

# **Development Finance Institutions in Kenya: Issues and Policy Options**

**Githinji Njenga**

**Rose W. Ngugi**

**Mbutu Mwaura**

*Private Sector Development Division*

*Kenya Institute for Public Policy Research and Analysis*

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© Kenya Institute for Public Policy Research and Analysis

Bishops Garden Towers, Bishops Road

PO Box 56445, Nairobi, Kenya

tel: +254 2 2719933/4

fax: +254 2 2719951

email: [admin@kippra.or.ke](mailto:admin@kippra.or.ke)

website: <http://www.kippra.org>

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## **Abstract**

*Development Finance Institutions (DFIs) in Kenya were set up to provide long-term finance to prioritized sectors as part of the industrialization strategy. Despite the existence of DFIs since the 1960s and 1970s, there is still a glaring development-financing gap in Kenya, thus raising concern as to how the private sector is going to expand and grow without appropriate finance to ensure long-term investment. Industrial growth cannot be achieved without long-term investment growth. The stock market as an alternative source of long-term capital is shallow and thin while the corporate bonds market is at a youthful stage of development. Deliberate efforts are therefore required to develop institutions for mobilizing long-term capital in Kenya. Various constraints have made DFIs unable to contribute significantly in meeting their responsibility in the development process. The constraints include their ownership structure, which has made the institutions susceptible to political interference in both management and investment decisions; regulatory issues, which have led to too many controls and bureaucracy; inadequate funding, especially with the withdrawal of government guarantee on loans obtained; and the downturn of the economy and unfavourable business environment, which have impacted negatively on financed projects. A number of options are suggested as a way of tackling these issues. The study proposes alternatives such as reducing government ownership to curb political interference. Various methods through which these institutions can raise funds, including floating long term bonds, floating shares, having budgetary allocations, accessing contractual savings, setting up a revolving fund, and establishment of a resources pot are also suggested. There is also need for efficient investment allocations for sustainability of DFIs. All this requires development of an appropriate policy framework to strengthen DFIs and enhance their efficiency.*

## **Abbreviations and Acronyms**

ACP-EEC	African, Caribbean & Pacific-European Economic Community
ADB	African Development Bank
ADF	African Development Foundation
ADC	Agricultural Development Corporation
AFC	Agricultural Finance Corporation
BDS	Business Development Services
CDC	Commonwealth Development Corporation
DEG	German Development Bank
DFIs	Development Finance Institutions
DFCK	Development Finance Company of Kenya
EADB	East African Development Bank
EIB	European Investment Bank
EPZ	Export Processing Zones
ERSWEC	Economic Recovery Strategy for Wealth & Employment Creation
FMO	Netherlands Development Finance Company
GMR	Guaranteed Minimum Returns
GMK	General Motors (Kenya)
IBRD	International Bank for Reconstruction and Development
ICDC	Industrial and Commercial Development Corporation
IDA	International Development Agency
IDB	Industrial Development Bank
IDC	Industrial Development Corporation
IFAD	International Fund for Agriculture Development
IFC	International Finance Corporation
KBL	Kenya Breweries Limited
KCB	Kenya Commercial Bank
KCC	Kenya Co-operative Creameries
KFA	Kenya Farmers Association
KFW	German Banking Group
KGVCU	Kenya Grain Growers Cooperative Union
KIE	Kenya Industrial Estates
KNAC	Kenya National Assurance Company
KTDC	Kenya Tourist Development Corporation
MFI	Micro Finance Institutions
MTEF	Medium Term Expenditure Framework
MSEs	Micro and Small Enterprises
NCPB	National Cereals and Produce Board
NBFIs	Non-Bank Financial Institutions
NBK	National Bank of Kenya
NGOs	Non-Governmental Organizations
NPLs	Non-Performing Loans
NSE	Nairobi Stock Exchange
NSSF	National Social Security Fund
PIC	Public Investment Committee
PSDS	Private Sector Development Strategy
RIDCs	Rural Industrial Development Centers
SCBK	Standard Chartered Bank Kenya
SILS	Small Industrial Loans Scheme

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## 1. Introduction

Financing development without appropriate vehicles for mobilizing resources is a major challenge. A major concern in developing countries is mobilization of long-term capital, which is very crucial in the development process. Experience shows that Europe was able to go through reconstruction and industrial development because it was able to access long-term capital from multilateral development institutions. The success saw the establishment of regional and national Development Finance Institutions (DFIs), which acted as catalysts in financial intermediation, extending long-term credit and contributing to economic development by removing credit shortage (Yaron, 1994).

At independence, the financial sector in Kenya was unable to serve the interest of African farmers and businessmen, or provide adequate long-term capital to finance economic growth. This was largely due to the inherent weak structure of the sector at the time. In response, the Government of Kenya took a deliberate effort to set up various DFIs with the responsibility to provide enterprises and projects with equity and long-term loans that commercial banks were unable or unwilling to supply (Popiel, 1994).

The DFIs were also expected to spearhead the Kenyanisation process by enhancing local participation in economic development. The development objective of the government was to integrate the marginalized citizens into the productive activities. The Industrial and Commercial Development Corporation (ICDC), for example, was established to lend to small businessmen, especially those acquiring businesses from non-citizens and those wishing to expand their trading activities. Further, under the Small Industrial Loans Scheme (SILS), Kenyans were assisted in acquiring enterprises dealing with saw milling, woodwork, shoe making, leather processing and clothing. The Agricultural Development Corporation (ADC),

through its subsidiary called Lands Limited, was responsible for purchasing large-scale farms from British farmers and leasing them to citizen farmers.

In the financial reform process, the capital market in Kenya has witnessed various changes. However, the market has remained thin and shallow, thus constraining its contribution to the development process. Despite the reforms in the Nairobi Stock Exchange (NSE), growth of listed firms has stagnated. Similarly, despite the extended maturity of Treasury bonds to ten years, floating of corporate bonds is negligible. At the moment, Micro-Finance Institutions (MFIs) are mushrooming and playing a significant role in financing Micro and Small Enterprises (MSEs), which previously never attracted most of the financial service providers. However, the economy cannot achieve the desired growth with the MSEs alone. These enterprises must have a vertical growth; for the MSEs to graduate, they require adequate and appropriate financing.

In the Economic Recovery Strategy for Wealth and Employment Creation (ERSWEC, 2003), the government looks at the private sector as the engine of economic growth. This means that the private sector must expand and grow its investment. Micro and Small Enterprises (MSEs) face problems of weak firm-to-firm relationship, inadequate workspace with basic infrastructure, adequate and appropriate financing, limited Business Development Services (BDS), and weak entrepreneurial development. Existing DFIs provided such services before they plunged into management and financial crisis. However, the role of DFIs is still relevant in the Private Sector Development Strategy (PSDS), but the Government needs to strengthen the development financial institutions so that they can play their developmental role.

This paper looks at issues facing the Development Finance Institutions (DFIs) and offers various options that the government can use to revitalize their operations in Kenya so that they can make a significant contribution to the

development process. Most of the information used in this paper is based on a questionnaire administered to various DFIs existing in the country.

