UNITED STATES AGENCY FOR INTERNATIONAL DEVELOPMENT (USAID) STRATEGY FOR THE DEVELOPMENT OF MFIs IN KENYA AND THE EXPECTATIONS OF FUNDED INSTITUTIONS

BY

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DECLARATION

This Management Research Project is my original work and has not been submitted for a degree in any other university.

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To all pro-poor microfinance development agencies

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LIST OF ACRONYMS

BDS	Business Development Services
CBS	Central Bureau of Statistics
CIDA	Canadian International Development Agency
CGAP	Consultative Group to Assist the Poor
DAI	Development Alternatives, Inc.
DANIDA	Danish International Development Agency
DFID	British Department for International Development
EU	European Union
GEMINI	Growth and Equity through Microenterprise Investments and Institutions
GOK	Government of Kenya
GTZ	Deutsche Gesellschaft fur Technische Zusammernarbeit (Germany Technical Assistance Cooperation)
JICA	Japan International Cooperation Agency
ICEG	International Center for Economic Growth
IFC	International Finance Cooperation
MFI	Microfinance Institution
MSE	Micro and Small Enterprise
NGO	Non-governmental Organization
REP	Rural Enterprise Program
RFA	Request for Application
ROSCA	Rotating Savings and Credit Association
SACCO	Savings and Credit Cooperative
SIDA	Swedish International Development Cooperation Agency
UNDP	United Nations Development Program
USAID	United States Agency for International Development

ABSTRACT

The microfinance sector in Kenya has grown rapidly in the last ten years. The sector has grown out of necessity primarily to provide financial services to the micro-economy, comprising all segments of the rural and urban population, including small scale farmers, microentrepreneurs, women and the poor.

The sector has grown largely through the support of development organizations in which the United States Agency for International Development (USAID) is among the leading donor agencies. This case study is to examine the factors that influence the USAID MFI development strategy, the expectations of the USAID-supported MFIs and a comparison of the USAID – MFI expectations.

The study had three objectives:

1. Establish how USAID's expectations influence its MFI development strategy for the sector in Kenya.
2. Identify the expectations/perceptions of MFIs supported by USAID.
3. Establish a comparison of USAID and MFI expectations.

Data was collected through questionnaires administered personally and circulated to MFIs. Both closed and open-ended questions were used. Data was collected from 7 USAID officials and 7 MFIs that have been directly funded by USAID over the last ten years. Secondary data was also used in the analysis. Basic statistical analysis such as frequency distribution, simple and cross tabulations, proportions and percentages were used. A content analysis was also carried out.

USAID has an MFI development strategy that shows that the future of microfinance lies not with limited donor funds, but with the private sector. In other words, microfinance services should become part of the country's private financial system in order to be sustainable. The strategy is highly influenced by pre-determined expectations that have been jointly agreed upon by many donor agencies through the Consultative Group to Assist the Poor (CGAP). The results also show that MFIs have the same expectations as donors and no major standing out controversy was noted in the study.

On the part of MFIs, there is a general consensus that if they are to grow enough to reach, on a long-term basis, the millions of low income people without access to financial services, they need access to more sustainable sources of finance to support their development. These will have to include private sources of debt and equity and savings.

There is still a role for donors in further development of the microfinance industry in Kenya to address a number of constraints including lack of capital for on-lending and institutional capacity of MFIs.

In spite of the sustainability and even profits that have been reported by MFIs, there are few signs that the microfinance industry in Kenya has evolved into a real business that will grow and reach more low-income people without subsidy, whether it is given by foreign donor agencies, national governments or charities. This is partly because microfinance is still perceived as subsidy-dependent activity, and the continuing flow of donor funds 'crowd-out' profit seeking finance. The study shows that there is little sign that start-up capital is flowing to microfinance. The MFIs' intentions and strategy of less reliance on donor funding will be tested over time.

The enactment of the Microfinance legislation to allow qualifying MFIs mobilize deposits from the public is absolutely necessary. The Bill should be enacted without delay. Savings is a viable source of capital for on-lending purposes to many MFIs that are presently registered as NGOs or finance companies. In addition, the Microfinance legislation will enable MFIs develop other financial services that are appropriate for the majority of the rural population.

A policy and regulatory framework for MFIs and pro-poor programs is required. The policy framework will address a number of issues about pro-poor financial services and programs such as awareness and education, establishment of appropriate support institutional framework such as an MFI fund to support the industry, establishing a legal framework that ensures that courts are effective in the collection of debts.

CHAPTER ONE: INTRODUCTION

1.1 Background

1.1.1 Definition and History of Microfinance

In recent years, a growing number of developing countries including Kenya have embarked on reforming and deregulating their financial systems, transforming their institutions into effective intermediaries and extending viable financial services on a sustainable basis to all segments of the population (Seibel, 1996). By gradually increasing the outreach of their financial institutions, some developing countries have substantially alleviated poverty. Supported in their innovative thrust by various donor agencies, developing countries have utilized various avenues to more effectively serve the poor, including poverty lending, institutional strategies and financial systems approaches. In the process, a new world of finance has emerged, which is demand-led and savings driven and conforms to sound criteria of effective financial intermediation. There is now incipient experience with the successful integration of microfinance strategies into macropolicies, which makes banking with the microeconmoy and the poor both viable and sustainable.

Therefore, microfinance has emerged as that subsector of the financial system which provides financial services to the microeconomy, comprising all segments of the rural and urban population, including small scale farmers, microentrepreneurs, women and the poor. This microfinancial sector comprises local financial institutions which may be formal, semiformal or informal. Furthermore, such institutions may be owned, fully or in part, by individuals, groups or organizations in the micro-economy. Microfinance services include savings, loans, insurance, money transfers, remittances, etc.

It is acknowledged that the need to extend the poor's access to formal financial services is not new. Initially, in the 1950's, development projects began to introduce subsidized credit programs targeted at specific communities. For example, governments and donors provided subsidized agricultural credit to small and marginal farmers with the goal of raising productivity and incomes. These subsidized schemes were rarely successful because the funds seldom reached the poor, ending up in the hands of better-off farmers. Moreover, subsidized interest rates introduced a culture of non-repayment, which in turn made it difficult for lasting financial systems to emerge.

The general failure of large subsidized credit schemes inspired social entrepreneurs in developing countries to test alternative ways to offer credit to poor people. Beginning in the 1970s, experimental programs run through non-governmental organizations (NGOs) in Bangladesh, Bolivia, and a few other countries extended tiny loans to groups of poor women who could invest in micro-businesses. This type of microenterprise credit was based on solidarity group lending in which every member of a group guaranteed the repayment of all the other members (CGAP Annual Report, 2003).

Throughout the 1980s and the 1990s, these NGO-based credit programs improved upon the original methodologies and bucked conventional wisdom about financing the poor. First, it was shown that poor people, especially poor women, repay their loans. Near-perfect repayment rates, unheard of in the formal financial sectors of most developing countries, were common among the better credit programs. Second, the poor were willing and able to pay interest rates that allowed MFIs to cover their costs. Third, the combination of these two features, high repayment and cost-covering interest rates enabled some MFIs to achieve long-term sustainability while reaching large numbers of clients. The promise of microfinance as a strategy that combines massive outreach, far reaching impact, and financial sustainability makes it unique among development interventions.

The development of microfinance has benefited significantly from technical and financial assistance from bilateral and multilateral donor agencies in the last decade. Rukwaro (2001) in the study of credit rationing by Microfinance Institutions (MFIs) noted that the microfinance subsector has emerged as an alternative source of credit to a large number of MSEs in Kenya. The study found that 20% of MFIs obtained their lending capital from donor agencies, 50% from internal operations, 25% from borrowing and 5% from members' deposits. It is further noted that internal operations involved operating revolving funds that were initially financed by donor agencies. Many of the MFIs rely on donor agencies for funding as they are not financially stable enough to access commercial funding (Ledgerwood, 1993).

1.1.2 Factors that Influence Donor Support Strategy for MFIs

Donors have broad-based goals in their economic development support for Kenya. These goals are expected to be consistent with the development priorities of the government of Kenya (GOK). The microfinance sector is one sector that has been identified as a priority focus according to the GOK's Economic Recovery Strategy for Wealth and Employment Creation 2003 – 2007 (GOK, 2003). Therefore the involvement of donor agencies is considered to be very important in the development of the MFI sector. However, there are a number of factors that have an influence on the donor strategies for supporting the MFI sector.

Microfinance is a powerful tool to fight poverty. When poor people have access to financial services, they can earn more, build their assets, and cushion themselves against external shocks. Poor households use microfinance as a means to move from everyday survival to planning for the future: they invest in better nutrition, housing, health, and education.

Microfinance means building financial systems that serve the poor. In most developing countries, poor people are the majority of the population, yet they are the least likely to be served by banks. Microfinance is often seen as a marginal sector—a “development” activity that donors, governments, or social investors might care about, but not as part of the country’s mainstream financial system. However, microfinance will reach the maximum number of poor clients only when it is integrated into the financial sector (CGAP Donor Brief, 2004).

Microfinance can pay for itself, and must do so if it is to reach very large numbers of poor people. Most poor people cannot get good financial services that meet their needs because there are not enough strong institutions that provide such services. Strong institutions need to charge enough to cover their costs. Cost recovery is not an end in itself. Rather, it is the only way to reach scale and impact beyond the limited levels that donors can fund. A financially sustainable institution can continue and expand its services over the long term. Achieving sustainability means lowering transaction costs, offering services that are more useful to the clients, and finding new ways to reach more of the unbanked poor.

Microfinance is about building permanent local financial institutions. Finance for the poor requires sound domestic financial institutions that provide services on a permanent basis. These institutions need to attract domestic savings, recycle those savings into loans, and provide other services. As local institutions and capital markets mature, there will be less dependence on funding from donors and governments, including government development banks (Lennon & Rostal, 2003).

Poor people need a variety of financial services, not just loans. Like everyone else, the poor need a range of financial services that are convenient, flexible, and affordable. Depending on circumstances, they want not only loans, but also savings, insurance, and cash transfer services.

Microcredit is not always the answer. Microcredit is not the best tool for everyone or every situation. Destitute and hungry people with no income or means of repayment need other kinds of support before they can make good use of loans. In many cases, other tools will alleviate poverty better—for instance, small grants, employment and training programs, or infrastructure improvements. Where possible, such services should be coupled with building savings.

Interest rate ceilings hurt poor people by making it harder for them to get credit. It costs much more to make many small loans than a few large loans. Unless microlenders can charge interest rates that are well above average bank loan rates, they cannot cover their costs. Their growth will be limited by the scarce and uncertain supply soft money from donors or governments. When governments regulate interest rates, they usually set them at levels so low that microcredit cannot cover its costs, so such regulation should be avoided. At the same time, a microlender should not use high interest rates to make borrowers cover the cost of its own inefficiency.

The role of government is to enable financial services, not to provide them directly. National governments should set policies that stimulate financial services for poor people at the same time as protecting deposits. Governments need to maintain macroeconomic stability, avoid interest rate caps, and refrain from distorting markets with subsidized, high-default loan programs that cannot be sustained. They should also clamp down on corruption and improve the environment for micro-businesses, including access to markets and infrastructure. In special cases where other funds are unavailable, government funding may be warranted for sound and independent microfinance institutions (CGAP Donor Brief, 2003).

