Comments to be submitted by March 15, 2018

Consultative Paper on the Review of the Microfinance Legislations

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CONSULTATIVE PAPER ON THE REVIEW OF THE MICROFINANCE LEGISLATIONS

1.0. Introduction

The Central Bank of Kenya (CBK) is revising the legal and regulatory framework governing the microfinance banking sub-sector in Kenya to ensure it is up to date and relevant to the sub-sector's dynamic operating environment. In this regard, CBK is currently conducting a review of the Microfinance Act, 2006 and Regulations, 2008. Following stakeholder consultations in the last quarter of 2017, CBK has developed a consultative document on the proposed amendments to the Microfinance Act, 2006 and Regulations, 2008. In line with the constitutional requirement on public consultations, CBK is releasing the consultative document for public review and further input which will be considered in developing the paper further and determining the necessary amendments. We would appreciate your feedback at your earliest convenience but not later than March 15, 2018.

1.1. Background

The Central Bank of Kenya (CBK) is mandated to foster the liquidity, solvency and proper functioning of a stable market-based financial system {section 4(2) of CBK Act}. One way it achieves this is through the licensing, regulation and supervision of financial institutions falling under its regulatory purview. These include commercial and microfinance banks, mortgage finance companies, money remittance companies, forex bureaus and credit reference bureaus.

Through the Microfinance Act 2006 and Microfinance (Deposit Taking Microfinance Institutions) Regulations 2008, the CBK is tasked with developing a vibrant, efficient, stable and sound microfinance banking industry through the regulation and supervision of microfinance banks (MFBs). The microfinance legislation came into force on May 2, 2008 to provide a platform for the broadening and deepening of access to financial services throughout Kenya, especially to the low income populace and Small and Medium Enterprises (SMEs) in both urban and rural areas.

1.2. Developments in the Microfinance Industry

Following the enactment of the Microfinance Act and Regulations, the dynamics within the microfinance industry have changed significantly with the industry experiencing growth and transformation. Innovation and dynamism within the microfinance industry has increased and the industry has experienced growth in the number of customers and diversity in the range of services and products provided.

Since the first microfinance bank was licensed in May 2009[1], the number of licensed microfinance banks has increased to thirteen (13), eleven (11) being nationwide (Faulu Kenya MFB, Kenya

[1] Faulu Microfinance Bank Limited

Women MFB, SMEP MFB, REMU MFB, Rafiki MFB, Century MFB, SUMAC MFB, Caritas MFB, Maisha MFB, Uwezo MFB and U&I MFB) and two (2) being community-based MFBs (Daraja MFB and Choice MFB).

The microfinance legislation has been amended on a number of occasions. These include:

a) The amendment of the Microfinance Act through the Finance Act, 2010 to expand the definition of places of business in order to allow for the use of agencies and marketing units as places of business.
b) The amendment of the Microfinance Act through the Finance Act, 2010, and publication of the 'Guideline on the Appointment and Operations of Third Party Agents by Microfinance Banks', to allow MFBs to increase outreach through third parties.
c) The issuance of the 'Guideline on the Opening, Relocation and Closure of Marketing Offices and Agencies of Microfinance Banks' effective May 17, 2012 to allow MFBs to use their marketing offices to conduct deposit taking business.
d) The amendment of the Microfinance Act through the Finance Act, 2011 to permit MFBs to participate in the Kenyan Credit Information Sharing (CIS) mechanism.
e) The amendment of the Microfinance Act through the Finance Act, 2013 to among other things; change the name from "deposit taking microfinance institution" to microfinance bank; allow MFBs to operate current accounts, issue cheques (and participate in the national payment system) and engage in foreign trade operations as well as require MFBs to share both positive and negative credit information with Credit Reference Bureaus (CRBs).

To support the rapid growth of the microfinance banking industry, the existing microfinance legislative and regulatory framework calls for considerable review to suit the industry's current realities. To kick start the legislative and regulatory review process, CBK invited key stakeholders, including licensed microfinance banks and the Association of Microfinance Institutions (AMFI) to submit comments and proposals for consideration in the review process in September, 2017. The comments have been considered and incorporated in this concept paper to reflect their proposals on the way forward in the development of a robust microfinance policy, legal and regulatory framework.

