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Kenya Rural Enterprise Program

Case Study of a Microfinance Scheme

Glenn D. Pederson
Washington K. Kiiru

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KENYA RURAL ENTERPRISE PROGRAM: CASE STUDY OF A MICROFINANCE SCHEME

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Studies published in this series are a joint effort between MFI networks in Africa and the Action Research task team of the World Bank. For information on this series contact:

Shimwaayi Muntemba, Task team leader
Tel: 202 458 7370
Fax: 202 473 8185
Email: SMuntemba@WorldBank.org

For further information on K-REP contact:

Kenya Rural Enterprise Programme (K-REP)
Att. Kimanthi Mutua, Managing Director
Ring Road, Kilimani
P. O. Box 39312, Nairobi;
Kenya
Tel: 254-2 722792, 720173, 718301/2
Fax: 254-2 711645

FOREWORD

The purpose of the World Bank's **Action Research Program on Sustainable Rural and Micro Finance Institutions in Africa** is to strengthen local rural and micro finance institutions and contribute to mechanisms for supporting sustainable grassroots institutions which provide financial services to the poor. Action Research emphasizes capacity-building at the national level, by distilling and disseminating "best practices" and strengthening local networks of microfinance providers.

The program adopts a participatory approach to capacity-building. Leading rural and micro finance institutions, mainly NGOs, oversee the process through a core group, the "champion", one of which is normally the coordinating agency. In Phase 1 of the program, diagnostic studies of practices in two or three selected institutions are conducted and discussed at a national workshop. During this phase, networks are also formed or strengthened. In Phase 2, the network may opt for more in-depth studies, as in Phase 1, or it may focus on one issue or delivery mechanism drawn from four or more institutions. These are discussed at a second national workshop. The program also supports a newsletter and periodic meetings of the network to encourage wider participation, dissemination of international best practices, further sharing of experiences, development of guidelines and policy dialogue with the government. At the end of three years, networks are encouraged to become self-supporting.

This report on Kenya Rural Enterprise Programme (K-REP) is one in a series of diagnostic studies being carried out in six countries. It represents efforts by rural and micro finance institutions throughout Africa to reach poor producers normally ignored by the large, commercial institutions. Kenya Rural Enterprise Programme is an intermediary NGO receiving money from donors for onlending to other NGOs whom it has also trained in microfinance management. In recent years, K-REP has developed mechanisms for minimizing its dependence on donors in order to become more sustainable. It has entered negotiations with the Government and Central Bank of Kenya to become a full fledged bank serving the poor. Kenya Rural Enterprise Programme represents an NGO that appreciates the dynamism of innovative techniques, and draws on approaches from other institutions, worldwide, but adapts them to the socio-cultural situation of its clients.

The Action Research Program is funded by the Swiss Agency for Development and Co-operation and is managed in the Bank by a cross-sectoral team comprising Shimwaayi Muntemba (team leader, Environment), James Coates (Agriculture), William Steel (Private Sector Finance), Alexander Amuah (Consultant), and Liisa Hietala (Assistant). The team has collaborated with a Bank-wide initiative: "Sustainable Banking with the Poor," and with a team of colleagues at headquarters and resident missions working on microenterprise issues and with NGOs. In conducting this study, the two main consultants, Washington Kiiru (local) and Glenn Pederson (international), were supported by two local social scientists, Nicky Nzioki and Charles Nzioka. The multi-disciplinary and cross-sectoral nature of the management and research teams have brought strength to this grassroots-focused initiative.

Cynthia Cook
Sector Manager
Environment

Thomas W. Allen
Sector Manager
Private Sector Finance

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LIST OF ABBREVIATIONS AND ACRONYMS

CBE	Community-based Enterprise
CMA	Capital Market Authority
EU	European Union
GoK	Government of Kenya
K-REP	Kenya Rural Enterprise Programme
KIWA	Group of thirty
KWFT	Kenya Women Finance Trust
MFI	Microfinance Institution
NCCK	National Council of Churches in Kenya,
MIS	Management Information System
NGO	Nongovernmental Organization
NIM	Net Interest Margin
NSE	Nairobi Stock Exchange
PFI	Private Finance Institution
ROE	Return on Equity
SDI	Subsidy Dependence Index
SECA	Small Enterprise Credit Association
SME	Small and Microenterprise
UNDP	United Nations Development Program
USAID	United States Agency for International Development
WATANO	Group of five
WEREP	Western Kenya Rural Enterprise

EXECUTIVE SUMMARY

This report summarizes the findings of an action research conducted on the operations of Kenya Rural Enterprise Programme (K-REP), a microfinance institution (MFI) in Kenya. Action research documents the experiences, innovations and changes in the performance of microfinance institutions, and shares these with others within the community of MFIs. Through the exchange of information about K-REP, it is expected that nongovernmental organizations (NGOs) undertaking similar activities can benefit from these experiences and adopt positive changes in their own organizations.

Establishment and Evolution

Kenya Rural Enterprise Programme was established in 1984 by World Education, Inc., a US-based private voluntary organization. Kenya Rural Enterprise Programme was designed as an intermediary NGO to provide credit and technical assistance to other NGOs.

The organization has gone through many changes in the process of developing a strategy for financing microenterprises in Kenya. A fundamental change in methodology occurred in 1989. In that year, after limited success in using an integrated approach to credit delivery, the K-REP Board of Directors decided to reduce the number of NGOs receiving its assistance and promote a minimalist lending program. Kenya Rural Enterprise Programme has maintained most of its original activities (namely, support to NGOs, research, training, evaluation, innovation, information dissemination and consultancies) but has added a direct lending program. It places great emphasis on efficiency in credit delivery and overall sustainability and has adopted a new strategy to combine the Juhudi and Chikola schemes at the area and field office levels, and to separate the sustainable (microenterprise lending) activities from the unsustainable (non-financial) ones. The separation strategy involves establishing a bank, thus enabling the organization to mobilize savings to support its lending functions. Financial and economic performance indicators for K-REP during 1991-1995 are reported in Annex A. Total outreach increased significantly, while the recovery rate remained high above 90 percent.

Kenya Rural Enterprise Programme has been growing rapidly regarding human resources and the development of its branch network. In 1990, the institution had a total of twenty-four employees. This number nearly doubled to forty-four employees in 1992, ninety-three in 1994, and 112 in 1995. Similarly, the number of branches increased from one branch and one field office in 1990 to five branches and eleven field offices in 1995. The growth of K-REP is noteworthy since Kenya's financial sector generally experienced difficulty during this period because of macroeconomic instability.

Operations

The activities of K-REP coincide with Government of Kenya (GoK) efforts to promote the small-scale and microenterprise sector as a means of accelerating economic growth and generating employment opportunities. During the early 1990s, the GoK placed emphasis on the financial sector and enacted policies in its support. Donor agencies have been a major source of support in providing grants to the GoK and other institutions for on-lending, training, and development of an enabling infrastructure.

Kenya Rural Enterprise Programme is currently implementing three credit schemes — both directly through group-lending and indirectly through other NGOs. Under the Juhudi scheme, K-REP helps establish groups and provides loans to individual members of the group. The repayment of the loan is a joint responsibility of the entire membership of the group. The Chikola scheme provides credit to individual entrepreneurs through existing rotating savings and credit associations (RoSCAs). Under the Chikola scheme, K-REP identifies an existing group to whom it provides a single loan that is then retailed by the group to its individual members. After a Juhudi group has been in existence for some time, it may transform, with the approval of K-REP, into a Chikola group. In addition to these two schemes, K-REP maintains a wholesale credit facility for selected NGOs, which on-lend to their clients using the Juhudi credit methodology.

Access, Outreach and Impact

At the end of 1995, K-REP had operations in five areas in the country. In 1994 the areas of operations included West and East Nairobi, Eldoret, West and East Mt. Kenya. Within five years (1991-1995) the number of offices had increased. The number of direct individual borrowers also increased from 1,377 in 1991 to 5,522 in 1993 and to 14,844 in 1995. During this period, the offices served both a rural and an urban clientele with the exception of the Nairobi offices, which serve a primarily urban population. The major sectors of microenterprise activity being served are commerce and trade, manufacturing, and services (in declining order of importance).

Member savings are required in order to borrow from K-REP. The institution obtains funds from commercial banks for on-lending to its borrowers. Due to the requirement that clients save a minimum amount of 10 percent of the loan before becoming eligible to borrow, the volume of savings deposits has increased with the increase in the number of borrowers and volume of loans. Total savings increased from Ksh 2.4 million in 1991 to Ksh 55.3 million in 1995. There were 2,337 active K-REP savers in 1991, and the number rose to 5,429 in 1993, and 15,014 in 1995.

Like many other intermediary NGOs in Kenya, K-REP lends to clients who under normal circumstances would find it difficult to access credit from commercial banks. A notable feature of the K-REP scheme is that it involves the beneficiary groups in making major decisions, such as loan approvals and improvements to the schemes. The clients have been able to expand their businesses and increase the numbers of their employees. By accessing commercial banks, the clients have been introduced to the banking system, which has reduced their fear of banks and integrated them into the formal financial system.

Financial Performance

Kenya Rural Enterprise Programme has been dependent on donor funding for on-lending and institutional support. Between 1991 and 1995, the organization received Ksh 352 million in the form of donor grants. During the same period, total assets increased from approximately

Ksh 66 million in 1991 to Ksh 377 million in 1995. Lending activity of K-REP has increased as a proportion of total assets during 1991-1995. In 1991 loans outstanding represented about 50 percent of total assets, but by 1995 loans accounted for about 67 percent of total assets. Underlying this trend has been an increase in the level of direct lending to individual borrowers as members of groups. Direct lending activities of K-REP have grown rapidly in recent years with total loan volume outstanding increasing from Ksh 32.5 million in 1991 to Ksh 109.6 million in 1993 and to Ksh 294 million in 1995. A significant share of this growth has been in the Chikola credit scheme, which was developed in 1991 and expanded significantly in 1993 and 1994. Growth of K-REP can be attributed to several sources. They include an expansion of the number of branch offices, increased efficiency in credit delivery, and the addition of committed staff who are trained in the use of group-lending methods.

Arrears and defaults on loans had generally been low until the year 1995. Loans in arrears and default in the Juhudi credit scheme which stood at about Ksh 4.4 million in 1993, increased to Ksh 23.6 million in 1995. The Juhudi scheme recorded an average repayment rate of between 96 and 99 percent during 1991-1993. In 1995 the Juhudi repayment rate was reported to be 97 percent. The Chikola scheme experienced a repayment rate of 99 percent in 1991. During 1994 and 1995 the repayment rate for Chikola loans fell to about 90 percent, due primarily to problems encountered in one of its branches.

Increased sustainability has been an objective of donors and K-REP management in recent years. Measuring the degree of sustainability which K-REP has achieved presents some challenges, since both financial (loans) and non-financial services (consultancy, training, etc.) are involved. These programs vary in their sustainability, therefore any overall measure of sustainability of the institution must be interpreted with caution. While total income (excluding grants) covered only 59 percent of total operating expenses in 1991, this increased to 88 percent in 1994 and 98 percent in 1995. Overall, revenues generated through lending and investing activities are beginning to approach levels which could eventually make K-REP self-sustainable.

The Subsidy Dependence Index (SDI) for the combined operations of K-REP measures the overall relationship between net subsidies received and earnings on the loan portfolio. Between 1992 and 1995, the SDI fell from 1,105 to 74 (using the rate of inflation plus 2 percent as the market cost of funds). This indicates a reduced dependence on subsidies over time. Positive developments (those contributing to subsidy independence) include an increase in the average yield on earning assets, reduced inflation, and improvements in expense control.

Innovations and Lessons Learned

Innovation, as interpreted by the Action Research process, occurs when an institution makes modifications over time based on an analysis of the feedback received from clients and guided by the socio-economic environment. Part of that process is the development of capacity within the organization to identify problems early and assess the impact of changes in programs on clients. This is an important contribution to institution-building. Lessons learned and innovations that K-REP developed fall in three broad categories: organizational, operational, and outreach.

The initial innovation of K-REP was to develop a group-based credit model following experimentation with a pilot Juhudi scheme, an indigenous credit system. Secondly, K-REP shifted towards a minimalist approach by which it provided credit to its clients with minimal amounts of training and social services. These two changes led to a significant increase in outreach, both in number of clients and loan volume, under the Juhudi scheme.

The organization has been able to overcome initial problems with loan defaults by studying the underlying causes of default. The reasons for default are related to both lender and the borrower actions. Among the lender factors are the manner in which the microfinancing institution (MFI) operates: whether it charges market based interest rates or subsidized ones. Secondly, the manner in which the institution perceives its customers is important: whether as clients of a financial institution or beneficiaries of welfare services. Delegating all responsibility of credit assessment to groups leads to poor results, as group members are usually not objective enough with their colleagues. Poor screening of potential borrowers by the credit officer and poor appraisal of the investment also increases the default rate. The use of aggregate group savings as collateral may cause dissent as some members do not like to forfeit their savings when others default. The major factors among borrowers are bad investment, theft or destruction of business assets, mismatch in loan size and the flow of income expected from the investment made, diversion of loan purpose, fraud, sickness or death of the borrower.

The Chikola methodology involves a group loan which is on-lent by the group to its members in order to cover their individual borrowing needs. The Chikola scheme has the advantage of using existing groups of entrepreneurs who run small-scale and microenterprises but who may need additional access to credit. Since such groups and businesses already exist, the initial costs of group formation are not borne by K-REP, and therefore the problems associated with formation of cohesive groups are minimized.

By extending the group-based lending approach to Chikolas, K-REP initially reduced its cost of delivering credit. The Chikola model effectively reduced transaction costs, therefore K-REP was able to achieve greater outreach in the target population of entrepreneurs, in the early phase of its introduction. However, K-REP's experience in 1995 revealed that the Chikola groups must pass the same test of cohesiveness in order to yield the expected reduction in costs and improvements in sustainability. For example, K-REP found that several groups in the Nyeri Branch did not exhibit the required level of solidarity, and therefore repayment rates within that Chikola scheme declined to unacceptable levels.

