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THE CASE FOR COOPERATIVE LOAN ASSOCIATIONS IN KENYA

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For the sake of those genuinely interested the main points of the paper, which are listed below, should serve as a guide. For those only remotely concerned, the same points together with "conclusions" on the last page might serve as an outline of the topic.

Introduction:

(a) Part of a study on financing of small scale enterprises.
(b) Limitations of the subject as treated here.

A. The need for credit:

(a) Is there a need, - and if so, how is it determined?
(b) Existing credit institutions and their scope for expansion.

B. Cooperative financing in Principle:

(a) Criteria for membership and the creation of credit.
(b) The principle of collective collateral.
(c) Maturity terms and ways of repayment.
(d) Conversion and renewal.

C. Cooperative financing adapted to local conditions:

(a) Where applicable: Industry, Commerce, Agriculture and Housing.
(b) Administration and cost.
(c) Its part in development.
(d) Legislation and money market effects.

D. Conclusions: (points for discussion)

Introduction:

It is very likely that this discussion paper is premature from more than one point of view. First of all, the study on which it is to be based is only three months old and actually much too young to give birth to a new offspring of such a complex a nature. Secondly the local environment into which this concept of cooperative financing is to be delivered might not be at all ready to receive it. This is what I don't know, and that is why this is a discussion paper in the true sense of the word. The fact that I have worked with cooperative financing before is mentioned only to serve as an explanation for conceiving the idea and does not in any way preclude a critical treatment of the subject here, because not only was it operating in a much more sophisticated economy, it was also quite evident to some of us that the system could be improved.

As far as I know cooperative loan associations, such as I am going to outline in this paper, have not been attempted in any other country which might reasonably well be compared with Kenya. I am therefore limited by not being able to refer to past experience in developing system. Whether or not the implementation of such financing will, in fact, be one of the recommendations flowing from my study of "Financing of small scale Enterprises" can only be determined by the research itself and after a critical analysis of the implications. But, as in any research, you need to have your theses viewed from all angles and at the earliest possible stage. I am therefore vitally interested in having this idea subjected to discussion among those who have a much longer and more practical experience with conditions here.

The extent of this paper does not allow a listing of all the details in the practical implementation of a cooperative of this sort. Likewise there are monetary policy aspects of this, which are only touched upon lightly and, admittedly, out of proportion to their significance in the long run from a macro-economic point of view.

A. The need for credit

"A shortage of capital is usually considered one of the most immediate and pressing as well as one of the most fundamental obstacles to domestic and private investment and thus to economic growth in the less developed countries." This quotation from Sayre Schatz[1] expresses something which may not be as undisputed as it seems. In the same study he himself points to what is now known as the Capital Shortage Illusion by suggesting that in the case of Nigeria the situation (1956-62) was such that "rather than a large number of viable projects vainly seeking capital, - capital has been vainly seeking viable private projects". He found that even after a liberal appraisal of loan applications to the Federal Loan Board of Nigeria only 18% were recommended for loans, and out of these only about half of the enterprises were successful.

Other similar studies seem to indicate that the percentage of viable and successful projects is higher in some other developing countries[2]. It soon becomes obvious

[1] The Capital Shortage Illusion: Government lending in Nigeria. Oxford Economic Papers Vol. 17 No.2 July, 1965.
[2] Nathaniel Engle: Industrial Development Banking in Action pub. in Pakistan Industrial Credit Corporation 1962. Shirley Boskey: Problems and Practises of Development Banks. publ. for IBRD by Johns Hopkins Press 1959.

that in order to compare, it is essential to know what type and size of projects apply for loans and to ask what the criteria for viability is. Schatz uses the term very broadly saying that "if for any reason a project is considered unlikely to be commercially successful, is badly conceived or the applicant has insufficient entrepreneurial ability or because conditions external to the enterprise are unfavourable, such as the whole economic environment, then the project is not viable."

This definition clearly has many implications, - and the more it tries to qualify the reasons for potential commercial failure the more implications arise, To arrive at the right answer it is important to know whether, for instance, the reason for rejection of an application is due to "economic environment" or to being a "badly conceived project", just to mention two of the very general terms, which in themselves might proffer an equally useless answer, namely in the first case: a shortage of capital, and in the other: a shortage of viable projects.

