

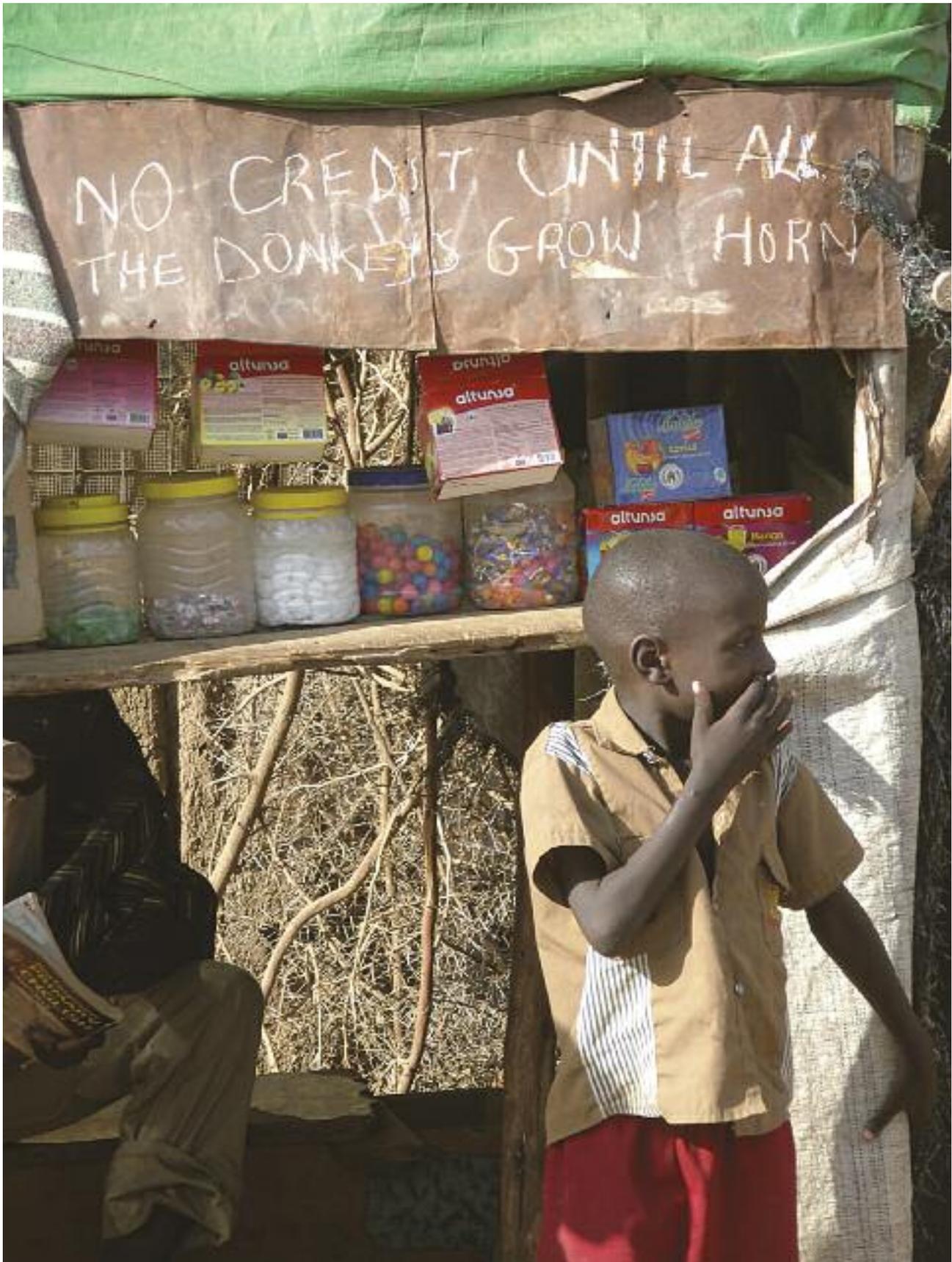


ANNUAL REPORT

2007



FSD Kenya
Financial Sector Deepening



Many Kenyans experience constraints in accessing finance. FSD's Mission is to support the development of inclusive financial markets in Kenya as a means to stimulate wealth creation and reduce poverty.

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Acronyms

ABIC	Area-Based Institutional Capacity	ICT	Information and Communication Technology
AMFI	Association of Microfinance Institutions	KCB	Kenya Commercial Bank
ARP	Action Research Partners	KDA	K-REP Development Agency
ASAL	Arid and semi-arid Lands	KES	Kenya shilling
ASCA	Accumulating Savings and Credit Association	KFS	K-REP Fedha Services Ltd.
ATM	Automatic Teller Machine	KPOSB	Kenya Post Office Savings Bank
CBFO	Community Based Financial Organisations	KRA	Kenya Revenue Authority
CBK	Central Bank of Kenya	KWFT	Kenya Women's Finance Trust
CGAP	Consultative Group to Assist the Poor	MFI	Micro-finance Institution
DFI	Development Finance Institution	MFMI	Micro-finance Management Institute
DFID	Department for International Development	MoCDM	Ministry of Co-operatives Development and Marketing
DFS	Decentralised Financial Services project	MSME	Micro, Small and Medium Enterprises
EAGC	Eastern Africa Grain Council	NBK	National Bank of Kenya
FLSTAP	Financial and Legal Sector Technical Assistance Project	NGO	Non-Government Organisation
FSA	Financial Services Association	PIC	Programme Investment Committee
FSD	Financial Sector Deepening Kenya	POS	Point of sale/service
GDP	Gross Domestic Product	ROSCA	Rotating Savings and Credit Associations
GOK	Government of Kenya	SACCO	Savings and Credit Co-operative
GSL	Group Savings and Loans	SME	Small and Medium sized Enterprises
G2P	Government to Person	UN	United Nations
HSNP	Hunger Safety Net Programme	VCD	Video Compact Disc
IFC	International Finance Corporation	WOCCU	World Council of Credit Unions
ILRI	International Livestock Research Institute	WRS	Warehouse Receipts System

DIRECTOR'S NOTE

This report is the first of what intend to become an annual, concise but comprehensive overview of FSD's work. Our objectives are two-fold. First, we want to help build a better understanding of the development of financial markets in Kenya and FSD's role in expanding access. Second, FSD and its funders are committed to being fully accountable to stakeholders. In order to meet that commitment we need to present the result of our work in a clear and accessible way. We would very much welcome feedback on how we can improve this report to better achieve these two objectives.

All FSD's work is founded on supporting the development of sustainable financial markets. The first section of this report provides a brief overview of this approach, which is often referred to as making financial markets work for the poor. The last four years has seen remarkable changes in the financial sector in Kenya. In the second section we offer our perspective on recent developments in Kenya's financial markets and the impact on financial inclusion. Following these two introductory sections, the report on our activities is organized according to our five focal theme areas: (i) building core capacity, (ii) pushing the access frontier, (iii) agricultural finance, (iv) expanding finance for growth and (v) deepening the payment system.

Since FSD's inception building the capability of the core formal financial system to support greater financial inclusion has been a priority. It provides the foundation on which much other work will build in future. Again in 2007 this first theme area saw the greatest level of activity. However we anticipate that over time this will gradually be supplanted by our more targeted work. This is covered in the next three theme areas whose aims are, respectively, to reach more remote rural areas, expand finance for smallholders and address the growth businesses in the small and medium enterprise (SME) segment. Levels of activity have increased markedly in each of these areas over 2007. Our final theme area has been focused on the development of the payment solution system. FSD's involvement arose from the needs of the government and donors from a payment solution to permit the implementation of new social protection programmes. However, the importance of the payments infrastructure in expanding access goes far beyond these programmes.

All our work is based on partnerships. Over 2007 we worked with a range of partners from the private sector, civil society, government and development agencies. The table below lists just those with whom we directly worked. It omits many with whom we interacted indirectly in various ways. The length of even this abbreviated list serves to emphasize the vital importance of collaboration to FSD's work. While we work with partners in a wide variety of ways the common theme is a shared commitment to the goal of financial inclusion in Kenya. We would like to take this opportunity to thank all our partners for their support and efforts over the year and look forward to deepening this work in the future.

