BRINGING SMART POLICIES TO LIFE

MEETING THE FINANCIAL NEEDS OF THE AGRICULTURAL SECTOR THROUGH PRUDENTIALLY REGULATED SACCOS IN KENYA

Case Study No. 9
September 2017

AFI SMEF WORKING GROUP PUBLICATION

CONTENTS

ACRONYMS

Authority:	Sacco Societies Regulatory Authority
BOSA:	Back Office Service Activities
Sacco:	Savings and Credit Cooperatives
SASRA:	Sacco Societies Regulatory Authority
SMEs:	Small and Medium Enterprises
FOSA:	Front Office Service Activities
DT:	Deposit-taking

KENYA'S FINANCIAL LANDSCAPE

Kenya's financial landscape consists of commercial banks, deposit-taking microfinance banks, non-regulated credit-only microfinance institutions, licensed deposit-taking Savings and Credit Co-operative Societies (Saccos), non-deposit-taking Saccos, mobile money operators, a large number of community service providers such as village banks, financial services associations (FSAs) and savings groups, and a growing number of FinTech start-ups looking to build a new generation of financial services

There are three main deposit-taking institutions in Kenya: commercial banks, microfinance banks, and deposit-taking Saccos. The chart below details the performance of deposit-taking institutions in Kenya as of December 2015.

While the Sacco sector is much smaller than banks in absolute terms — Saccos account for just 10% of assets of deposit-taking intermediaries — they provide financial services to over four million Kenyans and frequently offer services that cannot be found elsewhere. In rural areas, many farmers depend on their Sacco for credit and payment services. As member-owned institutions, they provide an important alternative to banks and, as we learned from the 2008 global financial crisis, diversity can contribute to resilience.

REGULATION OF FINANCIAL INSTITUTIONS IN KENYA

There are five financial regulators in Kenya. The Central Bank of Kenya (CBK) oversees monetary and fiscal policy and regulates commercial banks, microfinance banks, credit reference bureaus, mortgage finance companies and others in the banking sector. The Capital Markets Authority (CMA) regulates capital markets; the Retirement Benefits Authority regulates the pension industry; the Insurance Regulatory Authority (IRA) regulates industry players, such as insurance companies, insurance brokers and insurance agents; and the Sacco Societies Regulatory Authority (SASRA) regulates deposit-taking Sacco Societies.

TABLE 1: **PERFORMANCE OF DEPOSIT-TAKING INSTITUTIONS IN KENYA, DECEMBER 2015**

AMOUNTS (USD MILLION)	BANKS	MICROFINANCE	SACCOS	TOTAL FINANCIAL SYSTEM	SACCO %
NUMBER	42	12	181	235	77
BRANCH NETWORKS	1,523	109	599	2,231	27
TOTAL ASSETS	34,926	695	3,428	39,049	10
NET LOANS	20,913	458	2,511	23,882	11
TOTAL DEPOSITS	24,859	405	2,374	27,638	9
CAPITAL RESERVES	5,706	116	625	6,447	10

1 The Bank's 2016 supervision report had not been published, so 2015 figures are used.

KENYAN COOPERATIVES

Cooperatives are democratic organizations owned and controlled by members for a common good. They are important to realizing Kenya's medium- and long-term economic and social development objectives, as they have immense potential to create wealth and employment and to alleviate poverty. Cooperatives have played a major role in the development of agriculture, financial services, trade, manufacturing and other sectors of Kenya's economy.

Today, Kenya's cooperative sector is the largest in Africa, with over 15,000 registered co-operative societies and over 12 million members. There are more than 350,000 employees of cooperatives and two million people are engaged in small-scale and informal enterprises funded by cooperative loans. The sector has mobilized over USD 4 billion in savings, about 31% of Kenya's national savings. Cooperatives provide financial services to 11% of the population, 70% of whom depend directly or indirectly on cooperative-related activities for their livelihood.

