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IMPLEMENTATION COMPLETION REPORT

KENYA

FINANCIAL SECTOR TECHNICAL ASSISTANCE PROJECT
(CREDIT 2058-KE)

FINANCIAL PARASTATALS TECHNICAL ASSISTANCE PROJECT
(CREDIT 2147-KE)

MARCH 17, 1995

Public and Private Enterprise Division
Eastern Africa Department
Africa Region

CURRENCY EQUIVALENTS

Currency Unit = Kenyan Shilling (KSh)

US$ 1.0 = KSh 58.0 (1994)

WEIGHTS & MEASURES

Metric System

ABBREVIATIONS

(1) CREDIT 2058-KE

BSD	Banking Supervision Department
CBK	Central Bank of Kenya
CBF	College of Banking and Finance
FSAC	Financial Sector Adjustment Credit
FSPN	Financial Sector Policy Note
FSRP	Financial Sector Reform Paper
GCBK	Governor of Central Bank of Kenya
GOK	Government of Kenya
MIS	Management Information Systems
OMO	Open Market Operations

(2) CREDIT 2147-KE

CEO	Chief Executive Officer
DFCK	Development Finance Corporation of Kenya
DFI	Development Finance Institution
FSAC	Financial Sector Adjustment Credit
FSTAC	Financial Sector Technical Assistance Credit
GOK	Government of Kenya
IDA	International Development Association
IDB	Industrial Development Bank
ICDC	Industrial Commercial Development Corporation
KIE	Kenya Industrial Estates
MOF	Ministry of Finance
SOE	Statement of Expenditures

GOVERNMENT OF KENYA FISCAL YEAR

July 1 - June 30

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Preface

IMPLEMENTATION COMPLETION REPORT
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Both these financial sector projects in Kenya were implemented during the same period and closed at the same time. Consequently, a joint review and assessment was conducted.

(I) Financial Sector Technical Assistance Project (Credit 2058-KE)

This is the Implementation Completion Report (ICR) for the Financial Sector Technical Assistance Project (FSTAC) in Kenya, for which Credit 2058-KE in the amount of SDR3,871,000 (US$5,000,000 equivalent) was approved on July 11, 1989 and made effective on September 6, 1989.

The Credit 2058-KE was closed on June 30, 1994. Final disbursement took place on August 8, 1994 at which time a balance of SDR3,074,992 (US$3,971,967 equivalent) was cancelled.

The ICR was prepared by Ms Nancy McInerney-Lacombe, AF2PE of the Africa Region and was reviewed by Mr. Robert E. Hindle, Division Chief. The borrower provided comments that are included as appendixes to the ICR.

Preparation of this ICR began during the Bank's final supervision/completion mission from June 19 - July 1, 1994. It is based on material in the project file. The borrower contributed to preparation of the ICR by contributing views reflected in the mission's *Aide Memoire*, and by commenting on the draft ICR.

(II) Financial Parastatals Technical Assistance Project (Credit 2147-KE)

This is the Implementation Completion Report (ICR) for the Financial Sector Technical Assistance Project (FPTAP) in Kenya, for which Credit 2147-KE in the amount of SDR4,700,000 (US$6,000,000 equivalent) was approved on June 18, 1990 and made effective on August 22, 1990.

The Credit 2147-KE was closed on June 30, 1994. Final disbursement took place on October 31, 1994, at which time a balance of SDR2,124,434 (US$2,744,131 equivalent) was cancelled.

The ICR was prepared by Ms Nancy McInerney-Lacombe, AF2PE of the Africa Region and was reviewed by Mr. Robert E. Hindle, Division Chief. The borrower provided comments that are included as appendixes to the ICR.

Preparation of this ICR was begun during the Bank's final supervision/completion mission, from June 19 - July 1, 1994. It is based on material in the project file. The borrower contributed to preparation of the ICR by contributing views reflected in the mission's *Aide Memoire* and by commenting on the draft ICR.

SUMMARY CONCLUSION

FSTAC and FPTAP were two projects which were implemented concurrently with and designed to complement the 1989 Financial Sector Adjustment Credit (FSAC). Both projects, which closed on June 30, 1994, are rated unsatisfactory mainly on the basis of poor implementation. It is important to recognize that implementation difficulties partially resulted from serious shortcomings in the policy and governance environment existing in Kenya at the time. However, since that time, the Government of Kenya has responded to the severe weaknesses in financial sector management by replacing the senior management of the Central Bank, by closing down some failed institutions and by adopting a more appropriate macro-economic policy framework.

The Central Bank, to promote a deepening of the current reforms, now is undertaking, or intends to undertake, much of the work which was to have been funded under FSTAC from their own resources. In the case of FPTAP, the Government is currently reviewing the funding options for a special review of the Development Finance Institution Sector to resolve, once and for all, the long-term sustainability issue.

KENYA

FINANCIAL SECTOR TECHNICAL ASSISTANCE PROJECT

CREDIT 2058-KE

IMPLEMENTATION COMPLETION REPORT

EVALUATION SUMMARY

FINANCIAL SECTOR TECHNICAL ASSISTANCE PROJECT

CREDIT 2058-KE

KENYA

A. Introduction

1. The Financial Sector Technical Assistance Credit (FSTAC) was designed to complement the adjustment measures under the 1989 Financial Sector Adjustment Credit [(FSAC) - Credit 2049, Project Completion Report (PCR) dated December 24, 1992]. FSAC was designed to support the Government in returning stability to the financial sector which had resulted from a loss of monetary discipline and adverse external factors. FSTAC was to support the policy and institutional reforms within the Central Bank of Kenya (CBK) which were needed to implement FSAC. (para 20)

B. Project Objectives

2. The project's main objectives included (i) strengthening the legal framework for prudential supervision, (ii) strengthening the supervisory capabilities of the Central Bank; (iii) establishing a reserve money management system to support the introduction of open market operations (OMO); (iv) designing and implementing a restructuring program for troubled financial institutions; and (v) establishing a College of Banking and Finance (CBF) to provide training to banking professionals, particularly from smaller and indigenously owned institutions. (para 20)

3. The original project objectives, with the exception of the CBF, were based on detailed analysis undertaken for the concurrent FSAC. The financial feasibility work by the Government supporting the decision to build the CBF was fairly thin. Given the very low pass rates for the Institute of Bankers examinations in Kenya at the time and the clear need for some skilled bankers, the financial risk relating to the sustainability of the CBF was viewed as justified. Overall, the project objectives were general and, in the case of Banking Supervision (BSD) and the restructuring component, would have benefitted from greater clarity and precision. Although the objectives were well integrated with the FSAC, more specific and monitorable triggers within FSTAC would have been desirable. (para 26)

4. The objectives for BSD and the restructuring component were far more complex than the credit took account of. The political aspect to both supervising and restructuring politically connected financial institutions was not adequately addressed by the credit. Based on the magnitude of the problem existing at that time and remaining in the sector up to the present, the credit objectives were overly optimistic relative to the resources devoted to the task. (para 27)

5. There were no specific loan covenants within FSTAC, outside of the normal credit and prudent practices requirements. The main conditionality was incorporated within FSAC, requiring adequate Phase I and Phase II financial institution restructuring plans which integrated with the fourth (iv) objective of FSTAC, as outlined in para 2 above. Specific triggers were virtually non existent, for example, even training plans did not require IDA Approval. This lack of actionable triggers was partially attributable to the fact that the very measurable technical improvements were completed under an SPPF and PPF and consequently additional triggers were not viewed as required. (para 27)

C. Implementation Experience and Results

6. The credit closed essentially undisbursed. The credit objectives were largely not met. In many cases, the CBK, in fact, did meet its own objectives in certain project components with its own resources. It is unfortunate, however, that the credit closed largely undisbursed, with the main beneficiary departments within CBK indicating funds still are needed for worthwhile infrastructure support, including training and technology upgrades. (para 28)

7. On the other hand, major progress in the legal framework for prudential supervision has been achieved since 1988, and subsequent to a change in management of the CBK in 1993, the overall health of the banking industry has improved. Licensing standards including "fit and proper" criteria have been introduced, minimum capital levels increased, single name lending limits reduced and the powers of the minister to override a decision of the CBK curtailed. (para 29)

8. A project team assisted the BSD with the establishment and upgrading of its on and off site supervisory methodology. This work was assessed as timely and effective. Modules were developed in the major risk areas of liquidity, capital, asset quality and compliance. Examiners were trained on and off the job. The consultants played an effective role in capacity building. Regulatory guidelines also were developed to address the major risk areas and disseminated to the system by the credit's close. The quality and quantity of on-site examinations improved. (para 30)

9. Against this background, however, BSD has had to function in a highly political and self-serving environment. In certain of the bank restructuring situations, BSD has been totally or at least partially excluded from the senior decision making. Until Government interference in the supervisory function is eliminated, the authority and credibility of the function will be undermined. (para 33)

10. In 1988/89, once financial institution restructuring had begun, it became apparent that the banking situation was far worse than originally envisaged. Twenty-eight institutions representing 15% of the deposits of the system required restructuring. It appropriately was decided to proceed with a staged approach. Unfortunately, the weakness in the financial system was not contained within these originally cited troubled institutions. Instead, the situation was permitted to erode to the point of a banking crisis by 1993. (para 37)

11. A reserve money management system has been introduced to support OMO and therefore, technically this objective has substantially been met. In spirit and as outlined in the Financial Sector Policy Notes ((FSPN) dated June 7, 1993) and the Financial Sector Policy Notes Update ((FSPNU) date June 7, 1994), much remains to be done. The CBK is undertaking the necessary work, outside the scope of this credit. (para 38)

12. The $3.993 million credit component to construct the CBF remained undrawn at closing due to procurement differences between the CBK and IDA. Despite this lack of utilization, the CBF is built totally funded by the CBK and expected to open December 1994. (para 39)

13. Of the total $5 million, the CBF component ($3.993 mm), which was never drawn, represented 70%. Excluding the CBF component, first year disbursements were at close to 70% of forecast, by 1991 they were down to 10%, mainly due to a lack of capacity to absorb the training funds. By 1992, training was the main component utilized. With the consultant's term now complete, no disbursements were made beyond 1993, except for a correction of a dated entry in August 1994. The credit closed at approximately 22% disbursed with 44% utilization of the training/consulting component. (para 39)

14. Preparation and appraisal underestimated the complexity of bank restructuring needs and the importance of timely action in dealing with weak financial institutions. The credit design lacked measurable and monitorable outcomes, which if built in as conditionality, may have kept the credit focused and the momentum from dissipating after the first two years of intensity. The Bank's response to the CBF procurement issue was totally appropriate. In view of the materiality of the CBF component as well as the fact the remaining credit was not disbursing well (43.5% of forecast by 1991), it would have been appropriate to restructure or cancel the credit in its entirety. (para 50)

15. Bank supervision of this credit is mixed. In view of the link to FSAC, supervision was frequent in the first two years of the credit. The project, however, was not supervised in the field in 1992. By 1992/1993, as a result of the financial crisis and the FSPN, there was a move by the Government, once again, to restructure the sector (with resources mainly outside of this credit). In conjunction with this renewed activity, the Bank made one last attempt to constructively reallocate US$500,000 of the CBF funds to worthwhile infrastructure support within BSD and CBF. This proposed reallocation was not agreed to by the CBK. (paras 48 to 53)

16. The CBK, as the beneficiary of the credit, evidenced strong commitment to the project objectives during the first two years. Commitment to the policy and policy reforms relating to the technical capacity of both the BSD and the Research function of the Central Bank was strongly in evidence and, as required, a significant amount of resources were committed to the task. Equally, the initial bank restructuring efforts were undertaken in good faith and the CBK did conclude the Phase I restructuring, as agreed. Beyond this point, by 1991, the commitment to financial reform began to wane as evidenced by the weak enforcement by BSD of the Phase II restructuring plan. A new Governor in 1993 brought a renewed commitment to overall reform, however, this did not translate to consistently strong regulatory enforcement. Lack of commitment to BSD enforcement remains an issue. (paras 54 to 56)

17. Overall, the project is rated unsatisfactory. It failed to achieve two of its critical project objectives. First, while the BSD function was technically strengthened in terms of its methodology and staff, weak enforcement of regulatory powers renders them largely ineffective in dealing with the serious issues in the sector in a timely and transparent manner. Equally, the restructuring efforts within the financial sector have been ineffective in addressing the population of weak financial institutions, notwithstanding some individual exceptions. (paras 57 and 58)

E. Summary of Findings, Future Operations and Key Lessons Learned

18. The technical capacity enhancements, that is, the legal, regulatory and open market operations, achieved under this credit are considered sustainable, if supported by the appropriate policy environment. The bank restructuring efforts undertaken by this credit are not assessed as sustainable. Unless the CBK and the GOK adopt a much more effective strategy to the regulation/restructuring/closure of weak financial institutions in the sector, the stability of the sector will remain fragile and ineffective as a tool for supporting monetary and industrial policy. The sustainability of the CBF will depend on whether it can differentiate itself in the domestic and regional market. Overall, the politicization of the Kenya banking system was not given enough weight when designing the program. The negative impact that this single factor has had on the restructuring efforts and the effectiveness of BSD, in attempting to regulate within this environment, has been pervasive. Any future operation will need to address the political will to reform and build into its design strong control features to keep the program focused and on-track. (paras 45 to 47)

19. The key lessons learned include: (i) the importance of maintaining Government commitment and how project design, including monitorable triggers, can support this; (ii) the need to design projects with a clear underlying of the political environment; (iii) implementation of a liberalization program in Kenya did not adequately take account of the condition of the financial sector. Certain pre-conditions need to be met prior to embarking on such a program when a financial system is weak; (iv) a material change in the environment for the credit should prompt a special review process; and (v) a change in Task Manager should force a structured review of the credit status (at the handover stage) to test validity of the existing design and approach. (para 61)

PART I. PROJECT IMPLEMENTATION ASSESSMENT

A. Statement and Evaluation of Objectives

1. Statement of Objectives

20. The main purpose of this credit was to complement the financial sector adjustment measures under the 1989 FSAC. Its main objectives included (i) strengthening the legal framework for prudential supervision, (ii) strengthening the supervisory capabilities of the Central Bank; (iii) establishing a reserve money management system and the introduction of OMO; (iv) designing and implementing a restructuring program for troubled financial institutions; and (v) establishing a CBF to provide training to banking professionals, particularly from smaller, indigenously owned institutions.

2. Evaluation of Objectives

(a) Strengthening of the Legal Framework

21. At inception of the credit, the legal framework for prudential supervision was very weak. Kenya had undergone a period of expansion of the financial sector in the early 1980's to encourage indigenous participation in the sector, which to that point, was foreign controlled. As a result, licensing requirements were relaxed which allowed the proliferation of mainly smaller-sized banks and NBFIs, many with direct or indirect political affiliations. As evidence of this easy entry policy, between the early to mid eighties the number of banks almost doubled to 24 and the NBFIs more than doubled to 54. Many of these smaller institutions were severely undercapitalized, had thin margins due to paying higher than market rates to attract deposits and were very poorly managed. Consequently, with the move to economic liberalization, it was most appropriate that Kenya move to tighten the control of its banking system, which had already shown signs of strain with the collapse of the Continental Bank in 1986.

(b) Strengthening of Banking Supervision

22. Prior to 1988/1989, the regulatory function for the financial sector was virtually non-existent. The emphasis of the credit was to develop, almost from scratch, a regulatory methodology and recruit and train the appropriate personnel. This early emphasis on the technical requirements, albeit fundamental, did not identify the potential difficulty which would evolve as the most important impediment to effective supervision, that being enforcement. Training also was a significant input to support the achievement of this objective. The selection of training courses was solely at the discretion of the CBK. It was a design flaw of this credit that training plans did not require IDA's prior approval. It was only when IDA attempted to reallocate funds between components in 1993, that the requirement for a formal training plan was introduced.

(c) Establishment of a Reserve Money Program and the Introduction of OMO

23. In order to implement the liberalization program under the 1989 FSAC, the Government needed to have tools to estimate and manage its cash flow. The development of the reserve money program was an important tool in moving to OMO and was an appropriate first step in liquidity management.

