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FINANCIAL INCLUSION – A CASE FOR KENYA[1]

1. INTRODUCTION

Kenya plays a significant role in the East African Economy where it accounts for 40% of the region's GDP and 30% of the region's population. Kenya is classified as a Low Income Country in which 30% of the population lives on less than $1.25 a day and 40% live on less than $2 a day. However, Kenya has been experiencing rapid growth and in 2010 its GDP growth was estimated at 5%. One of the most important sectors that largely account for the country's economic growth is the financial sector.

The Kenyan financial landscape comprises forty three (43) commercial banks; one (1) mortgage finance company; three (3) Representative Offices of Foreign Banks; two (2) Credit Reference Bureaus; six (6) Deposit Taking Microfinance Institutions; and one hundred and twenty four (124) Foreign Exchange Bureaus. The Branch network has grown significantly from 772 bank branches in 2008 to 1,102 bank branches in June 2011 (42.7% growth).The deposits in the banking sector have also risen from Ksh. 573.5b in 2006 to Ksh. 1,420b in June 2011. The number of adults with bank accounts rose from 14% of the population in 2006 to 22% in 2009.

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1 The following sources contributed to the compilation of this paper: 1. Deposit Protection Fund Board Statistical Reports; 2. FinAcess (Kenya) 2009 Survey Report; 3. Findings of a Case Study on Kenya's engagement with the financial sector standard setting bodies and the implications for financial inclusion (2011) by The Centre for Financial Regulation & Inclusion.

Kenya's Economic Development Plan was formulated in 2006 under the banner of Vision 2030. It sets out policy objectives and action plans that are geared towards transforming Kenya into a middle income level country by the year 2030. Vision 2030 pays specific attention to the development of the financial services sector and embodies a policy commitment to financial inclusion. The goal is to expand banking services to parts of the excluded population, i.e. the rural areas in order to act as a catalyst for greater pool of savings with which to finance productive investments. The Kenyan Government is committed to providing policy support for financial players acting in support of financial inclusion.

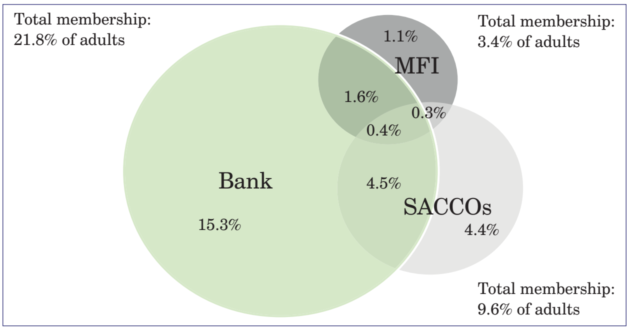
2. FINANCIAL INCLUSION INITIATIVES

The Kenyan Government passed a deliberate policy of promoting financial inclusion in order to reach the unbanked and promote savings to drive investments and economic growth. This policy also seeks to alleviate poverty among the Kenyan citizens. Key initiatives to drive this policy objective include the following:

- Deposit Taking Microfinance Institutions have been licensed by the Central Bank of Kenya and this has expanded the deposit base by reaching out to new segments of the market.
- Agency Banking: this model has allowed banks to spread their reach to more customers without having to invest in expensive "brick and mortar" branch-network.
- Savings and Credit Cooperative Societies ("SACCOs") sector has been streamlined through legislative framework.
- Credit Referencing has been introduced to improve the credit culture and promote credit expansion at affordable cost while ridding the banking sector of the incidence of bad debts.
- Innovations by non-bank telecom service providers have promoted and deepened financial access through mobile telephony and other electronic payment platforms. The M-PESA mobile model in Kenya has revolutionized money transfer in the financial and telecom sectors.
- Partnerships in Global Financial Inclusion forums to keep with the current trends and standards.
- Kenya seeks to broaden and deepen its financial sector and reach a large population financially excluded from formal financial system.