Donor funds should complement private capital, not compete with it. Donors provide grants, loans, and equity for microfinance. Such support should be temporary. It should be used to build the capacity of microfinance providers; to develop supporting infrastructure like rating agencies, credit bureaus, and audit capacity; and to support experimentation. In some cases, serving sparse or difficult-to-reach populations can require longer-term donor support. Donors should try to integrate microfinance with the rest of the financial system. They should use experts with a track record of success when designing and implementing projects. They should set clear performance targets that must be met before funding is continued. Every project should have a realistic plan for reaching a point where the donor's support is no longer needed.

The key bottleneck is the shortage of strong institutions and managers. Microfinance is a specialized field that combines banking with social goals. Skills and systems need to be built at all levels: managers and information systems of microfinance institutions, central banks that regulate microfinance, other government agencies, and donors. Public and private investments in microfinance should focus on building this capacity, not just moving money.

Microfinance works best when it measures—and discloses—its performance. Accurate, standardized performance information is imperative, both financial information (e.g., interest rates, loan repayment, and cost recovery) and social information (e.g., number of clients reached and their poverty level). Donors, investors, banking supervisors, and customers need this information to judge their cost, risk, and return.

1.1.3 USAID Support in Kenya

USAID is one of the donor agencies in Kenya supporting the microfinance sub-sector. Others include the British Department for International Development (DFID), the European Union (EU), United Nations Development Program (UNDP), the Netherlands Embassy, Ford Foundation, CIDA, SIDA, World Bank, JICA, DANIDA, and GTZ.

The United States Agency for International Development (USAID) is an agency of the government of the United States of America that was established by President John F. Kennedy in 1961 to promote development around the globe (USAID/Kenya, 2001-2005

Strategy). Most of its activities are concentrated in third world countries where the need for assistance is greatest. The goal of USAID is to promote broad-based sustainable economic growth of these needy countries. To facilitate its work, USAID has fully established offices in each country of focus to design and implement programs that are consistent with the needs of that country. These offices are staffed with locally-hired personnel and with a small number of personnel seconded from USAID headquarters in Washington, D.C.

The partnership between United States and Kenya evolved in the 1950s when it became evident that Kenya was on the way to independence. The U.S. Government decided to devote resources and expertise available in the United States to support Kenya's development efforts. During the pre-independence period, about $8 million of assistance was provided. Of particular importance was the help in building the University College of East Africa (now the University of Nairobi) which was to provide education and expertise to future leaders of the country. In subsequent years, the U.S. Government consolidated most of its economic assistance program under USAID. USAID has provided significant, sustained assistance to Kenya since its independence in 1963. It has supported agricultural research, population & health programs, private sector programs (particularly trade policy reforms and microenterprise development), infrastructure development, natural resource conservation, and political reform programs. Through all the years, USAID continues to devise new programs and new implementation approaches that are responsive to the economic development priorities of the Kenyan Government. Thus, the partnership continues to evolve but the basic goal remains the same: a better life for all Kenyans.

1.2 Statement of the Research Problem

The most notable factor in the development of MFIs in Kenya is the involvement of donor agencies, both bilateral and multilateral development organizations. Rukwaro, (2001) in the study of credit rationing by MFIs found that 20% of MFIs obtained their lending capital from development agencies, 50% from internal operations, 25% from borrowing and 5% from members' deposits. It is noted further that internal operations involved operating revolving funds that were initially funded by donor agencies. The study also found that 75% of the MFIs reported that the donor agencies have pulled out of these institutions.

Also in another MFI survey study by Lennon and Rostal (2003), it was observed that future prospects for significant donor grant funding are virtually non-existent, many MFIs have opted toward pursuing some form of subsidized credit. However, in Kenya, as in most other countries, the supply of subsidized credit schemes is extremely limited. As such, the pipeline of inexpensive credit for MFIs cannot service the growing needs of a flourishing microfinance sector in which only 10% of MSEs have access to financial services (CBS, ICEG & K-Rep Holdings, 1999). As a result, many MFIs have gone commercial by sourcing, or attempting to source, growth capital at prevailing market rates through local banks. For most MFIs, this strategy is not sustainable. Given the conservative nature of the banking system and relatively short track records of MFIs, most banks have put into place excessive collateral requirements, and in the absence of hard collateral, these banks price most good deals out of the market.

Yet donor agencies, including USAID, consider microfinance as a powerful tool for alleviating poverty. To achieve this goal, USAID expect MFIs to have strong and effective management (including good leadership and skilled financial management), good governance, and the potential to reach both high levels of outreach and sustainability; to reach the maximum number of poor clients, microfinance has to be integrated into the country's mainstream financial system; building local institutions that provide services on a permanent basis; MFIs should charge interest rates that are well above average bank loan rates in order to cover their costs; role of government is to enable financial services, not to provide them directly; donor funds (grants, loans, and equity) for microfinance should complement private capital, not compete with it and such support should be temporary; the key bottleneck in microfinance is the shortage of strong institutions and managers – capacity building; and microfinance works best when MFIs measure and disclose their performance.

In light of these developments in the MFI sector and USAID expectations, it is important to investigate the USAID's funding strategy for MFIs and how its expectations influence the development strategy, the expectations of the supported MFIs and how they perceive the USAID support strategy.

1.3 Objectives of the Study

1. Establish how USAID's expectations influence its MFI development strategy for the sector in Kenya.
2. Identify the expectations/perceptions of MFIs supported by USAID.
3. Establish a comparison of USAID and MFI expectations.

1.4 Importance of the Study

There has been paucity of literature on the assistance strategies of donor agencies in the MFI sector in Kenya. Most researchers in this sector have studied the impact of credit on various economic variables like employment, increase in household incomes and enterprise output (Oketch, 1991; Coppers et al, 1991). Other scholars have studied the MFIs on the cost of various credit programs, sustainability development, training, technical assistance methodologies, number of clients reached, client drop out from MFIs and repayment rates (Khandker and Pitt, 1996; Gurgad, Pederson and Yaron, 1994; Yoder, 1993). More recent studies include credit rationing by MFIs (Rukwaro, 2001) and governance practices (Wainaina, 2002). The findings of this study will add to the existing literature on MSEs in the area of donor support for the MFI sector in Kenya.

Donor agencies have played a significant role in the development of the microfinance sector in Kenya over the last two decades. Therefore, in addition to adding to the literature available on donor funding strategies, the results of this study is to benefit a number of stakeholders, including:

The government in terms of policy formulation and charting a way forward for the development of the sector in relation to changing donor support.

Local strategic management researchers and scholars who would like to identify areas for further research in this sector.

MFIs to establish the funding criteria used by donor agencies and thereby enlightening them on what factors are important to access donor support.

The USAID management who will be interested in systematically following the evolving funding strategy for MFIs as one way of evaluating it and to inform future programming for the sector.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

As indicated in Chapter 1, microfinance is not a recent phenomenon. The need for financial intermediation targeting low-income people is an activity that has been in existence since the 1950's. Various strategies have been tried to extend resource-poor peoples' access to formal financial services a viable business. In this chapter, the results of the relevant literature review are presented. These include the history of the MFI development and why donor agencies stepped in; the demand for MFI services; an overview of the Kenya microfinance sector; legal issues of NGO MFIs; possible sources of financing for the microfinance sub-sector; the concept of strategy; and strategies for donor support of the microfinance sub-sector.

2.2 History of MFI Development

Mainstream financial institutions cannot easily serve microenterprises. Banks must process loans at a cost that can be covered by interest charges, and they must have confidence in the borrower's intent and ability to repay. The practices that most banks use to gain confidence in the quality of loans are expensive. They involve credit checks to gain information about a client's character, project appraisal to assess the client's business prospects, and formal collateral. These techniques cannot be used in microenterprise lending. Project appraisal is too expensive, microenterprises do not keep records. Microenterprises have no established credit rating. They lack marketable collateral. These factors keep commercial banks out of microenterprise lending (Otero & Ryhne, 1994).

In response, donor-funded programs have stepped in. Rather than adopting new methods for serving microenterprises, they have tended to use commercial bank methods that emphasize project appraisal while relaxing collateral requirements and charging low interest rates. The resulting combination of costly services, poor security, and low revenues require large subsidies. Such programs have constituted the major response of the formal sector to microenterprise credit needs.

On the savings side, many financial institutions provide deposit services to the poor. Commercial banks, government-owned post office banks, and other institutions take very small savings deposits. Few of these institutions return those deposits in the form of the loans to the communities or client groups from which they draw them, however. In Kenya, commercial banks, with their extensive branch networks, gather savings in remote areas and lend them mainly in Nairobi and other major cities. Thus, an imbalance often exits whereby the poor and microenterprises have greater access to savings than to credit services. Despite the wider availability of deposit services, however, large populations remain without such services or with services not adapted to their requirements.

An alternative source of both savings and credit for microenterprises is the informal financial sector. Informal systems are more available to microenterprises than are formal systems but are nevertheless regarded as inadequate due to their lack of depth of intermediation and very high interest rates. Informal financial flows that channel increased formal-sector liquidity into the microenterprise sector could serve as vehicles for financial deepening. That effect depends, however, on the existence of interactions between the formal and informal sectors. Further, a most commonly cited shortcoming of the informal financial sector is its segmentation from the financial mainstream, since much of its financial flow now enters the formal sector.

Similarly, flows of trade and supplier credit could reach microenterprises. The limited evidence from a variety of countries suggests, however, that the linkages between microenterprises and larger businesses are weak, accounting for only a small fraction of microenterprise sales. Although some researchers advocate building greater links between informal and formal markets, systematic methods for doing so have not evolved.

2.3 Demand for MFI Services

The vast majority of people in developing countries such as Kenya are small scale farmers, microentrepreneurs and casual income-earners. They constitute that part of the economy which lies outside the regulatory framework of the state and is referred to as the informal sector, or *Jua Kali*, or more recently also as the microenterprise sector or the microeconomy. Large numbers of people in that sector are poverty-stricken, poorly educated and without access to social and financial services (Drake, Deborah & Otero, 1992). Yet it is this informal sector which provides employment and income in the rural and urban and produces basic goods and services for an overgrowing population. Unlike its formal counterpart, the microenterprise sector relies on private initiative and market mechanisms, with the exception of those small segments that have been targeted by special programs.