(d) Designing and Implementing a Restructuring program for Troubled Institutions

24. The Government needed to deal with the existing weaknesses in the financial sector if it was to have any success with its liberalization program. The banking failure noted earlier had caused significant disruption in the financial system, with the usual "flight to quality" by depositors causing cases of extreme liquidity problems for some market participants. Therefore, it was most important (1) to be seen by the market as doing something about the problem and (2) to actually implement a solution.

(e) College of Banking and Finance

25. This component represented 70% of the total credit and its purpose was to construct a residential college to serve the training and professional needs of the banking system. In line with the developments anticipated in the banking sector, the objective in itself, was complementary to the remainder of the project. The financial feasibility work for the CBF was, however, thin. The Government at the time was prepared to accept this financial risk given the very low pass rates for the Institute of Bankers examinations in Kenya at the time.

(f) Summary Evaluation of Objectives

26. In view of the weak state of the banking system, the original project objectives, were largely (with the partial exception of CBF) consistent with the needs of the banking sector. Significant analysis had been undertaken for the concurrent FSAC credit to support these findings. The financial analysis supporting the CBF decision was inadequate to justify the long term sustainability of CBF. Additionally, the objectives were general and in the case of BSD and the restructuring component, would have benefitted from greater clarity and precision regarding the outcomes expected. A case in point is the earlier example of no requirement for a formal training plan. This lack of actionable triggers was partially attributable to the fact that much of the easily measurable technical improvement (e.g. updated legislation, supervisory methodology) were completed under SPPF and PPF facilities and additional triggers were not viewed as required. Notwithstanding that the objectives under FSTAC were well integrated with the FSAC, which had its own conditionality, more specific and monitorable outcomes would have been desirable.

27. The objectives for BSD and the restructuring component were far more complex than the credit took account of. The political aspect to both supervising and restructuring politically connected financial institutions was not adequately addressed by the credit. Given the magnitude of the problem at that time (and remaining in the sector today), the objectives were overly optimistic.

B. Achievement of Objectives

28. The credit closed at 22% disbursed with only 44% of the consulting and training budget utilized. Overall, the credit objectives were not met. Significant training and bank restructuring work remains. In addition, enforcement of Banking Supervision continues to be politically driven and inconsistent. In many cases, however, the CBK implemented the project components with its own resources. A review of each of the project components follows.

1. Strengthening the Legal Framework

29. Major progress in the legal framework for prudential supervision has been achieved since 1988. The banking bill underwent a major revision in 1989 with further amendments in both 1991 and proposed

in 1994. Together these addressed the major weaknesses highlighted under this credit and the FSPN. Licensing standards including "fit and proper" have been introduced, minimum capital levels increased, single name lending limits reduced, the powers of the minister to override a decision of the CBK curtailed etc. The three revisions required to achieve a prudential level of requirements is symptomatic of the evolutionary state of the regulatory process. Consequently, the adoption of the fit and proper and the curtailment of powers amendments are indicative of a shift to a more control-oriented culture, particularly under the new management of the CBK.

2. Strengthening of Banking Supervision

30. A project team was recruited to work with and provide an oversight role for the strengthening of the BSD. This work was assessed as timely and effective. Firstly, BSD adopted a regulatory system modelled after the Federal Reserve of the USA which incorporated both an on and off-site supervisory methodology. Modules were developed to guide the on-site work of the examiners in the major risk areas, including, liquidity, capital, asset quality and compliance. Examiners were trained on and off the job. All banks and NBFIs institutions were rated according to a five-grade system from strong through unsatisfactory. The consultants played an effective role of building the regulatory capacity of the group by allowing the examiners, over time, to take the lead role in an examination/restructuring supported by the consultants in a back-up capacity. Regulatory guidelines also were developed to address the major risk areas and disseminated to the system by the credit's close. The quality and quantity of on-site examinations improved significantly over the term of the credit.

31. An off-site monitoring system was also developed to permit the regular monitoring of the institutions for early detection of problems. While the system was originally limited to balance sheet data, it now includes some elements of income statement reporting. BSD faced a significant challenge in developing its off-site monitoring system due to the poor standards of accounting in the country, which this credit did not directly address. Notwithstanding this, perseverance by the BSD regarding upgrading the quality of financial institution reporting has resulted in a fairly reliable, if still rudimentary, data base. While BSD acknowledges it needs to upgrade the off-site reporting to permit a greater breadth (income statement and cash flow capability) and depth of analysis (progressive levels of ratio analysis based on the risk profile of the institution), the senior management of the CBK prefer to fund systems enhancements out of own resources.

32. BSD has issued eleven Guidelines/Directives over the term of the credit to the banking system. This is a significant amount of regulation for any financial system to digest. Additionally, certain of these Guidelines, particularly regarding capital adequacy and loan classification and loan accounting, are, for the smaller unsophisticated institutions, difficult to understand and therefore difficult to apply and accurately report. This coupled with weak overall accounting standards in the system, low management capacity in the smaller weaker institutions, have made the strengthening of the effectiveness of BSD a sizable challenge.

33. Against this background, BSD has had to function in a highly political and self-serving environment. Conflicts of interest between the regulator and the regulated were not uncommon. Enforcement and follow-up of the results of off-site monitoring and on-site inspections remain weak. In certain of the restructuring situations, BSD has been totally or at least partially excluded from the senior decision making which completely undermined its authority and credibility in the financial system. Consequently, the judgement to enforce the regulatory power, rests outside of the department. Until Government interference in the supervisory function is eliminated, the credibility of the function will be undermined. A regulator cannot be effective if the regulatory environment is not transparent, independent, consistent and enforced. BSD has only achieved the first of these four requirements.

3. The Design of a Restructuring Program for Troubled Financial Institutions

34. The results of the implementation of the off-site monitoring system were that the situation was far worse than originally envisaged. Of the 24 banks and 50 NBFIs in existence at the time, close to 20% of the banks and 50% of the NBFIs or 28 institutions in total were extremely weak. As a result of the magnitude of the task, it appropriately was decided to proceed with a staged approach.

35. Stage one included a restructuring plan, merging the worst 3, then increased to 9 institutions, into a new bank. BSD, assisted by the consulting team, drove the execution of this program. As would be expected with this complex a transaction, there were significant delays and complications, including a fair amount of asset stripping. However, the deal eventually was concluded with the injection of new equity by the Deposit Insurance Fund and the conversion of parastatal deposits into equity. The decision to merge and recapitalize these banks was mainly politically motivated. The decision did not result in the creation of a sustainable healthy organization but rather served to contain the damage these institutions could do to the financial system.

36. Phase II of the restructuring plan addressed 10 further institutions to be restructured and was incorporated as a second tranche release condition of FSAC in June 1990. The CBK, in its proposal for the Phase II institutions, took a dramatically different and less proactive approach. The CBK recommended, and IDA accepted, that these institutions be allowed to undertake internal restructuring to improve operational efficiencies and be permitted time to raise and inject additional capital. This turned out to be ineffective. As could be expected, very little concrete action was taken by the shareholders, as it was very unlikely at this late stage that any investor would risk further capital. This lack of action by the shareholders coupled with the lack of enforcement by BSD, permitted these institutions to languish, many of which continue to be cited by BSD for restructuring or closure.

37. Not surprisingly, the weakness in the financial system was not contained within these originally cited troubled institutions. Instead, the delay in dealing with the problem permitted the situation to erode to the point of a banking crisis by 1993. The level of non-performing assets in the overall system had threatened to paralyse the financial sector, with total non-performing assets estimated between 5% to 18% of GDP by June 1993. If not before, it was evident by this point that the initiatives undertaken by FSTAC, regarding the financial institution restructuring had been seriously underestimated. Prompted by the financial crisis of mid-1993, special audits of the weaker financial institutions resulted in the closure of 3 banks and 12 NBFIs with two banks undergoing major restructuring. Notwithstanding this and many other reforms which did, in fact, strengthen the soundness of the financial system, many of the institutions cited for major restructuring or closure have not been fully dealt with.

4. Reserve Money Management and the Introduction of OMO

38. A reserve money management system has been introduced to support OMO and therefore, technically, this objective has substantially been met. In spirit and as outlined in the FSPN and the FSPNU, much remains to be done. While the level of information has improved, the continued weaknesses in the technological and MIS capabilities to support the CBK in managing the trade-offs between different monetary targets, impairs the development of OMO beyond rudimentary levels. While one advisor was funded under this credit at inception, the current position of CBK is that they do not see the need for long term technical assistance in this area. At this point in the cycle, specialized short term technical assistance would be more appropriate to refine and advance the basic systems already in place.

5. The College of Banking and Finance

39. This $3.993 million credit component remained undrawn at closing. Despite this lack of utilization, the CBF is built and expected to open December 1994 totally funded by the CBK at a total cost now estimated at Ksh430 million/US$10 million against an original budget figure of Ksh 110 million/US$5 million.

40. One reason for the doubling of the cost is the expansion of the original plans for the college. The college now incorporates, a computer facility, a computerized banking facility, a sports complex, a library, staff housing and accommodation for 240 students in residence. Difficulties arose early with this component. Firstly, there were substantial delays in finalizing the land site. Following this, IDA held months of discussions/deliberations regarding the CBK's structuring of the construction contract which was against IDA Guidelines. CBK wanted to contract the sub-contractors directly, whereas IDA required that the sub-contractors be contracted through the general contractor, to avoid mismanagement of the project. In the end and 18 months behind schedule, the CBK decided to proceed without IDA support. While the objective for this component technically was met, in that the College is substantially built and set to operate, it was done outside the credit.

C. Major Factors Affecting the Project

1. Politicization of the Banking Sector

41. In the 80's, Kenya adopted a liberal approach to their licensing standards for banks and NBFIs, in an attempt to redress the foreign imbalance in the financial sector, resulting from its colonial history. Politically it was a very popular move. In addition, to promote the domestic banking system, all deposit taking institutions were not required to operate on the basis of a level playing field. The NBFIs, while excluded from the foreign currency markets and relegated to a domestic banking role, were not subject to the same controls as existed for banks. Initially, NBFIs were not required to hold reserves and they were excluded from deposit and lending ceilings. This had two consequences. First, NBFIs could offer above market rates for deposits to fund riskier assets at thinner spreads. Second, there was significant influence peddling as weak institutions competed for lucrative parastatal deposits. Additionally, the regulatory control system was not strengthened in parallel to offset the increased risk profile of the financial sector and a deposit insurance scheme, by eliminating risk to the small depositor, was at the public's expense. The combination of all these factors did prove disastrous for the sector which, due to the continuing lack of political will, has not been fully addressed to today. While controlled somewhat by the legislative changes in 1989, strengthening of the licensing requirements was not properly addressed in law until the amendment of 1994 when the Government acknowledged the "fit and proper standard" as appropriate for the banking sector. The politicization of the banking sector achieved the direct opposite results which it originally set out to achieve for it actually impaired the development of a thriving "domestic owned and operated" financial system.

2. Macroeconomic Policy Integrated with Financial Sector Reform

42. In late 1986, following the GOK's Sessional Paper on Economic Management for Renewed Growth, a major stabilization and adjustment program was introduced supported by IDA and the IMF. By 1988/89 during the design and approval stage of this credit, the GOK was making some progress. By late 1988, the budget deficit was down to 4% of GDP (7.6% in 1987) and as noted in the 1989 FSAC, the cash deficit estimates were forecast as low as 3.2% of GDP by FY1992. Instead, by 1991 the budget deficit was as high as 1981 and, by 1992/1993 Kenya was in a state of financial crisis. The CBK had lost control of monetary growth and inflation. Due to the growing lack of confidence in the

economic management of the country, the shilling was under significant pressure and interest rates by 1991/92 were about double the 1988 levels. The real sector was experiencing severe difficulties which had an impact on their ability to repay their loans.

43. A strong banking system would have had difficulty functioning well in this economic environment. The weakness of Kenya's banking system, although in the throes of restructuring, could not withstand the strain. Kenya was extremely overbanked, undercapitalized and in many cases due to large non-performing portfolios, illiquid and technically insolvent (see FSPN). The combination of a weak financial sector, albeit the most developed and diverse financial systems in SubSaharan Africa, with a liberalization program proved a difficult combination for Kenya to manage. In retrospect, Kenya's financial sector did not have the capital strength nor the management experience to manage through this turbulent period. This coupled with a lack of enforcement of sound banking practices by the CBK, allowed the situation to deteriorate to crisis proportions by 1992. Only by April-May 1993, did the Government adopt more conservative monetary and financial sector policies including: (a) raising the cash ratio in three steps from 6% to 12%, (b) preventing banks from overdrawing their accounts with the CBK,(c) amending Section 53 of the Banking Act to significantly reduce the powers of the Minister of Finance to grant exemptions from prudential regulations (d) reversing a number of illegal transaction between the CBK and four commercial banks and revoking three out of four of the banking licenses. The replacement of the Governor of the CBK was evidence of the Government's commitment to fiscal and financial sector reform. Nevertheless, the results through to June 1994 are mixed and the situation remains fragile.

3. Accounting, Evaluation and Disclosure Standards

44. Accounting evaluation and disclosure standards are weak. While Kenya is better than most in the area of accounting, this remains a major impediment to effective enforcement of prudential guidelines and supervision. This problem is a "doubled edged sword". Firstly, the financial institutions are granting credit based on poor quality financial statements of their clients which significantly impairs the bank's ability to improve their credit analysis which, in turn, impacts the institutions loan portfolio, profitability levels and capital base. Equally low standards are then applied in the preparation of the financial statements of the financial institutions, which impairs BSD's ability to rely on the financial as stated and consumes significant additional resources to attest to their accuracy.

D. Project Sustainability

45. The technical capacity enhancements, that is the legal, regulatory and open market operations, achieved under this credit are considered sustainable as long as they are supported by the appropriate policy environment. In fact, a continued enhancement of these areas as the market evolves would be expected. For example, the regulatory methodology developed under this credit will continue to develop as Kenya's open market and money market operations become more sophisticated over time. New methodology in the area of credit and treasury risk management will evolve as the financial institutions CBK regulate, begin to expand outside traditional banking products and borders. Technological advances in managing open market operations and monitoring of the health of the financial system need to be continually upgraded to ensure the CBK keeps pace with the market that it is managing.

46. The bank restructuring efforts undertaken by this credit are not assessed as sustainable. Despite the restructuring of Consolidated Bank, it is again insolvent. Unless the CBK and the GOK adopt a much more effective, proactive strategy for the restructuring/closure of weak financial institutions in the sector, the stability of the sector will remain fragile and ineffective as a tool for monetary and industrial policy.

47. While the CBF was not funded under the credit, IDA is unaware of any research or data which supports the affirmation of its long term sustainability. In fact, in view of the overcapacity of banking schools/colleges in the market at the current time, it would suggest that unless, the CBF achieves the significant differentiation from the rest of the market, which it had originally set out to do, its sustainability as a college will be uncertain. The delay in the opening of the college has permitted the development of other entrants in East Africa, which CBF may have been able to discourage from entry. A market demand analysis would provide the CBF the opportunity at this point to determine if it is properly positioned in both its domestic and regional market.

E. Bank Performance

48. This credit of $5 million was designed to complement the 1989 FSAC of US$120 million. On the one hand, as a result of this complementarity, the program was very visible, as it was the technical assistance under this credit which would allow the GOK to meet FSAC conditionality. On the other hand, once the FSAC conditionality passed with second tranche release in 1990, a slip in the performance of FSTAC was not well addressed.

49. There is no doubt that the technical assistance funded under FSTAC was urgently needed by the CBK. During preparation, a SPPF and PPF most appropriately permitted a project team to move quickly to address the banking supervision and restructuring issues. However, the credit did lack specific measurable outcomes, which if built in as conditionality, may have kept the credit focused and the momentum from dissipating after the first two years of intensity. Examples of conditionality could have included timeliness for legislative amendments, supervisory guidelines, undertaking selected training programs, implementation of reserve money management systems including simulation models, stages of construction of the CBF, etc. Instead, only the restructuring conditionality was built in as a condition of the FSAC and it was not effectively utilized, with the second tranche release approved on the basis of a very weak action plan which was to be instituted at the discretion of the CBK. In essence, IDA gave up the one strong card it had. In addition, in retrospect the Phase I restructuring plan, although politically acceptable to the GOK, did not address and only postponed the problem. The design of the restructuring efforts and the supervisory capacity to manage the initiative were underestimated both in terms of the complexity of restructuring weak financial institutions and the depth of the problem within the financial sector. The 1993 FSPN and FSPNU attest to that fact.

