CO-OPERATIVES AS POTENTIAL CHANNEL FOR ENHANCING FINANCIAL INCLUSION

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DURING THE ENHANCING FINANCIAL INNOVATION & ACCESS (EFInA) FORUM

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1. Background Information

1.1 Kenya Financial Sector and Financial Access

The Kenya financial sector comprise of commercial banks, microfinance institutions, Savings and credit Cooperatives (SACCOs), investments banks, mortgage finance institutions, development finance institutions, retirement benefits, insurance and capital/securities market. However, the deposit taking market is dominated by the commercial banks, SACCOs and now Deposit Taking Microfinance institutions (DTMs). SACCOs and DTMs are classified as non Bank Financial Institutions. Below is a summary of the key deposit takers and the regulatory agency responsible.

#	Financial Institutions	No. as at Dec. 2011	Government Institution Responsible for Regulation
1.	Commercial Banks	43	Central Bank of Kenya
2	Deposit Taking Microfinance Institutions	6	
3	Mortgage Finance Institutions	1	
4	Financial Cooperatives *(includes SACCOs (3887), Housing (890) and investment Cooperatives(95))*	4872	Ministry of Cooperatives and Sacco Societies Regulatory Authority (SASRA)
5	Informal groups	Thousands	Non regulated

Table a: Deposit taking Institutions in Kenya

a) Kenya's Vision 2030 and Financial Services Sector Reforms

Kenya's national development plan to 2030, christened Kenya Vision 2030 aims to transform Kenya into a newly industrialized ***"middle-income country that provides a high quality life to all its citizens by the year 2030".*** The Vision is based on three pillars: the economic, the social and the political. The development plan identifies six priority sectors namely**:**

a. Financial Services
b. Tourism
c. Agriculture
d. Wholesale and retail trade
e. Manufacturing
f. Business Process Offshoring (BPO)

b) Financial Services Sector Reforms

Under the financial services sector, the Kenya Government further identifies various reforms whose ultimate goal is to:

- Create a vibrant and globally competitive financial sector that will create jobs and also promote high levels of savings to finance Kenya's overall investment needs.
- Savings rates will rise from 17% to 30% of GDP in about a decade.
- Increase bank deposits from 44% to 80% of GDP.
- Streamline informal finance and Savings and Credit Co-operative (SACCOs), as well as micro-finance institutions.

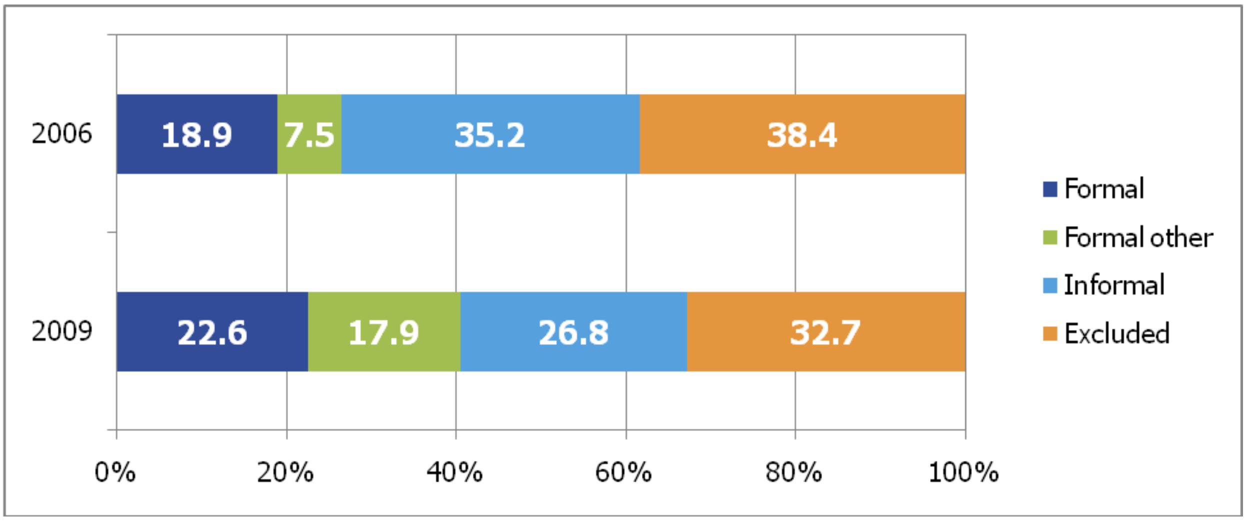
c) Financial Access in Kenya

The Central Bank of Kenya in partnership with Financial Sector Deepening Trust of Kenya pioneered a study on financial access trends in Kenya in 2006 and the same was repeated in 2009. The financial access study was based on a review of:

- *Formal* financial sector– bank, Postbank or insurance companies
- *Other formal* financial sector – non-bank financial institutions (NBFIs), SACCOs and microfinance institutions (MFIs)
- *Informal* – informal financial services providers, e.g., rotating savings & credit associations (RoSCAS); accumulating savings & credit associations (ASCAs), groups/individuals other than family/friends
- *Unbanked*

Below are two graphs that summarize the key findings for the two studies.

Graph a: Access by formalization level



Reducing Financial Exclusion through Broadening and Deepening Access

The financial access study is conducted on the adult population (persons above 18yrs) which stood at 17.4m people in 2006 and 18.7m people in 2009. Based on 2009 FinAccess Study[1], Kenya is making progress in deepening access as the number of those excluded reduced to 6.1 million from 6.7 million in 2006.

Between the two studies, Commercials banks and MFIS registered remarkable progress deepening their outreach in terms of financial services. According to FinAccess 2009 remittance of money through mobile telephones -M-PESA (Safaricom mobile telephone cash transfer services) raised the transaction services whereby 39.9% of those surveyed claim to have used M-PESA more than the users of any other financial institution or product in Kenya. M-PESA has crowded out not only informal, but also other formal remittances channels.

In 2006, half of the surveyed used friends and families to send remittances, while a third used either a bus or matatu (taxi) driver or the post office.

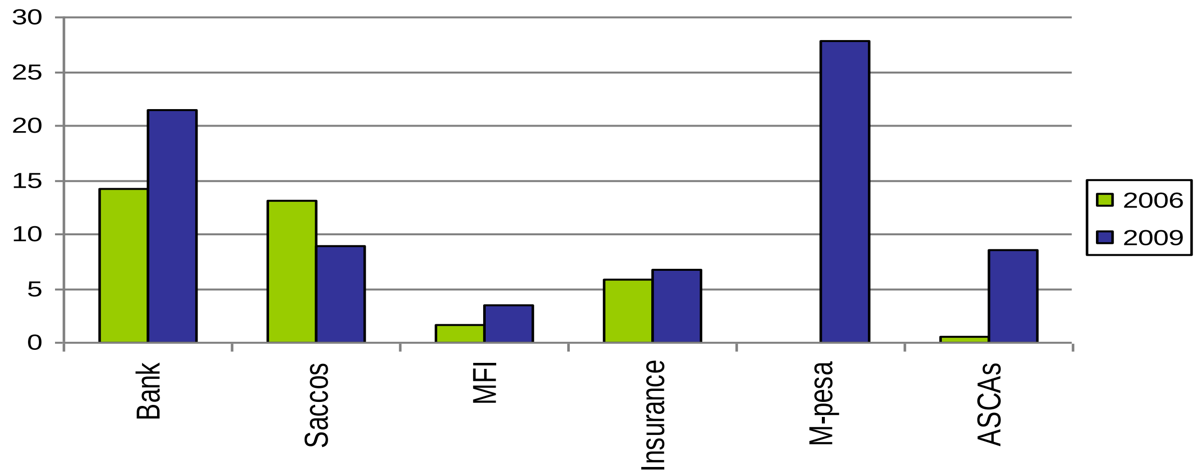
In 2009, on the other hand, only 24.7 %(29.9%) use friends and family to send personal (business) remittances, 2.6 %(5.9%) a bus or matatu (taxi) driver and 3.1 %(2.2%) the post office. 65.6% of surveyed use M-PESA for personal remittances and 51.1% for business related remittances; probably an attribute to it being the least risky, the fastest, most accessible and one of the least expensive channels of remitting transfers.