Kenya Rural Enterprise Programme has deduced that provision of lending services requires good management skills, qualified staff, and an effective information system. In this regard, there has been a continuing effort to train personnel and upgrade the management information system.

In the early 1990s, K-REP recognized a potential danger in combining the provision of financial services (loans and deposits) with non-financial services (training and technical assistance). This problem arose from difficulty in assessing the cost of non-financial services, leading to such costs undermining the financial sustainability of the institution. This resulted in the organization adopting a minimalist approach. Increasingly K-REP has taken the approach that it must charge interest rates that enable it to cover its operating and eventually financial costs since long term sustainability cannot be reached while depending on donor funds. The institution has therefore begun a process of transforming the financial services part into a bank. This would enable it to mobilize savings in the areas it serves. Grants and subsidized loans may be justified to start and strengthen MFI operations, but the strategy is to decrease dependence on them over time.

Kenya Rural Enterprise Programme has implemented a system of performance indicators for evaluating its financial structure and operations. This process involves identifying appropriate operating and financial performance indicators and matching them with the information needs of management.

Some of the most promising innovations that K-REP has adopted are those which surfaced through interactions with its Juhudi borrowers. More flexible loan sizes and frequent group meetings are two primary examples of such innovations. These changes also contribute to reduced costs of intermediation, a greater potential for outreach to new clients, and ultimately to improvements in K-REP's financial self-sustainability.

Outreach

(i) Kenya Rural Enterprise Programme has found that there are a number of ways in which clients can contribute to the evolution of a lending institution. Client input is necessary to assess the performance of a microfinance institution and advise on further policy for the development of the institution. Through interactions with its clients and its own internal research and evaluation efforts, K-REP has pursued innovations in its lending activities. The initial innovation was to adopt the group-based Juhudi scheme in 1989. This was followed by the adaptation of the group-lending approach to Chikola (also referred to as "merry-go-round") groups. These innovations appear to have provided greater access and outreach to clientele and improved the overall self-sustainability of the organization.

(ii) Kenya Rural Enterprise Programme has tried to define strict rules to govern credit operations. However, because of its focus on the poor, the processes and instruments are simple and comprehensible.

(iii) There is a challenge to K-REP and other MFIs to identify alternative forms of collateral and ways in which to incorporate that collateral into their lending schemes. This issue becomes significant for MFIs that must expand the range of their lending products to serve clients demanding larger loans. Microfinance institutions such as K-REP have found that wide variations in member loan size within a group results in increased repayment due to peer pressure. Thus, alternative forms and uses of collateral need to be considered within the context of the group-lending approach.

(iv) Feedback from clients has inspired other innovations in the modes of operation such as changing group size requirements, adjusting loan size limits for repeat borrowers, streamlining the loan approval process, selectively modifying the frequency of group meetings, and creating client feedback forums. These changes are intended to maintain and enhance loan repayment and collection, reduce and control transaction costs associated with client savings and lending activities, and create greater efficiency in forming and sustaining client groups.

As an institution, K-REP has witnessed some internal shifts in its approach that have affected the methodology. A significant impact on the methodology resulted from temporary declines in the repayment rate in the Juhudi scheme at Kibera and the Chikola scheme at Nyeri. In each instance, the management responded by intensifying control over how the groups are formed and administered. One such response has been to require a longer gestation period for the groups before they can receive a loan. This responsibility lies with the credit officer who evaluates the cohesiveness and stability of the group prior to the extension of credit and may extend loans on different sequences which imply faster or slower disbursement.

The transformation of the K-REP credit methodology also resulted in a shift in its role as an NGO intermediary. In order to improve efficiency, K-REP reduced the number of NGOs to which it provided funding from twelve to four. The number was subsequently increased to five with the addition of Kenya Women Finance Trust (KWFT).

1. BACKGROUND

Initial Objectives and Evolution

From its inception in 1984, K-REP's mission has been to empower low-income people, promote their participation in the development process, and enhance the quality of their lives. The corresponding goals of K-REP have been to alleviate poverty through improving microenterprise credit programs, strengthening institutions, and increasing employment and income opportunities. The strategy used has been provision of loans, training and technical assistance.

Kenya Rural Enterprise Programme was established as an intermediary non-governmental organization to promote the development of micro-enterprises through strengthening the credit programs of local NGOs. The strategy consisted of providing on-lending, training and technical assistance to other NGOs in Kenya in order to build their institutional capacity. It started as a project of World Education, Inc. In 1987 it was locally incorporated as Western Kenya Rural Enterprise Programme (Werep) Ltd., which was changed to Kenya Rural Enterprise Programme in 1992. All its credit programs were motivated by the charity and social welfare concept. It became clear, however, that this approach had a limited impact and was not cost-effective. Subsequently, K-REP started to emphasize the business-oriented approach as opposed to a charity-based one. The institution became driven by the motivation of self-sustainability. In 1990-1991, K-REP initiated its own direct lending schemes. It sought to be a more effective financial institution, and therefore reduced the number of NGOs it supported from twelve to four. These modifications, however, narrowed its role as an intermediary organization for the other NGOs.

The initial methodology was designed to promote integrated assistance to microenterprises on an individual project basis. Due to continued disappointing performance by its NGO clients, K-REP redesigned its credit approach in 1990, drawing on world-wide experience gained through visits to poverty-oriented lending programs in Bangladesh, India and Latin America. The organization also benefited from its participation in regional and international workshops, discussions with donors and international NGOs, and earlier experiments by NGOs in Kenya. Currently, it emphasizes the minimalist credit model (loans without training or technical assistance) and a financial systems approach (including savings mobilization and self-sustainability). The Juhudi credit scheme was introduced in 1987, as a loose adaptation of the Grameen Bank group-lending model.

Initial Organization and Resources

The initial organization of K-REP (as a channel of funds to Kenya's NGO community for on-lending) did not require high levels of manpower or a branch network. By providing grants and technical assistance, K-REP aimed at building the capacity of the NGOs in credit delivery and employment generation (Table 1).

Table 1: Services Provided by K-REP

Financial Services:	• Group savings • Loans
Non-financial Services:	• Consultancy • Training of NGO staff • Technical assistance to NGOs • Information dissemination

Kenya Rural Enterprise Programme encountered problems with the Juhudi scheme as it redesigned its credit programs. The pilot scheme in Kibera, a neighborhood on the outskirts of Nairobi, experienced poor initial repayment performance. To provide better insight as to the nature of the problem, an in-house study of defaulters was conducted. The study concluded that sufficient attention was not paid to the lack of cohesiveness of the Juhudi groups prior to extending credit. Consequently, the fundamental feature of peer pressure among group members and solidarity of the group were lacking, resulting in an unacceptably low repayment rate. The K-REP response was to extend the "gestation period" for the Juhudi groups, so that there was a longer interval between group formation and extension of the first loans.

Resource demands for implementing the integrated credit program (individual loans with business training and management assistance) led K-REP to focus on changing its strategy in order to improve its operational efficiency. Accordingly, the NGO revolving-loan program was reduced to just four NGOs (who also used the group-lending approach). This meant that each of the NGO clients which K-REP served was also to become more self-sustainable and better able to repay the funds to K-REP. As a consequence, K-REP changed the terms of its NGO loans from 100 percent grant funds to 70 percent loan and 30 percent grant funds.

The primary sources of funds for lending activities have been donor funds. During 1984-1992, K-REP received over USD15 million in donor funds to support its NGO on-lending and direct lending programs. The majority of those funds were provided by the United States Agency for International Development (USAID) (Table 2).

*Table 2: Grant Funds Received, 1990-1992 (Ksh 000)**

Source	1990	1991	1992
USAID	44,899	31,160	20,106
Ford Foundation	1,417	2,185	5,632
Total Grants	46,316	33,265	25,738

* exchange rate is about 36 Ksh/US$

Social and Macroeconomic Context

Initial Context

During the formative years (the late 1980s and early 1990s), socio-economic conditions in Kenya were marked by economic instability and deterioration (Table 3). Real GDP per capita increased slowly in the latter 1980s but declined during 1990-1994. Annual inflation remained relatively stable at about 9-10 percent during the 1980s, but increased significantly to 27 percent in 1992.

Table 3: Macroeconomic Indicators for Kenya, 1990-1992

Indicator	1990	1991	1992
GDP per capita - nominal (000 Ksh)	7.56	8.33	9.28
GDP per capita - real (000 Ksh)	3.81	3.77	3.66
GDP growth rate - nominal (%)	9.70	10.20	11.40
GDP growth rate - real (%)	0.80	(1.20)	(2.80)
Inflation rate (%)	15.80	19.60	27.30
Population (millions)	22.20	22.90	23.70

The rate of poverty in Kenya remained high at about 47 percent during the period 1980 to 1992, while average life expectancy was fifty-nine years (fifty-seven for males and sixty-one for females) in the late 1980s and early 1990s. Infant mortality fell from seventy-seven (per 1000 live births) in the early 1980s to sixty-six in 1990 while the mortality rate among children under five years fell from 150 to 105 (per 1000). Average literacy rate (primary school completion) was 67 percent (72 percent among males and 63 percent among females) in 1990. The distribution of both education and health services remains uneven and is associated with income and locational differences of the population.

The development of small-scale enterprises and the informal sector received greater attention from the Government of Kenya (GoK) in the mid-1980s in order to sustain economic growth and employment generation. By 1992, policies had been adopted to support this sector. Donors provided NGOs with most of the funds to on-lend to microenterpreneurs. Some of these NGOs were also involved in welfare programs.

The Period 1992-1995

Kenya's current situation places it in the group of countries which have achieved some improvement in broad social indicators but no growth in income. There has been no significant reduction in the incidence of poverty, while a decline in the real wage rate has been noted in all sectors of the economy. The consequent decline in purchasing power disproportionately affects the poor whose incomes are derived from the sale of agricultural and other products. Past over-extension of the public sector, combined with the inefficient and inequitable use of public resources, has continued to restrict the rate of economic growth. Essential public services have been under-funded, and the economic and social infrastructure (roads, electricity, community water and sanitation, health facilities and immunization programs and secondary schools) has deteriorated.

In recent years, the national population has grown at an annual rate of about 3.4 percent. Kenya's average population density is relatively low at thirty-seven inhabitants, but the range is large (from just over twenty in the coastal region to over 200 in the central region and over 300 in the west). Kenya Rural Enterprise Programme serves communities in the high density areas where the incidence of poverty is high (the Central Region, Nairobi and the Western Region). This gives the organization rich experiences out of which to model its credit delivery to the poor.

During 1992-1994, the GoK has been implementing a Structural Adjustment Program which has resulted in the liberalization of the economy. Importation of manufactured products has increased tremendously and has hurt the local manufacturing enterprises, with sectors such as textiles, motor vehicle assembly, etc. being major victims. To counter the possible initial negative social impacts of the liberalization process, the GoK has identified areas and projects needing external donor support, including small-scale and micro enterprises.

Unstable macroeconomic conditions between late 1993 and early 1994 have added uncertainty to the economic and financial environment within which K-REP operates (Table 4). Inflation escalated during 1992 and 1993 as a result of the Central Bank of Kenya losing control of the money supply and resultant monetary growth. According to the Central Bank of Kenya, the monthly rate of domestic inflation peaked at about 60 percent (annual) during August 1993-April 1994 and fell to an annual average of about 29 percent in 1994 and 1.5 percent in 1995. The inflationary spiral contributed to distress among the financial institutions in the country and led t a decline of real GDP during 1992 and 1993. As a consequence, real GDP in 1995 stood at about 46 percent of the level in 1990. Per capita incomes fell by a lesser amount (10 percent) during 1990-1995. Agricultural GDP grew the slowest at 0.7 percent (in real terms) during 1992-1994. The service sector grew at a real rate of 3.4 percent, but the government sector component of real GDP increased most rapidly at 8 percent.

In mid-1991, interest rates were liberalized in Kenya. However, between 1992 and 1994, nominal interest rates on savings deposits fluctuated less than the rate of inflation. Consequently, real interest rates became negative in real terms during 1993-1994. For example, the maximum real savings deposit rates were -27.7 percent in 1993 and -8.7 percent in 1994. However, in 1995 the rate of inflation fell significantly and the real rate of interest on savings deposits became positive at 11.3 percent. With the rise in inflation, the exchange rate also increased to a high of 68 Ksh/USD at the end of 1993 but fell to 45 Ksh/USD in December 1994, and 55 Ksh/USD in December 1995.

Macroeconomic policies and weaknesses in national legislation contributed significantly to the national economic instability in 1993-1994. Money growth rates greatly exceeded target levels in 1992 and the Central Bank was not effective in its efforts to control that growth due to institutional and policy failures attributable to the lack of autonomy and the weakness of monetary policy instruments. Moreover, there was a legal crisis in the financial sector caused by the lack of compliance with banking regulations. In July 1993, monetary policy was tightened significantly, and the economy began to stabilize because of an encouraging implementation of the structural reforms. All remaining exchange controls were either relaxed or completely removed during 1995.

Table 4: Macroeconomic Indicators for Kenya, 1993-1995

Indicator	1993	1994	1995
GDP per capita-nominal (000 Ksh)	11.05	12.75	14.8
GDP per capital-real (000 Ksh)	3.55	3.54	3.52
GDP growth rate-nominal (%)	19.0	15.40	5.2
GDP growth rate-real (%)	(3.0)	(0.30)	5.2
Inflation rate (%)	46.0	28.8	1.5
Commercial bank interest rates (%)	30.5	36.2	27.9
Loans and advances (ave.,max. %)	18.3	20.1	12.8
Savings deposits (ave., max. %)	36.8	8.9	19.5
Interbank rate (%)	36	45	55
Exchange rate (Ksh/USD)	68	43	55

Financial Services Sector

Kenya has a relatively well developed financial sector comprising thirty-three commercial banks (foreign and local), fifty-one nonbank financial institutions, seven development finance institutions, insurance companies, a stock exchange with fifty-four listed companies, twenty stockbrokers and a Central Bank. In recent years, the Central Bank has come under scrutiny following the collapse of some financial institutions and inadequate control of the money market. The development of secondary financial markets is basically the responsibility of the Capital Market Authority (CMA) established in 1990. The CMA has created greater confidence in the security of investments and has regulated new lending procedures and instruments. It has also developed a primary market in private securities and has removed impediments to long-term investments. These developments have seen increased dealings at the Nairobi Stock Exchange (NSE). In 1994 for example, a total of 43 million shares worth Kshs 3076 million were traded in the NSE compared to 27 million shares worth Kshs 890 million in 1993.