David Ferrand
Director

FSD's direct partners in 2007

Government/regulators	Financial service providers	Non-profits/industry associations	Consultants	Development partners
Central Bank of Kenya	ABC Bank Ltd.	AMFI	Bankable Frontier	AFD
Kenya Revenue Authority	Care International	East African Credit Bureau Association	DAI	CGAP
Ministry of Co-operatives Development and Marketing	FINA Bank Ltd.	Eastern Africa Grain Council	ECI Africa	DFID
Ministry of Finance	Equity Bank	Decentralised Financial Systems	GFA Consulting	FSD Tanzania
Ministry of Home Affairs	Jitegemee Trust Ltd.	Kenya Gatsby Charitable Trust	Genesis Analytics	FinMark Trust
Ministry of Trade and Industry	Kenya Post Office Savings Bank Ltd.	Kenya Institute of Supplies	Ideal Business Line Ltd.	Financial and Legal Sector Technical Assistance Project (FLSTAP)
	Kenya Women Finance Trust Ltd.	Leasing Association of Kenya	Investeq	IFC
	K-Rep Fedha Services	Microfinance Opportunities	JM Mantle Consulting	SIDA
	Faulu Kenya Ltd.	MicroSave	Microfinance House	World Bank
		World Council of Credit Unions (WOCCU)	Oxford Policy Management	
			Pipal Ltd.	
			Research International	
			Shore Bank Consulting	
			Steadman Group	
			Strategic Business Advisers	
			Walker Kontos	

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FSD'S APPROACH: BUILDING MARKETS

The importance of the financial system to economic development is well understood and Kenya's long-term plan for national transformation, Vision 2030, identifies it as one of six priority sectors under the economic pillar. Although Kenya's financial sector is the most developed in the region, it is far from achieving its full potential. Notably, despite the marked expansion of the retail industry in the recent past, the financial sector in Kenya has only met a modest fraction of the growing demand from poorer households and small and medium enterprises.

Credit plays a vital role in supporting growth among businesses of all sizes, from large to small, and across all sectors from agriculture to services. Smaller enterprises are particularly important for poverty reduction, given the direct impact of such businesses – especially in the agricultural sector – on the livelihoods of poorer people. However, the importance of financial services goes beyond credit. Secure savings rank among the most needed financial services by poorer households, allowing them to reduce their vulnerability to fluctuations in cash flow, cope with emergencies and accumulate funds for investments in the household or productive opportunities. A broad range of financial services can make a difference for the poor, encompassing credit, savings, investment, money transfers and insurance.

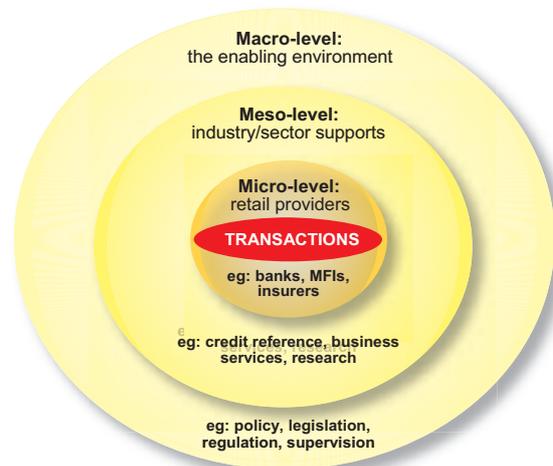
FSD takes a market-based approach to financial sector development. Evidence from a diverse range of institutions in Kenya and globally shows that financial services can be provided profitably to low-income markets and smaller enterprises. The essential challenge in developing pro-poor finance is in opening up these markets.

Opportunities and constraints to market development may exist at a number of levels.

- At the macro level, government policy, legislation, regulation and supervision set the basic framework within which markets operate. An effective and enabling environment reduces the costs and risks of doing business, and so helps to make financial services accessible for lower-income clients.
- At the other end of the spectrum, at the micro level, it is retail providers who actually deliver services, from investment banks to village banks. Developing practical know-how among financial institutions is at the heart of market development. Frequently, the lack of experience and technical expertise or the risks faced in entering and developing an unfamiliar market deter financial institutions from expanding into new client segments.

- Between these two levels, at the meso level, are industry and sector services on which retail providers depend, encompassing such areas as audit, training, IT services, credit reference, marketing, research and consultancy. All of these are vital to the sector's efficient functioning. Building the capacity and know-how among relevant service providers to the industry can enhance market development.

Fig 1: The structure of financial markets



FOCAL THEMES DURING 2007

To ensure coherence and maximise impact, FSD is guided by focal themes. They are reviewed annually so that they can evolve as markets develop. During 2007, FSD had five focal themes:

Building Core Capacity

Capacity development for the delivery of basic financial services remains at the heart of achieving FSD's goal of making financial markets work for the poor. Efficient and sustainable capacity in the financial services industry provides the basis for delivering services to lower-income consumers or smaller enterprises, whether directly or indirectly. Considerable gains are possible through expanding operations and outreach by the larger financial services providers with strong national branch networks.

Pushing the Frontier

Despite promising developments, many very poor households and micro enterprises in more remote rural areas will remain beyond the reach of banks and large microfinance institutions (MFIs) for many years. Decentralised financial systems like small, community-based

financial organisations (CBFO) have lower transaction costs, but experience also shows that they often suffer from severe governance and capacity problems, translating into high rates of organisational failure and, ultimately, losses to their clients. Low-cost, appropriate capacity building, support and supervision can help to mitigate these problems.

Agricultural Finance

With around 80% of Kenyans involved directly or indirectly in the agricultural sector, agricultural finance is clearly a major priority. To date, few commercial banks or MFIs have developed effective products for the sector. Orthodox approaches to risk management have proven of limited use for agricultural credit. While there are challenges in tackling this area, international experience nevertheless points to promising new directions in the context of liberalising agricultural markets.

Growth Finance

Broad-based growth is strongly linked to the development of the small and medium enterprise (SME) sector. Few financial

institutions address this market effectively – SMEs' financial needs often fall in the gap between what is provided by commercial banks at the upper end of the market, and MFIs at the lower end. Successful products for this market can borrow techniques from both segments, but a more nuanced approach is needed to address the distinctive credit management challenges posed by SMEs. Again, international experience shows this can enable SME lending to be undertaken profitably in a developing economy context.

Developing the Payments Market

Strongly linked to the first focal theme, FSD has recently started looking at ways to encourage the development of the payments system to reach lower-income and more remote markets. New information and communication technologies offer the prospect of significantly reducing unit costs and extending the reach of the payments system. By directly supporting domestic and international remittances, the payments system also provides the basic infrastructure on which other financial services can be developed.

Box 1: Key findings of the FSD strategic review 2007

An independent review of FSD was commissioned by DFID and carried out by the Law and Development Partnership. Their key findings are detailed below:-

The FSD strategy is consistent with the Economic Recovery Strategy (ERS), recognising in particular the emphasis in the ERS on the improvement of access to financial services and the need for finance by MSMEs, and is consistent with Vision 2030, the Private Sector Development Strategy and Kenya Joint Assistance Strategy (KJAS). FSD aims to be a major source of funding for pro-poor financial market development in Kenya. The challenge is to reach markets not reached by the existing orthodox, formal financial sector.

The sectoral approach to development is endorsed, and the particular emphasis on the meso and micro level recognises the fact that FSD's role at the macro level is essentially supportive of FLSTAP. Addressing constraints on a (meso) cross-sectoral basis is advantageous from a market development perspective. Intervention at micro level in a small number of institutions can be effective in demonstrating viability and building capacity, provided that care is taken to minimise market distortions.

The targets adopted under the 2007 Business Plan reflect developments in the Kenyan financial services sector, which have overtaken the original targets identified in the 2001 logical framework; have refined the annual indicators, which has to some extent narrowed the focus of the indicators but has made them more easily verifiable; but have retained the essential focus of the logical framework. The main issue related to the targets selected is that they tend to be quantitative rather than qualitative, reflecting the lack of data available and the need to ensure targets can be verified.

Over the years 2005 and 2006 targets have to a large extent been achieved. As a grant funder (at least at present), the implication is that FSD interventions should have a catalytic impact that will result in a sustainable improvement in access to finance by the rural and urban poor, and MSMEs. The conclusion of this review is that FSD has indeed developed an impressive portfolio of projects that can be said to have had 'ground-breaking' or catalytic impact.

FINANCIAL INCLUSION IN KENYA

Sustained recovery in economic growth over the last three years following a long period of weak performance has been reflected in the financial sector. There are strong signs of recovery and increasing competition. At the retail level there have been major developments, notably a growing interest in providing services to lower-income segments and smaller scale enterprise which had previously received scant attention. Specialist business services addressing the financial sector have grown although progress on market integration has been relatively modest. Work has moved forward on developing a more coherent Government financial sector policy, reflected in the Government's overarching long-term plan for national development - Vision 2030 and a number of significant reforms are in process. However the scale of the challenge remains huge. According to the most recent data in 2006 only 19% of adult Kenyans reported having access to a formal, regulated financial institution and over a third (38%) indicated no access to even the most rudimentary form of informal financial service.

FINANCIAL SECTOR GROWTH

The financial sector's growth rate has increased significantly over the last three years as shown in Figure 2 and Figure 3, although its overall direct contribution to growth remains relatively modest with the sector only accounting for 3.2% of GDP. There are a number of factors which have contributed to this recovery, not least of course increased opportunities associated with the economic growth. Five years ago the banking system was facing a major crisis with a huge stock of non-performing loans threatening the financial position of a number of institutions. Central Bank of Kenya's (CBK) banking supervision department has overseen a resolution of this crisis, strengthening the regulatory and supervisory framework and maintaining pressure on institutions to provide fully against the bad loans accumulated in the previous decade.

