## Njuguna Ndung'u: Legal frameworks for microfinance – a rush to regulate

Opening address of Prof Njuguna Ndung'u, Governor of the Central Bank of Kenya, at the official opening of the Kenya Microfinance Workshop, Strathmore University, Nairobi, 23-24 November 2007.

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The Honourable Minister for Finance, Mr. Amos Kimunya
The Vice Chancellor, Strathmore University
The Chairperson, the Association of Microfinance Institutions (AMFI)
The Chief Executive Officer, AMFI
Microfinance Practitioners
Development Partners
Distinguished Guests and Participants
Ladies and Gentlemen

It gives me great pleasure to be with you today during this very important Microfinance Conference and to make the opening address "Legal Frameworks for Microfinance: A Rush to Regulate". Before I make my opening remarks, let me take this opportunity to thank the organizers and facilitators of this conference for inviting me to make the opening address on this pertinent topic.

This Microfinance Conference comes at the right moment when the microfinance industry is awaiting the implementation of the Microfinance Act, 2006. The licensing, regulation and supervision of deposit-taking microfinance institutions under the Microfinance Act is expected to enhance the orderly growth and development of a sound, vibrant and stable microfinance industry in Kenya.

Ladies and Gentlemen; a number of studies have shown that the provision of microfinance services in a long-term, sustainable and viable manner does have a positive impact, and in fact has changed the quality of life for millions of people in developing countries by allowing them to build income and assets, either by savings mobilization or the productive investment of loan capital. This helps them manage risk to increase production, cushion themselves in times of crisis, improve their welfare, upgrade their standard of living and improve the quality of their lives. The majority of the poor, low income households and MSEs, in Kenya, just like in many developing countries, however, largely experience lack of access to financial services, including credit, savings, insurance, money transfers among others.

According to a most recent survey on the access to financial services in Kenya, *FinAccess Study*, whose findings were launched in January 2007, only 19% of Kenyans have access to formal financial services through commercial banks and Postbank. An additional 8% of Kenyans are served by SACCOs and MFIs, while 35% depend primarily on informal financial services such as ROSCAs and ASCAS. This brings to about 62% the population that is "financially included" meaning that they have access financial services and products either from formal, semi-formal or informal financial service providers. On the other hand, 38% of Kenyans, classified as "financially excluded", have no access to financial services and products. This implies that more effort is required to improve access to financial services and products.

Ladies and Gentlemen; previously, it had been argued that lending to the poor was not only administratively costly, but was highly risky because of their limited saving propensity and inability to come up with sufficient traditional collateral as a guarantee for loans. Formal financial institutions thus tended to concentrate their lending on investment opportunities and transactions that had high or more assured rates of returns. Conversely, the success of microfinance in many developing nations in Africa, Asia, and Latin America has slowly caused microfinance to be embraced by the rest of the world as a key tool to reduce the cyclical and persistent plague of poverty. A diverse range of alternative service providers, including SACCOs, MFIs, ROSCAs and ASCAs, have mushroomed across Africa, Asia, and Latin America to fill the gaps left by formal financial institutions. Serving over 100 million households worldwide, they have shown great commitment in serving those who have been excluded from sourcing services from the formal banking sector. Undeniably, providing financial services to the poor, low-income households and MSEs can go a long way in alleviating poverty.

In Kenya, microfinance services and products are provided by a variety of institutions of different institutional forms under more than nine different Acts of Parliament. These microfinance providers can be clustered into three broad categories, notably, formal, semiformal and informal institutions, with the level of formality defined by the degree of formal regulation and supervision. The formal category includes banks and financial institutions licensed under the Banking Act, building societies and the Kenya Post Office Savings Bank. The semi-formal category includes SACCOs, Development Finance Institutions Agricultural Finance Corporation (AFC), Industrial and Commercial Development Corporation (ICDC), Kenya Industrial Estates (KIE), Industrial Development Bank (IDB), and Kenya Tourist Development Corporation (KTDC)} and microfinance institutions; while Accumulating and Rotating Savings and Credit Associations (ASCAS, and ROSCAs), shopkeepers and money-lenders dominate the informal category.

I am happy to note that these alternative financial services providers have emerged with new, innovative, and pro-poor alternative modes of financing the poor, low income households and MSEs in the rural and urban areas of Kenya. They have indeed played a key role in providing increased access to financial services and products to the underserved or un-served segments of the Kenyan population.

Ladies and Gentlemen; with respect to the diversity in the microfinance operations in Kenya, however, come a number of constraints that have had to be addressed to enable the providers improve their stability, outreach and financial sustainability. The major challenge has been the lack of a specific legal and regulatory framework and appropriate regulatory oversight to govern and guide the specific operations of microfinance business in Kenya. This has had a bearing on a number of other constraints faced by the industry including weak corporate governance and management capacity, weak internal controls, unhealthy competition and multi-lending, low scale & outreach, unfavorable image and public confidence, information constraints, high transactions costs, limited access to funds and the lack of industry performance standards and accountability. To reduce these constraints, while also harnessing the emerging innovations within the sector and stimulating the effective development of the sector, it was necessary to put in place appropriate laws and regulatory and supervisory framework clearly defining the roles to be played by the Government, the Central Bank of Kenya, and the microfinance practitioners in the development of the sector.

