

# ANNUAL REPORT

2014





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). Current funders include the UK's Department for International Development (DFID), the Swedish International Development Agency (SIDA), and the Bill and Melinda Gates Foundation.



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# Abbreviations

<b>AFD</b>	Agence Française de Développement	<b>KCISI</b>	Kenya Credit Information Sharing Initiative
<b>ASCA</b>	Accumulating Savings and Credit Association	<b>KFS</b>	K-Rep Fedha Services Ltd.
<b>AMFI</b>	Association of Microfinance Institutions	<b>KPOSB</b>	Kenya Post Office Savings Bank
<b>CBK</b>	Central Bank of Kenya	<b>KSH</b>	Kenya Shilling
<b>CGAP</b>	Consultative Group to Assist the Poor	<b>KWFT</b>	Kenya Women Finance Trust
<b>CRBs</b>	Credit Reference Bureaus	<b>MFI</b>	Micro-finance institution
<b>DFID</b>	Department for International Development	<b>PIC</b>	Programme Investment Committee
<b>DTM</b>	Deposit-taking Micro-finance Institution	<b>POS</b>	Point of Sale
<b>FSA</b>	Financial Services Association	<b>ROSCA</b>	Rotating Savings and Credit Association
<b>FSD</b>	Financial Sector Deepening Kenya	<b>SACCO</b>	Savings and Credit Co-operative
<b>GDP</b>	Gross Domestic Product	<b>SASRA</b>	SACCO Societies Regulatory Authority
<b>GSL</b>	Group Savings and Loans associations	<b>SIDA</b>	Swedish International Development Cooperative Agency
<b>G2P</b>	Government to Person	<b>SME</b>	Small and Medium Sized Enterprise
<b>HSNP</b>	Hunger Safety Net Programme	<b>USAID</b>	United States Agency for International Development
<b>KBA</b>	Kenya Bankers Association		

## Director's note

This is FSD Kenya's tenth annual report. In the last decade, we have witnessed tremendous change. Kenya has been at the forefront of East Africa's digital financial revolution. The rate of change continues apace but there remains a long way to go. As we understand more about the financial lives of the poor we realise how much more is needed before we can say that financial markets are really working for them. The innovations we have seen represent important and laudable achievements, but there remains a disconnect between how poor people see and manage their finances, and the offerings of financial institutions. In delivering year four of our 2011-2015 strategy, this has been at the forefront of our minds.

In June 2014, we released the results of our Kenya Financial Diaries. This is one of the most in-depth pieces of research FSD has ever undertaken. We tracked the financial lives of 300 low income Kenyan households for over a year. The resultant 'financial diaries' gave us some exceptionally rich insights into what it means on a day-to-day basis to be poor. What stood out above all was the complexity of the financial management challenges faced by low income households.

We talk about the need for client-centricity in financial inclusion – but for it to have any value, that handy catchphrase needs to translate into action. This year, we at FSD have thought hard about how some of the stories in the diaries could have had better outcomes. People need solutions to real world problems – juggling competing financial demands, managing challenges and opportunities, and navigating risks and uncertainty. Only once we understand the financial lives of the poor, can we start trying to create the tools they need.

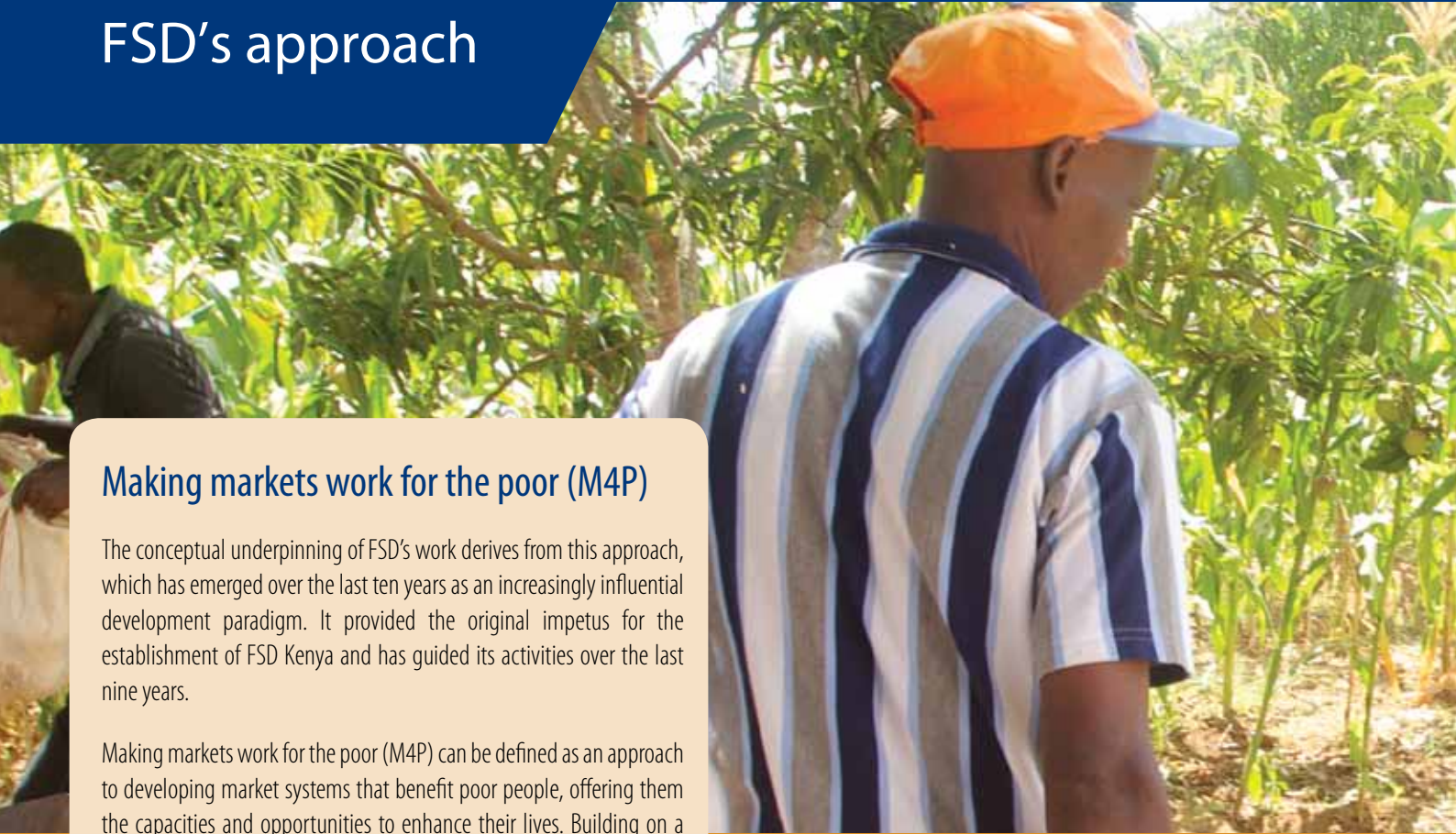
The familiar challenge, of course, is that Kenyans can't afford to pay much to manage an income of KSh 2,000 per month. Average transaction costs must come down drastically if greater usage is to become an option. But could we one day exploit the full potential of technology to reduce costs to near zero?

