

# Regulation and Supervision of Microfinance Institutions in Kenya

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## ESSAYS ON REGULATION AND SUPERVISION

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#### **ABOUT THE SERIES**

The *Essays on Regulation and Supervision* series has been commissioned for the Microfinance Regulation and Supervision Resource Center, funded by the Consultative Group to Assist the Poor (CGAP) and implemented by the IRIS Center. These essays are intended to provide additional insights and perspectives on the experiences of microfinance institutions, regulators, donors, and others regarding specific microfinance legal and regulatory environments.

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# Introduction

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**MICROFINANCE**, the provisions of financial services to the low-income households and micro and small enterprises (MSEs), provide an enormous potential to support the economic activities of the poor and thus contribute to poverty alleviation. Widespread experiences and research have shown the importance of savings and credit facilities for the poor and MSEs. This puts emphasis on the sound development of microfinance institutions as vital ingredients for investment, employment and economic growth.

The potential of using institutional credit and other financial services for poverty alleviation in Kenya is quite significant. About 18 million people, or 60% of the population, are poor and mostly out of the scope of formal banking services. According to the National Micro and Small Enterprise Baseline Survey of 1999, there are close to 1.3 million MSEs employing nearly 2.3 million people or 20% of the country's total employment and contributing 18% of overall GDP and 25% of non-agricultural GDP. Despite this important contribution, only 10.4% of the MSEs receive credit and other financial services. The formal banking sector in Kenya over the years has regarded the informal sector as risky and not commercially viable.

According to the Poverty Reduction Strategy Paper (PRSP) of 1999, a large number of Kenyans derive their livelihood from the MSEs. Therefore, development of this sector represents an important means of creating employment, promoting growth, and reducing poverty in the long-term. However, in spite of the importance of this sector, experience shows that provision and delivery of credit and other financial services to the sector by formal financial institutions, such as commercial banks has been below expectation. This means that it is difficult for the poor to climb out of poverty due to lack of finance for their productive activities. Therefore, new, innovative, and pro-poor modes of financing low-income households and MSEs based on sound operating principles need to be developed.

In the past, microfinance institutions (MFIs) established using either an NGO or a savings and credit co-operative societies framework have been important sources of credit for a large number of low income households and MSEs in the rural and urban areas of Kenya. The MFIs have, however, operated without an appropriate policy and legal framework. There is therefore need to focus more on these institutions to enhance their effectiveness in the provision of savings, credit and other financial services to the poor and MSEs.

The Government of Kenya recognizes that greater access to, and sustainable flow of financial services, particularly credit, to the low-income households and MSEs is critical to poverty alleviation. Therefore, an appropriate policy, legal and regulatory framework to promote a viable and sustainable system of microfinance in the country has been developed via the proposed

Deposit Taking Micro Finance Bill. In drafting the Bill, the Government has consulted with stakeholders to get their views on the best way to create the required enabling environment for the microfinance sub-sector. In addition, full-fledged microfinance units have been established in the Ministry of Finance (the Treasury) and the Central Bank of Kenya to formulate policies and procedures to address the challenges facing microfinance institutions, especially in the rural areas, and to build a database to facilitate better regulation and monitoring of their operations.

Over 100 organizations, including about 50 NGOs, practice some form of microfinance business in Kenya. About 20 of the NGOs practice pure microfinancing, while the rest practice microfinancing alongside social welfare activities. Major players in the sector include Faulu Kenya, Kenya Women Finance Trust (KWFT), Pride Ltd, Wedco Ltd, Small and Medium Enterprise Programme (SMEP), Kenya Small Traders and Entrepreneurs Society (KSTES), Ecumenical Loans Fund (ECLOF) and Vintage Management (Jitegemee Trust). The Kenya Post Office Savings Bank (KPSOB) is also a major player in the sector but only to the extent of providing savings and money transfer facilities. Many microfinance NGOs have successfully replicated the Grameen Bank method of delivering financial services to the low-income households and MSEs.

The proposed Bill aims at ensuring that licensed MFIs contribute to poverty alleviation and at the same time comply with the requirements of financial sector safety and soundness. The MFIs to be regulated under this Bill shall provide savings, credit, and other financial services to MSEs and to low-income households in both rural and urban areas.

## Constraints to the Provision of Microfinance Services

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**THE MICROFINANCE SECTOR** in Kenya has faced a number of constraints that need to be addressed to enable them to improve outreach and sustainability. The major impediment to the development of microfinance business in Kenya is lack of specific legislation and set of regulations to guide the operations of the microfinance sub-sector. Microfinance institutions in Kenya are registered under eight different Acts of Parliament namely:

- The Non Governmental Organizations Co-ordination Act
- The Building Societies Act
- The Trustee Act
- The Societies Act

- The Co-operative Societies Act
- The Companies Act
- The Banking Act
- The Kenya Post Office Savings Bank (KPOSB) Act

Some of these forms or registrations do not address issues regarding ownership, governance, and accountability. They have also contributed to a large extent to the poor performance and eventual demise of many MFIs because of a lack of appropriate regulatory oversight. This has had a bearing on a number of other constraints faced by the industry, namely: diversity in institutional form, inadequate governance and management capacity, limited outreach, unhealthy competition, limited access to funds, unfavorable image and lack of performance standard. The lack of oversight, however, has enabled them to innovate and develop different techniques of providing micro finance services. Therefore, to stimulate the development of the sector, appropriate laws, regulations and supervision framework need to be put in place. This can best be achieved through enactment of a microfinance legislation that clearly defines the roles to be played by the Government, the Central Bank of Kenya, and the microfinance practitioners, hence the proposed Deposit Taking Micro Finance Bill.