Kenya's cooperatives are classified into two broad categories: financial and non-financial cooperatives. Non-financial cooperatives play a facilitating role in the business chain and do not provide direct financial services. There are different types of non financial cooperatives across various sectors and they include marketing cooperatives, producer cooperatives, consumer cooperatives and transport cooperatives. Financial cooperatives are also referred to as Savings and Credit Cooperative Societies, or Sacco Societies. The key purpose of Saccos is to pool the savings of its members and advance credit based on this collateral.

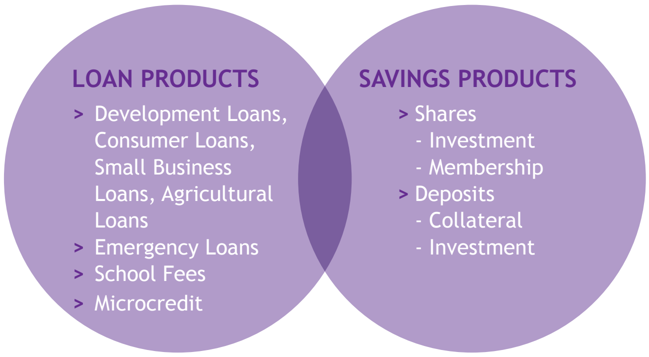
Cooperatives are further classified into deposit-taking and non-deposit-taking. Non-deposit taking Sacco Societies only accept long-term deposits, which are used as collateral that members borrow against. These deposits cannot be withdrawn unless a member leaves the Sacco Society. Deposit-taking Saccos, by contrast, perform bank-like functions and accept demand deposits that can be withdrawn from time to time and used to provide credit to members. It is because of this intermediation, and the systemic risks they pose in the market, that deposit-taking Saccos are regulated prudentially by the Sacco Societies Regulatory Authority (SASRA).

LICENSED DEPOSIT-TAKING SAVINGS AND CREDIT COOPERATIVES

In addition to providing savings and credit facilities for its members, Kenya's Saccos have shifted to offering services commonly known as FOSA, or Front Office Service Activities. This part of the Sacco offers services similar to banks, except checking accounts as they are not members of clearing house. These services are categorized as back office (BOSA) or FOSA products:

BOSA Products

Back office products are generally long-term loan products pegged on members' savings, which guarantee the loans.



These loan products serve various needs of Sacco members, such as healthcare, education, development and farming. Table 2 below shows the types of long-term loans offered by the back office of deposit-taking Sacco Societies.

The rapid shift Saccos have made from offering traditional credit-only services to rolling out the innovative products listed above, required a new prudential regulatory regime to address the emerging regulatory gaps.

TABLE 2: **LONG-TERM LOANS OFFERED BY THE BACK OFFICE OF DEPOSIT-TAKING SACCO SOCIETIES**

PURPOSE OF LOAN/LOAN TYPE	REPAYMENT PERIOD
Consumer loans - Emergency loans, loans for school/college fees	12 months (maximum)
Development loans (various purposes)	3 to 8 years (maximum
Small business loans - working capital, asset financing [e.g. for Bodaboda (motorbikes), matatu (public transport vans), or equipment], tender loans, etc.	3 to 6 years (maximum)
Agricultural loans - crop advance, bonus loans, livestock loans	Varies by crop type, etc.

To monitor and analyze performance and associated risks, licensed deposit-taking Saccos (DT-Saccos) are classified into five main categories. These are based on the original common bond that defined their membership: government, teacher, farmer, private sector or community. Table 4 below shows the distribution of total assets, total deposits, net loans and membership of each type of DT-Sacco.

Government-based DT-Saccos are those that derived their original membership from government ministries and departments, state corporations, public universities and colleges. They account for 38.0% of the system's asset base, 39.1% of the total deposit base, 40.3% of net loans and 15.2% of membership.

Teacher-based DT-Saccos are those that derived their original membership from the country's teaching fraternity. Even though the teaching fraternity is part of the mainstream government, the common bond of the teaching profession makes teacher-based DT-Saccos unique enough to warrant a separate category. They represent 34.5% of total assets in the DT-Sacco system, 33.3% of total deposits, 34% of net loans and 19.7% of total membership.