The purpose of the consultative paper is therefore to propose a number of critical areas that need to be interrogated within the Act and Regulations for comments from members of the public.

1.3. Current Status of the microfinance sector

The Microfinance sector has witnessed significant growth since 2008 when the first MFB was licensed. The number of licensed MFBs has grown to 13 with a total of 114 branches as at December 2017. The number of marketing offices has grown to 106 as at December 2017. However, a considerable drop in performance was observed in the year 2017 with the total assets decreasing by 4.6 percent from KSh. 72 Billion in December 2016 to KSh. 69 Billion in December 2017. The level of profits has also declined in the last three years from KSh. 549 Million for the period ended December 2015 to a loss of KSh. 377 Million and KSh. 731 Million for the period ended December 2016 and 2017 respectively. The continued drop in profits is largely attributed to reduction of financial income. The key financial indicators are as highlighted below:

Key Financial Highlights (KSh. 'Million')

Key Indicator	31.12.13	31.12.14	31.12.15	31.12.16	31.11.17
No. of Institutions	9	9	12	13	13
Total Assets	41,350	56,972	69,465	72,510	69,170
Total Shareholders' Funds	5,330	10,600	11,633	11,622	11,055
Net Loans/Advances	27,476	39,183	45,749	47,047	43,051
Deposits	24,745	34,486	40,589	40,198	39,416
Core Capital	4,731	9,601	10,352	10,400	9,818
Profit/(Loss) Before Tax	530	1,002	592	(377)	(731)
Non-Performing Loans	2,047	2,348	4,264	7,371	9,911
Core Capital/TRWA (%)	15	22	21	20	20
Liquidity (%)	36	25	32	32	28
NPLs/Gross Loans (%)	6	8	9	15	22
Provisions/NPLs (%)	37	35	32	22	23
Return on Assets (%)	2	2	1	(0.5)	(1.2)
Return on Equity (%)	15	9	5	(3.2)	(7.2)
No. of branches	91	97	109	112	114
No. of Staff	3,903	4,329	4,500	4,423	4,321

Source: Central Bank of Kenya

1.4. Challenges facing the microfinance sector

The Microfinance sector is currently facing various challenges most of which are as result of the rapid growth experienced and the changing market dynamics. These challenges form the key drivers of change and include;

i) The need for enhanced corporate governance structures and practices in the changing banking sector environment. This presents the need to review current shareholding structures and introduce new structures such as non-operating holding companies.
ii) Need for resilient and viable business models through ensuring adequacy of capital and liquidity given the changing market dynamics across the entire banking sector.
iii) Elevated credit risk which has contributed to increasing non-performing loan portfolios.
iv) Reduced reliance on deposits and increased reliance on more expensive borrowed funds. This is attributed to the low visibility of microfinance institutions which hinders the mobilization of deposits. In addition, the few willing depositors demand for higher interest return, which is not sustainable in the long-run.
v) The need for improved transparency mechanisms and on-demand customer response mechanisms owing to growing consumer complaints.
vi) Emerging financial technology (Fintech) which has created new opportunities as well as new risks that need to be understood and mitigated.
vii) Change in pricing and uptake of credit due to imposition of interest rate caps.

viii) Changes in the reporting standards, including the introduction of the revised International Financial Reporting Standards (IFRS) 9.

1.5. Rationale for comprehensive review of the microfinance legal and regulatory framework

It is indeed evident that the Kenyan microfinance banking industry has witnessed considerable changes. Not only has the number of licensed microfinance banks increased, but their operating environment and business models have also changed dramatically in terms of service delivery owing to the changes in technology. Their organisational structures have changed, and their financial, economic and risk exposures continue to evolve rapidly. Against this background and in light of the continuously evolving institutional environment, a comprehensive review of the existing legal and regulatory framework for microfinance banks is paramount.

The amendment proposals contained herein are intended to promote a more transparent, resilient and stable microfinance banking industry capable of adapting to emerging risks, challenges and opportunities. This will in turn reinforce the financial system stability and contribute towards a more inclusive and sustainable economy. The proposals are also aimed at ensuring the interests of consumers of financial services are protected throughout their relationships with financial institutions, thereby fostering and embedding a customer-centric culture within microfinance banks.