Research has shown that Kenya has significantly expanded the reach to financial services. According to the FinAccess Survey of 2006 and 2009 formal financial inclusion increased from 26.4% in 2006 to 40% in 2009; the number of financially excluded population decreased from 38.4% in 2006 to 32.7% in 2009; and in urban areas, financial exclusion was cut by half from 42.9% in 2006 to 20.9% in 2009. The research also revealed that Banks, MFIs and SACCOs serve about 27% of adult population (banks serve 25%; SACCOs 9.6%; MFIs 3.4%) and many of the customers are served by more than one type of institution. The chart below illustrates the composition of the customer base for the three types of financial institutions.

Chart 1. Comparative client bases of Banks, MFIs and SACCOs (percentage of adults 16 years and older)



Source: FinAccess, 2009.

3. OVERVIEW OF FINANCIAL INCLUSION IN KENYA

3.1. A fast-changing financial sector landscape

There has been a rapid expansion of bank branches within Kenya and across the neighbouring countries that form the East African Community. The country has further witnessed the licensing of new banks and deposit-taking MFIs. There has also been a proliferation of new innovative business models that have revolutionized the banking system, e.g. agency banking and mobile-phone money transfers. The increased complexity in the financial industry brought about by innovations such as the convergence of financial services with the telecommunications industry has complicated the industry and presented new risk profiles from a deposit insurance perspective.

3.2. Transformational impact of innovation in mobile payments

The largest mobile telecommunication company in Kenya, Safaricom, launched a mobile payment system known as "M-PESA" in March 2007. Thereafter, other service providers launched similar services, i.e., Airtel Money, Yu Cash, Orange Money & Tangaza. The initial focus of M-PESA was geographic money transfers and electronic payment of bills. However, the service has since been expanded to include linkage with partner banks to provide a range of banking services through the M-PESA platform, e.g. depositing cash into one's bank account by transacting through the telephone handset. By August 2011, 18.5 million users of mobile payment systems across the four networks were being served by 52,689 agents. These users accounted for a monthly average of 39.3 million transactions with a value of Kshs.107.3 billion. M-PESA remains the dominant service and it controls over 90% of this market segment.

3.3. New generation of banks and micro-finance deposit-taking institutions leading the way

A number of commercial banks in Kenya have specifically focused on the Microfinance arena and thereby succeeded in extending financial services to the previously un-served population. A good example of this is Equity Bank, which was registered in 1984 as a Building Society and then transitioned to a Commercial Bank in 2004. Since then, Equity Bank has registered phenomenal growth and by June 2011, it held 5.8m accounts, representing 40.7% of total accounts in the banking sector. Equity Bank has partnered with Safaricom to link with M-PESA electronic money transfer platform to its banking platform through a service known as "M-KESHO". Other players in the industry that have a focus on the mass market include Kenya Commercial Bank; Co-operative Bank of Kenya; Family Bank; and K-REP Bank.

3.4. The Microfinance Act, 2006

The Microfinance Act, 2006 became operational in May, 2008. The Act facilitates the transformation of credit-only Microfinance Institutions ("MFIs"), upon meeting set criteria, into Deposit-Taking MFIs ("DTMs"). After conversion, the DTMs now have the ability to access additional funds from customer deposits for on-lending. The DTMs fall within two major categories, *viz*, (1) National outreach, or (2) Community based. The Central Bank of Kenya has, since 2009, licensed 6 DTMs, which had a deposit base of Ksh.9.6 billion as at June 2011. The MFIs that are deposit taking are also subjected to the insurance cover under the deposit protection scheme.

3.5. Participation in the global financial inclusion initiatives

The Central Bank of Kenya ("CBK") is a founding member of the Alliance for Financial Inclusion ("AFI"), formed in 2009. AFI is a global network of policy makers from eighty one (81) developing countries in Asia, Latin America and Africa. AFI seeks to promote sharing of cutting edge financial inclusion policies. Kenya's Financial Inclusion initiatives have benefited from experiences gained within the AFI network. For instance, the Agency banking model was informed by experiences of AFI members in Brazil and Colombia. Through AFI, CBK was nominated as a non G20 partner of the Global Partnership for Financial Inclusion ("GPFI") in 2010. Through GPFI, a case study on Kenya's experiences with Standard Setting Bodies ("SSB's") including IADI was released in October 2011. The case studies on Kenya and four other countries have been shared with SSB's in order to review standards and inform development.

