New Partnership for
Africa's Development (NEPAD)

Comprehensive Africa Agriculture
Development Programme (CAADP)

Food and Agriculture Organization
of the United Nations

Investment Centre Division

GOVERNMENT OF THE REPUBLIC OF KENYA

SUPPORT TO NEPAD–CAADP IMPLEMENTATION

TCP/KEN/2908 (I)

(NEPAD Ref. 04/06 E)

Volume II of IV

BANKABLE INVESTMENT PROJECT PROFILE

Agriculture Focused Rural Finance Project

December 2004

KENYA: Support to NEPAD–CAADP Implementation

Volume I: **National Medium–Term Investment Programme (NMTIP)**

Bankable Investment Project Profiles (BIPPs)

Volume II: **Agriculture Focused Rural Finance Project**

Volume III: **Integrated Land and Water Resources Management**

Volume IV: **Disease Control and Facilitation of Livestock Commodities Marketing**

NEPAD–CAADP BANKABLE INVESTMENT PROJECT PROFILE

Country: Kenya

Sector of Activities: Rural Financial Services

Proposed Project Name: **Agriculture Focused Rural Finance Project (AFRFP)**

Project Area: Rift Valley, Nyanza, Western, Coast and North Eastern Provinces

Duration of Project: 5 years

Estimated Cost:
Foreign Exchange .... US$23.76 million
Local Cost .... US$9.00 million
Total .... US$32.76 million

Suggested Financing:

Source	*US$ million*	*% of total*
Government	4.00	12
Financing institution(s)	23.76	73
Beneficiaries	2.00	6
Private sector	3.00	9
Total	***32.76***	***100***

KENYA:

NEPAD–CAADP Bankable Investment Project Profile

"Agriculture Focused Rural Finance Project (AFRFP)"

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Abbreviations

AFC	Agricultural Finance Corporation
AFD	*Agence Française de Développement*
AFRFP	Agriculture Focused Rural Finance Project
ASCA	Accumulating Savings and Credit Association
CAADP	Comprehensive Africa Agricultural Development Program
DANIDA	Danish International Development Agency
DFID	Department for International Development
ERSWEC	Economic Recovery Strategy for Wealth and Employment Creation
FSA	Financial Services Association
GOK	Government of Kenya
IFAD	International Fund for Agricultural Development
MESP	Micro Enterprise Support Program
MFI	Microfinance Institution
NEPAD	New Partnership for Africa’s Development
NGO	Non–Governmental Organisation
PRSP	Poverty Reduction Strategy Paper
POSB	Post Office Savings Bank
SACCO	Savings and Credit Cooperative Society
SONY	South Nyanza Sugar Company
SRA	Strategy for the Revitalization of Agriculture
USAID	United States Agency for International Development
WEDCO	Western Development Company

I. PROJECT BACKGROUND

A. Project Origin

I.1. The Ministries of Agriculture and Livestock and Fisheries Development together are implementing a recently completed *Strategy for the Revitalization of Agriculture 2004–2014*. Lack of access to financial services is among the priority constraints recognised in that document. This proposed project is the result of a request from the ministries for assistance in developing a bankable project to address that constraint.

I.2. The priority given to solving the problem of a lack of financial services was confirmed in a NEPAD/CAADP validation workshop held with participation with staff of the two ministries, amongst other stakeholders who included farmers, agribusiness, researchers and donors. The project has been developed by the CAADP country team in collaboration with staff of the two ministries.

B. General Information

I.3. Kenya at independence was initially one of the most promising economies in Africa. In the 1960's and 1970's economic growth averaged a respectable 7 percent driven in large part by public investments in supporting agriculture — the generation and widespread adoption of hybrid maize varieties, land resettlement and redistribution schemes, and supportive marketing systems with tied credit arrangements. Agricultural credit, as well as markets for inputs as well as outputs were provided, or guaranteed, by the government.

I.4. The systems designed for a large farm sector proved unsustainable in a sector increasingly dominated by smallholders. By the late 1980's government found support to agriculture, along with all the other sectors it was supporting, financially unsustainable. Structural adjustment brought reforms in the markets for foreign exchange and liberalised interest rates, exchange rates and all manner of macroeconomic fundamentals. Agricultural markets also were liberalized leading to the collapse of the tied credit arrangements of the past.