50. The bank's response to the CBF procurement issue was appropriate. Numerous efforts were made to convince the Government and CBK to adopt IDA's procurement procedures. There was little more that could have been done to address the disagreement. While it might be argued that better preparation may have uncovered the issue earlier, it is unlikely. In view of the materiality of the CBF to the total amount of the credit, as well as the fact the remaining components were not disbursing well (43.5% of forecast by 1991), there certainly was justification in 1991 to restructure or cancel the credit in its entirety.

51. The effectiveness of the Bank in the supervision of this credit was mixed. There was limited technical restructuring/supervisory expertise included in the supervision missions. In view of the extent of the problem, inclusion of this expertise would have been extremely helpful and may have prevented the serious erosion of interest evidenced over time. However, the strong support at the front end, as noted above, as well as extensive support over the procurement differences and also in ensuring project audits were received in a relatively timely manner, was both appropriate and effective. In view of difficulties experienced in the sector, and the unresponsiveness of the Govenor to supervision missions, the project was not supervised in 1992. To complicate matters further the Task Manager changed in 1992 during this turbulent period. By 1992/1993 as a result of the financial crisis there was a move by the

CBK to, once again, restructure the sector (mainly with resources outside of this credit). In June 1993, with disbursements for the non-CBF components up to 60% and the financial crisis deepening, IDA made one last attempt to constructively reallocate US$500,000 of the CBF funds to worthwhile infrastructure support within BSD and CBF. This reallocation failed as a result of the lack of support by the CBK.

52. One area which is addressed below under Borrower performance but should also be noted here is there was no strong coordinating/administrative role between the three major project beneficiaries. Correspondence within the CBK acknowledges a lack of co-ordination and control of expenditures under the project. In view of the many stakeholders in this credit, it would have been appropriate to require a coordinating and control mechanism.

53. The fact that the project was not supervised in 1992 (between the June 1991 and 1993 supervision missions) only reinforced the level of disinterest, having much more serious problems to deal with in the sector at the time. The attempt in 1993 to resurrect the program was optimistic in view of the thinking within the Central Bank at the time. The fact that IDA was unaware of the new Governor's thinking regarding (1) not using IDA credits for what was considered normal CBK expenditures and (2) CBK's preference for short term verses long term technical assistance, indicates that IDA may have been out of touch with the thinking of the new management of the CBK.

F. Borrower Performance

54. The CBK, as the beneficiary of the credit, evidenced strong commitment to the project objectives during the first two years of the credit. Commitment to the policy and policy reforms relating to the technical capacity of both the BSD and the Research function of the Central Bank was strongly in evidence and, as required, a significant amount of resources were committed to the task. Equally, while the objective of the institutional reform was not met as detailed above, the restructuring efforts were undertaken in good faith and the CBK showed significant determination and did conclude the Phase I restructuring, as agreed. In view of the complexity of the transaction, this was no small undertaking.

55. The lack of a strong central coordinating function for the credit, impaired its overall administration, but was not a major deterrent to effectiveness. Well beyond the credit's close, IDA was still attempting to recover the proceeds of the Special Account, despite assurances from the CBK that the remittance had been sent. The Special Account remittance was received by the date of this report.

56. A lack of commitment to BSD enforcement remains a major issue today and will continue to be one, until the problems in the sector are dealt with. Once again, it is imperative to acknowledge the difficulty of the task at hand. However, the effectiveness of the function remains compromised, if enforcement is weak.

G. Assessment of Outcome

57. Overall, the project failed to achieve two of its critical objectives. A major objective of the project was the strengthening of the Banking Supervision function. While the technical and human capacity for effective supervision is in place, it is impossible to be an effective regulator without strong and timely enforcement. Until BSD's enforcement is fully transparent, consistent, independent and timely, it cannot effectively regulate the sector.

58. Secondly, again despite the significant effort of BSD, the restructuring efforts have had little impact on the health of the sector. Overall, there is little tangible benefit remaining today from the

Phase I restructuring and the liquidation efforts of a handful of the weaker banks, notwithstanding certain notable exceptions.

H. Future Operation

59. The CBK does not see the need for a further operation to support the development of the supervisory, research or college of banking functions. It is the thinking of the CBK that further work needed in these areas will be funded internally by CBK resources. Equally, the CBK has determined it will proceed with its restructuring efforts of the weak financial institutions on its own terms, however, dialogue with IDA will continue as part of future analytical work and operations.

60. The Government, however, could be assisted by IDA and the IMF on a consultative basis to review (i) the state and effectiveness of their regulatory framework and whether the design of the deposit insurance scheme appropriately supports it, (ii) a harmonization of entry and exit rules with their regional partners as well as their competitiveness in the international arena, (iii) the micro and macro aspects of supervision and the infrastructure for adequate decision making, particularly in times of crisis.

I. Key Lessons Learned

61. The major lessons drawn from FSTAC include:

(i) the importance of Government commitment to the project and the need to design specific components such that the interest in the project is maintained. Detailed monitorable targets would direct the focus and support the momentum of the initial project activity;

(ii) the capacity to absorb change needs to be realistic and considered in the framework of the political environment. Phase II bank restructuring efforts under FSTAC were not implemented due to the lack of political will of the Government coupled with the politicization of the regulatory environment such that needed restructuring was not enforced;

(iii) implementation of the liberalization program in Kenya did not adequately address the condition of the financial sector prior to its introduction. In order to eliminate or reduce disruption to the financial system as possible, there needs to be certain preconditions met prior to embarking on such a program;

(iv) there should be a mechanism which forces a special review for a credit where there has been a material change from the original design. In the case of FSTAC, the fact that the CBF was not being financed under the project and the other components were not disbursing well should have prompted a cancellation or, at least, a significant redesign earlier than the reallocation attempted in 1993; and

(v) if a change in Task Manager during implementation could not be avoided, there should be some formal mechanism to promote an orderly transition. Preparation of a comprehensive handover note (on the background, current status and understandings reached with the borrower and implementing agencies and other critical information which may not be available in the supervision reports) would be one mechanism, with a presentation to either a peer group or the implementing agency to test validity of the existing design and approach.

KENYA

FINANCIAL PARASTATALS TECHNICAL ASSISTANCE PROJECT

CREDIT 2147-KE

IMPLEMENTATION COMPLETION REPORT

EVALUATION SUMMARY

FINANCIAL PARASTATALS TECHNICAL ASSISTANCE PROJECT

CREDIT 2147-KE

KENYA

A. Introduction

1. The design of the credit was to support the Government in implementing the framework it had developed for Development Finance Institution (DFI) restructuring. Historically, IDA, had supported the original development of the DFI sector and had extended previous credits. The ultimate objective of this operation was to establish self-sustaining and commercially-viable institutions with appropriate niches and diversification strategies to compete effectively in a liberalized financial market. (para 17)

B. Project Objectives

2. The main components included (i) long term consultants to restructure DFIs, (ii) short term consultants to assist with client firm workouts and (iii) overseas and local training to improve the indigenous capacity to manage financial institutions. (para 17)

3. While certain specific measurable and monitorable targets were designed into the program which would have supported project achievement to some extent, a two year delay in implementation made many of the dated covenants either no longer applicable or late dated and ineffective as control triggers.

4. An extensive review of the DFIs was undertaken by the Ministry of Finance, in October 1989 and funded under the Industrial Sector Adjustment Credit (ISAC), as an ISAC second tranche release condition. This review, coupled with other sector studies, concluded that the two main DFIs, Industrial Development Bank (IDB) and Industrial and Commercial Development Corporation (ICDC) were potentially viable and had a specific market niche. IDA only supported this conclusion if the DFIs could be restructured and made to operate commercially. The program did not envisage a recapitalization by the treasury but rather funding for operations would come mainly from the proceeds of sale of the DFI investments, which at inception of the credit were estimated between $22 and $35 million. Client firm workouts, which would also lead to eventual privatization, was consistent with the main credit objective, as was the training of DFI staff. If the institutions could not become self-sustaining, then they would need to be closed. The objective of achieving eventual self-sustainability, while promoting the development of the long term financing market, was appropriate and well founded. (para 19 and 20)

C. Implementation Experience and Results

5. The project closed at approximately 60% disbursed, following two years of intensive restructuring activities, with over $3 million spent on long term expatriate technical assistance and only 13% of the training budget utilized. The DFIs still have not found a source of sustainable financing nor established a sustainable long term operating plan. (para 23)

6. The objective of the credit was to restructure the DFIs to make them independently sustainable and funded entities. The objective of self-sustainability has not been achieved and while much has been accomplished to place the operations of these entities on a commercial basis, the long term strategic positioning and funding of these entities has not been resolved. (para 24)

7. Matters were complicated during implementation by the link between the objectives of this project and those of the Parastatal Reform. This link was especially important as, under the Parastatal Reform, it was the assets of ICDC and IDB which were to be divested. This raised the question of the ownership of the investment as well as the direction of the proceeds of sale. If the proceeds were not to be reinvested in these DFIs, it was critically important to find an additional source of long term capital. (para 25)

8. The commitment to the reform of the DFI sector varied over the life of the credit and across the stakeholder groups. This lack of commitment to a single course of action by all parties was a major deterrent to achieving project objectives. The Government's eventual articulation of its support of the DFI sector, that is, that it was not politically feasible to close either of these institutions, coincided with the credit's close, and did not permit undertaking an important strategic review to resolve the future positioning of both the DFIs and determine the source of future funding. (para 32)

9. To complicate matters further the credit was suspended in March 1994 due to a breach of financial covenants, having not supplied adequate project audits. This added complication prevented the Government and IDA from mounting a rescue operation at the credit's close to permit the strategic review to proceed. (para 33)

10. Both the Bank and the Borrower's performance in the management of this credit is assessed as deficient. On the Bank's side, in view of the difficulty in moving this project forward, as well as the confusion created by the introduction of the Parastatal Reform Project, supervision at once a year was too infrequent and the final closing mission was too late to effect any meaningful change. The deficient rating for the Borrower stems from a lack of articulated Government policy regarding the DFIs. The indecision regarding closure of IDB and the lack of decisive action regarding the treatment of key financial statement items (e.g. the Exchange Rate Adjustment Fund (ERAF), the Rivatex option and the Soya Oil account) precluded the DFIs from establishing their independence. An earlier decision regarding these issues would have permitted completion of the strategic review, the financing of this review under the credit, as well as possibly respond to any new training requirements identified by the review. (paras 37 to 45)

D. Summary of Findings, Future Operations and Key Lessons Learned

11. The project closed in a unsatisfactory state with the future of the DFI sector unresolved. The extensive restructuring efforts, at a sizable cost of over $3 million, are at risk of loss, if the future of these DFIs is not resolved quickly. (para 35)

12. While the restructuring efforts produced significant positive operational and financial results, the project failed to achieve self-sustainability. Without the latter, the long term prospects for the DFIs are in peril and, as such, the development objective of promoting a multi-faceted self-sustaining commercially oriented DFI sector, which would reduce the market segmentation and promote the development of the longer term capital market, cannot be achieved. (paras 26 to 28)

13. Prior to undertaking a strategic review of DFIs, the Government needs to resolve the policy issues affecting them. Cleansing the balance sheets of material items is a must, otherwise this will preclude the interest of a long term investor. As well, the Government needs to finalize its position regarding Corporate Governance to ensure it's role is transparent and in line with international standards. No serious investor will tolerate intervention by the Government in the operation of a commercially based enterprise. The DFIs will be no exception. (para 47)

14. A future operation in the area of capital market development would be an appropriate way of dealing with the DFI issue, as well as addressing structural issues in the market especially to promote and support the mobilization and rationalization of long term capital flows. (para 48)

15. There are four key lessons which IDA needs to address in the management of its projects. Firstly, when the implementation of a project is significantly delayed, as it was in this case, there should be some mechanism which forces a special review process to check that the original design of the project remains appropriate and that, it has not been overtaken by other events or project (Parastatal Reform Project). If it has been overtaken by events, the credit should be redesigned. There is a strong argument that FPTAP should have been fully redesigned in 1992 concurrent with the design of the Parastatal Reform. Secondly, if a change in Task Manager during implementation cannot be avoided, there should be a mechanism to enforce an orderly transition. Preparation of a comprehensive handover note would be one mechanism, with a presentation to either a peer group or the implementing agency. Thirdly, the design of the project raises issues regarding the sequencing of reform. In the case of the FPTAP, IDA's approach was at the financial sector level, whereas the Parastatal Reform efforts were directed to the private sector. Both were equally valid efforts but the Parastatal Reform should not have gone forward prior to the resolution or redesign of this key financial sector component. There may be a natural sequence and a rationale to having preconditions for the status of one sector, being in evidence prior to tackling a sub-sector. Finally, the frequency of supervision missions, at one per year, is not adequate to keep a major technical assistance project on track. (para 49)

PART I. PROJECT IMPLEMENTATION ASSESSMENT

A. Statement and Evaluation of Objectives

1. Statement of Objectives

17. The main purpose of this credit was to support the Government in implementing the framework it had developed for DFI restructuring. The ultimate objective was to establish self-sustaining and commercially viable institutions which had appropriate market niches and diversification strategies to compete effectively with banks and NBFIs in a liberalized financial market. The main components of the program included (i) long term consultants to restructure the assets and liabilities and operations of the DFIs, (ii) short term consultants to assist with workouts of potentially viable client firms in their portfolios, and (iii) overseas and local training to improve the indigenous capacities to manage financial institutions.

2. Evaluation of Objectives

(a) Restructuring of the DFIs

18. At the time of the project preparation in 1989/1990, the objective of restructuring of the DFIs was a very controversial one. There was significant debate at the Bank's own Board which resulted from a larger global debate which concluded that DFI type institutions had failed to operate as commercial enterprises, notwithstanding how well designed the reform program. Consequently, Kenya's proposed restructuring strategy was directly opposed to much of the thinking of the day and there was significant discussion of the project at the Board.

19. Despite this, an extensive review of the operations of the DFIs was undertaken by the Ministry of Finance, concluding in October 1989. This work was funded under the Industrial Sector Adjustment Credit (ISAC) and was a condition of the ISAC second tranche release. This review, coupled with other sector studies completed at about the same time, concluded that the two main DFIs, IDB and ICDC, were potentially viable and showed a continuing need for this type of financial services in the market. This was acknowledged in an environment where the commercial banking sector did not have the risk tolerance to extend maturities beyond three years. This left a very large market gap for a source of long term funds, which was viewed as a major constraint to enterprise and industrial development. Consequently, it was concluded that Kenya needed the DFIs to be viable market players as providers of term finance domestically and to support the Government's industrial and trade sector adjustment programs at the time.

20. While it was the conclusion of the Government that there was indeed a role for DFIs in the market, IDA supported this conclusion only if the DFIs could be restructured and made to operate commercially. Jointly it was agreed that the six existing DFI institutions in the market at the time were not needed and any restructuring efforts should be very focused on the two institutions which had the greatest chance of success, IDB and ICDC. The economic benefit of the proposed restructuring included a reduction of pressure on the budget to recapitalize, as the restructuring program did not envisage a recapitalization by the treasury. Rather, funding for DFI operations would come from the normal operating cash flow supplemented by the proceeds of sale of the DFI investments, which at inception of the credit were estimated between $22 and $35 million. It was felt that this orderly divestiture would realize significantly greater amounts than a "fire sale" which

would have occurred if the DFIs were to be shut down immediately. If the institutions could not become self-sustaining, having followed this orderly market oriented strategy, then they would need to be closed. The objective of achieving eventual self-sustainability, while promoting the development of the long term financing market was appropriate. The appropriateness of the DFIs directly competing with the banks and NBFIs was questionable. However, positioning them in the long term and related markets was and still is viewed as appropriate.

(b) Client Firm Workouts

21. As the DFIs were not to be recapitalized by the treasury and their future source of initial cash for operations relied on the self-sustainability of operations including the successful sale of assets and investments, the improvement of these holdings was integral to their restructuring plan and the achievement of the project goals. Specifically, this objective supported the restructuring of 25 potentially viable enterprises in the DFI portfolios and represented 25% of the technical assistance component.