3.6. Strengthening Kenya's financial inclusion initiatives

Kenya is promoting an evidence based financial inclusion policy and in this regard, an updated National Financial Access Survey is targeted for release in 2012. The country also aims at enhancing consumer empowerment by development of national financial education strategy undertaken through public-private partnership. There is a move to strengthen disclosures/transparency of charges and lending rates within the banking sector. Another policy objective is directed at providing proportionate regulation to support development of the widespread financial service delivery channels/touch points across the country. Finally, deposit protection/safety net mechanisms are being strengthened.

4. PRACTICAL ISSUES/CHALLENGES

4.1. Challenges with safety net players and other standard setting bodies (IADI, BCBS & CPSS)

The regional expansion by Kenyan banks within the East African countries is posing cross-border risks that need to be addressed. As the financial services broaden, there is need for increased consumer protection and financial education with an emphasis on provision of sound financial products. The newly introduced agency banking has created a new set of players who bring with them a new risk profile. Along with this, comes the challenge of defining who a "bank customer" is.

4.2. New innovative payment models have changed overall risk landscape for banking

Mobile payment systems operate float accounts that are held in trust by Kenyan banks. With the growth of mobile payment systems, the deposits held in these float accounts are subjected to further uncertainty. The mobile payment systems are currently outside the direct oversight of the banking regulator (CBK) yet market confidence partially depends on the regulator's ability to protect the soundness of the financial system.

4.3. What constitutes banking business requires rethinking of BCBS Principle 2 on Permissible Activities

Recent innovations in the mobile payments systems will necessitate rethinking the BCBS Principle 2 on Permissible Activities. There are systemic links between banks, mobile network operators and payment systems in the overall banking landscape. The nexus of these players creates a need for interaction between the respective regulators and the respective standard-setting bodies. BCBS and CPSS should establish a demarcation on what constitutes "banking business and deposit-taking" and how mobile payment systems fits within the greater risk framework. Mobile payment systems may not constitute banking business as funds collected are not inter-mediated by the mobile payment service provider. The deposits held in Kenyan banks as float accounts imply some level of responsibility for the banking regulator.

4.4. CPSS Principles yet to find way into legislation

In 1998, Kenya began a modernisation programme for its national payment system. In this regard, the Nairobi Clearing House was automated in 1998. The Kenya Electronic Payments System ("KEPPS"), a Real Time Gross Settlement (RTGS) System was implemented in 2005. High Value Capping was introduced in 2009 and all payments from bank accounts in excess of Kshs.1 million must be made by Electronic Funds Transfer. A Cheque Truncation System (i.e. paperless clearing house) has been implemented starting in 2011.

4.5. The national payments systems bill, 2011

The Bill seeks to regulate and supervise payment systems and payment service providers, and for connected purposes. The Bill addresses payment instruments whether tangible or intangible that enables a person to obtain money, goods and services, or to otherwise make payment. The Bill defines a "Payment Service Provider" as anyone who acts as a provider in relation to sending, receiving, storing or processing of payments or the provision of other services in relation to payment services through any electronic system. This Bill, once enacted, will bring on board a legal framework according the central bank the oversight mandate, among others, and streamline innovations in the financial sector that are technologically driven.

