Enhancing Financial Inclusion through Technological Innovations

PROBLEM STATEMENT

Access to financial services is increasingly recognized as key to unlocking economic opportunity for the poor. Making financial systems work better is a widely shared goal among policymakers across the world.

Admittedly, bringing financial services to the poor and especially rural clients is the biggest challenge for broad-based financial inclusion. Poor infrastructure and telecommunications, and heavy branch regulation restrict geographic expansion of bank branch networks. In Kenya, there are fewer bank branches per rural resident than per urban resident. Non-bank financial institutions help fill this gap. Barriers associated with the cost of building physical infrastructure or the combination of low income and low population density leaves most rural areas incapable of supporting branch locations. M-PESA in Kenya has made great strides with retail agents, who cash-in and cash-out money transfers all over the country. Allowing banks to operate through agents, including partnerships with postal networks and retailers, reduces the fixed costs associated with geographic expansion and holds great promise for improving access to financial services, especially in poor and remote areas. But calibrating the regulation to safeguard both consumers and the banking system is tricky—trickier than regulating straightforward money transfers.
This memo highlights the broad objective of Kenya with respect to enhancing financial inclusion and identifies the potential role technological innovation coupled with appropriate policy frameworks could play.

BACKGROUND

Largely due to the rollout in 2007 of M-Pesa by Safaricom and subsequent initiatives by other mobile service providers (Airtel 2009, Essar 2009, Orange 2010, Mobipay 2010, MobiKash 2011), payments and banking borders in Kenya have been extended by roughly 40,000 agents. The next stage of development has been started with growing numbers of banks establishing links between banks and mobile payment providers. Against this background there is need to continuously review the emerging environment and determine the best policy options to sustain the momentum.

In Vision 2030, the Government of Kenya identifies the achievement of middle-income (MIC) status as a nation its principal goal.¹ In financial inclusion terms, MIC status today means that at least 60% of adults will then be banked.² Based on current population projections, a formal inclusion target of 60% would translate to an additional 21 million people entering the banking system between 2010 and 2030. This is a massive increase on today’s banked population. The increase in

¹ Government of the Republic of Kenya, 2007. Ministry of Planning and National development and National economic and social Council (NESC), Office of the President
² By banked we refer to financial services provision through a regulated financial institution (which could include banks, deposit-taking micro-financing institutions - DTMs and SACCOS).
incomes associated with the shift to MIC status will provide a ‘pull’ towards this level of inclusion assuming that Kenya’s financial system is no less efficient than levels seen in other MICs. However the exceptional progress Kenya has seen in recent years gives hope that technological innovations coupled with appropriate policies in the financial system could ‘push’ inclusion beyond the limits of the current frontier, simultaneously providing a stronger impetus to economic growth.

Central Bank of Kenya policy objectives with respect to retail electronic payment systems and instruments remain the same as for the payment system as a whole, namely to promote and oversee the development of safe, sound, and efficient payment, clearing, and settlement systems. CBK considers such systems to be part of the core infrastructure of the financial sector. With respect to retail, one additional objective is added: in the words of the CPSS General Guidance for National Payment System Development (2006), “more access for more people” (Guideline 11). This objective is entirely consistent with the wider objective of the Central Bank to promote financial inclusion in support of the Vision 2030.

Current initiatives by the Bank geared towards the above overall policy objective include the proposed National Payments System Bill, which seeks to strengthen the above mandate by expressly providing for the oversight of all payment systems including large value payments and retail payments, including payment cards and innovative mobile money transfer services among others. In line with the provisions of the Central Bank of Kenya Act, the Bank has drafted regulations for the supervision
of electronic retail transfers and e-money issuers. In developing these regulations, CBK has collaborated with many stakeholders including mobile phone companies.

**ANALYSIS**

According to David Porteous, achieving financial inclusion of 60% will require a steep decline in financial sector transaction costs.\(^3\) Cost penalties particularly relevant in Kenya (though also observed in other parts of the world) include the small size of the market at both national and local levels, which is partly attributable to low geographic density of population, and pronounced economic isolation (especially in rural areas). This factor is compounded by the deficiencies of transport and communications, as well as extremely low transaction sizes and the inappropriateness of some standard products to the needs of small clients.

CGAP has made similar observations indicating that a major obstacle to financial inclusion is cost. Relevant costs include not only the cost incurred by banks in servicing low-value accounts and extending banking infrastructure to underserved, low income areas, but also the cost incurred by poor customers (in terms of time and expense) in reaching bank branches.\(^4\)

Another issue is the difficulty of assessing credit worthiness and enforcing contracts. Low levels of perceived creditworthiness in Kenya relate to the poor quality and scarcity of information about individual

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\(^3\) David Porteous, Bankable frontiers (unpublished)
\(^4\) Michael Tarazi and Paul Breloff CGAP “Regulating Banking agents” No. 68 March 2011
risks as well as to a high incidence of shocks (weather, health, social disruption) exogenous to the agents and often systemic or at least covariant. A 'high road' scenario sees Kenya dramatically reducing its dependence on cash – a key source of cost – shifting to a “cash-lite” economy with electronic payments replacing all but the smallest value transactions. For this to occur, the Kenyan economy must get over the 'hump'—the point at which cash is no longer used as intensively since people are able to transact electronically, so that the demand for cash in and cash out transactions declines.  