Savings mobilization is dominated by the four main banks: Kenya Commercial Bank, Barclays Bank of Kenya, Standard Chartered Bank and National Bank of Kenya, which also control lending activities. The domination of deposits extends to a comparison of bank versus private financial institution (PFI) deposits. In September 1995, commercial banks held Kshs

149.3 billion in deposits while the nonbank PFIs held Kshs 49.5 billion. The commercial banking system has approximately 490 service outlets in Kenya and has a widespread presence in the villages and towns. However, they are primarily engaged in mobilizing rural savings, as their agricultural credit portfolios have been declining rather rapidly through 1993. This decline in lending activity is particularly problematic because of their excess liquidity positions. Another alarming development in the rural areas is the shrinking number of commercial bank branches and service outlets. Standard Chartered Bank recently closed several branches in the countryside, and other banks are expected to take similar actions. This can only result in MFIs having less access to formal banking facilities. The development banks have for a long time been the main source of project financing, however their cumbersome policies and procedures have resulted in their operations becoming inefficient.

There remains a significant gap between the level of credit supplied and the effective demand for credit in the rural areas of Kenya. A recent estimate placed the gap at Kshs 57.0 billion. The production gap varied from Kshs 10.4 billion among small-scale farmers (77 percent of the effective demand) to Kshs 7.9 billion among large-scale farmers (49 percent of the effective demand). The investment credit shortfall is estimated to be Kshs 26.2 billion (82 percent of the effective demand). The estimated credit gap among rural microentrepreneurs is also large at Kshs 12.5 billion (a 90 percent credit gap). The aggregate credit gap was estimated to be about Kshs 57 billion (76 percent of the effective demand for credit).

The lack of credit in rural areas is a formidable problem, because there are several barriers to building a durable rural financial market. The noncredit constraints include low profitability of small farmers in low potential areas, lack of infrastructure, improved technology and extension support, absence of clear land titles, lack of drought protection, and absence of policy coordination relating to rural credit issues. In addition, several credit-related constraints were recently identified in a Study on Rural Financial Markets in Kenya (1995).

Since the early 1990s, the GoK has shown an interest in the development of small-scale and microenterprises and has published policies that are intended to support the sector. A full-fledged Ministry of Research, Training and Applied Technology has been put in charge of the sector and initiatives have been made to channel donor funds to the sector for on-lending and supporting other complementary activities, such as site development, technology, and innovations. In 1994, the GoK signed an agreement with the World Bank for about Ksh 1.4 billion to be used mainly for training microentrepreneurs, supporting innovation in the sector, and providing infrastructure. The current country program of the United Nations Development Program (UNDP)is emphasizing support of the sector, while other donors such as Overseas Development Administration (ODA), USAID, the European Union (EU), Ford Foundation, and the Canadian International Development Agency (CIDA) are becoming increasingly involved. Their support is mainly in the form of grants for on-lending and institutional support. In recent years, entrepreneurs in small-scale and microenterprises have organized themselves into associations and federations to advocate for access to the assistance being offered to the sector. There is now an increasing awareness among entrepreneurs that these funds are not hand-outs (as previously perceived) but credit which must be repaid.

A notable change has occurred in the commercial banking sector. Although commercial banks have previously ignored the microenterprise sector, credit programs have now been developed by two of the major banks (Kenya Commercial Bank and Barclays Bank) for channeling credit directly or through other intermediary organizations to small-scale and microenterprises. The creation of the Small Enterprise Credit Association (SECA), with commercial banks, NGOs and development finance institutions as founders, is facilitating the sharing of information on clients. This type of activity is bound to improve cooperation among institutions supporting the sector.

2. STRUCTURE AND OPERATIONS

Organizational Structure

The organizational structure of K-REP has been changing over the years to reflect changes in institutional objective, growth, focus and challenges. Until early 1993, the organizational structure provided for a Managing Director (a post held by expatriates until 1992) and five departments — Institution Credit, Juhudi Credit, Research and Evaluation, Finance and Administration, and Training. In early 1990, sustainability of K-REP became a major objective and a policy change was made to undertake direct lending. This change meant an expansion in staff and creation of field offices. The Juhudi Credit Department was charged with the implementation of the scheme, and in 1991 an area office was opened in Kibera (Nairobi) and another in Eldoret. In 1993, two additional branches were opened in Kawangware (Nairobi) and Nyeri (see Annex B for Nyeri Branch Profile).

The training and technical assistance functions of K-REP have existed since the establishment of the institution and were departmentalized in 1988 with the formation of the Training Department to train field officers and program managers of selected NGOs in project appraisal and management. With the increased focus on sustainability and efficiency in 1990 and K-REP's involvement in direct lending, new training needs such as interaction and communication skills became necessary.

The Institution Credit Department stems from K-REP's initial role as an intermediary institution since its introduction in 1988. The department has been in charge of the Community-based Enterprise (CBE) program. In 1991, the Chikola credit scheme was developed within the department, reflecting a shift in strategy towards working more with self-help associations for more effectiveness and higher efficiency. The department is also in charge of collaboration with other agencies involved in activities similar to those of K-REP.

The Research and Evaluation Department was established in 1987, its initial focus being to monitor and evaluate K-REP's operations. Its mandate has been expanded gradually to include innovation and development of new methods for microenterprise development, documentation, and dissemination of new information, conducting of research and evaluation, and facilitating policy dialogue on microenterprise development. In 1994 K-REP (with funding from ODA) established the Arifu Documentation Center which is perhaps the best equipped referral center on the small enterprise sector in the country.

The Finance and Administration Department has seen a lot of changes in its size. It started as a one-staff office and expanded to a full-fledged department with representation in the branches. The department is in charge of managing finances, general administration, personnel and assets. It also supports other departments in finance-related matters. Computerization of the accounting system and the introduction of a loan tracking and accounting system has made it possible to generate prompt reports on individual accounts, branch accounts, reports to donors etc.

During 1993-1994, K-REP increased its emphasis on sustainability and changes have occurred in the organizational structure to reflect a gradual separation of sustainable activities (financial services) from unsustainable activities (non-financial services) as illustrated in the organizational chart (Figure 1). The organization has been restructured into two major divisions — the Financial Services Division (lending and savings mobilization) and the Non-financial Services Division (research, training, technical assistance, information dissemination, evaluation and consultancy). Each division is under a Deputy Managing Director assisted by various departmental managers.

In 1994, a major change also occurred in the Financial Services Division which led to the consolidation of servicing of the Chikola and Juhudi group credit schemes. In 1994 and 1995, administration of the two programs was merged.

Legal and Operational System

Kenya Rural Enterprise Programme has two registrations — as an NGO under the NGO Co-ordination Act and as a limited company. The head office is in Nairobi and there are five area offices. Each area office is headed by an area credit manager. Relations with commercial banks are crucial in all branch offices since the banks are used to hold client savings, as collateral to expedite disbursements and increase loan repayment.

The organization's strategy is to move towards more rural centers, making access by its rural clients easier, yet also providing them with convenient access to banking services. To penetrate new areas, K-REP officers work closely with the local administration (especially local chiefs) for ease of operating logistics and "protection." There is also collaboration with the Ministry of Culture and Social Services which has records of existing and registered groups. The Ministry registers all *kiwas* and Chikola groups before they access K-REP loans. During outreach, the credit officers work with business community leaders in the centers, since they command respect and are more effective in organizing meetings and reaching the community. In areas where other NGOs are also operating, the officers work closely with them especially to help eliminate duplication in loans. Though physically located in the provincial (urban) centers, most of the area offices can be classified as rural because of the clientele they serve (Table 5).

Table 5: Number of K-REP Field Offices in 1995

Office Type	Total Number	Primarily Rural	Primarily Urban
Area Offices	5	3	2
Field Offices	11	9	2

In 1995, K-REP had about 112 employees. This compares with 93 employees in 1994. Approximately 37 percent of these employees were located in the head office (Nairobi) in 1995 (Table 6). There were fifty-one women employees in 1994 and fifty-eight in 1995. Those numbers include thirty-three women credit officers in 1994 and forty-four in 1995. In 1994, distribution of staff was approximately 66 percent in the Financial Services Division and 34 percent in the Non-financial Services Division.

Table 6: Number of K-REP Employees, 1994 and 1995

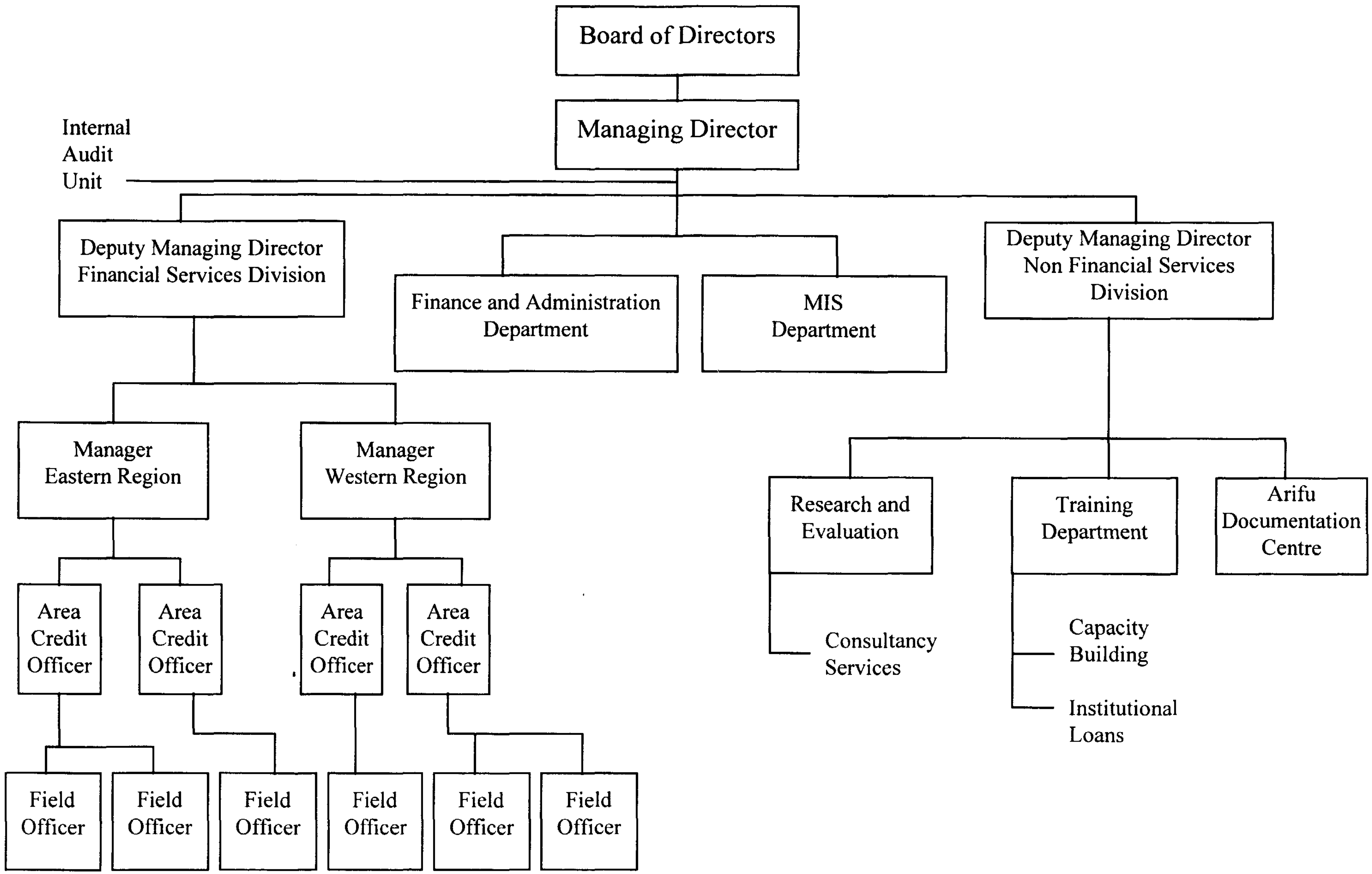
Employee Location and Category	1994	1995
Head Office	39	41
Field Offices	54	71
Women Employees - total:	51	58
Departmental Managers	5	5
Senior Managers	5	5
Credit Officers	33	44
Other Professionals	32	38
Support Staff	15	17

Management

Kenya Rural Enterprise Programme is led by a Board of Directors. The Chief Executive is an ex officio member of the Board. The composition of the Board is diverse and there are no representatives of any specific interest group or organization. The donors assisting K-REP do so on the basis of an agreement which spells out reporting requirements and what is expected of K-REP.

Kenya Rural Enterprise Programme identified the need to elect a Board whose members could make a useful input into guiding the institution. Beginning in 1983, the Board was composed of individuals who were not only able to contribute towards to the success of the institution, but also understood what was happening in the institution. Policies were developed concerning how Board members would serve, who qualified to join the Board, and how they would leave the Board.

FIGURE 1. Organizational Chart for K-REP



Management Information System

Kenya Rural Enterprise Programme has developed a Management Information System (MIS) which is used to produce the monthly monitoring reports for the field officers, management information on overall portfolio status as well as periodic reports to the donors. The accounting system is able to produce all sets of accounts at year-end (including area office accounts). The area offices keep records on borrower status, which are subsequently consolidated by officer and by area office. Each area office produces its own profit and loss statement and balance sheet. In the past, records and reports on the Chikola scheme were maintained in the head office, this responsibility has gradually been transferred to the area offices for better efficiency in loan monitoring. Secondly, the accounting packages in use were off-the-shelf spreadsheet and accounting software with some in-house improvement and supplementation; in 1995 K-REP adopted the computer software Micro-Banker to meet its information management needs.