The rest of the paper is organized as follows: Section 2 reviews the scope of activities and type of products offered by DFIs in Kenya; section 3 discusses the ownership and legal status of DFIs; section 4 analyses the funding of DFIs, while section 5 looks at the financing products and experience of DFIs in repayments. Section 6 concludes the paper and offers alternative policy options.

## **2. Scope of Activities for Development Finance Institutions in Kenya**

During their active year, Development Finance Institutions (DFIs) in Kenya played their development role by providing a wide range of products including finance, workspace, Business Development Services (BDS) and technological development. They also covered a wide range of clientele including small, medium and large firms as indicated in Table 1.

**Table 1: Development Finance Institutions in Kenya, year of establishment and activities**

Institution	Year of incorporation	Products offered
ICDC	1954	Equity and loans in medium-and large scale industrial and commercial projects. Loans for small-scale projects
DFCK <sup>1</sup>	1964	Equity and loans in medium-and small-scale projects, mostly manufacturing Loans to small-scale projects
ADC	1965	Management of state and private farms. Equity and loans in agro-industrial enterprises
KTDC	1965	Equity and loans in tourism projects and hotel management
KIE	1967	Development of industrial estates
AFC	1969	Provision of agricultural loans
IDB	1973	Equity and loans in medium and large-scale industrial projects

*Source: Grosh, 1991 and Government of Kenya Development Plans, 1970-1974 and 1974-1978*

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<sup>1</sup> Currently known as Development Bank of Kenya (DBK).

The Kenya Industrial Estates (KIE) provided medium and long-term machinery, equipment and finance to small and medium industrial enterprises, either for start-ups, expansion, modernization or rehabilitation of projects throughout the country. It offered payment to suppliers of equipment, mortgage terms for sheds/incubators, and direct payment to clients in terms of working capital. It also provided workspace industrial sheds/parks to small and medium enterprises through development of industrial estates countrywide. The Industrial Estates Programme entailed construction of factory buildings for rental, with attached administrative and technical services blocks. This was crucial in supporting technological development.

Twenty-eight estates were established with a total of 444 sheds. However, some of these have been sold to indigenous entrepreneurs on mortgage terms. As a result, Kenya Industrial Estates withdrew the Technical Service Centers, which consisted of a pool of machines, engineers, and economists who undertook feasibility studies, technical advise and supervision.

In the Rural Industrial Development Centers (RIDCs), KIE provided simple facilities for industrial production on a modest scale. KIE also started Industrial Promotion Areas (IPAs) and workshop clusters in both urban and rural areas. These activities were particularly notable in helping disperse industries to the smaller towns in Kenya. KIE also provided Business Development Services (BDS), including preparation and appraisal of business plans, project implementation, entrepreneur training, supervision and financing of short-term working capital.

Further, Kenya Industrial Estates offered a sub-contracting exchange/linkage programme. This programme provided short-term working capital loans, bill discounting, factoring, and training on quality assurance, International Standardization Organization's (ISO) certification, process re-engineering, and cleaner production and technology transfer. This means that the institution had put a framework of encouraging firm-to-firm

linkages. Such initiative is very relevant in strengthening the linkages between large and small enterprises.

The Kenya Industrial Estate has notable success cases of firms that have graduated to become large enterprises. These include East African Spectre, Mastermind Tobacco, Mareba Industries, Haco Industries and Kuguru Foods. The products of KIE, therefore, have the ability to propel graduation of firms to large enterprises.

The Industrial and Commercial Development Corporation (ICDC) loan facility includes the commercial loan programme for working capital. ICDC used to run the Small Industrial Loans Scheme (SILS), which provided financial assistance to small-scale industrialists for purchase of machinery and equipment. However, this scheme experienced a high level of default due to lack of proper management and technical expertise on the part of the entrepreneurs. Two new products were developed; ICDC/KBL/GMK loan scheme, and corporate loans were introduced in 1999 and 2001, respectively. The ICDC/KBL/GMK scheme finances the purchase of trucks from General Motors Kenya for distributors of Kenya Breweries with guarantee from Kenya Breweries. This is important for strengthening linkages across the various sizes of firms. The ICDC also has personal (unsecured) staff car and commercial fleet loans.

The Development Finance Company of Kenya (DFCK) and the Industrial Development Bank (IDB) provided term loans and/or equity to medium and large-scale industrial enterprises, and also tourism enterprises in co-operation with other DFIs in Kenya. The emphasis centered on creation of new assets, maintenance or improvement of existing capacity through projects expansion, diversification and refurbishment programmes. IDB provided medium and long-term finance, direct equity investment, guarantees for loans from other sources, bridging finance, and underwriting of security issues, stocks and promissory notes.

The Agricultural Finance Corporation (AFC) has been Kenya's largest single agricultural credit institution providing agricultural credit and advisory services to the development of agriculture and agricultural-based industries. It provided loans to farmers, agricultural-based co-operative societies, incorporated group representatives, private companies, public bodies, local authorities, and other persons engaged in agriculture or agricultural industries. AFC operates a wide range of loan types based on the geographical suitability and tailored to suit the individual farmer's unique requirements. The various lending agricultural development programmes undertaken by AFC include: land transfers, Guaranteed Minimum Returns (GMR)<sup>2</sup> now under seasonal crop credit schemes, crop development loans (for example in horticulture, tea, coffee, sugarcane), livestock development loans (for example beef, dairy, poultry, and pork processing), infrastructure development and general farm development. The loans were of different maturities depending on the need of the client. For example, the maturity periods for seasonal crop credit schemes, development loans and livestock loans were 1 year, 3-5 years and 2-3 years, respectively. Loans to buy farm machinery mature within a period of 2-3 years. The Corporation restricted seasonal crop lending to farmers with more than five acres of land while development loans are available to all farmers. With an outreach of 49 branches<sup>3</sup> distributed throughout the country as at the year 2000, from an initial six (6) in 1964, the Corporation had been making a substantial contribution to agricultural development in Kenya.

The Agricultural Development Corporation (ADC) executed substantial direct investments for the government in productive agricultural enterprises. It was responsible for purchasing large-scale farms from British farmers

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<sup>2</sup> GMR was discontinued in 1978 as a result of general abuse, which made it a failure.

<sup>3</sup> Due to economic constraints and declining resources, some branches have been closed. The number of branches as at 2004 was 30. With the restructuring process, staff was also downsized from about 1,200 to the current 548 employees.

and leasing them to citizen farmers. Some of the farms acquired by ADC required more capital and management skill than the new tenants could reasonably provide. ADC therefore retained a few of them. By mid 1970s, thousands of medium and large-scale farms and ranches in Rift Valley Province and parts of Central Province had changed hands through the Lands Transfer Programme. A few of the farms retained by ADC, together with five established National Farms were used for the production of certain important agricultural inputs, which were in short supply; that is high quality breeding stock especially cattle and pigs and crop seeds (National Development Plan, 1970-1974). Up to the year 1994/1995, ADC was the single largest grower of seed maize in Kenya. The institution played the role of availing sufficient quantities of good seed to the Kenyan farmer. Also, as the custodian of the national livestock studs, ADC ensured continued existence of the breeds and availability of quality stock to the Kenyan farmer. The institution has potential to expand its activities to the semi-arid areas in Kenya.

