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**FINANCIAL INCLUSION, REGULATION AND STABILITY:
KENYAN EXPERIENCE AND PERSPECTIVE**

SESSION 3



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Financial Inclusion, Regulation and Stability: Kenyan Experience and Perspective



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1.0 Introduction

- Financial services play a catalytic role in the efficient allocation of productive resources thereby contributing to trade, investment and economic growth
 - Important to expand coverage, make financial services more affordable and secure, competitive and efficient - reduce transaction costs and protect customers' deposits and investment.
 - The sector is among the six key drivers of high growth identified in Kenya's Vision 2030; other sectors are: tourism, agriculture, manufacturing, wholesale and retail trade and business process outsourcing (BPO).
- Government aims at creating a vibrant and globally competitive financial sector promoting high-levels of savings and financing investment needs.
- Kenya also intends to become a regional financial services centre through:
 - Undertaking legal & institutional reforms to make the sector more competitive
 - Reforming banking sector to facilitate consolidation of small banks into larger and stronger ones;
 - Establishing credit a referencing mechanism;
 - Streamlining informal finance and savings and credit cooperative societies (SACCOs) & microfinance institutions (MFIs);
 - Deepening financial markets by raising institutional capital through pension funds, expanding bond and equity markets, and tapping international sources of capital

2.0 Financial Sector Regulation and Stability in Kenya

- ❑ Safeguarding financial system stability is an integral part of preserving monetary and macroeconomic stability in an economy. It is a legal mandate of the Central Bank of Kenya (CBK).
- ❑ CBK regulates and supervises commercial banks, mortgage finance companies, deposit taking MFIs, forex bureaus, credit reference bureaus, and the payments and settlement systems
- ❑ But, financial system stability is much wider than institutions regulated by CBK....
 - Hence the need for system-wide approach to financial stability to cover capital markets, non-bank financial institutions (NBFIs), non-financial institutions and financial infrastructure such as trading platforms, payments infrastructure and settlement systems.
 - Failure of a few major players or shocks to any of these components can easily spillover to the other components and spillover across the system, culminating into a systemic crisis.

2.0 Financial Sector Regulation and Stability in Kenya...

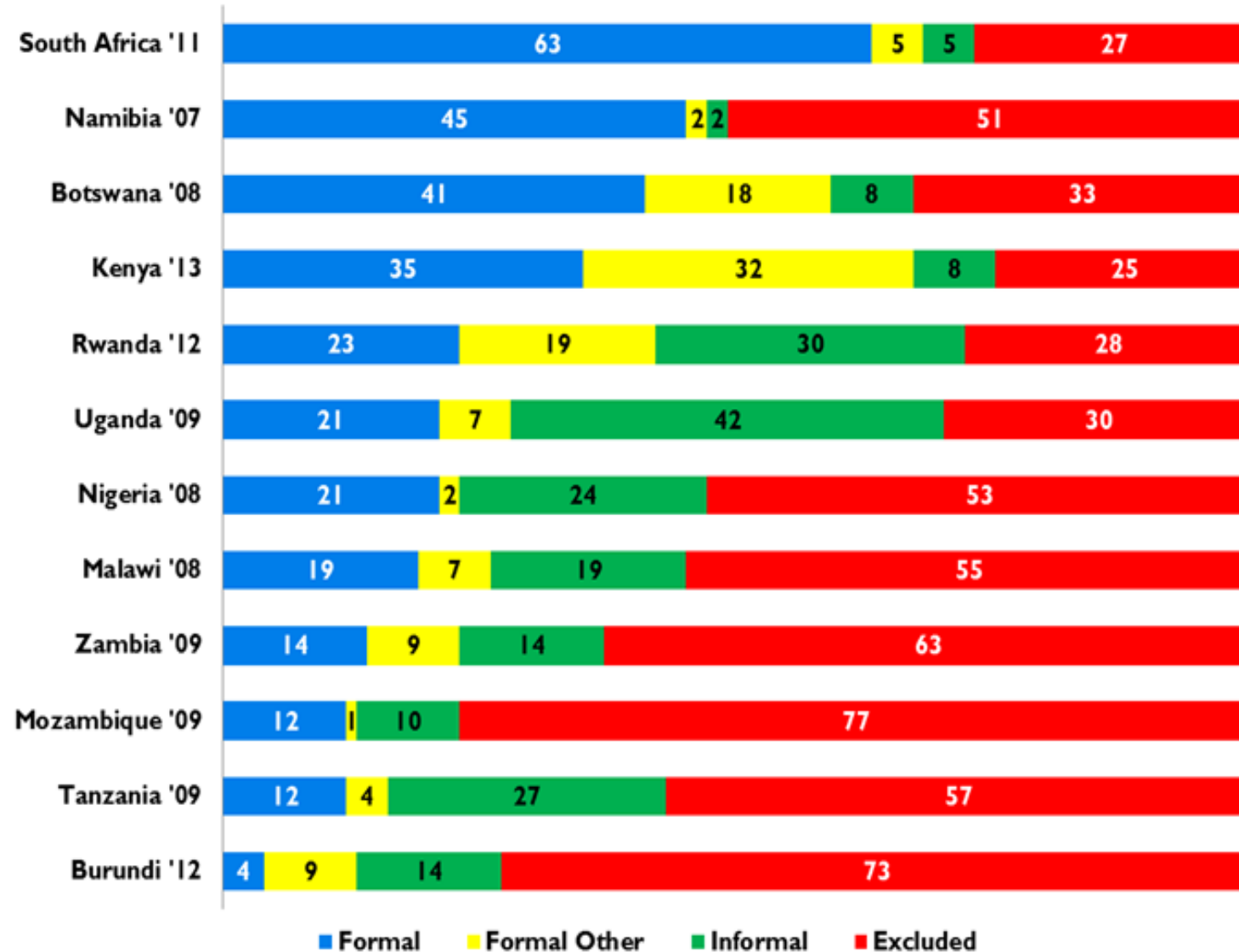
- Thus, a Financial Sector Regulators Forum was established in 2009 (under an MOU) to foster cooperation, share information and enhance policy coordination among financial regulators in Kenya comprising: CBK, capital market authority (CMA), Retirement Benefits Authority (RBA), Insurance Regulatory Authority (IRA) and Sacco Societies Regulatory Authority (SASRA) with the National Treasury as an observer
 - The Forum contributes to the effectiveness of financial regulation by providing a high-level forum for cooperation and offers a platform for generating informed public discussions on key aspects of financial sector stability in Kenya
 - The Forum prepares a Financial Sector Stability Report on bi-annual basis that:
 - provides the public and key stakeholders with an assessment and analysis of developments and performance of the economy and the financial sector in Kenya;
 - highlights major risks and vulnerabilities in the economy and the financial system; and
 - outlines policy actions taken to mitigate those risks and vulnerabilities by the regulators, government & other domestic and international agencies to achieve & sustain stability.
- Within the Central Bank, the Board of Directors established a Financial Stability and Investment Committee (FSIC) that plays an oversight role in financial stability.
- As part of its reforms, the Bank has recently created a Financial oversight Department to, among other things, coordinate financial sectors stability initiatives including conducting regular Finance access (FinAccess) surveys.