In 2014, we sought to find ways to apply technology driven innovation across all areas of FSD's work. Building on some of the successes we've had in recent years, we have been helping retail financial service providers to create better ways to meet needs in the market. We've continued to work with the financial services industry, policymakers and regulators to create the industry infrastructure and enabling laws and regulations to support the necessary reduction in costs. There are growing prospects now for a breakthrough in the payments space with the foundations laid for an interoperable system. Community based finance remains a key channel through which to reach many rural areas. Successfully linking formal and informal forms of finance could hold the key to reaching the poor effectively. At the other end of the spectrum, improving finance for growth of businesses remains an important part of the inclusion puzzle. We are now convinced that client-centricity is no less relevant to finance for small and medium enterprises.

A decade ago we were probably unrealistically optimistic about how far along the path we were to creating a truly inclusive financial system. Today we now see a little better the scale of the challenge. Looking to the future there is nevertheless cause for guarded optimism that if Kenya can successfully exploit the new tools at its disposal, we could see major breakthroughs in the reach and relevance of financial services for the poor over the next five years.

**David Ferrand**  
Director

# FSD's approach



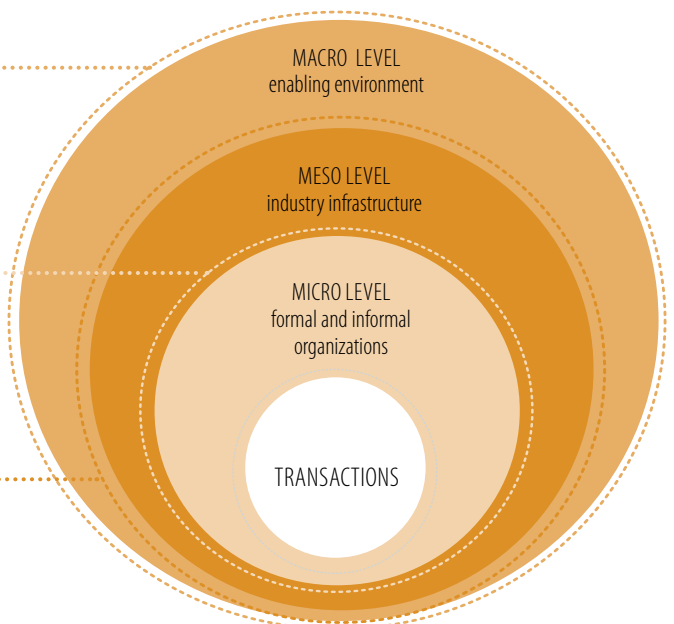
## Making markets work for the poor (M4P)

The conceptual underpinning of FSD's work derives from this approach, which has emerged over the last ten years as an increasingly influential development paradigm. It provided the original impetus for the establishment of FSD Kenya and has guided its activities over the last nine years.

Making markets work for the poor (M4P) can be defined as an approach to developing market systems that benefit poor people, offering them the capacities and opportunities to enhance their lives. Building on a detailed understanding of market systems and a clear vision of the future, M4P allows agencies to address identified systemic constraints and bring about large-scale and sustainable change.

### MARKET DEVELOPMENT REQUIRES ADDRESSING CHALLENGES AT THREE LEVELS:

- At the **macro level**, government policy, legislation, regulation and supervision set the basic framework within which financial services providers operate. An effective and enabling environment reduces the costs and risks of doing business and encourages innovation.
- At the other end of the spectrum, at the **micro level**, it is retail providers who actually deliver services. Developing practical know-how among providers as diverse as commercial banks and community-based associations is at the heart of market development.
- Between these two levels, at the **meso level**, are other services on which retail providers depend. Building the capacity and know-how among relevant service providers such as credit reference, audit, training, and research can enhance market development.