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### **3. Ownership and Legal Status of DFIs**

The ownership of DFIs is crucial in defining their scope of activities and ability to contribute to development. DFIs are generally public or quasi-public institutions. Initially, DFIs were conceived as privately-owned institutions, operating under concession funding from the government. However, when the World Bank opened a loan window to governmental DFIs, these institutions changed their ownership structure and became public institutions (Mayer, 1989).

In Kenya, the government is a majority shareholder in Development Finance Institutions, either directly or indirectly through the Industrial and Commercial Development Corporation (ICDC). For example, the government wholly owns the ICDC. The government through Treasury owns 99 percent of Kenya Industrial Estates while the Ministry of Trade and Industry holds one percent shareholding. When the Industrial Development Bank (IDB) was established, the government through ICDC invested about 32 percent of the total equity. The ownership has since changed and, presently, Treasury holds 58.2 percent shareholding, ICDC 12.1 percent, Kenya Reinsurance Corporation 9.9 percent, Kenya National Assurance Company (under liquidation) 9.9 percent and National Bank of Kenya 9.9 percent. Through the ICDC, the government also owns 89.3 percent of shareholding in the Development Finance Company of Kenya. A similar picture is portrayed in South Africa where the Industrial Development Corporation (IDC) is solely owned by the Government of South Africa.

Some DFIs also have shares held by foreign institutions. This is largely because at the initiation stage, most of these institutions were established with the support of both the government and development partners. The Development Finance Company of Kenya, for example, had equal subscription by the Commonwealth Development Corporation (CDC),

German Development Bank (DEG) and the ICDC. More shareholders joined later, such that the ownership structure was as follows: ICDC (30.5 percent), DEG (28.8 percent), CDC (10.7 percent), Netherlands Development Finance Company-FMO (22.8 percent) and International Finance Corporation-IFC (7.2 percent). ICDC has, however, bought the shares held by DEG, FMO and IFC.

The DFIs in Kenya are established by different Acts of Parliament. They are governed through their respective legislations in consultation with parent ministries. The State Corporations Act also regulates the various Development Finance Institutions. The Agricultural Development Corporation is established through Cap 346 of 1965, while the Agricultural Finance Corporation was reconstituted in 1969 under the Agricultural Finance Act (Cap 323 of the Laws of Kenya) with wider powers and assuming the responsibilities of the Land Agricultural Bank. The Industrial Development Bank was initially registered under the Companies Act but was later placed under the Banking Act in 1979. When ownership of the Kenya Industrial Estates was transferred in 1978 to the Treasury and the Ministry of Trade and Industry, it became an independent state corporation registered under the Companies Act (Cap 486). DFIs are expected to adhere to the State Corporations Act, and as such, besides consulting the parent Ministry and the Ministry of Finance, the Office of the President has to approve any decision made. For example, as a statutory body, the Agricultural Finance Corporation is under the Office of the President. However, the Corporation works in close consultation with the ministries of Finance, and Ministry of Agriculture in its day to day operations. Like the AFC, the Agricultural Development Corporation (ADC) is also responsible to the government through the Ministry of Agriculture. This creates bureaucracy through multiplicity of reporting, and therefore slows down the decision making process. Furthermore, the State Corporations Act is considered not conducive for commercial orientation activities as it

puts too many controls. For example, section 5(2) of the Act states that the power of a state corporation to borrow money in Kenya or elsewhere shall be exercised only with the consent of the Minister and subject to such limitations and conditions as may be imposed by the Treasury in respect to state corporations generally or specifically with respect to a particular state corporation.

The running of DFIs is entrusted on a Board of Directors, who in turn administer the respective institution through a Managing Director, or Chief Executive. The government exerts some control on management of the institutions through appointment of the board and the chief executives. The appointments have generally been based on political considerations rather than merit. As a result, it has been difficult to take action against poor managers because they are seen as politically-correct. For example, in one of the institutions, a chief executive stayed in office for 15 years despite continuing deterioration in performance of the institution.

## **4. Sources of Financing DFIs**

Development Finance Institutions (DFIs) have relied substantially on external financing, besides government financing. Part of the external funding has come from international and regional development finance institutions such as the World Bank, African Development Bank (ADB), East African Development Bank (EADB), and European Investment Bank (EIB). Other funding has come from the governments of Germany, Belgium, Britain, Netherlands, Korea, Saudi Arabia, Switzerland, China and India.

There are differences, though, on the type of external financiers that institutions attract, as indicated in Table 2. For example, the Agricultural Development Corporation (ADC) was initially set up through grants from the Kenya, British and the Netherlands governments. It also obtained a loan in 1990 from the Commonwealth Development Corporation (CDC), which was guaranteed by the Government of Kenya. The main sources of finance for the Industrial Development Bank (IDB) have been the International Bank for Reconstruction and Development (IBRD) of the World Bank, German Development Bank (DEG), African Development Bank (ADB), European Investment Bank (EIB), and other foreign-denominated lines of credit from Switzerland, Saudi Arabia, India, Korea and China. The Agricultural Finance Corporation (AFC) got funding from World Bank through the International Development Association (IDA), the ADB, International Fund for Agricultural Development (IFAD), and German Banking Group (KFW), among others. The financiers of the Industrial and Commercial Development Corporation (ICDC) included the Belgium government, KFW, DEG, Indozuez Bank, East African Development Bank (EADB), Kenya Commercial Bank (KCB), Standard Chartered Bank-Kenya (SCBK) and Shelter Afrique. The financiers of the Kenya Industrial Estates included the African Development Bank (ADB), KFW, the Belgium government, and African Development Foundation (ADF). The European Investment Bank (EIB) was the major source of foreign line of credit for the

**Table 2: Sources of funds for DFIs in Kenya**

<b>DFI</b>	<b>Governments</b>	<b>Foreign institutions</b>	<b>Local financiers</b>
ICDC	Kenya, Belgium	KFW, DEG, IndoSuez Bank, EADB, Shelter Afrique	Kenya Commercial Bank and Standard Chartered Bank of Kenya
KIE	Kenya, Belgium	ADB, ADF, KFW	Barclays Bank of Kenya
DFCK	Kenya, Belgium	EIB	Lion of Kenya Insurance, Concord of Africa Insurance, Old Mutual Life Insurance, American Life Insurance Kenya Reinsurance Corporation, Norwich Union Life Insurance, Kenya Shell Provident Trust, and Prudential Insurance
ADC	Kenya, Britain, Netherlands	CDC	Kenya Commercial Finance Company
IDB	Kenya, Switzerland, S. Arabia, India, Korea and China	DEG, ADB, EIB, IBRD	-
AFC	Kenya	IDA, ADB, IFAD and KFW	-

*Source: ICDC, KIE, DFCK, ADC, IDB and AFC*

Development Finance Company of Kenya (DFCK). Loan advances and facilities from the European Investment Bank (EIB) were contracted under the ACP-EEC Lome Conventions and guaranteed by the Government of Kenya.