Before embarking on an analysis of present conditions in Kenya we need to have a clearer frame of reference. The simple criteria of commercial success would have to be supplemented with the availability of collateral from the commercial banker's point of view, whereas government agencies, on the other hand may disregard collateral and make their financing of enterprises a matter of policy. In fact, the concept of commercial success may be entirely lost, as in the case of farm subsidising (settlement schemes) housing and social welfare programmes.

How can the effective need, if any, be measured in regard to magnitude?[3] Rather than go into an academic discussion here of the criteria for viability, let us turn to the local capital market and simply ask how the situation looks as viewed by the decision-makers of various financial institutions. My research has not yet progressed far enough for me to give a conclusive presentation, but it has soon become obvious from interviews that answers are consistent enough to justify some generalisations, which in turn will be supported by some relevant figures from available statistics.

In spite of the fact that deposits in commercial banks had been moving thus:

	1959	1960	1961	1962	1963	1964	May-June-July-65		
Mill.£	56,9	50,2	52,4	59,2	62,5	65,0	60,6	61,0	61,9

the most important concern was lack of domestic savings, because total loans had gone up 9% from 1963 to -64 (as compared to 4% rise in deposits). The three major commercial banks indicated that they have to turn down otherwise profitable and creditworthy projects.

[3] To be sure, there will always be a need for credit, whether imagined or real. The effective need would then be those projects rejected for the reason of lack of capital by the existing outlets, given that all projects were aware of these outlets and their conditions and had made application. Another way of trying to determine the effective need for credit would be to make a survey of borrowers. These would necessarily include present as well as potential seekers of credit, which in theory would be close to the numbers of households. In order to determine what was an effective need one would have to apply to these answers a test of viability.

In the case of building societies, only one is at the moment making loans. The others are functioning merely as savings banks, because of the crises of 1960-61 with a large outflow of capital, which forced them stop their financing of mortgages. Here again deposits have been increasing at an even faster rate since 1963, apparently because the public - especially Africans - are now saving more than before and are becoming "interest-conscious". This is especially true of the East African Building Society, which has decidedly catered for Africans and has seen a 35% rise in deposits and investment shares from '63-64. Still the number of applications for loans "wait-listed" is growing.

The Stock brokers have experienced an increasing amount of funds flowing through their business to invest in local shares. They ascribe this fact to the effects of the exchange control and therefore it is perhaps temporary, but the rise in stock prices, which this has brought about, may attract other funds not formerly interested in this type of investment.

The wholly owned government agencies such as I.C.D.C.[4] and D.F.C.K.[5] are largely based on capital from abroad. The same is true of A.D.C.[6] and the new housing development corporation. In contrast to the commercial banks they engage in longer term loans for investment and development purposes. Their criteria for viability are different from other agencies and they do not have to rely on local savings.

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4) Industrial and Commercial Development Corporation : Revolving fund of £50,000, - Total assets £4 Mill. in shares £5 Mill. in loans.

5) Development Finance Comp.of Kenya. Authorised capital £1 Mill.

6) Agricultural Development Corporation.

It is difficult to get statistics for the rate of defaults they encounter but it is quite clear that the smaller the venture the higher the risk. In the case of I.C.D.C. the function of the agency is not only to finance small scale indigenous enterprises but to suggest such projects and to assist them once they are established. Unlike the D.F.C.K. which invests on a more strictly commercial basis the former finds itself with a much higher rate of default. Experience from Uganda seems to indicate a shift from pure development aims to more commercially sound projects in the field of industry and commerce.[7]

The survey of financial institutions has not yet produced a concrete figure for the present need for credit, but its stand was clear. Another way of approaching exact expression though perhaps not as realistic because of uncertainties, is to look at the proposals set forth in the Kenya Development Plan 1964 - 1970, where a growth rate of 6% per year is established as a desired minimum. The question is then: How much investment is needed to attain this goal and how much is going to be available?

Without going into a critical analysis here of the figures in the plan, suffice it to state the following:[8]

Investment for the 6 year period total		£330 Mill
Government will plan to invest	£80,6	
Public non-government bodies	£51.6	132,2 Mill
Balance = investment of private sector		£197,8 Mill.