3.0 Promoting Financial Inclusion

- ❑ **Financial Inclusion** - broadly defined as a state in which all people who can use financial services have access to a full suite of quality financial services, provided at affordable prices, and in a convenient manner.
- ❑ Financial inclusion remains low in SSA countries: only 34.2% of adult population have an account at a formal financial institution compared to developed economies, e.g. US (93.6%) and Germany (98.7%) (World Bank, 2014).
- ❑ What explains low financial inclusion?
 - **Barriers To Entry: Supply side**
 - Costs; Access/distance to financial markets; lack of traditional collateral; stringent requirements for opening and maintaining accounts; high transaction costs and lack of appropriate products; improper risk assessment criteria and information asymmetry.
 - **Barriers To Entry: Demand side**
 - Low incomes and lack of permanent income flows or employment; low education and financial literacy levels and cultural, religious and social barriers.
 - **The risk factor**
 - Fear of losing savings with collapse of banks (Cash transactions gives them a feeling of being in control)
 - Presence of informal markets especially, in African economies

3.0 Promoting Financial Inclusion ...

Regional Comparison of Financial Access



Financial access in SSA is characterized by:

- Presence of segmented markets.
- Low access to formal financial services.
- Greater access to informal than formal financial services.
- Existence of a large unbanked population, without access to any form of financial service, formal or informal.
- Formal financial access is skewed towards males while informal financial services is skewed towards females.
- Exclusion levels are higher in rural than urban areas.

3.0 Promoting Financial Inclusion ...

□ Why promote financial inclusion and development:

- Monetary policy cannot work effectively when a large proportion of the population is excluded from the market.
- Financial inclusion for the poor will solve the poverty problem sustainably.
- Build strong institutions to support the markets and foster financial system stability.
- Build capacity for future growth through finance – Long-term and targeted finance.
- Financial inclusion is a public policy:
 - ✓ Poverty reduction sustainably - affordable financial services are important for raising incomes and improving lives through investment and capital accumulation.
 - ✓ Financial inclusion through appropriate financial innovations will allow market access and increase market participants - will lower unit costs.
 - ✓ Developing and deepening the financial markets - through financial sector development.
 - ✓ Monetary policy transmission – by improving efficiency of monetary policy.
- Important for facilitating international trade in goods and services

3.0 Promoting Financial Inclusion ...

Promoting financial inclusion through innovation

- ❑ Kenya has embraced financial innovation to enhance coverage and reduce transactions cost e.g. electronic money transfers
- ❑ Financial innovation increases the efficiency of the financial system:
 - Improves efficiency of the financial system and availability of funds for business activities - a positive effect on long-term economic growth.
 - Supports credit market development making it easier for banks to hedge credit risk, manage maturity and credit mismatches thereby enhancing financial system stability.
 - Facilitates monetary policy operations.
- ❑ Financial Innovations:
 - Impacts on Monetary Policy transmission mechanism or affects the information content of the indicators that central banks regularly monitor.
- ❑ Monetary policy frameworks must then develop to cope with the changing financial development agenda.

3.0 Promoting Financial Inclusion ...

Promoting financial inclusion through innovation ...

□ The scope of sustainable financial inclusion can be increased through targeted products for each market segment and development of appropriate delivery channels. These include:

➤ **Mobile Phone Financial Services**

- ✓ Leverage on information technology for cost effective financial services to increase the level of financial inclusion through use of mobile telephones. Prevalence of mobile telephones is recorded to be three times the number of bank account holders.
- ✓ Mobile phone financial services started as a product for money transfer- Now it is a platform for transfer, payments, savings and credit.

➤ **Microfinance Banks (MFBs)**

- ✓ Focus on rural and peri-urban areas where financial inclusion is lowest - closer reach to low income segments.

□ **Agent Banking**

- Turning non-bank outlets into financial services providers to enable third parties to offer limited financial services.