Donor agencies have recognized the role of microenterprises in economic development and have provided a variety of support to facilitate the growth of the sector. In this regard, the cross-cutting issues in development that is of direct relevance to donor-supported microfinance programs include:

Poverty alleviation which raises the issue of banking with the micro-economy and the poor. The question then becomes whether microentrepreneurs and the poor are best served as beneficiaries of charitable social banking programs, or whether they are market segments yet to be developed for profitable banking. Depending on the answer, the choice of terminology will vary in terms of the poor vs. microentrepreneurs; beneficiaries vs. bank customers or clients; target groups vs. market segments or banking with the poor vs. local finance

Women in development has become another cross-cutting issue since the 1970's. Accordingly, the role of women in credit programs has gained increasing attention, resulting in a discussion of banking with women akin to that of banking with the poor. While there may be wide cultural variations among developing countries in patterns of labor division between the genders, it is both women and men who contribute, through income-generating activities, to the survival of their household economy and of the informal sector, with women frequently in a role of major providers of livelihood. Two major approaches have been identified; discriminatory approaches that target women directly and exclusively, attempting to offset the unusual discrimination in favor of men; and nondiscriminatory or integrated approaches, which aim at both women and men in a balanced way without any strong preferential treatment of either gender.

While some claims have recently been presented in favor of the latter approach, there is yet no clear picture of the overall evidence. As women have frequently turned out to be the better microsavers and microborrowers, many microfinance programs have evolved in the direction of increasing women participation.

Hitherto thought of as improvident, incapable of saving and investing and unable to organize themselves, it is now being realized that microentrepreneurs and the poor have a considerable capacity for self-help insofar as their propensity to save is high; they finance their microenterprises or other income-generating activities largely from their own resources; and they organize in numerous types of self-help groups, including business associations and informal financial institutions such as ROSCAs (rotating savings and credit associations). They are not passively waiting for government assistance. Left on their own initiative, they are doing their best to alleviate their poverty (Herwegen, 1987).

While merely forming an economy of survival in the poorer developing countries, the informal sector has not only persisted in the more successful ones but also demonstrated competitive strength and innovative capacity, plus a remarkable resilience in times of crisis, outperforming in some instances the formal sector. Many small and medium enterprises have originated in the microenterprise sector, which provides ample opportunities for on-the-job experimentation and training.

In light of the dismal picture of government interventions in the formal financial and economic sectors and the doubtful efficacy of many microenterprise and poverty programs, some have suggested that the informal sector with its microenterprises, self-help groups and the informal financial institutions be best left alone lest it loses its self-reliance and dynamism. Yet neglect, discrimination and outright repression of the microenterprise sector, which have variously characterized official stances in many countries, are not appropriate policies to harness that sector in the quest for progress. The pace of population growth, previous market distortions favoring the formal sector, increasing global interdependencies and the threat of mounting poverty do require policies and measures to create conducive frameworks and positively strengthening the small farm and microenterprise sector and its self-organized institutions.

With regard to the poorest of the poor, direct poverty lending may be required, but this does not have to be financially subsidized and yet can be highly effective on broadening scale. For those small scale farmers and microentrepreneurs who may be poor but not among the poorest of the poor, other approaches may be more appropriate. Yet regardless of the type of approach, a consensus is building up that microlending can be profitable banking and need not be relegated to marginal world of charity.

2.4 The Kenya Microfinance Sector

The Kenya microfinance sector consists of a large number competing institutions which vary in formality, commercial orientation, professionalism, visibility, size, geographical coverage, etc. These institutions range from informal organizations e.g. rotating savings and credit associations (ROSCAs), financial services associations (FSAs), savings and credit cooperatives (SACCOs), NGOs, to commercial banks that are downscaling (Aleke Dondo, 2003).

Table 2.a below outlines the distribution of formal microfinance institutions in Kenya as of June 2003.

Table 2.a: Types of formal microfinance institutions

Type of Organization	Number
Microfinance banks	1
Commercial banks downscaling	2
Microfinance NGOs	56
Companies limited by shares	2
Companies limited by guarantee	4
Building societies	2
Saccos	Over 3,200
Parastatals	2
Wholesale lending institutions	2
Joint Loan Board Schemes	20

Source: Dondo, Aleke (November 2003), an Overview of the Microfinance Industry in Kenya, a paper presented at the Kenya Institute of Bankers' Conference, Nairobi

Table 2.b is a summary of types of informal microfinance institutions

Table 2.b: Types of informal microfinance institutions

Type of Organization	Number
Financial service associations	71
Accumulating savings & credit associations (ASCAs)	Over 10,000
Rotating savings & credit associations (ROSCAs)	Over 30,000
Money lenders	Over 10,000

Source: Dondo, Aleke (November 2003), an Overview of the Microfinance Industry in Kenya, a paper presented at the Kenya Institute of Bankers' Conference, Nairobi

2.4.1 Features of the Kenya Microfinance Sector

Diverse legal forms in which the microfinance institutions are registered under 8 different Acts of parliament. These include banking, companies (limited liability companies, and companies limited by guarantee), NGO coordination, building societies, cooperatives, trustee, Kenya Post Office Savings Bank, Kenya Industrial Estates, and societies

Informal MFIs are also registered, though the legal status is feeble. MFIs such as FSAs, ASCAs, and ROSCAs are registered as self-help groups not by the registrar's office but by the ministry in charge of social services, currently ministry of gender, sports, and social services.

Outreach of MFIs in Kenya is extensive. As of June 30, 2003, outreach of leading MFIs was 1,357,168 borrowers and 3,846,635 savers. This is summarized in Table 2.c.

Table 2.c: Outreach of leading MFIs

Type of Organization	No. of Borrowers	No. of Savers
Commercial banks	48,166	111,520
Building societies	75,000	247,000
Limited liability companies	46,000	46,000
Companies limited by guarantee	96,952	96,952
NGO MFIs	34,865	35,163
Saccos	1,000,000	1,300,000
Kenya Post Office Savings Bank	-	2,010,000
Informal organizations	56,185	1,107,257
Total	1,357,168	3,846,635

Source: Dondo, Aleke (November 2003), an Overview of the Microfinance Industry in Kenya, a paper presented at the Kenya Institute of Bankers' Conference, Nairobi

Loans granted by MFIs have grown over the years as indicated in Table 2.d.

Table 2.d: Trends in outstanding portfolio (Ksh. millions)

Type of organization	1999	2000	2001	2002	2003
Commercial banks	278	392	821	1,329	1,483
Building societies	425	653	1,080	1,699	1,689
Limited liability companies	302	401	541	926	865
Companies limited by guarantee	321	505	754	1,015	1,192
NGO MFIs	36	56	94	131	154
Saccos	29,112	37,961	48,915	60,000	66,000
Total	30,474	39,968	52,205	65,100	71,383

Source: Dondo, Aleke (November 2003), an Overview of the Microfinance Industry in Kenya, a paper presented at the Kenya Institute of Bankers' Conference, Nairobi

Urban bias whereby most MFIs have operations only in urban areas. There is a limited rural reach by formal MFIs.

Products and services offered by the MFIs are mainly credit biased using individual and group-based lending methodology. Others include savings (voluntary and forced savings), micro-insurance, micro-leasing, money transfers, and remittances

Funding of NGO MFIs largely depends on donor funding; informal microfinance organizations rely on own capital; and MFIs registered as companies are increasingly relying on commercial capital.

2.4.2. Achievements of the Kenya Microfinance Sector in the last 5 years

Key achievements of the microfinance sector includes improved accessibility to financial services by low-income Kenyans – although the improvement has been rather slow;

Kenyan leading MFIs have maintained reasonably low default rates by international standards; the top 10 MFIs have an average default rate of 5% which compares very favorably with Kenyan commercial banks that have an average rate of 35%; formation of an association of microfinance institutions; drafting of the microfinance bill; successful transformation of one NGO MFI to a microfinance bank regulated under the Banking Act; successful transformation of two building societies to microfinance institutions; downscaling of two commercial banks; commercial banks lending to MFIs; establishment of three wholesale lending organizations; large reservoir of well trained microfinance professionals whose potential in being used in the sub-Saharan Africa; and increased recognition of the role of microfinance in economic development by Kenyan government and other stakeholders.

2.5 Legal Issues of NGO MFIs

Microfinance service providers include a range of institutions that use specialized methods to serve their particular market niches. These can include commercial and development banks, credit unions (Saccos), mutual or community banks, non-governmental organizations (NGOs), finance companies, savings and credit associations, and other specialized intermediaries. While many of these institutions have legal ownership structures, NGOs are established as non-profit organizations. Its formal status should be such that the institution has an existence and a stability of its own, i.e., is to a certain degree independent of the people behind it, and is legally in a position to conduct serious lending business and receive donations from foreign institutions. These are therefore registered under the NGO Coordination Act. There are of course well known problems with NGOs. A general weakness of this legal form is that an NGO does not have a formal owner and therefore always runs a risk that no one will feel fully responsible for its survival. The incentives to ensure its efficiency and growth are notoriously weak. However, if the internal structure of an NGO is designed carefully, these form of institutions have provided financial services to target groups more effectively (Seibel, 1996).

2.6 Possible Sources of Financing for the Microfinance Sub-sector

2.6.1 Bilateral Agencies

Bilateral capital funding often involves government-to-government support for targeted development projects. While the loans and grants may be from one government to another, in practice they are provided or lent on to specific institutions undertaking the identified development initiative. MFIs have benefited from technical and financial assistance provided through agencies established by bilateral donors. These agencies provide grants and concessional loans to support specific programs and projects. The largest contributors to bilateral development assistance are Japan, the United States, France, Germany, the United Kingdom, Netherlands, Sweden, Belgium and Denmark.

Other bilateral funding may be direct loans to private companies from official export credit agencies. Export credits should usually be viewed as supplements to larger financing packages, filling gaps in financing or assuming risks best covered by government agencies. These agencies provide a special form of direct bilateral loan made with a small initiation fee for a specific industry development. The loan usually bears no interest, is amortized over a long period, and may allow a grace period before repayment, which may be in a lump sum.

2.6.2 Multilateral Banks

These banks are international organizations formed by governments to fund development. The multilateral financial institutions also fulfill a vital catalytic role, far exceeding the value of their direct financing or co-financing support, Consultative Group to Assist the Poor (2003). Multilateral bank supports MFIs through equity investment or grant funding channeled via a multi-donor agency such as CGAP. For example, the International Finance Corporation (IFC), which is part of the World Bank Group, has invested in a number of MFIs through equity holding. The World Bank requires a government guarantee for repayment of its loan. Thus, its loans are normally made to governments and government facilities. The World Bank assists Private sector financing of projects through financing of public sector shares in joint ventures through its guarantee instruments. In certain cases, arrangements are made for the World Bank loans to support private investments through government - affiliated intermediaries.

2.6.3 Debt Financing

In debt financing, money can be borrowed from external sources, either through direct loans from commercial banks or capital markets (bonds, debentures). The top five MFIs in Kenya have accessed at least one form of debt finance, from subsidized to commercial credit, to meet their portfolio growth requirements. One MFI is presently considering issuing a bond to be underwritten by an international bank and guaranteed by a donor agency. Debt financing is generally an expeditious and flexible method of raising capital for financing strong MFIs. However, for most MFIs this financing strategy is not sustainable. Given the conservative nature of the banking system and relatively short track records of MFIs, most banks have put into place excessive collateral requirements, and in the absence of hard collateral, these banks price most good deals out of the market. For example, unsecured credit is priced at 20 percent or more, and a fully collateralized loan is priced at 10 percent with zero leverage. In the latter case, cash is deposited at the bank, and then the bank relends the deposited amount back to the MFI with the loan to value ratio at 100 percent (no leverage).