Some DFIs have also received funding from local commercial banks and insurance companies. For example, the Agricultural Development Corporation (ADC) acquired a loan from Kenya Commercial Finance Company (then a subsidiary of Kenya Commercial Bank) on recommendation of the Treasury.<sup>4</sup> The Industrial Development Bank (IDB) got loans from the National Social Security Fund (NSSF). Up to early 1990s, the Development Finance Company of Kenya (DFCK) acquired short term advances from Lion of Kenya Insurance, Concord of Africa Insurance, Old Mutual Life Assurance, American Life Insurance, Kenya Reinsurance Corporation, Norwich Union Life Insurance, Kenya Shell Provident Trust, and Prudential Assurance. This is an indication that contractual savings can be used to finance DFIs. The Industrial and Commercial Development Corporation (ICDC) got a loan from Shelter Afrique in 1998 to develop Funguo Estate.

Funding from the Government of Kenya to DFIs has been in form of loans and grants, through the Consolidated Fund with approval from Parliament. The flow of these funds has, however, fluctuated over time. For example, the last time that Agricultural Finance Corporation (AFC) had budgetary allocation was in 1982, while the last major donor funding to AFC was in 1989. It is only recently (2003/2004 period) that the government resumed funding to AFC through equity contribution by injecting Ksh 520 million for on-lending to farmers. For Kenya Industrial Estates, the government resumed financial assistance in the year 2001 through the Medium Term

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<sup>4</sup> The Treasury did not service the loan as and when due, forcing the corporation to make repayments.

Expenditure Framework (MTEF) for on-lending activities. The MTEF allocates 4 percent of KIE's annual loan requirements for lending and other activities. With the recognition of KIE as a key player in the poverty eradication programme, a total of Ksh 5.9 billion was earmarked in the 2003-2007 period to support the micro and small enterprises (MSEs) sector.

In addition, the government guaranteed most of the foreign lines of credit. However, this was withdrawn in early 1990s due to perennial default of loans by DFIs, which made the government bear the burden of repaying the debts. The foreign debt service default was mainly due to financed projects falling into arrears or being put under receivership (5th Public Investment Committee-PIC report, 1994). These changes constrained the institutions from continuing financing their activities, as internally-generated funds were not sufficient. However, the withdrawal remains a major challenge to individual efforts by the institutions to raise funds, as potential development partners demand government guarantee.

Faced with the problem of inadequate financing, some DFIs sought for alternative sources. Institutions such as the Industrial Development Bank and Development Finance Company of Kenya converted to banks<sup>5</sup> in order to mobilize deposits. The Industrial Development Bank (IDB), for example, laid emphasis on deposit mobilization from its own financed projects where all new projects had to place interest-bearing deposits. Since its conversion to a universal bank, mobilized deposits have contributed less than 20 percent of the total funding of the activities. Without government guarantees, IDB had to rely on its reputation and balance sheet to source funds. However, it became increasingly difficult to mobilize sufficient financial resources from both local and foreign sources. Although some success has been achieved in obtaining tied credits, IDB has continued to face difficulties in securing credits from foreign financiers, who have continued to demand government

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<sup>5</sup> IDB has since closed its banking operations.

guarantees or the privatization of IDB itself to qualify for funding. For Development Finance Company of Kenya (DFCK), the proportion of deposits to total funds grew from 10.8 percent in 1997 to 72.9 percent in the year 2003.

The autonomy to raise funds has been a major issue for some DFIs. For example, though the Agricultural Finance Corporation (AFC) Act allows the corporation to borrow money or obtain credit either in Kenya or abroad subject to approval by Treasury, this has not been possible due to the below market statutory interest rate that AFC is supposed to observe when advancing credit. Consequently, AFC was forced to suspend some of its essential programmes, since internally generated funds in form of past loans collection were not adequate to finance all the programmes. Section 15 (1) of the AFC Act restricts the funding base of the corporation to government funds, donor funds or the Corporation's borrowing upon approval by Treasury. This has constrained the Corporation's lending activities as these funds have not been forthcoming as the demand for the same has dictated. Currently, the demand for credit from the Corporation is estimated to be Ksh 10 billion annually.

The efforts of the Kenya Industrial Estates to get finance directly from the capital market have been thwarted by the need for approval by the Cabinet and the unattractiveness of its balance sheet. KIE has presented to government a proposal to restructure the balance sheet, without much success. From Table 3, it is evident that the amount owed to both foreign financiers<sup>6</sup> and Government of Kenya by KIE are enormous. This is not surprising considering the fact that the rates of repayment by clients have been low. As at the year 2003, the Agricultural Development Corporation (ADC) was only able to repay 19 percent of its total loans due compared to

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<sup>6</sup> It is suspected that Treasury may have been repaying the external loans, but it is not possible for KIE to establish the amounts because KIE normally has no contract with the financiers.

**Table 3: KIE's levels of overdue payments and repayment rate to financiers**

Period	Amount (Ksh millions) from foreign agencies	Amount (Ksh millions) from Government of Kenya	Repayment rate (%)
1990	208.5	124.4	9.1
1991	255.8	128.2	6.8
1992	288.8	131.9	4
1993	340.5	135.6	0
1994	393.6	149.4	0
1995	463.6	159.1	0
1996	516.4	163.1	0
1997	542.9	197.3	0
1998	563.9	215.3	0
1999	581.4	223.9	0
2000	598.7	239.5	0
2001	616.3	235.1	0
2002	633.7	259.7	0
2003	650.7	283.3	0.1

*Source: Kenya Industrial Estates*

33 percent in the previous year. The serial default by farmers has made AFC not to be able to repay loans owed to financiers. As at 1997, the Corporation was not able to service any portion of the redeemable loan of Ksh 1.4 billion, most of which had fallen due from 1989. Similarly, the Corporation did not service the accumulated interest of Ksh 1.5 billion on account of both irredeemable and seasonal credit loan of Ksh 1.8, some outstanding since 1989 (9th PIC Report, 2000). However, unlike other institutions, the Development Finance Company of Kenya (DFCK) had been repaying its financiers as and when loans are due without defaulting. For the period 1990-2003, DFCK had no outstanding payments to its financiers.

Another complication that the DFIs faced was loss of funds invested in collapsed financial institutions. A total of Ksh 82 million was invested in such institutions by the Kenya Industrial Estates (KIE) in total disregard to financial regulations on investment of surplus funds. So far, only 28.8 percent of the amount has been recovered (9th PIC report, 2000). The Agricultural Finance Corporation (AFC) lost money when deposits were made in collapsed financial institutions such as Trust Bank. The deposits were made contrary to the Treasury regulations with regard to the investment of surplus funds (9th PIC report, 2000).

An alternative of financing DFIs would have been through internally-generated funds or attracting new equity. However, the performance of the institutions has been very poor. The return on net asset indicates a weak performance while return on equity paints a grim picture of the institutions. A low return on equity pushes away potential investors, and yet attracting equity funds is crucial as such funds are less expensive to use in the institutions' activities.