A key question is the extent to which the growth of the financial sector can be seen to be driving growth or simply following it. While the savings rate has improved over the last three years, overall rates remain low in comparison with other emerging economies where rates in excess of 30% are seen. Kenya's investment ratio has meanwhile shown a marked increase, exceeding 20% for the first time in the last decade. There are however few indications that private sector credit is driving this.

Fig 2: Growth in financial sector GDP

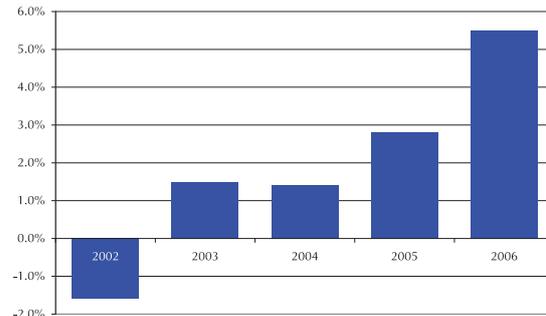
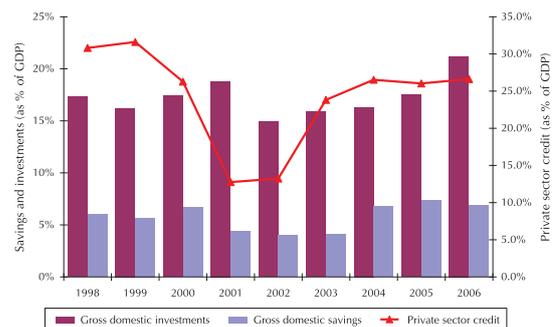


Fig 3: Savings and investment rates



BASELINE FINDINGS ON INCLUSION

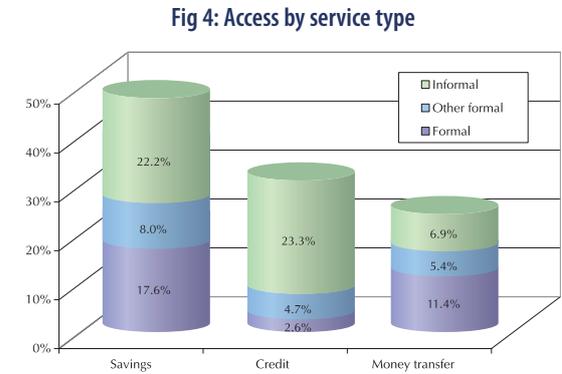
The 2006 FinAccess survey, analysis of which was completed in early 2007, now provides reliable baseline data on financial inclusion in Kenya (see box 2). Key findings on inclusion are summarised in an 'access strand' shown in figure 3 which illustrates levels of financial inclusion in Kenya. Access to financial services is broken down according to three broad categories, following the institutional sources of financial services: banks, other formal and informal. The vertical axis of the graph provides a highly qualitative (and subjective) representation of the quality and completeness of the service offer in each case. 19% of adult Kenyans report having access to the first category of provider which includes all formally regulated financial institutions together with the Kenya Post Office Savings Bank (KPOSB). Savings and credit co-operatives (SACCOs) together with micro-finance institutions (MFIs) extend the level of formal financial inclusion to 27%. While formal and largely centralised in their operations, SACCOs and MFI were not subject to regulatory oversight in 2006. Over a third of adult Kenyans are financially served through informal institutions, bringing the total level of financial inclusion to 62%. This category however includes services from a very broad range of organisational forms from the

least sophisticated, rotating savings and credit associations (ROSCAs), through group savings and loan associations or accumulating savings and credit associations (ASCAs) to more sophisticated community based financial providers such as financial service associations (FSAs). Service provision here ranges from the most rudimentary to a relatively sophisticated offer which can include credit, savings and money transfer services. An interesting finding from the survey is that many Kenyans make use of more than one type of financial service. It is not uncommon to find people who have a bank account, also being a member of a SACCO and participating in a ROSCA.¹

The likely rationale for this multiple usage becomes clearer when service use is broken down according to access to the major categories of financial service used: savings, credit and money transfer (as illustrated in figure 2). Relatively few Kenyans obtain credit from banks and SACCOs clearly provide an important alternative formal source. However the vast majority of those obtaining credit do so from informal sources. Credit from shops accounts for nearly three quarters of all credit provision in Kenya.

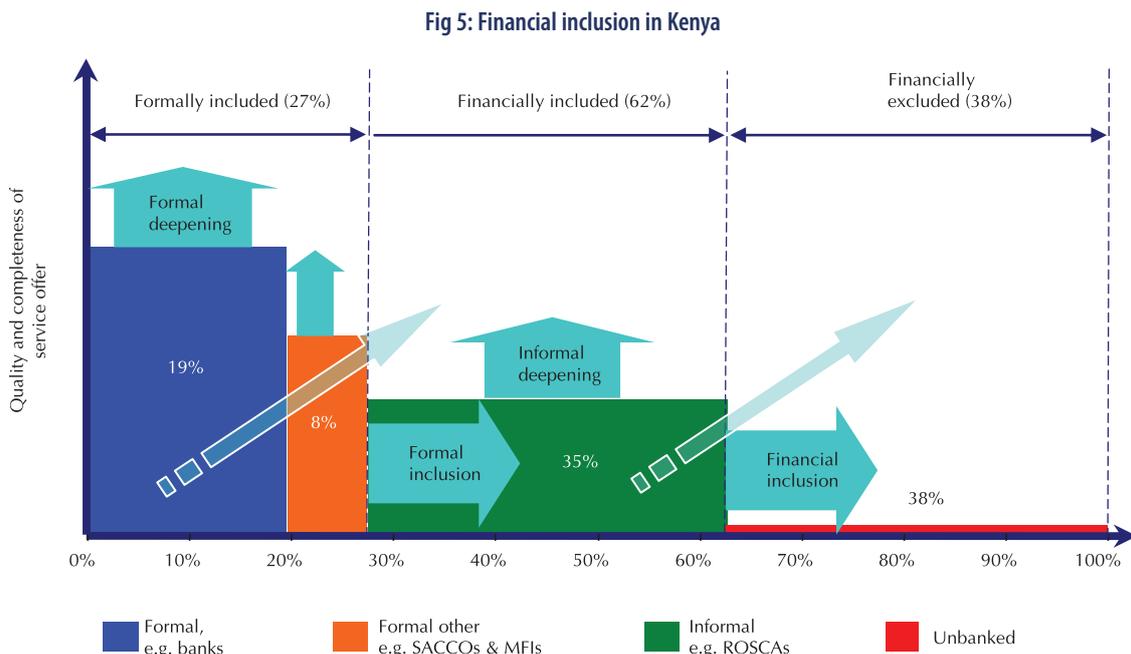
STRONG RETAIL EXPANSION

The last year has seen continued strong developments at the retail level with the growth of institutions focused on lower-income and smaller-scale enterprise market segments. This has been spearheaded by Equity Bank, the growth of which has been unprecedented in the Kenyan financial sector. In five years it has



expanded its asset base ten fold and increased its number of clients by over nine times. Ten years ago it was a small building society scarcely noticeable on Kenya’s financial landscape. Today it is among the most talked about financial institutions in the country, finishing 2007 among the top ten banks by assets. More significantly from the perspective of access has been the increase in share of the number of accounts in the banking system. By June 2005 Equity had become the largest institution in terms of outreach (with the exception of the Kenya Post Office Savings Bank) with over half a million accounts, amounting to 21% of the total number of bank accounts in Kenya. This expansion has continued unabated, ending 2007 with a market share of 39%, representing over 1.8m accounts.

While no other institution has matched this growth in absolute terms, a number of other players have also expanded rapidly – again



¹ This isn't represented in the access strand which shows people according to the most formal service used. For example 13% of the population use SACCOs, but of these many also use banks (thus counted under 'formal' in the strand) and therefore SACCOs are only shown as increasing financial access by 8%.

focussing on lower-income markets and the 'unbanked'. Family and K-Rep banks have both shown especially strong growth rates while Co-operative, Barclays and National while starting from a higher base have also added more 100,000 accounts over the last three years. While the number of accounts is only a proxy for the level of financial inclusion the growth is strongly consistent with improved access. On the most optimistic assumption that the number of accounts per individual has remained constant since the FinAccess survey (undertaken in August/September 2006), the extrapolated level of formal inclusion could have risen by over 8%, with formal inclusion over 27%. A more cautious interpretation would be to suppose that only half of the new accounts represent the previously unbanked. This would imply an increase of more than 4% to bring formal inclusion to over 23%. Although it will not be possible to confirm the impact on inclusion until the results of the next FinAccess demand study are produced, the indicators are clearly positive.