2.6.4 Equity Investments

Equity can be raised in the capital markets by public offering of the shares of the MFI or through private placement of the shares of the MFI with individual or institutional investors. Public offering of equity shares requires approval from relevant authorities. No MFI in Kenya has raised equity capital through the stock market. K-Rep Bank raised equity capital through private placement of its shares with institutional investors including IFC. Equity investment is an important part of most private sector involvement in MFI business. These investments can be made by local investors, foreign direct investors, and portfolio investors and managers, including equity funds.

2.6.5 Self Finance

Self-finance is reinvestment of internal funds earned through operations. Most MFIs use internally generated funds, or retained earnings, to finance their operations. Self-finance is usually an important part of the complete financing package for an MFI that is seeking external resources to expand its operations or start a specific project. A number of funding agencies, especially bilateral donors requires at least 25 percent self-finance of the capital cost for the projects that they support.

2.6.6 Deposits

For many years, development finance efforts were geared exclusively to providing credit to borrowers in developing countries and to finding means to channel loans to borrowers. This situation has changed during the last decade. Savings in the double sense of providing deposit facilities to the target groups and of mobilizing funds which financial institutions can employ for their lending business is no longer "the forgotten half" of development finance (Reinhard H. Schmidt & C.P. Zeitinger, 1994). Savings is considered the cheapest source of lending capital for MFIs. However, MFIs requires to be regulated or registered in order to mobilize savings for their lending business.

2.6.7 Sovereign Finance

Sovereign finance is capital supplied by the host government of the country in which the MFI operates. This is normally the case for microfinance services provided by parastatals such as Kenya Industrial Estates. The host government may raise capital by borrowing or obtaining it from taxes. In other cases, it may borrow or receive grants from multilateral or bilateral organizations. A special role of sovereign finance occurs when a government guarantees commercial loans. This puts the risk of succession on the government yet assures adequate access to capital for the MFI entity.

2.6.8 Project Finance

This is a form of medium term borrowing that has been developed for a particular purpose. The underlying idea behind this type of finance is that the security against which the funds are advanced is the project rather than the standing or potential of the borrower, or an asset of the business. Samuel's, Wilkers and Brayshaws (1995). Project financing is defined as where the source of the repayment is the expected revenue from the project and does not rely on the credit of the sponsors or the underlying value of the project assets. Project financing lenders are generally willing to take term risk. They are willing to accept that payments may be delayed or may not be on a strictly contractual schedule. However, what project financing lenders are unwilling to accept is the principal risk, the risk that because of the project structure or the industry characteristics, there is a real potential that they may not be repaid at all.

Project finance has been used to finance various development projects. The project sponsors contribute equity, Eugene and Gapenski (1996). The assets and cash flow of the project itself secure debt, not the sponsors other available resources. Since the repayment of the loan is primarily dependent on the success of the project, lenders pay close attention to project risks. In terms of raising project finance, the African market is now relatively well positioned. Project finance is being used to build power plants in many countries, it involves setting up an independent entity to serve as the builder, owner, and or operator of the power facility, Jones (1996). The intent is to create revenue generating project entity that operates profitably under market economy conditions and has no interference from the host country. A portion of the revenue stream from the project is then dedicated to repaying the debt. Project finance has not been used in the MFI sector but the likelihood is high.

In any project financing, the political risks are a wider concern because there are not only areas where political actions or events could endanger loan repayment and recovery, but there are also many political risk arrears where the government, municipalities and their various agencies are either directly or indirectly involved in the project or at least have an interest in the project. Project finance vendors charge high interest of at least 10% to cushion themselves against commercial and political risks. The International Finance Corporation (IFC), a unit of the World Bank dealing with private sector funding, is one of the major sources of project finance.

2.7 The Concept of Strategy

Strategy is the match between an organization's resources and skills and the environmental opportunities and risks it faces and the purposes it wishes to accomplish (Schendel & Hofer 1979:11). It is meant to provide guidance and direction for the activities of the organization. This idea is in line with Ansoff's (1965) view that strategy is the "common thread" among an organization's activities and product/markets that defined the essential nature of the business that the organization was in and planned to be in the future. It is a pattern of decisions in a company that determines and reveals its objectives, purposes or goals, produces the principal policies and plans for achieving those goals (Andrews 1987).

The major tasks of managers is to assure success (and therefore) survival of the companies they manage. In order to achieve success the companies have to adequately adjust to meet environmental challenges. Failure to do this will cause the company to experience a big strategic problem. This problem arises out of the mismatch between the output of the company and the demand in the market place. Strategy is useful in helping mangers tackle the potential problems that face their companies (Aosa 1998). Strategy is a tool, which offers significant help for coping with turbulence confronted by business firms. It therefore merits serious attention as a managerial tool, not only for the firm but also for a broad spectrum of social organizations (Ansoff 1990). If the concept of strategy is to be of value, correct strategies have to be formulated and implemented, a process known as strategic management.

2.7.1 Donor Agencies, MFIs and Strategic Management

Strategic management which is concerned with arriving at decisions on what the organization ought to be doing and where it ought to be going, is important in helping managers ensure survival of their organization (Howe 1993). Teece (1984:87) define it as the on going process of ensuring a competitively superior fit between the organization and its ever-changing environment. Pearce & Robinson (1997) look at strategic management as the formulation, implementation, control and evaluation of business strategies to achieve future objectives.

However defined, strategic management includes all of the activities that lead to the definition of the organization's objectives and to the development of programs, actions and strategies to accomplish these set objectives. It provides the basic direction and framework within which all organizational activities take place.

Donor agencies and MFIs undertake strategic planning periodically to ensure that the development programs and business they undertake fit or match the ever-changing environment in order to realize their missions. There are many internal and external factors that affect the environment in which these institutions operate and therefore the need for strategic management. For example, the economic and political environment influences the level of funding provided by the donor agencies. Most of these agencies, including USAID, base their funding decisions to a country's economic and political reforms. If performance in relation to the conditionalities set by donors is poor, then the overall level of funds inflow into the country is affected, and therefore, funding available for microfinance activities. Donors are faced with multiple and often competing development assistance needs. Microfinance is not the only area of development assistance. Donor priorities keep changing depending on many factors, and this affects funds allocated for specific activities. Markets are dynamic and constantly require assessment to establish the need for donor interventions, and also to ensure that funded programs enhances further market development.

MFIs on the other hand are faced with increasing competition as more and more providers come into the market place. The customer needs are changing rapidly and the push by the government to go into rural areas where the need for microfinance is greatest. As the MFIs are growing, increased human and systems capacity is required. These needs change overtime and necessitate constant skills upscaling, as the MFIs' businesses grow and become evermore sophisticated. With this growth and sophistication, internal systems and controls need upgrading. As systems are upgraded, management and their direct reports require training and additional upscaling. Donor funds are becoming scarce and therefore the need to diversify sources of funding. The legal and regulatory framework is being developed and this will change the environment microfinance activities operate.

Therefore, as Hoffman and Hagarty (1989) noted, the very emergence of strategic management was out of necessity. Managers have been faced with the need to adapt increasingly complex organizations to rapidly changing environments. Strategic management helps organizations cope with the dynamic environment, which they face. It is an invaluable tool for any organization to ignore.

2.8 Strategies for Donor Support

A Committee of Donor Agencies for Small Enterprise Development and Donor's Working Group on Financial Sector Development, developed Donor Guidelines for Microfinance International Best Practices. The World Bank Private Sector Development serves as the secretariat. The guidelines were adopted in June 1995. The purpose of the principles is to establish common standards for donor agencies to apply in supporting broader access to financial services for micro and small enterprises. In establishing the principles, it was observed that funding based on large, ongoing subsidies with a charity rationale has failed. Such programs have drained resources without becoming sustainable, and have contributed to the mistaken notion that the poor are unbankable. Funders should provide financial and other support in forms that foster the movement to scale, financial self-sufficiency, and independence from donor support, taking into account the particular characteristics of different types of institutions (CGAP, 1995).

2.8.1 Appropriate Uses for Grants

Support for institutional development is appropriate at all stages of an institution's life, and for a wide range of institutions, although the nature and extent of such support should evolve with the institution. Such support should become more selective, as institutions become able to meet more of their organizational development needs from within. It should also become more specialized, as institutions tackle more difficult problems.

Capitalization, or grants for equity are of strategic importance in enabling organizations to build a capital base. Capitalization can be used to generate investment income, build the loan portfolio, and leverage funds from local banks. One of the key purposes of providing capital funding is to enable institutions to mix costs of grant funds with commercial sources during the period it takes to build efficient operations and scale (Seibel, 1996). Externally-financed capitalization should be used as a catalyst and complement to domestic mobilization of funds by local institutions. Grant equity contributions can also help institutions seeking to become formal financial intermediaries to meet minimum capital requirements.

Operating losses may be very high for some MFIs. However, donors should avoid covering operating losses except during a clear, time-limited start-up or expansion phase. By the nature of the small loan business every program will take some time to reach a break even point. Donors should be willing to provide support during that time. Afterwards, however, such support becomes counterproductive.

Fixed assets are necessary for any organization, including MFIs. Donors may wish to support purchase of fixed assets, such as computers, vehicles or premises. Such funding may be seen as contributions to the equity base of the institution.

2.8.2 Appropriate Uses of Loans

Donor support through loans is appropriate for lending-based institutions that meet performance standards. However, loan capital from local and commercial sources should be sought as early as possible, even at start-up. Care should be taken to avoid burdening young institutions with foreign exchange risk in loans denominated in foreign currency, unless adequate precautions are taken. Donors are also advised to be careful not to undermine savings mobilization efforts of savings-based institutions, such as savings and credit associations by making loans available to them below the cost of mobilizing funds in the local financial markets.

2.8.3 Commercial Sourcing of Funds

The transition to fully commercial sources of funding requires special forms of support that help introduce institutions to the financial system. Donors can act as catalysts to effect this transition through means such as investor equity, from both official and private sources in which donor support can help leverage private investment; second-tier operations, which raise funds from commercial sources and on-lend to microenterprise finance institutions; and partial guarantees of loans made by commercial banks to MFIs.

2.8.4 Coherence of Donor Policies

Institutions following sound principles for sustainability must not be undermined by others providing competing services below cost or in ways that cannot be sustained. When providing subsidies (grant or loan) to small and microenterprise institutions, donors should ensure that they coordinate that support with other funders, such that institutions are given clear incentives to become financially viable. In particular, donors need to consult each other regarding appropriate interest rates and other terms on which assistance to any given institution is supplied (CGAP Donor Brief No. 1, 2002). Donors should also coordinate institutional support with sectoral policies such that financial institutions, including informal and semi-formal sectors, find enabling conditions for institutional development and growth.

2.8.5 Donor Selection Criteria

The following identifies characteristics donors seek in selecting institutions to support. Intermediaries seeking support should be able to demonstrate the following institutional performance standards and plans characteristics, either in current operations or through credible plans underpinned by concrete measures. Since institutions are at different stages of development, it may be appropriate in some cases to adopt modified standards for limited support to new or transforming institutions.