(c) Training

22. Prior to the restructuring exercise, it was evident that the DFIs had not historically operated on a commercial basis as loan and investment decisions were often politically, socially or otherwise influenced. Commercial principles were not adhered to, nor rewarded. Consequently, the training challenge at the outset of the restructuring exercise was sizable, as it needed to not only impart skills e.g. financial analysis and credit risk management etc. but also to shift the psyche of the institutions to a commercial basis. The training objectives were clear, well articulated and extensive at close to $2 million and promoted the overall development of the DFI staff and represented 30% of the overall credit.

B. Achievement of Objectives

23. The project closed at approximately 60% disbursed, following two years of intensive restructuring activities and over $3 million spent on long term expatriate technical assistance and only 13% of the training budget utilized. More seriously, the DFIs still have not found a source of sustainable financing, nor established a sustainable long term operating plan.

1. Restructuring of the DFIs

24. The objective of the credit was to restructure the DFIs to make them independently sustainable and independently funded entities. The Government and IDA both supported the extensive restructuring efforts because there was enough evidence to support the premise that these institutions could be viable, as they had a specific niche as providers of long term financing in the market, as well as having the opportunity to compete in other market segments as their market and client base expanded.

25. It appears that despite the assertion at the outset that these institutions could be viable, there was a rethinking and debate during the life of the credit regarding the ultimate viability of each of IDB and ICDC. The question raised was whether the two entities should be merged, closed, recapitalized, sold etc.. Unfortunately, the lack of commitment to a single course of action slowed the process which, due to the front end problems with the design of the technical assistance, was already two years behind. To complicate matters further and addressed below, was the question of

how the objectives of this credit linked with those of the Parastatal Reform Project, especially as it was the assets of ICDC and IDB which were mainly slotted for divestiture. This raised the question of the ownership of the investment, as well as the direction of the proceeds of sale.

26. In this environment, it is important to note that the consulting team recruited did make good progress with the restructuring of both these entities, as outlined within their mandate. Results included: (i) a major internal restructuring of both institutions, (ii) the adoption of a new commercial mandate, (iii) implementation of a portfolio management approach to managing credit, (iv) discontinuation of unprofitable activities, (v) cleansing of the portfolios of weak and/or non-performing borrowers and (vi) collection of arrears against measurable targets. New lending administration controls and procedures were implemented as well as venture capital guidelines. These were further supported by the establishment of a committee approach for the review of credit, which supported capacity building of the credit skills of local staff. Also, extensive on-the-job training was undertaken which was viewed by local management as effective. DFI staff now were competent in identifying commercially- based viable projects. All of the above, was achieved in an environment of constraint and with a significantly reduced work force. In addition, the consultants were able to guide the process to have the Government agree to isolate and compensate the DFIs for the management of Government-directed projects. The latter development was a critical acknowledgment that, indeed the business of the DFIs had to be commercially-based or they required adequate compensation and coverage of the risk.

27. Also, over this period of restructuring, with the emphasis placed on cash collections and reducing the level of arrears, the consultants were instrumental in placing a number of projects in receivership. It was their guidance which resulted in significant progress being made in collection. The consultants also worked closely with the Parastatal Reform Program Committee (PRPC) and actively supported its privatization efforts for those investments held within the IDB/ICDC portfolios and cited for privatization. The privatization of a number of these investments was successfully completed in 1993/1994 and represented a significant percentage of the PRPC privatization program.

28. Both IDB and ICDC recorded a profit in 1993. This was a significant achievement for IDB, which had a history of significant losses. In the case of ICDC, the 1993 profitability level was the second highest in their history. Both institutions undertook a strategic planning exercise to position themselves against each other and against other competitors in the market, in a hope to sell their strategy to outside investors. This exercise, was somewhat premature. Before these institutions could realistically attract serious outside investors, there remained certain major issues which the Government needed to resolve. At a micro level, these issues include the ERAF (exchange rate risk carried on its books for reimbursement by the GOK) for IDB; and the Rivatex share purchase option [GOK directed transaction] and the Soya Oil account [Government directed transaction] for ICDC. Each of these items individually could have a major balance sheet impact, with income statement implications. Together, they threaten the solvency and future viability of these institutions. Additionally at the macro level, the Government needed to commit to applying market based principles regarding its role in the corporate governance of these institutions. (An amendment to the *State Corporations Act*, prompted by the Parastatal Reform Project which does not yet fully address this issue, was to be passed October 1994.)

29. Without the strategic review completed to delineate the products and services each of these institutions should provide and how their growth is to be funded (as the proceeds of sale of investments under the Parastatal Reform Project now go to a joint account with Treasury and not as originally intended to the DFIs), the vision for the DFI sector will remain blurred. Without direction

and funding, the DFI sector will not be in a position to support the industrial sector either in the provision of long term debt/equity or more sophisticated capital market type products. In their current state, neither DFI is likely to act as the catalyst to the development of Kenyan financial markets which was originally envisaged in the design of the credit.

2. Client Firm Workouts

30. The workouts for 25 client accounts were not completed. While the restructuring team undertook a level of work in this area, it was not of the depth envisaged under the original credit. Rather, the efforts were focused on restructuring the credits and a resolution of the non-performing status. No specialty expertise including legal and accounting was devoted to privatization preparation efforts and, therefore, no specialized short term consulting contracts were undertaken. One reason for the lack of utilization of this component was the development, since inception of the credit, of the Parastatal Reform Project which was also to facilitate privatization efforts and also had a fund of similar design within that project. Also, because the initial start up was so delayed, the priority of the consultants over the remaining two years of the credit was focused on the major restructuring issues. The credit closed without separate client firm workouts being undertaken.

3. Training

31. The training budget was only 13% utilized and only then within the final six months of the credit and at the prodding of IDA. The training included project and credit appraisal and analysis, venture capital, investment monitoring as well as computer skills. The training undertaken was very focused and of high calibre. The capacity to undertake the sizable restructuring and retrenchment at these institutions, within a compressed time frame due to the credit's late start as well as undertake significant external training, was limited. Also, an additional factor included the hesitancy of senior management and the Government to invest in significant training when the strategy and the future of the DFIs was still being debated up to the credit's close.

C. Major Factors Affecting the Project

1. Commitment to the Project Objectives

32. The commitment to the reform of the DFI sector varied over the life of the credit and across the stakeholder groups. This lack of commitment to a single course of action, by all parties, was a major deterrent to achieving project objectives. In 1990, all stakeholders appeared committed to the original design of the project, which was based on the privatization of the investments to fund the on-going operations of these companies. Within months, with some bad press on long term technical assistance, and despite the scarcity of the required skills in the country at that time, commitment of the Government to the program was wavering. By 1991/1992 with the introduction of the Parastatal Reform Project, the mission for the DFIs became blurred between the two projects. By 1993, the debate resumed as to whether one of the DFIs should be closed. This resulted in critical decisions being postponed until a final decision was reached regarding the fate of these institutions. Other initiatives including training were equally effected as everyone awaited the definitive decision on the fate of these companies. The Government's eventual articulation of its support of the DFI sector, that is, that it was not politically feasible to close either of these institutions coincided with the credit's close, and did not permit the undertaking of an important strategic review to resolve the future positioning of both the DFIs and determine the source of future funding.

2. Credit Suspension

33. The poor performance in supplying the required and covenanted project audits, which resulted in the credit being suspended in March 1994, was unfortunate, but warranted. This added complication, however, prevented the Government and IDA from undertaking a strategic review at the credit's close.

3. Policy Environment

34. The postponement of key policy decisions relating to (i) the treatment of the foreign exchange risk inherent in IDB's balance sheet, (ii) the Rivatex options (the GOK has the legal obligation to buy back Rivatex shares at par at a loss ranging between Ksh 175 million to Ksh376 million), (iii) Soya Oil account losses (estimated at BEF 494.5 million) for ICDC, as well as (iv) an affirmation of the Government's policy stance regarding the issuance of transparent corporate governance guidelines for state owned/controlled corporations, preclude or seriously impeded both IDB and ICDC from moving forward to seek out an additional source of capital.

D. Project Sustainability

35. The project closed with the future of the DFI sector still unresolved. The extensive restructuring efforts, at a sizable cost of over $3 million, are at significant risk of loss, if the future of these DFIs is not resolved quickly. The commitment to commercial principles by these institutions needs on-going reinforcement, as historically, certain stakeholders' commitment to commercial principles were abandoned in favor of more expedient returns. The Government needs to act quickly to protect its $3 million investment and complete the strategic review and packaging of these entities to attract a source of long term capital to support their future growth. Without accomplishing a sustainable source of financing, these DFIs are at risk of reverting to non-viable entities, over a relatively short period of time, needing and relying on budgetary support.

36. The extensive investment in on-the-job training provided by IDI and complimented by the limited but concentrated external training should be of on-going benefit to the sector, if those people who were trained, remain in the financial system. The loss of qualified and talented people by the DFIs will be a function of the perceived future opportunities, offered by these entities.

E. Bank Performance

37. The project went to the Board in May 1990 and despite becoming effective August 22, 1990, implementation did not commence until February/March 1992. The long delay in start-up was partially the result of a change in Government thinking regarding the use of long term technical assistance which precipitated a request to redesign the credit and reallocate certain proceeds in January 1991. As it happened, USAID had agreed to fund two expatriate advisors with grant funds, so IDA was asked to move certain of its consulting budget to training. The changes were agreed by IDA by February 1991. Following this, certain procurement delays were experienced wherein all short listed firms were re-invited to bid for the restructuring mandate. All contract problems were resolved by January 1992 and the IDI consulting team arrived in Kenya in February/March 1992.

38. Just as the project was getting started in 1992, the Task Manager changed. In addition, in some ways the project was overtaken by events with the development of the Parastatal Reform initiatives where, of the top 20 companies cited for sale, 12 were investments held by the DFIs.

Creation of the ESTU administrative arm of the PRPC caused confusion and overlap with the privatization component of this project, as they legally controlled all privatizations. This was eventually overcome through cooperation, however, it did slow and therefore impede the process somewhat. The major problem between this project and the Parastatal Reform Project which was not adequately addressed, however, was the fact that the proceeds of sale which were originally designed to be reinvested in the DFIs to fund on-going operations, now under the Parastatal Reform were to be directed to a joint account within the Treasury. In principle, as this was a fundamental change to the original design of the credit, it would have been better to redesign FPTAP at that point.

39. By 1993 the consultants were challenged to rethink their terms of reference in the context of a broader review exercise to address inherent viability of these institutions. By this point in the exercise, it was too late to make any meaningful change. Consequently, the consultants proceeded with their original TORs, while the decision making within the Government came to a virtual standstill, awaiting a resolution of the future of IDB to be concluded by a strategic review to be undertaken quickly. Unfortunately, due to the consultants presenting their own strategic review which was assessed by the Government and IDA as far from conclusive, other reviews and were not undertaken.

40. Commencing restructuring efforts in such an environment was difficult at best. The DFIs had not been prepared by the Government to understand the scope and objectives of the restructuring efforts, which increased the consultants work and slowed the process considerably at the front end. However, the consultants remained fairly steadfast in their mandate over the term of the main contract. In retrospect, the six-month extension at the project's end to permit the consultants to coordinate the DFI training efforts was overly generous and, viewed poorly by DFI staff. This is understandable when, against this extension, retrenchment and constraint were the order of the day.

41. In view of the difficulty in moving this project forward as well as the confusion created by the introduction of the Parastatal Reform Project, supervision at once a year was viewed by the consultants as too infrequent and the final closing mission was too late to effect any meaningful change. It is disappointing to the management and staff of these DFIs to come so far with the improvement of their operations and not to resolve the most critical question of their future strategy and mission. It was in this vein that the Bank attempted to launch a rescue operation and have a final strategic review completed and financed under this credit. Unfortunately, the continued suspension of the credit prevented the execution of this strategic review and the credit closed a failure. The Bank's performance is rated as deficient.

F. Borrower Performance

42. Many deficiencies at the front end in the management of this credit impaired its overall efficiency. The redesign of the technical assistance component was protracted. As well, the initial preparatory work to have been completed prior to contract inception, was not prepared and resulted in an increased project workload. Commitment of the DFIs to the project and the presence of the consultants, was viewed as lukewarm, at best, which further slowed and impaired the restructuring process in the early days of the contract. Better project preparation may have addressed these weaknesses. In addition, the supervision of the contract, as viewed by the consultants, was somewhat confused, in view of the ambiguity of the powers of DGIPE. For example, this caused a delay in the implementation of the early retirement scheme due to the late intervention by the Office of the President, as this area came legally within their scope. Consistency of policy and its coordination was viewed as poor between and within Ministries. The coordination of the Parastatal Reform and

the FPTAP projects required better and a clearer exchange of information between the Government and the DFIs. This was eventually resolved.

43. The overriding reason, however, for the deficient rating is the lack of articulated Government policy regarding the DFIs. To learn that it was politically unacceptable at the credit's close to contemplate closure of one or both of the DFIs seriously impeded IDA's ability to support the Government in its policy stance over the last year of the credit. In addition, the lack of decisive action regarding the treatment of the ERAF, the Rivatex option and the Soya Oil account reinforced the lack of independence of the DFIs in establishing their own course until these issues were resolved. An earlier decision would have permitted completion of the strategic review much earlier in the year, to permit its financing under the credit, as well as possibly respond to the training requirements of any revised strategy.

44. The fact that the project was suspended due to overdue project audits evidenced a weakness in the project management. Inability of the auditors to respond to clear the suspension within a three month period on a very straightforward audit was unfortunate.

45. Notwithstanding these weaknesses, there were, in fact, positive developments over the life of the credit. The main achievement was the shifting of the DFI organizations to a commercially-based orientation and introducing normal enforcement and control mechanisms. This they did with the full support of DGIPE and the eventual support of the senior management of IDB/ICDC. Also, an independent review of the appropriateness of the application of an investment trust vehicle prompted by the 1993 mission, uncovered a major difficulty with the structure of the ICDC agreements, which precluded the use of this vehicle for eventual privatization. Additionally and very importantly, the Government, and specifically, DGIPE, promoted the corporate governance amendment to the *State Corporations Act* to eliminate Government control of the management of the Parastatals. While the amendment currently before parliament only partially addresses this issue, it is progressed from the credit's inception.

G. Assessment of Outcome

46. While the restructuring efforts produced significant positive operational and financial results, the project failed to achieve the most important objective of self-sustainability. Without the latter, the long term prospects for the DFIs are in peril and, as such, the development objective of promoting a multi-faceted self-sustaining commercially oriented DFI sector which would reduce the market segmentation and promote the development of the longer term capital market cannot be achieved.

H. Future Operation

47. Prior to undertaking the strategic review, the Government needs to resolve the policy issues impacting the DFIs. The cleansing of the balance sheets of material items (e.g. ERAF, Rivatex and Soya Oil) is a must. Otherwise, this will preclude the interest of a long term investor. As well, the Government needs to finalize its position regarding the corporate governance issue to ensure it's role is transparent and in line with international standards. No serious investor will tolerate intervention by the Government in the operation of a commercially-based enterprise. The DFIs will be no exception.

48. The eventual positioning of the DFIs to ensure self-sustainability and the funding of their future growth are the key issues remaining at the closure of this credit. However, the DFIs, as the main and almost sole providers of term finance in the market need to be positioned to not only be term lenders but also be designed and equipped to support the mobilization of funds for and the growth and development of the capital market. A natural link exists between the DFIs role in supporting commercially viable economic industrial growth and that of capital market expansion. The challenge to the DFI sector and the market is to design a commercially viable strategy which will promote the market's development and in essence, and over time, eliminate the need for Government to be involved in the financing of private sector growth.

48.1 A future operation in the area of capital market development would be an appropriate way of dealing with the DFI issue, as well as addressing certain of the structural issues in the market to promote and support the mobilization and rationalization of long term capital flows. Such an operation would also include support for institutional strengthening and or development. Kenya needs to address all of these issues, if it to foster a vibrant investment climate for indigenous, regional and international investment in the economy. If the anticipated investment boom materializes, the market needs to be positioned to absorb and redistribute its wealth. IDA will continue its ongoing dialogue, through many channels (e.g. the Policy Framework Paper (PFP) process) to assist the Government in addressing these important issues.