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## 5. Experience of DFIs in Financing Development Activities

Development Finance Institutions (DFIs) provided long-term loans in the range of between 8 to 10 years with a grace period of up to three (3) years. This was way beyond what other capital markets would have provided. For example, until recently, the bonds market was dominated by short-term maturities and attracted no private listing. Banks offered short-term loans while the Non-Bank Financial Institutions (NBFIs) could give up to medium term loans. The Industrial and Commercial Development Corporation (ICDC) has a corporate and industrial loan of up to 10 years while Kenya Industrial Estates (KIE) has a small-scale industrial loan. The Development Finance Company of Kenya (DFCK) provides long-term loans of up to 8 years. As indicated in Table 4, medium term loans are 3-5 years while short-term loans are 1-3 years. This means that the DFIs diversified the credit market with longer loan maturities, providing an ideal product for industrial development. Today, the bonds market has lengthened its maturity to 10 years, meaning that the DFIs must revisit the products they offer to the market.

Interest rates offered by the DFIs were generally low compared to what the commercial banks were offering. One may argue that the rates are low because the institutions receive concessionary loans. It is important to note that DFIs are holding products that demand a higher risk premium because of the uncertainty created by the lengthy maturities. If they were to offer at pure market rate, it means that they would not attract any customers. In addition, the clientele of DFIs is a high-risk group that includes micro and small enterprises that are just starting their business, and the agricultural sector that is prone to vagaries of weather. Presently, there is concern over the high short-term loan interest rates offered by the banking sector, an indication that the market cannot afford to pay high interest rates.

**Table 4: DFCK: Types of products by loan term and features**

Product	Grace period (Yrs)	Repayment period (Yrs)	Interest rate (%)	Target group/sector	Type of security required
Long-term loans	1-3	5-8	8-17.5	Industrial, agro-industries, tourism and horticulture	Charge on land and buildings (property) & debenture over other assets
Medium-term loans	1/2-1	3-5	12.5-17.5	Industrial, agro-industries, tourism, horticulture, trading and service business	Charge on land and buildings (property) & debenture over other assets
Short-term loans	None	1-3	12.5-17.5	Trading and service business	Charge on land and buildings (property) & debenture over other assets, plus cash cover and bank guarantee

Source: DFCK

Funds from the Government of Kenya to DFIs attracted a reasonably lower interest rate compared to other sources. The interest rate ranged between 3 and 6 percent per annum. Interest rate on loans obtained from the local commercial banks ranged between 19 and 22 percent per annum. Loans from the National Social Security Fund (NSSF) were charged between 5 percent and 18 percent and at times the market rate applied. Interest rate on the loans from the German Development Bank was 7.3 percent per annum while interest rate on East African Development Bank loan was 2 percent over the Treasury bill rate. The International Bank of Reconstruction and Development (IBRD) charged interest rates ranging between 8.2 and 10 percent, while the African Development Bank (ADB) interest rates were between 7.5 and 8.2 percent and those of Exim India between 6.69 and 8.85 percent. Loans by the European Investment Bank (EIB) in Kenya shilling attracted an interest rate of between 6.56 and 22.3 percent while amounts in US\$ were charged between 5.81 and 7.19 percent. The EIB's rates were subject to Central Bank of Kenya adjustment based on Treasury bills. Exim Korea.

Determination of interest rates in DFIs is mainly centered on the mandate of these institutions and the government policy towards economic development. Therefore, though prevailing market rates are considered, government influence is evident when setting the lending rates. In the case of AFC, there has to be concurrence between the parent ministry and the Treasury. For Kenya Industrial Estates (KIE), interest rates are set in consultation with both the Treasury and the parent Ministry of Trade and Industry. As for ICDC, which is wholly owned by the government, the management and the board of directors determine the interest rates. In the case of funds acquired through foreign lines of credit (common to IDB and DFCK) guidelines on the interest rate to be charged are outlined and the institutions are only allowed a certain mark-up on top of the indicative rates given.

Despite the lower cost of capital offered by DFIs, there is a declining trend on the number of loan applications. In the KIPPRA/World Bank (2004) survey, manufacturing firms indicated very minimal interaction with DFIs, maybe because DFIs are not able to meet loan demands due to the financial constraints that they face. The average amount of approved loans gives a clear indication of the sort of demands that the institutions face. For example, the average amount approved for projects by the Development Finance Company of Kenya (DFCK) is on average Ksh 32 million while that of Industrial and Commercial Development Corporation (ICDC) and Kenya Industrial Estates (KIE) is less than Ksh 1 million. As a result, this discourages potential borrowers.

Equity financing, which has a risk sharing advantage, was very popular at the initial period across the DFIs. However, this is no longer the case. In fact, some DFIs have lost even well to do firms through the privatization process. The Development Finance Company of Kenya (DFCK) prefers a percentage ownership of 12.5 percent or more but not exceeding 50 percent. In such firms, the institution is normally represented in the Board of Directors. With equity financing, ICDC is expected to hold not more than 40 percent shares in a firm. ICDC had by 1999 invested in 84 companies at a cost of Ksh 857 million. About 80 percent of these investments were made between 1964 and 1980. The Corporation had 100 percent ownership in 10 companies and some of them were quoted at the Nairobi Stock Exchange (NSE). Presently, 3 (3.6 percent) investments have stalled, 5 (6 percent) are in receivership, 23 (27.4 percent) have been liquidated or are in liquidation and 2 (2.4 percent) are in litigation. Divestiture/privatization under the privatization programme occurred in 35 (41.7 percent)<sup>7</sup> investments. Table 5 shows ICDC's shareholding in various institutions as at 2003.

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<sup>7</sup> This figure includes Kenya Industrial Estates, which became autonomous in 1978.

**Table 5: Summary of ICDC's shares in subsidiary and associate companies as at June 2003**

Name of company	Year invested	ICDC equity investment at cost (Ksh millions)	(%) share-holding
DFCK (DBK)	1964	10.15	30.50
Kenya National Trading Corporation	1965	0.20	100.00
ICDC Investment Company	1967	32.86	23.50
Eveready Batteries	1967	1.05	24.87
Aon Minet Insurance Brokers	1969	1.03	20.00
Kenya Wine Agencies	1969	9.42	72.66
Wananchi Sawmills (1974)	1970	1.73	45.30
Pan African Paper Mills	1971	7.34	5.60
IDB	1973	31.20	12.00
General Motors (EA)	1975	8.27	20.00
Mt. Kenya Bottlers	1975	6.65	20.07
Rift Valley Bottlers	1977	3.88	29.50
Uchumi Supermarkets	1979	3.00	7.50
South Nyanza Sugar Company	1979	10.00	0.71
Agro-Chemical Food Company	1980	16.90	28.17
Kisii Bottlers	1985	8.00	26.08

Source: ICDC

ICDC was prevailed upon by the Executive Secretariat and Technical Unit (ESTU) of the Parastatal Reform Programme Committee to sell such investments as shares in Firestone East Africa, Associated Battery Manufacturers, Chloride Exide Kenya, and Milling Corporation of Kenya at a loss, though the privatization process was done through competitive bidding. ICDC sold its shares in Firestone East Africa at an apparent loss of Ksh 460 million while shares in Associated Battery Manufacturers and Chloride Exide were sold at a loss of Ksh 44 and Ksh 110 per share, respectively (7th PIC report, 1997). This was despite the companies being profitable at the time of sale and therefore a source of income for ICDC.

