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Equity Building Society of Kenya Reaches Rural Markets

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Summary

Equity Building Society provides microfinance services to more than 250,000 low- and moderate-income citizens in Nairobi and Kenya's Central Province, via a network of branch offices and mobile banking units. After a decade of extending long-term mortgage loans to an untargeted clientele with meager results, Equity Building Society (Equity) altered its approach. In 1994, the bank began tailoring its loan and savings products to a microfinance market, eventually adding two loan products for tea and dairy farmers that are secured by agribusiness contracts.

By the end of 2003, Equity's deposit base had grown to US $44 million and loans topped $21 million. Thanks in part to strong donor support, Equity instituted a mobile banking program in 2000, with the purpose of efficiently reaching more clients in remote rural areas. Mobile operations have been successful, covering their costs, and accounting for more than $1.3 million in deposits in 2003. Mobile banking has also decreased branch congestion and improved the brand image and visibility of Equity. [1] This case study outlines the strategy employed by Equity to expand its rural outreach.

Background

Equity Building Society began business as a mortgage financing organization in Nairobi in 1984. It initially focused on providing term loans and deposit services, opening several branches in the nearby Central Province. Less than a decade after its inception, however, stagnant deposits, under-capitalization, poor management, a constrained macroeconomic environment, and the high risk of term loans led to the bank's near collapse. In 1993, the Central Bank of Kenya declared Equity insolvent: more than 50 percent of the loan portfolio was at risk of default and customer deposits were being used to meet operating expenses. [2]

The chairman of Equity responded to the crisis by bringing on new management and shifting the institution's focus to microfinance. The subsequent decade of Equity history was dramatically different, marked by consistent growth and competitive performance. Although registered as a mortgage lender under the Building Societies Act, regulatory amendments made in 2000 permitted Equity and other similar institutions to offer a full range of commercial banking services, except for checking accounts and foreign exchange operations.

Meeting the Challenges of Rural Services

In order to sustainably expand its client outreach in rural areas, Equity developed demand-driven products for farmers, improved operational efficiency and introduced mobile banking operations. The ground-work was laid for this with a much-improved management information system.

Developing Products that Responded to Rural Customer Needs

One of the first actions of Equity in 1994 was to revise its mission to reflect its actual clientele: low-

[1] Author correspondence with Graham Wright, *MicroSave-*Africa, during 2003.
[2] Coetzee, Kabbucho, and Mnjama, "Understanding the Rebirth," 2002.

and moderate-income borrowers. The bank then expanded its offerings beyond a single credit and single deposit product to include business, household, education, emergency, and group loans, as well as special savings accounts for businesses, children, groups and the elderly. Loan terms were revised to include shorter loans of up to 12 months, and average loan sizes were reduced to meet the needs and repayment capacity of small farmers and microentrepreneurs. Equity also instituted an active marketing campaign that resulted in significant growth in both clients and deposits (despite low minimum deposit balances of between US $6 and $13).

Two new products were specifically developed to meet the needs of agricultural customers: a crop advance loan and a farm input loan. These loans range in size from US $21 to $820 and are made to tea, coffee and dairy farmers for terms of up to one year. The crop advance loan is based on expected farm production and is intended to smooth consumption or permit farmers to invest in another enterprise before crop sales have been realized. The farm input loan is intended for the purchase of fertilizer, pesticide, farm labor, and other seasonal inputs. Farmers pay commercial interest rates of 21 to 24 percent annually on these loans, charged on the declining loan balance.

To mitigate risk, both loans must be secured by agribusiness contracts and are made only to farmers receiving regular payments by produce processing and marketing companies. Kenya Tea Development Agency (KTDA), for example, processes, markets and sells tea on behalf of farmers, paying them a monthly advance over the course of the growing season, followed by an annual bonus based on actual proceeds of the processed tea sales. In order to be eligible for Equity loans, farmers open a savings account with Equity, to which KTDA transfers monthly and bonus payments. Upon approval, Equity loan proceeds and automatic loan repayments are posted to this account, backed by the KTDA contractual payments.

Improved Management Information Systems

In order to successfully introduce mobile banking operations and new loan and deposit products that better met farmer needs, Equity had to significantly upgrade its management information system. Moreover, its information systems were unchanged despite rapid growth: from 1997 to 2000, the loan portfolio of Equity more than doubled, deposits grew by a factor of four, and staff grew from 70 to 117. At the same time, the average loan size decreased by 77 percent (from about US $3,400 in 1997 to about $800 in 2000), meaning that more administrative time was spent on each loan dollar disbursed.[3]

Account information was kept manually, which made for slow customer service, extensive staff paperwork, poor monitoring, and greater opportunities for staff error and internal fraud. Moreover, commercial banks in the more populated areas were beginning to downscale to microfinance customers and Equity systems were no match for their swift, computerized service.