In view of the challenges articulated above, the key areas for consideration in the review of the Microfinance Act and its attendant Regulations are as detailed below;

a) Review of existing provisions within the Microfinance Act and Regulations

i) Corporate Governance

To review the MFB corporate governance structures to provide for more effective corporate governance, including express provisions on the duties of the board of directors, vetting of directors, fiduciary responsibilities of the board and consequences of breach, independence of directors, and limit on the tenure of board members, among other provisions.

ii) Categorization of Microfinance Banks

The current microfinance legislation recognises two categories of microfinance banks: nationwide and community. The proposal is to merge the two licences and do away with the categorization and issue one licence for Microfinance Banks. This will address the need for resilient and viable business models which ensure capital adequacy given the changes in the sector.

iii) Minimum Capital Requirements

To review minimum capital requirements upwards to ensure that applicants and licensed MFBs demonstrate resilience as evidenced in their capitalisation. The proposal is to have the minimum capital requirements for all microfinance banks increased for both existing MFBs and new entrants.

iv) Shareholding Requirements

To review the shareholding limits in cognizance of the evolution of ownership structures over time. The proposed amendments touch on exemptions on shareholding limits, creation of non-operating holding companies and entrenchment of the vetting of significant shareholders into the Act as these are currently not in the Act. This will boost corporate governance in the Microfinance industry.

v) Risk classification of assets and provisioning

To review the current risk classification of assets and provisioning policy to be more reflective of the short term nature of the loan cycles within the microfinance industry. This concern has been raised regularly by the industry for the following reasons;

a) The classification structure assumes that microfinance loans are repaid on a weekly basis while the case on the ground is that they are paid on a monthly basis.
b) The structure also assumes that microfinance banks lend short term (3-6) months while in reality some of the portfolios have longer loan tenures.

b) Introduction of new and enhanced provisions

There are a number of prudential requirements which are not provided for in the current Act or the regulations. These areas are important and need to be adequately addressed in the law in light of developments in the global microfinance industry. They will also come in handy to address the challenges brought about by the various developments experienced in the industry. These include;

i) Consumer protection

We propose to develop guidelines for consumer protection in line with the industry practice and Kenya's consumer protection law. This will help to ensure fair treatment, transparency, financial education and creation of dispute resolution mechanisms. This will in turn address the issue of increased customer complaints.

ii) Consolidated Supervision

Financial innovation and the emergence of financial conglomerates are blurring the traditional business lines of financial institutions. As financial institutions within the financial industry express interest in microfinance banks, there is a need for CBK to adopt a consistent and more efficient approach to regulating the financial inter-linkages and risks. In this regard, it is recommended that provisions on consolidated supervision should be included in the Act. This will allow the industry to adjust to changing dynamics affecting business models and management of various risks.

iii) Cyber risk, Business Continuity Planning and Management (BCP and BCM)

There is need to develop clear guidelines for cyber risk and BCM. This should be flexible and in tandem with size and complexity of institutions. This will help manage the risks that are likely to arise due to changed business models and emerging technologies which continue to expose the institutions to emerging technology risks like cyber-crime.

2.0. Next Steps

The next steps involve;

i) Review of comments from the public and organising a consultative meeting with the industry by end March 2018.
ii) Incorporating the material comments in the initial draft of the Microfinance (Amendment) Bill, 2018 and Regulations.
iii) Submission of draft Microfinance (Amendment) Bill, 2018 and Regulations to the stakeholders and the public for comments (statutory minimum of 21 days) by May 2018. All comments received will be considered and incorporated in the draft Microfinance (Amendment) Bill, 2018 and Regulations as appropriate.
iv) Finalise drafting Microfinance (Amendment) Bill, 2018 and Regulations and preparation of requisite documentation for presentation to the State Law Office for drafting and Parliament for Legislation. This is targeted to be done by June 2018.

3.0. Request for Comments

CBK invites comments from the public on this consultative paper. The comments should be submitted to the undersigned by March 15, 2018.

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