Farmer-based DT-Saccos, on the other hand, were founded upon the agricultural activities of its would-be members, such as coffee, tea or sugarcane farming, or dairy production. The fact that Kenya is largely an agricultural based economy explains why this category accounts for the majority of members in the DT-Sacco system (52%). Although these DT-Saccos controlled only 13.8% and 13.0% of the DT-Sacco system's total assets and deposits respectively, it is imperative that some members who belong to other types of DT-Saccos (government, teachers, private sector and community) also belong to farmer-based DT Saccos

Private sector-based DT-Saccos are those whose memberships were drawn principally from privately owned companies, institutions or entities. The common bond is that members are employed by one private entity or group of similar private entities. This category accounts for the lowest number of memberships at just 6.5%, but it represents 11.1% of total assets and 11.8% deposits in the entire DT-Sacco system.

Community-based DT-Saccos are those whose original memberships were defined on the basis of a social association or membership in a community, such as a church or similar community group. These DT-Saccos contribute the least to total assets, total deposits and net loans: 2.6%, 2.7% and 2.8%s respectively.

TABLE 3: **FOSA PRODUCTS**

DEPOSIT FACILITIES	CREDIT FACILITIES	OTHER SERVICES	PARTNERSHIP PRODUCTS
> Savings Accounts	> Salary Advances	> Safe Custody	> Check Clearing
> Fixed Deposit Accounts	> Short-term Loans	> Standing Orders	> Bankers Checks
> Short/Call Deposits	> Emergency Loans	> Salary Processing	> International Money Transfer (Moneygram/Western Union)
> Special Accounts (SAYE) e.g. Joint, Children, Holiday, Medical, School Fees, etc.		> Electronic Funds Transfer	> ATMs
		> Internet Banking	> Personal Loans

TABLE 4: **CLUSTERING OF DT-SACCOS BASED ON ORIGINAL FIELDS OF MEMBERSHIP** - USD MILLIONS

ORIGINAL COMMON BONDS	TOTAL ASSETS IN USD MILLIONS	PERCENTAGE OF TOTAL ASSETS	TOTAL DEPOSITS IN USD MILLIONS	PERCENTAGE OF TOTAL DEPOSITS	NET LOANS IN USD MILLIONS	PERCENTAGE OF TOTAL NET LOANS	MEMBERS	PERCENTAGE OF TOTAL NET LOANS
Government based	1,497	38.0%	1,066	39.1%	1,164	40.3%	550,777	15.2%
Teacher based	1,358	34.5%	905	33.3%	993	34.4%	715,764	19.7%
Farmer based	542	13.8%	353	13.0%	321	11.1%	1,886,599	51.9%
Private sector-based	4,36	11.1%	322	11.8%	327	11.3%	226,717	6.2%
Community based	101	2.6%	75	2.7%	82	2.8%	252,840	7.0%
TOTAL	**3,926**		**2,721**		**2,887**		**3,632,597**	

LICENSED DEPOSIT-TAKING SACCOS FINANCING THE AGRICULTURAL SECTOR

Of the 176 licensed deposit-taking Sacco Societies in Kenya, 56 have farmers as the majority of their members. Most farmers produce cash crops, such as coffee, tea, pyrethrum and sugar cane, or they are dairy farmers. These Saccos have designed products that meet the unique needs of their members and are aligned with the farming season. For instance, coffee farmers are only expected to repay their loans after the crop is harvested.

Saccos have also come forward to assist farmers with the construction of processing plants. For example, a dairy-based Sacco formed a subsidiary that established a milk processing plant for farmers, who deliver their milk to the factory and are paid through the Sacco. Loans from Saccos have assisted farmers in other areas as well, such as allowing them to purchase insurance to protect against crop failure or loss of livestock due to drought. Saccos that did not include farmers in their original membership have also opened their common bonds to admit farmers. These Saccos have opened branches in rural areas where farmers access financial services.