2.8.5.1 Institutional Strengths

Institutional culture, structures, capacities, and operating systems that can support sustained service delivery to a significant and growing number of low-income clients. Requirements include a sound governing structure, freedom from political interference, good fit to local context, competent and stable staff, a strong business plan for expansion and sustainability, and mission and vision which create a sense of purpose, ownership, and accountability (Pattern & Rosengard, 1991).

Accurate management information systems that are actively used to make decisions, motivate performance and provide accountability for funds. Such systems are essential for effective and efficient management.

Operations that manage small transactions efficiently, with high productivity, as measured by variables such as loans per staff and operating costs as a percentage of average annual portfolio (while maintaining portfolio soundness).

Meaningful reporting standards. Transparent financial reporting that conforms to international standards and allows prospective funders to evaluate performance adequately. At a minimum, the raw data listed in the Annex should be reported, and institutions should regularly monitor financial condition using appropriate financial ratios derived from such data.

2.8.5.2 Quality of Services and Outreach

Focus on the poor. Evidence of services to low-income clients, women and men especially clients lacking access to other financial institutions. The focus need not be exclusive, as mainstream institutions such as banks are encouraged to become providers, but it must entail a distinct commitment to reaching the poor.

Client-appropriate lending. For example, for micro-level clients, institutions should feature quick, simple and convenient access to small, short-term loans, often short-term, that are renewed or increased based on excellent repayments. Use of collateral substitutes (e.g., peer guarantees or repayment incentives) or alternative forms of collateral to motivate repayment. Emphasis on character-based lending for smaller loans, with simple cashflow and project appraisal for larger and longer term loans.

Savings services. Offering savings mobilization services, where legally possible and economically feasible, that facilitate small deposits, convenient collections, safety, and ready access to funds either independently or with another institution. Growth of outreach. Making significant progress in expanding client outreach and market penetration, demonstrating both strong client response to services offered and competence in service delivery management.

2.8.5.3 Financial Performance

Appropriate pricing policies. Offering loans at rates sufficient eventually to cover the full costs of efficient lending on a sustainable basis (after a reasonable start-up period), recognizing that poor entrepreneurs are able and willing to pay what it costs an efficient lender to provide sustainable financial services. Interest charges by the retail unit should be set to cover the costs of capital (at the opportunity cost, including inflation), administration, loan losses and a minimum return on equity (CGAP, 1999).

Portfolio quality. Maintaining a portfolio with arrears low enough that late payments and defaults do not threaten the ongoing viability of the institution. For example, organizations with loans in arrears over 30 days below 10% of loans outstanding and annual loan losses under 4% of loans outstanding satisfy this condition.

Self-sufficiency. Steadily reducing dependence on subsidies in order to move toward financial self-sufficiency. Achieving operational efficiency, i.e., covering all administrative costs and loan losses with client revenues within a reasonable time period, given local conditions. International experience shows that successful intermediaries have achieved operational efficiency in three to seven years, and full self-sufficiency, i.e., covering all financing costs at non-subsidized rates within five to ten years.

Movement toward financial independence. Building a solid and growing funding base with clear business plans, backed by operational capacities, that lead to mobilization of commercial funds from depositors and the financial system, and eventually to full independence from donor support.

Financial performance standards apply only to activities that are an integral part of providing financial services. If programs also provide non-financial services, such as business advisory services, health, or education they must account for such services separately from financial services. Standards for financial self-sufficiency do not apply to such services, and defining appropriate standards for non-financial services is beyond the scope of this study.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Research Design

The research design is a combination of a case study and survey. It is a case study design where the unit of study is the U.S. Agency for International Development (USAID) and a survey for MFIs that have been supported by USAID. USAID is a leading international development agency that may be typical in its class of organizations in Kenya.

Case study designs are most appropriate when detailed analysis for a single unit of study is desired. Case studies do provide very focused and valuable insights to phenomena that may otherwise be vaguely known or understood. Therefore, since this is an analytical study, hard facts were used to conduct the research.

3.2 Population and Sample

USAID is the unit of the study and 7 MFIs that have received direct support from the organization. Sampling was not necessary for the MFIs surveyed due to the small size of the population.

3.3 Data Collection

The study involved collecting primary data through personal interviews of 7 officials involved in the USAID's strategic formulation, design of programs, implementation, and project evaluation. These are the country director, assistant director who is also responsible for program design and development, the division director for agriculture and microenterprise development, enterprise development officer, the director of financial management, the regional contracting officer, and the evaluation & monitoring officer. Also primary data was collected from 7 MFIs that have received support from USAID. Questions that were designed to obtain data from USAID officials and supported MFIs are contained in Appendix I and Appendix II respectively.

Secondary data was obtained from reports that are prepared by USAID and consultants engaged to carry out specific assignments such as project design and evaluation. The strategic plan papers were useful analysis documentation in this study. Also performance and evaluation reports of USAID-supported institutions were useful for the study. The secondary data was used to (a) identify a thematic development of the USAID support to the MFI sector in Kenya, and (b) establish the evolvement of the USAID funding strategy for MFI development.

3.4 Data Analysis

The primary and secondary data collected was largely qualitative. Content analysis was best-suited method of analysis for data obtained from secondary sources. Nachmias and Nachmias (1996) define content analysis as a technique for making inferences by systematically and objectively identifying specified characteristics of messages and using the same to relate trends. This approach has been used previously in similar research papers like the one by Koigi (2002). Strauss and Corbin (1990) do back use of qualitative data. They argue that the method is scientific as the data collected can be developed and be verified through systematic analysis. The qualitative method can be used to uncover and understand what lies behind a phenomenon under study. It can also be used to gain quite some fresh material even in what was thought to be known. The stated aim of the data analysis is to treat evidence fairly by relating casual relationships to produce compelling analytic conclusions that rule out alternative interpretations i.e. can stand reliability tests.

Descriptive analysis was used to analyze the data received from MFIs funded by USAID. This involved descriptive tools such as percentages and frequency distribution. This method was used by Muturi (2000). Descriptive statistics was also used to facilitate analysis of agreement or disagreement on donor's and MFIs' expectations in their relationship. The findings were summarized to include the expectations of the MFIs with a view to getting a conclusive answer to the study problem. The strategies that USAID used for funding MFIs have been documented.

CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND DISCUSSIONS

4.1 Introduction

This chapter presents and discusses the findings of the study. The results are organized on the basis of the objectives of the study. Incorporated in the body of the research findings is also supplementary data gathered through the unstructured interview and secondary data. The main thrust of this study is to establish how USAID's expectations influence its MFI development strategy, the expectations of the USAID-funded MFIs, and carrying out a comparison of USAID-MFI expectations and how they perceive the USAID support strategy. To achieve the objectives of this study, data for this analysis was obtained by interviewing 7 officials of USAID and responses received to the study's questionnaire circulated to 7 MFIs that have received direct support from USAID. The response rate in each category of respondents was 100%. Except for one MFI, the questionnaire was completed by the chief executive officers of these institutions.

4.2 Respondent Characteristics

4.2.1 USAID Officials

The USAID officials interviewed in the study were selected due to their knowledge and involvement in microfinance programs. The 7 officials had an average of 18 years working experience in development programs. Of these officials, 43% are Kenyans and 57% are Americans. The Americans had an average of 3 years working experience in Kenya compared to 15 years for Kenyans working for USAID in Nairobi. These officials have diverse professional background including economics, law, development finance and accounting.

4.2.2 MFIs Surveyed

Except for one, all MFIs surveyed have provided microfinance services for over 10 years. All the MFIs surveyed prepare period strategic plans.

4.2.2.1 Registration

As shown in Table 4.a, the majority (43%) of MFIs surveyed are companies limited by guarantee, 29% are companies limited by shares and are licensed as commercial banks, while 14% are companies limited by shares and 14% are NGOs.

Table 4.a: Registration of surveyed MFIs

Registration	Freq.	%
NGO	1	14
Company limited by guarantee	3	43
Company limited by shares	1	14
Company limited by shares (licensed as commercial bank)	2	29
Total	7	100

Source: Research Data

4.2.2.2 Lending Methodology

As shown in Table 4.b above, most of the USAID-funded MFIs use both individual and group lending methodology.

Table 4.b: Lending approaches

Lending type	Number of MFIs	%
Individual lending only	1	14
Group lending only	1	14
Individual & group	5	72

Source: Research Data

4.2.2.3 Services Rendered

As indicated in Table 4.c below, all the MFIs surveyed provide credit and savings services. However, 86% offer forced savings, a requirement that clients must satisfy before receiving a loan.

Table 4.c: Services offered

Services offered	Number of MFIs	%
Credit	7	100%
Voluntary savings	2	29%
Forced savings	6	86%
Micro-insurance	3	43%
Micro-leasing	2	29%
Money transfers	3	43%
Other financial services	2	29%

Source: Research Data

4.2.2.4 MFIs Strategy for Raising Lending and Capacity Building Funds

The 7 MFIs surveyed had received Ksh.2,111,203,778 in the form of grants for lending capital and capacity building during the last ten years. Ksh.1,413,234,883 (67%) was provided by bilateral donor agencies. Table 4.d and Table 4.e shows the source and proportion of lending capital and capacity building funds.

Table 4.d: Sources of lending capital

Source	Number of MFIs	%
Bilateral agencies	5	45
Multilateral agencies	1	3
Debt financing	4	15
Equity investment	2	10
Self-finance	7	6
Deposits[1]	2	20
Sovereign finance	2	2
Project finance	None	-

Source: Research Data

Table 4.e: Sources of capacity building funds

Source	Number of MFIs	%
Bilateral agencies	6	91
Self-finance	7	7
Sovereign finance	1	2

Source: Research Data

It is evident from the information in the above two tables that bilateral donors have provided most of the MFI lending capital (45%) and almost full-financed (91%) capacity building needs of these institutions. Deposits from the public provided 20% of the lending capital and therefore demonstrating the importance of this source of funds. Debt financing provide 15% of the needed lending capital. Debt financing is significant for non-deposit taking MFIs.

[1] Three MFIs anticipate converting to regulated service providers after the enactment of the Microfinance Bill to allow them take deposits from the public.

4.3 USAID MFI Development Strategy

Strategy is the match between an organization's resources and skills and the environmental opportunities and risks it faces and the purposes it wishes to accomplish (Schendel & Hofer 1979:11). It is meant to provide guidance and direction for the activities of the organization. Therefore, the USAID MFI development strategy is a guide to ensure that the development programs in the MFI sector fit or match the ever-changing environment in order to promote access to sustainable financial services for the poor and low-income people who are excluded from the formal mainstream financial institutions in Kenya.

4.3.1 USAID Support to the MFI Sector

USAID started providing assistance to the Kenya microfinance sector in 1984 through the Rural Enterprise Program (REP). REP was created as a means to strengthen and finance NGOs that deliver financial and non-financial services to the informal or microenterprise sector. REP which later made a transformation into an NGO was the primary vehicle of channeling USAID assistance to the sector. Two overlapping funding agreements were made under the Rural Enterprise Program. The first agreement provided $7.7 million between 1984 and1991. The second agreement provided $5.9 million from 1987 to 1994. Between 1984 and 1990, 12 NGOs received grants under REP to establish revolving credit funds and over 20 NGOs received technical assistance and training. These organizations included grassroots business associations such as community-based enterprises and ROSCAs.