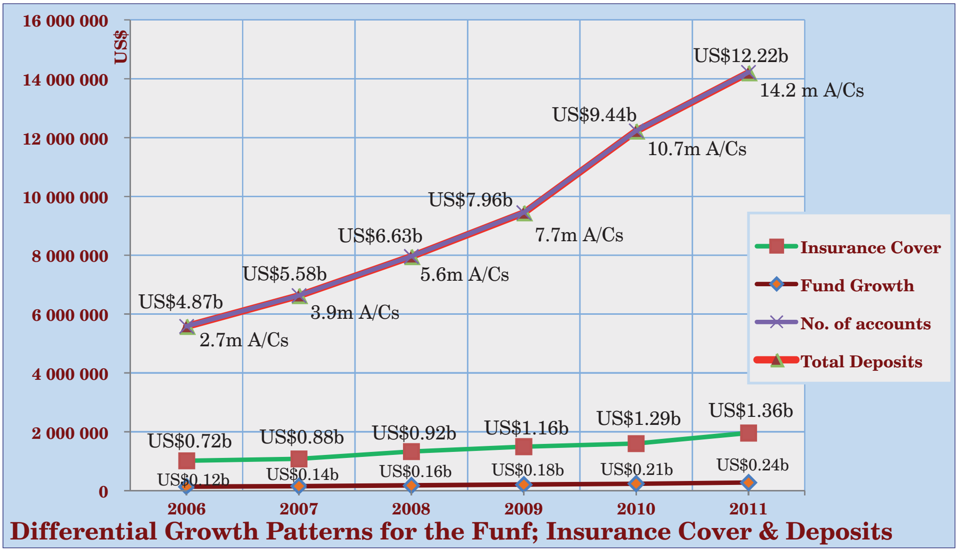
4.6. Financial inclusion and deposit insurance

It is difficult to keep pace with growth in deposits unleashed by the financial inclusion drive (See DPFB coverage statistics below). Are IADI guidelines on 20–40% coverage relevant for Kenya? DPFB needs to rethink how to expand current insurance coverage and what the ideal level of coverage should be. DPFB has the difficult task of balancing the need for fund growth against the desire to keep access to deposit services as inexpensive as possible in order to encourage financial inclusion.

Table 1. Protection & Exposure Indicators as at 30th June, 2011

	Banking Sector Deposits	30/06/2010	30/06/2011	%Change
1.	Total Deposits(Kshs. M)	1,222,160	1,420,457	16.20%
2.	Total Protected Deposits (Ksh.m.)	136,291	168,120	23.30%
3.	Protection Level (2/1)	11.15%	11.830%	0.68%
4.	Fund Balance (Ksh.m.)	24,101	28,124	16.70%
5.	Effective Cover (4/2)	17.68%	16.730%	(0.95%)
6.	Number of Deposit accounts ('000')	10,676	14,213	33.00%
7.	Number of accounts fully protected ('000')	10,057	13,365	32.80%
8.	Share of Protected accounts (7/6)	94.00%	94.000%	0.00%
9.	Exposure Level 2 – 4/2)	82.30%	83.300%	1.00%

Chart 2. Effect of Financial Inclusion on Deposit Insurance as at 30.06.2011



Source: Author's slide no 22 of the presentation at the Conference session.

- ❖ Number of fully insured accounts – 13,365,472 (94% of total accounts).
- ❖ Effective cover – 16.7% (against an international benchmark of 40%).

4.7. Risk landscape complicated by Kenyan banks regional expansion

The recent rapid expansion by Kenyan banks into Uganda, Tanzania, Rwanda and South Sudan has complicated the risk landscape. The major challenge is in how to assess the risk of financial difficulties in other jurisdictions and the potential impact on the domestic protection regime. Many of these neighbouring countries do not have deposit insurance and the question therefore arises on whether this large deposit insurance risks can be transferred to Kenya. Additionally, the exposure of Kenyan banks to risky business environments outside Kenya may impact their stability in Kenya, thereby putting local deposits at risk.

4.8. How should DPFB handle mobile payment models

The current model entails holding the float for M-PESA and other mobile payment systems accounts in Trust accounts in commercial banks. DPFB provides insurance cover for each depositor and the cover is not extended to individual agents who have each deposited their funds into the pooled trust accounts. This means that in case of failure by a bank holding such an account, the individual agents would not be in a position to lodge separate claims. DPFB acknowledges that some M-PESA clients use their mobile phone accounts for short-term savings and these do not enjoy deposit insurance protection in their favour. How then can deposit insurance be made more relevant for various mobile payment models and how should this be implemented? Deposit insurance coverage for funds in the mobile payment systems therefore, requires consideration by IADI members. There is also the need to harmonize with other non-bank financial institutions e.g. SACCOs; Insurance Companies; Capital Markets players; in a financial inclusion approach.