The growth in retail activity has been accompanied by a significant expansion in branch networks with the total number of bank outlets increasing by more than 20% over the year to reach 688 by December 2007. Three banks – Equity, Barclays and Kenya Commercial Bank – all opened more than twenty outlets each. More dramatic has been the expansion in alternative channels. Kenya now has 1,103 automatic teller machines (ATMs); a two and a half fold increase in less than three years. Safaricom and Celtel both launched mobile phone based payment systems during 2007. In a year since its launch in early 2007 Safaricom's M-PESA system has registered over 2.6 million customers and established over 1,200 agents across the country through which cash can be either deposited or withdrawn from the system. Value can be transferred between any of the more than 10 million mobile phones in the country at any time provided the user is within coverage (which now covers over 80% of the population).

TECHNOLOGY DRIVEN CHANGES AT THE INDUSTRY LEVEL

The payments market continues to develop in Kenya driving down the costs of provision. Interoperability of ATMs has until recently been limited resulting in significant under-utilisation of the installed capacity. While there is technical interoperability between many banks through the Visa switch, high switching and interconnect fees severely limit its use. The position is starting to improve. Pesapoint, a third party provider offering a network of 120 machines spread throughout the country, has enabled smaller institutions (including SACCOs) to provide national ATM access and reduce the competitive advantage associated with a large proprietary network. By the end of the year Kentswitch, the local payments switch, had expanded to allow customers of its member institutions to access roughly a quarter of ATMs in Kenya (including Pesapoint's) at reasonable cost. Use of debit cards is now growing rapidly but is still far from its

potential given major advantages from the perspective of both customers and financial service providers. This probably reflects in large part the historical weakness in the communications infrastructure, high costs of POS terminals and fee structures associated with the major card networks (Visa and MasterCard). Mobile phone technology has effectively addressed the communication problem for much of the market and the cost of terminals has reduced dramatically. Branchless banking is about to appear in Kenya, facilitated by on-line POS and card technology. As with ATMs the constraint to realising the full potential of such systems is likely to be interoperability. In Kenya the charging structure of debit cards is a legacy of the model developed from the earlier credit card products and appears to remain a constraint.

Progress on financial market integration has been relatively modest although hard facts remain scarce. Important links have been established between the capital markets and retail providers of financial services. Following Faulu Kenya's successful bond issue in 2005 (with a significant credit enhancement), in 2007 K-Rep Bank announced an issue of KShs 0.5bn in commercial paper, without any enhancement. MFIs and SACCOs are increasingly able to borrow from commercial banks with less stringent collateral requirements. There is however only patchy information on the volumes of finance flowing between the formal financial system and pro-poor providers. FSD intends to tackle this information gap over the coming year.

Turning to training and professional development, we still lack a comprehensive picture of the market. Where the demand is strongest appears to be at the middle-management layer and for specific technical skills. With expansion in the industry there are now growing reports of skills deficits. This is most obviously manifest in the rise in complaints of poaching of key staff. This is set to be a growing area of policy concern and a collective industry response is likely to be important to sustain the dynamism seen at the retail level.

INCREMENTAL CHANGE IN THE POLICY AND LEGAL FRAMEWORK

Policy with respect to financial sector has developed significantly and a number of GoK strategy documents have been drafted. These have informed the development of the new Vision 2030 national long-term strategy but have yet to be implemented. Reform of the state owned sector (comprising commercial banks, Postbank and development finance institutions - DFIs) made only limited progress during 2007. KPOSB has now developed and is implementing a new business model. National Bank of Kenya (NBK) has been recapitalised but its restructuring and privatisation has yet to move forward. Government shareholding in Kenya Commercial Bank has been diluted. Management of

some DFIs have managed to improve performance in individual institutions. Nevertheless the lack of a clear policy framework constrains the impact.

There have also been incremental developments in the legal and regulatory framework. The Microfinance Act passed into law at the end of 2006 and the regulations were drafted rapidly but were not gazetted by the year end. A SACCO Bill was finalised which, if passed will create a new SACCO Regulatory Authority to undertake prudential supervision of the largest societies and those offering front office services. The Government's proposal to increase the minimum capital of banks to KShs 1bn (from the current KShs 250m) to encourage consolidation and competition was however subsequently rejected by Parliament. Enabling legislation for credit reference was passed in 2006 but has yet to be implemented. This will require sharing of credit reference

information among commercial banks using licensed credit bureaus.

Economic recovery has been accompanied by the proliferation of investment schemes putatively offering consumers the prospect of participating in the gains from recent growth. There is strong evidence that a significant number of these are essentially pyramid or Ponzi schemes aimed at defrauding investors. While there have been moves to use existing legislation to control the problem, it is clear that there are limits to the effectiveness of such action. Informal or semi-formal financial service provisions are necessarily difficult to bring within the ambit of formal financial regulation. There is a growing recognition that the basis for protecting consumers will be improved financial literacy. This is equally important for increasing financial inclusion and market development and a public-private initiative is envisaged to start tackling the issue.

Box 2: FinAccess - Mapping the financial landscape

FinAccess is a study designed to measure the financial services landscape in Kenya. The first survey, undertaken in 2006, was designed to collect data on the demand and usage of financial services across the country. It is a stakeholder driven initiative working together in the Financial Access Partnership and supported by FSD Kenya. The survey questionnaire included sections on livelihood, usage of savings, credit, insurance and money transfer. A section on technology contained questions about the usage of mobile phones and add-on services.

It aims to meet the answer the following major questions:

- (i) What and where are the main barriers to access? Policymakers and regulators need to understand what reforms are required to improve access.
- (ii) What progress is being made? Are reforms having the desired effect? What impact are government-led and donor-led initiatives having? Reliable evidence is key to improving the effectiveness of interventions.
- (iii) What market opportunities exist? What products do previously un-served market segments need? This provides valuable guidance to financial service providers seeking to expand into new markets
- (iv) How does access to financial services impact on growth and poverty reduction? These are key policy questions which researchers in academia and policy institutes can better answer with improved data



FinAccess was officially launched in January 2007 at a well attended event, with representation across all segments of the financial sector. Benchmark figures generated by the study are now regularly mentioned in the media and in speeches by government officials. It has also been used in recent work on financial sector strategy, including the Vision 2030 national planning process.

FinAccess was conceived as a long-term initiative which not only measures demand using a national survey every two years, but also documents the supply of financial services. As FinAccess 2008 is planned, parallel studies on service provision by banks and SACCOs are in progress for 2008. The survey questionnaire, the top-line findings, a comprehensive report and details of the plans for the future can all be found at www.fsdkenya.org/finaccess.

BUILDING CORE CAPACITY

The growth of capacity in the formal financial system to deliver financial services continues to be a key building block for developing inclusive financial markets in Kenya. Efficient and sustainable capacity in the financial services industry provides the essential basis for delivering services to many lower income consumers or smaller scale enterprise, whether directly or indirectly. This theme area has been the greatest level of activity from the start of FSD's work and this continued in 2007, with initiatives supported across the macro, meso and micro levels.

THE LEGAL AND REGULATORY FRAMEWORK

The Government's Financial and Legal Sector Technical Assistance Project (FLSTAP), co-funded by the World Bank and DFID, provides the primary source of support for work in Kenya on the development of the legal and regulatory environment for financial sector development. FSD's work here has been focussed on those areas most directly impacting on financial access. Analytical work was undertaken with the World Council of Credit Unions (WOCCU) for the Ministry of Co-operatives Development and Marketing to support the development of the new SACCO regulatory framework. A new Bill was finalised by the Ministry during the year and is expected to be presented to Parliament in 2008. Effective regulation of the SACCO sub-sector presents major challenges; there are several thousand SACCOs in Kenya ranging from the largest whose size of operation rivals that of a medium sized bank to the smallest with a few hundred members. Under the proposed new framework, a two tier approach will be taken in which prudential regulation will be restricted to those whose failure presents the greatest risk to the financial system and the public.

In relation to the new Microfinance Act, FSD supported the Association of Microfinance Institutions (AMFI) and CBK to hold a workshop on transformation to regulated deposit-taking status for MFIs. A number of institutions found this helpful in understanding better the scale of the challenge faced. Meanwhile at the retail level, FSD started major technical assistance projects with two of the leading candidates for early transformation, Kenya Women Finance Trust (KWFT) and Faulu Kenya. The immediate aim is to support these MFIs in moving into deposit taking, enabling them to offer a wider range of services to their clients and strengthen their viability in the face of growing competition from down-scaling banks. A broader objective is to help blaze the trail for other institutions seeking to follow a similar path in the future. FSD will be looking to identify the lessons from these projects and disseminate to the industry.

Finally in order to inform the development of appropriate regulations for the fast-developing mobile-phone based payments market, working with the CBK, planning started on a study into the actual experience of users and agents of these new services. This will be undertaken during 2008.