### OUR LONG-TERM GOAL:

Since inception a decade ago our goal has been to generate sustainable improvements in the livelihoods of lower-income households through reduced vulnerability to shocks, increased incomes and employment.

Over time FSD has however changed its emphasis in how it goes about contributing effectively to the achievement of that goal. In recent years we have recognised the importance not simply of access to financial services but how these services are used.

### OUR CURRENT OBJECTIVE IS THEREFORE:

Increased use of a broad range of quality financial services provided by a stable and competitive financial system in a way which benefits the livelihoods of under-served lower income groups.

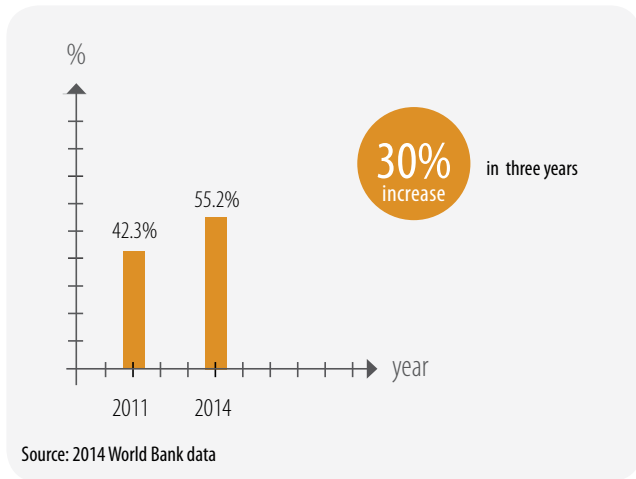
### HOW MIGHT FINANCIAL ACCESS LOOK IN 2020?

Identifying all potential future scenarios for financial access in Kenya would be difficult, if not impossible. It is, however, helpful to consider how it might develop over the next five years. The potential for technology to change Kenya's financial landscape is no longer in doubt; it has already changed dramatically and in a way scarcely anticipated just three years ago. How this now plays out will have significant implications for the development of financial inclusion. It isn't feasible to develop scenarios that cover all aspects of financial inclusion. However three stand out in providing a sense of how the current dynamics could play out:

- ▶ Low-level equilibrium trap – the low-value retail payment space is dominated by a single player. This could stifle competition and innovation
- ▶ Integration – technology-driven integration of formal and informal financial systems. The result could be a dramatic enhancement of the offer to poorer consumers.
- ▶ Take off - effective regulation and opening up of the market results in competition driving down the cost of electronic money, creating a "cash-lite" Kenya.

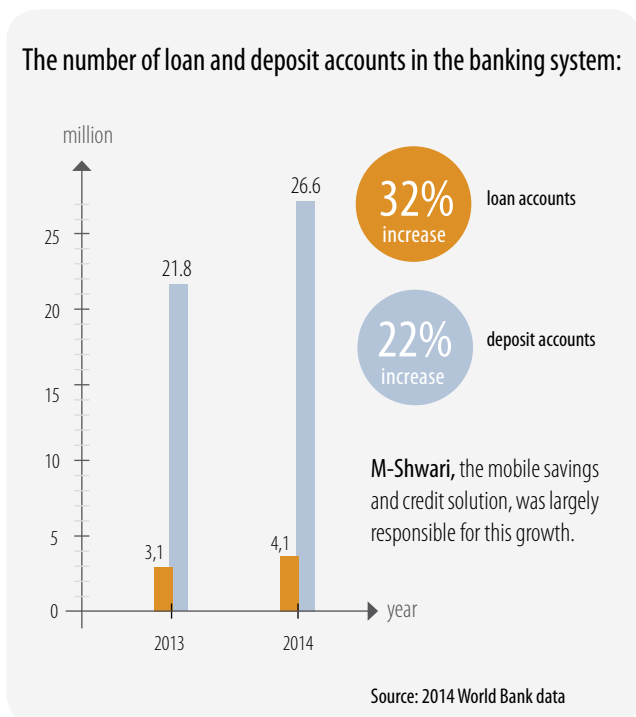
# Financial sector highlights

2014 World Bank data suggests that 55.2% of Kenyans now have bank accounts at financial institutions, up from 42.3% in 2011.



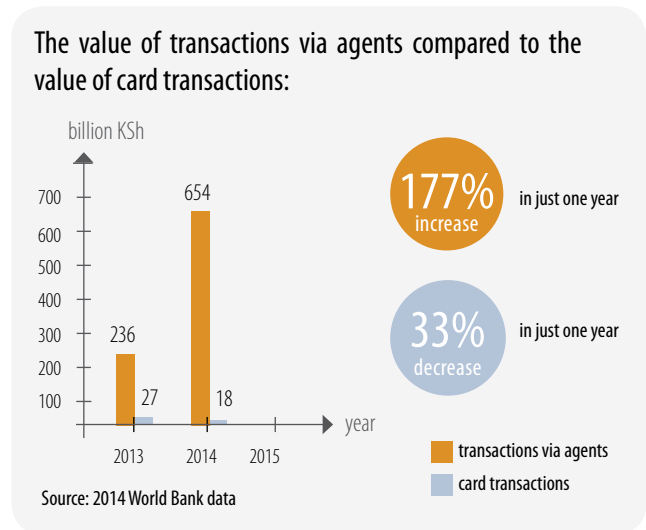
## SIGNIFICANTLY INCREASED ACCESS TO FINANCIAL SERVICES

The credit market in the banking sector continued to grow in 2014, reaching a record KSh 1.91 trillion in the third quarter of 2014, an increase of 24% compared to December 2013.