I. Key Lessons Learned

49. There are four key lessons which the Bank needs to address in the management of its projects. Firstly, when the implementation of a project is significantly delayed and, in this case it was approximately two years, there should be some mechanism which forces a special review process to test check that the original design of the project remains appropriate and that, as in the case of this credit, it has not been overtaken by other events e.g. Parastatal Reform Project. Otherwise, if it has been overtaken by events, the credit should be redesigned or canceled. Secondly, if a change in Task Manager during implementation cannot be avoided, there should be some mechanism to enforce an orderly transition. Preparation of a comprehensive handover note (on the background, current status and understandings reached with the borrower and implementing agencies and other critical information which may not be available in the supervision reports) would be one mechanism, with a presentation to either a peer group or the implementing agency. Additionally, the design of the project raises issues regarding the sequencing of reform. In the case of the FPTAP, IDA's approach was at the financial sector level, whereas the Parastatal Reform efforts were directed to the private sector. Both were equally valid efforts the Parastatal Reform should not have progressed prior to the resolution of a key financial sector component. There may be a natural sequence and a rationale to having preconditions for the status of one sector, prior to tackling a sub-sector. Finally, the frequency of supervision missions, at once per year, is not adequate to keep a major technical assistance project on track.

PART II: BORROWER'S CONTRIBUTION

FINANCIAL SECTOR TECHNICAL ASSISTANCE PROJECT

CREDIT 2058-KE

IMPLEMENTATION COMPLETION REPORT FOR THE FINANCIAL SECTOR TECHNICAL ASSISTANCE PROJECT CR. 2058-KE

BACKGROUND TO THE PROJECT

The original credit (US $ 5 million) was mainly to support the construction of the College of Banking and Finance. The remainder (30%) was to be utilised by the CBK for technical assistance to support:

1. redrafting of the banking law;
2. special audit of the weak problem institutions;
3. restructuring of the Government owned banks;
4. to pay for Research Department Advisor(s) who would assist with the refinement of the systems used in the management of open market operations; and
5. to pay for the training of Bank Supervision Department staff.

CONSTRUCTION OF THE COLLEGE OF BANKING AND FINANCE (CBF)

It was later decided that CBF would be constructed without IDA assistance. Consequently it was agreed to re-allocate the funds from the CBF construction component to support additional training requirements of the Bank Supervision Department as well as training and training aids for the CBF.

RE-DRAFTING OF THE BANKING LAW

Although the major part of the 1989 amendments to the Banking Act originated from this department, a private law firm was involved in the drafting. This involvement was most probably financed from the project allocation.

SPECIAL AUDITS

Special audits utilising external auditors were undertaken in thirty seven (37) institutions, namely:

1. Pan African Bank Ltd
2. Pan African Credit & Finance Ltd
3. Finance Institution of Africa
4. Lake Credit Limited
5. Trade Bank
6. Trade Finance
7. Diners Finance
8. Trans-National Bank
9. Trans-National Finance

10. National Bank of Kenya
11. Kenya National Capital Corp.
12. Delphis Bank Ltd
13. Middle East Bank
14. Middle East Finance
15. Trust Bank Limited
16. Trust Finance Ltd
17. Central Finance Ltd
18. Thabiti Finance
19. Nairobi Finance Corp
20. International Finance Co.
21. Consolidated Finance Ltd
22. United Bank
23. Consolidated Bank of Kenya
24. Bank of India
25. Credit & Commerce Finance
26. First American Bank
27. First American Finance
28. Kenya Commercial Bank
29. Co-Operative Bank
30. Kenya Commercial Bank
31. Prime Capital & Credit
32. Post Bank Credit
33. Prudential Finance
34. Housing Finance Company of Kenya
35. Biashara Bank
36. Exchange Bank Ltd
37. Kenya Finance Corp.

RESTRUCTURING OF THE GOVERNMENT OWNED BANKS

Bank Supervision has not been directly involved in any restructuring decisions on the state-owned banks.

RESEARCH DEPARTMENT ADVISOR

No funds were utilised for hiring of an advisor since CBK management did not view it as necessary.

STRENGTHENING OF BANKING SUPERVISION

A team of consultants was engaged to assist Bank Supervision Department with the establishment and upgrading of the department's on and off site supervisory methodology.

A number of the department's staff attended relevant courses and other training programmes.

OTHER ISSUES

1. Clause (32) of the report states that "Bank Supervision department has issued eleven Guidelines/Directives ...." and says that "This is a significant amount of regulations for any financial system to digest". We need to clarify that the guidelines are not new regulations but mere amplification of existing regulations with the aim of ensuring uniform interpretation and enhancing implementation.

2. On the restructuring programme for troubled financial institutions, the report misrepresents the fact that all institutions listed in Phase II, with the exception of Kenya National Capital Corporation and Finance Institution of Africa, have been placed under liquidation. The Phase II institutions include:

    a. Inter Africa Credit Finance Ltd
    b. Inter national Finance Co. Ltd
    c. Middle East Finance Co. Ltd
    d. Allied Credit Ltd
    e. Central Finance Ltd
    f. Trade Bank Ltd
    g. Lima Finance Ltd (later changed name to Trade Finance Ltd)
    h. Nairobi Finance Corporation Ltd
    i. Finance Institution of Africa Ltd
    j. Kenya National Capital Corporation Ltd

3. The report assumes that the Banking (Amendment) Bill 1994 has been enacted into law.

4. It suggests that IDA and IMF could be engaged on a consultative basis to review:

    (i) the state and effectiveness of our regulatory framework and whether the designs of the deposit insurance scheme appropriately supports it;
    (ii) a harmonisation of entry and exit rules with our regional partners as well as our competitiveness in the international arena; and
    (iii) the micro and macro aspects of supervision and the infrastructure for adequate decision making, particularly in times of crisis.

We feel that the CBK has sufficient capacity in terms of manpower and expertise to carry out the above without costly external assistance.

CONCLUSION

Consequent to the decision to fund the construction of CBF from own resources, only 20% out of the total allocation of US $ 5 million had been disbursed by June 1994, the closing date.

As far as we are concerned, the Financial Sector Technical Assistance Project (FSTAC) is rated unsatisfactorily implemented by IDA mainly on the basis of non-use of the funds availed to the Bank. Much of the work which was to have been funded under FSTAC has been or is to be undertaken from CBK's own resources.

BANK SUPERVISION DEPARTMENT
CENTRAL BANK OF KENYA

PART II: BORROWER'S CONTRIBUTION

FINANCIAL PARASTATALS TECHNICAL ASSISTANCE PROJECT

CREDIT 2147-KE

No response was received from the Borrower relating to Credit 2147-KE.

ANNEXES

KENYA

FINANCIAL SECTOR TECHNICAL ASSISTANCE PROJECT

CREDIT 2058-KE

Table 1: Summary of Assessments
KENYA
Financial Sector Technical Assistance Credit 2058

A. Achievement of objectives	Substantial	Partial	Negligible	Not applicable
	(✓)	(✓)	(✓)	(✓)
Macroeconomic policies	☐	√	☐	☐
Sector policies	☐	√	☐	☐
Financial objectives	☐	☐	√	☐
Institutional development	☐	√	☐	☐
Physical objectives	☐	☐	√	☐
Poverty reduction	☐	☐	☐	√
Gender concerns	☐	☐	☐	√
Other social objectives	☐	☐	☐	√
Environmental objectives	☐	☐	☐	√
Public sector management	☐	☐	√	☐
Private sector development	☐	☐	√	☐
Other (specify)	☐	☐	☐	☐

B. Project sustainability	Likely	Unlikely	Uncertain
	(✓)	(✓)	(✓)
	☐	√	☐

C. Bank performance	Highly satisfactory	Satisfactory	Deficient
	(✓)	(✓)	(✓)
Identification	☐	☐	√
Preparation assistance	☐	√	☐
Appraisal	☐	√	☐
Supervision	☐	☐	√

D. Borrower performance	Highly satisfactory		Satisfactory	Deficient
	(✓)	(✓)	(✓)	
Preparation	☐	☐	√	
Implementation	☐	☐		√
Covenant compliance	☐	☐		√
Operation (if applicable)	☐	☐		√

E. Assessment of outcome	Highly satisfactory	Satisfactory	Unsatisfactory	Highly unsatisfactory
	(✓)	(✓)	(✓)	(✓)
	☐	☐	√	☐

Table 2: Related Bank Loans/Credits
KENYA
Financial Sector Technical Assistance Credit 2058[1]

Loan/Credit Title	Purpose	Year of Approval	Status
Preceding operations			
1. Industrial Sector Operations	Privatization	1989	Closed
2. Financial Sector Adjustment	Structural Adjustment	1989	Closed
Following Operations			
1. Financial Parastatal Technical Assistance Project	Restructure DFIs	1990	Closed

[1] Includes projects in the same sector/subsector as this project and adjustment operations with related objectives. A limit of ten years is observed when listing preceding operations.

Table 3: Project Timetable
KENYA
Financial Sector Technical Assistance Credit 2058

Steps in project cycle	Date planned	Date actual/latest estimate
Identification	09/09/86	09/09/86
Preparation	05/00/88	09/03/88
Appraisal	11/15/88	12/00/88
Negotiations	04/26/89	04/26/89
Board presentation	06/27/89	07/11/89
Signing	07/12/89	07/12/89
Effectiveness	07/31/89	09/06/89
Project completion	12/31/93	06/30/94
Loan closing	06/30/94	06/30/94

Table 4: Loan/Credit Disbursements: Cumulative Estimated and Actual
KENYA
Financial Sector Technical Assistance Credit 2058
(US$ thousands)

	FY1990	FY1991	FY1992	FY1993
Appraisal Estimate	1,731.5	1,411.5	1,206.5	550.5
Appraisal Estimate Cummulative	1,731.5	3,143.0	4,449.5	5000.0
Actual	541.2*	67.2	362.0	93.8
Actual Cummulative	541.2*	608.4	970.4	1064.2
Actual as % of estimate	31.2%	4.8%	27.7%	17.0%
Actual cumulative as % of cummulative estimate	31.2%	19.4%	21.8%	21.3%
Date of final disbursement	08/08/94			

*Special Account balance of $107 excluded from number as refunded at credit closed.

Table 5: Key Indicators for Project Operation
KENYA
Financial Sector Technical Assistance Credit 2058

Key operating Indicators	Estimated	Actual
1. Training of Banking Supervision Staff.	Development of a trained cadre of banking supervisors.	Technical skills significantly improved.
2. Off site monitoring of FIs and restructuring	CBK to supervise FIs effectively and development of action programs for restructuring troubled institutions.	Off-site monitoring rudimentary, but developing. Action plans for troubled institutions encounter political interference.
3. Implementation of monetary instruments	Enhance capacity of CBK to undertake monetary programming and assist with OMO.	Completed but needs on-going enhancement.
4. Financing of College of Banking and Finance (CBF)	Completion of College estimated July 1991. To provide training in banking and management development to staff of member institutions.	CBF to open December 1994. Training programs on-going need to attract more senior bankers to management training courses.

Table 6: Project Cost
KENYA
Financial Sector Technical Assistance Credit 2058

Item	Appraisal estimate (US$th)			Actual (US$th)		
	Local Cost	Foreign Cost*	Total	Local Cost	Foreign Cost*	Total
Consultancy Serv. & Training	1,581.5	363.5	1,945.0	322.3	741.9	1,064.2
Civil Works and Furniture/Equipment	3,055.0	937.5	3,992.5	10,000.0*	0.0	10,000.0*
TOTAL	4,636.5	1,301.0	5,973.5	10,322.3	741.9	11,064.2

Table 7: Project Financing
KENYA
Financial Sector Technical Assistance Credit 2058

Source	Appraisal Estimate(US$th)			Actual (US$th)		
	Local Cost	Foreign Cost	Total	Local Cost	Foreign Cost	Total
IDA	363.5	4,636.5	5,000.0	322.3	741.9	1,064.2
Domestic contributions	937.5	0	937.5	10,000*	0.0	10,000*
TOTAL	1,301.0	4,636.5	5,937.5	10,322.3	741.9	11,064.2

*Due to procurement disagreements, the Government of Kenya decided to finance 100% of the College of Banking and Finance component. The US$10,000 actual showing here was 100% Government contribution.

Table 8: Status of Legal Covenants
KENYA
Financial Sector Technical Assistance Credit 2058

Agreement	Section	Covenant type 1	Present status[2]	Original fulfillment date	Revised fulfillment date	Description of covenant	Comments 3
DCA	3.03	5	C	on going	n/a	CKB Shall Carry on its operations and conduct its affairs in accordance with sound administrative, financial and banking practices under the supervision of qualified and experienced management assited by competent staff in adequate numbers	
	3.02	5	Unable to determine compliance as the College of Banking and Finance was not funded under this credit	n/a	n/a	CBK shall at all times operate and maintain its plant, machinery, equipment and othe property, and from time to time, promptly as needed, make all necessary repairs and renewals thereof, all in accordance with sound banking, financial and engineering practices; and	
	3.03	5	No longer applicable as the College of Banking and Finance was not funded under this credit	n/a	n/a	CBK shall take out and maintain with responsibile insurers, or make other provision satisfactory to the Association for, insurance against such risks and in such amounts as shall be consistent with appropriate practice.	

1. Covenants Types:
   - 1 = Accounts/audits
   - 2 = Financial performance/revenue generation from beneficiaries
   - 3 = Flow and utilization of project funds
   - 4 = Counterpart funding
   - 5 = Management aspects of the project or executing agency
   - 6 = Environmental covenants
   - 7 = Involuntary resettlement
   - 8 = Indigenous people
   - 9 = Monitoring, review, and reporting
   - 10 = Project implementation not covered by categories 1-9
   - 11 = Sectoral or cross-sectoral budgetary or other resource allocation
   - 12 = Sectoral or cross sectoral policy/regulatory/institutional action
   - 13 = Other

2. Present status:
   - C = covenant complied with
   - CD = complied with after delay
   - CP = complied with partially
   - NC = not complied with

3. If the covenant is complied with only partially or not at all, the reason is provided

Table 9: Bank Resources: Staff Inputs
KENYA
Financial Sector Technical Assistance Credit 2058

Stage of project cycle	Planned		Revised		Actual	
	Weeks	US$	Weeks	US$	Weeks	US$
Through Appraisal	10*	N/A	10*	N/A	10*	N/A
Appraisal - Board	8*	N/A	8*	N/A	8*	N/A
Board - effectiveness	2*	N/A	2*	N/A	2*	N/A
Supervision	32	16,432*	24	16,432	19.9	10,962*
Completion	N/A	N/A	11	16,263	N/A	N/A
TOTAL	N/A	N/A	55	N/A	N/A	N/A

*As of FY1994

Table 10: Bank Resources: Missions
KENYA
Financial Sector Technical Assistance Credit 2058

Stage of project cycle	Month/ year	#of persons visit	*Days in field	Specialized staff Skills represented	Performance Rating		Types of problems
					Implementation status	Development impact	
Through appraisal	9/86 to 10/88	5	11		-	-	
Appraisal through Board approval	11/88 to 7/89	4	10		-	-	
Board approval through effectiveness	7/89 to 09/89	2	6		-	-	
Supervision							
1989	09/89	1	N/A	-	satisfactory	Low	
1989	12/89	1	N/A	-	satisfactory		
1990	2/5 - 3/5	4	18	-	satisfactory		1990 CBK disbursement problems developing
1991	6/12-6/21	2	6	-	satisfactory		1991 CBF delayed 18 months due to land problems
1992	no mission						
1993	6/14-19	2	13	-	satisfactory		1992 Attempted reallocation of credit proceeds from CBK to training and equipment
Completion	6/94	2	4	Banking Supervision	-	-	-

*estimates

ANNEXES

KENYA

FINANCIAL PARASTATALS TECHNICAL ASSISTANCE PROJECT

CREDIT 2147-KE

Table 1: Summary of Assessments
KENYA
Financial Parastatals Technical Assistance Credit 2147

A. Achievement of objectives	Substantial	Partial	Negligible	Not applicable
	(✓)	(✓)	(✓)	(✓)
Macroeconomic policies	☐	☐	☐	√
Sector policies	☐	√	☐	☐
Financial objectives	☐	√	☐	☐
Institutional development	☐	√	☐	☐
Physical objectives	☐	☐	☐	√
Poverty reduction	☐	☐	☐	√
Gender concerns	☐	☐	☐	√
Other social objectives	☐	☐	☐	√
Environmental objectives	☐	☐	☐	√
Public sector management	☐	☐	√	☐
Private sector development	☐	√	☐	☐
Other (specify)	☐	☐	☐	☐

B. Project sustainability	Likely	Unlikely	Uncertain
	(✓)	(✓)	(✓)
	☐	☐	√

C. Bank performance	Highly satisfactory	Satisfactory	Deficient
	(✓)	(✓)	(✓)
Identification	☐	√	☐
Preparation assistance	☐	√	☐
Appraisal	☐	√	☐
Supervision	☐	☐	√

D. Borrower performance	Highly satisfactory		Satisfactory	Deficient
	(✓)	(✓)	(✓)	
Preparation	☐	☐	√	
Implementation	☐	☐		√
Covenant compliance	☐	☐		√
Operation (if applicable)	☐	☐		√

E. Assessment of outcome	Highly satisfactory	Satisfactory	Unsatisfactory	Highly unsatisfactory
	(✓)	(✓)	(✓)	(✓)
	☐	☐	√	☐

Table 2: Related Bank Loans/Credits
KENYA
Financial Parastatals Technical Assistance Credit 2147[1]

Loan/Credit Title	Purpose	Year of Approval	Status
Preceding operations			
1. Industrial Sector Operations	Privatization	1989	Closed
2. Financial Sector Adjustment Credit	Structural Adjustment	1990	Closed
3. Financial Sector TA Credit	Infrastructure Support	1989	Closed
Following Operations			
1. Parastatal Reform Project		1992	Current

[1] Includes projects in the same sector/subsector as this project and adjustment operations with related objectives. A limit of ten years is observed when listing preceding operations.