I.5. The result has been that economic growth declined and stagnated beginning in the early nineties to the present day. Annual average economic growth rates of 7 percent in the seventies, declined to below 2 percent over the last decade. Factors contributing to this include poor governance, intermittent implementation of reforms, resource constraints, poor infrastructure and an inefficient state bureaucracy, among other factors. The result has been reduced private investment throughout the economy. Agriculture has been particularly badly hit.

I.6. Kenya is primarily an agricultural country with overall economic growth rates closely tied to agricultural growth rates. Agricultural sector growth rates have declined from 5 percent in the 1960's to 3.5 percent in the 1980's down to a paltry 1 percent over the last decade. Factors contributing to this include declining commodity prices, and climatic shocks as well as domestic policies that distorted both input and output markets, a poor legal and regulatory framework and poor infrastructure, all of which hindered private investment. The major private investors in agriculture are the 3 million rural households who derive most or all of their livelihoods from farming, animal husbandry and fishing. That lack of investment manifests in two main ways: reduced acreage, and lower investments in land preparation, quality seed, fertilizer application and weeding on the land still under production. Numerous studies have found that farmers do not lack the knowledge of what optimal production technologies are available or what optimal practices are. A recent study (World Bank, 1999) on awareness and adoption of technological recommendations generated by research, and extended by the extension service shows how factors outside the control of research, affect its impact. Lack of funds was cited most often as the reason for non–adoption, or discontinuation of recommended practices. Lack of confidence in the markets for outputs, and financing constraints, are the main reasons why production and productivity in the Kenyan agricultural sector is low and falling. The constraints facing crop farmers are mirrored in sub–optimal husbandry practices in the livestock sector and among fishermen.

I.7. The previous government had prepared a *Poverty Reduction Strategy Paper* (PRSP) that ranked agriculture as the number one sector. A new government came to power in 2003 and is committed to reviving agriculture. This commitment was laid out in its pre–election manifesto. The new government took the PRSP and the manifesto and prepared an *Economic Recovery Strategy for Wealth and Employment Creation* (ERSWEC) that also confirmed the priority of agriculture. ERSWEC is a national strategy further elaborated in the sectoral *Strategy for the Revitalization of Agriculture* (SRA), prepared in late 2003.

I.8. Both the ERSWEC and SRA confirmed that inefficient rural financial systems and lack of access to agricultural credit were major causes of the decline in agricultural productivity. This makes it difficult for households to accumulate and save financial assets on a regular basis that can be used to make the occasional, but relatively large outlays needed for their agricultural activities. This has had the impact of lowering agricultural productivity in many rural areas. Productivity is higher where financial institutions exist.

I.9. Major constraints to increased access to financial services in rural Kenya include:

- ***Collapse of Marketing Outlets:*** Marketing boards and other state owned agricultural corporations acted as very good financing institutions for rural households in the sixties and seventies. Most of these have collapsed. The private sector has been unable to fill the gap. Sectors affected include dairy, pyrethrum, coffee, maize and sugar and cotton among others.

- ***Conflicting Policy Environment:*** It is unclear what the government policy for financial sector reform is. The newly revived *Agricultural Finance Corporation* is lending at subsidised rates, thus distorting the market while at the same time legislation for micro–finance institutions and co–operatives promoting a liberalised environment are being finalised for presentation to parliament. Policy reforms and statements of intent have given limited attention to the needs of typical rural household, the majority of whom live below the poverty line.

- ***Limited Information:*** There is limited information on, or understanding of, the rural household as a (potential) consumer of financial services. This acts as a disincentive to private sector and even NGO investment in products and expansion of financial services targeted at them. These institutions have made comfortable returns placing their efforts and funds with better–understood risks like government paper, trader and consumer credit.

- ***Weak Institutional Capacity:*** With the exception of the large banks, there is limited institutional capacity in terms of human and financial resources to develop financial products targeted at rural households. Many of the large financial institutions have serious bad debt problems and are unable to focus on expanding into new markets. Rural co–

operatives also have resource and capacity constraints and only operate in cash crop areas.

- ***High Costs of Service Delivery:*** Poor infrastructure and a sparse population density, coupled with the low per capita incomes of many rural households have made traditional models for service delivery too expensive relative to expected returns for the private sector to invest.

II. PROJECT AREA

II.1. Some parts of the country are better off in terms of access to financial services than others. In order to increase the access to financial services in Kenya, the proposed project will limit itself to these underserved areas where less than 30 percent of households have any form of account. The project will focus on the areas with limited access: the Coast, Eastern province, Nyanza, Western and North Eastern Province.