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7) The Uganda Credit-and Savings Bank has turned into a fully pledged commercial bank.

8) Kenya Development Plan page 38 and 123. (It was recently announced that a revised plan will be published at the end of this year.)

We shall only concern ourselves with the private sector, thus £ 197,8 Mill. over six years equals £33 Mill. per year. Looking back through the period of 1954-62 private capital formation has amounted to 62% of the total, which corresponds to 16,5% of GDP carried over from nominal figures for 1962 this would mean a private capital formation of £20,7 Mill. Let us assume that the recent rise in domestic savings will facilitate an extra 4 to 5 Mill. in loans, - still 8 to 9 Mill. are needed.

This figure of about £10 Mill. has been verified by the planners and we will take it to mean a challenge to the local money market to expand.

Is there sufficient and immediate scope for expansion in the existing institutions? The subject needs further study, but it seems apparent that in the case of commercial banks their physical facilities for attracting savings are limited by a less attractive interest rate. In addition commercial banks are by tradition confined to the short term loan market with emphasis on collateral, and this is not where the immediate demand is most urgent.

The Savings and Loan Association along with the other Building Societies - save one - are still greatly handicapped by having to channel their deposits to the bodies which assisted them with funds during the crises. True, some of these bodies make local investments, but that is not most efficient way of utilising these savings.

The government-owned agencies could of course try to get more capital from abroad or from local government issues but this becomes a matter of policy rather than economic efficiency.

It just may be that the capital market has reached a point where there is a call for new ways of financing. Indeed the coming establishment of a central bank is an indication of this. Legislation enabling Trust Funds to come into being - and this is on the way, is another indication of a maturing market. From an investors point of view, a regular supply of securities is as important as acceptable terms and interest rates. It is therefore important to cater for the supply side as well.

B. Cooperative financing in principle:

As the name suggests the principle of cooperative financing is one of forming a group of people, who have at least one thing in common, that of seeking credit. Whether the object for financing should be decisive as to their membership of the group will be taken up later, as will the size of the group and other prerequisites for membership.

The main idea behind this particular form of cooperative is the way in which financing is provided. Unlike many other cooperatives, which will provide short term credit to their members out of their reserves obtained from their primary function as a marketing coop. or the like, this one does not need these reserves, because its way of creating credit is by issuing bonds to be sold on the open market by the members themselves, at whatever price they can get. Since bonds are issued at nominal values and with a nominal rate of interest, the price at which they can be sold determines the real rate of interest for both seller and buyer. This is trivial. What is much more vital are the determinants of the price. Clearly enough the price will adjust to the pattern of interest rates as prevailing at any given time. The crucial matter, however, is how much confidence the buyers will place in the form of security or asset, which the bonds represent to them, competing with all other forms of available assets.

This is where the collectiveness of cooperatives is important, because it serves as security or backing for the bonds issued. In short, the members are responsible one for all and all for one. This might be a drawback from the members point of view if the group is too small or too "one-sided" in its composition of members. The cooperative finance institution should therefore be thought of in terms of large heterogeneous groups joined together administratively in one cooperative.

The extent to which defaults and settlements of bad debts are encountered is, of course highly dependent on the way in which applications for loans are scrutinzed, The rate of collateral required and the diversification of the groups will influence the extent to which the association is affected.

It may be argued that if a cooperative of this kind is going to succeed, especially when starting off in an environment unaquainted with this form of financing, it will have to be so careful in admitting applicants to the society (= granting loans) that these individuals might as well obtain the same amount of credit in the existing institutions, and without having to share in a collective risk. This may be true, though it often is not. But the point is this: Assuming there will always be credit available to people who are prepared to pay the price asked[9], out problem is not just to make credit available but to do it on reasonable terms. When the differential in interest rates on the local market is aroud 4% and 8% maximum there is a case for getting demand and supply of credit in "closer touch". This is the <u>function</u> of the cooperative loan association.