3.0 Promoting Financial Inclusion ...

Promoting financial inclusion through innovation ...

Innovative Financial Instruments – Support Infrastructure

❑ Credit Reference Bureaus

- Reducing cost of doing business - Build information capital, reduce information search costs and problems associated with information asymmetry; and extending credit based on financial identity. This allows change in the collateral technology in use. So far CBK has licensed 3 credit reference bureaus.

❑ Currency Centres

- Reducing cost of doing business - Cash-in-Transit costs for banks and their branch networks across regions.

❑ Consumer Protection

- The missing link in financial inclusion and innovation – encouraging transparent disclosure, fair treatment, dispute resolution and financial education/awareness and costs.

3.0 Promoting Financial Inclusion ...

Promoting financial inclusion through innovation ...

Integrating Payments and Banking Platforms

- ❑ Broad characteristics and growth of Mobile Phone Financial Services (case of Kenya):
 - The service (M-Pesa) started as a cash in/cash out money transfer payments service, with e-value backed by funds in bank accounts.
 - With time, mobile phone payment platforms have integrated with financial institutions to provide financial services including transfers, payments, savings and credit.

- ❑ Such interfaces enhance financial services accessibility to many clients and is cost efficient for financial institutions.
 - **Examples:** M-Kesho, Pesa-Pap, M-Shwari, KCB Mtaani, Faulu Popote, ATMs mobile phone link are some of the initiatives to integrate the mobile phone payment platform with the banking sector.

3.0 Promoting Financial Inclusion ...

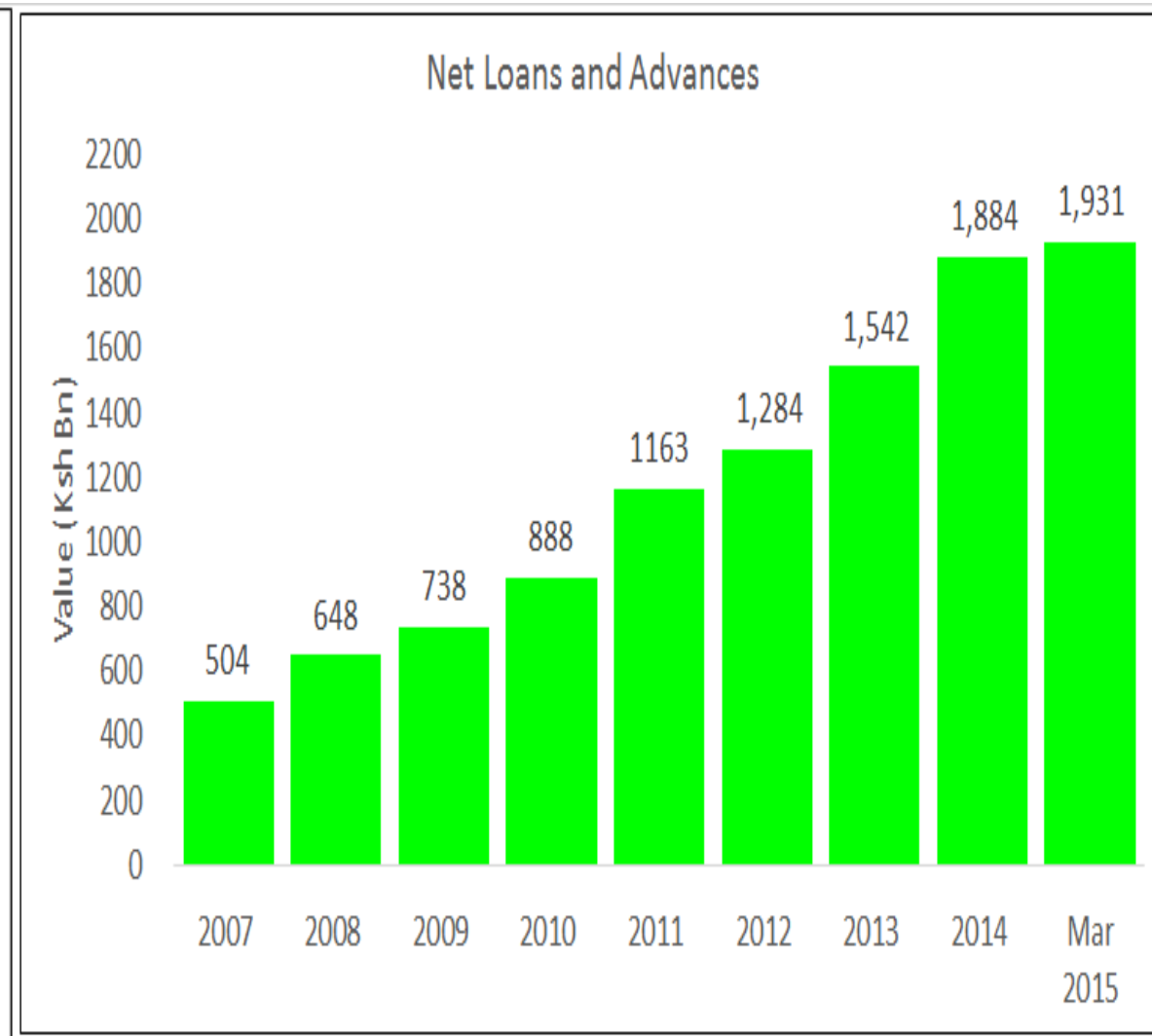
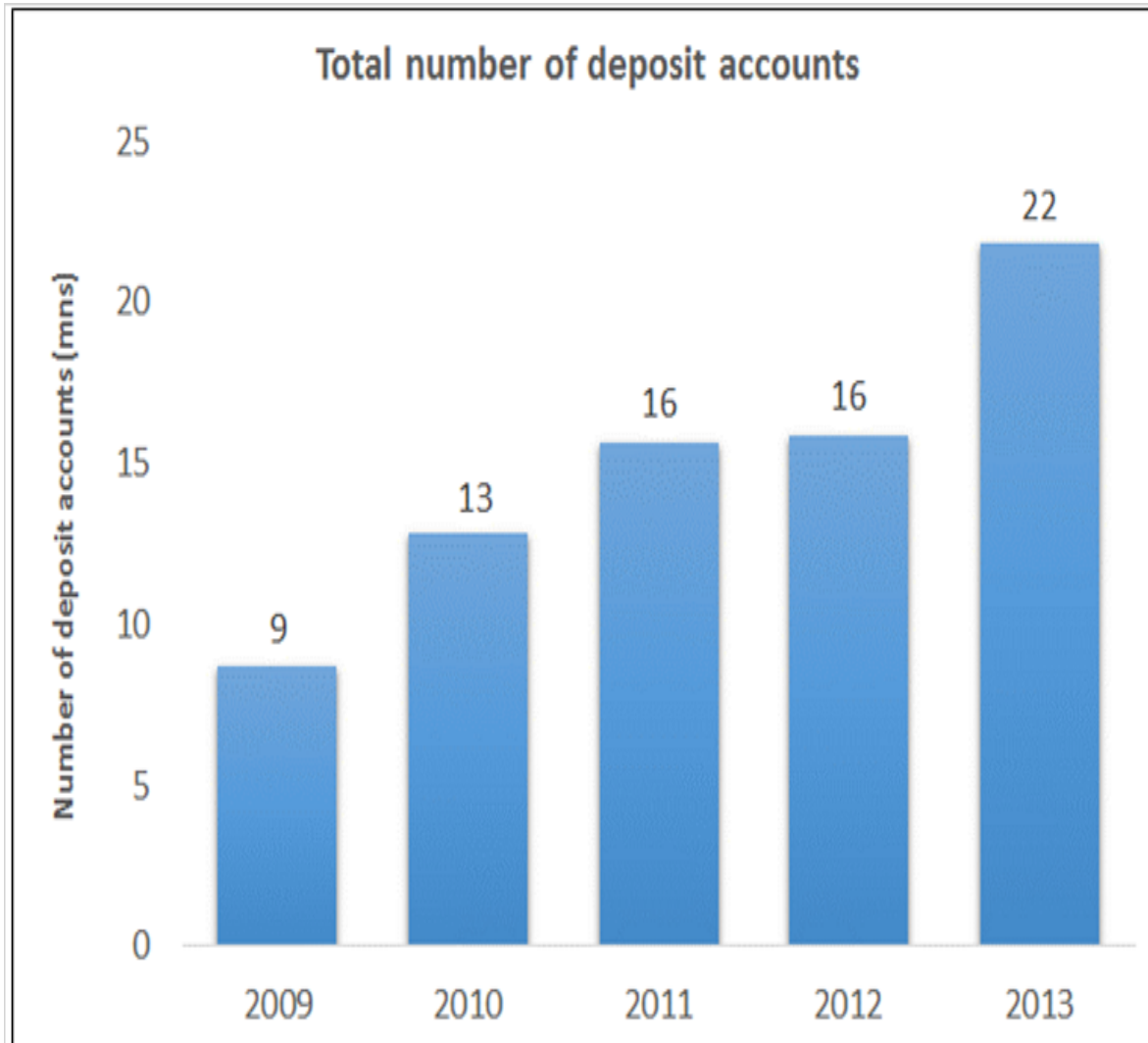
Promoting financial inclusion through innovation ...