INFORMATION FLOWS

A major focus for FSD's involvement at the macro and meso levels has been in supporting the flow of information in the market. In order to be effective we need to look at the whole cycle from information generation through dissemination to how it is used by various audiences. During 2007 much of our effort has been devoted to the FinAccess project (discussed in box 2 above) which looks at a wide range of market information but focussed most immediately on the needs of policy makers, the financial sector, donors and researchers. However the flow of reliable and usable information to consumers is vital to the effective functioning of markets. Concern has frequently been raised in the past by commentators on the level of bank charges in Kenya. Price controls, often proposed as a means to tackle this issue, have usually proven ineffective and – worse – can discourage the financial sector from tackling more marginal markets, increasing financial exclusion. By contrast, effective competition in markets will produce sustainable reductions in price as efficiency improving investments by financial players translate into lower operating costs. However the effectiveness of competition depends on consumers making informed choices. The Central Bank of Kenya (CBK), with support from FSD Kenya, has developed a new survey on bank interest rates and charges which presents the typical costs faced across banks for using transaction, savings and credit services.

Strongly linked to the provision of information is helping people make good use of it. Evidence from around the world suggests that financial literacy is a problem in many countries – too few people understand how to manage their finances effectively and make the best use of financial services. Financial education promises to help people strengthen their livelihoods through better financial management, expands and improves market function and provides the first line of defence for consumers. While regulation is often expected to protect consumers, too few people know the basic questions to ask which would help them avoid the fraudulent pyramid schemes which have emerged in recent years. Building on the strong interest expressed by stakeholders in a workshop held late in the year, FSD has started work on developing a financial education project.

DEVELOPING INDUSTRY KNOW-HOW

The third phase of the MicroSave project, in which FSD has been a major investor, came to a conclusion at the end of the year. MicroSave has been a major champion of the shift towards market-led micro-finance, working with some of the leading retail institutions in the region. The project received a very positive appraisal from an independent review (see box 3). Its know-how in developing market-led financial services, codified in its toolkits and many publications, has been passed across to a number of service providers in addition to those partners with whom it has worked over the nine years of its operation. A private sector consulting company (MicroSave Consulting Ltd) has now been spun out of the project offering MicroSave's unique expertise to the market on a fully commercial basis.

The regulatory impact assessment commissioned by FSD in preparation for the proposed regulation of the SACCOs sub-sector revealed some of the challenges SACCOs will face in meeting the proposed new regulatory requirements. This new regulation combined with growing competition from the banking sector and the opportunity to provide a better level of services to their members, provides a strong incentive for change. Help will be needed to support change but any capacity building project working directly with SACCOs, unless it has huge resources, will only be able to reach a fraction of the likely demand given the number of SACCOs in Kenya. In order to meet the potential scale of demand, FSD is partnering with WOCCU to develop business service providers in Kenya to meet this need through the SACCO Cap programme. From the outset the focus is on building a market for business services which can provide support to large numbers of SACCOs on a long term basis. In its first full year of operation, SACCO Cap established partnerships with business service providers and SACCOs to simultaneously develop the capacity of the service providers while strengthening the SACCOs.

BUILDING RETAIL CAPACITY

In the past financial sector support programmes have focussed heavily on the development of retail institutions. As markets develop, the role for FSD at the micro level is set to diminish. Nevertheless there has continued to be a strong case for supporting demonstration models where innovators can not merely expand outreach through their own efforts but help establish a path which others can follow. Work already mentioned on supporting the leading MFIs through the first transformations is an exemplar of this

approach. Similarly the first round of the SACCO Fund launched in 2007 selected five SACCOs for technical assistance with strong prospects for reaching the proposed new regulatory standards and providing a demonstration model for others. The SACCOs were identified through a competitive process open to all larger SACCOs operating front office services. It is strongly linked to the SACCO Cap programme which will back-stop the service providers offering the technical assistance. Another project under development is support for high growth potential MFIs which have a real prospect of bringing new products and delivery approaches to the market.

There is also a case for supporting retail level institutions which have significant direct market impact. Kenya Post Office Savings Bank (KPOSB) is a good example. It reaches nearly a million people, many from lower income groups and in more remote areas where banks often do not operate. FSD is providing technical support to KPOSB to develop a new card based business model which promises to dramatically improve efficiency and customer service. The result will be a direct impact on services provided to over 5% of adults in Kenya, the prospect of extending that service to many more and increasing competition in markets. Good progress is being made and the new model will be launched in the course of 2008.



Tabitha Kihara, the sole proprietor of Tabby Fashions (designers and makers of baby wear), joined Faulu Kenya's credit scheme in 1997. Since then she has taken six loans ranging from KSh 20,000 to 200,000. She says "Tabby Fashions has recorded 200% growth, with cash shooting sky high. I have expanded the boundaries of my business, increased production and equally been able to do lots of marketing. Faulu Kenya has been largely instrumental!"

Table 1: Building core capacity projects

Project	Partners	Objective	Status
FinAccess development	Financial Access Partnership which includes Central Bank of Kenya (CBK)	Deepen the analysis of the FinAccess study and actively support its dissemination and use across the financial sector	Development
Financial sector mapping	As above	Pump-prime the implementation of a joint government-industry initiative to measure the supply side of the financial services industry	Development
SACCO regulation planning project	Ministry of Co-operatives Development and Marketing (MoCDM), World Council of Credit Unions (WOCCU)	Prepare for the establishment of an appropriate legal and regulatory framework for prudential regulation and supervision of SACCOs in Kenya	On-going
SACCO regulatory impact study	WOCCU, MoCDM	The impact assessment will determine the benefits, costs and risks of the proposed regulatory framework for the SACCOs sector and identify the impact on the various stakeholders in the sector	Complete
SACCO regulation planning project	MoCDM, WOCCU	Prepare for the establishment of an appropriate legal and regulatory framework for prudential regulation and supervision of SACCOs in Kenya	On-going
Microfinance law and regulation II	Association of Microfinance Institutions (AMFI), Central Bank of Kenya (CBK)	To support the development of an appropriate legislative and regulatory environment to facilitate the growth of the micro-finance industry in Kenya	On-going
Consumer information	CBK, Bank Supervision Department	Improve the generation and dissemination of consumer information on financial services to improve competition and consumer choice	On-going
MicroSave: market-led microfinance	Kenya Gatsby Charitable Trust, Consultative Group to Assist Poor (CGAP), Norwegian Agency for Development Co-operation, Austrian Government	Inform and build the capacity of the financial sector to provide high quality financial services to poor people	Complete (See box 3)
Micro-finance individual lending development training	MicroSave Africa	To develop a training guide on individual lending to micro entrepreneurs and build local capacity in training lenders and their managers on sound underwriting for micro credit loans to individual business entrepreneurs	Complete
Jitegemee Trust restructuring	Jitegemee Trust Ltd	Development and implementation of a new institutional structure for Jitegemee Trust to support its objective of providing equitable access to financial services to low income individuals through appropriate intermediaries on a commercial basis	Development
SACCO Cap	WOCCU, MoCDM	Develop the capacity of SACCOs through the development of a sustainable business services industry	On-going
CapFund I	-	To test the effectiveness of a capacity building fund to support the growth of market based training and other human resource development business services in East Africa	On-going
CapFund II	To be identified	Support the growth of market based training and other human resource development business services in East Africa	Planning
MFI growth programme	Microfinance Management Institute (MFMI)	Development of the capacity to effectively manage rapid growth in high potential micro-finance institutions	Development
Second tier MFI support	AMFI	Support the emergence of dynamic, growth oriented MFIs from the second tier MFI segment	Development
Kenya Post Office Savings Bank (KPOSB) II	Kenya Post Office Savings Bank (KPOSB)	To support the implementation of a radical new business model in Postbank in order to dramatically enhance the efficiency and service offer of the bank as a basis for improved competitiveness, financial performance and increased outreach	On-going
KWFT transformation support I	Kenya Women Finance Trust (KWFT)	Support KWFT to become a licensed national micro-finance institution	On-going
Faulu transformation support I	Faulu Kenya	Support Faulu in undergoing institutional transformation to become a leading provider of financial services to low income households and micro-enterprise	On-going
SACCO Fund I	MoCDM, WOCCU	Support to institutional strengthening of SACCOs with a view to strengthening governance, financial stability and operations to comply with the new regulatory framework	On-going

Box 3: MicroSave - Market-led financial solutions

MicroSave's mission is "to strengthen the capacity of financial service providers to deliver market-led financial solutions." The project comprised three main components:

- (i) action research partnerships (ARP) – to create successful market-led financial service providers targeting the poor, as laboratories and demonstration vehicles for the rest of the industry;
- (ii) toolkits and resources – to prepare and disseminate knowledge resources derived from working with ARPs to operationalise market-led approaches for use by the financial sector; and
- (iii) service provider capacity building – to develop the capability of technical service providers to supply support services, based on knowledge resources developed, after the project ends.

