Crony Capitalism and State Capture 2: Documents Reveal the Kenyatta Family's Plans to Take over Lending to SMEs

By David Ndii

> *"Uhuru Kenyatta's assumption of the presidency has injected fresh energy into his family's commercial empire, putting a number of its units on an expansion mode that is expected to consolidate its position as one of the largest business dynasties in Kenya"*
> Business Daily, Monday, November 11, 2013.

A few days ago, the Dairy Board of Kenya published, then recalled, draft regulations that sought, among other things, to outlaw and criminalize farmer-to-consumer raw milk sales. Essentially farmers would be compelled to sell milk to processors or other intermediaries (cooperatives or businesses) licensed and regulated by the Board. The withdrawal was in response to a huge public blowback, including a trending hashtag #Kenyattamilkbill, mobilising for the reactivation of the boycott against Brookside Dairy products. It was notable that the Dairy Board's reversal of its draft regulations followed a press release by Brookside Dairies objecting to the regulations citing specifically the levies that the Board proposed on dairy businesses. Tellingly, Brookside's statement was silent on the question of outlawing farmer to consumer raw milk sales.

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As a previous column, *Crony Capitalism and State Capture: The Kenyatta Family Story* observed, Uhuru Kenyatta's presidency has delivered remarkable returns-on-investment for the family enterprise:

> "During Uhuru Kenyatta's first term the consumer price of milk increased 67 percent (from KSh 36 to KSh 60 per half-litre packet), while producer prices remained unchanged at Sh 35 per litre), effectively increasing processors' gross margin by 130 percent (from Sh37 to Sh 85 per litre). Given the industry's 400m litre annual throughput and Kenyatta family's market share, which stands at 45 percent, the consumer squeeze translates to an increase of the Kenyatta Family's turnover from KSh 13 billion to KSh 22 billion, and gross margin from KSh 6.7 billion to KSh 15 billion a year."

Not enough, not by a long shot.

> The platform will offer micro and small enterprises an overdraft facility of up to KSh 50,000, and a loan of up to 12 months with a limit of KSh 200,000. The initiative targets five million sign-ups, and two million users in the first year. How it plans to do this is a frightening demonstration of the workings of state capture in the Uhuru Kenyatta era.

Kenya's annual milk production is estimated at 3.5 billion litres, of which 80 percent is consumed or traded informally. Put another way, only 20 percent, about 600,000 litres, is handled by processors. If these regulations were only to double the processors intake to 50 percent, we are talking of growing Brookside's turnover and gross margin to KSh100 billion and KSh 67 billion respectively.

But this column is not about the milk, at least not literally – even if the milking metaphor is quite apt. This story is about an even more audacious scheme in the Kenyatta empire's "expansion drive", the most egregious case of policy and regulatory capture I have encountered, and I have been round this block a few times. What follows is based on an internal document entitled 'Restoring Credit Access to Micro and Small Sized Businesses' shared by whistleblowers in institutions that have been corralled into the scheme by force.

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The name of the scheme is *Wezesha* ('enable'). It is a proposed mobile phone lending platform described as a "collaborative initiative to bridge the access to credit by micro and small enterprises". It will be managed by five banks, namely NIC Bank, Diamond Trust Bank (DTB), the Kenya Commercial Bank and Cooperative Bank under the leadership of the Kenyatta Family-owned Commercial Bank of Africa. CBA is in the process of acquiring NIC, alongside the smaller microfinance oriented Jamii Bora bank. KCB, Kenya's largest bank by asset base, and Cooperative Bank, are quasi-public banks, while Diamond Trust Bank is associated with the Aga Khan. The platform will offer micro and small enterprises an overdraft facility of up to KSh 50,000, and a loan of up to 12 months with a limit of KSh 200,000. The initiative targets five million sign-ups, and two million users in the first year. How it plans to do this is a frightening demonstration of the workings

of state capture in the Uhuru Kenyatta era.