By 1966, the Development Finance Company of Kenya (DFCK) had invested in or was committed to investment in a total of 15 projects (National Development Plan, 1979-1983) and this trend continued over time. The performance of some equity investments has, however, been disappointing. For example, in the 1999-2002 period, about half of the equity investments

had to be provided for as doubtful investments; that is East African Sugar, Kenya United Steel, Rehabilitation Advisory Services, and Sera Coatings. Kenya Capital Partners was disposed in 1999. Other equity investments disposed earlier largely through receivership include Kicomi, Mountex, and Synthetic Fibres.

As at 1992, the Industrial Development Bank (IDB) had invested in 25 companies. A greater portion of the equity investment was, however, not profitable. In 1992, only 11 companies declared dividends amounting to Ksh 6.6 million, 14 did not declare dividends while 8 had never declared dividends despite the fact that some of the investments dated as far back as 1977 (5th PIC report, 1994). Most of these companies were disposed off during the privatization programme. Provisions for losses had to be made for both the loans and equity investments. This has weakened the quality of IDB's assets. Between 1996 and 2002, IDB wrote-off seven companies from its books as indicated in Table 6.

**Table 6: IDB's summary of equity investments at cost (Ksh millions) 1996-2002**

Period/Firm	1996	1997	1998	1999	2000	2001	2002
Associated Vehicle Assemblers	2.70	-	-	-	-	-	-
Elson Plastics of Kenya	0.75	0.75	0.75	0.75	0.75	0.75	-
Mt Kenya Bottlers	2.30	2.40	2.40	2.40	2.40	2.40	2.40
Nzoia Sugar Company	5.00	5.00	5.00	5.00	5.00	5.00	5.00
Thika Cloth Mills	4.30	4.30	4.30	4.30	4.30	4.30	4.30
Hotelspan	6.90	6.90	6.90	-	-	-	-
African Tours & Hotels	0.79	0.79	0.79	0.79	0.79	0.79	-
Sony Sugar Company	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Sonot International	0.03	0.03	0.03	0.03	0.30	0.30	-
Kicomi	2.50	-	-	-	-	-	-
Rehabilitation Advisory Services	0.55	0.46	0.46	0.28	0.28	0.15	-
Consolidated Bank	20.8	20.8	20.8	20.8	20.8	20.8	20.8
African Export-Import Bank	5.70	5.70	5.70	7.30	7.70	7.80	7.80
Acacia Fund	-	0.18	0.30	0.54	0.63	0.68	0.77

*Source: IDB Annual Reports*

Note: (-) means not existing in the book accounts

Upon its establishment, the Agricultural Development Corporation (ADC) took over two investments, which the government had just made or was about to make. These were Chemilil Sugar Company and Kenya Fruit Processors (already privatized). More investments were later made, especially in the agricultural-based industries. Most of the investments have been performing poorly, and therefore not paying dividends regularly. Firms like the Kenya Grain Growers Cooperative Union (KGGCU), now Kenya Farmers Association (KFA), and Kenya Cooperative Creameries (KCC) have been in financial problems and rehabilitation plans are on. During the privatization exercise, the Agricultural Development Corporation (ADC) divested from 12 firms through private placements. As shown in Table 7, only eight (8) investments were in the institution's books as at 2003.

The balance sheets of DFIs comprise of non-performing loans (NPLs), which have eroded the capital base due to provisions made on such loans. This status of balance sheets tends to limit the institutions' scope for sourcing of funds. In 1996, provisions for loans and investments in the Industrial and Commercial Development Corporation (ICDC) increased to Ksh 1 billion

**Table 7: ADC's schedule of investments as at 2003**

Firm	Year investment made	% shareholding held		Status of the firm
		At initial period	As at 2003	
KPCU	1966			Operating
Chemilil Sugar Company	1969	96.2	96.2	Operating
Kenya Seed Company	1976	52	52	Operating
Kenya Cooperative Creameries	1976			Liquidated
Agrochemical & Food Company	1981/82	28	28	Operating
KGGCU (now KFA)	1987			Operating
Muhoroni Sugar Company		74	74	Operating
KCC Holdings	2002			Operating

*Source: ADC*

*Blank spaces denote missing data*

from Ksh 344 million in 1995. Due to inherent culture of non-payment of debts by clients, DFCK's levels of non-performing loans as a percentage of total loans increased from 21.3 percent in 1997 to 36.5 percent in 2002. The Industrial Development Bank (IDB) had to make provisions for losses on both the loans and equity investments. This has weakened the quality of IDB's assets. Currently, the levels of NPLs stand at 30 percent of the total loans. In the case of AFC, the loan collections have hardly been 50 percent since early 1990s, as shown in Table 8. The dismal loan collections have made the loan portfolio of the Corporation unhealthy over the years. For example, as at the end of 2002, about 90 percent of the loan portfolio constituted arrears. Even after a huge write-off of loans in 2003, the position has not been better either. Loans repayment has been a major challenge for the Kenya Industrial Estates. For example the loan repayment rate declined

**Table 8: AFC's loans collections performance 1994-2003**

<b>Period</b>	<b>Amount due (Ksh million)</b>	<b>Amount collected (Ksh million)</b>	<b>% of amount collected</b>	<b>% of arrears to total portfolio</b>
1994	3148.1	741.5	24	48.1
1995	2548.7	731.0	29	87.1
1996	2509.4	866.6	35	57.0
1997	3022.4	708.7	23	62.0
1998	2303.0	415.8	18	67.2
1999	3454.3	413.3	12	73.1
2000	2630.3	401.7	15	78.6
2001	2386.7	256.9	11	83.2
2002	2680.4	226.7	8	89.9
2003	2680.5	153.1	6	82.3

*Source: AFC*

from 59 percent in 1995 to 8 percent<sup>8</sup> in 2003. The level of non-performing loans therefore increased from 92.8 percent in 1997 to 99.8 percent as at 2003.

Among the factors identified to explain the situation include general economic performance, which affected the performance of the firms; rising interest rate, which increased the cost of capital and reduced the private returns; failure of the institutions to adhere to the laid down procedures of granting loans, due to undue political influence; and liberalization of the grains and cereal marketing, which jeopardized AFC's control on credit recovery through marketing bodies like the Kenya Farmers Association (KFA) and the National Cereals and Produce Board (NCPB), among others.

It is also important to note that some investment decisions were politically-influenced, resulting in poor allocation of investment. A substantial number of bad investments by the DFIs were made under specific instructions by top government officials and ministers without due consideration of their viability. A case in point is the ICDC's investment in Soya Oil and Food Industries. Even after an inter-ministerial committee declared the investment unviable, ICDC was compelled by top government officials and ministers to undertake the project. As at 1996, about Ksh 941.9 million had been incurred but the project had not taken off, an indication of governance problem. The project was financed through a loan from Indozuez Bank, and guaranteed by the Government of Kenya (7th PIC report, 1997). The institution also undertook projects outside its core mandate, thus squeezing out its funds for on-lending. For instance, it incurred Ksh 32.5 million in financing the construction of a lecture theater at Moi University, terming it a donation, which was contrary to its mandate (7th PIC report, 1997).