Credit Administration

Loan appraisal and approval is done at the field level by the borrower group with the assistance of the Credit Officer. Preparation of cheques for disbursement is also done at the branch and forwarded to the head office for signature. Initially, the concept was to graduate clients to a formal financial institution. However, this has not been possible mainly because of the rigid requirements by these institutions (especially regarding collateral). Second, as K-REP has expanded, it has not been in its interest to off-load its good clients. The trend has been to adjust the loan limits in order to accommodate the needs of the larger clients. In recent times, K-REP has participated as founding member of the Small Enterprise Credit Association (SECA), bringing together banks, NGOs, and financial institutions in a forum for consolidating approaches to small-scale and microenterprise lending.

Human Resources

Staff Resources

Kenya Rural Enterprise Programme has experienced considerable growth in human resources. It reported twenty-four total employees in 1990. That number increased to thirty-nine in 1991 and in 1995 there were 110 staff. The distribution of staff at the end of 1995 within the head office and the area credit offices is shown in Table 7.

Field officers are in touch with their clients through either weekly or monthly group meetings. In the Juhudi scheme, the number of loans per credit officer and office manager was 132 in 1991, 142 in 1992, and ninety-eight in 1993. The decline in 1993 was associated with the opening of two new area offices, each with full staff. The staff productivity indicators for the Chikola scheme were generally higher, based on the number of retail clients, although the number of groups per credit officer and office manager was relatively small, at twenty-one in 1993. The number of groups per officer in 1993 translates into about 477 Chikola customers per officer.

Table 7: Distribution of K-REP Staff in 1995

Designation Level	Head Office	Kawangware	Eldoret	East Nairobi	Mt.Kenya West	Mt. Kenya East
Managers	9	1	1	1	1	1
Accountants	1	3	1	1	2	1
Credit Off.	24	10	7	12	10	9
Other Staff	7	2	1	3	2	2
Total	41	16	10	17	15	13

When the Juhudi and Chikola credit schemes were combined in 1994, the number of clients increased to 122 per officer. In 1995, the number increased to 265 customers per credit officer and manager. The role of the credit officer has shifted to reflect the need for closer monitoring (Box 1). This is a highly significant increase in productivity per field credit officer and suggests that K-REP attempted to increase the productivity of its field offices in 1995 in order to achieve financial sustainability. Part of this increase in productivity was accomplished by holding group meetings less frequently with selected client groups. The other factor which was increasing productivity is the observed growth in the number of K-REP borrowers during 1994 and 1995.

Box 1. Changing Role of the K-REP Credit Officer

At the time of opening the Nyeri Branch, K-REP credit officers had a target of ten groups per officer (i.e., 300 clients), but the present target has been increased to fifteen Juhudi groups. A Chikola officer is expected to manage up to twenty-five groups, although past officers managed up to forty such groups. As the Chikola credit scheme has grown and experience has been gained, it is becoming necessary to reduce the number of groups per credit officer to achieve closer monitoring. While the number of groups is being altered, it is also true that K-REP intends to combine the Juhudi and Chikola schemes. This potentially affects the group responsibilities of Credit Officers.

Flexibility has also been introduced into the Juhudi credit scheme in order to reduce the credit officer's workload. For example, first and second-loan groups generally meet weekly. However, third-loan groups hold meetings on a bi-weekly or monthly schedule. This modification has resulted in some flexibility in the frequency of savings and loan repayments. Some groups meet monthly but prefer weekly savings and loan repayments, while others meet weekly but repay monthly. However, first-year groups are still required to hold weekly meetings for closer monitoring.

All newly recruited Credit Officers undergo in-house training on the credit systems which involves both classroom training and attachment to area offices for on-the-job training. Initially, field officers went through a two-month induction course. That was increased to three months in 1994 and to nine months in 1995 for new credit officers. The organization also offers training on a consultancy basis to other NGOs. Furthermore, K-REP collaborates informally with other community development agencies (e.g., health workers, bankers, insurance staff, legal advisers) to educate clients. These services do not represent a variation from the minimalist credit approach, because they are provided costless to K-REP. Staff at the manager level and above can qualify for fellowships (funded by donors) to attend courses abroad and meetings, seminars, and forums on microenterprise development in Kenya.

Client Resources

The Managed Growth Plan of K-REP specifically identifies the provision of training, technical assistance and consultancy services as an important objective of the institution. However, over time K-REP has moved from providing client training and business skill development services to a minimalist approach to credit and financial services. This raises a dilemma for K-REP and other NGO financial institutions where the strategy is to become self-sustaining, yet clients are asking for assistance in developing these skills. From the K-REP perspective the dilemma is that providing training and human resource development services to the clients is relatively expensive. If these costs are not recouped through fees or higher interest rates paid by clients, the result is an increase in the level of noninterest expense, a reduction in net earnings, and, by definition, a challenge to self-sustainability.

To address this problem, K-REP has adopted the policy of either referring clients to other agencies or providing client training on a fee-for-service basis. The fact that the clientele base of K-REP has continued to grow suggests that clients may be obtaining the necessary skills via their group activities or through other means. It is clear that K-REP has made the transition from a traditional, socially-oriented institution to one which has a defined business orientation in the area of the financial services it provides to clients.

Future Plans

K-REP is currently taking actions to become a commercial bank. In order to reach self-sustainability, K-REP must reduce its dependence on donor funds and thereby collect savings as a source of funds. Under the current Kenyan law, NGOs are not allowed to receive deposits. Therefore, becoming a banking institution seems to be the only way to legally mobilize savings.

This transformation reflects the need by microenterprises to have a sustainable institution on which they can count. It will also allow K-REP to address other financial concerns. Consequently, K-REP will be reorganized into two institutions: K-REP the bank and K-REP the NGO. The latter will continue to manage the Non-financial Services Division. A survey conducted by K-REP indicated that clients were looking for a bank they can relate to, and K-REP could become that bank.

3. MODES OF OPERATION

Deposit Services

K-REP is not registered under the Banking Act. Therefore, it is not authorized to mobilize deposits from the public. Members of groups mobilize savings from among themselves. These funds are held in group savings accounts at nearby commercial banks. On average, such a group will be located within 15 km of a banking facility but further distances are possible if the communication network is good. Individual savings by a member are recorded in a passbook provided by K-REP at Ksh 75 per book, and members are required to save at least Ksh 50 per week. The interest earned on savings belongs to the group. Where a group has saved more than the required amount, it may withdraw the excess savings for group use. In some cases, Chikola groups have used their savings to on-lend to members in order to maximize returns. Kenya Rural Enterprise Programme is exploring ways of accessing group savings for on-lending as part of a long-term strategy to obtain registration under the Banking Act.

Deposit interest rates became significantly positive in 1995. This indicates an improved environment for savings creation in Kenya. After accounting for inflation, in 1994 the real rate earned on one year deposits was about 17 percent. In contrast, the real rate earned on such deposits was 10.7 percent for 1995 (Table 8).

Table 8: Commercial Bank Interest Rates on Savings and Time Deposits, 1995

Type of Instrument	Nominal rate	Real rate
Savings (ave., max. %)	12.8	11.3
Savings (range)	7.0 to 12.9%	5.5 to 11.4%
One-year Deposits (ave., max. %)	12.2	10.7
One-year Deposits (range)	8.8 to 11.8%	7.3 to 10.3%

Lending Services

Kenya Rural Enterprise Programme operates three credit methodologies: the Juhudi credit scheme the Chikola credit scheme and a wholesale lending facility for NGOs (which on-lend to clients).

The Juhudi credit scheme is a 1987 adaptation of the group-lending methodology developed by the Grameen Bank in Bangladesh. The officers of K-REP are involved in outreach to facilitate formation of five member groups (*watanos*). Up to six *watanos* confederate into a *kiwa*, which is registered by the Ministry of Culture and Social Services as a self-help group. Members then make weekly deposits of at least Ksh 50 each for eight weeks. Individual member savings are collected during weekly group meetings, recorded in their passbooks, and banked in the group savings account. Kenya Rural Enterprise Programme is a signatory to those accounts.

Initially, loans were extended to members of the *watano* in a sequence of 1:2:2 (i.e., one loan in the first round, two loans in the second round, and two loans in the third round) at intervals of four weeks. After each loan has been repaid, a member can graduate to a bigger loan, as long as s/he has saved at least 20 percent of the loan amount requested. The first loan has a maximum amount of Ksh 10,000. Subsequent loan amounts are Ksh 25,000 (for second) and Ksh 100,000 (for the third). Recently, some loans have significantly exceeded the Ksh 100,000 level. A *watano* is in charge of initial processing of the loan application by its members, endorsed by a *kiwa* loan committee, and approved by the *kiwa* membership. The *kiwa* provides a guarantee of repayment of individual member loans and stands to forfeit group savings in case a member defaults. Experience in 1994-1995 has led K-REP to adopt a more flexible policy which gives credit officers greater discretion to determine both the gestation period of their groups and the sequencing of loans to the group members (see Box 2).

Box 2. Innovations in the K-REP Group Methodology

Initially, the sequence of giving loans to a *watano* was 1-2-2, at intervals of four weeks. In 1993, the sequence was changed to 2-2-1 and later the credit officer in consultation with the manager was given authority to choose the best sequence for each group. Similarly, initial loan limits were set at a maximum of Kshs 10,000 repayable over fifty-two weeks. The practice is now to allow the credit officers and *kiwas* to add flexibility to the guidelines depending on the circumstances and the perceived stability and cohesiveness of the groups. This has also increased the responsibility of the credit officers in the schemes.

The group guarantee mechanism has been liberalized. It is now at the discretion of the group to decide whether the guarantee would be given at the *watano* or the *kiwa* level. The size of the *watano* has also been made more flexible and now varies from four to ten members. The initial requirement that a *kiwa* have thirty members was causing problems, especially when members dropped out, since the credit officer was forced to replace the missing member and possibly cause group cohesion to decline. The additional flexibility in group size has eliminated that problem. Previously, a *kiwa* had to gather at least thirty members to be registered. Over time, and with greater flexibility, fifteen members were allowed to register as a *kiwa*.

In addition to the standard procedures required by K-REP of all *kiwas*, each *kiwa* may develop some of its own operating procedures and systems. This results in minor variations from one *kiwa* to another. Disbursements are made by bank cheques to individual borrowers and delivered during the weekly *kiwa* meetings. The *kiwa* may exert pressure on a defaulter to obtain repayment. In order to be effective, some *kiwas* have introduced a requirement that members must provide personal assets (mainly household items) as chattel for the loans. (See an operational example in Box 3).

The Chikola credit scheme was developed in 1991. The aim is to provide credit to individual entrepreneurs through existing rotating savings and credit associations (RoSCAs). Kenya Rural Enterprise Programme provides a single loan to an established Chikola group, which on-lends the funds to its individual members. The group must be registered as a self-help group, have been in existence for at least one year, and have an average membership of twenty. Members must also be operating businesses in order to be eligible. This last criterion has been an increasingly important enforcement issue for K-REP, since it was identified as one of the primary reasons for the declining repayment rate in 1995. The Chikola must be operating or intend to operate a revolving loan fund and must have a group savings account. The qualifying level of savings is not less than 10 percent of the requested loan amount.

The K-REP credit officer appraises the loan application and makes the disbursement by bank cheque to the group. Previously, the Chikola scheme was monitored from the head office (where loan approval, disbursements and collections were made, and all documents, accounts and loan status records were maintained). These functions are gradually being transferred to the area offices.

Box 3. Forming Juhudi Groups in Nyeri

The Nyeri Branch Office is located within Nyeri Municipality, the provincial headquarters of the Central Province of Kenya. The Nyeri Branch started in early 1993 with one officer. It has been implementing both the Juhudi and Chikola credit schemes. Initially, the schemes were operated from separate offices but they are now combined. The opening of the office was preceded by a study of the area's potential, which included an enumeration of businesses in the area.

The initial launching of the schemes started with general awareness creation among the district administrators to give "legal" backing to the operations of K-REP in the area and the necessary support to the officers. Efforts also concentrated on identifying community leaders who were generally prominent, respected or popular business people. The Ministry of Culture and Social Services assisted in identifying these individuals and in creating contact with existing groups. These groups were used to help reach other new groups in subsequent years.

As more groups are taken in, younger groups start emerging, requiring more intensive assessment and monitoring. As the Juhudi groups mature, the required level of monitoring declines. By the time clients receive their third loan they would have acquired characteristics similar to the Chikola groups which tends to reduce the officer's workload.

One of the barriers encountered during the initial outreach was the association of the funds with "devil worshipping" because potential beneficiaries were highly suspicious of the motives behind granting of unsecured loans (a practice which is uncommon in Kenya's financial system). Some clients adopted a wait-and-see attitude. Even after joining a *watano*, they opted to receive their loans towards the end of the first cycle. In addition, the government was implementing its Rural Enterprise Fund Program at about the same time and by virtue of similarities in name, clients associated the K-REP scheme with "free funds."

Each group must meet at least once a month to conduct group activities including collection of savings and loan repayments. Scheduled group loan repayments are made (through standing bank orders) by transfers from the group savings account to K-REP's bank account. The loan limit is Ksh 25,000 per member for the first loan with subsequent loans varying in size according to the needs of the group and its individual members. Loans are mainly provided for business activities although subsequent loans can be diverted to meet social obligations, such as school requirements. The savings of the group serve as collateral for the loan, and each member agrees to forfeit his/her savings in the event of default by a group member. (An example is presented in Box 4).

Box 4. Green Vegetables Chikola Group in Nyeri

The Green Vegetables Group started as a self-help initiative in 1990. From the beginning, it has been involved in the retailing of green vegetables. Initially each member contributed Kshs 30 each evening. The total collected that evening was given to one of the members for their use. In 1991 the group received its first loan from K-REP in the amount of Kshs 5,000 per member. This loan was repaid, upon which a second loan of Kshs 40,000/member was received in 1993. Initially, the group was composed of just retailers, but now it includes some wholesalers of vegetables.

The group started with thirty members and has successfully maintained that number to the present. Prior to receiving the K-REP loan, the group was a borrower from the National Council of Churches of Kenya (NCCK). Subsequently, due to shortage of NCCK funds, the group was referred to K-REP for financing.