## Rationale for Regulation & Supervision of Microfinance Institutions

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**REGULATION AND SUPERVISION** of the microfinance sector is expected to lead to quality growth, broaden the funding base for MFIs eligible to mobilize and administer deposits, credit facilities, other financial services, and initiate the process of integrating these institutions into the formal financial system. The regulation of the sector will enable authorities to define procedures for their operations, entrance, exit, and ultimately create an environment for fair competition and efficiency in the sector. On the other hand, supervision encompasses all means by which regulators enforce compliance with a given legal and regulatory framework.

Deposit taking involves a potential risk of loss depending on how the deposits are employed. As such, MFIs intending to take deposits must be regulated and supervised by an external authority to ensure that deposits are prudently employed and cushioned by adequate capitalization. According to the proposed Bill, money is considered to be a deposit if it has been placed by members of the public; repayable on demand or at expiry of a fixed period or after notice and employed by lending, investing or in any other manner for the account and at the risk of the person employing the money.

There are also a number of responsibilities and sensitivities associated with deposit taking that would justify external regulation and supervision. These include convenience to depositors in terms of location and premises and provision of qualitative and physical security of deposits including insurance of deposits. Others include adequate liquidity, as depositors should be able to withdraw without subjecting the MFIs to solvency risks; attainment of acceptable rates of returns since depositors and shareholders of MFIs expect good returns.

In Kenya, like in many other countries, approaches to the regulation of MFIs are complicated by the fact that many institutions are involved in providing microfinance services under different legal structures. This presents a challenge in identifying an appropriate regulatory approach, which is conducive to the development of the sector while providing adequate flexibility to microfinance activities.

The tiered approach being recommended for Kenya recognizes the inappropriateness of the existing banking legislation for the regulation of specialized activities of microfinance and the diversity of the institutions engaged in the less-regulated sector. MFIs operating as banking institutions, savings and credit co-operative societies and Kenya Post Office Savings Bank are already regulated by Acts of Parliament that specify different supervisory authorities.

## The Way Forward

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**THE PROPOSED** Deposit Taking Micro Finance Bill will, *inter alia*, specify the following three different tiers of micro finance institutions and who should regulate and supervise them:

1. First tier — Formally Constituted Deposit-taking MFIs

MFIs intending to take deposits from members of the public will be regulated and supervised by the Central Bank of Kenya via the proposed Deposit Taking Micro Finance Bill. The proposed Deposit Taking Micro Finance Bill will empower the Central Bank of Kenya to license, regulate and supervise formally constituted micro finance institutions intending to take deposits from members of the public. Specific performance parameters and appropriate guidelines will be developed to facilitate supervision of this group of MFIs. This group of MFIs will also be members of the Deposit Protection Fund Board in order to have a deposit insurance scheme, that is, protection of depositor's deposit up to Kshs. 100,000.

2. Second tier — Formally Constituted Credit-Only MFIs

Formally constituted MFIs that do not take deposits from the public but accept cash collateral tied to loan contracts will be regulated and supervised by the envisaged Micro Finance

Unit in the Ministry of Finance through regulations issued by the Minister for Finance for the time being. The proposed Deposit Taking Micro Finance Bill and the legislation establishing the Micro Finance Unit could empower it to enforce compliance with its laid down regulations.

### 3. Third tier — Informally Constituted MFIs

Informally constituted MFIs like rotating savings and credit associations (ROSCAs), club pools, and financial services associations (FSAs) should not be supervised by an external agency of the Government. Donors, commercial banks, and government agencies from which they obtain funds or that support them should carry out due diligence and make informed decisions about them.

The proposed Micro Finance Bill has been developed by the Central Bank of Kenya, the Association of Microfinance Institutions in Kenya (AMFI), the Ministry of Finance and the Attorney General. The proposed Bill has been discussed with the stakeholders in various forums and their inputs have been incorporated in the draft. The proposed Bill is currently with the Attorney General for onward transmission to Parliament. Once the proposed Bill becomes law, the Central Bank of Kenya will be the implementing agent of the Government. In this regard, the Bank in 2000 set up a microfinance division in the Bank Supervision Department (now Financial Institutions Department) to participate in the drafting of the Bill and to develop prudential guidelines/regulations to be used once the Bill is in place. In 2004, the Central Bank established a Rural Finance Department to address various policy issues concerning rural finance, including microfinance. This Department, in liaison with the Financial Institutions Department, will be involved in developing capacity to regulate and supervise those microfinance institutions that will be licensed under the proposed Deposit Taking Micro Finance Bill.