II.2. A recent survey by Tegemeo Institute Egerton University showed that only 23 percent of Kenyan households have access to an account in a commercial bank. This proportion is declining over time. Access is particularly limited in non–cash crop producing areas: the eastern, western, and coastal lowlands, as well as in the arid and semi arid northern districts. The study also found that the average distance to any form of financial institution for Kenyan households is 20 km, with distances of over 100 km in more poorly served areas.

Table 1: Access to Financial Services in 2002 – Any Type of Account

Zone	% with account	Bank Account	SACCO/Co–op	Post Office SB
Central Highlands	92	22	67	3
Western Highlands	56	7	41	9
High Potential Maize Zone	53	37	10	7
Western Transitional	50	28	19	4
Marginal Rain Shadow	42	28	7	7
Eastern Lowlands	39	17	1	22
Coastal Lowlands	27	18	1	8
Western Lowlands	22	14	1	7
Average	53	23	22	8

Average distance: 20.5 km.
Source: Argwings–Kodhek, 2004.

II.3. In the Central Highlands, the SACCO movement has played a big role in getting financial services to people on the back of tea, coffee and dairy co–operatives. Ninety–two percent of the households in the region have access to some sort of bank account. SACCO's and Cooperatives are the driving force behind that high figure. For the rest of the country, less than 50 percent of the households have any form of bank account.

II.4. Many of the reasons for this low penetration of financial services come from the policy and institutional environment in the financial sector. This is being addressed by a number of initiatives. The proposed AFRFP project can add value to those efforts by increasing attention and thought going to the issues and commodities of underserved areas.

II.5. Area specific action research initiatives will be undertaken in 5 areas:

- Chemilil, SONY and Nzoia sugar zones in Nyanza and western province;
- Fishing communities around Lake Victoria and on the Indian Ocean coast;
- Nyanza, Busia and Makueni cotton production systems;
- The beef value chain along the Mandera–Nairobi axis;
- Trans Nzoia District in the main maize surplus zone of Rift Valley Province.

III. PROJECT RATIONALE

III.1. The significant decline in per capita output in the agricultural sector over the last twenty years must be reversed if Kenya is to reduce poverty. Both the ERS and SRA recognise enhancing agricultural productivity as a key pillar for economic growth in the future.

III.2. The NEPAD’s *Comprehensive Africa Agricultural Development Programme* (CAADP) pillars also support the need for expansion of agricultural output through additional use of inputs and better use of resources and technology. Increasing access to appropriate financial services for rural households is a key ingredient for enhancing productivity in the agricultural sector and ultimately reducing poverty levels.

III.3. Past efforts to increase access to financial services by government, donors and the non–governmental sector have been focused largely on micro–finance and support to state owned financial institutions. While the growth rates have been impressive, outreach is still limited with products and services largely focused on urban and peri–urban micro–enterprises. The client base of all the microfinance NGOs combined after two decades of donor funding is less than 300,000 individuals in a population of 30 million.

III.4. Government supported institutions have been unsuccessful. Problems of political interference, governance and management problems are largely responsible for this. A significant decline globally in resources available for lending to government owned rural finance institutions has been the result. Government owned development finance institutions, like the AFC, provide subsidised credit at rates that distort the market. The unfortunate outcome of their policies — including their being under the influence of politicians — is that the subsidy is captured by urban based, and large–scale producers. A 1998 survey of Kenyan agriculture found that the *Agricultural Finance Corporation* lends to only one percent of rural households. Eighty–six percent of AFC loans are made in the Rift Valley, 13 percent in the central highlands. Loans were made to farms averaging 19 acres compared to a national average farm–size of 4.3 acres, and 73 percent of borrowers had off–farm sources of income (Argwings–Kodhek, 1998).

III.5. Very little work has been done to promote access to financial services in rural Kenya, particularly in lower potential areas: western lowlands, the coastal lowlands, eastern lowlands and the arid and semi–arid districts.

III.6. Due to lack of information and the perceived risks of lending to this sector, private investment in innovative product development to reach rural households is limited and will continue to be so until there is sufficient evidence that rural households are “bankable”. This “moral hazard” presents justification for public sector intervention to reduce the market failure discouraging potentially profitable private investment.

