ACCOUNTANCY FUTURES

The future of microfinance in Kenya

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ABOUT ACCOUNTANCY FUTURES

The economic, political and environmental climate has exposed shortcomings in the way public policy and regulation have developed in areas such as financial regulation, financial reporting, corporate transparency, climate change and assurance provision.

In response to the challenges presented to the accountancy profession by this new business environment, ACCA's *Accountancy Futures* programme has four areas of focus – access to finance, audit and society, environmental accounting, and corporate reporting. Through research, comment and events ACCA will contribute to the forward agenda of the international profession, business and society at large.

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ACCA's conference, 'Better Business Kenya 2011', considered the prospects of the microfinance industry.

This paper summarises the resulting insights into four recommendations for the present and future leaders of the industry in Kenya.

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Introduction

Kenya's microfinance industry has come a long way since the 1980s, and particularly since the landmark Microfinance Intermediaries Act of 2006.

The country now has five deposit-taking microfinance intermediaries (MFIs) operating under a regulatory framework assessed by the Economist Intelligence Unit (EIU) as the best in Africa (EIU 2010).[1] Overall, the EIU rates Kenya as having the second best business environment for MFIs in all of Africa (and one of the top ten in the world).

Kenya has the second largest borrower base in the continent (MIX and CGAP 2010), and its largest savings and credit cooperatives (SACCO) movement (Johnston 2006). This is not unrelated to the country's world-leading position in mobile banking (EIU 2010), which has been proven to be a significant driving force in financial inclusion (Andrianaivo and Kpodar 2011).

Nonetheless, the microfinance industry globally is meeting difficulties as funding dries up, delinquencies rise and sceptics begin to question its efficacy in driving poverty reduction and development. Much of this critique focuses on some of the bolder claims, made more often by policymakers and consultants than by practitioners themselves (CSFI 2011).

In June 2011, ACCA's conference, 'Better Business Kenya 2011', asked what the prospects of the microfinance industry are and how professional accountants can ensure it lives up to its promise.

ACCA is grateful to all the high-calibre experts who participated, for their valuable insights. We have distilled these, alongside ACCA's global insights on access to finance, into four recommendations for the present and future leaders of the microfinance industry in Kenya:

1. Confront the challenge of governance head-on.

2. Invest in high-quality management information.

3. Be explicit: state your mission.

4. Learn from good practice while resisting fads.

1. Note that two new DTMs have been licensed since the EIU study was completed.

1. Confront the challenge of governance head-on

ACCA believes that solid governance should be the first priority for all financial intermediaries.[2] In the case of MFIs, this view is strongly supported by institutional agents but sometimes dismissed by practitioners in the more strictly regulated parts of the sector.[3] In principle, Kenya has in place an effective regulatory framework which should provide solid protection for borrowers, depositors and other stakeholders. Yet as the financial crisis of 2008–9 has made clear, supervision and regulation alone are not enough to control risk in the financial sector. Forcing regulators to compensate for a lack of proper governance will lead only to excessive regulation, whose costs could adversely affect the ability of institutions to reach out to the needy (Cull et al. 2009).

For most intermediaries, most governance risks originate from the challenges of growth, as organisations outgrow the personalities and skills of their founders as well as the control systems they put into place. What is often missing is an integrated approach; staff and directors who are ‘doing’ risk management or compliance in functional silos cannot always appreciate the true risk exposure of the organisation, its business model and its customers. Although internal controls in Kenyan intermediaries are generally of higher quality than those of their counterparts elsewhere in Africa (EIU 2010), the combination of multiple funding sources, domineering founders and investors fixated on doing business with the largest intermediaries (who thus fail to hold them properly to account), holds within it the seeds of future problems. And of course, while the regime for regulation and supervision of the more formal institutions is solid, a large number of credit-only institutions remain virtually unregulated.

ACCA believes that the finance profession has a role in ensuring better governance, by designing and overseeing appropriate controls and strengthening the sector’s often weak internal audit function. Even in the less regulated or informal parts of the sector, accountants should be ready to contribute to solid business planning as well as continuity management (including succession management), both of which are crucial to ensuring that organisations remain true to their missions without losing sight of what is required for their continued survival. Although compliance and sound management are not negotiable, intermediaries will also need to develop reputation management strategies so that the inevitable failures that will come about as the sector consolidates do not end up tarnishing the reputations of good lenders and the sector itself.