## IMPROVED ACCESSIBILITY

The number of active bank agents increased from 23,477 in December 2013 to 35,789 in December 2014, and the number of institutions using agency banking increased from 13 to 16. The overall value of transactions via agents increased nearly three-fold, from KSh 236bn to KSh 654bn, in just the first three quarters.



## MOBILE DRIVING RANGE

M-Shwari, the CBA mobile savings and loan service offered through M-PESA, continued to register impressive growth in its second year. In December 2014, CBA accounted for nearly a quarter of the total number of deposit accounts in the banking sector, second only to Equity Bank. Within the year, CBA overtook Equity as the lender with the highest number of loan accounts.

The success of M-Shwari has seen other lenders launch mobile money services, including Equity Bank, KCB's M-Benki, NIC bank's 'NOW' and UBA Kenya's product launched with Airtel. Equity Bank's rival product uses a mobile virtual network operator model. Credit Bank, Imperial Bank, Cooperative Bank and National Bank also launched mobile services.

Mobile payments continue to dominate retail financial transactions. Over KSh 2.3bn was transacted via mobile payments in 2014, representing 24.72% growth on a similar period in 2013. This can be attributed to the continued expansion of the network of mobile agents and introduction of new services. One standout was Safaricom's 'Lipa na M-PESA', which allows retail payments from customers to merchants using M-PESA, the ubiquitous mobile money service. By the end of the year 32,000 merchants were actively using the service.

As part of the government’s aim to strengthen the **regulatory architecture** in Kenya, a draft bill was prepared to create a new Financial Services Authority, intended to regulate and supervise institutions in the financial services sector outside the banking sector by consolidating existing non-bank regulators. We anticipate that greater emphasis will be given to market conduct regulation as part of the reforms.

To promote **credit information sharing**, 2014 saw revised regulations on credit reference bureaus (CRBs), so that they now allow both commercial banks and microfinance banks to share positive and negative information. All commercial and microfinance banks subsequently commenced submission of full file information to the two licensed CRBs in February 2014.

**REGULATORY ENVIRONMENT IMPROVING:**

In a major regulatory development, **the national payment system Act** of 2011 was promulgated, bringing the regulation and supervision of payment systems and payment service providers within the jurisdiction of the CBK. Regulations to operationalise the act were gazetted in August 2014. Key elements of the regulations include provisions to:

- ▶ foster interoperability,
- ▶ improve system stability,
- ▶ increase competition and consumer protection and
- ▶ safeguard against systemic risk

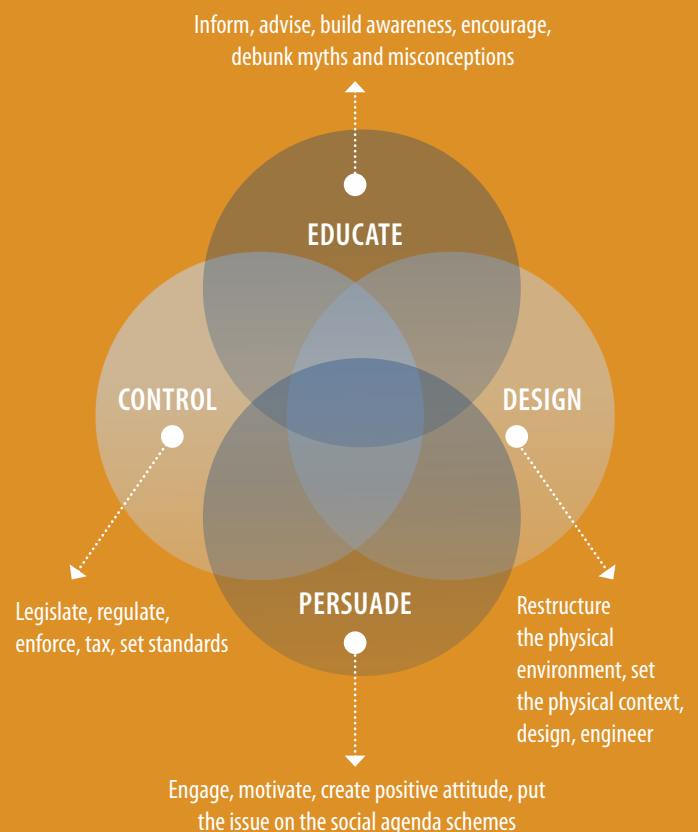
To improve **price transparency**, as of July 2014, commercial banks began disclosing the total cost of credit and repayment schedule for loans. An annual percentage rate (APR) measure was also defined to provide a standardised interest rate measure. This has so far been applied to term loans, but there are efforts to expand the scope of APR to cover other products.

CPF Financial Services introduced a mobile based pension plan, **M-Pension**, targeting individuals with a monthly income of less than KSh 10,000 employed in the informal sector, allowing daily contributions of between KSh 50 and KSh 300. This competes with the Mbao Pension Plan promoted by the Kenya Jua Kali Co-operative Society (an umbrella organisation of jua kali associations informal craftsmen) which allows contributions of as little as KSh 20.