III.7. Targeted investments in action research and product development envisioned under this project to prove/demonstrate the viability of providing financial services to the rural sector, disseminate that information, develop institutions and capacity inside and outside of government would add significant value to the governments efforts to reduce poverty levels and increase the productivity of agriculture in rural areas. The proposed project is justifiable in the current Kenyan context and would complement other efforts by the government to promote economic recovery.

IV. PROJECT OBJECTIVES

IV.1. The project will have the following objectives:

- To increase agricultural output by 20 percent over 5 years among participating households in Nyanza, Western, the Coast, Rift Valley and North Eastern Provinces;
- To increase per capita incomes by at least 25 percent among participating rural households in the target areas;
- To increase access to financial services amongst an additional 50,000 rural households;
- To increase knowledge and access to information on rural household financial service needs and demand;
- To improve institutional capacity to deliver financial services to rural households;
- To successfully pilot at least two new financial service products for rural households in Kenya;
- To revitalize at least two commodity chains through successfully piloting innovative financial services or products.

V. PROJECT DESCRIPTION

A. Project Outline and Principles

V.1. The main objective of the project is to increase access to financial services for rural households, which will in turn boost agricultural productivity and reduce poverty. In implementing the project, some basic principles have been applied. These principles include:

- ***Market Development:*** Interventions will be structured so that they contribute to developing a sustainable market for financial services. The role of the government and other implementing agencies will be purely that of facilitator for other actors with the sole intention of eventually creating an environment for the private sector to provide the service sustainable.
- ***Financial Systems Approach:*** Financial services, particular credit is often not used for purposes designated in project documents. Financial products act as an important resource protection and distribution mechanism for most households. Directed credit at one particular group or institution or purpose is not required. As long as households in a particular area have access to financial services, they are likely to use them for a wide variety of activities including agriculture, but not limited to agriculture. The objective of the project therefore will not be to target particular individuals but to improve access to financial services in the rural community through a variety of mechanisms.

B. Project Components

V.2. The proposed project components are aimed at addressing some of the constraints limiting access by rural households to financial services and agricultural markets. Constraints include: limited detailed understanding of rural household financial and marketing needs; limited availability of and capacity to develop specialised financial products for rural households, high costs of product delivery in rural areas and collapse of marketing outlets.

V.3. This project will make several interventions to address some of the major constraints identified by:

- Pilot testing through action research on developing and delivering financial services to rural households in five distinct and different areas of the country/commodities;
- Encouraging institutions to expand outreach and product development to rural areas through targeted cost–sharing subsidies;
- Providing capacity building to government to enhance its ability to improve the policy environment;
- Improving the institutional framework for provision of financial services by providing capacity building support;
- Conducting and disseminating specialised quantitative and qualitative sub–sector research that will help to reduce the risks of providing financial services to rural households.

V.4. The proposed components of the project are as follows: *Action research and information dissemination*; *Outreach and product innovation fund*; and *Capacity building*.

<u>Component 1:</u> Action Research and Information Dissemination

V.5. A major constraint to private and NGO investment in financial products and services for rural households is lack of information on their needs, demands and the potential risks and returns from providing those services. This component will increase the amount of practical, usable information on rural household financial service needs in Kenya by undertaking both original action research in product development and distribution as well as primary surveys. The information generated will be disseminated to appropriate audiences.

V.6. ***Action Research Sub–Component.*** Few financial institutions in Kenya have taken the time and financial resources to develop specific financial products for low–income farmers. A major reason for this could be that the financial institutions do not recognise the potential opportunities. Risks associated with rural financial services are perceived to be high and institutions have not allocated resources to product development. In order to demonstrate the potential in certain sub–sectors, five action research projects are proposed in the following sub–sectors selected

- Maize in Trans Nzoia;
- Sugar Farmers in Chemilil, SONY and Nzoia;
- Cotton farmers in Nyanza, western and eastern Kenya;
- Livestock traders from Mandera;
- Fishermen in the Indian Ocean coastal and Lake Victoria regions.

V.7. The key objective of each of the action research projects will be to provide access to financial services to these groups and link them to markets in the value chain. Initially these services will be provided by a selected implementing partner who will be required to spin off the product to the private sector should it be successful.

V.8. ***Primary Surveys Sub–component.*** In order to further understand the financial and consumer needs of rural households, detailed quantitative studies will be undertaken of rural Kenyan households. The surveys undertaken at the initiation of the project will act as a baseline for future impact assessment work, including an end of project evaluation and repeat survey. This work will provide useful information on the scope and nature of services provided to rural households. The survey will examine among other things: sources and uses of finance, consumption trends and habits, productive activities, supply and demand characteristics and seasonality trends in specific regions. This information will help in the design of appropriate financial products and services.