But for this to happen, several prerequisites must be addressed. Formal financial services must reach well beyond urban markets where they are concentrated today. The delivery channels to support this outreach must be both ubiquitous and low cost and affordable. To reach the position where most people have and can use an electronic account requires that first, the ‘wheels of cash’ must be ‘greased:’ it must be made as easy and as cheap as possible to convert cash to electronic value, and vice versa. This means that there must be a wide range of locations at which customers can deposit and withdraw cash in exchange for electronic value: bank branches, ATMs, and retailers (banking agents and other types of cash handling outlets).

The volume of Kenyan bank branches and ATMs at present are in line with Kenya’s level of income per capita; the country already has more than 30,000 access points for M-PESA alone, and more than 40,000 total, and 43 cash handling agents per 100,000 people. On this basis,

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5 This ‘over the hump’ scenario is the subject of the ‘MPayZ’ scenario in the CGAP/DFID Branchless Banking 2020 Focus Note (2009).
Kenya already has proportionately more cash handling agents than Brazil does.\textsuperscript{6} These cash handling agents are therefore already the most widespread channel for financial services in Kenya today. Until the “cash-lite” scenario is realized, financial providers need every incentive to acquire cash handling agents, agents need incentives to handle cash, and customers must have good reasons to use their local agents.

The success of these retail payment products has positively impacted both sides of demand and supply for retail payment services leading to a surge in the number of applicants seeking authority to rollout such value added payment products. Indeed, the mobile-based money transfer services have greatly enhanced access to financial services, which is one of the key objectives of the Government towards meeting its vision 2030 objectives.

Although the banks may have the resources to meet the overhead costs of setting up new systems that can help reach rural households and meet the financial service needs of small farmers, they have to work hard to make sure that the unit costs of operating these systems are sufficiently low. The use of technology by banks in Kenya as in other countries incorporates developments in hardware, software, and, to an ever-increasing extent, the internet.

At the same time, the Government can assist banks and other private financial intermediaries in this regard through efforts to build and repair various hard and soft infrastructures that are essential to the

\textsuperscript{6} Brazil has 160,000 agents, or 83 per 100,000 of population; but of these, only a quarter are actually handling cash
success of efforts to expand financial inclusion.\(^7\) Many of the products
conventionally offered by banks and even by MFIs in Africa are ill-
adapted to poor customers’ needs. By moving beyond what is generally
established, modern technology offers some possibilities for
leapfrogging some of the obstacles placed by slow-adjusting
infrastructures and other African environmental challenges (Ivaturi
2006). It is the responsibility of the Government to: establish
infrastructure including fibre optics, roads, railway, and electricity; to
facilitate investments within the communications and telecommunications sector; and provide other basic services.

Innovations by both banks and telecoms whose major cost relates to
their initial development and other fixed costs, with very low marginal
costs per transaction or per new customer engaged, offer important
prospects for expanding access to financial services at the bottom of the
pyramid. Achieving financial inclusion therefore requires innovative
models that dramatically reduce costs for everyone and thus pave the
way to profitable extension of financial services to the world’s poor.

**POLICY OPTIONS**

In Kenya as in other countries, the continued push for financial inclusion
must rest on three key pillars:

- The safety of any funds held in trust for people and the soundness of
  the institutions offering them;

- The availability of service, close to where poor people live; and

\(^7\) Patrick Honohan and Thorsten Beck- Making Finance Work for Africa. Pg 18
• The relevance, range, and quality of the financial services available to all segments of the population.

In order for the financial sector to contribute effectively to growth and stability, complex issues dealing with the functioning of mainstream financial systems as mobilizers of funds, providers of risk mitigation management services, and financers of medium – large scale enterprises and government, must be addressed. While we have identified technological innovations as an important source of innovation, we hasten to underscore the fact that such initiatives do not operate in a vacuum. Rather, there are complex legal and institutional frameworks that must also be in place.

Based on the relatively successful uptake of mobile-based payment services, one policy option for Kenya would be to be content and carry on with the existing legal, regulatory, and institutional framework.

The second option is for the country to consolidate the current gains due to early adoption of technological solutions, appreciate the limitations of current solutions, identify lessons learned, and commit adequate resources to conduct research and formulate and implement policy and institutional reforms geared towards sustainable financial inclusion.

RECOMMENDATION

In recommending the second option, there are emerging challenges that Kenya and other countries will have to address if the full potential of mobile and technology-based solutions will be sustainable. Key amongst
these is the legal and regulatory framework to provide for, among other things, the role of the private sector-banks and TELCOs, government and regulatory institutions, and competitive dynamics, especially within the telecom and banking sectors.