Group loans carried a declining balance interest rate of 35 percent p.a. in 1994-1995 with a 1 percent loan application fee. The interest rates which K-REP charges are largely determined in the context of what the commercial banks charge. The banks charged between 21.3 percent and 29.9 percent in 1995 (Table 9). This is a rate which is significantly lower than K-REP's declining balance rate. In this sense K-REP has been pursuing a policy of "market" interest rates on its loan portfolio. With the decline of inflation rates (and bank interest rates being sticky) the average real interest rate on loans has become sharply positive in 1995. Kenya Rural Enterprise Programme has charged one uniform interest rate to all its clients. Loans are normally repaid over a period of six to twelve months for the first loan and twenty-four months for subsequent loans. When borrowers fail to pay back their loans, various sanctions can be applied. First, K-REP relies on the group pressure through group savings that are pledged. Sometimes assets are pledged and can be ceased by the group. As last resort, K-REP can take legal action.

Kenya Rural Enterprise Programme provides a wholesale credit facility to NGOs that on-lend to their clients using the Juhudi credit methodology. Currently, there are five such NGOs. Although some of the institutions are involved in other broader development activities, they have all agreed to on-lend K-REP funds using a group-based lending methodology. Support provided by K-REP is normally in two components — a soft loan for on-lending and technical assistance (all funded by grant support). The loans are provided at a rate of interest of 10 percent (on a declining balance) repayable over four to seven years in quarterly installments. Nongovernmental organizations that receive support from K-REP are required to submit regular reports on their lending activities. Kenya Rural Enterprise Programme also conducts periodic evaluations of their credit programs.

Table 9: Interest Rates on Loans, 1995

Institution	Nominal rate	Real rate
K-REP	35%	33.4%
Commercial Banks (ave.)	27.9%	26.4%

Other Financial Services

Kenya Rural Enterprise Programme is not involved in providing financial services other than for loans and facilitating group savings. However, it manages an insurance fund equal to 0.5 percent of loan amounts borrowed by various members, as part of its lending scheme. The insurance fund is used to cover loan balances in the event of the death, incapacitation or prolonged illness of a borrower. The fund is operated at a regional level and decisions affecting utilization of the fund are made by a committee comprising the area manager, the credit officer, and *kiwa* representatives.

Non-financial Services

Kenya Rural Enterprise Programme has a history of providing non-financial services in the form of technical assistance to the NGOs it supports. However, it does not offer non-financial services to its borrowers. The functions of the Non-financial Services Division include research, training, technical assistance, information dissemination, NGO loan portfolio, evaluation, and consultancy.

Strategic Plans

The organization's business plan is documented in its Growth Plan and its Annual Operations Plan. The current Managed Growth Plan (1992-1998) retains the institutional mission of being a "development organization aiming to empower low-income people, serve as a catalyst for them to participate in the development process and to enhance their quality of life." Its goals are to generate employment and increase incomes.

Kenya Rural Enterprise Programme intends to design and operate the Juhudi and Chikola credit schemes on a commercially viable basis so that each branch becomes financially self-sustaining and generates surpluses to finance a portion of the costs of the head office. Furthermore, K-REP is exploring the possibility of an internal source of financing through the utilization of borrowers' savings (currently those savings are deposited at the commercial banks).

The Research and Evaluation Department and Consultancy Services will be separated from the other functional areas of K-REP to operate under the Non-financial Services Division. The Finance and Administration Department will upgrade the current accounting and administration system, internal controls and the management information system.

4. OUTREACH, ACCESS AND IMPACT

Economic Outreach and Impact

General Outreach

Kenya Rural Enterprise Programme operations are currently concentrated in Nairobi, Eldoret, Nyeri and Embu (the last two being in the Mt. Kenya area). Initially, it was intended that a branch office would serve clients within a radius of 5 km, but this has been increased to about 15 km depending on the communication network.

The operating target for an Area Credit Office is 1,800 clients. The selection of a location for an area office is based on a feasibility study. The target population for K-REP is selected by one of two criteria: total population or estimated number of small or micro enterprises (Table 10).

Table 10: Size of Population in Target Areas

Service Areas:	Population:
Kawangware (Nairobi)	52,118
Eldoret Municipality	132,800
Kerugoya/Kutus	11,384
Kibera (Nairobi)	145,661
Makandara (Nairobi)	69,127
Nyeri Town	108,385
Estim. No. of SMEs in the K-REP Service Area	910,000
Estim. No. of SMEs who receive formal credit	98,000
Estim. Pct. of SMEs served by K-REP	1.5%

Apart from the branch offices within Nairobi, all other K-REP branches service a rural clientele. Like similar microenterprise programs, the largest number of K-REP's beneficiaries have been women (Table 11).

Table 11: General Outreach Indicators for K-REP, 1992-1995

Indicator	1992	1993	1994	1995
Number of Borrowers (excl. NGOs)	2851	522	12761	14844
Pct. Growth in No. of Borrowers	107%	94%	131%	16%
Number of Women Borrowers (excl. NGOs)	1484	2223	5643	5011
Percentage of Women Borrowers	52%	40%	44%	33%
Percentage of Clients by Sector:				
Commerce and Trade	85	80	77	77
Manufacturing	8	15	14	14
Services	7	5	9	9

Clients served by K-REP fall in three broad sectors: commerce and trade, manufacturing, and services. The portfolio of K-REP is clearly dominated by an emphasis on commerce and trade activities (Table 11). Yet, it continues to make efforts to expand its financing of manufacturing enterprises with the view that those enterprises have superior future growth opportunities.

Kenya Rural Enterprise Programme does not currently finance agricultural production activities on a commercial scale. However, it is implementing pilot projects in agriculture in the Western Region in order to develop an approach which will eventually facilitate lending to the agricultural sector.

Savings Mobilization

Group savings is an integral part of K-REP's credit schemes, and each member of the group is required to save on a regular basis (weekly, monthly) and to retain those savings in a group account at a commercial bank. The working relationships between K-REP, its clients, and commercial banks are detailed in Box 5.

As indicated in Table 12, the increase in the number of active K-REP savers was 426 percent between 1992 and 1995 (from 2,850 savers in 1991 to 15,014 savers in 1995). This is an annual average rate of increase of about 140 percent. The corresponding increase in the nominal value of total savings was 945 percent (from about Ksh 5.3 million in 1992 to Ksh 55.4 million in 1995). That was more than twice the growth observed in the number of savers. However, when deflated, the real value of savings increased by a comparable amount of 422 percent in 1992-1995 (or about 140 percent per year). Because savings is required in order to receive a loan, the number of active savers has been growing in recent years. The Chikola scheme has shown the highest rate of growth.

Box 5. Linkages Between K-REP and the Commercial Banks

Normally, K-REP specifies the bank where the Juhudi bank account must be held. This is to ensure that the funds are in a bank where credit officers have created good working relations, therefore enabling access to information on the accounts. Moreover, they can also lobby on behalf of the groups for flexibility on issues such as minimum account balances, conditions of opening the account, etc. K-REP also wants to ensure that the funds are held with a "safe" bank. By having the group savings accounts in the same bank as the K-REP collection accounts, the client needs to visit only one bank for depositing savings as well as making loan repayments. This is not the case for Chikola groups who mostly have accounts with the Cooperative Bank of Kenya.

Kenya Rural Enterprise Programme became a signatory to the group bank account in order to better protect members' funds and to keep track of what is really happening in the group. For example, some of the groups have been able to maintain a 100 percent repayment rate by depleting savings. By being a signatory, K-REP is also able to ensure that loan disbursements are properly carried out.

Table 12: Number of Active K-REP Savers by Scheme, 1992-1995

Item	1992	1993	1994	1995
Total K-REP Savers	2850	5429	13085	15014
Juhudi scheme savers	2437	2564	3496	4655
Chikola scheme savers	413	2865	9589	10359
Total NGO savers	5234	6386	7464	

Group savings are used to guarantee loans to group members and to act as a qualification for loans. In cases where groups would have saved more than is required under the scheme, the savings may be released to the group for their domestic requirements (e.g., buying food, paying school fees, or increasing their business stocks). Apart from the required group savings accounts, groups also maintain their own saving schemes (usually RoSCAs) to help members meet the household financial needs, and so forth. Some of the Chikola groups use their savings to on-lend to their members. They are then able to realize a higher return than if those funds were retained in a bank. Members of the group are aware of the requirement to have a certain level of savings in order to obtain a loan.

Loans

The increase in the number of K-REP borrowers prior to 1993 was largely associated with the Juhudi credit scheme (Table 13). However, beginning in 1993 a different trend emerged. Since Chikola loans are extended to a large number of ultimate borrowers, growth in the number of "retail-level" clients in K-REP was dominated by the Chikola credit scheme in 1994 and 1995, as reflected by the increase in the number of groups (Table 13).

Table 13: Number of K-REP Borrowers, 1992-1995

Category	1992	1993	1994	1995
Total individuals	2851	5522	12761	14844
Male borrowers	1367	3299	7118	6126
Female borrowers	1484	2223	5643	5011
Total groups	98	203	282	575
Juhudi scheme	82	85	104	201
Chikola scheme	16	118	178	374

Total loans disbursed by K-REP to individuals grew by more than fifteen-fold between 1991 and 1995 from Ksh 23.2 million to Ksh 366 million. Once again, the fastest growth in loan volume disbursed occurred in the Chikola scheme. The number of direct loans disbursed by K-REP during 1992-1995 increased from 1,939 in 1992 to 11,137 in 1995 (Table 14).

Most of the loans disbursed under the Juhudi credit scheme are short-term (ranging from six months to twenty-four months), with the bulk being repaid within twelve months. Almost all the loans are for working capital purposes and go towards increasing raw materials and stocks of finished goods.

Table 14: Number and Volume of Loans Disbursed, 1992-1995

Category	1992	1993	1994	1995
Number of Loans Disbursed:				
directly by K-REP	1939	4331	5149	11137
by other NGOs	4288	2551	1961	1021
Amount of Loans Disbursed (Ksh million):				
by K-REP to clients	23.2	83.5	211.0	366.0
by K-REP to NGOs	25.0	25.0	2.2	3.0

The repayment rate for the Juhudi scheme declined somewhat from about 99 percent in 1991 to about 96 percent in 1993-1994 and about 97 percent in 1995. The Chikola scheme maintained a repayment rate of 95 percent through 1993, but that rate dropped to about 90 percent in 1994-1995. Some innovative loan recovery mechanisms are presented in Box 6.

Box 6. Loan Recovery Mechanisms

Loan recovery is undertaken at the *kiwa* group level. Most groups have insisted on members providing chattel as additional security for their loans. When deaths occur, the member's dues are recoverable from the insurance fund.

The insurance fund was previously not applicable to Chikolas. The argument for that exemption was that under the Chikola scheme clients are groups that do not die. However, Chikolas have now been incorporated into the fund. In 1995, arrears in the Chikola scheme stood at about 5.8 percent of the outstanding balance. As the Chikola scheme grows, younger, less-cohesive groups are formed that will need more scrutiny. Such scrutiny normally includes looking at the group's records of meetings to assess attendance, the group's register of members to assess age of group membership.

A recent census of microenterprises in Kenya recorded over 900,000 such enterprises. The majority of those enterprises have been operating purely with their own resources. Kenya Rural Enterprise Programme is the largest single microenterprise financing institution in Kenya, and the number of clients it has reached so far shows how large the untapped potential is at present. Most of the clients served by K-REP concentrate on the demand for foodstuffs (grains and vegetables), second-hand clothing and food kiosks. Some of the clients have moved from being retailers to wholesalers and have been involved in cross-border trade (mainly purchasing of clothing materials from outside Kenya and selling them in their market areas).

The rates of return earned in these enterprises are difficult to assess because there is no data available on investment levels and net earnings. However, an indirect indicator is the level of interest rates that the borrowers are able to pay. In 1994 and 1995, the loan rate charged by K-REP was 35 percent (declining balance rate), compared to the commercial bank rate on loans and advances which carried an average maximum rate of about 28 percent (nominal) during 1995. When they cannot access formal sources of credit, borrowers obtain loans at much higher rates from their own RoSCAs or in a few cases from local moneylenders (family, merchants, and so on).

Although credit programs such as K-REP have not grown to the magnitude that they can influence the level of interest rates, commercial banks have been sufficiently influenced by their activity to change their attitudes towards financing of microenterprises. Commercial banks have previously ignored the sector, but both the Kenya Commercial Bank and Barclays Bank have now developed schemes targeting these clients. Kenya Finance Bank is also in the process of developing a group-based lending scheme. No doubt such schemes borrow heavily from the experiences of K-REP and other lending NGOs.

Other Financial Services

Kenya Rural Enterprise Programme created an insurance guarantee fund as part of its lending scheme. The insurance fund is the result of a fee charged to borrowers equal to 0.05 percent of the loan amount. These funds are used to recover loan amounts from deceased or incapacitated members.

Non-financial Services

Since its inception, K-REP has been a major provider of technical assistance to other NGOs. That assistance includes training of staff especially in credit methodology and evaluation. The consultancy unit of K-REP has been a substantial source of revenue. It earned about Ksh1 million in 1991, Ksh 7 million in 1993, and Ksh 8.3 million in 1995. These consultancies are conducted both locally and outside Kenya. The organization also offers secretarial services to a publishing credit scheme.

Kenya Rural Enterprise Programme has been offering training and other technical services to NGOs. Technical services include systems development and installation, planning, monitoring, evaluation, and credit administration. Recently, its training activities have been extended to participants from Eastern and Southern Africa. The aim of this service is to strengthen the institutional capacity of governments and NGOs in the region. The emphasis of this training is on group-based lending and achievement of self-sustainability.

Social Impact

Kenya Rural Enterprise Programme has monitored the social impact of its support by determining the extent to which credit has altered the living conditions of its clients, their families and communities.

Client Participation in K-REP

Kenya Rural Enterprise Programme adopted the minimalist approach to reduce its cost of administering loans. Greater cost efficiency allows more loanable funds to be disbursed. The minimalist approach also bestows more financial responsibility on clients. Observation made in the field revealed that clients in both schemes are active participants in the decision-making process.

Chikola members determine the amounts of loans to be borrowed by each member, depending on individual needs. Similarly, Juhudi clients are actively involved in all aspects of the lending process. Loans are recommended or refused depending on an assessment of the borrower's ability to repay. There is also communication between credit officers and the clients. Where problems arose in cases of default, clients were quick to take action.