To address this critical challenge, the bank partnered with the United Nations Development Programme (UNDP), which provided grant and technical aid to Equity to install a computerized information management system that would permit its branches to communicate via a local area network. Equity launched its *Bank 2000* system in June 2000. The first year after the system was established, customer turnaround time at Equity branches decreased from around 35 to about 5 minutes.[4] Active loans and customer deposits grew by 71 percent and 65 percent respectively between 2000 and 2001, compared to 44 percent and 51 percent the year before. Current financial data is readily available to senior management for performance analysis and monitoring of delinquent accounts. The system, which continues to be upgraded and refined, will also make it easier for Equity to develop products with more sophisticated interest and repayment plans in the future.

Reaching Clients in Remote Areas

As Equity regained its footing in the late 1990s through the provision of more demand-driven products, it began to focus on building a larger clientele. Establishing permanent branches in remote rural areas was not financially tenable, so Equity struck on the idea of mobile banking units. Beginning with US $262,000 of Equity's own capital in 2000, two four-wheel drive vehicles were put into service in rural areas with population densities of over 400 per square kilometer. As the viability of the mobile units became clear, a $411,000 grant from the UK Department for International Development (DFID) permitted Equity to integrate more sophisticated technology and increase the scale of its mobile banking outreach.

The mobile units make weekly visits to each community that they serve and provide most services available at Equity branches, including processing and administering five different savings products, several loan products, and general financial services (such as the sale of cashier's

[3] See, Coetzee, Kabbucho, and Mnjama, "Understanding the Rebirth," 2002.
[4] Coetzee, Kabbucho, and Mnjama.

checks and inter-branch cash transfers). Mobile customers pay a modest monthly fee for the service (lower than bus fare to the nearest branch) to help Equity cover related expenses.

As of early 2004, Equity's mobile units profitably served 29 rural villages and about 12,000 clients on a regular basis.[5] A number of special features enable these units to operate successfully in the rural Kenyan environment:

- All-terrain, four-wheel drive vehicles ensure that the mobile banks can reach outlying areas, even during the rainy season.
- Mobile units are connected to the nearest branch via VHF radio to provide constant voice communication, security, and monitoring.
- Laptop computers inside the vehicles are connected to a central Equity database via a wireless telephone (GSM) network, providing access to account information and permitting immediate updates through a reliable, secure system.
- Roof-mounted solar panels provide power for voice and data transmission equipment.
- Vehicles are bulletproof, and Equity hires government security guards to accompany each vehicle.

Taking Stock

By the early 2000s, Equity had emerged as one of Kenya's leading microfinance institutions in a market dominated by grassroots savings and credit cooperatives.[6] Deposits grew at an annual rate of more than 40 percent after 1995, reaching US $44 million by 2003. The $21 million gross loan portfolio, with 65,000 borrowers, had a portfolio at risk over 30 days (PAR > 30) of 8.5 percent [the PAR figure is for 2002] in 2003. In addition to its Nairobi headquarters, Equity was successfully operating 10 branches in the largely rural Central Province and reaching 21 isolated communities via mobile banking units, with an overall operational self-sufficiency ratio of 129 percent.

Mobile clients also accounted for about 10 percent of most branches' clientele,[7] 4 percent of Equity's total deposit accounts, and 3 percent of over-all deposit volume, with the average mobile account (US $123) about 30 percent smaller than typical Equity accounts. While not a perfect proxy for income level, these factors suggest that the mobile units serve a lower-income clientele. Equity has, moreover, been able to cover the direct costs of its mobile banking services through associated fee and interest income.[8] As of 2003, *MicroSave* estimated the overall self-sufficiency ratio of Equity's mobile units to be 102 percent, despite a net loss for some units due to inadequate client volume.[9] (See table 1 for Equity's overall performance and outreach indicators.)