**OVERCOMING CONSUMER CHALLENGES AND BARRIERS**

FSD funded research showed misconceptions about plastic cards around: shopping with cards is for the elite; swiping is expensive or for ‘foreigners’. Consumers distrust the system. Many don’t even know bank cards can be used for transactions, not just withdrawing cash. A four pronged strategy was proposed to industry stakeholders to overcome these obstacles to card use:



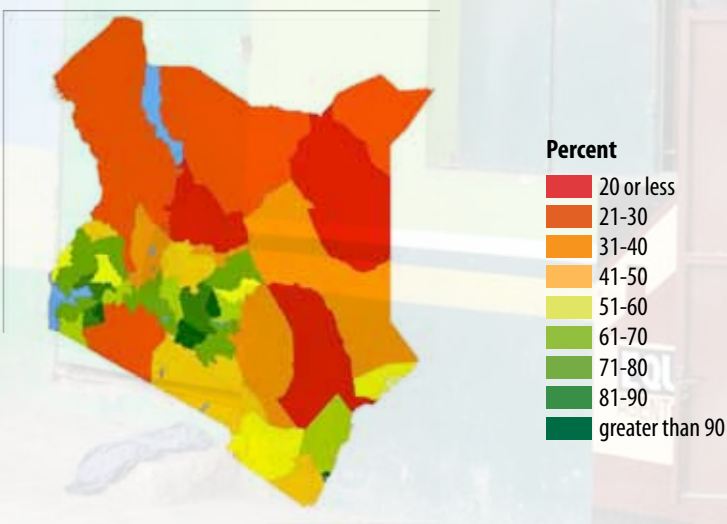
Source: Adapted from TNS’s behaviour change model

# Access: Where are we?

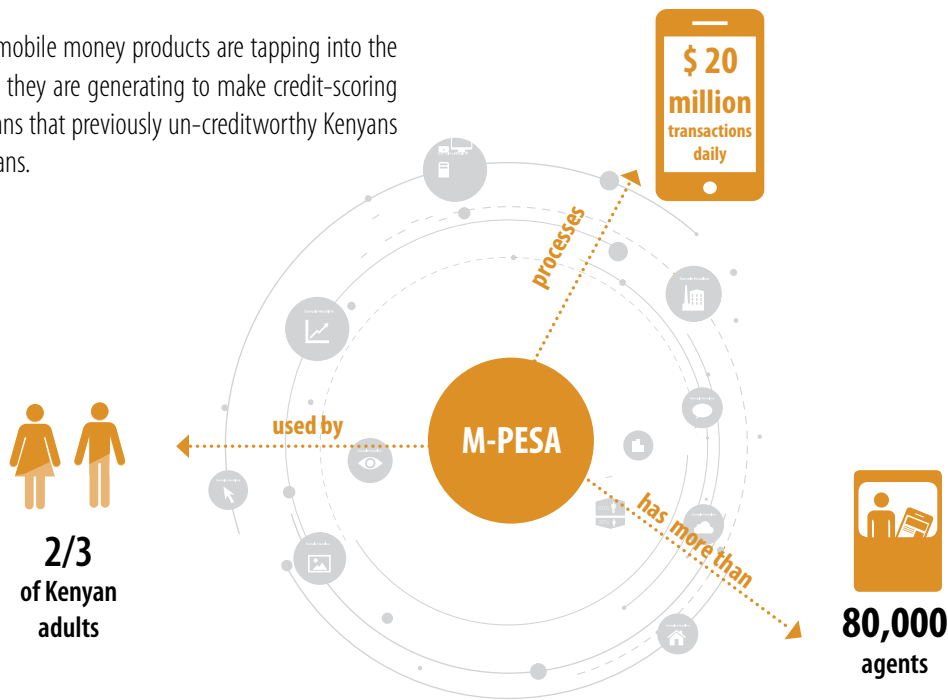


FINANCIAL ACCESS POINT

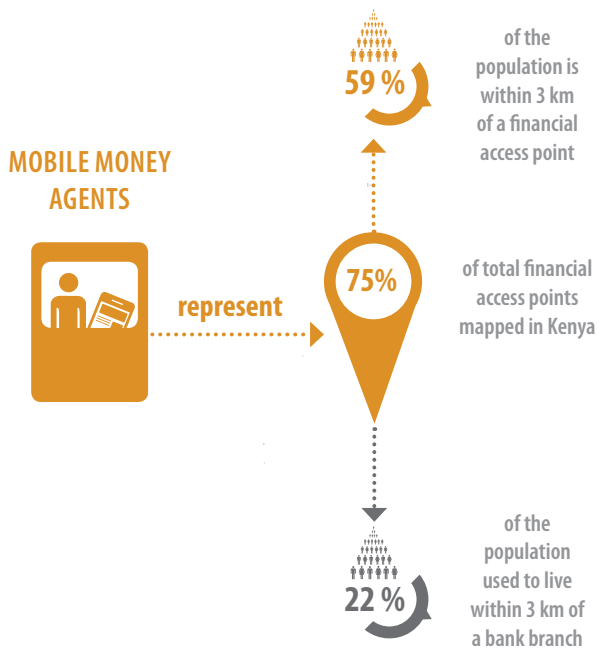
Percentage of population within 3 km of a financial service location



For the first time, mobile money products are tapping into the digital information they are generating to make credit-scoring decisions. This means that previously un-creditworthy Kenyans are now getting loans.