According to the annual USAID Microenterprise Results Reports, the Agency provided $9.2 million during the period 1995 to 2003 to 10 organizations for microfinance activities in Kenya. Of these organizations, 10 are MFIs, 2 are consulting firms and 1 is an association of MFIs. Most of these organizations were identified for support on a competitive basis. The activities supported include funds for on-lending, research & product development, human resource development, management information systems, strategic planning, MFI policy formulation & advocacy, operational systems development and strengthening, institutional assessments, dissemination of microfinance best practices, and governance and management strengthening.

4.3.2 Historical USAID MFI Development Strategy

There are two distinct historical USAID MFI development strategy in Kenya. The first phase covered the period from early 1980's to 1995. This period of the strategy was described as the formation program phase. The phase aimed to integrate highly disadvantaged groups or individuals into the microenterprise sector. During this phase, microfinance was considered a new development phenomenon in Kenya. The focus of the strategy was to finance micro-credit NGOs that used the group lending methodology to reach members of the society not served by the formal financial system. The strategy was characterized by the following: type of institutions supported – NGOs and self-help groups; extensive use of grants to cover institutional development, capitalization, operating losses, and fixed assets; no use of loans for lending capital; selection criteria focused more on evidence of service to low-income clients rather than institutional strengths and financial performance.

During the first phase, the USAID microenterprise/microfinance program was implemented through an umbrella NGO that was responsible for identification of recipient organizations and monitoring of results.

The second phase of the historical USAID MFI development strategy in Kenya covered the period 1996 to 2000. This phase was described as expansion program phase in which the focus was to assist microentrepreneurs to expand their operations. The strategy was to diversify support to a range of microfinance service providers. This phase was characterized by the following: type of institutions supported – NGOs, commercial banks, savings and credit cooperatives and other service providers; use of grants to cover institutional development and fixed assets, limited use of grants for capitalization and no funding to cover operating losses; the use of loans for lending capital was encouraged and facilitated as appropriate; selection criteria focused more heavily on quality of services and outreach, institutional strengths and financial performance.

During this phase, there was a major shift in the implementation approach of the microfinance program in which USAID started working directly with each individual MFI unlike in the first phase.

4.3.3 Current USAID MFI Development Strategy

The current strategy is described as transformation program phase in which the focus is to seek to graduate enterprises from micro to small enterprise, or informal to formal sector level. The support strategy targets high potential MFIs that can reach scale and financial sustainability; MFI transformation into regulated providers while also building the industry infrastructure to enable these new class of institutions play an efficient and effective financial intermediation; support innovation making financial accessible to underserved markets; and support policy environment that is conducive to microfinance development. This phase is characterized by the following: type of institutions supported – NGOs, SACCOs, commercial banks, and industry level institutions including the association of microfinance institutions, supervisory and regulatory agencies, and the government; limited use of grants to cover institutional development of industry level institutions and technical support for MFIs seeking to transform into regulated institutions; the use of loans is the only option for MFIs to secure lending capital facilitated by USAID; selection criteria for MFIs includes quality of services and outreach, institutional strengths and profitability; but industry level institutions are identified through market assessments taking into consideration their developmental role.

4.3.4 Choice of Interventions

The interventions supported by USAID are determined on the basis of the market needs but they have to be within the strategy as outlined in the preceding paragraphs. In general, these include: Start up - grants to start ups, support to range of diverse actors, industry wide-capacity building, training, and policy. Expansion - loan capital to lead MFIs, new players, technical assistance (internal controls, information and communication systems, management strengthening), support for microfinance associations, policy. Competition - new product development (savings, leasing, health insurance, agricultural credit), reaching rural and underserved markets, assist to leverage commercial capital through partial guarantees to financial institutions, regulation and supervision. Maturity - policy, commercialization support, creation of credit bureaus, appropriate collateral law, consumer protection, phase out of direct subsidy support.

4.3.5 Strategy Formulation Process

USAID MFI development strategy has been developed following the donor guidelines for microfinance international best practices. The strategy is developed in a consultative, open and transparent approach. It involves a cross-section of local and external experts, including stakeholders such as MFIs, donor agencies, government, USAID management and technical staff, private sector entities, businessmen, and representatives of the MSE sector. The process is very elaborate and involves analytical studies, substantive dialogue through many meetings and brainstorming sessions. All the MFIs surveyed as part of this study are aware that USAID has an MFI strategy. They have been involved in the USAID policy and strategy formulation: policy and strategy workshops, MFI market survey, partners meetings, and local network meetings. The MFIs have had a relationship with USAID starting 1984 to present. They have received support from USAID for on-lending capital and various forms of capacity building support.

4.3.6 USAID's Expectations and their Influence on the MFI Strategy

USAID supports microfinance as a tool to alleviate poverty in which poor households are moved from everyday survival to planning for the future by providing a vehicle for investing in better nutrition, housing, health, and education. The USAID's expectations to realize this goal are largely the same as those outlined in paragraph 1.1.2. These expectations have a major impact on the USAID MFI development strategy as follows:

USAID expects MFIs to have strong and effective management (including good leadership and skilled financial management), good governance, and the potential to reach high levels of outreach and sustainability, a key expectation by USAID and it is confirmed by the fact that all USAID-funded MFIs are among the top ten leading institutions in the sector. Mainstreaming microfinance is the focus of the present strategy in which USAID will provide technical assistance for those MFIs seeking transformation to regulated service providers upon the enactment of the Microfinance Bill. USAID expects that finance for the poor requires domestic institutions that provide services on a permanent basis and the support strategy targets these institutions. USAID expects MFIs to have interest rates policy in which the rates charged cover their costs, but the MFI should not use high interest rates to make borrowers cover the cost of its own inefficiency. The interest rate policy is integrated into the MFI selection criteria. USAID expects that the role of government is to enable financial services, not to provide them directly. There is a specific program working with the government to address policy issues facing the MSE sector and to create an enabling environment for MFIs. USAID expects that donor funds should complement private capital, not compete with it and such support should be temporary. This expectation is pivotal in the design of the strategy that has a phase-out approach for grant funding, especially lending capital. USAID MFI strategy clearly recognizes that the key bottleneck in microfinance is the shortage of strong institutions and managers and hence capacity building is a major focus of the support. USAID also expects MFIs to adhere to performance measurement requirements including period reporting.

4.3.7 Impact of USAID Supported MFIs

As shown in Table 4.f, the survey of the USAID-supported MFIs shows that both the number of borrowers and savers have grown; thus, more economically disadvantaged populations, including the working poor, have increased access to economic opportunities and financial services. Profitability has improved as demonstrated through solid achievements in most financial performance indicators, such as operating efficiency, return on equity, and return on assets. Of the surveyed MFIs, 43% have accessed at least one form of debt finance, from subsidized to commercial credit, to meet their portfolio growth requirements. The MFIs are using internally generated funds, or retained earnings, to finance a portion of their capacity building needs using a range of local business service providers from low-end training firms to high-end specialized consulting businesses. The MFIs are lobbying the changing needs of the sector before the government, and they have been instrumental in securing the support of the Government of Kenya with the Microfinance Bill.

Table 4.f: Key performance indicators of the surveyed MFIs as of December 2003

Indicator	Performance
1. Total portfolio (Ksh.)	3.62 billion
2. Total number of clients	230,932
3. Total number of employees	937
4. Operational self-sufficiency (% - average)	119
5. Financial self-sufficiency[2] (% - average)	85

Source: Research Data

From the above analysis, it is evident that USAID has a clear and consistent MFI development strategy that has evolved over time. The strategy is influenced by many

[2] Two MFIs have less than 10% financial self-sufficiency. One is due to low level operations and the other is primarily a research and innovation organization. It focuses on the development, testing, promoting and adoption of appropriate microfinance products and services for improving the accessibility of financial services to low-income people.

expectations including potential to reach both high levels of outreach and sustainability, strong and effective management of MFIs (includes good leadership and skilled financial management), and good governance. But USAID support is only temporary and its meant to demonstrate the potential and profitability of financial intermediation for low-income people. USAID grant funding for capitalization is almost non-existent at the present time and, therefore, MFIs have to look for financing from sustainable sources. It is evident that MFIs that expect to receive support from USAID must demonstrate high chances of achieving sustainability within a limited period of time.

4.4 MFI Expectations of USAID Support

MFI development in Kenya, as elsewhere in the world, is heavily donor dependent. However, donor funds and concessional finance are limited and not dependable in the long-term. There is a general consensus in the microfinance community that if MFIs are to grow enough to reach, on a long-term basis, the millions of low income people without access to financial services, they need access to more sustainable sources of finance to support their development. These will have to include private sources of debt and equity and savings. In this section, the study focuses on identifying expectations of the MFIs supported by USAID, how the expectations have influenced their present and future financing strategies.

The MFIs surveyed have a strong expectation to become sustainable and expand services to reach majority of low-income Kenyans. However, lack of funding is regarded as a major constraint to growth by many MFIs. A total of 71% of surveyed MFIs (primarily NGO MFIs) identified lack of available funding as the factor most likely to stand in their way of achieving sustainability, and hence realizing their growth and development goals.

A total of 86% of the surveyed MFI have their mission to empower low-income people through providing financial services and hence contribution to poverty alleviation, while 14% of the MFIs consider wealth creation as a better means to realize the same goal.

The support from USAID to enhance good governance and best management practices are key expectations mentioned by all the MFIs. The MFIs recognize that these elements are not only a critical requirement by USAID but also private funders and their clients.

All the MFIs surveyed expects that donors should support the building of local institutions, focusing on internal capacity building needs such as staff development, product development, service delivery methodologies and information and communication systems; they expect that donor funds will continue to flow into the sector but only 57% consider donor funds as complementary to private capital, but also they recognize that donor funds will decline over time; the MFIs expect to measure and disclose their performance to various interested entities including financiers (including donors), network organizations, borrowers, general public and government, regulatory agency; and they also expect the role of the government to be facilitative to their operations by creating a supportive environment.

4.4.1 Future Strategy for Raising Lending Capital and Capacity Building Funds

Analysis of the MFI expectations noted that the MFIs recognize that donor funds are limited and not dependable in the long-term. Therefore, their future strategy is to identify how to access more sustainable sources of finance to support their development. As indicated in Table 4.g, the three main future source of lending capital for MFIs surveyed are debt financing (86%), equity investment (71%) and deposits (71%). Funding from multilateral banks through special lines of credit for specified business activities is considered to be a key source of lending capital (43%) in the future. On the other hand, as shown in Table 4.h, all the MFIs surveyed consider self-finance as the major source of capacity building funds.