Another couple of points need to be touched on. One of them is the question of the time limit of the loans and hence the maturity of the bonds of the cooperative. It is evident that this will influence the price of this type of credit. The <u>nature</u> of the cooperative would be to provide long term loans of larger sizes, because not only are they cheaper to administer, but their purpose is to serve the function of creating investment capital, which in turn solves the problem of collateral in that the object for financing itself serves as collateral. The maturity terms should then be closely related to the economic life of the object being financed, - more than that would hamper the collateral, and less would not be in the interest of the borrower. It is only reasonable therefore that the association viewing the individual loan application should have the right to offer alternative loan proposals to the potential member in regard to maturity as well as nominal rate of interest.

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[9] Evidence from the field of agriculture suggests that as high as 180% is being charged by the local financier. A more typical rate in the Nairobi area is within the range of 24% on hire-purchase loans, over 10% on housing, 9% on short term bank loans down to 3% on certain government sponsored loans. Savings rates on the other hand reach 6½% with 4% being normal.

Another point is that of repayments. The association determines the sequences of repayments, whether annually, monthly, etc. and whether in annuity form degressive or progressive form. The important thing being that it is uniform. The borrower should naturally be permitted to make payments in the shape of bonds from his own group (bought in the market) or to repay the balance in full at any time.[10)]

In addition to the actual downpayment and the interest it is necessary to charge a fee of the order of 1% to be divided between the cost of administration and a reserve fund of a limited size for each group to meet the individual defaults, which will invariably occur.

The question of repayments can also be considered from the lenders point of view. He would naturally expect to get the full nominal value of his bonds at the time of expiration, but it is also conceivable that he might get it before, namely by way of a "lottery". This is not purely to attract attention to the scheme by catering to the need for gambling, but as repayments are coming in from members at an increasing rate from the time the first loan is granted and since they can only be used to repay the actual lenders[11)] (i.e. buying back their bonds) then there are good reasons for buying them back at the same rate loans are repaid. This can be done in two ways, either by buying them back in the open market as long as the price is below par[12)] or by buying back at par the number

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10) A one month notice might be appropriate.

11) It is not the purpose of the association to engage in any other form of business or to take on investments other than stated.

12) If above par it would be difficult to "make ends meet".

of bonds, which the association is in a position to purchase at any given time. The individual bonds to be bought are determined by way of a strict random selection from each of the groups of bonds and corresponding to the repayments from that particular group of members. Of the two ways the latter seems to be preferable, since it tends to keep prices at par and is neutral to buyers as well as sellers, and it is easy to fit into a budget and it provides for a faster flow of funds.

One last aspect of the principle on which this cooperative works should be mentioned here. This strictly concerns the member himself in the position of having obtained a loan from the association at a high nominal interest, which he of course would be compelled to pay for the duration of the loan. If the general level of interest had moved downwards it would affect him adversely and he may want to pay back the loan and try to obtain another. Since prices on bonds have gone up he would not choose to buy bonds in the market for repayment and if had originally sold under par he would also lose by paying back in cash. In such cases the member should be allowed to convert his original loan into another with a lower nominal interest. The price mechanism of bonds of this kind works in the following manner: When the interest level is declining prices will move up and bonds with a high nominal interest will first move above par, thereby changing the advantage of being redeemed by chance to a disadvantage, which is mounting as the declining level of interest encourages a larger number of conversions. Demand (lenders) will consequently seek the lower nominal interest bonds levelling out the price difference between high and low interest bonds. This, in turn, makes it advantageous for suppliers (borrowers) to repay their high interest loans with bonds which they purchase in the market by simultaneously selling low interest bonds from a new loan, thereby facilitating the conversion and eliminating the ill effect to the borrower, without hurting the lender. In line with conversion is the renewal of loans. This simply means that a member, who has already repaid a major part of his loan should be free to obtain additional loans (or new higher one) provided the collateral justifies such a renewal[13].

Finally, there is nothing to prevent a member of one association from becoming a member of other groups in the same association and likewise several associations could be formed giving preference to certain categories of loans such as land purchase building construction, land improvements, breeding stock, production facilities. In the case of housing, there might be associations taking only 1st mortages and others taking 2nd., the latter requiring a higher rate of collateral[14].

C. Cooperative financing adapted to local conditions:

The main argument against this concept of cooperative financing and its implementation locally will, no doubt, be its sophistication. But working under the fair assumptions that credit is needed, that local funds exist waiting to be exploited and that new institutions in the money market are urgent in order to facilitate a further creation of local credit for the purpose of development, - then it appears

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13) In the case of real estate in an urban area this is often the case.