Most clients felt they were unable to pay for the costs of training given their income levels; however, they hoped K-REP would organize such training programs. Some Chikola borrowers thought they had sufficient entrepreneurial skills and did not need additional training.

Impact of K-REP on Clients

Clients generally agree that credit from K-REP has resulted in improved incomes, increased output and growth in their businesses (either in size or numbers of employees). There was however a noticeable difference in the impact of credit on those who had large businesses and those who had small businesses (Box 7).

Box 7. David in the Juhudi scheme in Eldoret

David is a member of Soko, a *kiwa* in K-REP's Eldoret Branch. David dropped out of school after completing the upper primary level because of poverty and received no additional formal or technical informal training after that. He is married and supports nine children. David farmed for several years, but the yields were too low to provide for his large family, so he decided to go into business. He got some space at the municipal market in Eldoret where he sold cabbages and potatoes, but profits remained quite low.

When K-REP was introduced in Eldoret, David joined Soko (a Juhudi group) and received three loans of Kshs 10,000 each in 1991, 1992, and 1993. The loans were used to increase his stock of cabbages and potatoes, construct rental units on land he acquired outside Eldoret, and hire a truck to acquire and transport cabbages and potatoes from more distant locations such as Cherangani. As his business expanded, David was able to obtain contracts with the army, Eldoret Hospital, and Moi University. The money from the second and third loans was used exclusively to expand his retail business.

Since becoming a member of K-REP, David has managed to save about Kshs 45,000 through the Juhudi scheme and the local commercial bank. He can also provide adequately for his family now. David's family income has increased from about Kshs 1,800/month (when he was a farmer) to Kshs 64,000/month (from his farm, retail vegetable business, and rental units). David is hoping to receive a fourth loan of Kshs 100,000 from K-REP to further expand his business.

Borrowers who operate larger businesses complained that the impact of K-REP loans was too little. Those with smaller businesses reported greater impact. The primary complaint from those with larger businesses was that the loan sizes were too small to meet their financing requirements. Following these complaints, K-REP responded by making the loan ceiling flexible, though not sufficiently flexible to accommodate all clients. This complaint was more pervasive among Chikola borrowers, regardless of gender or their type of business.

Generally, clients indicated that K-REP had enabled them to increase their household incomes and more adequately pay for household needs such as school fees, food and clothing. Some clients also reported less "fear of loans."

Impact of K-REP on Institutional Capacity

Kenya Rural Enterprise Programme has a well-developed capacity to respond to social and political changes. It is innovative in its attempts to improve efficiency and offer better services to its clients. The organization's track record has enabled it to remain the channel of donor funds to many NGOs in Kenya. The organization's management uses a participatory approach, which allows for a free exchange of ideas between management and staff. The Research and Evaluation Department has also enabled the organization to remain well ahead of other intermediary NGOs in innovation.

The K-REP establishment is growing in response to credit demands in its new areas of operation. The availability of training opportunities both internally and externally has enabled the organization to develop a foresighted staff. The staff is well-motivated through remuneration and responsive improvements to the working conditions.

Capacity to Assess Impact

Within the K-REP organization there has been a continuing effort to develop a capacity to conduct program evaluations both internally (staffed by personnel from within K-REP) and externally (using consultants). At this stage, the capacity of K-REP to conduct an impact analysis is good. The primary vehicle for these evaluation efforts is the Research and Evaluation Department. The activities of the department are segmented into four areas: monitoring and evaluation, research, documentation and dissemination, and innovations and development. The monitoring and evaluation (M&E) group is involved with various analyses of operations. The M&E group provides on-going feedback on K-REP operations in its microenterprise minimalist credit schemes by comparing the effectiveness of strategies, estimating the impact of credit services on social and economic target variables, and providing periodic qualitative assessments of the programs and clients' perceptions.

The purpose of K-REP's evaluation system is to generate data representing the impact of K-REP services on its clients. The system also provides information such as changes in target groups. Such information is critical for regular program reviews, and in assessing the usefulness of a particular strategy or approach. Some of the variables measured are jobs created, level of business and household income, value of business and household assets and so on. The data is collected periodically, usually every six months, using a random sample.

Successive impact assessments revealed that there were weaknesses in K-REP's "before-loan, after-loan" method of evaluation. It decided to have a standard in-take form, and then a detailed baseline form for a sample of new clients which would be stratified on the basis of business sector, type, size, age, and gender. A time-series evaluation of new clients would then form the basis for a continuing evaluation. The sample size has also been affected by exits from the programs. Due to increased number of clients and general workload, data collection has often been delayed.

A K-REP evaluation includes two levels of analysis: the primary level and the secondary level. At the primary level, measurements are taken on effects of credit on employment, output, and profit. At the secondary level, the emphasis is on measuring the economic and social impacts associated with reinvestment or consumption of the additional resources generated as the primary effects. The K-REP methodology for evaluating impact is to measure the "with/without" and the "before/after" effects using experimental design and time series data.

Future Plans

The business plan of K-REP calls for a significant increase in the number of area credit offices. New locations will be selected based on sufficient population density to support a self-sustaining credit program (market centers with a microenterprise population of at least 5000), proximity to banking facilities, potential for clustering credit offices to achieve economies of scale, and the desire to avoid duplication with other schemes.

5. FINANCIAL PERFORMANCE

Sources and Uses of Funds

Kenya Rural Enterprise Programme has funded its loan programs and institutional investment activities through two primary means: internally-generated funds (in the form of loan program "reflows" from loan repayments and operating profits) and externally derived ones (through donor grants and loans).

Historically, K-REP has relied on donor grants for on-lending and institutional support and development. During 1992-1995, a total of Ksh 385 million was received from donors in the form of grants (Table 15). The dominance of grants in the funding of K-REP can be illustrated by looking at both the total amount of grants received over time and by comparing their annual amounts to reported annual income. During 1991-1994, grants accounted for between 69-87 percent of consolidated total income. In 1995 grant funding as a proportion of total income was at approximately 87 percent. Liabilities accounted for a small percentage of K-REP's funding during 1991-1995.

Table 15: Sources of Funds, 1993-1995

Source of Funds	1992	1993	1994	1995
Donor Grants (000 Ksh)	25738	150825	110751	97204
Other Income Funds (000 Ksh)	11572	22779	50425	77268
Donor Grants/Total Oper. Income (incl. grants)	69%	87%	82%	87%

Nominal total assets of K-REP grew from about Ksh 38 million at the end of 1990 to Ksh 328 million by the end of 1994 — an average annual compound growth rate of about 70 percent in nominal terms and 30 percent in real terms. Due to continued growth in the loan portfolio, nominal total assets increased to Ksh 377 million in 1995.

Cash and equivalents have constituted a major component of total assets (about 34-39 percent) during 1991-1993. In 1995, cash assets were reduced to about 13 percent of total assets, and the proportion of loans in total assets increased to 67 percent. Earlier (1991-1993), loans had represented 50-54 percent of total assets. Total liabilities continue to represent a relatively small proportion of the source of funds. Yet, combined short-term and long-term liabilities increased from Ksh 1.2 million in 1990 to Ksh 16.6 million in 1993, Ksh 20.7 million in 1994, and about Ksh 19.4 million in 1995.

Operating Performance

Loan volume has grown more rapidly during 1993-1995 than in previous years. In nominal terms, loan volume grew at about 184 percent in 1993, 87 percent in 1994 and 48 percent in 1995. In real terms the increase in loan volume was about 138 percent in 1993, 58 percent in 1994 and about 47 percent in 1995. Growth in loan volume, the number of borrowers, and average loan size has placed additional demands on the staff and resources of K-REP. In response, K-REP has established new targets for the number of clients and loan volume supported by each credit officer. This coincides with the strategy of increasing self-sustainability of the organization; however, the indicators of operational efficiency are mixed.

Loan volume per credit officer has increased in both the Juhudi and Chikola credit schemes (Table 16). The apparent shift in loan volume per officer which occurred during 1993-1994 corresponds with the combining of the Juhudi and Chikola credit schemes. The increase in loan volume per officer implies a significant increase in productivity per field credit officer, and is part of the overall strategy to achieve increased sustainability of financial service operations.

K-REP recently changed its definitions of arrears and defaults. During 1990-1992, arrears was defined as any loan with one installment past due (effectively one week), while defaults included any loan with two or more installments past due. Since 1993, arrears has been defined as three to twelve weeks past due and defaults as twelve to fifty-two weeks past due. At present, any loans with one to four installments due is in arrears while loans with over four installments due are in default. In 1993, total arrears and defaults in the Juhudi credit scheme amounted to Ksh 4.4 million. That amount increased to Ksh 8.2 million in 1994, and Ksh 23.6 million in 1995. During the earlier period, no arrears were reported under the Chikola scheme. This was because automatic account transfers from the Chikola savings account to the K-REP account were handled through the participating banks.

Table 16: K-REP Loan Performance, 1992-1995

Indicator	1992	1993	1994	1995
Loans Outstanding (Ksh mill.)	38.6	109.6	205.7	294
Annual Growth of Loan Volume	19%	184%	87%	48%
Average Loan size (Ksh 000)	11.9	19.3	40.9	32.9
Average Loan/GDP per capita	1.28	1.19	3.21	2.23
Outst. Loan Vol./Credit Off. & Manager (000 Ksh):				
Juhudi scheme	740	736		
Chikola scheme	1544	8418		
Combined			3809	4141
'No. of Loans/Credit Officer & Mgr.				
Juhudi scheme	142	98		
Chikola scheme	5	21		
Combined			122	265

In 1994, the Chikola scheme began to experience significant arrears and defaults. The repayment rate (amount paid/amount due) in the Juhudi scheme deteriorated from 99 percent in 1991 to 96 percent in 1993 and stabilized at 97 percent in 1995 (Table 17). In 1995, K-REP revised its policy on Chikola savings accounts to become a signatory to those accounts. This change in operating policy provided K-REP with better control of, and information concerning, the source of funds which was being used to make loan repayments. Thus, it was able to determine the extent to which savings were being depleted to make repayment, rather than using earnings from the Chikola enterprises.

In an attempt to defray the costs of loan defaults in the Juhudi scheme, K-REP pursued a policy of foreclosing on group savings accounts. The level of group savings foreclosed upon was about Ksh 1.5 million in 1992 and Ksh 1.4 million in 1993. In addition, K-REP established loan-loss reserves of Ksh 1.0 million and Ksh 600,000 during the same years.

Both the Juhudi scheme and the NGO portfolio experienced an arrears problem in 1992 and 1993. Arrears and defaults in the Juhudi scheme (as a percentage of outstanding loan portfolio) increased from about 7.5 percent in 1991 to 18.5 percent in 1992 and fell to about 7.8 percent in 1993. Arrears on NGO and Juhudi loans approximately doubled from about 14 percent to about 28 percent during that period. Total arrears in the Juhudi credit scheme stood at Ksh 23.6 million in 1995. That represents about 8 percent of the total (combined Juhudi and Chikola) loan portfolio. Throughout 1992-1993, the loan-loss reserve was relatively small.

Total income (excluding donor grants) covered about 98 percent of total operating expenses in 1995. This compares with 88 percent in 1994, 67 percent in 1993, 45 percent in 1992, and 59 percent in 1991. Thus, K-REP has recently improved its operational performance, but it has not attained operational self-sustainability. Total interest and fee income as a percentage of total operating expenses has generally increased from 28 percent in 1992 to 40 percent in 1993, 80 percent in 1994 but fell to 62 percent in 1995. Thus, revenues generated during 1992-1994 through lending and investing activities were beginning to approach levels which could eventually make K-REP self-sustainable. The decrease in interest income from investments and the relatively faster increase in operating expenses than credit scheme income caused the decrease in 1995.

Underlying the improvement in operating performance in 1994 and 1995 was an increase in the yield on earning assets. Interest and fee income on loans increased from 8 percent in 1993 to just over 15 percent in 1994 and about 20 percent in 1995. The higher yield on loans was associated with an increase in the interest rate charged. A slightly larger increase occurred in 1994 on the yield on investments. However, in 1995 loans became the higher-yielding asset in K-REP's portfolio. The percentage return on investments was 5.8 percent in 1993, 16.8 percent in 1994 and 11.4 percent in 1995. The improved yields on loans and investment assets led to a significant increase in the net interest margin (NIM) from about 9 percent in 1993 to over 16 percent in 1994 and about 15 percent in 1995.

Table 17: K-REP Direct Loan Portfolio, 1992-1995

Portfolio Indicator	1992	1993	1994	1995
Volume of arrears - Juhudi (mill. Ksh)	1.2	4.4	8.2	23.6
Loan repayment rate (%):				
Juhudi scheme	97.0	96.0	96.0	97.0
Chikola scheme	97.5	95.5	93.0	93.0
Combined	97.5	95.5	93.0	93.0
Provision for loan loss (Kshs 000) - (excl. the NGO portfolio)	1.0	0.1	-0.9	15.0 (est.)

Expense control has been another significant part of improvements in operational performance. Total operating expense as a percentage of loan volume has declined from 66 percent in 1993 to about 42 percent in 1995. Thus, as loan volume has grown, K-REP has been able to control the rate of increase in the cost of service delivery. Another indicator of that efficiency is the decrease in personnel expenses as a percentage of total assets. That percentage declined from 12 percent in 1993 to about 7 percent in 1994 and 6 percent in 1995. Taken together, the improvement in operational self-sustainability during 1992-1995 is the result of improved control of operating expenses, higher interest earnings, and growth in earning assets (viz., the loan portfolio) without an offsetting increase in loan losses.

Subsidy Dependence

The Subsidy Dependence Index (SDI) is an indicator of the degree to which a development finance institution is dependent on external grants and other forms of subsidies in order to sustain its operations (see Annex C). The primary subsidies to K-REP have been in the form of interest-free grants from international donors for the purpose of on-lending. These funds have been recognized as income without a corresponding interest expense. The SDI uses an alternative method of recognizing such funds. It treats them as a part of capital. This approach does not distort the reported level of net income from operations. In addition, the SDI applies an opportunity cost to the subsidized funds to reflect the impact of the subsidy on performance.