Finally, as more intermediaries move to formal status (Carlman 2010) and the wide variety of legal forms and business models in the industry begin to converge, the profession must remain alert to their implications. Convergence will inevitably mean common definitions, metrics and calculations for measuring and managing performance and ACCA believes that the profession needs to take the lead in shaping this consensus.

2. For a discussion in the context of financial services and the financial crisis, see ACCA (2008).

3. CSFI (2011). Globally, investors ranked governance fifth in importance among challenges to the sector (and second in Africa), but practitioners in deposit-taking institutions did not rank it within the top 10 at all.

2. Invest in high-quality management information

Information is a crucial input to all financial intermediation; yet the management information systems of many intermediaries in Kenya's microfinance sector are inadequate or rudimentary (Ndulu 2010). This does not bode well for the industry; with almost no ability to use collateral, it needs to be able to manage information asymmetries and spot early signs of problematic borrowing. Indeed, in countries where the microfinance sector has recently been hit hardest by rising delinquencies, a key problem was multiple borrowing, which solid management information systems (MIS) could have spotted early on (Chen et al. 2010). At any rate, with typically 350 borrowers, and even up to 800 in some cases, per loan officer it is unlikely that 'grassroots' insights alone can provide all the information that intermediaries need. Perhaps as importantly, management information can inform institutional and credit ratings or assessments of social impact, which should in turn make it much easier for intermediaries to source funds from investors and donors.

The proper use of MIS in microfinance relies on a very substantial investment of human and capital resources, putting them beyond the reach of some institutions. Although this may point to a role for government support, the industry has a responsibility to drive what solutions it can itself. We note, for instance, that proponents of innovations such as cloud computing argue that they can help bring the unit costs per transaction down to the point where even small and fairly informal intermediaries should be able to afford high-quality MIS.

Nor it is only the intermediaries themselves that are unable to create sufficient actionable information. Some intermediaries are in turn unable to access credit bureau data, and of course coverage of the population, whether as businesses or individuals, is still far from optimal (World Bank 2011).

ACCA believes that better information is essential to the growth of the microfinance sector. The industry is still working towards comparable disclosures and benchmarking tools, an agenda that the accounting profession must embrace. We note that, even among those intermediaries that are able to produce high-quality data, the importance of professional assurance services remains high.

ACCA also realises that a range of skills are complementary to MIS and believes that intermediaries investing in information must not overlook these. Management quality is a persistent problem as professionalism and technical expertise are in short supply, while appropriate leadership is scarce and expensive. The investment in skills required to deal with the systems and structures of modern banking is substantial and MFIs are rarely able to 'buy in' expertise from banks or other major financial services providers. Moreover, there is evidence that, in larger intermediaries at least, management and the back office are both working under considerable stress.

3. Be explicit: state your mission

The notion of sustainability is central to much of the debate on the future of microfinance, but consensus on its definition is still elusive. At one end of the spectrum is the idea of total commercial viability – whereby business models generate enough profits to keep themselves in operation, finance growth and attract external investment. At the other end is the idea of net social benefit – whereby business models produce social benefits, such as empowerment of individuals, poverty alleviation, job creation, and public revenues or savings, that are more valuable than the subsidies they receive.

We note that, since 2007, banks have made substantial inroads into the previously unbanked population (FSD Kenya 2009) by going 'downmarket' (Mugwe 2011) while some microfinance institutions have instead re-focused on small and medium-sized businesses or gone upmarket, with some SACCOs even targeting fairly well-to-do clients. This trend is actually fairly typical of this market segment around the world (IFC 2010), as intermediaries try to balance volume versus value. Although regulators would do well to allow these diverse business models to be tested by the market, the profession must aim to make explicit the trade-offs between commercial viability and social benefit that they offer. Intermediaries need to demonstrate clearly to their finance providers and other stakeholders where they sit on the value–volume spectrum, make explicit their assumptions about target customers and do their business planning accordingly.

'Commercial' sustainability in the narrow sense is important for growth as it allows institutions to leverage internal and external finance in order to expand their operations and reach more (and more diverse) clients (Carlman 2010). Indeed, the evidence suggests that the very availability of formal financial services may in some cases make a bigger difference to client welfare than the actual price of the service (FSD Kenya 2009). This suggests that, although a balance must be struck in any case, the notion of sustainability in terms of net social benefit may be more relevant to intermediaries operating in markets that are increasingly 'mainstream' or even fairly saturated. Clearly stated social objectives are crucial either way, because they allow intermediaries to link compensation to their preferred measure of social performance and offer a tailored and targeted offering, which in turn can help balance commercial and social sustainability (Copestake 2007).