Outcomes - ...*the number of institutions providing financial services to the lower income category has increased over time...*

- ❑ **Licensing of Microfinance Banks (MFBs):** By September 2014, Kenya had 9 deposit taking microfinance (DTM) institutions with 96 branches, 2.2 million deposit accounts valued at Ksh33.8 billion (USD388.5 million) and 0.4 million loan accounts with an outstanding loan portfolio of Ksh 37.6 billion (USD432.2 million).
- ❑ **Agent Banking:** 16 banks with 30,449 agents; 120.6 million transactions valued at Ksh 653.7 billion (USD7.5 billion) as at September 2014.
- ❑ **Credit Reference Bureaus:** 4.8 million reports requested by banks and 77,442 requested by customers as at September 2014 - solving information search costs.

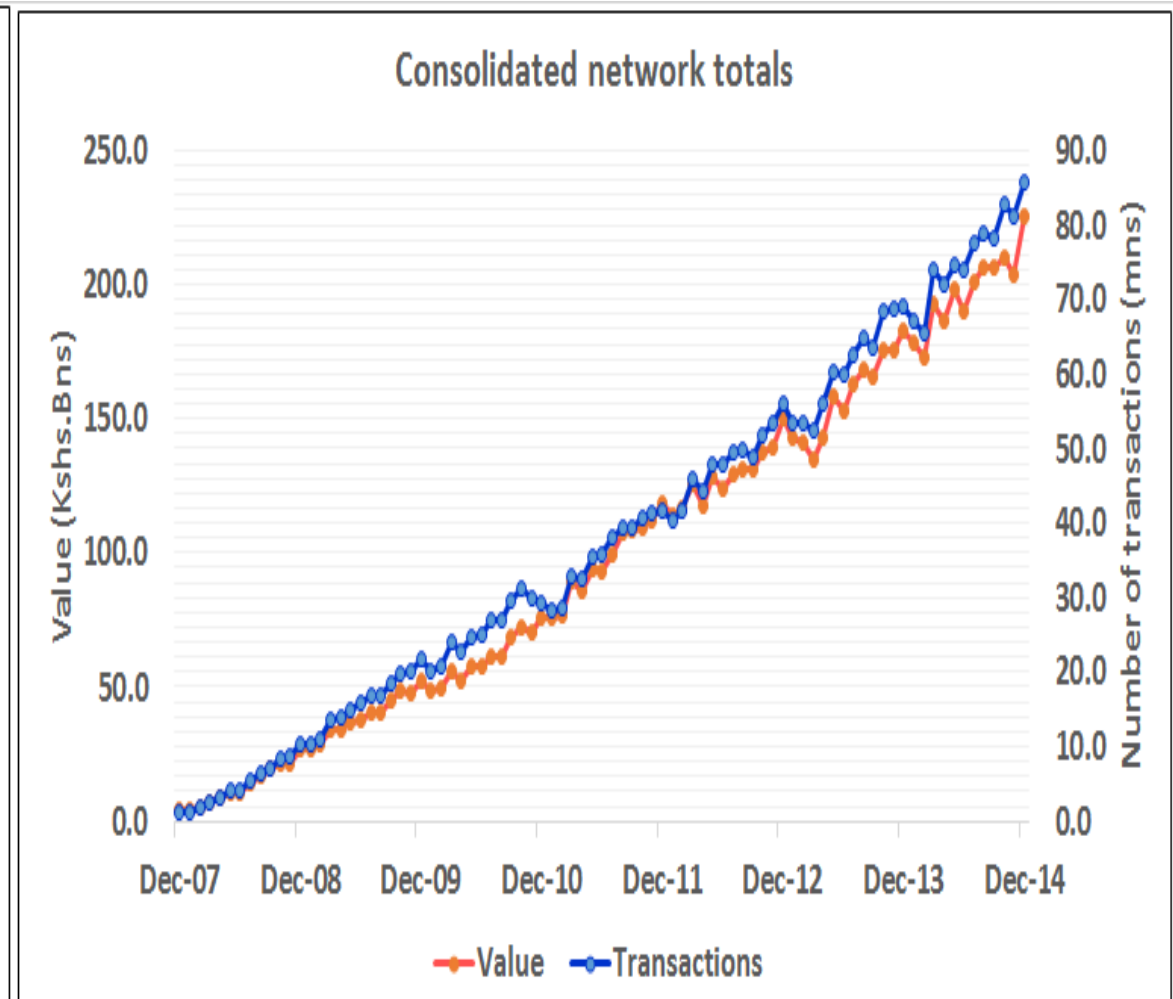
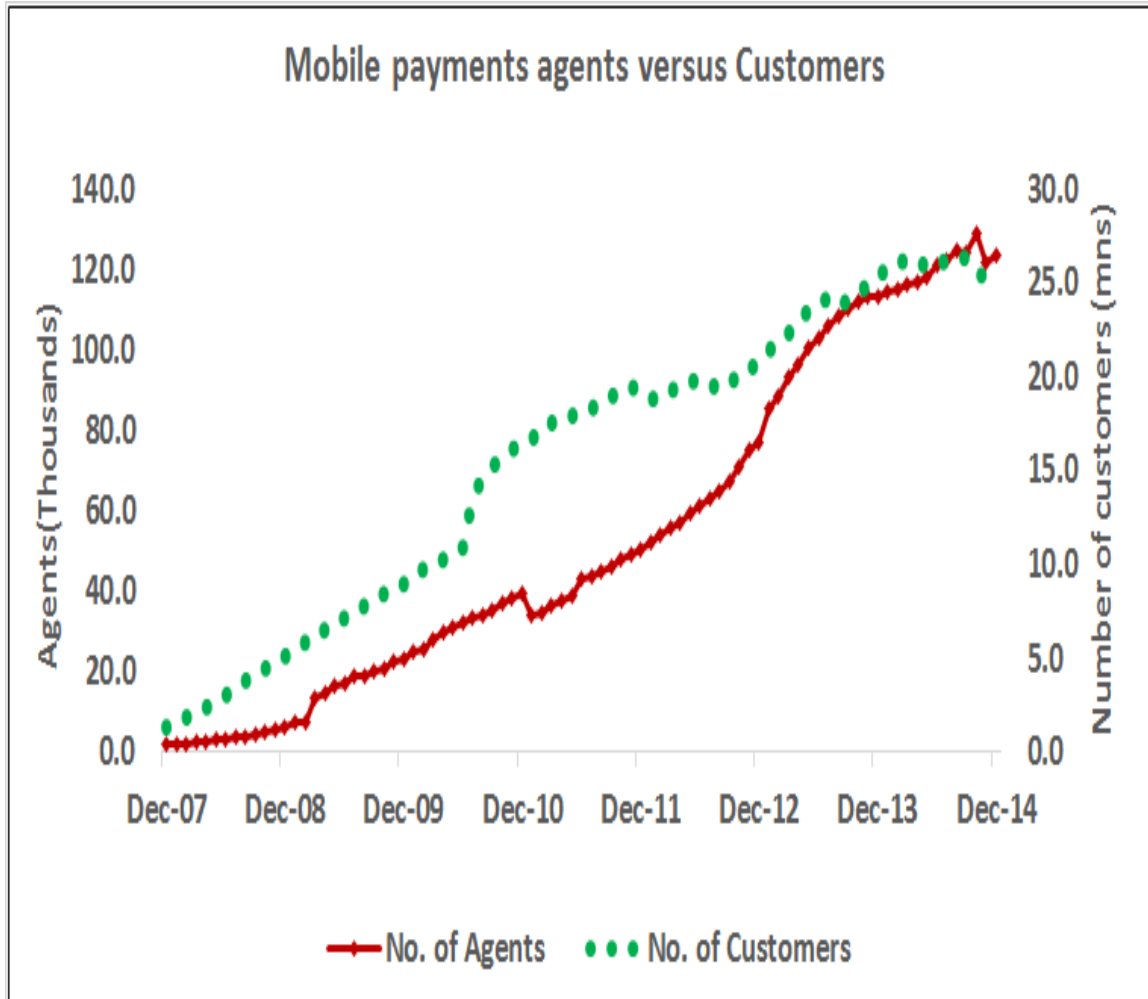
3.0 Promoting Financial Inclusion in Kenya ...