Table 3:Project Timetable
KENYA
Financial Parastatals Technical Assistance Credit 2147

Steps in project cycle	Date planned	Date actual/lastest estimate
Preparation	11/16/89	11/26/89
Appraisal	02/02/90	02/02/90
Negotiations	04/11/90	04/11/90
Board presentation	05/31/90	05/31/90
Signing	06/18/90	06/18/90
Effectiveness	07/01/90	08/22/90
Project completion	12/00/93	06/00/94
Loan closing	06/30/94	06/30/94

Table 4: Loan/Credit Disbursements: Cumulative Estimated and Actual
KENYA
Financial Parastatal Technical Assistance Credit 2147

US$Th

	Training	Consultants
Appraisal estimate	1,810.0	4,775.0
Actual	228.7	3,402.0
Actual as % of estimate	12.6%	71.2%
Date of final disbursement	11/14/94	

Table 5: Key Indicators for Project Operation
KENYA
Financial Parastatal Technical Assistance Credit 2147

Key operating Indicators	Estimated	Actual
1. DFI Restructuring	Self-sustaining commercially based development companies.	Commercially-based development companies which have no long term source of capital to ensure self-sustainability.
2. DFI Training	To position the DFI staff as professionally trained commercial bankers.	Some formal training completed but majority of training was on the job. Training requirements, requested prior to the credit's close, could not be funded as credit was in suspension.

Table 6: Project Cost
KENYA
Financial Parastatals Technical Assistance Credit 2147

Item	Appraisal Estimates(US$th)			Actual (US$th)		
	Local Cost	Foreign Cost*	Total	Local Cost	Foreign Cost	Total
Consultancy	770.0	4,005.0	4,775.0	0.0	3,402.0	3,402.0
Training	1,090.0	720.0	1,810.0	0.0	228.7	228.8
Equipment		22.0	22.0	0.0	0.0	0.0
Contingencies	292.0	601.0	893.0	0.0	16.7	16.7
TOTAL	2,152.0	5,348.0	7,500.0	0.0	3,647.4	3,647.4

Table 7: Project Financing
KENYA
Financial Parastatals Technical Assistance Credit 2147

Source	Appraisal Estimate(US$th)			Actual (US$th)		
	Local Cost	Foreign Cost	Total	Local Cost	Foreign Cost	Total
IDA	652.0	5,348.0	6,000.0	0.0	3,647.4	3,647.4
Domestic contributions	1,500.0	0.0	1,500.0	0.0	0.0	0.0
TOTAL	2,152.0	5,348.0	7,500.0	0.0	3,647.4	3,647.4

Table 8: Status of Legal Covenants
KENYA
Financial Parastatals Technical Assistance Credit 2147

Agreement	Section	Covenant type[1]	Present status[2]	Original fulfillment date	Revised fulfillment date	Description of covenant	Comments
DCA	3.01 (a)	3	CP			All non-commercial Borrower directed projects which do not meet the DFI's rate of return criteria, but are retained by the DFIs at the request of the Borrower, shall be supported by budgetary resources from the Ministry of Finance to ensure that the profitability of the DFIs is not impaired by such projects. An annual ceiling shall be placed on the number of such projects and the volume of funding from the budget which will be directed to such projects.	A mechanism defined for reimbursing DFIs for "Social" projects has been approved by the Board of Directors. No specific ceilings/limits set.
	3.01(a)	3	C			Each DIF has been directed to freeze all new Lending, except for projects considered potentially successful according to the proposed new criteria among the existing portfolios and with funds raised through divestiture.	Lending freeze commenced July 1991 and is still in effect until institution finds a source of long term capital.
	3.01(a)	5	CP			By September 30, 1990: (i) all investments in DFI portfolios will be classified into, successful for privatization, potentially successful for workout plans, uneconomic for liquidation and "Social Projects" for retention for policy reasons, in accordance with criteria which have already been agreed upon, and (ii) the assets earmarked for privatization through public offer will be prioritized with regard to the timing of the public issues.	Part (i) provided to IDA as part of briefing report of consultants. Part (ii) no longer applicable

1. Covenant Types:
   1 = Accounts/audits
   2 = Financial performance/revenue generation from beneficiaries
   3 = Flow and utilization of projects funds
   4 = Counterpart funding
   5. = Management aspects of the project or executing agency
   6 = Environmental covenants
   7 = Involuntary resettlement
   8 = Indigenous people
   9 = Monitoring, review, and reporting
   10 = Project implementation not covered by categories 1-9
   11 = Sectoral or cross-sectoral budgetary or other resource allocation
   12 = Sectoral or cross sectoral policy/regulatory/institutional action
   13 = Other

Continued on next page

2. Present status:
   C = covenant complied with
   CD = complied with after delay
   CP = complied with partially
   NC = not complied with

Table 8: Status of Legal Covenants
KENYA
Financial Parastatals Technical Assistance Credit 2147

Agreement	Section	Covenant type[1]	Present status[2]	Original fulfillment date	Revised fulfillment date	Description of covenant	Comments
DCA	3.01(a)	5	C			By December 31, 1990, each DFI shall: (i) prepare a manual on Portfolio Management Processes; (ii) take inventory of all assets in their portfolios; (iii) distribute a balanced portfolio among the different managers; and (iv) implement the new organization structure and appropriate processes.	See 3.03
	3.01 (a)	5	NC			By December 31, 1991, the DFIs shall: (i) complete workout plans for the potentially successful projects; (ii) initiate divestiture of assets to generate cash for operations; (iii) launch the first public offer; and (iv) prepare and launch a program for marketing successful loans.	The work plans were completed by 1994 and at least still required formal approval of the government and resolution of certain major balance sheet and income statement items.
	3.03	9	NC			The Borrower shall, by June 30, 1991, cause IDB and ICDC to furnish to the Association for its review and comments, comprehensive business plans, including inter alia, monitorable financial targets.	IDB submitted a five year business plan, however, needed amendment due to a Government policy change on the assumption of Foreign exchange risk. ICDC five year plan was in process at the time of our closing mission

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Table 8: Status of Legal Covenants
KENYA
Financial Parastatals Technical Assistance Credit 2147

Agreement	Section	Covenant type[1]	Present status[2]	Original fulfillment date	Revised fulfillment date	Description of covenant	Comments
DCA	3.04	5	NC			The Borrower shall, by December 31, 1990, appoint the external panel for the DFIs of internationally reputed experts to periodically assist DFIs with strategic planning.	It was felt that the External Panel was not required.
	3.05	9	C			The Borrower shall, by March 31 in each year furnish to the Association for its review and comments: (a) a program for overseas, local and in-house training of IDB and ICDC staff for the following Fiscal Year; and (b) an assessment of the training performance for the previous fiscal year.	Training plan and assessment of training performance for 1994 submitted as required.
	3.06	9	NC			The Borrower shall, by March 31 in each year review and agree with the Association on (a) a ceiling for the proportion of non-commercial Borrower directed projects in the total new investments for each of the DFIs, for the following financial year; and (b) the size of the annual budget subvention to compensate the DFIs for undertaking such projects.	see comments 3.01 (a)

1. Covenant Types:
   1 = Accounts/audits
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Continued on next page

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Table 9: Bank Resources:Staff Inputs
KENYA
Financial Parastatals Technical Assistance Credit 2147

Stage of Project Cycle	Planned		Revised		Actual	
	Weeks	US$	Weeks	US$	Weeks	US$
Through Appraisal	N/a	N/A	10*	N/A	5.2*	N/A
Appraisal - Board	N/A	N/A	14*	N/A	10.6*	N/A
Board - effectiveness	N/A	N/A	12*	N/A	8*	N/A
Supervision	41	16,432**	25	20,791**	19.6	24,819**
Completion	N/A	N/A	N/A	6,750	3.38	NA
TOTAL	N/A	N/A	N/A	N/A	47	N/A

* Estimates
** Only FY 1994

Table 10: Bank Resources: Missions
KENYA
Financial Parastatal Technical Assistance Credit 2147

Stage of project cycle	Month/ year	Number of persons	Days* in field	Specialized staff Skills represented	Performance Rating		Types of problems
					Implementation status	Development impact	
Through appraisal	11/89 to 02/90	3	13	_	-	-	_
Appraisal through Board approval	02/90 to 05/90	6	16.5	_	-	-	_
Board approval through effectiveness	05/90 to 08/90	2	6	_	-	-	_
Supervision							
1991	2/13 - 3/8	5	15	-	Satisfactory		1991 restructuring credit; Late start
1992	3/27 - 5/5	2	6	Banking	Satisfactory		1992 consultants only begining; parastatal reform overlap
1993	6/11-24	2	13	-	Satisfactory		1993 rethink viability and closure of IDB; corporate governance issues
Completion	6/22-7/1	2	4	Banking	-	-	-

*estimates

KENYA

FINANCIAL SECTOR TECHNICAL ASSISTANCE PROJECT

CREDIT 2058-KE

AIDE MEMOIRE

KENYA: FINANCIAL SECTOR TECHNICAL ASSISTANCE CREDIT (FSTAC)
Credit 2058
CLOSING IDA MISSION AIDE MEMOIRE

Background and Mission Objectives

1. An IDA mission consisting of Mr. Irfan Aleem and Ms Nancy McInerney-Lacombe visited Kenya from June 22 through to June 28, 1994. Among other things, one objective of the mission was to undertake a closing assessment of the FSTAC credit. The mission met with officials of the Central Bank of Kenya (CBK) and the College of Banking.and Finance (CBF). The members of the mission are grateful for the cooperation and kind courtesies extended during our visit.

2. A draft of this Aide-Memoire has been reviewed and discussed with the Director of Banking Supervision, the designated CBK focal point for the mission.

Current Status

3. **Background.** The original design of the credit was mainly to support the construction of the College of Banking and Finance; close to 70% of the original credit out of a total credit allocation $ 5 million was devoted to that segment. The remainder of the credit was to be utilized by the CBK for technical assistance to support (1) redrafting of the banking law, (2) special portfolio audits of the weak problem institutions, (3) restructuring of the Government owned banks and (4) a Research Department advisor(s) to assist with the refinement of the systems used in the management of open market operations. When the Government decided to proceed with the construction of the CBF, without IDA assistance due to the disagreement over the procurement of civil works, the last IDA mission in June 1993 agreed with the Government to reallocate the funds from the CBF construction component. The reallocation was to support additional training requirements of the Banking Supervision Department as well as training and training aids for the CBF. However IDA did not receive a formal request for reallocation. Consequently, the credit at the June 1994 closing date is only roughly 20% disbursed out of a total original allocation of US $ 5 million. There has been no utilization in the past year, with the exception of a small $35,000 item relating to outstanding payments to a consultant for services rendered in 1990.

4. Notwithstanding the fact that the credit remains largely undisbursed, all of the main beneficiaries of the credit within the CBK (Supervision and Research Departments and the College of Banking and Finance) still indicate that funds are needed for a variety of worthwhile infrastructure support mechanisms as discussed below.

Progress within the Various Credit Components

5. Despite the fact IDA funds were not used in the past 12 months for funding technical assistance activities, there have been varying degrees of progress in all areas identified for improvement within the credit. These are outlined in detail below.

6. **College of Banking and Finance.** Following the IDA supervision mission in June 1993, the CBF was formally established under the Companies Act in October 1993. Its shareholders became contributing members and this included the CBK, as well as some 60 plus member financial institutions. The mission was given to understand that the legal structure of the CBF is being revised to incorporate the CBF directly within the Central Bank. However the details are yet to be finalized.

The form of that transfer of assets is currently being debated and the changes to the current structure of funding (25% members, 50% fees and 25% from UNDP) is still to be finalized.

7. The current construction budget for the college totals Ksh 430 million, an increase over the original estimate. The increased outlay have resulted from an expansion of the original plans both in terms of capacity and sophistication of teaching facilities. The college now incorporates a computer facility, a computerized banking facility, a sports complex, a library, staff housing and accommodation for 240 students in residence. At the same time, management have incorporated the wiring for a potential trading room to meet the growing training requirements as a result of the move to open market operations. The increased scope of the facility will increase the carrying and maintenance cost significantly and consequently development of attractive training programs, outside of the normal banking diploma and junior/middle level employee training, needs to be developed. While there is a significant overcapacity in the market, as there are six other industry training facilities in existence, the uniqueness of the CBF is that its role is defined beyond just training, but incorporates a research and advisory component and should establish them in a particular high level niche within the industry.

8. The revised estimates for furniture, teaching aids and library equipment discussed with the mission last year needs to be totally revisited in view of changes to the plans for the college over the year. The training plans, however, still include the use of international technical assistance for teacher training in areas where such expertise may not be available locally (for example computer systems, treasury and open market operations (OMO)). In addition, and as noted above, there is a need to offer a slate of courses designed to attract senior management levels and targeted specifically at the small and indigenous financial institutions. Twinning and exchange arrangements with European and North American universities/private training facilities are being explored; in this regard the mission was able to provide a reference to a private banking college which we hope the CBF finds useful. The Director of CBF indicated that, as also discussed with the mission in June 1993, funds would be needed to support the training component and outfit the college with furniture, fixtures and equipment.

9. **Audits/Restructuring.** No special audits utilizing outside consultants/external auditors have been undertaken. Banking Supervision, and therefore the CBK, firmly believe that their own portfolio reviews are comparable in quality to those carried out by external audit firms. At the same time, Banking Supervision will call upon outside auditors to carry out portfolio reviews, as necessary (for example when seeking a second opinion or in the presence of capacity constraints). The mission was able to review the working papers relating to the portfolio audits for Kenya Commercial Bank, National Bank of Kenya, and Consolidated Bank. Based on this review, the mission agrees to a large extent with the position of the Supervision Department. However, the methodology could be strengthened from its current approach which classifies the loan portfolio based on duration of arrears; this approach should be augmented by cash flow analysis of borrowers.

10. Over the past twelve months, Banking Supervision has not been directly involved in any restructuring decisions involving the state owned banks, namely NBK, KCB and Consolidated, all of which are considered by IDA to require varying degrees of attention prior to privatization, as agreed to by the Government. This factor is of serious concern to the mission as the purpose of the technical assistance (TA) was twofold. Firstly, the TA was intended to restructure distressed banks to restore them to a financially sound and self-sustaining basis. As well, the TA was to be utilized to increase the capacity of the Banking Supervision Department. It is worrisome to the mission to have Banking Supervision department excluded from the key decision making and restructuring/supervision of the large government owned financial institutions. This lack of

involvement affects their credibility in the market and does not support a transference of skills. The mission reiterates that CBK give Banking Supervision a lead role in any restructuring of financial institutions.