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<sup>8</sup> The repayment for amounts under the Medium Term Expenditure Framework (MTEF) disbursed under strengthened conditions was 98 percent.

For the case of Agricultural Development Corporation (ADC), over 60,000 acres of the Corporation's farms were allocated to individuals in 1995 without being surrendered to the Settlement Fund Trustees that is charged with the responsibility of settling the landless. The procedure followed was in total disregard of the provisions of ADC's Act. Some farms were allocated to individuals without being surrendered to the Settlement Fund Trustees. At the same time, no criterion was used in the allocations and some farms were allocated to rich people, leaving out the poor and needy (10th PIC Report, 2001). In some cases, ADC engaged in unviable projects at the request of the government, with no funds provided to run the projects. As a result, this forced the Corporation to use commercially-borrowed funds. A case in point is the Garissa Irrigation Project where ADC used commercially-borrowed funds since the Government failed to extend any grants to the project (10th PIC report, 2001). Further, in 1995, a directive from the Office of the President to plant extra seeds to avert seed shortage resulted in a loss of Ksh 57 million to the Corporation (10th PIC report, 2001).

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## 6. Conclusion and Policy Options

Development process requires adequate and appropriate financing to achieve the set objectives. Despite the poor performance of Development Finance Institutions (DFIs) in Kenya, their role in the development process is still vital. Their relevance is clear from the private sector-led growth development strategies that the government adopted in the Economic Recovery Strategy (ERS). In this regard, the government should take deliberate efforts to sustain their operations as it strives to meet its development goals.

To deal with the issues raised in the previous sections, there are various options open and need to be weighed carefully to ensure that the institutions continue to meet their objectives.

### a) Ownership structure

The main objective in ownership of DFIs is to achieve efficient management, strengthen governance, curtail political influence and sustain the objectives of setting up the institutions. Various options are available.

#### *Retaining DFIs as parastatals*

Development Finance Institutions could retain their parastatal nature but undue political interference must be checked. The Acts establishing the institutions should be reviewed to curtail such interference and give the management more autonomy to hold managers accountable. Performance contracts already instituted should be strictly adhered to and set targets monitored. The Industrial Development Corporation (IDC) of South Africa, which has had success both at local and global levels, is a state-owned development finance institution.

*Divesting the government ownership*

This can be achieved in three forms. The government could fully divest from the DFIs and let private investors take up the ownership. While this may reduce political interference, it is not a guarantee that the core activities will be sustained. Diverting from the core activities may have its own repercussions on the industrialization process that these institutions are expected to drive unless there are alternative sources of long-term capital. Again, institutions that are privately-owned may fail to sustain the welfare objective because they look at private returns rather than social returns.

Other than fully divest, the government could sell a proportion of its shares in these institutions. This will still retain the DFIs as public institutions, though with a minority ownership of the private sector. An institution with majority government ownership can deliver as long as the institutional structures are strengthened. The private shareholders will have some confidence with the assured government commitment.

The government could sell majority of its shares (i.e. 51 percent) in DFIs and only retain minority shareholding of about 49 percent. The advantage here is that the institutions get opened to more public scrutiny, which helps in monitoring their operations. Further, when this is coupled with efficient management and commercial orientation, it enhances the performance and sustainability of the institutions enabling them to meet their objectives. In such a case, institutions can comfortably put government funds in projects with a welfare objective.

A challenge though is that floatation of shares requires the poor performing institutions to be restructured to allow them meet the listing requirements. The government could take up the debt that the institutions own to the creditors to clean their books and use the proceeds from listing to revitalize their activities. In the long run, the government will gain in terms of tax

revenue and the development objectives. This has been successfully done with Kenya Airways and the Government is reaping benefits now.

The institutions have also to deal with the debt owed to them. Strengthening the debt recovery efforts at institution level is important in order to reduce the level of non-performing loans. At the moment, Kenya Industrial Estates has instituted several measures to recover debts, including: establishing a debt recovery unit; reorganizing the debt registry; improved management information system; regular release of loan statements; negotiated debt settlement; and legal action as a last resort. The Industrial Development Bank (IDB) has also put in place a taskforce to spearhead debt collection, while the Agricultural Finance Corporation has instituted proper loan appraisals and project supervision to enhance debt collections. These efforts need to be complemented with a strong credit bureau and commercial court system.

The recovery process, though, may take time or may achieve minimal results. The institutions can take the example of Kenya Commercial Bank to remove the non-performing loans from their books but put an effort to follow them up. Such a move will clean the balance sheets and in turn attract both potential investors and financiers. New investors can help to inject the much-needed capital. Write-off may be a last resort especially if the firms (debtors) have since closed down, and where efforts to follow them for repayment may bear no fruits.

b) Funding the DFIs

Maintaining adequate flow of funds is important for the DFIs to sustain their activities and contribute significantly to the development process. Important though is that they must demonstrate the ability to repay and ensure the funds are affordable. The alternative financing products include:

*Floating a long term bond*

Presently, the bonds market has a maturity of up to 10 years, making it a potential source of long-term capital. The market has witnessed the floating of bond by Faulu Kenya, which is a micro-finance institution, and East African Development Bank, which is a regional DFI. A major drawback, however, is that the market suffers from short term nature. This means that investors demand higher expected returns, which would make the DFIs funds very expensive. Floating short and medium terms bonds may, on the other hand, constrain them from matching with the long-term demands. It is important that the bonds market is vibrant and liquid enough to attract investors.

*Floating shares through the stock exchange*

Public offer is a cheaper source of financial capital which, coupled with public scrutiny, compels the institutions to perform. Recently, the market has witnessed the government float shares of KenGen, which is a public company with limited liability. The main limitation for most of the DFIs is poor performance, which means that they cannot meet the basic listing requirement. Preparation for such offer requires a lot of effort in restructuring their assets. The alternative is private placement with a strategic investor. However, this can only be achieved with a clear public-private partnership policy.

*Government budgetary allocations*

The government should allocate a certain proportion of its budget to be channeled through these institutions for development purposes. It is important to remember that these institutions are channels for financing

development and the government can use them to achieve specific development objectives.

*Contractual savings*

Development Finance Institutions could access contractual savings from such institutions as the National Social Security Fund (NSSF), National Hospital Insurance Fund (NHIF), and pension and provident funds. Since these are long-term funds, they are better diverted to long-term gestation projects instead of being invested in short-term securities. However, this requires efficient management and lending practices among the DFIs. It also means that pension funds have to re-look at their investment policy.

*Revolving fund*

The DFIs should set up a revolving fund to sustain their financing. For the revolving fund to be well endowed, however, the principal amount of loans repaid by the clients should always be put back into the fund to ensure continuous availability of lending funds. This requires instituting effective debt recovery measures.