- Outcomes – the number of deposit accounts (million) and net loans and advances (Ksh billion) have increased ..



3.0 Promoting Financial Inclusion in Kenya ...

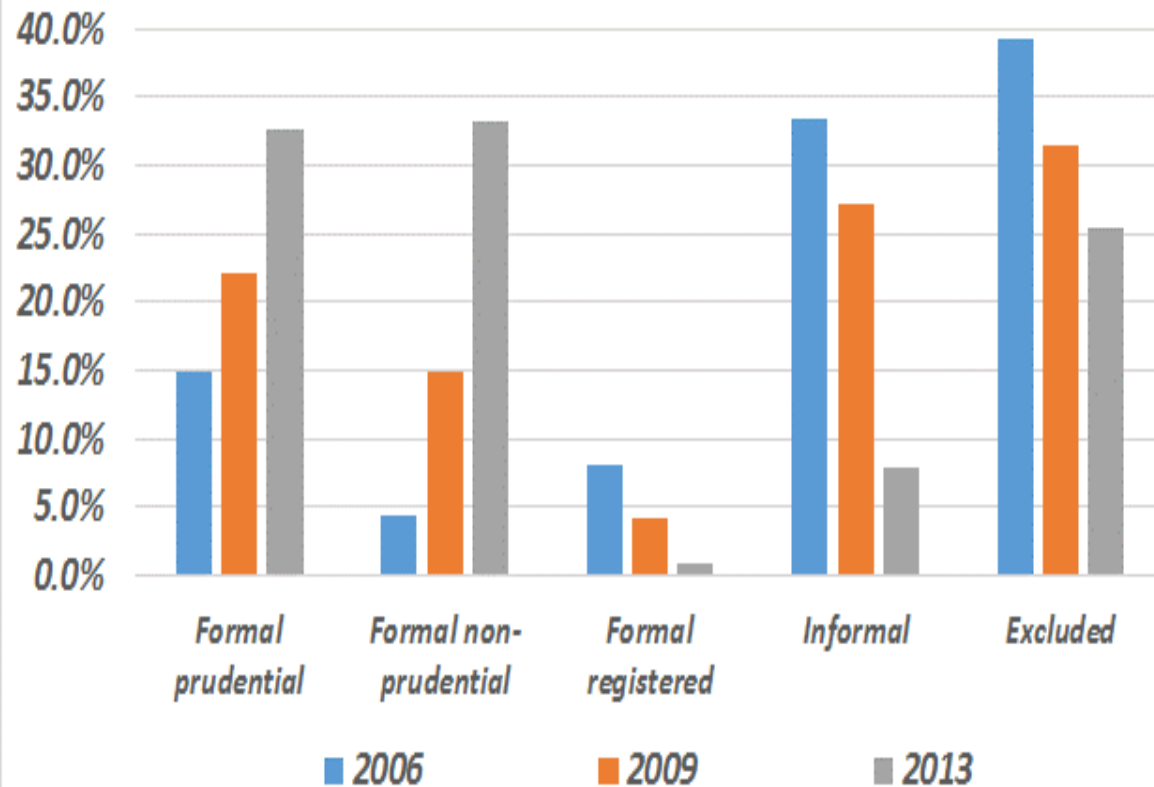
Outcomes – with introduction of mobile money transfers, number of transactions and value traded has increased over time ...