Prudential standards have been set to accommodate these unique types of loans, which are based on installments rather than number of days. Saccos are expected to define the installments in their credit policies. For instance, a farmer who takes out a loan to produce a sugar cane crop, which takes approximately 18th months to reach maturity, is expected to begin repaying the loan in the 18th month, with provision starting one day after the 18th month. Below is a sample regulatory return on asset classification that takes unique provisions for farmers into account.

FINANCING FOR SMEs

According to research by the Sacco Societies Regulatory Authority, approximately 37% of Sacco loans are disbursed to SMEs. Figure 1 illustrates how these loans are distributed.

The research also showed that MSMEs primarily take out loans for:
> Startup capital
> Business expansion
> Purchase of machinery and equipment
> Better cash flow
> Building and refurbishment

FIGURE 1: **DISTRIBUTION OF SACCO LOANS TO SMEs**

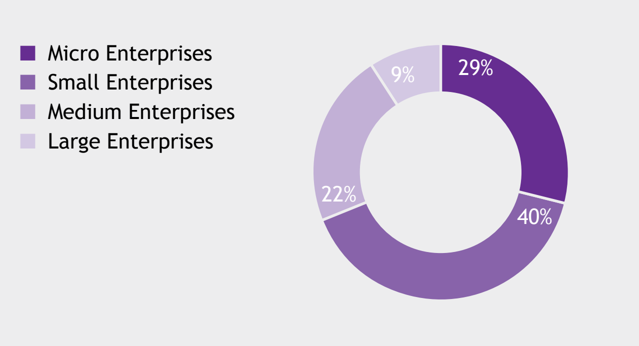


TABLE 5: **RISK CLASSIFICATION OF ASSETS AND PROVISIONING RETURN**

LOAN CLASSIFICATION	NUMBER OF ACCOUNTS	OUTSTANDING BALANCES	PROVISION	DAYS	INSTALLMENTS
Performing	-	-	1%	-	-
Watch	-	-	5%	1 to 30	1
Substandard	-	-	25%	31-180	2 to 6
Doubtful	-	-	50%	181-360	6 to 12
Loss	-	-	100%	Over 360	Over 12

2 Installment provision is for agricultural loan products, such as coffee and tea loans.

PRUDENTIAL REGULATIONS

The Sacco Societies Regulatory Authority (SASRA) is a statutory state corporation established under the provisions of the Sacco Societies Act (Cap 49B), Laws of Kenya, with a statutory mandate to license Sacco Societies for deposit-taking business in Kenya and to regulate and supervise Sacco Societies. SASRA regulates Saccos based on prudential standards that cover four main areas — capital adequacy, asset quality, earnings and liquidity — as well as several approvals aimed at addressing governance challenges and market conduct issues. These prudential standards are detailed in Table 6 opposite.

FINANCIAL PERFORMANCE OF DEPOSIT-TAKING SACCOS

Since commencement of operations of SASRA and subsequent implementation of prudential regulations, there has been tremendous growth in the sector (see Table 7 opposite). In 2010, DT-Saccos had assets of USD 1.71 billion, deposits of USD 1.23bn and capital of USD 54 million. These have since grown to USD 3.926bn, USD 2.721bn and USD 749m, respectively. This growth is evident in the agricultural sector, where approximately 60% of all loans from Saccos are channeled, while the remaining 40% are channeled toward education and health.

Further analysis shows that, on average, the sector's total assets have grown by 17.3%, gross loans by 17.2% and total deposits by 16.4% over a five-year period (ending December 2016). This trend is depicted in Figure 2 below.

Net loans outweigh deposits by a small margin, suggesting that Saccos seek external funding from commercial banks to fill the deficit. However, this external funding is capped by law at up to 25% of a Saccos' total assets.