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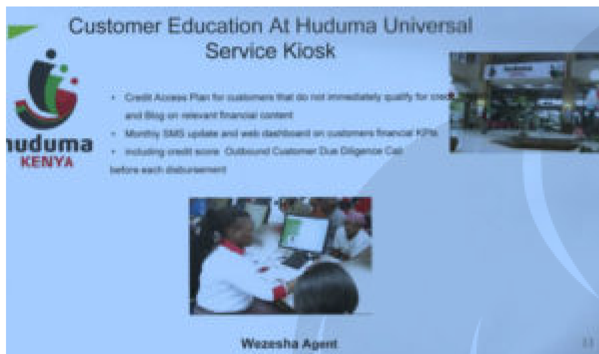
First observation: the contentious *Huduma Number* initiative features prominently in the scheme. The Huduma Number connection starts with an innocuous statement in a slide (the documentation is a powerpoint presentation) titled "How Customers will Qualify" that ends with a bullet point stating that "customers that don't immediately qualify can opt into a credit access plan (consumer education)." How so, is elaborated in another slide titled "Customer Education At Huduma Universal Service Kiosk" complete with the Huduma Kenya logo. Further along, in another slide titled "Functional Schema" a bullet point: "Distribution: An integrated network of GoK Huduma Centres, Bank Branches and agent locations to 'onboard' customers and offer information and advice to capital and business opportunities."



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But perhaps the question is already answered in another slide titled "Phase 2 Support for Scalability": New Huduma ID to be integrated once it is ready. This scheme could be used as a registration incentive."

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Also to be leveraged for scaling: "Moratorium from KRA Pin and Tax payment". This statement requires some thought. What would give a private business scheme the audacity to propose a tax compliance waiver as a tactic to attract customers?

But the crux, is this:

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Some background is necessary. The cost of bank credit is arrived at as follows:

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Cost of funds + Target income + Loan loss provision (NPLs)

Cost of funds is the interest the bank pays on deposits. Target income is the bank’s calculated profit margin that will translate into an acceptable return on investment. Loan loss provision is

the income that the bank sets aside to compensate for loans that are not repaid. Banks are required by the regulator to “provide” from their income equivalent to non-performing loans (NPLs).

Based on this costing, the Scheme’s promoters seem to have arrived at the conclusion that the initiative is not commercially viable. They appear to have determined this in the following way: The lending rate is set at nine percent arrived at by setting cost of funds, target income and a target loan loss provision at three percent each. Next, the Scheme factors in the Kenyan banking sector’s actual NPL rate, which was 11.6 percent at the close of 2018. They then calculate that at 9 percent the initiative would have run at loss of 5.6 percent (9 – 3-11.6 = -5.6).

This is how the case for a public credit guarantee scheme is made. In the computation provided, the public credit risk guarantee would cover the difference between banks’ target and the industry NPL. In the documents that we have seen, an example is provided in which the target NPL is set at three percent as above; the industry NPL at 10 percent and the actual NPL of the lending scheme is set at 12 percent. In this case, the public would pay seven percent (10% – 3%) and the banks would absorb five percent, the target income is projected at three percent, and the additional two percent that is over and above the industry NPL of 10 percent.

Let me illustrate. If for argument’s sake, the scheme lent out KSh 100 billion at nine percent, a 12 percent NPL reduces the performing portfolio to KSh 88 billion, which translates to an interest income of KSh 7.92 billion. A 12 percent loan loss provision (KSh 12 billion) changes that to an interest income loss of KSh 4 billion. But above three percent NPL the public credit insurance kicks in and injects KSh 7 billion, making a total revenue of KSh 14.92 billion (less KSh 12 billion loan loss provision) leaving a net revenue of Sh. 2.92 billion. This translates to a loss of KSh 0.8 million, given that the cost of funds is KSh 3 billion.

What are we missing?

This is a very strange way of pricing a product. The conventional way is to do one of two things: (a) cost the product and compare it with the market price; or (b) take the market price and work backwards to see whether you can beat the price. Sometimes, the product may cost more than the completion, then it becomes a question of whether it can be sold at a premium, like for example, an iPhone, or a Ferrari.

Either way, one arrives at a break-even interest rate of 17.6 percent by adding up the cost of funds (three percent), the targeted income (three percent) and industry NPL rate (11.6 percent).

The next question is whether they would get sufficient uptake of the product at say 18-20 percent. The answer is an unequivocal yes.

For mobile money loans, the money is not in the interest rate but in the transaction fees.

So, why would these banks price the loans to SMEs, the riskiest segment of the market, at 9 percent (about the same as Treasury Bill rate), which for all intents and purpose is the risk-free rate?