Ladies and Gentlemen; the Microfinance Act was enacted in December 2006 to provide a level playing field and the appropriate legal, regulatory and supervisory framework for the microfinance industry. The Act is expected to promote the growth and development of the microfinance industry in Kenya, set prudential standards, create an enabling environment and act as a road map and catalyst towards achieving the desired objectives of increased outreach and sustainability of MFIs. We expect that this legal and regulatory framework will promote a viable and sustainable system of microfinance in Kenya by ensuring that licensed MFIs contribute to poverty alleviation and at the same time comply with the requirements of financial sector safety and soundness. Through this we expect that the fast-growing Kenyan microfinance industry will develop into an integral part of the financial system in Kenya, and will play a pivotal role in deepening financial markets by expanding access of affordable financial services and products to majority of Kenyans.

Ladies and Gentlemen; we are pleased with the steady growth in the microfinance portfolio of the six mainstream institutions involved in microfinance, namely Equity Bank Ltd, Cooperative Bank, K-REP Bank, Family Bank and Kenya Commercial Bank as well as the Kenya Post Office Savings Bank (KPOSB). These models have had far reaching impact while influencing the microfinance practices and outreach modalities of similar microfinance institutions within the Eastern African region. This steady growth in Kenya's microfinance portfolio indicates that prudentially regulated and supervised institutions are more able to mobilize savings on a viable and sustainable basis. This is to say, in other words, that appropriate and effective supervision with necessary and appropriate prudential rules provides a conducive and enabling environment for microfinance business to grow and thrive. This is also an indication that microfinance institutions that will opt to be licensed and regulated under the Microfinance Act will be in a better position with regard to improved efficiency, effectiveness (increased outreach) and long-term sustainability. This will further enable these institutions to establish sufficient and effective linkages to commercial banks and payment systems.

Ladies and Gentlemen; the Central Bank acknowledges that prudential regulation and supervision of microfinance institutions is not only intrusive, but has cost implications, not only to the regulator, but also for the regulated institutions. The regulation and supervision of institutions is anchored on a legal and regulatory framework that requires, first and foremost, the assessment of the adequacy of the institutions' capital to meet their business requirements to match their risk profiles and to protect the interests of their depositors. Although prudential regulations, which subscribe minimum corporate governance standards, capital adequacy levels, liquidity requirements and adequate provisioning for loan losses etc, create a stringent regime, it is essentially necessary for deposit-taking microfinance institutions. This is to ensure the protection of their financial soundness in order to protect depositors' funds and uphold confidence in the financial system.

The Central Bank also acknowledges that although prudential regulation is considered necessary when there are depositors to protect, it is not appropriate for credit-only MFIs which fund themselves from donors' funds or commercial loans. The Bank asserts that such MFIs require relatively non-intrusive, non-prudential regulation, involving, for example, screening out unsuitable owners/managers or requiring transparent reporting and disclosures. To this end, the Microfinance Act, Section 3 makes appropriate provisions for the deposit taking and credit-only microfinance institutions respectively to allow for the expansion of microfinance in Kenya.

Ladies and Gentlemen; the regulation and supervision of the microfinance sector is important as it is expected to lead to quality growth, broaden the funding base for deposit-taking MFIs and initiate the process of integrating these institutions into the formal financial system. The regulation and supervision of the sector will enable Central Bank to define, and enforce, rules and procedures for MFIs operations, entrance, exit, and ultimately create an environment for fair competition and efficiency in the sector. These rules will further aim to contribute to the stable and efficient performance of these institutions and protect clients (in particular those making deposits) against excessive risks that may arise from failure, fraud, or opportunistic behaviour.

Ladies and Gentlemen; to achieve the above, and in preparation to regulate and supervise the institutions that will be licensed under the Microfinance Act, the Central Bank is deeply involved in its capacity as well as the microfinance industry's capacity, in collaboration with key microfinance stakeholders. The cost of regulation and supervision are not to be overlooked, for both the regulator and the soon-to be regulated microfinance institutions. Research and development, infrastructure development, human resource capacity building for both CBK and the industry, and the development of appropriate performance standards and regulations for MFIs are some of the activities that will need great financial input and technical assistance to develop. Although there are cost implications for MFIs, the outcomes, with regard to expansive outreach to majority Kenyans and financial sustainability are benefits worth considering against the costs. The Central Bank, therefore, will seek to advance market discipline as a complementary layer to reducing the costs of regulation and supervision.

In conclusion, Ladies and Gentlemen; I am pleased to inform this forum that the Central Bank is not only committed to fostering the soundness, stability and integrity of the financial sector in Kenya but also is also committed to fostering the development and growth of alternative financial service providers for the benefit of our people. Microfinance is one sub-sector that the Central Bank is very keen to develop as a powerful tool for fighting poverty and increasing access to financial services and products to majority of Kenyans.

As a way forward, let me underscore the important role of the microfinance industry and the need for all microfinance industry players and key stakeholders to continue to promote close partnership and collaboration with the Central Bank of Kenya and the Government in the development of this industry. I recommend that partnership should involve regular consultations towards seeking solutions to issues and challenges facing the industry with the objective of building a sustainable and sound microfinance industry. Together, as a team, we can change the microfinance landscape, set the pace and ensure the development of a sound and stable microfinance industry in Kenya as an integral part of the financial system.

Ladies and Gentlemen; let me take this opportunity to thank the organisers, Strathmore University and the Association of Microfinance Institutions (AMFI), for organising this important conference. I look forward to seeing more collaboration amongst key microfinance industry stakeholders in fostering the growth and development of the microfinance industry.

Thank you.