V.9. In addition to the baseline survey, funds will be allocated for at least five detailed sub–sector studies in the project regions. These sub–sector studies will be commodity focused and aimed at unlocking the constraints and opportunities in the value chain in each. This will allow the design and implementation of specific interventions that will enhance access to financial services. Commodity sub–sectors that will be identified for study will be those that are found to have the potential for additional value to be created if the financial market problem is solved. Examples include the cashew nut industry at the coast and cotton in Nyanza and western where productivity is low because farmers cannot finance timely, adequate, and quality pesticide applications.

V.10. ***Dissemination Sub–component.*** A major objective of the dissemination component is to gather information that will enhance market players own interest in investing in developing products and services for rural households. Dissemination will be targeted mainly at the private, cooperative and NGO sectors. Lessons learned from the project will also be shared widely within Kenya as well as internationally. A key strategy in disseminating information will be to link the sub–sector action research and primary survey findings to the product innovation component presented below. Interested organisations will be invited to submit proposals for product development targeted at the sub–sectors identified.

Component 2: ***Outreach and Product Innovation***

V.11. Providing financial services in rural areas has proven to be expensive for institutions using traditional approaches to financial service provision. Perceived risks due to lack of information have also acted as a deterrent for expansion into rural areas or for investment in product development. This component will seek to address this by providing cost sharing grants to the private sector for outreach and expansion into rural areas and the development of innovative financial products and services for rural households.

V.12. ***Outreach Sub–component*** The main objective of this component will be to broaden access to financial services amongst rural households by encouraging the private sector to invest in service provision on a cost–sharing basis. Financial institutions will apply for a grant to expand/set up a branch in a rural area. Grants will be disbursed on a cost sharing basis. Grant applications will be backed by financial projections indicating that the grant should lead to sustainable service delivery. Smaller institutions (e.g. SACCOs) in rural areas can also receive funds for increasing credit delivery in new areas on a pilot basis or for establishing front offices in remote, but agriculturally significant locations.

V.13. ***Product Innovation Sub–component.*** The main objective of this sub–component will be to encourage the development of innovative financial service products for rural households. Institutions will be invited to apply for grants to develop and pilot test these products. In some cases the project itself will identify gaps and opportunities through the sub–sector research carried out. However institutions with their own ideas will also be encouraged to apply for grants. Grants can also be given to institutions that would facilitate product development along the value chain rather than just at farm production. Examples could range from crop warehousing receipts, contract management for service provision such as advisory services, tractor hire or harvesting services. Proposals to develop insurance products, factoring, bills discounting, futures/options, and the development of Islamic banking products for North Eastern or coastal communities would be particularly welcome.

Component 3: ***Capacity Building***

V.14. This component will be divided into two, i.e. capacity building for GOK officials in rural finance and policy; and capacity building for institutions interested in product development for rural households.

V.15. ***Capacity Building for GOK Officials.*** This sub–component will seek to build the capacity of Government officials to develop and implement policy reforms targeted at increasing rural financial intermediation in Kenya. There are already several initiatives focused towards policy reform in the sector such as the introduction of the Micro–finance and SACCO bills and efforts to restructure larger state owned financial institutions. This project will not seek to replicate or interfere with these initiatives, but rather to complement them and to ensure that decisions made are appropriate for the agricultural sector.

V.16. The project will seek to expose a wide range of government officials to the latest thinking on rural development finance through exposure visits to countries in the world where such insights can be gained. The component will also finance training both locally and internationally in development finance and policy analysis. Officials from all relevant ministries — finance, agriculture, cooperative development, livestock — will be eligible subject to criteria set up by the project. The key innovation under this component is to increase capacity to deal with issues of rural finance in the Agriculture and Livestock ministries. They have not shown an interest in the area despite lack of financial services being the perpetual complaint of their clients.

V.17. ***Capacity Building for Implementing Organisations.*** A major constraint to increasing access to financial services is the capacity of existing institutions to deliver effective financial services to poor communities. As poor communities form the bulk of the Kenyan population, finding resources to build institutional capacity are important. Areas of weakness identified include:

- Governance and strategic planning;
- Delinquency management;
- Information systems and equipment;
- Market analysis;
- Accounting and financial management;
- Product development; and
- Institutional development.