MicroSave's action research partners in Kenya were Equity Bank and Kenya Post Office Savings Bank. An independent review concluded that "MicroSave has led a paradigm shift in microfinance thinking and practice, one which puts the needs of poor consumers at the heart of financial sector development. ... More specifically, most ARPs have experienced business growth, with clear evidence of strategic and operational changes resulting from MicroSave interventions. MicroSave has produced more than fourteen toolkits, sixty briefing notes, four VCDs, several books and over one hundred other papers and notes. Knowledge resources have been developed to a high standard and disseminated widely and are commonly characterised as practical, hands-on and useful. The project has trained and certified thirty-nine senior service providers and thirty-six other consultants, nine Young Executive Professionals (YEPs) and six MicroSave staff, who have completed seventy-six paid assignments." Fundamentally the success of the project provides a strong affirmation of the importance of the market-led approach to micro-finance. The review also identified a number of important lessons for future projects:

- A wider financial sector development agenda – moving from organisations to systems.
- The centrality of good market understanding to effective intervention.
- Build scope for pilot initiatives and flexibility into intervention design.
- Interventions need to be guided by a strategy or "pathway" for wider systemic change.
- The role of agencies as catalysts to facilitate market system change, not participate in markets directly.
- The importance of a rigorous, transparent approach to sustainability from the outset.
- Market development requires time, good people and multi-faceted interventions, not necessarily enormous resources.

Given the strength of the demand for MicroSave's expertise, the team has now established a consulting company to offer services on a commercial basis in the future. With a full order book and an excellent reputation the prospects for success look strong.



Working with Equity Bank and Kenya Post Office Savings Bank, MicroSave has led a paradigm shift in microfinance thinking and practice, one which puts the needs of poor consumers at the heart of financial sector development.

PUSHING THE ACCESS FRONTIER

The FinAccess survey showed that over 70% of Kenyans lack access to the formal financial system. 35% depend on informal services from village banks to ROSCAs, while 38% have no access to any financial services. In spite of continued gains made by commercial banks and mainstream MFIs in broadening access, it is clear that many households and businesses in Kenya, especially those far below the poverty line and in more remote rural areas, remain beyond the reach of these institutions. Decentralised financial systems like smaller, community based financial organisations (CBFOs) can capitalise on lower transaction costs, but often suffer from severe governance problems and capacity constraints. Low cost, appropriate capacity building, support and supervision can help to reduce the high rates of organisational failure and losses to their clients. FSD continued to support development of sustainable systems of CBFOs during 2007.

At the meso-level Decentralised Financial Services (DFS), an action research programme started in 2005, continued developing and testing simple support tools for CBFOs and exploring mechanisms for delivering these effectively. Tools for supporting Accumulating Savings and Credit Associations (ASCA) managers have been refined and results show that their use has led to improved group performance. Development of tools for the Financial Services Associations (FSA) and SACCO models is underway.

At the micro-level, following a successful pilot of the management contract approach in FSAs, FSD Kenya and K-Rep Development Agency developed a project to transform the FSA network into a sustainable system based on the approach (see box 4).

In 2006, DFS undertook a study into the sustainability of the group savings and loans (GSL) association model which has been implemented in a number of countries in sub-Saharan Africa. Focusing on Zanzibar, where the model has been implemented for a significantly longer period than most areas, DFS found evidence to support both the contended sustainability and impact of this approach. FSD has supported CARE Kenya to design a GSL development project that will: (i) refine the basic GSL model, (ii) identify appropriate cost-effective delivery channels for a national roll-out, and (iii) develop a clear understanding of the extent to which the groups are able to meet the financial service needs of the target market. DFS, with its track record in action research, will take charge of the research and documentation of the lessons learned from the project, due to start in 2008.

During the year FSD commissioned a study to look into whether there were opportunities for working with the formal service providers such as banks and MFIs to extend their outreach to the 'next poorest' client through incremental developments in products or delivery



Itoleka FSA is one of the 49 FSAs that have already signed management service agreements with KFS (see Box 4). The FSA which was launched mid 2000 had 2,622 members by end of July 2008, with 1,396 of them as active savers. At that time the FSA had mobilized a share capital of KShs 8.8 million and the net savings and loan portfolio stood at KShs 5 million and KShs 22 million, respectively.

channels. The consultant visited most of the formal providers currently serving the micro-finance market and held discussions with their senior management on policy issues and future developments. Drawing on the feedback from these players, the consultant reported little tangible interest beyond the organisations

with which FSD is already working (such as Postbank, Equity Bank, KWFT and Faulu). Overall there are few indications that developing the project would add much value to the work in which FSD is already engaged. The report will be finalised early in 2008 then published.

Table 2: Pushing the access frontier projects

Project	Partner	Objective	Status
Decentralised financial systems II	Decentralised Financial Services programme	Develop and test simple and effective tools and delivery techniques to strengthen operations, management and governance in community/rural base financial organisations as a building block for developing sustainable and robust decentralised financial systems in Kenya	On-going
Financial Services Associations (FSA) transformation II	K-Rep Fedha Services Ltd	Demonstrate sustainability at the regional level and expand the network of commercial FSA management services laying the foundations for full sustainability of the system	On-going (see box 4)
Group Savings and Loans Associations (GSL) development	CARE Kenya	Develop the GSL system to the stage at which a programme of national scale-up to reach large numbers across the country would be viable	Development
Deepening at the margins	To be identified	Identify evolutionary developments in product, delivery channels and operations of formal financial service providers to incrementally expand outreach to lower income clients	Development



The De-centralised Financial Systems (DFS) project has developed group management and operations training tools, which have significantly improved the performance of Accumulating Savings and Credit Association (ASCAs), Muunganos (FSA model) and microfinance groups (SACCO model).

Box 4: Financial Services Associations: Pushing the access frontier

The majority of the 38% of Kenyans who have no access to financial services live in sparsely populated rural areas. High transaction costs associated with small transaction sizes, poor infrastructure, high poverty incidences and low population densities typical of rural Kenya dissuade other service providers, such as MFIs, from operating in these areas.

HISTORY OF FSAs IN KENYA

Financial Services Associations (FSAs) are rural member-based financial institutions that provide credit, savings and money transaction services to their members. Characterised by lower costs and the ability to operate in more remote rural areas, FSAs offer an important way to increase access to financial services in Kenya. K-Rep Development Agency (KDA) started promoting the FSA concept in 1997. With support from a number of development partners, it has since established 80 FSAs in five of the eight provinces of the country. FSAs were originally conceived as user-owned, financed and managed institutions requiring minimal outside intervention apart from training and an initial period of oversight. It had been assumed that following the initial support, the FSAs would become self-reliant. However, like many other member-managed organisations, the FSAs suffered from poor management and weak governance. To counter these challenges, KDA experimented with a management contract arrangement under which it hired qualified managers for the FSAs. The performance of the FSAs where the approach was tested improved markedly, leading to increased confidence in the FSA and greater usage by communities.

FSD'S INVOLVEMENT WITH FSAs

Following the successful test of the management contracts, KDA and FSD Kenya developed a project to introduce them throughout the KDA FSA network to transform it into a sustainable system. The aim was to establish a commercially viable management services company to provide services and supervision to the FSAs. At the outset, the performance of most of the FSAs was weak and a lot needed to be done to turn them into viable operations. K-Rep Fedha Services Ltd (KFS), a limited liability company, was registered to provide management services and supervision to the FSAs at a fee. During the transformation period, FSD Kenya is providing financial support towards operations, institutionalisation of KFS and capacity building for both KFS and the FSAs. The transformation will help to separate management from ownership and governance, eliminating conflicts of interest. Results from the first 18 month phase of this transformation project have been positive, with the two pilot regions attaining operational self-sufficiency.

The FSA transformation project is currently in its second phase to refine the model before rolling it out to the rest of the regions. One of the key challenges faced by the FSAs has been the ability to generate accurate and timely reports to facilitate decision-making. Among the services to be provided by KFS is a computerised information system enabling FSAs to provide daily reports, making monitoring and supervision more effective. A system has been identified and is being piloted in three FSAs. This second phase will entail training for both KFS and FSA staff to enhance their ability to manage and provide quality services to the increasing FSA membership. In addition to training, KFS will also support the FSAs in market research and product development, strategic planning, business development, branding and marketing. This current phase of the transformation project is expected to demonstrate the ability to attain operational self-sufficiency at the regional level across the whole network.

WHAT DOES THE FUTURE HOLD FOR FSAs?

Due to challenges related to remoteness and minimal economic activity in some districts, not all the existing FSAs have yet been able to join the management contract arrangement. The new model has to be commercially viable and as a result only 49 of the 80 FSAs have thus far signed service agreements with KFS. Discussions are underway with five others, and eight new FSAs will be established based on this new model in the next two years. Through the new FSA model, membership is set to more than double expanding from the current 70,000 to reach 150,000 rural low-income clients over the next two years. Once the model is proven, it will be extended to other areas where it can operate sustainably.