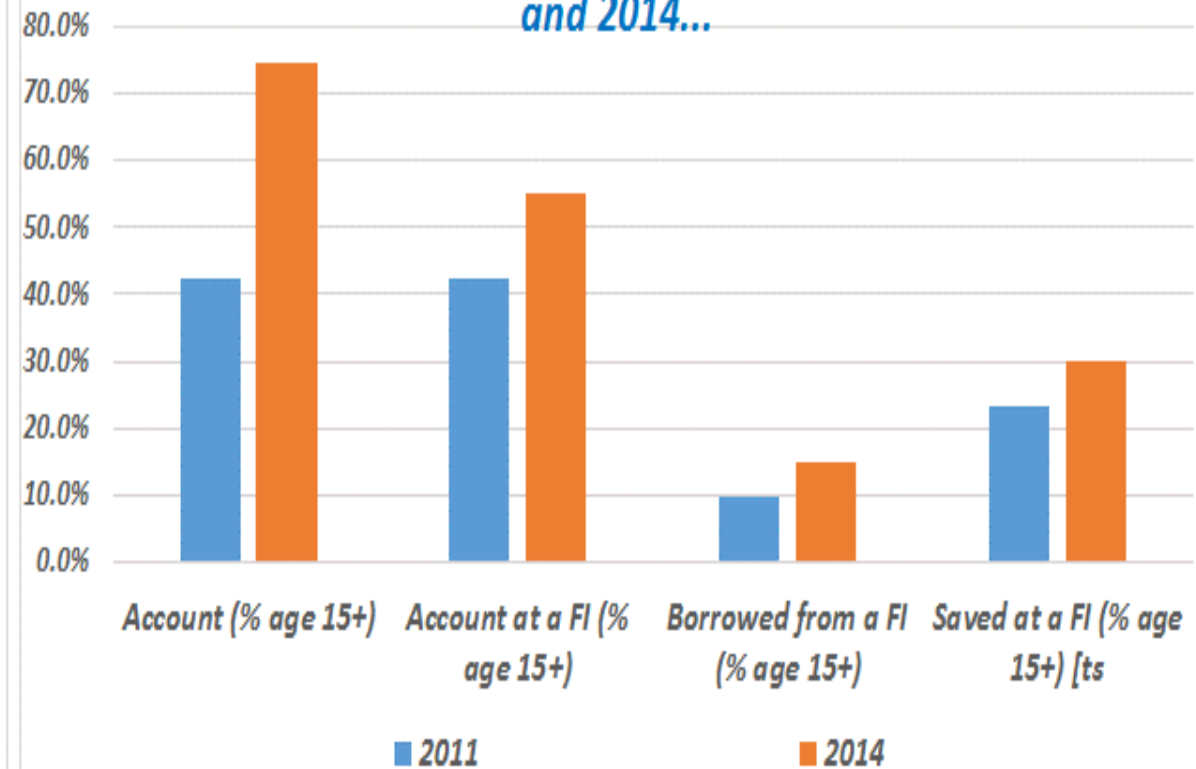
3.0 Promoting Financial Inclusion in Kenya...

Outcomes – with financial innovations, access to financial services has increased

Proportion of the population with access to formal financial services increased while those in the informal or exclude declined significantly...



The % of Kenyans aged 15 years and above the held an account, borrowed or saved at a financial institution (FI) increased significantly between 2011 and 2014...

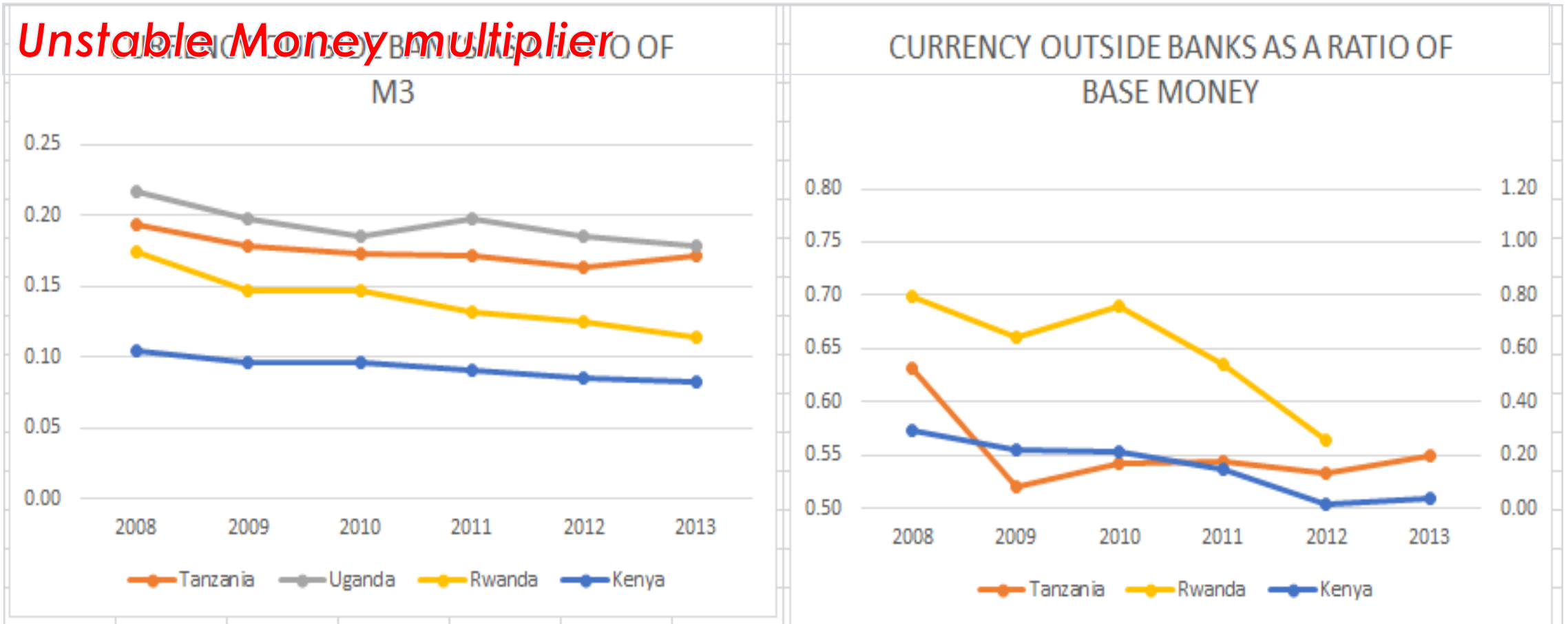


4.0 Implications for Monetary Policy: Declining Velocity of Money

- ❑ Velocity of money has been declining at a slower pace in Kenya since 2010 compared with previous years
- ❑ Unstable velocity of money implies unstable demand for money function over time which can inhibit effectiveness of monetary policy
- ❑ The fall in velocity of money implies less cash being used in the economy – hence money is mostly ‘inside money’ which can support improvement in the transmission mechanism of monetary policy.