*Common resource pot*

Because of DFIs weak asset position, poor performance and management problems, it is very difficult for most of them to get to the market individually to raise funds. Further, with the restriction on government guarantee, the options of most of the DFIs are limited. The study proposes the establishment of a common resources pot from which the various sector-specific DFIs can draw funds for on-lending. This will allow pooling of risks; strengthening of the negotiation position with potential donors, both local and foreign; and ensure that DFIs concentrate on ensuring the funds are allocated

efficiently and effectively. The Development Finance Company of Kenya (now Development Bank of Kenya), which is not focused on specific sectors, can take the responsibility. The idea would be to mobilize the resources and share them among the DFIs. These institutions, however, would be expected to strengthen their operational base to ensure that resources are utilized efficiently and repaid.

c)       Efficient investment allocations

Efficient investments contribute in sustaining the DFIs. This means that DFIs must put in place adequate systems for monitoring and evaluating projects to help them reduce the information gap and enhance allocative efficiency. The challenge, though, is to balance social and private returns in deciding on the investment projects. As vehicles for development, DFIs must ensure that they meet their objectives, which are generally geared towards enhancing social welfare. With social welfare as an objective, and given the objective of the Economic Recovery Strategy of employment generation, DFIs must focus on labour-intensive firms for job creation. However, to achieve a competitive edge, emphasis on production of high quality products is imperative.

In addition, it is important to establish a monitoring and evaluation strategy to enable close monitoring and review of the activities of DFIs. This will ensure that emerging issues are dealt with on a timely basis.

Investments may perform poorly because of a poor investment climate. The government must complement the activities of DFIs by providing a favourable environment for businesses to flourish. For example, the government must make provision for adequate infrastructure where workspaces are provided in order to attract private firms.

Another factor that may affect the sustenance of DFIs is lack of graduation of firms. Some firms fail to take off because they cannot gain a market position. The government could support small businesses by offering a ready market for their goods through the tendering process. The present review of the procurement procedures aims to promote entrepreneurship by giving new entrants a chance in tendering. However, only entrepreneurs who are properly skilled and making standard products should be allowed.

d) Regulatory framework and legal status of DFIs

To give DFIs a defined space in the development process, it is important that a policy framework is developed to define clearly their responsibilities and financing strategies. Such a framework needs to place the institutions under one supervisory authority so as to eliminate multiplicity of reporting and bureaucracy.

In addition, the role of DFIs must be clearly brought out in government development strategies. Though such strategies as highlighted in the development plans are short to medium term, it is also important to focus on long-term development goals to accommodate the role of DFIs. This is because of the institutions' lending, which has long-term maturities. There is also need to bring out clearly what is expected of DFIs in terms of deliverables. While some of these DFIs were set up to support industrial development, the Industrialization by 2020 Strategy highlights the restructuring programme but no expected deliverables are mentioned. The same also applies to the recent Economic Recovery Strategy for Wealth and Employment Creation: 2003-2007.

e) Restructuring the institutions

Rigorous internal restructuring of DFIs is important to enhance efficiency. This means ensuring that they remain focused in their activities, rationalizing the branch networks, and getting rid of non-core activities/non-strategic assets.

It is also important to re-look at the responsibilities of DFIs *vis a vis* the emerging development challenges. Presently, the set up of the DFIs is based on sectors. Although this seems appropriate given that the DFIs focus on specific aspects of the sector, this should not remain the situation. At the moment, the economy is facing various challenges relating to workspaces for enterprises, low graduation of firms, lack of regional distribution in location of firms, weak firm-to-firm linkages, inadequate infrastructure and housing, and low technological and entrepreneurship development.

Kenya Industrial Estates (KIE) is relevant in nurturing growth of firms in the private sector-led and export-led growth strategies. Workspaces, Business Development Services, and technical support are important for firm growth as they facilitate productivity of the firm. However, the activities must be anchored to the development goals. For it to succeed, KIE must work closely with relevant ministries and institutions such as the Ministry of Trade and Industry, Ministry of Local Government, universities, research institutions and MSEs organizations.

The Industrial and Commercial Development Corporation (ICDC), the Industrial Development Bank (IDB) and the Development Finance Company of Kenya (DFCK) seem to have similar clientele. It is important that the institutions focus on specific aspects of industrialization at a time. They need to support key industrial activities that the government finds core in achieving its development goal. Spreading their efforts thinly may not lead to the achievement of the industrialization strategy. For example, if the government identifies value adding to agricultural products as the main

activity, then support from DFIs should be skewed towards agro-based manufacturing firms. If the government identifies car manufacturing, then the institutions should put their efforts towards funding activities related to car manufacturing. The institutions, however, require to work closely with universities, research institutions like Kenya Industrial Research and Development Institute, and relevant internal and external private sector institutions.

The Agricultural Finance Corporation supports agricultural development by providing finance and advisory services. It is important the institution concentrates on development of agriculture and let the industrial activities be supported by other DFIs. This means that AFC could put a lot of effort in ensuring that food security is tightened. The Corporation should also be dynamic in supporting new activities such as tree cultivation in dry areas. Although this may not seem to contribute to food security directly, it enhances the environment and the ability to purchase. The institutions should work closely with research and marketing institutions in identifying the area of focus.

The Agricultural Development Corporation (ADC) has the role of promoting and executing schemes for agricultural development. With the country going through difficult and frequent drought conditions, the Corporation could focus its attention to semi-arid areas and take the initiative to invest in enhancing productive agricultural activities. However, for this to happen, basic services must be available, including security and infrastructure.

Kenya Tourist Development Corporation (KTDC) develops tourist facilities and services in the tourism sector. The institution should continue to complement private initiatives by facilitating local investment and provision of credit to small and medium enterprises in the sector. Also, funds for refurbishment of the existing facilities should be provided.

A new DFI focusing on housing is needed to deal with the prevailing housing problems in urban areas. It would work very closely with the municipal councils in meeting the housing demands. It is also important to establish a DFI focusing on infrastructure development. This will facilitate the private-public-partnership strategy that the government is taking up at the moment.

f) Collaboration with MFIs

At the moment, there are various micro-finance institutions (MFIs) financing the MSEs. The MFIs provide financial support and skills on how to run business mainly to ensure that the client can repay the loans. However, enterprises need more than just bookkeeping skills. They require technical support to be innovative and take up new technology. It is also important to note that MSEs face constraints in terms of space to do business. When the DFIs were set up, they covered virtually all-firm sizes. They provided start-up capital, sheds for incubation of businesses, technical support and other business development services. This means that the two types of institutions have intersection points that can provide a basis for collaboration.

The Kenya Industrial Estates (KIE) provides space for businesses with the sheds and presently the Export Processing Zones (EPZ) facilities. KIE could collaborate with Micro-Finance Institutions (MFIs) in supporting businesses by providing working spaces. In these facilities, the businesses will receive the technical and other Business Development Services. This will facilitate the MFIs clientele in developing their entrepreneurial capabilities. Growth-oriented businesses will of course surpass the financing limits of MFIs and this will be the time for the DFIs to come in and provide financial support to facilitate the graduation of firms to the next level.

Micro-Finance Institutions are well known to use the social capital approach in the loaning process and achieve over 90 percent repayment despite high

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interest rates of about 30 percent. Most DFIs largely failed because of non-repayments. MFIs could act as conduits for DFIs to channel funds to the small businesses. The government could therefore adopt a deliberate policy to ensure that all funds targeted to small enterprises, even those from the development partners, are channeled through DFIs. The advantage of this is that the government can achieve its objective of a growing private sector with increased participation in productive activities.

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