FIGURE 2: **FINANCIAL PERFORMANCE OF DEPOSIT-TAKING SACCOS**, USD MILLIONS

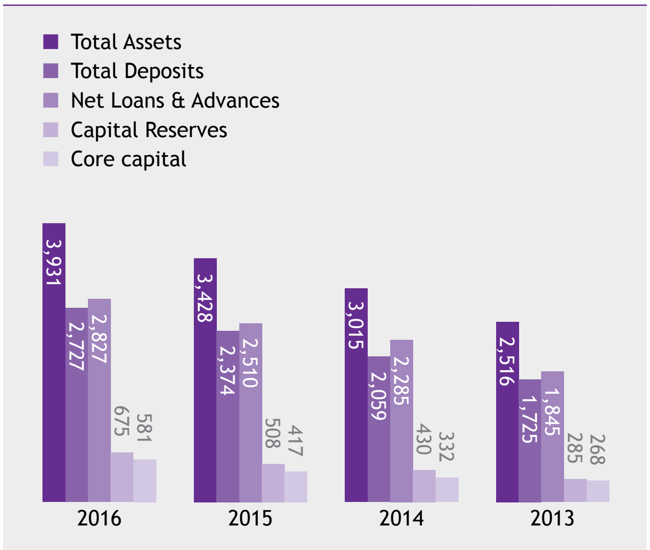


TABLE 6: PRUDENTIAL STANDARDS

FINANCIAL SOUNDNESS INDICATORS	PRUDENTIAL STANDARDS
Capital Adequacy Requirements	
Core capital	≥ USD 100,000
Core capital / Total Assets	≥ 10%
Core capital / Total Deposits	≥ 8%
Institutional/Total Assets	≥ 8%
Asset Mix And Quality	
Non-earning Assets or PPE/Total Assets	≤ 10%
Land and Buildings/Total Assets	≤ 5%
Earning Assets	
Non-Governmental Securities/Deposits	≤ 5%
Non- Governmental Securities/Core Capital	≤ 40%
Gross Loans & Advances / Total Assets	>=75%
Funding Mix	
External Borrowing/Total Assets	≤ 25%
Core Capital/Total Assets	≥ 10%
Pricing on Borrowed Funds	2% mark-up

TABLE 7: **CONSOLIDATED STATEMENT OF FINANCIAL POSITION 2015/2016**

ASSETS (USD MILLIONS)	2016	2015	2014	2013
Cash & Cash Equivalents	337	293	261	156
Prepayments & Sundry Receivables	193	190	181	134
Financial Investments	151	206	132	174
Net Loan Portfolio	2,887	2,511	2,232	1,934
Property & Equipment & Other Assets	357	228	209	176
Total Assets	3,926	3,428	3,016	2,574
Liabilities				
Total Deposit Liabilities	2,721	2,374	2,060	1,827
Accounts Payable & Other Liabilities	472	429	238	203
External Borrowing	198	182	194	160
Total Liabilities	3,193	2,804	2,492	2,190
Equity				
Share Capital	246	208	169	117
Retained Earnings	175	139	261	213
Other Equity Accounts	311	277	93	54
Total Equity	749	625	354	267
Total Liabilities & Equity	**3,926**	**3,428**	**3,016**	**2,574**

IMPACT OF SACCO REGULATIONS ON AGRICULTURAL FINANCE

The major impact of regulation has been higher levels of member confidence, which is evident in the usage of Sacco services and growth across all areas, including assets, membership loans and deposits. Certain key features distinguish Saccos from other types of financial institutions and these have also had an impact on agricultural finance. These characteristics and impacts are detailed below.

MEMBER-BASED INSTITUTION

One of the major differentiating factors of Saccos from corporate organization is that members are both customers and owners. As a member, one can participate in the governance process of electing the board and a democratic decision-making process. Since Saccos trade with their members, there is “primary” relationship, and solutions are easily found since Saccos understand the financial needs of their individual members.

AFFORDABLE INTEREST RATES

The interest rates charged by Saccos are relatively lower than those charged by commercial banks and microfinance banks. This is because Saccos’ interest rates are not pegged to bank lending rates, rather, they lend from the cheap funds of its members. Bank interest rates are currently capped at 14%, while a Sacco lends at 1% per month on average on a declining balance. This low rate has enabled members, and farmers specifically, to access credit and support their production activities.