4.0 Implications For Monetary Policy ...

Unstable Money multiplier



- ❑ A declining ratio of currency outside banks to M3 and RM has been observed in the region. However, the decline has been more pronounced in Kenya.
- ❑ Improved access to financial services has led to reduction in currency outside the banking sector.

5.0 Collaboration on Financial Sector Issues at the Regional Level

- ❑ At the East Africa Community (EAC), Common Market for Eastern and Southern Africa (COMESA) and SSA regional level, CBK actively participates in the policy formulation governing the regions and adheres to all reporting requirements for the set targets (convergence criteria).
- ❑ The main objective of these regional integration initiatives is to deepen and widen financial integration within and across countries as a way of promoting regional trade, investment, economic growth and poverty reduction.
- ❑ The integration process within EAC has four phases:
 - Customs Union
 - Common Market
 - Monetary Union; and
 - Political Federation
- ❑ Customs union was achieved in 2005, Common market protocol became effective in July 2010 while Monetary union protocol was signed in November 2013

5.0 Collaboration on Financial Sector Issues at the Regional Level ...

- Within the EAC, partner states (Burundi, Rwanda, Uganda, Kenya and Tanzania) have committed to develop and integrate their financial, payments and settlement systems.
 - EAC common market protocol- allows for free movement of factors of production including services and capital. The scope of EAC common market has three key provisions;
 - ✓ Deepening and widening integration process beyond customs union;
 - ✓ Free movement of factors of production including labour, capital and services;
 - ✓ Grant EAC citizens freedom of movement and right of establishment anywhere in the EAC area.
 - It also has two key principles:
 - ✓ Non-discrimination of any partner state on grounds of nationality
 - ✓ Equal treatment of EAC nationals
 - However, there are challenges:
 - ✓ Constrained movement of goods and services on account of non-tariff barriers e.g. road blocks and axle load requirements
 - ✓ Multiple membership by some partner states e.g. EAC, SADC
 - ✓ Non-uniform domestic taxes
 - ✓ Transfer of tourist by own national vehicles; Etc

5.0 Collaboration on Financial Sector Issues at the Regional Level ...

- Under the EAC Monetary Union Protocol Partner States have agreed to:
 - Adopt common principles and rules for regulation and supervision of the financial system
 - promote financial deepening and inclusion
 - Facilitate coordination and promotion of a speedy region-wide response to crisis within the financial system
 - Ensure that the system is resilient to both endogenous and exogenous shocks and structural changes
 - Facilitate effective assessment, pricing and management of risks
 - The EAMU protocol also provides for the establishment of the East African Financial Services Commission (EAFSC) responsible for financial services (other than banking) in the region. Other institutions proposed in the protocol include institutions responsible for surveillance, compliance and enforcement; statistics*

- Currently, there are ongoing initiatives to harmonise regulatory frameworks, rules and standards for the financial sector by various Committees of the EAC.

6.0 Lessons to take Away From Kenyan experience

- ❑ **Better regulation** is key in building strong institutions that define the rules of the game as well as appropriate incentives (penalties) to encourage prudent behavior in the market thereby ensuring financial system stability and integrity.
- ❑ Kenya has allowed financial innovation to take place. This has allowed the market and regulators to partner and achieve sustainable outcomes:
 - Generated appropriate products for the various market segments and kept the market vibrant
 - Resulted in increased financial inclusion, which:
 - ensures capital accumulation for the poor to escape poverty
 - encourages access, which increases the number of participants – reducing the unit cost of financial services hence more financial inclusion.
 - Increased financial deepening, which is expected to improve welfare, enhance efficiency as well as the evolution of monetary policy
- ❑ Financial institutions are increasingly embracing innovations, implying, **regulation** and **supervision** must continuously evolve to keep pace with innovations in the market place.
- ❑ Changes in financial sector landscape has implications for monetary policy formulation and implementation
 - Impacts monetary policy transmission mechanism and the information content of indicators regularly monitored by Central banks

7.0 Concluding Remarks

- ❑ Need to foster overall financial system stability, through effective policy coordination with other regulatory agencies in the country, regional and international bodies dealing with economic and financial sector issues.
 - Clear institutional arrangement coupled with building capacity for this function should therefore be a policy priority.
 - Policy frameworks to be backed by necessary legal instruments
 - Should also entail sharing of credible data, in a timely manner, to support decision making process.
- ❑ Financial sector developments and innovations have implications for monetary policy; developing countries must develop their monetary frameworks to cope with the changing financial landscape.
- ❑ Enhance macro-financial surveillance mechanism to detect and identify cross-border and cross-sector risks spillovers in order to arrest any potential threats.
 - This is very important given the rapid expansion of Kenya's financial institutions into Eastern Africa region and increasing interlinkages between the banking system and other sectors such as insurance, capital markets, and telecoms.
- ❑ Continued cooperation at the EAC regional level and SSA Regional level on initiatives advocating for financial stability.
- ❑ Although progress has been made at national and regional level, challenges associated with rapid financial innovation and slow implementation of agreed regional policies remain



THANK YOU