14) A rate of 200 to 250 per cent is the order on which collateral should be present.

worth while trying to modify the above concept to fit into our present setting.

There are always good reasons for building on existing institutions rather than establishing new ones, although at a later point it might be advisable to separate functions, such as has been the case with commercial banks and finance companies (owned by the banks). In this case we shall move through the sectors of industry and commerce, agriculture, and housing and see where and how this type of credit creation can be adapted.

In the field of industry and commerce it is especially the locally based smaller scale enterprises, which are in need of capital. The banks are in the picture, but as stated before, mostly with short term working capital and high collateral. The other institution tending to development in this field is the I.C.D.C.

Space does not allow a closer evaluation of its functions other than that has already been said, but it is quite apparent that it is suffering from lack of funds, partly because foreign sources are reluctant to tie up larger amount in something which is not very profitable; nor is it a strictly educational matter, which could attract such funds.

The idea of raising money in the local market is not at all alien to this Institution. In fact tentative plans for a bond issue are on the way. The idea is to turn the issue - if approved by the government - over to local banks and let them serve as a unit trust handling the collection of payments and interest, taking subscriptions and redeeming coupons as well as bonds at maturity.

A few points need to be raised. First, the loan policies of the I.C.D.C. will inevitably have to undergo revision, if defaults are not to make redemption impossible, thereby spoiling the market for later issues. Secondly, according to the principle of cooperative financing, there is no need to have the total issue subscribed at once, as is customary.

It is important that in the field of industry and commerce a wide diversification of lenders is attained. This comes quite naturally in regard to type of business, but it must be emphasised also in regard to size and geographical areas.

In the field of agriculture it deserves mentioning that short term financing already exists on a cooperative basis in that several of the marketing cooperatives furnish very short and comparatively small loans to their members out of their own funds.[15] In keeping with the mature plans for the establishment of a new Cooperative Bank in Kenya for the purpose of serving the various cooperatives and chanelling their funds to the areas where needed, it is logical that this body should be in the picture when credit is needed for investment by members of the existing cooperatives. It is conceivable that the individual cooperatives should be viewed as members, as the size of loans would otherwise tend to be too small and thereby greatly increase the unit cost of administration. Already the commercial banks in some cases provide cooperatives with credit for recurrent expenditures on the basis of the collateral, which is present by way of the assets of members.

15) By their nature cooperatives should not keep funds, but they do exist. Either because there are lacks in distributing income or members have been encouraged to use their coop. as a savings bank or both.

The need for investment capital, however, is not covered by this and only a few cooperatives enjoy this good-will with the banks (and perhaps rightly so) but the banks have indicated an interest in the new Cooperative Bank realizing that this is less of a competitor than a welcome supplement in a field where they were not vitally interested. Another advantage of linking long term invest ment financing to the local cooperatives is that they are on the spot and have a first hand knowledge of the project, the entrepreneur and the value of the asset in question.

The Land Bank and settlement schemes have not been considered as they are separate schemes set up for specific purposes and of limited duration. The agricultural Finance Corporation could very well serve as the basis for another loan association, since it is concerned with a different type of enterprise within agriculture.

We turn now to the much suffering field of housing. Due to reasons already outlined there has been a severe lack of credit in this sector and only through foreign lending have there been any positive steps taken to correct this situation.

The financing of housing is perhaps the type which lends itself best to a cooperative loan association. The assets are substantial, immovable and readily assessable. The loans are sizeable and therefore cheaper to administer. Most loans will be awarded in urban areas, where property values (under normal conditions) are increasing and where members are, to a large extent, salary earners. They are already prepared for the more complex financial transactions and here legislation can be more speedily and forcefully enacted.

The question is whether cooperative financing will fit into the existing framework or whether there is a case for a separate body. The immediate reaction would be to turn to the building societies, but the nature of their business is more like the American Loan and Savings Association, or, naturally, like building societies in Britain. They might not be interested in setting up a scheme,, which in effect will be competing with their present business.

For the sake of competition and to give the new type of financing a secure backing the proper agent would be the new Housing Development Corporation, which can count on government support. It is essential however that here again strict economic efficiency in granting loans to members be kept in mind, - and separate from any other development schemes this organisation may undertake.