Kenya offers better access to **financial points** than its regional neighbours – 58.7% of Kenya’s population lives within 3km of a financial access point compared with only 28.3% in Tanzania. But financial access is growing fastest in wealthier and more densely populated areas, excluding large areas of the country. A public, online, spatial-mapping portal ([www.fspmmaps.com](http://www.fspmmaps.com)) launched in March 2014 demonstrates this disparity clearly.



Data from the Kenya Financial Diaries survey revealed a lot about people’s needs and the importance of physical access. In the average Kenyan household, **income** fluctuates  $\pm 55\%$  from month to month. **Consumption** meanwhile fluctuates  $\pm 43\%$ . The median household moves the equivalent of 128% of its income through a variety of financial ‘devices’ which range from the formal (for example, bank accounts) to the informal (rotating savings and credit associations or *chama*) The typical household is constantly moving the same money into and out of financial devices, even short term ones, such as high frequency chamas or saving in the house. The day-to-day strategy is all about juggling obligations and keeping some leeway for needs that might arise.

Money is rarely left to sit idle; savings are either shuffled to financial devices that provide immediate benefits, or directly to the saver. Rotating savings and credit associations (ROSCAs) put savings to work instantly, for example by helping a neighbour grow her business while the saver waits their turn. Currently, only about 9% of the typical household’s savings are held in formal institutions reflecting the disconnect of formal services with people’s needs.

## FSD's portfolio

In line with our strategy and the annual business plan, our work at the start of the year was organised into five areas:

- ▶ Poverty impact
- ▶ Future financial system
- ▶ Digital innovations
- ▶ Knowledge
- ▶ Inclusive growth

To concentrate our efforts in key areas, shifting from small to larger and more comprehensive projects, the number of active projects decreased from 22 to 17. As the number of projects decreased, the size and level of activity within them increased.

### ▶ POVERTY IMPACT

Poverty impact projects are geared to using financial services to deliver livelihood benefits to specific excluded or under-served groups. While major gains have been made in expanding financial access in the last ten years, those gains are smallest among the poorest. The majority of Kenya's population lives in rural areas, where agriculture is the primary source of income. Poverty impact projects therefore focus on the rural poor, placing emphasis on developing community based financial intermediation models which have been shown to be effective here.

A number of community based approaches are supported. These range from the simplest, savings groups through financial services associations offering a range of financial services to SACCOs, some of which have reached a scale and complexity which exceeds that of many banks. Although the needs vary significantly across organisational forms, the themes are common: increasing outreach, enhancing the value of what can be offered to members and above all strengthening stability to improve the safety of the members' funds which they intermediate.

### ▶ FUTURE FINANCIAL SYSTEM

Our work here is about creating a formal financial system which supports inclusion. Electronic payments offer benefits to the economy, but, perhaps most notably, they enhance the prospects of dramatically improving financial inclusion. FSD's work is therefore heavily weighted towards achieving FSD's strategic goal of a 'cash-lite' economy in Kenya. The target is to achieve a significant and sustainable reduction in end-to-end transaction costs in accessing the retail formal financial system. If realised, this could transform the financial landscape.

### ▶ DIGITAL INNOVATIONS

Through digital innovations, we are trying to find ways to use new technologies to meet the needs of consumers. DFID's original support for Vodafone and Safaricom in establishing M-PESA was essentially an exploratory exercise. Through our retail innovations initiative, we are helping to plug the exploration gap, applying knowledge practically, sharing the risks to support prospective innovators, whether large firms or new entrants, and mobilising investment effectively to tackle market opportunities. The initiative is complemented by our centre for insights into financial inclusion, which was established to undertake research to support digital financial inclusion. The focus is on developing insights into how financial solutions can create real value for people.

Although a lot of the technology already exists to create a cash-lite economy, achieving it requires support and adoption across government, businesses and consumers. Since the government is the single biggest user of payments services in the economy, its adoption of electronic payment forms is a key driver of uptake of electronic payment forms.

## ▶ KNOWLEDGE

We recognise that investment in research and knowledge is critical to delivering our mandate. Our work to promote knowledge thus cuts across all of FSD's work. In addition, we have three specific knowledge projects: FinAccess retail; FinAccess business, and FSD impact research, now in phase II.

2014 saw the groundbreaking release of the Kenya Financial Diaries, the most comprehensive and detailed survey of the financial lives of Kenyans ever conducted. How, exactly, do low income families make ends meet? What can an in-depth understanding of financial behavior show us about their financial service needs? The Diaries research has given rise to a host of publications on a wide range of specific sub-topics, and poignant respondent profiles, and is a space that is constantly being updated.

The latest round of the national financial access survey, FinAccess, will be conducted in 2015. FinAccess, conducted in partnership with the Central Bank of Kenya and other stakeholders provides the most comprehensive dataset on inclusion in Kenya.

## ▶ INCLUSIVE GROWTH

SMEs play a critical role in employment generation and income growth. This is reflected in the government's long-term 'Vision 2030' strategy, which has a key aim of increasing Kenya's economic growth. The government has committed itself to overcoming policy constraints to increased access to finance by SMEs. We are currently working on two core areas to support their objectives: increasing the capacity of financial providers to better meet the needs of SMEs and expanding the credit information sharing system.

GrowthCap, FSD's SME finance capacity building project, seeks to draw on experience from around the world for successful SME financing to create the best approach for Kenya. The project is currently working to ensure that at least one banking partner is fully committed to and implementing an SME strategy before the end of the project in October 2015.