In the case of K-REP there are two alternative opportunity costs of funds which could be considered: the annual rate of inflation plus 2 percent (for the cost of mobilizing funds) or the savings rate plus 2 percent (for the cost of mobilizing savings deposits). Using either measure for the market cost of funds, the level of subsidy dependence remained high during 1991-1995. If the inflation rate is used in the computation, the SDI was 1087 in 1991 (Table 18). This suggests that in order to become subsidy free, K-REP would have needed to increase the interest rate it charged on loans by 9.87 times in order to eliminate the subsidy it received from donors in that year. The corresponding SDI levels were 1105 in 1992, 1394 in 1993, 420 in 1994 and 74 in 1995. The sharp decrease in the SDI in 1994 was associated with the increase in interest income received and operational efficiency as well as the decline in the rate of inflation. The decrease in SDI in 1995 was primarily associated with the further decline in the rate of domestic inflation and the ability of K-REP to maintain its lending rate at 35 percent. If one uses the full cost of savings deposits, the SDI was approximately 887 in 1991. It declined to 311 in 1994 and by 1995 the SDI was 160.

Clearly, the picture which emerges during 1991-1995 is that K-REP has improved its financial performance. It remains significantly dependent on subsidies in the form of grants, a situation it is conscious of and is working hard to correct. Moreover, the remaining high level of subsidy dependence is associated with K-REP's on-lending to NGOs at an artificially low rate.

Table 18: K-REP Subsidy Dependence Index, 1991-1995

SDI Measure	1991	1992	1993	1994	1995
Market rate = (inflation rate + 2%)	1087	1105	1394	420	74
Market rate = (savings rate + 2%)	887	790	680	311	160

Challenges and Future Plans

K-REP faces a set of new and continuing challenges as the leadership in the organization attempts to position it for greater growth, client outreach, and continued improvements in self-sustainability. The following is a representative sample of those issues. First, K-REP is in a consolidation phase. To move ahead, the organization must develop a strategy to improve its MIS, refine the Juhudi and Chikola schemes, continue to make adjustments in management, work for sustainability, and develop cost-effective strategies for expansion. Second, client enterprises (in the Juhudi and Chikola schemes) can grow, but they require larger loans and in some cases different methodologies. This implies larger loans and different loan terms. Third, K-REP will need to develop its intermediary role further as a "financial system," so that it provides a more complete set of financial services (credit and savings) for microenterprises. Fourth, separating the retail and wholesale activities to improve the capacity for achieving long-run sustainability will need to be accomplished.

Kenya Rural Enterprise Programme is about to complete its negotiations for establishing a bank. The organizational structure has been changed in anticipation of that action. The Financial Services Division incorporates activities which have the potential of being self-sustaining. As a bank, K-REP could engage in the mobilization of savings which would in turn serve as a source of funds for on-lending to its borrowers. A feasibility study has been undertaken, and a decision has been made to obtain the necessary government approvals. A foreseen problem with this plan is that K-REP may not have the loan portfolio to effectively benefit from the bank strategy, if one looks at other institutions that have formed banks.

6. Innovations and Lessons Learned

The transformation which occurred in K-REP between 1990 and 1995 has involved several innovations in its credit methodology and changes in its role as a financial institution. At several important junctures in this transformation, there have been opportunities to identify lessons learned.

First, innovations in products, modes of operation or organizational structure are an integral part of an overall institutional growth strategy. The initial innovation was to adopt the group-based credit model following experimentation with a pilot Juhudi scheme. The related modification was to employ the minimalist credit approach by which K-REP provides credit to its clients with minimal amounts of training and social services. These two factors have led to a significant amount of outreach in terms of clientele and loan volume under the Juhudi scheme.

Initial problems with loan defaults in the Juhudi scheme were overcome by studying the underlying causes of nonrepayment and addressing those issues. The primary finding was that group formation and the stabilization process must be carefully undertaken before loans are extended, or group cohesiveness and peer pressure are not enough to obtain an acceptable level of loan repayment. Moreover, the factors that lead to default are linked to both the lender and the borrower. The way the microfinancing institution operates and perceives its clients affects the rate of loan default. Subsidized interest rates, credit programs linked to social services, and the perception of clients as beneficiaries (instead of clients) may increase the risk of nonrepayment.

Delegating all responsibility of credit assessment to the groups may result in poor credit assessment as group members are not objective with their colleagues. Bad screening of potential borrowers by the credit officer and bad appraisal of the investment also increase the default rate. Finally, dependence on group members' savings as collateral could result in default as borrowers do not like to forfeit their savings on account of their peers. Among borrowers, the major factors are bad investment, theft or destruction of business assets, mismatch in loan-size and the flow of income expected from the investment made, diversion of loan purpose, fraud and death or sickness.

A major innovation has been the adaptation of the group-based lending approach to Chikola groups. The Chikola methodology involves a group loan that is on-lent by the group to its members in order to cover their individual borrowing needs. The Chikola scheme has the advantage of using existing groups of entrepreneurs running small-scale and microenterprises, but who need additional access to credit. The initial costs of group formation are therefore not borne by K-REP and the problem of forming cohesive groups is avoided. Additionally, the Chikola scheme seems to be a convenient and cost-effective vehicle for the retailing of loans. Operationally, K-REP provides one loan to the Chikola group during each borrowing cycle. The additional costs of distributing the loan to the individual clients and collecting loan repayments are borne by the Chikola group.

By extending the group-based lending approach to Chikolas, K-REP initially reduced its cost of delivering credit. Because the Chikola model could effectively deal with the problem of transaction costs, it allowed K-REP to achieve greater outreach in the target population of entrepreneurs in the early phase of its adoption. However, K-REP's experience in 1995 revealed that the Chikola groups must pass the same test of stability and cohesiveness in order to yield the expected reduction in costs and improvements in financial self-sustainability. If the Chikola groups are not stable and cohesive, the repayment rate falls, loan losses rise, and there is an increase in the costs of credit administration. Each of these factors result in a lower net income from loans and a threat to self-sustainability. For example, K-REP found that several groups in the Nyeri Branch did not exhibit the required level of solidarity. Loan repayment rates in the Chikola scheme declined in 1994 and 1995 to unacceptable levels. K-REP adjusted the Chikola methodology to increase group stability before advancing loan funds, and then became a signatory to the Chikola group savings account.

An institution also needs to look at innovation as an action research process in which the institution makes modifications over time, based on an analysis of the feedback received from clients and the socio-economic environment. An important part of that process is the development of a capacity within the organization to identify problems early and assess the impact of programs and changes in those programs on clients. This is an important part of institution building. Some of the most promising innovations which K-REP has adopted are those which have surfaced recently through interactions with its Juhudi borrowers. Several modifications of the group-based lending approach have been the result. Overall, there has been an effort to be more flexible in administering credit and providing more group involvement in the process. More flexible loan size and the frequency of group meeting are two primary examples of innovations which have resulted. These changes also help reduce the costs of intermediation, and provide greater potential for outreach to new clients, and ultimately to improvements in K-REP's financial self-sustainability.

Several other lessons can be drawn from the K-REP experience. First, lending services require good management skills, qualified staff, and an effective information system. Second, there is a danger of mixing the provision of financial services with training and technical assistance. The latter are difficult to price and thereby undermine the sustainability of the institution. Third, a micro-financing institution (like other financial intermediaries) must charge interest rates that enable it to cover its operating and financial costs. As a related point, sustainability cannot be reached while depending on donor funds. The institution needs to access funds from the financial market. Grants and subsidized loans may be justified to start and strengthen operations but they must decrease gradually in the long run.

The microfinancing institution needs to select appropriate performance standards by which to monitor its operations. This process begins with the identification of appropriate operating and financial performance indicators.

Clients must be involved in evaluating the progress of microfinance services. Clients often remain passive and do not contribute to the evolution of the lending institution. Their input is necessary to assess performance and plan further policy and development of the institution. The microfinancing institution needs to define strict rules to govern its credit operations even though it deals with the poor. However, processes and instruments developed by the lending institution must be simple and comprehensive for the clients.

There is a challenge for microfinancing institutions to identify alternative forms of collateral and ways in which to incorporate that collateral into the lending schemes. This factor becomes significant for those MFIs who must expand the range of their lending products to serve the segment of their client base which is demanding larger loan size. Microfinance institutions such as K-REP have found that large variations in member loan size within a group reduces peer pressure as an incentive to make repayment. Thus, alternative forms and uses of collateral need to be considered within the context of the group-lending approach.

Annex A. Financial and Economic Indicators for K-REP (1991- 95)						
I. Economic and Financial Environment		**1991**	**1992**	**1993**	**1994**	**1995**
GDP per capita - nominal (000 Ksh)		8.33	9.28	11.05	12.75	14.78
GDP per capita - real (000 Ksh)		3.77	3.66	3.55	3.54	3.52
GDP growth rate - nominal		10.2	11.4	19	15.4	5.2
GDP growth rate - real		-1.2	-2.8	-3	-0.3	5.2
Inflation rate		19.6	27.3	46	28.8	1.5
Interest rate ceilings		removed	none	none	none	none
Commercial bank loan rates - nominal, ave. max.		20	21.4	30.5	36.2	27.9
Commercial bank loan rates - real, ave. max.		0.4	-5.9	-15.5	7.4	26.4
Commercial bank saving rates - nominal, ave. max.		13.5	13.7	18.3	20.1	12.8
Commercial bank saving rates - real, ave., max.		-6.1	-13.6	-27.7	-8.7	11.3
Exchange rate (Ksh/ USD)		28.1	36.2	68.2	45	55
Socio-economic:	population (million)	22.9	23.7	24.5	25.4	26.2
	population density	37	(24 to 307)			
	literacy rate - overall	67				
	literacy rate - male	72				
	literacy rate - female	63				
	life expectancy	59				
	infant mortality (per 1000)	67				
	child mortality (per 1000)	105				

II. General Description		1991	1992	1993	1994	1995
Type of institution		NGO	NGO	NGO	NGO	NGO
charter (1984 - 1987)	Project of World Education					
charter (1987 - 1995)	Kenyan limited company					
Year established	1984					
Objectives	Promote employment and income generation among the poor					
Clients	Trade (%)	85	85	80	77	77
	Service (%)	3	7	5	9	9
	Manufacturing (%)	12	8	15	14	14
Ownership		Private	Private	Private	Private	Private
Governance		Board of Dir.	Board of Dir.	Board of Dir.	Board of Dir.	Board of Dir.
Scope of fin. services		Loans	Loans	Loans	Loans	Loans
Nonfinancial services						
Branches	Area Offices	1	2	4	4	6
	Field Offices	0	0	0	7	11
Village banks		none	none	none	none	none
Use of groups		yes	yes	yes	yes	yes
Use of mobile staff		yes	yes	yes	yes	yes
Loan application		Field Officer	Field Officer	Field Officer	Field Officer	Field Officer
Loan approval		Branch Mgr	Branch Mgr	Branch Mgr	Branch Mgr	Branch Mgr
Decisions on interest rates		Head Office	Head Office	Head Office	Head Office	Head Office
MIS	outputs	financial and credit oper. reports (wkly, monthly)				

III. Outreach - Clientele:		1991	1992	1993	1994	1995
Number of borrowers	individuals - total	1377	2851	5522	12761	14844
	individuals - male	639	1367	3299	7118	6126
	individuals - female	738	1484	2223	5643	5011
	groups - Juhudi	49	82	85	104	201
	groups - Chikola	7	16	118	178	374
	women - Juhudi (%)	52	50	51	35	51
	women - Chikola (%)	57	96	65	60	62
Growth in no. of borrowers (%)			107	94	131	16
Employees	total - incl. support staff	39	44	80	93	112
	women (%)	39	43	51	58	52
	women - Credit Officers	5	8	20	19	23
Staff incentives					pay bonus	pay bonus
SME population reached (as % of the 910,000 SMEs who have received credit)						1.5

IV. Outreach - Loans:		1991	1992	1993	1994	1995
No. loans disbursed to clients by KREP (combined)		1507	1939	4331	5149	11137
No. loans disbursed to clients by NGOs		3142	4288	2551	1961	1021
Vol. loans disbursed to clients by KREP (mill. Ksh)		14.3	23.2	83.5	211	366
Vol. loans disbursed to NGOs by KREP (mill. Ksh)		23	25	25	2.2	3
Outst. loan portfolio	excl. NGO (mill. Ksh)	32.5	38.6	109.6	205.7	294
Ave. loan size	excl. NGO (000 Ksh)	9.5	11.9	9.3	40.9	32.9
Ave. loan size/ nominal GDP per capita		1.14	1.28	1.19	3.21	2.23
Loan size limits	first loan - Juhudi (Ksh)	10,000	10,000	15,000	20,000	25,000
Eligibility requirements - Juhudi		Kenyan, over 18 years old, Watano group member, assets<300,000 Ksh				
Eligibility requirements - Chikola		Registered group, operates a ROSCA , 10% savings, SME businesses				
Outst. loan vol./credit off. & mgr. (000 Ksh) - Juhudi		690	740	736		
Outst. loan vol./credit off. & mgr. (000 Ksh) - Chikola		1441	1544	8418		
Outst. loan vol./credit off. & mgr. (000 Ksh) - Combined					3809	4141
No. outst. loans/ credit off. & mgr. - Juhudi		132	142	98		
No. outst. loans/ credit off. & mgr. - Chikola		7	5	21		
No. outst. loans/ credit off. & mgr. - Combined					122	265

V. Outreach - Deposits:		1991	1992	1993	1994	1995
Deposit/savings instruments offered		Passbook	Passbook	Passbook	Passbook	Passbook
Volume of deposits	Juhudi (000 Ksh)	2241	4741	7802	12106	22142
	Chikola (000 Ksh)	160	543	5758	7250	33214
No. of active savers	Juhudi	2280	2437	2564	3496	4655
	Chikola	57	413	2865	9589	10359
Size of accounts	Juhudi (Ksh)	980	1950	3040	3463	4757
	Chikola (Ksh)	2800	1310	2010	756	3206