The advantage of having existing institutions taking on this new financing medium is not only their familiarity with the market and vice versa, it is also a matter of keeping down administrative cost, because, as is especially true in financing, economies of scale are very important. Certainly, if existing agencies each took on a third of the estimated issue of approximately £10 Mill. it would be possible for them to handle it within the suggested cost of 15.000/- (½%) whereas this would be impossible for a separate institution.

It is taken for granted that the administrative body as well as the members make full use of the commercial banks, stock brokers and others who are there to transact such business. It may even be that the banks would want to engage in advertising to this effect, since they have the needed capacity and are widely spread.

When circulation grows and new issues from one agency reach around £10 Mill. there is scope for the formation of separate body. It will then have reached a yearly revenue of 1 Mill.

There is perhaps an argument for following the example of the past (and for that matter of other developing countries) of leaving the creation of such finance to the government, thereby securing automatically the guaranty and legacy of the whole matter and not worrying about cost. This is again a political issue: but I would venture to say that this seems not to be the policy of the present Kenya Government.[16]

This leads us to another point regarding government's involvement in the bond issues of other agencies. As Nevin points out[17] it is in the governments interest to support such new developments in the finance sector, because they are instrumental in developing other sectors of the economy. It should therefore serve as guarantor for such bonds in the beginning and until the issuing agencies become sufficiently well established not to need such support.

Further it is to be expected that the government-owned central bank will be encouraged to take up such issues along with other "gilt edged" and that the establishment of a national provident funds, which is on the way, will also serve as an investor in these assets.

As has been said about the development of industry, government should also provide in this field new avenues of

[16] The present market situation could then have been much more exploited because there is, in fact, a surplus demand for "gilt edged".

[17] Edward Nevin. McMillan and Co. London 1961. Capital Funds in underdeveloped countries.

educating people to think in terms of modern techniques and there is no more effective education than that of being exposed to these techniques. One of the ways this can be done is by supporting new private developments, and in this case, the very effort of advertising and popularizing would also serve the purpose of attracting the funds now being boarded or not saved at all.

The question of new legislation for cooperative loan associations to function is beyond the scope of this paper, but it is essential that such faces as collateral rates and reserve funds be stated. The rights of members as well as bondowners must be established, likewise the rights and responsibilities of the governing body.

The limitations on the amount one or more of these cooperatives can float may be considered since, in abnormal situations, their capacity to create credit per se is unlimited, and they might very well have to be under same kind of regulation by the central bank as is customary for the commercial banks. This danger is not an immediate one, because the amount of bonds floated will not reach such levels for some time, - and even at that point, properly regulated the cooperative loan associations through their bonds become a very direct medium for a country's monetary policy.

D. Conclusions (points for discussion)

1. The need for credit in Kenya seems real and not temporary. It is estimated at a magnitude of about £10 Mill. which is expected to come from the private sector.
2. The existing financial institutions are handicapped by their tra ditional pattern of operation and the lack of local savings in meeting this demand. Though deposits have gone up and have become more interest concious there is still a span of about 4 - 5% between deposits and loan rates.
3. A cooperative loan association would serve the purpose of getting supply and demand for credit closer together, and would not have to have funds of its own. This is accomplished by forming groups of "loaners" who pool their collateral and receive bonds issued by the association equal to the amount they have been granted in loan.
4. To obtain liquidity the members have to sell these bonds in the open market through the normal channels. A "lottery" system of redemption will tend to keep prices stable and make it attractive to investors as long term paper as the bonds are of longer maturity, roughly speaking equal to the economic life of the collateral envolved.
5. The cooperative loan association would be applicable in the fields of Industry and Commerce, Agriculture and Housing as the basis for long term investment borrowing.

One existing body has already thought long these lines, but there are other agencies in these fields who could serve as the administrative body to this form of financing. This is especially important to start with as the cost of administration would be high per unit of loan granted, also they have the experience and apparatus to scrutinize applications for loans.

6. Government should guarantee these bonds to start with and should encourage the central bank, the provident fund and the like to invest in these bonds, thereby giving them "prestige" and making them attractive to the general public, insurance companies and commercial banks.

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