AGRICULTURAL FINANCE

Agricultural finance remains a priority for the government and donors alike in Kenya. After many decades of failed agricultural finance schemes in Kenya as elsewhere on the continent, new approaches are needed. Advances made in more than a decade of investment in pro-poor financial services have largely bypassed this sector. It has been argued that micro finance has often overly focused on meeting the short-term working capital needs of traders and others in the service sector, neglecting the more complex requirements of other sectors. There is no question that much of the effort in capacity building, product and system development has failed to focus on the peculiar characteristics of farming, its exogenous risks of weather, pestilence and price uncertainty, and its irregular, 'lumpy' seasonal cash flows.

New approaches to agricultural finance place particular emphasis on better understanding the opportunities and risks in agricultural business. Identifying the margins (and hence capacity to bear debt) achievable at each link of the value chain for any given commodity or farm enterprise is a critical step in developing appropriate finance for agriculture. FSD's emphasis has been on the use of service providers who can help manage the link between farmer and credit provider, filling the information gap to allow financiers to manage agricultural risk effectively. FinAccess 2006 headline results were consistent with expectations; farmers growing cash-crop have the highest access to the formal financial system at 30% and those dependent on livestock the least at 11%. Financial exclusion follows these trends: cash-crop farmers, able to utilise semi or informal sources of financial services – notably SACCOs – have an exclusion rate of only 20%, while livestock farmers have an exclusion rate of 56%.

DELIVERY CHANNELS

In developing practical solutions to agricultural finance, there is need for a thorough understanding of the delivery channels through which small-holder farmers can be reached. During 2007, FSD commissioned an Area-based Institutional Capacity (ABIC) study in partnership with the AGMARK Trust that works with local agro-input stockists or 'agrovets' in the west of Kenya. The study analysed existing and potential channels for the delivery of agricultural finance to smallholder farmers and the SME stockists who support them. The study gives a detailed picture of how smallholders are currently able to finance improved productivity (through seeds, fertiliser etc), examining the role of supplier credit, remittances and informal groups as well as more formal financial institutions. FSD

had hoped to use the survey findings to explore a wider range of capacity building initiatives with promising institutions that have a strong current or potential focus on service delivery to small-scale farmers. However, the survey of the smallholder farmers undertaken as part of the study was confined to those associated with the AGMARK programme that is working in areas with relatively higher agricultural potential, and it was therefore not possible to generalise from these findings. Further work will be done to analyse the findings and establish clearer conclusions before publishing the report in 2008.

WEATHER INSURANCE

FSD Kenya started work on an index-based weather insurance in 2006, targeting smallholder maize farmers in Eldoret, Nakuru, and Kitale. The first phase of work exploring the application of this concept in Kenya was concluded during 2007 and the experiences to date will be documented in a report and disseminated to stakeholders. Index-based weather insurance has the potential to help farmers and financiers manage weather-related production risks. The main advantage of this approach in contrast to traditional insurance products, is that the payout is not based on the state of the crop, but on the weather conditions and therefore minimises moral hazard and administrative costs. In case of adverse variations in the insured weather condition, e.g. drought, the insurer does not need to visit each individual farm to determine the loss, but look at the rainfall received in the area to determine if a payout from insurance is due. Weather-based insurance could help the farmers obtain credit by making lending for farming activities less risky.

Further work is envisaged in this area and will involve additional partners, helping to increase the prospects for identifying successful applications. The International Livestock Research Institute (ILRI) has expressed strong interest in the application of index-based risk products to livestock production and brings significant research expertise in this area. Rockefeller Foundation, with a strong track record in agricultural development, has also indicated an interest in partnering with FSD.

PRICE RISK MANAGEMENT

A study commissioned by FSD on commodity price risk management instruments found only limited opportunities. Local awareness of the potential of price hedging is low and though coffee

traders use futures routinely, interest even from large commercial growers is negligible. Local banks have shown a similar lack of enthusiasm. The findings of the study will be disseminated but no further work is anticipated by FSD in the short-term.

WAREHOUSE RECEIPTS SYSTEM

Following a careful development phase and completion of a feasibility study, a warehouse receipts system (WRS) project was developed in partnership with the Eastern Africa Grain Council

(EAGC). The aim of the project is to develop a sustainable warehouse receipts system that will provide collateral for short-term lending to grain farmers. Implementation of the project started in the final month of 2007. The WRS system will open a window for smallholder farmers to access credit from financiers for the acquisition of farm inputs without having to dispose of their grain at the low prices frequently seen immediately after harvest. Bulking of the grain by the smallholder farmers and storage in a certified warehouse will enable them to maintain the quality of the grain and obtain better prices later in the season.

Table 3: Agricultural finance projects

Project	Partner	Objective	Status
Index based weather insurance	World Bank, Equity Bank, Co-operative Insurance Company, K-ECLOF	Ascertain the viability of a smallholder index based weather insurance product in close co-ordination with the insurance industry	Concept development
Commodity price insurance	None	Ascertain the viability of commodity futures in Kenya to provide price insurance accessible to smallholder farmers	Concept development
Area based institutional capacity study	AGMARK Trust	Analysis of existing and potential channels for delivery of agricultural finance to smallholder farmers	On-going
Warehouse receipts system	Eastern Africa Grain Council	Develop warehouse receipts contract as a collateral instrument to manage seasonal price fluctuation for short term lending and futures contracts	On-going



A smallholder farmer delivering maize to a warehouse. The warehouse receipts system enables farmers to get financing for farm inputs and other needs immediately after delivery of grain and sell when market prices improve.

EXPANDING FINANCE FOR GROWTH

GrowthFin is an FSD programme which started in 2006 to address the lack of suitable financial products and services for the growing number of small and medium sized enterprises (SME) in Kenya. GrowthFin focuses on companies whose financial needs are either too large or complex for micro finance institutions and that are considered either too small or risky by traditional financial institutions. These entities, regardless of the precise number of employees or turnover, are either growing or have the potential to grow with suitable financial products and services.

GrowthFin is a three-year project working at the retail, advocacy and policy levels of the market. It seeks to act as a catalyst to create an enabling environment and provide some of the infrastructure necessary to develop sustainable innovations in SME finance. To accomplish this mission, GrowthFin works with

key partners in private and public sector institutions committed to the maximising the contribution of the SME sector to economic growth:

- At the retail (micro) level, GrowthFin invests in partner financial institutions targeting the SME sector to build capacity for better service. This is largely accomplished through action research projects, pilot products or services and best practice training.
- At the advocacy (meso) level, GrowthFin partners with institutions and associations that are working towards an enabling environment for SME finance. GrowthFin investment can be utilised for increasing advocacy capacity, building public awareness and confidence in the represented institutions, or enhancing governance abilities.
- At the policy (macro) level, GrowthFin works with partners in the Government of Kenya to assist in the identification of ways in which the legal and regulatory framework can be changed to better support SME finance.

In 2007, its first full year of operations, GrowthFin devoted much time to creating awareness of the programme's presence in the marketplace. The foundation work included establishing a brand, developing marketing materials, making contact with key players in the financial sector and conducting a series of studies and workshops. As a result of its focussed efforts, recognition of the role of GrowthFin as a catalyst in expanding SME finance in Kenya has increased steadily.

INSTITUTIONAL SUPPORT

Two action research projects were supported at two SME oriented banks. These projects, at Equity Bank and FINA Bank, increased the capacity of both institutions to assess SME risk with the assistance of leading international specialists in SME finance. As a consequence, both institutions have revamped their SME divisions, resulting in a substantially increased credit and savings portfolio from the sector. The lessons learnt from these two projects will be made available to industry players in case studies currently under preparation.

RESEARCH EFFORTS

During the year, three important market studies were commissioned that will identify follow-on activities to increase SME access to finance. In co-operation with the Kenya Institute of Supplies



Following a successful pilot in 2005, FINA Bank approached FSD to assist with technical assistance to form an SME lending department in order to re-orient the Bank to become an SME focused bank.

Management, a study was conducted on the major supply chains in the country and how these supply chains can be utilised to increase appropriate financial products and services for the SME sector.

In our role as an implementing partner of the Ministry of Trade and Industry's MSME competitiveness project, in co-operation with the IFC, a study was undertaken of the capacity constraints facing risk capital fund managers in Kenya. This study will be useful in designing technical assistance interventions. Related to this same area, a study was also undertaken of the constraints facing retirement benefit schemes, life insurance funds and other holders of long-term funds in investing in risk capital for SMEs. This study is critical to understanding how the legal and regulatory framework governing the use of these funds might be altered to so that long-term savings can be matched with long-term investments in SMEs.

SUPPORT FOR INDUSTRY ASSOCIATIONS

As part of its effort to support professional services that will have a positive effect on access to finance, a publicity campaign was supported for the launch of the Credit Bureau Association to enhance public awareness of this critical function. This contributed to the renewed urgency for gazetting the final credit bureau regulations that will allow the licensing and operation of these institutions.