WIDESPREAD BRANCH NETWORK

Commonly known as the “poor man’s bank”, Saccos branches extend far into rural areas, and DT-Saccos have 176 head offices in counties across the country. These head offices are an important focal point in these communities, and have made a major contribution to financial inclusion and financial access in Kenya. Figure 3 opposite shows the 15 counties with the highest concentration of DT-Saccos and which account for 132 of the 176 head offices.

Nairobi City County, home to Kenya’s capital, hosts the highest number of DT-Sacco head offices (41), followed by counties where agriculture is the dominant economic activity, especially coffee, tea and dairy farming.

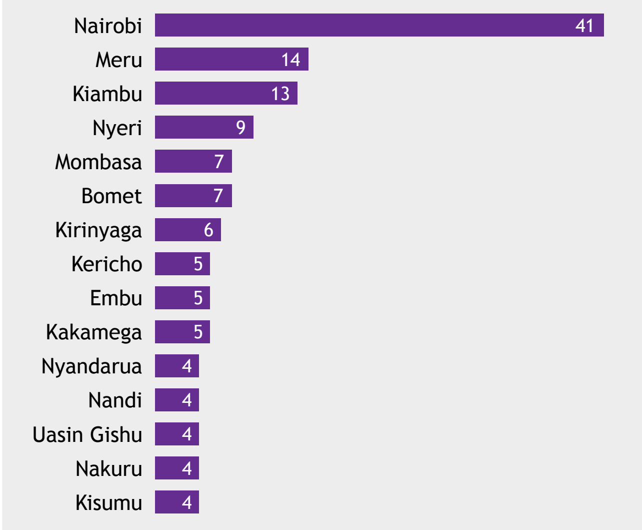
In addition to the 176 head offices, there are 423 branches of DT-Saccos spread across various counties. Figure 4 opposite shows the counties with the highest concentration of branch networks of DT-Saccos.

SOCIAL COLLATERAL

Recognizing that most of its members are poor without any collateral for loans, Saccos have devised a form of social security in which members guarantee each other. This model has dual benefits: Sacco loans are secured as they can be recovered from the guarantors if a member defaults, and the member does not require any form of physical collateral to qualify for a loan.

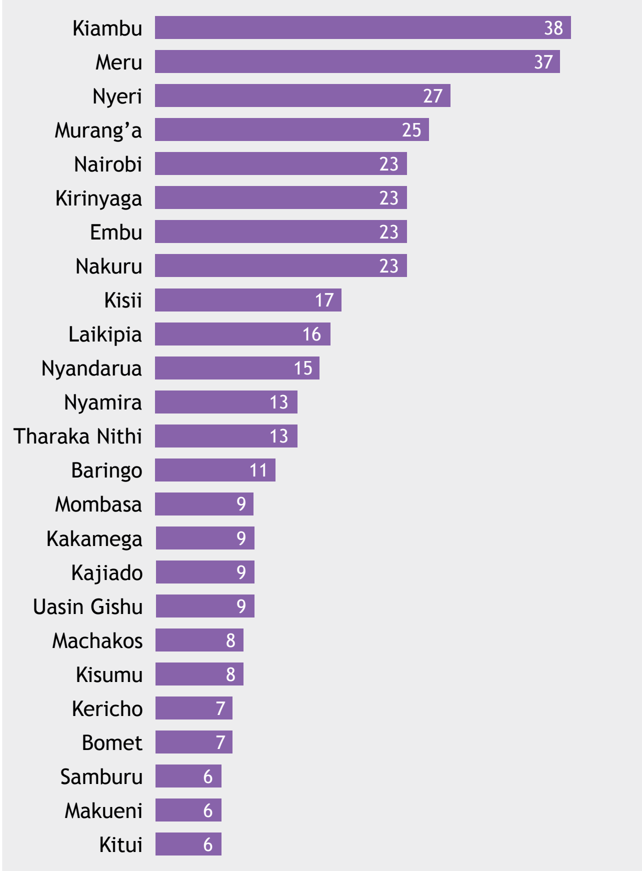
This practice has encouraged farmers to seek loans for cultivation, agricultural equipment, inputs such as seed and fertilizer and other needs.