A similar challenge for intermediaries is the trade-off between seeking repeat business and ensuring the self-sufficiency of client households and businesses, especially those run by women and young people. Lenders will need to commit to a minimum level of good practice in promoting self-sufficiency and empowering customers, and to align their lending criteria and information systems to monitor this, but they should also look into building business models based on the progressive cross-selling of additional services rather than a dependence on credit.

ACCA calls on market participants to operationalise their understanding of 'sustainability' relentlessly in their performance measurement, recruitment, compensation and reporting. The latter will always benefit from a consistent and standards-driven approach; it is clear that more work needs to be done to develop means of reporting on social impact, and to embed this double-bottom line approach into institutional ratings (Beisland and Mersland 2011). ACCA supports the development of, and will always champion, common standards in this type of impact assessment.

4. Learn from good practice while resisting fads

The G20's renewed commitment to the Financial Inclusion agenda in the Pittsburgh summit of 2009 (G20 2009) was welcome, much needed and well intentioned. Yet it has already spawned a substantial operational schedule that looks eerily familiar.

Indeed, much of the received wisdom on microfinance originates from an effort to attract donor funds by replicating their preferred set of best practices (Stein 2008). ACCA believes strongly in evidence-based policy and that practitioners should be required to demonstrate empirically the effect of their preferred business models or products on financial inclusion, as well as their commercial viability; doubly so if they seek public or donor funding. That said, we also feel that practitioners should not need to justify practices beyond this point just because they deviate from a given blueprint.

Admirable though its aims are, the G20 Financial Inclusion agenda and its search for 'scalable' solutions (IFC 2010) could yet give rise to a new generation of received wisdom on microfinance (not to mention a small army of specialist consultants), to the detriment of proven or promising business models.

ACCA-commissioned research on donor-funded NGO accountability (Agyemang, et al. 2009) suggests some steps that could be taken to shield the sector and the donor community from such a trend.

- The dominant practice of 'upward-accountability reporting' needs to be complemented with more holistic (downward and lateral) accountability engagements involving field officers, beneficiaries and other stakeholders.
- The timescales employed for reporting and evaluation must match the nature of the business rather than donors' reporting cycles, in order to reflect true performance.
- All parties must allow for a greater role for qualitative performance reporting, especially with regard to the unintended consequences of lending activity. There should be frank discussion of commercial or operational failures.

That said, it is clear that the sector still has much to learn from an examination of best practice, though this is not necessarily what the donor community has come to expect. When viewed against the evidence, some sacred cows of the microfinance industry will clearly not survive unscathed. The group-lending principle is likely to come under further scrutiny.[4] The impressively low default rates of the early days of microfinance may soon be consigned to history (Chen et al. 2010) and reliance on the knowledge and efforts of individual loan offices will be reduced. More worryingly, many successful intermediaries may move upmarket, further increasing the risk of mission drift for the industry.

4. See, for instance, the discussion of perverse incentives in Cassar and Wydick (2010).

Conclusions

Ultimately, the potential of the microfinance industry is determined by the numbers and needs of those without access to financial services – and these are likely to grow in the medium term. Despite strong evidence of progress in the fight against financial exclusion, about one-third (33%) of Kenya's population is still unable to access finance in its various forms (FSD Kenya 2009). Moreover, the aftermath of the global financial crisis and the economic downturn that followed will make the inclusion agenda more challenging for years to come. The challenge in future will be to complete the microfinance offering with appropriate and transparently priced products, and to re-focus the attention of policymakers and donors on the range of services that microfinance providers can offer, beyond credit.

As trusted business advisers, accountants working in or for intermediaries, and their colleagues working with borrowers and potential borrowers, will be crucial to this process. To fulfil its promise the industry must complete a journey of financial education and organisational learning. It is not only the unbanked that need to be educated by knowledgeable individuals about the best use of a variety of financial products and services. Intermediaries need to be educated in matters of governance, risk management and business planning, and to be convinced of the value of common standards in reporting and commercial practice.

ACCA believes that the microfinance industry is, on the whole, a force for good in Kenya and the wider world and can look forward to further growth as it continues to make inroads into its enormous potential market. We see the sector as a substantial employer of Kenya's finance professionals and will continue to pursue ever-closer partnerships with market participants and authorities. But we also recognise that microfinance is only one of the development tools at the nation's disposal and that its effectiveness must be measured against the ex ante claims of practitioners, not the well-meaning desires of proponents at home or abroad.

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