11. The mission feels that there is a need for further training of Banking Supervision staff as a result of the evolutionary changes in the financial markets in Kenya. A move to a greater level of computerization in all aspects of banking requires that Banking Supervision improve their computer examination skills. Additionally, the market developments in the treasury area, as a result of the move to open market operations, needs to be understood by staff in order for them to supervise it. The requirement for interest rate risk and foreign exchange exposure management training is not unique to Kenya, as many supervisory functions are grappling with the same issues. It is imperative that Banking Supervision keep pace with the markets and products of their constituents, in order that they are in a position to adequately assess the risk and assist in mitigating against it.

12. The mission was informed that Banking Supervision's own use of computers needs development. Software and hardware requirements are needed specifically to support their off-site surveillance activities. Greater efficiency in the processing of off-site information will greatly enhance their early warning systems and enable them to respond quicker to address the risks in the financial system. The Director of Banking Supervision is reviewing his requirements with the senior management of CBK.

13. **Legal Framework.** Once again, CBK has undertaken, at its own initiative, the amendment of the legal framework evidenced by the proposed changes contained in The Banking (Amendment) Bill, 1994. The powers addressed include those relating to the Minister and the Central Bank in the area of licensing, powers to open/close branches, uniformity of financial year ends, removal of auditors, terms for loss of deposit insurance, fit and proper standards for owners and management of financial institutions, minimum capital requirements, and the lowering of large exposures limits. All these changes are seen to enhance their supervisory powers to enable them to more adequately manage risk in the financial system. Complimentary to the legislation, guidelines have been issued to the banking system to support the above legislation, as well as others introduced to cover Limitations on Trading and Investments, Prohibited Business, Liquidity and the Provisioning for Bad and Doubtful Advances. The scope of this mission does not allow for a full critique of the legislation or guidelines against international norms and IDA's recommendations contained in the June 1993 Financial Sector Policy Note. The mission undertakes to review the material and revert to the Director, Banking Supervision with further comments.

14. The mission understands from the Banking Supervision department that the market is having some difficulty with the application of some of the above mentioned guidelines and, therefore, it may be necessary to hold training sessions for the industry. In view of the technical nature of the legislation and guidelines, especially in the very critical areas of loan accounting, capital and liquidity, we support the thinking that training is required. Training at the front end of the process will save management time for both the institutions and the examiners relative to both their on and off-site surveillance. We recommend that the College of Banking and Finance be asked to develop a Legislative Compliance seminar for the industry. The mission believes the CBK and the industry would find it to be money and time well spent.

15. **Monetary Policy Development.** The credit provided funds for the hiring of a Research Department Advisor which the new management of CBK did not view as necessary. Consequently, no TA was used and this segment of the credit not utilized. CBK indicates it has, however, moved forward on its own momentum to improve its monetary programming activities. A Monetary Policy

Committee has been established which is chaired by the Governor and is well attended by his Deputy and the Directors in the key areas of research, supervision, and foreign exchange. Its main role is to be a coordinating committee for developing monetary policy and, to date, has proven to be a useful tool.

16. A CBK delegation has visited the German Central Bank to consult with them on their management of open market operations. The mission was advised that where the CBK may require TA support is in the establishment of a framework/model to manage the trade-offs between different monetary targets. CBK want to have a system to provide guidance to its operations people on how to respond to different developments in the market. It is a general feeling within CBK that they are not in need of long term advisors but they may require specific short term consultants in certain specialized areas. Additionally, they may need support to send their people abroad for exposure in other central monetary authorities.

17. The mission explained that as the credit was closing there was no further availability of funds under this current operation as of the June 30, 1994. However, the CBK has the option to request further assistance from IDA in this area.

IDA's Overall Recommendations and Comments

18. The mission is unable to recommend an extension of Credit due to the low level of utilization of the Credit in general, and during the last 12 months in particular. The mission was informed that the lack of utilization in the last 12 months was due to (1) the re-organization of CBK during this period, and (2) a rethinking of the role of technical assistance and how it would be best utilized. However, the CBK is at liberty to make a case for an extension of the Credit if it strongly feels the need for such funding.

19. IDA plans to send Part I of the Project Completion Report (PCR) for the Government's assessment of the project by October 1, 1994. CBK has agreed to prepare its own report, Part 2 of the PCR, on the Credit for transmission to the Bank as required under the terms of the Credit Agreement. The mission has agreed to provide some samples of Part 2 from other reports.

20. We have been advised by the Director, Banking Supervision that the Special Account has been remitted in full in the last week. We appreciate the timely response regarding this remittance.

KENYA

FINANCIAL PARASTATALS TECHNICAL ASSISTANCE PROJECT

CREDIT 2147-KE

AIDE MEMOIRE

KENYA
FINANCIAL PARASTATAL TECHNICAL ASSISTANCE PROJECT (FPTAP)
Credit 2147-KE
CLOSING IDA MISSION AIDE MEMOIRE

Background and Mission Objectives

1. An IDA mission consisting of Mr. Irfan Aleem and Ms. Nancy McInerney-Lacombe visited Kenya from June 22 through to July 1, 1994. The objectives of the mission were to undertake a supervision of the FPTAP Credit prior to its scheduled closure on June 30, 1994. Mr. Phillipe LeRoux of Peat Marwick joined the mission from June 22 to June 24, 1994 at the request of the Government to assist in the formulation of a future strategy for the DFI sector following the Credit's closure.

2. The mission met with the Permanent Secretary, the Investment Secretary, and other senior Government officials at the Treasury, senior management of Industrial & Commercial Development Corporation (ICDC) and Industrial Development Bank Limited (IDB) and representatives of International Development Ireland Ltd. (IDI). The members of the mission are grateful for the cooperation and kind courtesies extended during our visit.

Main Findings and Recommendations

3. The mission focussed its discussions on the following aspects of the Project: (a) progress made in restructuring ICDC and IDB since the previous supervision mission in June 1993 including a review of the strategy for the sector following the credit's closure, (b) training of the staff of the two institutions during the past 12 months, and (c) Government/DFI request relating to the closure of the Credit.

4. **Restructuring of IDB and ICDC** The mission was pleased to see some concrete results of the recent restructuring efforts including cleansing of the portfolios, refinement of the product lines and strengthening and rationalization of the administration of both IDB and ICDC. These results are attributed to the commitment to reforms of the senior management of these institutions, supported and guided by IDI and outlined in detail in the attached annex. Practical steps have also been implemented to improve the control and credit cultures of both institutions along commercial lines.

5. At the same time initial actions have been taken by the Department of Government Investment and Public Enterprise (DGIPE) at the Treasury to improve corporate governance and restructure the balance sheets of ICDC and IDB (in consultation with the managements of the two institutions). If these institutions are to attract new sources of finance and expand their customer base, they need to convince their stakeholders that they are operating on commonly accepted commercial principles and at arms length from the Government. Implementation of these principles is being addressed in the form of an Amendment to the State Corporations Act, presently before parliament. This amendment will go a long way to promoting a transparent corporate governance structure and the mission recommends that its adoption be expedited.

6. General agreement has also been reached between the managements of ICDC and IDB and DGIPE on the restructuring of the balance sheets of the two DFIs, although specific items are still in need of approval by the Cabinet. To move forward with a sustainable DFI sector, it is imperative that the Government move quickly to restructure the balance sheets of both IDB and ICDC as was

recommended in our June 1993 Aide Memoire. In so doing, the major items impairing the balance sheets, including the responsibility for exchange rate losses and issues concerning Rivatex and the Soya Oil project must be resolved. Without a resolution of these issues and the proper corporate governance framework in place, it will be difficult to obtain future funding.

7. The critical unanswered questions at this juncture for the Government and the DFIs relate to the future role of the DFI sector and how this role will be financed. Without a sound resolution of these issues, sustainable restructuring will be difficult to achieve. Thus inspite of the fact that it has restructured itself internally and has recorded profits in FY94 (see annex), IDB has been unable to find an equity investor in the past 12 months and the prospects for finding such an investor in the near future do not look promising; given the budgetary constraints on the Government, it is difficult to see how IDB can become a viable self-sustaining financial institution without obtaining new funding from a non-budgetary source, be it a donor or a private investor. Some of the specific questions that need to be answered in this context are: What are the sources of capital to support the long term growth of both of these entities? In line with this, what does the Government, as major shareholder, need to do in order to attract the identified sources of capital, thus alleviating the potentially escalating burden of funding future growth from the Treasury? In addition, is there a viable new role for these institutions to offer a non-traditional product line complimentary to their long term lending role which would both be supportive of the development of the capital market and, at the same time, make them more appealing to outside investors?

8. The mission has discussed the above issues with concerned officials and recommends that the Government develops and implements a comprehensive strategy and action plan involving steps that are needed in a number of critical areas. The areas to be covered by such a strategy should at a minimum include:

(a) **Expeditious implementation of the proposed new system of corporate governance and associated amendments to the State Corporations Act;**

(b) **Early restructuring of the balance sheets of the DFIs, resolving once and for all the issues relating to exchange losses, Rivatex and Soya Oil issues (see annex for details);**

(c) **Preparation of a proposal to elicit future funding for long-term investment financing not available from the private sector. Preparation of the proposal will require a two-step process:**

(i) Completion of quick review of the Government's vision for the DFI sector including definition of the role, ownership, product line(s), sources of future financing, and any further restructuring of the DFIs that is needed consistent with this new vision (a draft proposal for a short (2 month) consultancy review, to build on the work already done by IDI, is attached for the Government's consideration);

(ii) Launching of a marketing program to seek out alternate investors for the DFI sector based on the outcome of the above noted review.

9. **Training** There has been a significant effort made by the Government to utilize the training component of the Credit during the past year. The mission has learned that the total approved costs of $231,075 for both IDB and ICDC personnel have been incurred for training. Of this amount,

roughly $210,000 remains to be paid. This outstanding item will need to be addressed upon the mission's return to Washington, in view of the fact it was approved and delivered prior to the suspension of the Credit in March 1994. Training undertaken represented 642 man days; most of the training was provided locally by international firms. The mission was advised the training, which was mainly focused on portfolio and credit risk management, was viewed as extremely worthwhile. Both IDB and ICDC jointly have put forward an additional training request totalling $385,000, once again, with the majority to be locally sourced and delivered. The mission has been unable to support this additional request in view of the credit's suspended status and imminent closure. Nevertheless, the requested training is considered important to reinforce the initiatives mentioned above and efforts should be made by the Government to fund this requirement from other sources.

10. **Other items** The mission discussed the status of other agreements reached with the June 1993 mission which required Government action. These included:

a. **an independent review of the market for services provided by DFIs including term lending.** A review was completed by IDI by the agreed December 1993 date but the results were not viewed either by the Government as conclusive enough to base the future strategy of the DFIs. The mission believes that a good start has been made but further work needs to be done in a number of areas - see attached comments from the IDA consultant. This additional work can be done under part c(i) of the strategy recommended in para 8 above.

b. **a review was to be completed regarding the application of an investment trust as a privatization mechanism for the equity investments of ICDC.** This review was completed by S.G. Warburg, assisted by IDI, also by the December 1993 date. A complication has arisen regarding the use of such a vehicle due to the incorporation within ICDCs agreements of a pre-emption rights clause. The implication of the latter is that the other shareholders have first call on the purchase of those shares being sold/transferred and, upon consultation with ICDC, have indicated they would take up their option. Consequently, the concept of an investment trust vehicle does not appear viable for ICDCs current holdings. However it may prove practical for future investments, assuming the same pre-emption conditions do not apply. Given the restriction on the formation of a unit trust, and in view of the urgent need for obtaining funding for new investments, the mission recommends that the Government/ICDC should proceed with and expedite the sale of equity holdings in ICDC's portfolio on an individual basis.

c. **Treasury would finalize its decision regarding the future of IDB within one year.** Treasury has resolved that for political reasons closure is not an option for IDB. However, what is less certain is the Government's future strategy for IDB and how this will integrate and compliment that of ICDC. Again the review to be done under part c(i) of the strategy recommended in para 8 above will facilitate a decision on this matter, and which in the mission's view should be reached before the Government floats the proposal mentioned in para 8 (c) above to investors.

11. **Government/DFI Request Relating to the Closure of the Credit** The mission agreed with the Government that no further extensions of the Credit are desirable. However, it was agreed that the funds from the Credit could be used to complete the preparation of the proposal mentioned in para

8 (c) above over the next four months (to end-October 1994) including reviews and inputs needed from consultants to prepare the proposal. The consultancy inputs (costing $250,000) are to be provided by the firm of Peat Marwick, whose selection was approved by IDA last September. The mission was given to understand that the contract with Peat Marwick had been finalized. The mission indicated to the Government that IDA approval of the consultancy contract with Peat Marwick was conditional upon: (i) the Government obtaining the required audits of the Project accounts so that IDA can lift the existing suspension on disbursements, (ii) submission of the consultancy contract with Peat Marwick for IDA approval; and (iii) completion of all inputs prior to October 31, 1994.

12. Additionally, IDB and ICDC have both requested IDA's support for the provision of a line of credit facility to support future operations. The mission acknowledges this request for consideration by IDA management. However, in its view, this request should be formally made to IDA management only after the Peat Marwick study has been completed and the proposal outlined in para 8 (c) above has been prepared.

13. The mission was advised that the Special Account relating to this credit has been remitted in full in the last week. Following the scheduled closure of the Credit on June 30, 1994, Part 1 of the Project Completion Report (PCR) will be sent to the Government by October 1, 1994. Concurrently, as required by the Credit Agreement, the Government has agreed to complete Part 2 of the PCR, and transmit the same to IDA.

ANNEX 1

KENYA
FINANCIAL PARASTATAL TECHNICAL ASSISTANCE PROJECT (FPTAP)
Credit 2147-KE
CLOSING IDA MISSION AIDE MEMOIRE

1. **Background.** Although the Credit became effective May 1990, activity under the credit only began in March 1992 when the consulting firm, IDI, commenced their assignment. Since 1992, IDI has worked with the Government and the senior management of ICDC and IDB to meet the original objectives of the credit which were: (a) to restructure the two main Development Finance Institutions (DFIs), ICDC and IDB, to place both institutions on a commercially-based financially sustainable footing;(b) oversee the design of corporate workouts for assets held and (c) co-ordinate the training of the DFI staff.

2. There has been varying degrees of progress in all three areas of the credit as outlined in detail below. The highlights, however, include major internal restructuring of each institution. Both institutions are recording improved financial results. In the case of IDB, which has the more pressing funding need, a five year corporate plan has been documented by the Senior Management team and strategic options against which to move forward have been formulated. ICDC, which in the immediate term has the potential to be self-funding and so therefore does not have the same funding pressures as IDB, has a new Managing Director, who is in the process of finalizing their corporate plan. Both institutions have or are adopting a fairly traditional view of development banking with their corporate plans focusing on their role as provider of long term funds, whether in terms of equity or debt, complimented by commercial banking type ancillary services including export finance, short term lending and advisory services.

3. In view of the late start to the credit, and certain delays caused by a rethinking of the objectives during the course of the project at all levels which, in turn, had an impact regarding the impetus to both hire corporate work-out specialists as well as train the DFI staff, the credit at the date of closing will be only approx. 60% disbursed. A further complication, as a result of unsatisfactory audits, caused IDA to suspend disbursements under the credit in March 1994. The unfortunate implication of the existing suspension is that the remaining training budget could not be accessed for additional training for DFI staff as discussed above.

IDB

4. **Restructuring.** IDB has made commendable progress over the past year in implementing the restructuring of its operation. Staff have been streamlined from 120 to 74, with cuts spread across all departments and at the same time reorganized according to a portfolio management approach. Operational and lending policies have been introduced and/or strengthened. Tracking mechanisms for arrears have proved extremely effective with a reduction from 64% in 1991 to 46% of the lending portfolio by the end of 1993. Guidelines for business conduct have been introduced to encourage a commercial orientation.