A major lesson learnt from all the GrowthFin activities in 2007 is that the scale and scope of access to finance for SMEs can only be markedly improved if a serious effort is made to enhance Kenya's chronically limited capacity to understand and mitigate SME risk. As a result, a major focus of efforts in 2008 will be to work with its partners towards an effective long-lasting solution to this capacity constraint.

Table 4: Finance for Growth projects undertaken during 2007

Project	Partners	Objective	Status
Credit Development	Equity Bank	To support the roll-out of Equity Bank's new lending strategy	Ongoing
Support to FINA Bank	FINA Bank	To develop an SME lending business within FINA Bank demonstrating the viability of lending to the SME market to the Commercial Banking sector	Ongoing
Capacity constraints facing risk fund managers in Kenya	MSME Competitiveness project, Ministry of Trade. IFC SME Solutions Center Consultants: InvesteQ	Identify constraints to long term funding and design appropriate interventions	Complete
Operation of procurement and supply with respect to SME's	The Kenya Institute of Supplies Management. Consultants: ECI Africa	Construct a picture of major supply chains as they affect SME's so appropriate interventions to increase access to finance might be developed	Complete
Availability of long term funding for risk capital funds investing in SME's	Consultants: Strategic Business Advisors	Seek solutions to unlock long term finance held in retirement schemes and life funds for risk investment in SME's	Complete
Public Awareness Campaign	East African Credit Bureau Association Consultants: Tell-Em Public Relations (EA) Ltd.	Raise the profile of credit bureaus in anticipation of enactment of regulatory framework	Complete
Policy makers forum	Leasing Association of Kenya Africa Leasing Association	Raise key issues with Central Bank, Treasury and Kenya Revenue Authority to include in the Budget to improve the performance of Leasing	Complete
Leasing Practicum	Leasing Association of Kenya Kenya Revenue Authority Consultants: ABF Outsourcing	Senior management of KRA and Leasing Association taken through leasing transactions by a leasing best practice expert	Complete

DEEPENING THE PAYMENT SYSTEM

The Government of Kenya (GOK), in partnership with the UK's Department for International Development (DFID), is introducing a new cash transfer scheme which will provide small regular cash grants to some of the poorest and most vulnerable households in Kenya. The Hunger Safety Net Programme (HSNP) targets poor and vulnerable households in the arid and semi-arid lands (ASAL) that are subject to regular drought. Meanwhile the orphans and vulnerable children (OVC) programme will help households caring for such children, the number of which has increased sharply as a result of the HIV/AIDS pandemic. FSD is working with the partners in these programmes to help develop viable payments solutions. Our aim is two fold: (i) to support these new social programmes and (ii) to use this as a means to deepen the payments system in Kenya.



Recipients of the pilot OVC-CT programme to support families caring for orphans and vulnerable children receiving payment from the post office.

BACKGROUND

In 2006, an intergovernmental conference on social protection was co-hosted by the Government of the Republic of Zambia and the African Union in Livingstone. The event was attended by ministers and senior representatives from 13 African countries, Kenya, Ethiopia, Lesotho, Madagascar, Malawi, Mozambique, Namibia, Rwanda, South Africa, Tanzania, Uganda, Zambia and Zimbabwe, with Brazil, development partners, UN agencies and NGOs.

The conference noted with concern the continuing high levels of poverty in Africa and the likelihood that the Millennium Development Goals will not be reached in the region unless development strategies incorporate direct action to enhance social development. Social protection directly tackles poverty, contributes to economic growth and stimulates local markets. It was also noted that providing social protection in the form of social transfers is affordable in African countries with the resources currently available. The provision of cash directly to poor people enhances economic growth as the transfers are used for both investment and consumption. The transfers can stimulate local markets, benefiting the whole communities. Delegates called for social transfer programmes, including the social pension and social transfers to vulnerable children, older persons and people with disabilities and households to be pursued more often as a policy option in African countries. This case for basic social protection in Africa became known as the 'Livingston call for action'.

WHY THE PAYMENTS MECHANISM MATTERS

A carefully conceived payments mechanism can enhance the impact of social transfers. Social transfers may create a critical mass that encourages financial service providers to improve an area's financial infrastructure. For example, the introduction of financial infrastructure to deliver social transfers may include point of sale devices, ATMs or bank branches that also allow the delivery of savings, loans, money transfer and insurance products appropriate to the wider community. This enhanced access to financial services is useful for both beneficiaries and non beneficiaries of the social protection programme, as it creates opportunities in poor households for income generation, asset accumulation and reducing vulnerability to shocks.

Payments mechanisms are often regarded as an afterthought in social protection schemes, but close attention needs to be paid to their design and structure to take advantage of opportunities for wider impact. FSD's aim is to select payment mechanisms that can both efficiently deliver social payments and expand access to appropriate financial services for low-income Kenyans.

FSD'S INVOLVEMENT

Delivering these social payments safely and affordably presents a huge challenge in Kenya where the financial system is currently unable to reach those targeted for support under the new



A Point of Sale device with an electronic finger print reader being used by a shop keeper to authenticate the identity of a recipient of child benefit in South Africa.

programmes. Financial Sector Deepening Kenya (FSD Kenya) and the Consultative Group to Assist the Poor (CGAP), formed the Kenya Social Protection Payments Challenge Fund (SPPCF) in December 2006. The SPP Challenge Fund was created to encourage providers of payment services to develop innovative payment solutions to support the delivery of these schemes. In March 2007 the SPPCF reviewed the eight bids submitted and selected two for a co-founding grant. Successful awardees were required to develop a working prototype of their proposed solutions

A grant was given to Vodafone in partnership with local Mobile Network Operator Safaricom, which proposed to extend its recently launched M-PESA mobile payments solution so that it can operate off-line through specially appointed and equipped SPP agents, and

A grant was also given to the Sevak Consortium, comprising international IT consultancy Sevak Solutions, Paynet Holdings and Kenya Commercial Bank (KCB) which wanted to leverage the existing network of PesaPoint ATMs, KCB branches and create new solutions based on deploying point of sale (POS) terminals at merchant locations.

In September the Challenge Fund Panel reconvened to assess the first milestone of the project, the creation of a prototype solution. The Panel considered that both the Sevak Consortium and Vodafone/Safaricom had met the conditions of the first milestone.

However, there were challenges to overcome to make these prototypes operational.

Safaricom's M-PESA provides basic transaction functionality to people with a mobile phone in GSM coverage areas. This awardee focused on developing a prototype solution for the envisaged case of neither beneficiary nor the agent being in GSM reception areas, hence having to operate off-line. Beneficiaries would receive a contactless smart card which could be activated and then used at special M-PESA SPP terminals. The use of a contactless card is a major advantage in harsh environments where the physical robustness of the token is an issue. The terminals (of which a prototype was demonstrated) would function off-line to allow withdrawals, balance enquiries and deposits from beneficiaries; and the link to M-PESA would allow transfers from other M-PESA customers. However, the POS device (or at least its memory on a USB stick) would need to be brought into coverage on a regular basis to refresh and update the database. This could be done by having roaming base stations; or mobile field support.

In the case of the Sevak solution there was a constraint in an offline environment. Satellite-connected POS devices were too expensive to use for the volumes envisaged per agent; but the price of GPRS data transfer via satellite is expected to become more affordable in the near future. Their agent's would benefit from liquidity support from KCB bank branches. However, to make the model work as currently envisaged it would be constrained to online areas potentially making beneficiary travel long distances to collect their cash transfer.

Despite their differences in connectivity, both solutions have in common their main reliance on a decentralized cash handling solution, via agents. But there may still be a need for risky and expensive cash movements to payment points to supplement liquidity. The practicalities of acquiring a new agent network in areas of low density and limited economic viability are largely unknown to both as yet; and both solutions would require considerable support to agents and customers (who would likely not have used cards or PINs before) in the early stages.

It had been envisaged that both the OVC-CT and HSNP would be tendered together by the third quarter but whilst both were delayed the OVC-CT faced the most delays; meaning that successful payment service providers will have to deliver in the more challenging HSNP areas first. In December FSD launched the procurement process to identify potential payment service providers (PSPs) for the Hunger Safety Net Programme. This process is due to culminate with the appointment of PSP(s) in second quarter of 2008.



Pastoralists in northern Kenya are vulnerable to drought, flood and conflict. When they lose their livestock they also lose their livelihood. These ex-pastoralist are the type of people that will become beneficiaries of the Hunger Safety Net Programme. Once they have been targeted and enrolled by the administrative component of the programme, regular cash payments will be made to them through Equity Bank's network of agents. For more information about this project, please see the section entitled 'Deepening the Payment System'.



The Kenya Financial Sector Deepening (FSD) programme was established in early 2005 to support the development of financial markets in Kenya as a means to stimulate wealth creation and reduce poverty. Working in partnership with the financial services industry, the programme's goal is to expand access to financial services among lower income households and smaller enterprises. It operates as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). In addition to the Government of Kenya, funders include the UK's Department for International Development (DFID), the World Bank, the Swedish International Development Agency (SIDA) and Agence Française de Développement (AFD).