Table 4.g: Future sources of lending capital

Source	Number of MFIs	%
Bilateral agencies	1	14
Multilateral banks	3	43
Debt financing	6	86
Equity investment	5	71
Self-finance	7	100
Deposits	5	71
Sovereign finance	None	-
Project finance	None	-

Source: Research Data

Table 4.h: Future sources of capacity building funds

Source	Number of MFIs	%
Bilateral agencies	2	29
Self-finance	7	100

Source: Research Data

The most striking finding is that MFIs are planning less reliance on donor grant funding than before. Only 14% of the surveyed MFIs still expect donor funding for their lending capital requirements compared to 29% of the MFIs that require donor support for capacity building activities. This is consistent with donor funding strategy for market conditions that is moving towards attaining maturity.

Based on the above analysis, MFIs are aware of the USAID funding requirements and their expectations are very consistent with those of USAID. The MFIs recognize that USAID funding is only for a short period of time and the level of funding is reducing. Therefore, if MFIs are to grow to reach, on a long-term basis, the millions of low-income

Kenyans without access to financial services, they need access to more sustainable sources of finance to support their development. These will have to include private sources of debt and equity (both socially-motivated investment and commercial investment) and savings.

4.5 Comparison of USAID - MFI Expectations/Perceptions

All the MFIs surveyed are aware of USAID's expectations in supporting the sector in order to fight poverty, the need for good governance and management practices, build sustainable local institutions, measuring and disclosure of performance and strengthening a facilitative role of government. In addition, 57% of the MFIs reported that USAID expect a variety of financial services offered to the targeted groups, donor funds are complementary to private capital, and that there is a shortage of strong institutions and managers in the sector with the capacity to reach millions who need financial services. It was also noted that 71% of the MFIs are aware that USAID expect financial services to reach a very large number of poor people, while only 14% of the MFIs are aware that USAID have a strong emphasis to build financial systems for the poor, although they recognize that micro-credit is not always the answer. The most notable finding is that none of the MFIs is aware of USAID's expectation that interest rate ceilings hurt poor people. However, it was noted that all the surveyed MFIs charge interest rates that are above the average market rate. The study also found that MFIs do not have different expectations from that of USAID.

4.5.1 Use of Grants

The analysis of responses for the use of grants shows that there is agreement between USAID and MFIs on: Start up and expansion - high use of grants for institutional development and capitalization; moderate to high use of grants to cover operating losses support for fixed assets. Competition - low use of grants for institutional development; low grants for fixed assets and no grants to cover operating losses. Maturity - no grants for operating losses and fixed assets.

However, there is disagreement in the use of grants for: Competition - MFIs prefer moderate grants for capitalization but USAID's strategy is not to use grants for capitalization at this level of market development. Maturity – USAID's strategy is to stop the use of grants for all forms of support to individual institutions. But 86% of the MFIs surveyed prefer low to high grants for institutional development, and 57% would still require grants for lending capital.

4.5.2 Use of Loan Capital

The MFIs response on the appropriate use of loan at different levels of market development had the following results: Start-up - USAID does not require use of loan capital for start-ups, a strategy supported by 71% of the MFIs surveyed. However, 29% of the MFIs would prefer low levels of loan capital at start-up. Expansion - low loan capital strategy is preferred by 29% of the MFIs; 43% would prefer moderate loan capital, which is in agreement with USAID's strategy; whereas 29% would take loans as the main source of their lending capital. Competition - USAID require at least moderate levels of loan capital as the main source of lending capital, a strategy agreed to by all the MFIs surveyed. Maturity - USAID and MFIs are in agreement that the high use of loan capital is most appropriate at maturity level of market development.

4.5.3 USAID MFI Selection Criteria and Process

The MFIs to be supported by USAID are identified on a competitive basis. The process involves the issue of request for applications (RFA). The RFA species the selection criteria that is organized into three main categories: institutional strengths, quality of services provided and outreach, and financial performance. The RFA is advertised in the local main-stream print media and also posted in the USAID web site. The selection criteria was rated by MFIs as follows: Fair (14%), satisfactory (14%), good (57%), and excellent (14%). The overall process of receiving funding from USAID compared to other donor agencies rated fairly difficult (71%) and difficult (29%). It was noted by 29% of the MFI respondents that USAID has longer processing periods than other donors, and that the process is laborious, mazed in a flurry of rules and regulations that add little to the development process of MFIs. However, 57% of the MFIs indicated that USAID has a very comprehensive assessment and walks with the partner the whole way.

4.5.4 MFI Impact Rating of USAID Support

The MFIs use a number of indicators that include outreach, portfolio quality, profitability (sustainability), and efficiency to measure their performance. Overall, 100% of the respondents rated USAID support as significant. The MFIs had various explanations for their assessments including USAID assistance helped establishment of a bank (14%); USAID is largely responsible for the creation and development of the organization (43%); the resources injected into the institution plus the goodwill, and the regional and international exposure gave the organization a head start (14%); it encouraged existing and potential MFIs at the time to replicate the lending model which added discipline and accountability (57%); the support has seen the MFI sector and the industry in Kenya and in the region evolve and grow very rapidly (86%); computerize operations (71%); access loan funds (86%); staff development (100%).

4.5.5 Coherence of USAID MFI Development Strategy with Other Donors

USAID is a member of the private sector donor coordination group. One of the main objectives of the donor coordination group is to ensure that there is harmony and consistency in their financing strategies and policies in the private sector. Through this forum, donor agencies consult each other in their support policies and strategies for the MFI sector. All the MFIs surveyed responded that USAID strategy is quite coherent and clear on what the organization wants to support. The policies are good, relevant, and target-oriented.

Based on the analysis above, it is evident that there is consensus between USAID and its supported MFIs on the USAID MFI development strategy in Kenya. The MFI expectations mirrors very well those of USAID. The main explanation for this is that the surveyed MFIs have been involved in the formulation of the USAID MFI development strategy. Although the MFIs perceive USAID as a fairly difficult donor agency to access support from, nevertheless, they rate the support as significant in the development of their institutions and the MFI sector in general. This study also indicates that there is still a role for donor agencies in the further development of the MFI sector, especially in the area of institutional capacity building.

CHAPTER FIVE: SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Findings

The analysis of the primary and secondary data shows that donor agencies, including USAID, have played a major role in the development of the MFI sector in Kenya during the last 10 years. Grants of over Ksh.2.1 billion were provided to the MFIs surveyed to support lending capital and capacity building needs, of which 67% was supplied by bilateral donor agencies.

USAID has a clear strategy for supporting the MFI sector. The strategy, although developed on a consultative basis involving other market players, is highly influenced by donor expectations. Poverty alleviation, expanded outreach, sustainability of the MFIs, good governance and effective management practices, integration of MFIs into formal financial system, and an enabling environment set by the government are some of the expectations that influence the USAID's MFI development strategy.

The USAID MFI development strategy and approaches have evolved over time. The funding strategy and choice of interventions used for the support are largely determined by the level of market development. A number of MFIs registered as NGO in Kenya are progressing towards maturity. More and more MFIs are accessing debt financing for lending capital.

Microfinance institutions are aware of the USAID MFI development strategy and expectations. While MFIs and USAID are in fully agreement in the use of loan capital at maturity level of market development, however, MFIs still require grant funding for institutional development and to a less extent, funds for lending capital.

There is unanimous agreement between USAID and MFIs concerning the role of the government. The government should play a facilitative role rather than directly run microfinance programs. For example, the government should design policies that will support the sustainable development of microfinance in the country.

The microfinance sector in Kenya has three biases. First, it is biased toward urban areas, leaving the vast rural areas where the majority of the poor Kenyans live. The MFIs compete for clients in a few choicest urban areas yet most rural areas remain unserved. The second bias of the sector is that provision of credit dominates their services. Poor people also need other financial services such as savings, micro-leasing, insurance, housing mortgage. etc. The third bias of Kenya MFIs is the bias towards operators of micro and small enterprises, admittedly MSEs are important and deserve financial support. However, the predominant sector in Kenya in terms of number of people involved is smallholder agriculture – yet very few farmers have access to microfinance services from MFIs.

5.2 Conclusions

USAID has an MFI development strategy that shows that the future of microfinance lies not with limited donor funds, but with the private sector. In other words, microfinance services should become part of the country's private financial system in order to be sustainable. The strategy is highly influenced by pre-determined expectations that have been jointly agreed upon by many donor agencies through CGAP. The results also show that MFIs have the same expectations as donors and no major standing out controversy was noted in the study.

On the part of MFIs, there is a general consensus that if they are to grow enough to reach, on a long-term basis, the millions of low income people without access to financial services, they need access to more sustainable sources of finance to support their development. These will have to include private sources of debt and equity and savings.

There is still a role for donors in further development of the microfinance industry in Kenya to address a number of constraints including lack of capital for on-lending, lack of training facilities for MFI personnel, lack of appropriate microfinance loan tracking software, policy & regulatory issues, awareness and education, inappropriate service delivery methodologies that is predominantly provided through the group-based lending approach, poor products, and inadequate market driven product development.

In spite of the sustainability and even profits that have been reported by MFIs, there are few signs that the microfinance industry in Kenya has evolved into a real business that will grow and reach more low-income people without subsidy, whether it is given by foreign donor agencies, national governments or charities. This is partly because microfinance is still perceived as subsidy-dependent activity, and the continuing flow of donor funds 'crowd-out' profit seeking finance. The study shows that there is little sign that start-up capital is flowing to microfinance. The MFIs intentions and strategy of less reliance on donor funding will be tested over time.

5.3 Recommendations

The enactment of the Microfinance legislation to allow qualifying MFIs mobilize deposits from the public is absolutely necessary. The Bill should be enacted without delay. Savings is a viable source of capital for on-lending purposes to many MFIs that are presently registered as NGOs or finance companies. In addition, the Microfinance legislation will enable MFIs develop other financial services that are appropriate for the majority of the rural population.

MFIs need to take pro-active measures and rethink their long-term financing strategy. If the want to grow to reach, on a long-term basis, the millions of low-income Kenyans without access to financial services, they need access to more sustainable sources of finance to support their development. These will have to include private sources of debt and equity (both socially-motivated investment and commercial investment) and savings.

A policy and regulatory framework for MFIs and pro-poor programs is required. The policy framework will address a number of issues about pro-poor financial services and programs such as awareness and education, establishment of appropriate support institutional framework such as an MFI fund to support the industry, establishing a legal framework that ensures that courts are effective in the collection of debts.

Donor agencies will need to find out innovative and sustainable ways of continuing to provide institutional building support to the MFI sector. The response by the surveyed MFIs shows a strong need for capacity building support even when MFIs are considered to have reached maturity level. A market like Kenya where there are very few sustainable service providers for the lower end of the market, there seem to be justification for subsidies to finance activities such as capacity building for MFI personnel in areas such as product development; funds dedicated to innovative activities to develop innovative microfinance products particularly those suited to the poor in rural areas; support for appropriate programs such as national MFI fund; etc. Donors could, for example, focus their funding on MFIs with programs for smallholder farmers and pastoralists who constitute about 90% of the poor in Kenya; establish/support appropriate programs facilitate policy formulation, analysis and creation of supportive environment; facilitate and encourage the development of opportunities for raising capital locally from the capital markets; aggressively support diversification of MFI services away from credit, to deepen the market; support product development and research in innovative service delivery methodologies and the mainstreaming of viable products and services into commercial viability; support MFIs willing to start incubator initiatives to bring more people out of the poverty bracket into proper enterprise; support BDS initiatives in order to stabilize the MFI market and ensure sustainability of microenterprises and future markets for MFIs.