The impact of M-PESA on the use of other financial services has been limited. Most of the users of M-PESA, are also users of formal and other formal financial services, while only few people in the informal and excluded segments of the access strand use M-PESA. Specifically, 41.1% of M-PESA users also use formal banking services, while 34.3% use at least other formal services from SACCOs and MFIs. Only 11.4% of M-PESA users are excluded from any other financial service.

Unfortunately, SACCOs lost their market share in spite of their geographical spread in the country compared to other financial providers. According to the FinAccess 2009, the SACCO's loss of customers is attributed to two factors. First is the competition from banks through proactive outreach by offering easy access transactions accounts as well as consumer loans. The second factor is the attrition of the SACCO's market base as a result of retirements in the public sector and preference by younger employees to patronize banks.

[1] FinAccess Study Reports are available in www.fsdkenya.org.

Graph b: Access by the different financial services providers



A third study of the financial access trends is being planned and should be conducted in 2013 and we expect to register further progress in reducing of those excluded from formal financial sector in Kenya. SACCOs will remain important in providing access to finance and in particular credit to individuals especially with the cost of lending by Banks rising to above 17% per annum from late 2011. SACCOs always provide a convenient alternative to Banks for consumer and personal development loans.

2. **Historical Perspectives of Cooperatives in Kenya**

Cooperatives have occupied a special place in Kenyan economy from pre-independence days with the first Cooperative society being registered in 1908. Their eventual growth and development can be attributed to two major factors: intensive colonization which left the vast majority of Africans outside the monetary economy until late 1950s and the extensive involvement of the government in the affairs of the Co-operatives thereafter. Although there were initially no legal and policy structures in place, Co-operatives expanded through white colonial farmers' agitation. In the pre-1945 period, the white settlers consolidated their farming by forming settler organizations that included the Kenya Planters Co-operative Union (1903), Kenya Farmers Association (1923), and Kenya Co-operative Creameries (1925). These organizations were originally registered under the Business Practices law but became registered as co-operatives in 1931 when the first Co-operative Societies' Ordinance was promulgated to regularize the operations of co-operative societies.

In 1946, a new Co-operative Societies' Ordinance was enacted and a Department of Co-operatives started. This new Ordinance allowed Africans to form Co-operatives. When Africans were allowed to grow cash crops in 1955, a lot of Cooperatives were registered to assist in marketing of crops namely cereals, coffee, cotton, fruits and vegetables, pyrethrum, sisal, sugarcane, dairies, poultry and others involved in ranching and farm purchase. These co-operatives also provided auxiliary services like farm inputs, credit and other services. By 1969, a total of 1894 Cooperative societies had been registered

On gaining independence in 1963, the Government of Kenya's (GoK) policy of involving all Kenyans in the economic activities of the new nation ensured that Cooperatives remained relevant. The Sessional Paper No. 10 of 1965 on "*African Socialism and its Application to Planning in Kenya*" developed by the Government advocated for principles akin to those adopted by the Co-operative Movement. Co-operatives were considered as suitable vehicles with an appropriate framework for Kenyans' participation in economic development. The aim was to ensure that Public and Co-operative sectors grew rapidly together to embrace a large section of the economy.

Consequently, Co-operative policies were therefore instituted to enable co-operatives to address technical and managerial skills, improve their performance, enjoy marketing monopolies; and consolidate the movement in those areas where it was not very active. This led to enactment of the Co-operative Societies' Act [CAP 490] Laws of Kenya in 1966 under which the Government was to use Co-operatives as a medium to realize its socio-economic development agenda. In order to enable the movement to prosper, the GoK strengthened and intensified its support for the movement. More importantly, the GoK was able to inject massive assistance in form of finance and technical expertise. In order to marshall this support to the Cooperative sector, Government entered into agreements with a number of development partners who included the World Bank, United States , Germany and the Nordic countries, who assisted in technical expertise, financing in the form of loans and grants to needy Cooperatives. This benevolence of the Government and the pragmatic policies adopted served the Cooperative sector well making Kenya's Co-operative sector the most developed in Africa.