### Key points from DFID's 2014 review of FSD's progress:

FSD Kenya continues to play an important role in Kenya's economy and has helped facilitate financial sector development which would otherwise take much longer to materialise – such as M-Shwari, which has provided credit and loan services to 8.5m Kenyans.

Challenges remain, with an estimated 4.7 million adult Kenyans (25% of the adult population) living without access to formal financial services and some 39% of the low-income populations citing cost as a constraint to saving.

FSD Kenya is providing excellent value for money, with its administration costs the lowest among the seven FSDs in Africa, and benefits on average 9 times greater than its costs.



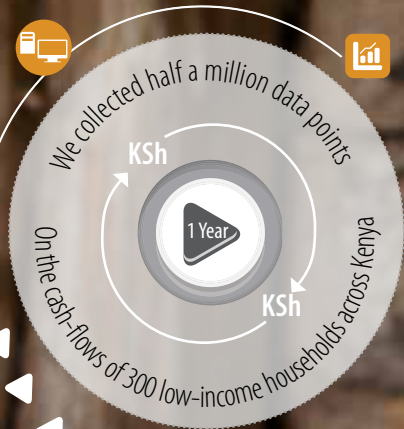
## Financial diaries

### THE DIARIES DATA COLLECTION

We recorded the additional data on sources and destinations of these transactions.

We recorded every single transaction: e-money payments, in-kind transactions to cash

We interviewed households every two weeks, witnessing their shocks and triumphs



Insights into potential market opportunities and more sophisticated business modeling

On August 12th 2014, FSD launched the Financial Diaries Study and, in doing so, made a game-changing contribution to our understanding of the financial lives of Kenyans. The study is possibly the most ambitious research project FSD has ever undertaken.

*"Just as FinAccess highlighted the market opportunity at the bottom of the pyramid for the formal financial sector, this study, reframes the challenge of financial inclusion. Rather than looking at usage of financial products, the project highlights consumers' real financial needs, opening up many new ideas for how financial services could have a real impact on the lives of low income Kenyans."*

Julie Zollman, Kenya Financial Diaries' principal investigator

We collected half a million data points on the cash-flows of 300 low-income households across Kenya. The real-life stories of individuals who participated provide a compelling window into the drivers and uses of finance in Kenyans' everyday lives. Since the study took place over a full year, researchers got to know their respondents. They interviewed households every two weeks, witnessing their shocks and triumphs and recording the ways people dealt with these through their daily financial flows. The research recorded in minute detail every single transaction, from e-money payments to in-kind transactions to cash, often with the additional data on sources and destinations of these transactions.

If, for example, an M-PESA transaction came in from a son or daughter working in Nairobi, the data shows how and when this was later withdrawn and how it was spent. Financial surveys usually capture ex-post costs of things

like medical care, but are not so good at capturing care that is delayed or foregone. With the Diaries, both are visible.

This qualitative and quantitative database not only provides insights into potential market opportunities by giving us a rich picture of demand, but it also enables more sophisticated business modeling, based on actual volumes and values transacted in real life scenarios. The data has already been deployed to help design new solutions like the M-Changa 'e-harambee' product, which is now on the market, and has been used to inform new initiatives on micro insurance and agriculture.

Kenyans use a surprisingly large array of often informal, financial instruments to stretch their unpredictable, low-value incomes. Methods of coping with long and short-term needs are currently mostly outside the formal sector, but even informal financial institutions often fail to provide appropriate solutions to cope with short-term volatility and longer terms needs like old age, education and opportunities for growth. The study highlights instances where lack of access to credit, insurance and savings products impacts the wellbeing of large swathes of the country's population, even though people are highly creative in finding ways to manage their finances. It provides a wake-up call, for innovators and investors in the financial industry, and also for policy makers in their efforts to address poverty.

A host of presentations, workshops and analyses followed the release of the Diaries in August. Our goal is to share the learnings of the Diaries as widely as possible. As we move into 2015, the Diaries team is continuing to respond to the needs of existing and potential industry and policy partners, mining the data to address new solutions and initiatives for financial inclusion.



#### MONICAH AND ISAAC, TWO FINANCIAL DIARIES RESPONDENTS:

Since October, Monicah had been growing increasingly sick. The 36-year-old mother of four had been staying home with her children after the recent birth of her son. Now, she was getting tired and losing weight. She couldn't keep food down. In and out of the hospital, she waited for a diagnosis that only came in late November: a throat tumor. It would cost KSh 23,000 (about \$260), to remove. Isaac and Monicah had already used up their savings. Isaac, a fisherman, even sold two rooms they were renting out to pay for the admission fee and x-rays that had gotten them this far. Where would they get this money? Monicah was discharged from the hospital and told to come back when she could pay for the surgery. She went to rest at her mother's home. On Boxing Day, she died.

