of all members. The members were paid ordinary banking rate on their deposits with UBS.

6.4.3 *The Cooperative Production Credit Scheme (CPCS)*

Development of CPCS is outlined in Table 28 below:

TABLE 28

The Cooperative Production Credit Scheme 1982-1984

	1982	1983	1984
Loans balances outstanding K Sh Million	210.5	271.4	303.9
Growth; K Sh Million		60.9	32.5
Growth %		28.9	12.0
Inflation %		14.5	9.1
Number of Loan accounts	70,310	72,730	81,773
Average Loan Shs	2,994	3,732	3,716

Source: Ministry of Cooperative Development
(Calculations by the Author).

Under CPCS the following types of loans are given:

- 1) short-term loans (STL) with a repayment period of 18 months for seasonal credit purposes
- 2) medium terms loans (MTL 1) with a repayment period of 36 months for diversification purposes
- 3) medium term loans (MTL 2) with a repayment period of 60 months for diversification purposes.

The loans are issued either in kind (from the stores section) or in cash.

The members qualification for a loan is based on a three-year-delivery record to the society:

- a) STL 22% of three years earning from the society
- b) MTL 1 50% of three years earnings
- c) MTL 2 80% of the three years earnings.

There was considerable growth in 1983 and 1984 in CPCS. The average loan balance increased significantly in 1984 as only some 2,500 loan accounts were added while the balance of loans outstanding increased by 60 mill shs. This indicates disbursement of loans in 1983 in excess of the average balance.

According to a circular issued by Commissioner for Cooperative Development (CCD) UBS are allowed to charge a rate of interest of 2% in excess of bank rate or 16% at the moment. In Muranga UBS farmers were charged interest at 15%.

Reliable information on recovery performance as a whole is not available. In Muranga UBS loan arrears amounted to 4.3% at end of June 1985 and 5.6% at end of December 1985.

6.4.4 *Viability of UBS*

UBS are to operate on a very small interest margin as they are mainly funded through CSS and to a lesser part through loans from CBK at 14% interest. UBS also have few possibilities to generate other income. In practice they charge the annual ledger fee for savings and loans accounts. Furthermore number of transactions is high and volume of work per shilling of deposit very big. For this

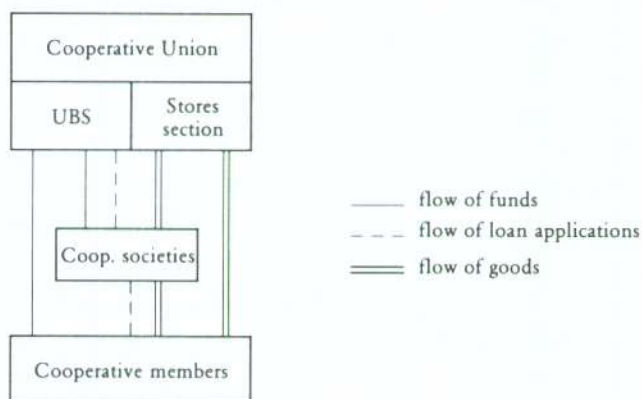
purpose UBS were set up within Unions in order the unions would guarantee the viability of UBS during the first years of operation until there was enough funds in the system to enable the activity to reach break-even.

In 1985 an impact study of CPCS was carried out on behalf of MOCD. The findings of the study showed that as an agricultural production credit scheme the CPCS had failed to a) increase members volume of production and sales, and b) realize diversification of farm products.

It was further noted in the conclusions of the study that while credits may play an important role in facilitating production, their role should not be exaggerated: price structures, returns and markets, producer education and appreciation of production needs etc, may be much more important influences of agricultural production than credits.

In Muranga the spread was calculated at 2.82% as at end of January 1986. Ledger fees were being charged at 20 Shs per year and account. Still Muranga UBS produced a surplus of 2.2. mill Shs according to preliminary accounts for 1984/1985. However, Muranga is considered one of the very best managed UBS and also the volume of deposits per account is considerably over average. According to reports from MOCD quite a few UBS seem to face trouble due to lack of funds at the moment. Members' savings funds have in some cases been diverted to finance the operations of the cooperative unions. For this reason there is a move in MOCD to have UBS separated from the unions and set up as autonomous banking unions for savings and credit services to members.

CHART 3: Operational contact net-work of UBS



Source: MOCD

6.4.5 Conclusions

Through introduction of CSS another nearly 600 mill Shs has been mobilized in the Kenyan economy. It has been mobilized from smallscale farmers with an average cash income of a few thousand shillings per year.

While it can be considered the informal set-up of a savings and credit service within a marketing cooperative has proved to be one way of introducing simple savings and credit services to cooperative small-scale farmers it would appear, from present reports on diversion of members savings funds, that at present some of the unions with UBS lack the necessary prudence to administer members' funds entrusted as deposits. It is also clear that the present set up makes the system prone to diversion of savings funds for other financial purposes, particularly in cases of financially weak unions. One way to control this problem is the move introduced by MOCD to make autonomous banking unions of MOCD. This way the members will maintain full control over their savings and credit activity, which, on the other hand, will be a small and financially vulnerable unit. Another approach to cement a foundation

for CSS, mentioned in the Central Bank could be to have CBK take it over, while leaving CPCS to be administered by the marketing cooperative Union. This way CSS would be brought under the deposit Protection Scheme to be introduced for banks. In this system the cooperatives would have to surrender the interest margin to CBK and borrow all funds at a rate of bank loan interest.

February, 1986