Mid 1980s, the GoK started implementing the Structural Adjustment Programmes (SAPs) to enhance a free market economy through Sessional paper No. 1 of 1986 on *"Economic Management for Renewed Growth*" which emphasized the importance of unfettered private sector led economic development in a competitive market economy. This saw the State withdrew from direct involvement in management of co-operative societies.

Sessional Paper No. 6 of 1997, on "Co-operatives in a Liberalized Economic Environment' further defined a new relationship between the Government and the Co-operative sector with the role of Government being left to that of creating a conducive environment for growth and development of co-operatives through formulation of effective co-operative development policies, overseeing development and administration of co-operative legislation and regulations. The need for GoK involvement in co-operatives was substantially reduced and co-operatives were encouraged to manage their affairs democratically and professionally in accordance with the co-operative principles, values and ethics. However, this Policy shift called for a gradual process of government withdrawal and allowing for attendant measures by government to assist co-operatives to adjust and cope with the resulting effects of liberalization and competition. This has had mixed results necessitating continuous review of the policy stance by GoK to ensure that Cooperatives remain a key player in economic development particularly for the low and middle income households. This is more so under the Vision 2030, Kenya's blueprint for National development where the GoK through my Ministry has given singular focus to the following activities in order to integrate and cascade the Vision 2030 with the Cooperative sector:

(a) Constantly review legal and regulatory framework to entrench good corporate governance and best business management practices;
(b) Harmonize and improve the quality of Co-operative education and training programmes;
(c) Develop an efficient marketing system through product improvements, value-addition and market research;
(d) Restructure and strengthen the management of Co-operative institutions and organizations;
(e) Promote new Co-operatives ventures in disadvantaged l areas; and
(f) Incorporation of ICT into the sector's operations among others policy interventions.

3. Financial Cooperatives (Saccos, Housing and Investment Cooperatives)

As at end of 2011 Financial Co-operatives accounted for 60% of the 14,126 registered Cooperatives and form the most active segment of the Co-operative sector in Kenya. However, only half (4062) of the registered financial Cooperatives were active as at end of 2011. 3887 of the 4062 are SACCOs while the balance is housing and investment cooperatives. Legally, active means they filed their annual audited accounts with the Ministry of Cooperatives. These Cooperatives are organized on employment, trade, Jua Kali (Small-scale industries), transport and community basis to afford members an opportunity to accumulate savings thereby creating a pool from which members can access credit on favourable terms for personal growth and enterprise development purposes.

Table b: *Registered Cooperatives as at 31st December 2011*

	Type of Cooperatives	1985	1990	1995	2000	2005	2010	2011
1	Non Financial Cooperatives	2,045	3,162	3,975	5,777	5,882	6,490	5,701
2	**Financial Cooperatives**	1,460	2,478	3,197	4,095	5,190	7,469	8,425
2.1	SACCOs	1,352	2,251	2,891	3,627	4,678	6,737	7,440
2.2	Housing and Investments	108	227	306	468	512	732	985
3	**Total Registered Coops**	**3,505**	**5,640**	**7,172**	**9,872**	**11,072**	**13,959**	**14,126**

By the end of 2011 the active Saccos were serving about 4.5 million members and had mobilized deposits and share capital amounting to USD 2.25 billion (Ksh. 189 billion) and loan to members of USD 2.25 billion. The total assets and deposits of the SACCOs (excluding the

SACCO Unions) stood at USD 2.95 billion (Kshs.248 billion) and USD 2.1 billion (Kshs.180 billion) by close of 2011.

From the 1970s, SACCOs have recorded impressive growth but the greatest impetus for their rapid expansion came in the 1990's when commercial banks closed their operations in rural areas through merging of branches, centralized services and automation leaving small depositors, mainly in rural areas, without banking services. Similarly, banks increased their minimum deposits for opening and operating bank accounts. This development in the banking sector saw the introduction and rapid growth of quasi banking services by rural SACCOs through the Front Office Service Activities (FOSA). This provided alternative 'banking services' to thousands of farmers, teachers, civil servants and other low and middle income individuals as they could get salaries and crop proceeds paid through their SACCO.