Although Equity's agricultural portfolio reached US $1.8 million and nearly 15,000 clients in 2002,[10] the reliance on agribusiness payments as a form of security means that large numbers of independent farmers are ineligible for these loans. In terms of dollar volume, agricultural credit accounted for about 12 percent of the total loan portfolio in 2002,[11] and business loans, around 74 percent. Repayment rates on farmer loans are high: in 2002, the PAR > 30 on this portfolio segment was only 2.9 percent.[12]

Donors and Investors

Equity Building Society is a privately held Kenyan company. The majority of its equity (84 percent) is held by Equity management, staff, and clients. In 2003, the international equity investment fund AfriCap purchased 16 percent of the company. Equity pro-actively sought international assistance to accomplish its goals and donors responded to the institution's focused requests. Since 1993, the bank has received donor and investment assistance in the following forms:

- Technical and financial support, including the refinement of new financial products (the NGO Swisscontact)[13]
- A detailed market study conducted by *MicroSave* (Swisscontact)
- A grant to help launch the mobile banking program (DFID's Financial Deepening Challenge Fund)

[5] Arora, "Financial Deepening Challenge Fund," 2004.
[6] Coetzee, Kabbucho, and Mnjama, "Understanding the Rebirth," 2002.
[7] Malkamaki, Johnson, and Wanjau, "One Step Beyond," 2003.
[8] Equity Building Society.
[9] Malkamaki, Johnson, and Wanjau, "One Step Beyond," 2003.
[10] Ayee, **"**Equity Building Society: Agricultural Lending." 2003 Report, based on Equity financials and staff interviews.
[11] Money is fungible however, and a proportion of loans designated for specific uses, including agriculture, are diverted for other purposes.
[12] CGAP data, 2003. Despite the relatively small agricultural portfolio, approximately half of Equity clients in 2001 depended on agricultural income, mostly medium- and small-scale tea and dairy farming. See Coetzee, Kabbucho, and Mnjama, "Understanding the Rebirth," 2002.
[13] Craig and Goodwin-Groen, "Donors as Silent Partners," 2003.

Table 1. EBS Performance and Outreach Indicators, 1999–2003

Item	1999	2000	2001	2002	2003
Outreach					
Outstanding gross portfolio (US$)	4,487,742	6,453,374	11,014,992	15,108,453	22,060,988
Number of active borrowers	2,753	8,162	18,312	41,024	65,068
Average outstanding credit per borrower	1630	791	602	368	339
Average credit per borrower as % of GNI per capita	453%	226%	172%	102%	87%
Total savings deposits (US$)	8,335,038	12,545,253	20,675,014	27,869,571	44,465,375
Number of saving accounts	66,967	71,682	105,987	155,883	252,186
Average deposit balance (US$)	124	175	195	179	176
Sustainability/Profitability					
Return on assets (%)	2.35%	1.74%	1.36%	3.35%	3.01%
Return on equity (%)	24.91%	13.24%	10.16%	26.58%	24.11%
Operational self-sufficiency (%)	111%	109%	108%	133%	129%
Operational efficiency					
Operating expense ratio (Expenses/Average portfolio)	25.36%	26.75%	28.86%	23.05%	26.26%
Loan officer productivity [b] (# Clients per loan officer)	172	480	509	NA	NA
Portfolio quality					
PAR > 30 days	12.10%[a]	14.60% [a]	8.80% [b]	8.67%	8.56%
Exchange rate (KES/US$)	72.89	77.94	77.82	76.86	75.76

Source: The MIX Market, www.mixmarket.org; [a]Planet Rating, 2001. [b]Ayee, 2003.

- Intensive training and technical support leading to the development of new financial products, improved marketing, and growth in market share (*MicroSave*, provided to Equity as a *MicroSave* Action Research Partner)
- A grant and technical assistance for the development of a computerized management information system, or MIS (MicroStart program of UNDP)
- Capacity building support (EU Microenterprise Support Program, DFID, UNDP, and AfriCap's grant-funded Technical Support Facility)

One of the most important factors of donor funding has been a commitment to providing Equity leadership and staff with the skills and expertise necessary to make sound, strategic decisions on their own.[13] Donors have focused on building institutional capacity, standing back to let Equity develop its own products and implement necessary changes.

[13] Craig and Goodwin-Groen, "Donors as Silent Partners," 2003.

Lessons Learned

The following lessons can be gleaned from Equity's experience in reorienting its services toward microfinance clients, including rural borrowers and savers:

- Developing a market-driven, customer-focused approach was a prime factor in turning around a poorly performing portfolio, increasing deposits, and reaching rural customers.
- Mobile banking units can be a viable answer to reaching isolated clients in rural areas.
- Flexible rural delivery mechanisms such as mobile banking need not be restricted to credit and deposit services, but can be used to offer a number of different services, including inter-branch cash transfers.
- Loans secured by contractual agribusiness payments can be an effective method of extending credit to farmers without taking on extensive risk, although this practice can exclude many smaller farmers.
- A sound MIS provides the basis for any product or technological innovation. The combination of

a reliable MIS and innovation can improve institutional efficiency, lower the cost of service delivery, increase customer satisfaction and perception, and allow for greater product customization.