5. A committee structure has been established at the senior management level with a strengthened reporting relationship to the Board. Corporate governance by the Board is viewed by some to be too strong and thus intrusive in the day-to-day operations of the bank. A paper proposing the delegation of certain lending limits from the Board to senior management has been rejected outright. A concentration of decision making power at the Board and the Board committee level

impedes the ability of the bank to be responsive to the marketplace, with clients having to wait up to three months for a final decision on its loan proposal. The Government and the Bank will need to address this weakness, if the Bank is going to sustain a commercial orientation in the market.

6. **Financial Performance and Position**. The mission has been encouraged by the improved financial performance of IDB from year end December 1993. More importantly, these results appear to be sustainable through the third quarter 1994 and beyond. The year over year profit recorded as at June 1993 totalled Ksh 148 million against a loss in 1992 of Ksh 68 million. Nine months to March 1994 shows a profit picture of Ksh 147 million against a budget of Ksh 34 million or 332% of the original forecast and annualized, should be close to Ksh 200 million. Administration expenses alone are 14% better than budget and, excluding an extraordinary item, results are closer to 20%. IDI have reviewed the portfolio, account by account, and view the company as well provisioned against future loss.

7. While the profit picture is evidence that IDB can be commercially viable, there are major balance sheet issues with income statement implications that need to be dealt with promptly by the Government. One such case is the Exchange Rate Adjustment Fund (ERAF) which was a fund set up by the Government to cover the exchange rate mismatch created by foreign lines of credit used for domestic borrowing. This was one way the Government alleviated the foreign exchange risk from impacting the financial statements of IDB's and ICDC's borrowers. Until the ERAF is addressed, IDB will be in a difficult position from a cash flow point of view by the end of the calendar year or before. IDB is required to service its debt with the Government, while the Government does not reciprocate in funding the very large balances (approx Ksh 1 billion) it owes IDB under ERAF. The resulting impact on cash flow is significant and this coupled with the foreign debt obligation of Ksh 220 million will require IDB to revert to its June 1992 position when it needed to rely on Treasury to meet its debt obligations, if the Government obligation under ERAF is not resolved.

8. The recent budget cancellation of the ERAF raises an important strategic issue for IDB. Under ERAF, the foreign exchange risk was carried by the Government. With its cancellation, IDB will have to better match its sources and use of funds. While IDB's response to the ERAF cancellation is to seek out more exporters in order to net its currency exposure, it may be unrealistic to believe that (1) this matching is easily done or (2) that the demand for foreign borrowing will meet the supply, particularly in the development market where the propensity for borrowing is in local currency, until the business has matured to the point where export markets are sought. Consequently, export clients and their foreign currency earnings will be at a premium in the market, increasing the potential for risk and due to the competition, lower returns.

9. Even though IDB has made great strides in the improvement of its performance and has shown it can sustain a commercially viable operation, the non-commercial based debt servicing imbalance relating to its Government obligations won't be understood by the market and IDB will, once again, be viewed as a defaulter, further reducing its access to open market funding.

ICDC

10. **Restructuring.** ICDC has undergone an equally dramatic organizational and cultural turnaround as has IDB and the successful implementation by May 1, 1994 of the new structure is to be applauded. The main difference between IDB and ICDC, is that ICDC did not have the profit pressures so evident with IDB. Notwithstanding this, outside of its long term investment portfolio, ICDC had little success in making its lending operations commercially viable. A portfolio driven organizational structure, coupled with new investment and lending guidelines and policies has been

introduced. A major review of the small loan program of 5000 credits resulted in a direct write-off of close to 20%. Strict scrutiny of loan commitments resulted in a 50% reduction. An agreed policy for social loans was adopted by the Board such that the Government will fund such lending in a transparent manner. All of this has been accomplished with a 22% reduction of staff from 392 to 305 under a voluntary retrenchment program costing ICDC Ksh 33 million (fully recovered in two years) and this coupled with attrition of 8% brings the total reduction to 30%.

11. **Financial Performance and Position.** ICDC recorded its second highest level of earnings since inception in 1993, showing Ksh 92 million and this was after provisions of Ksh 318 million. ICDC's success to date is mainly attributable to its long term investment portfolio. Of the 60 investments held, 32 are significant and performing. Unrealized gains on this portfolio measured Ksh 3.8 billion at the fiscal year end. Consequently, ICDC is projected to be able to fund its new investments and its loan portfolio from the proceeds of the sale of equities estimated at the rate of sale of 8 to 10 holdings per year. While the equity cushion provides short term funding support for this operation, there is no guarantee that equally lucrative investments are available for replacement. Consequently, the mission stresses that senior management needs to take a long term view to assure itself of self- sustainability beyond the scope of three to five years.

12. Notwithstanding this positive position, there are certain items offsetting this performance picture. ICDC has certain major items threatening its comfortable financial position. Firstly, many years ago ICDC granted the German Development Bank (DEG) a share purchase option at par value for its Rivatex shares. Today, because the shares are virtually worthless, ICDC was required to record a contingent liability in the 1993 balance sheet of Ksh 376 million. ICDC hope to negotiate a settlement at a much lower figure. However, if unsuccessful, a full or close to full settlement would significantly impair its financial position and make external funding more difficult. A prudent provision of Ksh 175 million has been included in the proposed restructured balance sheet currently being considered by the Government. An even more serious case is the Soya Oil account totalling BEF 494.5 million. While the mission was advised that the Government has committed to service and repay this debt, no legal documentation supports this obligation. Any potential equity investor in ICDC would consider this and the Rivatex option a deal breaker, unless satisfactorily resolved.

Terms of Reference for an Action Plan to Make Kenyan Development Finance Institutions More Competitive and Identify Sources of Funds for Future Development.

Background

Over the past five years the Government of Kenya (GOK) has defined and begun to implement a program of financial sector reform. In addition to strengthening the legislative and policy framework for the financial sector, GOK has substantially reformed its two key development finance institutions, Industrial and Commercial Development Corporation (ICDC) and Industrial Development Bank (IDB). Under an IDA structural adjustment loan, GOK commissioned the Irish Development Institute (IDI) (1992-94) to assist ICDC and IDB to undertake a major restructuring effort in order to become more competitive and profitable, including:

- The adoption of a new commercial mandate requiring that they operate profitably, documented in a Statement of Policies and Operating Procedures (SPOP);
- Discontinuation of uncommercial activities, principally the small loan schemes, and acting as a lender of last resort to bankrupt companies;
- The establishment of a new portfolio based organization structure with responsibility devolved to line managers;
- The improvement of credit management and information processes;
- Identification of assets and liabilities on the balance sheet that require either further attention by management or in specific cases where GOK assistance is needed;
- Performance related pay schemes for key staff;
- Review staffing requirements, skills and training needs.

Considerable progress has been made by both institutions and following major write-offs by GOK, they now appear to have the potential to operate profitably, based on their existing portfolios. **Nevertheless, GOK is concerned about their future role as providers of financial products and services to medium and large size companies because GOK is unclear about:**

(a) what products and services the institutions should provide; and

(b) how their growth should be funded.

The principal objective of development banks is to provide debt and equity finance to areas of the economy that are not receiving sufficient financial resources from the private sector. These institutions are not designed to compete with the commercial banking sector, but essentially to support the economic development of Kenya. **It is of critical importance to GOK, therefore, that IDB's and ICDC's financing activities also serve as catalysts in the development of Kenyan financial and capital markets. These functions might include:**

(a) provision of long term debt and equity capital to the industrial sector;

(b) specialized transaction-based loan management to turn apparently unattractive opportunities into bankable propositions;

(c) providing mezzanine venture capital finance to leverage private venture capital; and

(d) mutual fund/investment trust mechanisms that would efficiently mobilize domestic savings formation for domestic equity investment.

As part of the restructuring program for IDB and ICDC, GOK is considering a number of measures to place both institutions on a commercial and self sustaining footing. This is particularly urgent due to the pace and direction of privatization within Kenya, which will have a strong effect on the demand for corporate finance services. In order to meet the expected demand, GOK wishes to rapidly strengthen their two important financial institutions, and encourage equity and debt participation by bi-lateral and multi-lateral international financial institutions (IFIs), GOK recognizes that to attract such institutions it will need to complete the following steps:

- GOK agreement to restructure ICDC and IDB's balance sheets further through debt conversion and debt reduction mechanisms, specifically:
  - a liability involving the DEG put option of Rivatex shares;
  - a liability involving the soya bean processing plant;
  - the foreign exchange losses of the ERAF scheme.
- GOK approval, in principle, to equity investments by IFIs and also private investors for ICDC and IDB, and
- Parliamentary approval of the State Corporations (Amendment) Bill 1994 as it relates to corporate governance.

Several international financial institutions have been approached about taking equity in IDB and ICDC for the purpose of funding their further expansion. However, international financial institutions are concerned about the likelihood of commercial independence of these institutions and the nature of the financial services they will provide. Therefore, in order to stimulate concrete investor interest, it will be necessary for GOK to establish clear guidelines.

The Objectives of this Assignment

The objectives of this assignment are:

(i) **to provide technical assistance to the Government to assist them to develop their vision for the DFI sector, including definition of the role, ownership, product line(s), sources of future financing and any further restructuring of the DFIs that is needed, consistent with this new vision.**

(ii) **to provide technical assistance to the Government to enable them to launch a marketing program to seek out alternate investors for the DFI sector based on the outcome of the review outlined in (i) above.**

The Tasks of this Assignment

The key tasks of this assignment are to analyze the Kenyan market in terms of what financial services and products are required and how the development banks, ICDC and IDB, can best supply them. At the same time the assignment envisages that the consultants will enter a dialogue with the IFIs as to their environmental and operations pre-conditions for investment in ICDC and IDB . The key deliverables of the assignment will be:

(a) a document outlining the vision for the DFI sector together with supporting evaluation, analysis, and data.

(b) a formal marketing package which the Government can use to attract investors.

(c) a time-based action plan to be undertaken by ICDC and IDB in order to attract investment from the IFIs.

The tasks required to achieve the assignment's objectives would include:

1. **Analysis of the Lessons Learned.** Examine the lessons to be learned from development banking in Kenya and relevant countries. Development banking has a connotation which is no longer in favor. Nevertheless, there exist a number of models in development banking which reportedly scored success in Japan, Germany and elsewhere. In Kenya, ICDC has a long history, which includes some very notable successes. It would thus seem relevant to understand the nature and reasons for this success, particularly:

   - Key factors that have been responsible for ICDC's successes, particularly the complementary relationship between ICDC's equity investments and providing long term debt;

   - Whether any of these factors should guide decisions in the future.

2. **Review of Existing Studies.** A number of studies of the market for financial services have been completed, so a review of this material should be undertaken before embarking on new field work.

3. **Market Analysis: undertake a comprehensive study of the development finance sub-sector to establish the current and projected institutional demand for equity and long term debt in the domestic market and the extent to which this demand can be served by existing and new IDB and ICDC products.** Here the task is to estimate the size and character of the available market within which IDB and ICDC and its direct and indirect competitors are likely to operate. This includes an analysis and recommendations regarding the need for new financial instruments, their characteristics, and the likely distribution mechanisms. Furthermore, as demand for finance within certain segments (industrial, manufacturing, distribution, and retailing, etc) is skill dependent the bankable demand volume is highly dependent on the financial institutions's ability to turn apparently unattractive projects into bankable ones. Therefore, it is necessary to identify existing as well as potential demand and the skills IDB and ICDC need in order to access this demand.

4. **New Product Analysis and Recommendations: examine new structures, such as investment trusts and mutual funds (for tapping and encouraging individual and contractual savings), and back-stop facilities (such as the facility extended by IDA to Argentina) for recycling existing equity and long term loans to the domestic institutional**

market and also to attract new domestic debt and equity investments. While it may make sense for a development bank to take a long term equity position in companies it helps to finance, once these companies become self-sustaining and profitable, the development bank should divest itself of these equity investments, preferably to domestic investors, and 'recycle' the funds into additional ventures. The establishment of investment trust/mutual funds has proven to be an effective way for development banks to divest themselves of large equity positions.

5. **Organization Analysis and Recommendations.** Outline the organizational structure within the legal constraints of the Kenyan environment, best suited to undertake the delivery of the financial products/services described in steps (3) and (4) above. Different products and services would entail different requirements in terms of organizational skills and, thus, how the organization is to be rebuilt, where necessary. For example, a product which includes a mix of equity-like risks would require a high degree of direct involvement with the end-customer in terms of advice and monitoring. By contrast, a product with a heavy emphasis on term lending and f/x trading entails building a totally different trading-oriented culture.

6. **Brief Review of the Enabling Environment.** Concurrent with the above, it will be necessary to undertake an analysis of the financial, economic, legal and institutional conditions that will be pertinent to the success of any new entities to be created, such as investment trusts and mutual funds, and make recommendations to GOK about changes necessary to allow the formation of the products and organization, outlined in (4) and (5) above.

7. **Marketing Documents.** Prepare brief marketing documents on IDB and ICDC aimed at international financial institutions which could be interested in investing in IBD and ICDC and providing funds for on-lending. This module would involve discussions with representatives of various multilateral and bilateral agencies/organizations throughout the project period to determine the pre-conditions, nature, extent, and timing of potential investment, and

8. **Time-based Action Plan.** Create a time-based action plan to move from the current situation to the recommended vision/strategic objective. This may include a review of further restructuring to be undertaken as well as preparing a decision paper on key issues for GOK to consider and pass enabling legislation, if appropriate. In addition, it will be necessary to prepare an outline financial plan for IDB and ICDC evidencing commercial sustainability based on the products outlined.

Project Staffing, Timing and Cost

Staffing: The project team will consist of four professional consultants, including a senior economist, a merchant banker, a financial institutions specialist and a junior economist. It is estimated that the project will entail seven man months.

Timing: The total running time for the project would be approximately 9 weeks, with a final completion date of no later than October 31, 1994. This would include two, two week missions to Kenya, one week of meetings with international financial institutions, five weeks of analysis and preparation of deliverables for GOK, a one week wrap-up in Nairobi with DGIPE and other interested parties and a final week to make adjustments and changes based on the Nairobi meetings.

Budget: The budget for the project would be @ $250,000.

Review of the Demand for Financial Services from the Kenyan Industrial Sector and the Possible Role of Development Finance Institutions by IDI in December, 1993

The purpose of the study was to examine the financial services that could be provided to the industrial sector by the Kenyan development finance institutions, such as IDB and ICDC. The study reviews the previous relevant reports and a survey of the requirements of members of Kenya Association of Manufacturers for financial services and products. It concludes that, with GOK assistance, IDB and ICDC should provide long term finance and equity.

As a data collection exercise the survey is quite interesting. It demonstrates that the commercial banks are not able or interested to develop the market for long term debt. They also appear to have unnecessarily onerous collateral requirements. It points out that there is considerable demand for longer term local currency loans, which is within the control of GOK to remedy. However, there is insufficient theoretical framework behind the analysis. The fact that IDI can identify the demand for low cost long term money (i.e. below the rate of inflation) in the form of debt or "free" money in the terms of equity does not mean that IDI has identified a product. Of course, borrowers want long term money at subsidized rates. The issue, which is multi-faceted, is under what conditions IDB and ICDC can deliver that product.

To be self sustaining IDB and ICDC must create products that have a margin between the cost of acquiring funds - which cannot be ignored when discussing demand - and the pricing of the product at a level sufficient to reward the risk of investing the funds and the cost of administering the investment. The study does not address properly the issue of funding IDB and ICDC, except to say that it needs to be funded and if it cannot be funded from outside them GOK should do so.

The task of a market study should be to estimate the size and character of the available market within which IDB and ICDC and its direct and indirect competitors are likely to operate. This includes an analysis regarding the need for new financial instruments, their characteristics, and the likely distribution mechanisms. Furthermore, as demand for long term finance within certain segments (industrial, manufacturing, distribution and retailing, etc) is skill dependent the bankable demand volume is highly dependent on the financial institution's ability to turn apparently unattractive projects into bankable ones. Therefore, it is necessary to identify existing as well as potential demand and the skills IDB and ICDC need in order to access this demand.

The inadequacies of IDB's study are that it does not link IDB's and ICDC's future funding costs with the supply and distribution of a potential product at a sustainable price to the market. Nor does it address the problem of the banking skills required to create bankable products that can, based on their own cash flow, provide sufficient comfort to the lender.

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