VI. Conditions:		1991	1992	1993	1994	1995
Types of financing	activities	Chikola - primarily manuf.; Juhudi - primarily trade and commerce				
	sectors	Nonfarm	Nonfarm	Nonfarm	Nonfarm	Nonfarm
Collateral required	savings	10% of initial loan request				
	physical	Varies by Kiwa group				
	social (group solidarity)	yes	yes	yes	yes	yes
Repayment frequency	expected	weekly	weekly	weekly	weekly	weekly
	actual	weekly	weekly	weekly	weekly	weekly
Enforcement of repayment		Kiwa group officers and local community chief				
Repayment incentives		Future loans; loan size increments for repeat borrowers				
Monitoring	frequency	weekly	weekly	weekly	weekly	weekly
Loan maturities	working capital	6 mo. , 1 yr.	6 mo. , 1 yr.	6 mo. , 1 yr.	6 mo. , 1 yr.	6 mo. , 1 yr.
	term loans				2 yr.	2 yr.
Loan rates	nominal (declining balance)	28	28	35	35	35
	real	8.4	0.7	-11	6.2	33.5
	nominal (flat rate)	20	20	20	20	20
Loan size increments	amount (Ksh) - second loan	5000	10000	15000	20000	25000
Graduation		no	no	no	no	no
Access to deposits	collection	weekly	weekly	weekly	weekly	weekly
	retrieval	weekly (if minimum balance of 10% is met)				

VII. Loan Portfolio:		1991	1992	1993	1994	1995
Arrears	definition	Pre-1993: 1 week past due, but effective 1993: 3-12 weeks past due.				
	volume - Juhudi (mill. Ksh)	0.26	1.2	4.4	8.2	23.6
Repayment rate	(Loans repaid/Amount due)					
	Juhudi (%)	99	97	96	96	97
	Chikola (%)	99	97.5	95.5	93	93
	Combined (%)	99	97.5	95.5	93	93
Provisions for loan losses excl. NGO (mill. Ksh)			1	0.1	-0.9	15.0 (est.)
Write-offs of loans		0	0	0	0	0

VIII. Financial Performance:		**1991**	**1992**	**1993**	**1994**	**1995**
Sources of funds	donors grants (000 Ksh)	33264	25738	150825	110751	97204
	other income (000 Ksh)	3457	11572	22779	50425	77268
Donor funds/Total operating income		0.83	0.69	0.87	0.68	0.35
Cash and equiv./Total assets		0.39	0.34	0.35	0.24	0.13
Total loans/Total assets	Combined (%)	0.5	0.54	0.49	0.62	0.672
Yield on loan portfolio		0.11	0.11	0.13	0.07	0.17
Interest paid/ Interest earned				0.01	0.08	0.12
Net interest margin		0.09	0.093	0.089	0.164	0.117
Gen. and admin. exp./ Ave. total assets		0.46	0.42	0.25	0.21	0.21
Gen. and admin. exp./ Ave. total assets		0.11	0.17	0.19	0.13	0.11
Gen. and admin. exp./ Loan vol. disbursed		0.31	0.2	0.09	0.13	0.16
Personnel exp./ Ave. total assets		0.07	0.08	0.12	0.07	0.06
Personnel exp./ Loan vol. disbursed		0.05	0.05	0.09	0.07	0.04
Staff train exp./ Loan vol. disbursed		0.001	0.001	0.001	0.001	0.001
Financial expenses/ Ave. loan vol. outstand.				0.001	0.01	0.02
Operat. income (excl. grants)/ Operat. expenses		0.59	0.45	0.67	0.88	0.98
Operat. income (incl. grants)/ Operat. expenses		1.64	1.47	0.73	1.28	1.39
Operat. income/ Operat. and financing expenses				0.72	1.18	0.7
Subsidy Dependence Index:						
	mkt. rate = inflation rate + 2%	1087	1105	1394	420	74
	mkt. rate = savings rate + 2%	887	790	680	311	160
Growth of equity capital - consolidated (%)		62	12	215	45	114
Rate of return on loan assets (financial service div.)		0.11	0.17	0.07	0.13	0.17
Capital/ Total assets (financial service div.)		0.23	0.35	0.78	0.81	0.84

Annex B: Nyeri Branch Profile

The Nyeri Branch Office is located within Nyeri Municipality, the provincial headquarters of Central Province of Kenya and operates in rented premises. The branch has been implementing both the Juhudi and Chikola credit schemes. Initially, the schemes were operated from separate offices, but since late 1994 they have been combined under one roof. The opening of the office was preceded by a study of the area's potential which included an enumeration of businesses in the area.

The initial launching of the schemes started with raising awareness among the District administrators to give "legal" backing to the operations of K-REP in the area and the necessary support to the officers. Efforts also concentrated on identifying community leaders and prominent individuals. The Ministry of Culture and Social Services assisted in identifying these individuals and in creating contact with existing groups. These groups were used to help reach other new groups in subsequent years. Nonetheless, some difficulties had been encountered during the initial period of outreach. One such difficulty was from rumors that the funds brought in were associated with "devil worship." Potential clients were highly suspicious of the motives behind the granting of unsecured loans (a practice which is uncommon in Kenya's financial system). Some clients adopted a "wait-and-see" attitude. Even after joining a *watano*, they opted to receive their loans towards the end of the first cycle. Furthermore, the government was implementing its Rural Enterprise Fund Program at about the same time and (by virtue of similarities in name) the K-REP scheme tended to be associated with "free funds."

The Nyeri Branch started in early 1993 with one officer. In May 1993 this officer was joined by four credit officers and an accountant. Three credit officers were added in December 1993. Currently, the staff consists of eight credit officers, an accountant, an office messenger, a secretary and the branch manager. Most of the credit officers hold diplomas from the Cooperative College of Kenya or other diploma-granting institutions. The Nyeri Branch currently serves thirty-six Chikola groups (907 members) with Kshs 15.6 million outstanding and thirty-four Juhudi groups (1036 members) with about Kshs 10 million outstanding. The geographical location of the clients is key to determining the number of clients served by each credit officer. By combining the Juhudi and Chikola schemes, the geographical area covered has also increased. Previously, a Juhudi officer operated within a maximum radius of 30 km. Initially, the Juhudi credit scheme was intended to operate within 5 km (i.e., within the Nyeri Municipality). Currently, some officers cover as many as 50 km. The Nyeri Branch Office is now in charge of Nyeri, Muranga, Laikipia, and Nyandarua districts. Because of this wider geographical area, new field offices are being opened.

At the time of opening the Nyeri Branch, credit officers had a target of ten groups per officer (i.e., 300 clients), but the target in 1995 was increased to fifteen Juhudi groups. A Chikola officer is expected to manage up to twenty-five groups, although past officers managed up to forty Chikola groups. As the Chikola credit scheme grows and gains experience, the number of groups per credit officer has to be reduced in order to achieve closer monitoring. Recent changes in the Chikola scheme also place more responsibility on the officer. These changes include K-REP becoming a signatory to the Chikola group bank account remittance of loan repayment to the branch office account (rather than the head office account), and preparation of Chikola reports at the branch level. K-REP became a signatory to the group bank account in order to better protect members' funds and to monitor the group more closely. For example, some of the groups have been able to maintain a 100 percent repayment rate by depleting savings. This implies a default, once savings are fully depleted (already repayment is estimated at 85 percent). In addition, by being a signatory, K-REP is able to ensure that subsequent loan disbursements and repayments are on time.

As more groups are taken in, younger groups start emerging that require more intensive assessment and monitoring. As the Juhudi groups mature, the required level of monitoring declines. By the time clients receive their third loan they have characteristics similar to the Chikola groups. This tends to reduce the officer's workload. Flexibility has been introduced into the Juhudi credit scheme in order to reduce the credit officer's workload. For example, first and second loan groups generally meet weekly. However, third loan groups hold meetings on a bi-weekly or monthly schedule. This modification has resulted in some flexibility in the frequency of savings and loan repayments. Some groups meet monthly but prefer weekly savings and loan repayments, while others meet weekly but repay monthly. However, for closer monitoring, first-year groups are required to hold weekly meetings.

Experience gained in the course of implementing the Juhudi scheme has also led to other changes and modifications. Initially, the sequence of giving loans to a *watano* was 1-2-2 in intervals of four weeks. In 1993, the sequence was changed to 2-2-1 and later the credit officer, in consultation with the manager, was authorized to choose the best sequence for each group. Similarly, initial loan limits were set at a maximum of Kshs 10,000 repayable over fifty two weeks. The current practice is to allow credit officers and *kiwas* to add some flexibility to the guidelines depending on the circumstances of each case. For example, within the same *kiwa* some members could be repaying loans over three months and others over six months. The first loan (with a maximum of Kshs 15,000) is now repaid over a maximum period of six months, a second loan (with a maximum of Kshs 30,000) is to be repaid over a maximum period of twelve months, and third loans (Kshs 50,000 and higher) over a maximum period of twenty four months. The group guarantee mechanism has also been liberalized and it is now at the discretion of the group to decide whether guarantee will be at *watano* or *kiwa* level. The size of the *watano* has also been made more flexible and now varies from four to ten members. The initial requirement (that a *kiwa* have thirty members) was causing problems especially when members dropped out, since the credit officer was forced to replace the missing member and possibly disrupt group cohesion. The additional flexibility in group size has eliminated that problem. In addition, upon enrolling into a *kiwa,* previously, one had to wait for the membership to build up to thirty before the group is registered. With greater flexibility now, fifteen members can register as a *kiwa*. These changes in the credit methodology used by K-REP in the Nyeri Branch and elsewhere reflect past interaction with clients and accommodation of the views expressed by the borrowers. Each year leaders hold a meeting (composed of elected representatives of the groups), where they discuss various aspects of the credit programs. Some of these ideas developed in such meetings, have led to the changes cited above.

Group meetings for Juhudi are normally held in the morning while those for Chikola can be held even in the afternoon. A typical Juhudi group meeting lasts about two hours and involves loan repayments, savings collection, new loan approvals and applications, and group discussion of other matters (e.g., rotating savings club transactions, burials, marriages, social functions). When discussing loan applications, the subject member is asked to go out and the case is presented by the member's *watano*. Members are given the chance to review the application the week before the meeting. Savings are banked by one of the members, but for security reasons that person is not selected until the end of the meeting. Once funds are deposited, four banking slips are issued — one slip is retained for bank records, a second slip is retained by the bank to be collected by the branch manager or his representative (usually the accountant), and two are taken by the client (one for group records and the other is delivered to the credit officer). As a control mechanism, the copy held by the credit officer and the one collected by the manager are compared to reconcile the transaction.

Kenya Rural Enterprise Programme normally specifies the bank where the Juhudi bank account is held. This is not the case for the Chikola groups (who generally have accounts with the Cooperative Bank of Kenya). This is done so that the funds can be in a bank where credit officers have created good working relations and, therefore, can easily access information on the accounts. They can also lobby on behalf of the groups for flexibility on issues such as minimum account balances, conditions of opening the account, etc. K-REP also wants to ensure that the funds are held with a "safe" bank. By having the group savings accounts in the same bank as the K-REP collection accounts, the client needs to visit only one bank for depositing savings as well as making loan repayments.

The problem of arrears has been recent at the Nyeri Branch (since October 1994) and affects only a few Juhudi groups. At the end of 1995, one of the groups had about Kshs 28,000 in arrears involving half of the group members while two other groups had small arrears. Efforts are always made to recover the loan amounts without having to recover from the group savings. Recovery is basically by the group and, in at least one instance, a group has used the police to assist in recovery from a defaulting member. Most groups have insisted on members providing chattel as additional security for their loans. There have been four deaths and, in such cases, dues are recoverable from the insurance fund. Upon death, the total amount due is recovered from the fund while the savings are released to the next of kin. The insurance fund was previously not applicable to Chikolas. The argument for that exemption was that under the Chikola scheme the clients are groups, and groups do not die. However, Chikolas have now been incorporated into the fund.

Arrears in the Chikola scheme are more disturbing. Out of Kshs 24 million in loan volume outstanding, Kshs 1.4 million (about 5.8 percent) is in arrears. As the average age of participants in a Chikola scheme decreases, groups are likely to be less-cohesive, leading to the need for more scrutiny. Such scrutiny normally includes looking at the group's records of meetings to assess attendance; the group's register of members to assess the age of group and membership turnover.

Branch accounts and monitoring reports, all of which are computerized, are submitted monthly to the head office. The Nyeri Branch has had an accountant who is responsible for compiling these reports, disbursing cheques and forwarding them to the head office for signature. He reports to the finance manager who is stationed at the head office, but is administratively answerable to the branch manager. Staff meetings are held every Monday morning when officers report on repayments, group intake activity, attendance at group meetings, and so on. Credit officers are also responsible for preparing their individual operational plans, targets and resources required. These plans are consolidated into the branch operational plan for the year and forwarded to the head office in Nairobi.

Annex C: Calculation of the Subsidy Dependence Index

The analysis of financial performance is typically focused on profitability, as reflected by the ratio of return on equity (ROE). However, the ROE does not distinguish between income earned in the marketplace and income from subsidies recorded in the income statement. In addition, the ROE ignores subsidies that are not recorded in the income statement (e.g., the difference between the market reference deposit interest rate and the cost of concessional liabilities).

Calculating the SDI involves aggregating all the subsidies received by the financial institution. The total amount of the subsidy is measured against the on-lending interest rate multiplied by the average annual loan portfolio (i.e., the interest earnings presented in the income statement). Measuring annual subsidies as a percentage of interest income indicates the percentage by which interest income would have to increase in order to eliminate all subsidies.

The amount of the annual subsidy received is

$$S = A\,(m-c) + \{(Em) - P\} + K$$

where S = annual subsidy received; A = concessional borrowed funds outstanding (annual average); m = interest rate paid for borrowed funds if access to borrowed concessional funds were eliminated; c = weighted-average annual rate of interest actually paid on concessional borrowed funds; E = average annual equity; P = reported annual profit before-tax (adjusted, when necessary, for loan loss provisions, inflation, etc.); and K = the sum of all other annual subsidies received.

$$\text{The Subsidy Dependence Index (SDI)} = \frac{S}{L \times i}$$

where S = annual subsidy received (see above); L = average annual outstanding loan portfolio; and i = weighted-average, on-lending interest rate earned on the loan portfolio.