V.18. The project will not provide capacity building directly, but will allow institutions to apply for grants which they can use to get services from appropriate service providers in the private market. Institutions targeted for capacity building include: private traders, producers organisations, banks, MFI's, SACCO's, and community banking institutions such as FSA's and managed ASCA's.

VI. ESTIMATED PROJECT COSTS

VI.1. Presented in the table below are the estimated costs for the project:

Summary of Project Costs, by Component		
Item	Cost	Total
1. Research and Information Dissemination		
Primary Surveys		
Baseline Survey	1 @ 200,000	$200,000
End of Project Survey	1 @ 200,000	$200,000
Sub–sector Surveys	4 @ 50,000	$200,000
sub–total		*$600,000*
Action Research		
Maize sub–component		$1,550,000
Sugar sub–component		$1,350,000
Cotton sub–component		$1,250,000
Livestock sub–component		$1,600,000
Fisheries sub–component		$1,450,000
sub–total		*$7,200,000*
Dissemination		
Writing publications		$150,000
Workshops	6 @ 10,000	$60,000
Other Dissemination		$50,000
sub–total		*$260,000*
Sub–total Research and Information Component		$8,060,000
2. Outreach and Product Innovation		
Outreach Fund		$5,000,000
Innovation Fund		$4,000,000
Fund Administration @ 20%		$1,800,000
Sub–total Outreach and Innovation Component		$10,800,000
3. Capacity Building		
Capacity Building for GOK		
Exposure visits	10 @ 10,000 20 @ 5,000	$200,000
Training	100 @ 2,000	$200,000
Capacity Building for Implementing Organisations		*$3,000,000*
Sub–total Capacity Building Component		$3,400,000
Project Management		$1,500,000
Total Project Costs		$23,760,000

VII. PROPOSED SOURCES OF FINANCING

VII.1. A number of donors may be interested in financing this project or at least specific components of it. DFID, USAID and several Nordic countries already have ongoing financial sector reform projects, although none of them except for DANIDA are focusing on rural finance.

VII.2. DFID is launching the *Financial Deepening Trust Fund* which will be a multi–donor fund (also supported by the World Bank) targeted at financial sector deepening. Some of its funds may be targeted at rural finance and the co–operative sector. The European Union is financing a wholesale lending organisation *Micro Enterprise Support Program* (MESP) that provides external capital to small micro–finance institutions. The GOK and French (AFD) are also preparing a wholesale lending programme which will have a small component for capacity building for emerging MFI’s and SACCO’s. Potential exists to approach IFAD or the African Development Bank to fund this project as they currently are looking for opportunities in this sector.

VII.3. As designed, the project will also be co–financed by the government of Kenya in the form of personnel, physical facilities and taxes forgone. The private sector and NGO partners will also contribute to project costs directly with their own funds, but also through personnel time, office facilities etc.

VIII. PROJECT BENEFITS

VIII.1. The project will have a range of types of benefits and beneficiaries. The main benefits anticipated from the project are:

- an improved policy environment conducive to poor rural producers gaining access to financial services;
- an increase in the numbers of such producers accessing such services and thus increasing their incomes and production;
- a reduction in the number of Kenyans living in poverty;
- more efficient and remunerative agricultural markets;
- more private sector interest in financing rural producers.

VIII.2. An estimated 300,000 beneficiaries can be expected to benefit from the outreach and innovations funds using a Kenyan benchmark of US$25, or Ksh2,000, per beneficiary.

VIII.3. If each can benefit in the form of income increasing by at least double that amount, the project can generate net benefits of US$75 million. Previous investments in delivering services to the underserved have been able to increase participants income by well over Ksh2,000 per year.

VIII.4. Direct beneficiaries of the action research components will be

- 5,000 households with an average of an extra 75 bags of maize produced each year and sold for Ksh1,000 rather than 750 per bag. Total benefits of Ksh1.3bn over 5 years;
- 5,000 households producing an extra 185 tons of sugarcane per year worth Ksh1.3bn per year or Ksh6.5bn over 5 years;

- 9,000 households each producing an extra 500 kg of seed cotton per acre per year worth Ksh2.025bn over 5 years;
- 100 fisherman upgraded to larger boats with engines and better nets and doubling their income as a result. Extra income of Ksh500m over 5 years;
- 20 livestock traders increasing their turnover, and off–take from farmers in Northern Kenya, thus increasing incomes of producers as well as traders.