3.1 Development of Legal and Regulatory Framework to Support Growth and Development of Financial Cooperatives in Kenya

Until 2004, there was no legislation, regulations or rules specific to SACCOs business or financial Cooperatives. Being Cooperatives, SACCOs were regulated under a general Cooperative legislative framework. The growth and development of quasi banking business or Front Office Service Activity (FOSA) by a majority of the SACCOs demanded that appropriate regulatory framework be developed to address the unique aspects of quasi banking business and the attendant risks. Therefore, in 2004 the GoK introduced legal provisions in the general Cooperative laws to address the unique business of financial intermediation that SACCOs were undertaking. During these amendments, the Government also noted the urgent need for a SACCO specific regulatory framework given their growth and importance in the Kenya Financial System.

In order to increase the national savings relative to the GDP, the Government under Vision 2030 identified the need for financial sector reforms anchored on three key pillars namely:

a. Providing wider **access** to affordable financial services, including rural areas, thereby creating employment.

b. Enhancing **efficiency** in the delivery of financial services to reduce cost of delivery.

c. **Stability** of the financial system to reduce risk of financial crisis.

These reforms included the strengthening of alternative financial service providers such as SACCOs and MFIs to complement the commercial banks especially among individual Kenyans and small businesses segments of the financial services market.

Acknowledging the important role that SACCOs and Cooperatives in general are expected to play in realizing development goals under Vision 2030, the Ministry of Cooperatives

Development and Marketing mandate was refined *to promote a vibrant Cooperative sector through policy and legal framework for sustainable social-economic development in Kenya.*

Below are policy highlights that have informed the legal and regulatory framework for Cooperatives including financial co-operatives to make them more effective in serving their members in modern Kenya.

a. Prudential regulation of Savings and Credit Cooperatives (SACCOs)

In Kenya, the growth and development of the Sacco subsector especially in quasi banking services was demand driven with the Government adopting a 'wait and see' stance. However, with Vision 2030 and the need to re-store confidence among members and the general public that their money is safe with a SACCO, the Government underscored the urgent need for a regulatory framework that promotes transparency and accountability in the management of SACCOs. This would not only ensure financial stability of SACCOs as financial service providers but also enhance public confidence and hence attract more members to patronize their services.

Consequently, the regulatory reforms noted in the SACCO subsector in Kenya have been informed by that need to position SACCOs as an integral part of the Kenya financial sector and therefore a safe place to save money. This saw the enactment of Sacco Societies Act in 2008, a *risk based regulatory framework* and establishment of the Sacco Societies Regulatory Authority (SASRA) to license and regulate the Sacco societies. The law provides for operational regulations and prudential standards similar to those required of banks or deposit taking microfinance institutions to underscore the primary policy objective of protecting member deposits.

b. Improving Governance reforms in the Cooperative Sector

Cooperative leadership through elected officials has inherent challenges especially when absolute democracy is exercised in electing such officials. The Government has continued to ensure that the regulatory framework facilitates election of leaders who are accountable and answerable to members by adopting best management practices. This is supported by code of conduct, rotational elections of directors, declaration of wealth, strategic plans, member education, annual audits and general meetings of members every year. This ensures that members evaluate and hold the directors to account.

c. Redefining the role of the Governance in the Cooperative Sector

Heavy involvement of Government in management affairs of Cooperative Societies is counterproductive and creates a dependence syndrome. The current policy stance aims to rationalize the role of Government vis-à-vis the co-operative movement in line with co-operative principles while ensuring that interests of the members are safeguarded in an environment of good governance and professional management practices. The regulatory framework by Government should therefore promote such practices and appropriate enforcement actions taken for non-compliance.

d. Consolidating self-Regulation within the Cooperative Movement

The Government should strike a balance between regulation, facilitation and control. As private businesses, the Financial Cooperatives should be facilitated to develop and grow in a network or system such that the system rewards the best managed SACCOs while punishing those that are not well governed. This will gradually ensure checks and balances and hence the much needed self-regulation within the Financial Cooperative System which will free excessive Government involvement in Cooperatives management.

e. Improving the Quality of Cooperative Education and Training

Kenya has a fairly developed national cooperative infrastructure with capacity to provide education and training to Cooperative Societies. Thus the policy concern is the quality and relevance of the trainings to develop an enlightened and responsible leadership and management capable of directing and effectively controlling co-operative enterprises for the benefit of members. Policy emphasis should be made on the duties and responsibilities of members and understanding of their triple role as members, customers and owners of the Co-operative enterprise. The Government should set standards to guide institutions that undertake Co-operative education and training including financial Cooperatives.