- The initial expense of new technology, such as an MIS and mobile banking units, may justify initial donor grant support.
- Emphasizing institutional capacity building is a proven tactic for donors to effectively support long-term MFI sustainability and growth.

Conclusion

The successful turnaround of Equity between 1993 and 2003 shows tremendous institutional adaptability and commitment. Its mobile banking operation provides rural Kenyan citizens with access to secure financial services at an affordable cost and on a consistent basis, and has increased both the deposit base and profitability of the bank. Many former branch customers are now opting to use mobile services instead, resulting in reduced congestion and improved efficiency of Equity branches, as well as better economies of scale for the mobile units.[14] Although the mobile units are reaching an increasing number of rural borrowers—primarily farmers who save and borrow for consumption, agriculture, and other business purposes—Equity currently offers no loan products designed for small independent farmers without agribusiness contracts. This represents a market opportunity, as over half of Equity's clients depend on agricultural income—mostly through medium and small-scale tea and dairy farming.[15]

Equity is currently attempting to reach further down-market by tailoring new services to poorer clients and smaller entrepreneurs. Loan sizes currently range from just US $6 to over $30,000, and effective annual interest rates vary from 21 to 53 percent. This trend towards poorer clients can be seen in increasingly smaller loan sizes and a new savings account with no minimum balance, introduced in 2004, for small farmers. The new account, offered in partnership with the NGO Pride Africa, will allow lower-income farmers to access Equity services for the first time.

[14] Arora, "Financial Deepening Challenge Fund," 2004.
[15] Coetzee, Kabbucho, and Mnjama, "Understanding the Rebirth," 2002; the 56 percent estimate is as of July 2001.

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Agricultural Microfinance Case Studies
FINANCIAL INDICATORS DEFINITIONS TABLE

Outstanding gross portfolio—the outstanding principal balance of all of the MFI's outstanding loans including current, delinquent, and restructured loans, but not loans that have been written off.

Number of active borrowers—the number of individuals who currently have an outstanding loan balance with the MFI or are responsible for repaying any portion of the gross loan portfolio.

Average loan balance per borrower—the outstanding gross portfolio divided by the number of active borrowers.

Average loan balance as percent of GNI per capita—average loan balance per borrower divided by the country's World Bank-published gross national income per capita.

Total savings deposits—the total value of funds placed in an account with the MFI that is payable on demand to the depositor. This item includes any current, checking, or savings accounts that are payable on demand. It also includes time deposits, which have a fixed maturity date.

Number of savings accounts—the total number of deposit accounts at the MFI, as a proxy for the number of depositing individuals that the MFI is liable to repay. This number applies only to deposits that are held by the MFI, not to those deposits held in other institutions by the MFI's clients. The number is based on individuals rather than the number of groups. It is possible that a single deposit account may represent multiple depositors.

Average deposit balance—total savings deposits divided by number of savings accounts, as a proxy for average client savings.

Portfolio at risk (PAR > 30 days)—the value of all loans outstanding that have one or more installments of principal past due more than 30 days. This item includes the entire unpaid principal balance, including both the past due and future installments, but not accrued interest. It also does not include loans that have been restructured or rescheduled.

Return on assets (ROA)	Net operating income plus taxes / Average assets	Measures how well the MFI uses its total assets to generate returns
Return on equity (ROE)	Net operating income less taxes / Average equity	Calculates the rate of return on the average equity for the period
Operational self-sufficiency	Operating revenue / (Financial expense plus Loan loss provision expense plus Operating expense)	Measures how well an MFI can cover its costs through operating revenues. In addition to operating expenses, it is recommended that financial expense and loan loss provision expenses be included in this calculation as they are a normal (and significant) cost of operating
Financial self-sufficiency	Adjusted operating revenue / Financial expense plus Loan loss provision expense plus Adjusted operating expense	Measures how well an MFI can cover its costs taking into account a number of adjustments to operating revenues and expenses. The purpose of most of these adjustments is to model how well the MFI could cover its costs if its operations were unsubsidized and it were funding its expansion with commercial-cost liabilities.
Operating expense ratio	Operating expense / Average gross loan portfolio	Includes all administrative and personnel expense, and is the most commonly used efficiency indicator
Loan officer productivity	Number of active borrowers / Number of loan officers	Measures the average caseload of each loan officer

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