5.4 Limitations of the Study

Limitations of the study arose from the methodology used. The methodology employed as indicated in Chapter 3 was a case study and survey of MFIs that have been directly supported by USAID. However, the MFIs surveyed may not be a good representation of the diverse players in the sector, and therefore the weakness of generalization. For example, smaller or nascent MFIs that have not received any donor funding may have different perspectives of donor funding strategies, selection criteria and expectations. But this limitation has been considered when evaluating the research findings in order to help put them in the proper perspective.

5.5 Suggestions for Further Research

A similar study on another donor agency in the MFI sector could be undertaken to provide comparative data and information and additional insight in the rationale of donor funding strategies. Alternatively, considering the different form of donor agencies that support the MFI sector, e.g., bilateral donors, multilateral or international financial institutions, government, religious-based organizations, private foundations, private companies, etc, a study can be undertaken to establish the consistence and coherence of funding strategies by these organizations.

Another area of study that would be of great interest to a wide audience is the impact of the services provided by MFIs. There is often criticism that MFI services do not reach the intended groups especially the poor. For instance, do MFIs have to sacrifice financial sustainability to reach the poor? Therefore, a study in this area will generate useful information concerning the effectiveness of microfinance as a tool to addressing poverty.

As microfinance is coming of age in Kenya, another critical area of study could focus on the main barriers to growth and development confronting microfinance – specifically access to finance and legal and regulatory constraints.

Another study can focus on a comparison of the performance of Kenya's main organizational models for microfinance delivery – SACCOs, NGOs, "downscaling" commercial banks, and microfinance banks.

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APPENDICES

Appendix I

Questionnaire for interviewing USAID officials. The questionnaire is organized into two categories: Category A (senior management) and Category B (middle level management and operations personnel).

Category A

1. For how long have you worked for USAID Kenya?
2. What are the objectives/expectations of USAID's involvement in the MFI sector development?
3. Explain briefly how the MFI strategy is developed, including the participants in the design process.
4. How has the MFI support strategy changed over the last two decades?
5. What factors have influenced the change of the USAID's MFI support strategy?
6. What do you consider to be the most appropriate use of grants at the different levels of MFI market development?
   (a) Start-up
   (b) Expansion
   (c) Competition
   (d) Maturity
7. When do you think the use of loan capital from local commercial sources is most appropriate?
8. What support does USAID provide to MFIs in transition to fully commercial sources of funding? (e.g. investor equity, partial guarantees to financial institutions, etc.)
9. What do you see as the role of the government in microfinance development?
10. What is the exit strategy of USAID support to MFIs?

Category B

1. For how long have you worked for USAID Kenya?
2. What is your involvement in the MFI programs?
3. Have you participated in the formulation of the USAID strategy for MFI support? If so, what was your contribution in the design process?
4. How do you describe the overall MFI strategy development process? (e.g. is it exclusive, participatory, consultative, etc.?). Explain your assessment.
5. What is USAID's selection criteria for MFIs to support?
6. What kind of support is provided by USAID to the MFIs?
7. Explain how the support is provided?
8. What do you consider to be the most appropriate use of grants at the different levels of market development?

Start-up:

(a) Institutional development	[ ] none [ ] low [ ] moderate [ ] high
(b) Capitalization	[ ] none [ ] low [ ] moderate [ ] high
(c) Operating losses	[ ] none [ ] low [ ] moderate [ ] high
(d) Fixed assets	[ ] none [ ] low [ ] moderate [ ] high
(e) Others (specify)	[ ] none [ ] low [ ] moderate [ ] high

Expansion:

(a) Institutional development	[ ] none [ ] low [ ] moderate [ ] high
(b) Capitalization	[ ] none [ ] low [ ] moderate [ ] high
(c) Operating losses	[ ] none [ ] low [ ] moderate [ ] high
(d) Fixed assets	[ ] none [ ] low [ ] moderate [ ] high
(e) Others (specify)	[ ] none [ ] low [ ] moderate [ ] high

Competition:

(a) Institutional development	[ ] none [ ] low [ ] moderate [ ] high
(b) Capitalization	[ ] none [ ] low [ ] moderate [ ] high
(c) Operating losses	[ ] none [ ] low [ ] moderate [ ] high
(d) Fixed assets	[ ] none [ ] low [ ] moderate [ ] high

(e) Others (specify) [ ] none [ ] low [ ] moderate [ ] high

Maturity:

(a) Institutional development [ ] none [ ] low [ ] moderate [ ] high

(b) Capitalization [ ] none [ ] low [ ] moderate [ ] high

(c) Operating losses [ ] none [ ] low [ ] moderate [ ] high

(d) Fixed assets [ ] none [ ] low [ ] moderate [ ] high

(e) Others (specify) [ ] none [ ] low [ ] moderate [ ] high

9. Have you used loan capital from local commercial sources as a financing tool for MFIs? If so, when is it considered most appropriate?

(a) Start-up [ ] none [ ] low [ ] moderate [ ] high

(b) Expansion [ ] none [ ] low [ ] moderate [ ] high

(c) Competition [ ] none [ ] low [ ] moderate [ ] high

(d) Maturity [ ] none [ ] low [ ] moderate [ ] high

10. How does USAID coordinate with other donor agencies to ensure coherence of MFI support policies?

11. What performance indicators are used to assess the impact of USAID support to the MFIs, e.g. asset level, number of employees, outreach, self-sufficiency, portfolio quality, etc.?

12. Overall, how do you assess the impact of USAID support to the MFI sector?

[ ] None [ ] Minor [ ] Moderate [ ] Significant

Appendix II

Questionnaire for MFIs

A. Organization Data

1. Name of the organization
2. Year of establishment
3. Legal form: NGO, bank, company (shares or guarantee), building society, etc.
4. Number of employees
5. Portfolio size, number of clients and self-sufficiency as of December 2003

    Portfolio: Ksh.________

    Total number of clients:____________

    Operational self-sufficiency: ______________

    Financial self-sufficiency:_________________

B. Services and Products

6. What services are provided by your organization? Tick as appropriate.

    (a) Credit [ ]

    (b) Savings [ ]

    (c) Micro-insurance [ ]

    (d) Micro-leasing [ ]

    (d) Others, specify ___________

7. Lending methodology

    (a) Group-based [ ]

    (b) Individual [ ]

    (c) Both (group & individual) [ ]

    (d) Others, specify ____________

C. Planning and Strategy

8. What is the organization's mission statement?
9. Does the organization develop strategic plans and when was the last such plan developed?
10. What is the organization's strategy for raising capital and capacity building support for its microfinance operations?
11. Have you received donor support to finance your organization's microfinance activities during the last ten years? If so, please provide the name of the donor, the amount and the activity for which the funds were used to finance.
12. What are the other sources of lending capital for your organization? E.g. bilateral donor agencies, multilateral banks, debt financing, equity investments, self-finance, host government, etc. Please indicate source and the proportion of total capital.
13. What do you think are the expectations of donors in supporting the MFI sector? Please list as many of the expectations as possible with brief comments for each.
14. Do you have different expectations from that of donors in the development of the MFI sector? If so, please state in which area and explain briefly your position.

D. USAID Funding Strategy

Your organization is listed among microfinance institutions that have received support from USAID for various microfinance activities during the last 15 years.

15. How did you get to know USAID?
16. What was the length of the relationship between your organization and USAID? If continuing, indicate the date when it started?
17. What support has your organization received from USAID?
18. Do you think USAID has a funding strategy for MFIs?
19. How has USAID involved your organization on matters of its strategy formulation relating to the MFI sector?

20. What do you consider to be the most appropriate use of grants at the different levels of market development? Tick as appropriate.

Start-up:

(a) Institutional development [ ] none [ ] low [ ] moderate [ ] high

(b) Capitalization [ ] none [ ] low [ ] moderate [ ] high

(c) Operating losses [ ] none [ ] low [ ] moderate [ ] high

(d) Fixed assets [ ] none [ ] low [ ] moderate [ ] high

(e) Others (specify) [ ] none [ ] low [ ] moderate [ ] high

Expansion:

(a) Institutional development [ ] none [ ] low [ ] moderate [ ] high

(b) Capitalization [ ] none [ ] low [ ] moderate [ ] high

(c) Operating losses [ ] none [ ] low [ ] moderate [ ] high

(d) Fixed assets [ ] none [ ] low [ ] moderate [ ] high

(e) Others (specify) [ ] none [ ] low [ ] moderate [ ] high

Competition:

(a) Institutional development [ ] none [ ] low [ ] moderate [ ] high

(b) Capitalization [ ] none [ ] low [ ] moderate [ ] high

(c) Operating losses [ ] none [ ] low [ ] moderate [ ] high

(d) Fixed assets [ ] none [ ] low [ ] moderate [ ] high

(e) Others (specify) [ ] none [ ] low [ ] moderate [ ] high

Maturity:

(a) Institutional development [ ] none [ ] low [ ] moderate [ ] high

(b) Capitalization [ ] none [ ] low [ ] moderate [ ] high

(c) Operating losses [ ] none [ ] low [ ] moderate [ ] high

(d) Fixed assets [ ] none [ ] low [ ] moderate [ ] high

(e) Others (specify) [ ] none [ ] low [ ] moderate [ ] high

21. When do you think the use of loan capital from local commercial sources is most appropriate?

(a) Start-up [ ] none [ ] low [ ] moderate [ ] high

(b) Expansion [ ] none [ ] low [ ] moderate [ ] high

(c) Competition [ ] none [ ] low [ ] moderate [ ] high

(d) Maturity [ ] none [ ] low [ ] moderate [ ] high

22. What support, if any, your organization require from USAID to make transition to fully commercial sources of funding? (e.g. investor equity, partial guarantees to financial institutions, etc.)

23. How do you assess the coherence of USAID support policies for your organization and the MFI sector?

24. USAID selection criteria for MFIs to support is broadly organized into institutional strengths, quality of services and outreach, and financial performance. How do you rate this criteria:

[ ] Poor [ ] Fair [ ] Satisfactory [ ] Good [ ] Excellent

Explain your assessment/rating and state briefly how the selection criteria can be improved.

25. How do you assess the impact of USAID support for your organization?

[ ] None [ ] Minor [ ] Moderate [ ] Significant

26. On a scale of 1-5 (1 being very easy and 5 the most difficult) how do you rate the overall process of accessing support from USAID compared to other donors?

[ ] 1 [ ] 2 [ ] 3 [ ] 4 [ ] 5

Please explain your assessment/rating.

General questions

27. Does your organization measure and disclose its performance? If so, what performance indicators are used and to whom are they disclosed (e.g. internal use only, financiers (including donors), network organizations, borrowers, general public, government, regulatory agency, etc.).

28. What do you consider as major bottlenecks facing the microfinance sector in Kenya today?

29. What do you see as the role of the government in microfinance development?

30. What role, if any, can donor agencies play to address the bottlenecks mentioned in question 28 above?