4. Impact of Prudential Regulatory Framework for SACCOs

SACCO Societies Regulatory Authority (SASRA) is prudentially regulating FOSA operating SACCOs which number 215. A total of 122 were licensed by August 2012 and therefore under the prudential supervision of SASRA. The 215 FOSA SACCOs offering quasi banking services account for 80% of the total assets and deposits in the SACCO subsector. The 122 licensed SACCOs account for two-thirds of the total assets and deposits within the SACCO subsector. Thus SASRA is regulating the large SACCOs with financial and technical capacity to meet the prudential standards and operational demands under the new regulatory framework. It is these large SACCOs with complex operations including numerous branches, automated teller machines and mobile transactions capability that present significant systemic risks.

Thus the primary policy objective of the prudential regulatory for the Sacco societies is to enhance transparency and accountability in the governance of the SACCOs as financial institutions and there guarantee safety of member deposits.

The following are some of the notable impact from prudential regulation of the deposit taking SACCOs in Kenya.

a. **Performance systems and Risk management**

The licensed SACCOs are required to review and align their operational policies and systems to the regulatory standards thereby underscoring the business risks they face namely credit, operational, liquidity, market, reputation among others. This has assisted to address the persistent historical challenge where the elected leaders would make decisions with little regard for business sense in order to keep their electorate happy. The SACCOs are increasingly more conscious of the need to put the safety of members first in all financial decisions.

b. **Investment in management information systems**

Ineffective management information systems have been one of the biggest setback for SACCOs in Kenya and Africa in general. However, with clearly defined operational requirements and performance standards, this is fast changing as all licensed SACCOs upgrade their information systems to effectively administer their operations and produce standard reports on financial performance on a monthly basis. This is a drastic change from the practice in the past where financial statements were produced at year end for the general meeting.

c. **Encourage professionalism in financial and operations management**

In the development and implementation of risk management systems as required by regulations, SACCOs have had to hire professionals, invest in training and draw a clear line between the responsibilities of the Board and management thereby enhancing professionalism in the management of SACCOs. This is reinforced by the law through the continuous monitoring of financial performance from regulatory reports submitted by the licensed SACCOs to SASRA. This promotes good management practices and will enable SACCOs compete more effectively in provision of financial services to the members.

d. **Increased marketing and promotion of SACCOs as financial services providers**

Prudential regulation of SACCOs has triggered aggressive marketing by SACCOs to recruit new members as they have a seal of approval similar to that given to Banks and DTMs through prudential regulatory framework. Thus SACCO specific regulations have assisted to promote the SACCO as financial service providers. The aggressive marketing initiatives have seen many Saccos rebrand to have a national appeal and attract more members.

e. **Targeted Education and Training to Address skills gaps**

There is increased interest by education and training institutions to assist SACCOs through targeted training relevant to SACCO business. This is because of the clarity of the SACCO business and required standards of performance and hence competences. This is welcome and will complement the general Cooperative education programmes.

f. **Potential Consolidation and Mergers of SACCOs**

Good corporate governance will enhance competition in the SACCO subsector and those who cannot measure up will inevitably loose members to more successful and competitive SACCOs. This is a potential impact as large SACCOs invest in systems and product development to remain competitive. Small SACCOs with a handful of members will increasingly find it difficult to compete and attract business forcing their members to move to more competitive providers of financial services.

g. **Convergence of SACCO Subsector into a Financial Cooperative System**

Licensed SACCOs are increasingly realizing that they need each other to address such challenges as liquidity through central liquidity facility similar to lender of last resort for commercial banks. This is a desirable impact as it allows SACCOs in a Country or a State to operate as a system or network unlocking huge benefits for the members. This is what has seen SACCOs in developed economies play a significant role in 'retail banking' and small business segment while retaining their identity as Cooperatives.

The foregoing has not been without negative impact as generally no change is welcome. Prudential regulation has come with costs for the SACCOs but in the medium to long term, the benefits of ongoing reforms are much greater than the short terms costs experienced by the subsector.