For mobile money loans, the money is not in the interest income charged on loans but in the

transaction fees. In fact, most products do not charge interest at all. The pricing structure varies widely. To get the actual cost of the loans, we need to calculate a standardized rate known as the Annual Percentage Rate (APR). The APR is obtained by adding up all the cost of the loan and converting them to the equivalent annual interest rate, for example a three month, KSh 10,000 loan with a 5% fee and interest of 2.5% per month costs 1250 (Sh. 500 fee plus Sh. 750 interest) which annualizes to KSh 5000 (Sh. 1250 x 4), which is an APR of 50%. KCB charges a 2.5 percent transaction fee and interest rate of 1.16 percent a month for loans ranging from one to six months which works out to APR of 19% to 44% for the six and one month loans respectively. In general, the shorter the term, the more expensive. CBA charges a 7.5 percent fee for a one-month *Mshwari* loan. This is an APR of 90 percent. The recently launched *Fuliza* overdraft tariff range from 5/- a day for amounts below KSh 500 to KSh 30 per day for amounts above KSh. 2500. A Sh.10,000 *Fuliza* overdraft at KSh 30 per day translates to an APR of 110 percent.

When fees are factored in, the case for public credit insurance collapses like a house of cards.

Let's go back to the monetary illustration. Assume the scheme achieves its borrowing target of two million customers. Our portfolio of KSh100 billion works out to an average individual loan of KSh. 20,000. Further, assume they churn the funds six times a year, that is, each of the customer borrows and repays a loan every two months on average. A five percent transaction fee translates to an income of KSh12 billion a year, and a total income of KSh19.92 billion — well above the 18 percent required for the scheme to meet its profit target.

> So what is going on here? First, *Wezesha* is simply a scheme to fleece the public. In today's financial lingo, the Scheme is fully "de-risked"…par for the course in "public-private partnership" (PPP) business, where the profits are privatized, but the losses are socialized (i.e. borne by the public). The second, is to see *Wezesha* as a strategy to finance undercutting the competition by pricing below cost at entry, with the intention of charging monopoly prices once the competition is driven out of business.

The nine percent interest is a bait. Its purpose is to make the case for the proposed government credit insurance scheme *by purporting to offer SMEs affordable credit*.

So what is going on here? There are two ways to look at it. First, *Wezesha* is simply a scheme to fleece the public. In today's financial lingo, the Scheme is fully "de-risked." This is par for the course in "public-private partnership" (PPP) ventures, where the profits are privatized, but the losses are socialized (i.e. borne by the public).

The second, is to see *Wezesha* as a strategy to finance undercutting the competition by pricing below cost at entry, with the intention of charging monopoly prices once the competition is driven out of business. In competition economics, we call this predatory pricing. It is illegal under competition law. In this case, the public insurance serves both as a financial cushion as well as insurance from regulatory scrutiny.

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As students of economics and finance know from the concept of information asymmetry, the most important asset in credit markets is information about customers' creditworthiness. On the strategy

for “scaling up” the documents refer to “integration to other financial institutions and service providers.” The intention is clear. First, use the government machinery and public money to drive customer acquisition. The CBA already controls consumer credit data on account of its Safaricom partnership. This Scheme is designed to make the CBA the gatekeeper for the entire banking and financial services to micro-and small enterprises, and I quote: “*CBA Digital* shall play a lead arranger role to develop and operate the credit risk management model for the full credit lifecycle.”

Even if there was an economic rationale for a credit insurance scheme of this kind, no government in its right mind would confer such a market advantage to some players. It is instructive that, in what looks like a case of the tail wagging the dog, KCB the crown jewel of public banks has been brought into the scheme. We should not be surprised if down the road, it turns out to be an acquisition target.

Uhuru Kenyatta’s sole accomplishment after extricating himself from the ICC may turn out to be framing the corruption issue exclusively as plunder of the budget, perhaps even deliberately giving his associates leeway in that theatre—recall *“mnataka nifanye nini”* (what do you want me to do)—as he provides cover for the Family to do the more serious boardroom stuff. Plunder of the budget ends once the thieves leave office. Wholesale enclosure of large chunks of the economy will keep the dynasty in the black long after he has left office.

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