FIGURE 3: COUNTIES WITH THE HIGHEST CONCENTRATION OF DT-SACCOS HEAD OFFICES



Source: SASRA database

FIGURE 4: COUNTIES WITH THE HIGHEST CONCENTRATION OF DT-SACCOS BRANCHES



CHALLENGES

THE UNCERTAIN IMPACT OF DT-SACCO LOANS

Many DT-Saccos have long opened their original common bonds and now serve a wider segment of the public. For instance, teacher-based DT-Saccos can now admit and advance credit facilities to a person who is not necessarily a teacher.

The key challenge, therefore, is a lack of uniform standards for activities or groups of activities covered by DT-Saccos loans. In the absence of such a standard, it has been very difficult to assess with certainty the depth of DT-Saccos' contribution to key sectors of the economy, particularly housing, agriculture and agri-business, education and entrepreneurship.

SASRA has commissioned an in-depth investigation of the main sectors of the economy or activities for which DT-Saccos provide loans (including other systemically important Saccos). The primary focus will be on the extent to which DT-Saccos have financed these sectors, including, but not limited to, housing; agriculture, agricultural equipment and agri-business; education; entrepreneurship; medium, small and microenterprises (MSMEs); youth and women's groups; and consumers.

DEVIATION FROM THE CORE OBJECTIVES

Recently, SASRA has noted intentions, proposals or plans by some licensed DT-Saccos to either convert to commercial or microfinance banks, and/or to merge with or acquire majority (controlling) interests in them. This has been driven by a desire to venture into the banking business, which is seen as comparatively more profitable given Kenya's competitive financial services sector.

This change, if realized, could have a devastating effect on Sacco members who have been enjoying the benefits of these deposit-taking institutions. SASRA has drafted a policy to be tabled that will require DT-Saccos to retain their current form.

THE EFFECT OF WEATHER ON LOAN QUALITY

Fluctuating weather conditions have a negative impact on the business activities of traditional farmer-based DT-Saccos, which largely peg their credit facilities and repayment on agricultural products, particularly tea, coffee and sugarcane. This affects the ability of members (farmers) to promptly repay their loans and, in turn, the quality of the loans farmers receive, the liquidity of the Saccos and their ability to deliver services to farmers.
In response to this, farmer-based Saccos have diversified and opened their common bonds to allow members from other sectors.

DIVERSE MEMBERSHIP

Kenya's Co-operative Laws allow an individual to be a member of different Saccos as long as the Saccos have different objectives. For example, a teacher can be a member of a teacher-based Sacco, a farmer-based Sacco and a community-based Sacco at the same time. Naturally, this member will be tempted to borrow from all of the Saccos, and it can become difficult to service several loans on a limited income. This situation is made worse by the fact that Saccos are not yet fully participating in the Credit Information Sharing Bureaus. To address this challenge, SASRA has taken steps to review the laws to allow Saccos to participate in credit information sharing.

LOW ENTREPRENEURIAL CAPACITY OF MEMBERS

Most Sacco members, especially farmers, tend to have low incomes, low levels of education and lack the entrepreneurial skills to use their loans effectively. This not only affects loan repayment, but also hinders economic growth, as the funds are not applied to economic activities that spur economic growth.

CONCLUSION

Despite the challenges, Sacco Societies, with their farmer-friendly products, are still the major development partners of Kenyan farmers. However, capacity building and policy initiatives are needed to create an enabling environment for innovation to flourish and to address the financial needs of low-income populations and SMEs. Specifically, by:

> Enacting SME-specific prudential provisions in the regulations;

> Capacity building for Saccos, Sacco members and SMEs;

> Establishing a National Credit Guarantee Scheme; and

> Publicity, advocacy and visibility campaigns to sensitize policymakers to the economic contribution of Saccos.

eISBN 978-967-15450-6-5

Alliance for Financial Inclusion
AFI, Sasana Kijang, 2, Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia
t +60 3 2776 9000 **e** info@afi-global.org www.afi-global.org
www.facebook.com/AFI.History @NewsAFI