VIII.5. The action research component will provide direct benefits of US$40m, compared to costs of US$6m. The project will also assist private enterprises increase employment and profits as they meet an expanded demand for financial products. Government officers also will benefit from insights gained through exposure visits.

IX. IMPLEMENTATION ARRANGEMENTS

IX.1. There are several options for implementation of the project depending on the component. Presented below are possible options broken down by component:

IX.2. ***Research and Information Dissemination Component.*** This component should be contracted out to a third party to manage. An ideal party would be an organisation that already has experience in research (e.g. *Tegemeo Institute*). The contracted party would then outsource all the Action Research sub–components to reputable local organisations capable of implementing them, e.g. *K–Rep Development Agency* or WEDCO among others.

IX.3. ***Outreach and Product Innovation Component.*** This component should either be contracted out to a third party through competitive bidding, or the funds be placed in the DFID trust fund for management and with clear implementation instructions. Placing the funds in the DFID fund may be more cost effective, however as they are just starting out, the effectiveness of working with them is uncertain as they are answerable to other donors as well.

IX.4. ***Capacity Building Component:***

- *Government Capacity Building.* The funds for this component should be given directly to an appointed steering committee for this project to manage. Such a committee should include officers from Treasury and Central Bank as well as the line ministries of Agriculture, Livestock and Fisheries, and Cooperative Development.
- *Capacity Building of Implementing Organisations.* As mentioned earlier, the government and the AFD are planning a wholesale lending programme which will have a capacity building component. Possibilities exist to link project funds to this component and thus save on the administrative costs for managing the funds. The alternative would be to either contract out management of this component or once again seek to have the funds managed by the *Financial Sector Deepening Fund*. A third approach would be to see if MESP would be interested and have the capacity to manage the funds.

IX.5. ***Evaluation.*** It is proposed that this component be contracted out to an external party, preferably a reputable research organisation or consulting firm. Results should be made available to the inter–ministerial committee.

IX.6. ***Overall Coordination, Benchmarking and Monitoring.*** Given the complex and interrelated nature of the program it is proposed that the individual sub–components be coordinated by a dedicated central management unit. This unit would be contracted to any of the types of institutions mentioned above, or by the Nairobi United Nations Operations Office. More background work would be required to better inform a final decision. A distinct line item for project management has been included in the budget.

X. ISSUES AND PROPOSED ACTIONS

X.1. ***Institutional.*** The project enters a crowded and slightly confused institutional and policy environment. The intention is to ensure that agricultural line ministries become more involved in issues related to finance. However this need should be tempered by the understanding of which other parts of government have jurisdiction over the whole area of financial institutions, products and regulations. Currently much of this lies in Central Bank and in its recently formed *Rural Finance Department* whose roles and responsibilities are not yet clear. It is possible that the department will become the focal point for the licensing, regulation and promotion of SACCO's, microfinance institutions and community or lower tier commercial banks. This project would need to be designed with this institutional ambiguity in mind, and designers will need to follow the evolution of financial sector regulation in Kenya over the design period

X.2. ***Management.*** The project may benefit from a dedicated management team rather than the diffuse management structures and contracts proposed. A key argument for a management unit/consultant is that it is too early to determine the capacity, time and authority that will be vested in the inter–ministerial committee. It may also become prudent to include individuals from outside government into that committee to bring the benefits of wider private sector, NGO and financial management experience on board.

X.3. ***Financial Performance.*** Since some of the funds will revolve, they should not expect to be completely depleted. The detailed project design team will have to deal with the practical and realistic financial flows in this project that could prove fairly complicated given that a large portion of project funds will be repaid.

XI. POSSIBLE RISKS

XI.1. ***Agricultural Risks.*** The agricultural sector does face some inherent risks, e.g. crop failure, drought, fire and Acts of God. A key contribution of this project will be in the way it quantifies and deals with those risks. Those risk mitigation measures will need to be a part of the dissemination activities under the project to indicate to potential private sector players that the agricultural sector, with appropriate risk mitigation measures, is indeed bankable. Lessons learned through the process will have wide applicability to the agricultural sector in Kenya and around Africa and the world.

XI.2. ***Regulatory Risk.*** The Government of Kenya has a number of proposals on reform of the financial sector in the pipeline. Some of these may impact the proposed project as they may limit or expand the scope of financial services and institutions available to rural inhabitants. Project designers and managers will need to keep abreast of, and possibly influence developments.