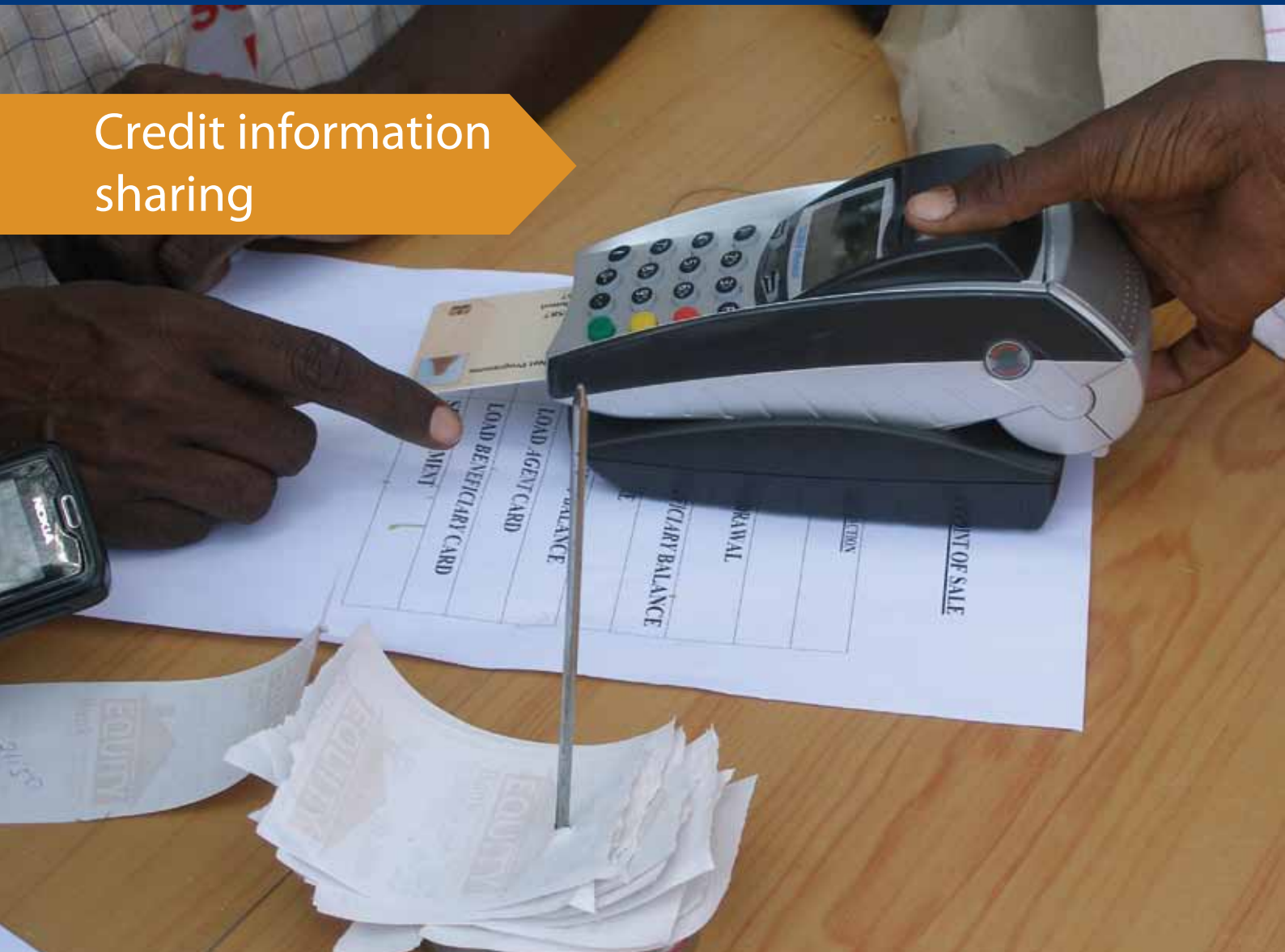
Immediately, there was an outpouring of gifts and contributions from friends and relatives, within a single day surpassing what was needed to pay for the surgery that might have saved Monicah's life. For Isaac, his social network worked, but too late to save his wife. Isaac reflected later, "Wakati ukienda ni kama moshi. Haurudi tena." or "Time is like smoke. Once it is gone, it does not come back."

We have been astounded by how powerful informal risk sharing can be as a coping mechanism. Social networks in Kenya are one of the backbones of the economy and help people manage shocks and seize opportunities. But, in too many cases, like Isaac and Monicah's, we have seen the social network fall short. It is in those areas of weakness that we find opportunities for the financial sector to offer new kinds of solutions, to leverage networks at the right time and at the right cost.

#### In short, what did we learn?

- ▶ Poor Kenyans face both low incomes and lots of volatility. They piece together their incomes from many different sources out of necessity.
- ▶ Low earners don't have enough money to do everything they need to do with their money. They make trade-offs between stretching their budget to smooth consumption and investing in their future earning potential, the main force for pulling oneself and one's family out of poverty.
- ▶ With many competing needs, our respondents feel it's essential that all of their money is constantly working, enabling them, or their social networks to accomplish something immediately. Money that simply sits in liquid savings – on M-PESA, in a bank account, or even under the mattress – feels wasteful.

## Credit information sharing



FSD has been supporting the government of Kenya and Kenyan credit providers in implementing a robust credit information sharing (CIS) mechanism since 2009. We envisage that full file information sharing among credit providers will help both collateral-constrained small businesses access credit, and lower the cost of borrowing for those who create and maintain a good credit record.

2014 was the final year of the second phase of our support of a CIS mechanism as a stand-alone project in Kenya. Our input has been geared towards ensuring the sustainability and future growth of the CIS mechanism that is now in place, and, through a series of events and partnerships, working to raise the public profile of CIS.

The Association of Kenya Credit Providers (AKCP), which was launched in 2013, has been our main partner in implementing the CIS mechanism. In October 2014, the AKCP launched its five-year strategic plan for the period 2015 – 2019.

In November, the AKCP was instrumental in the launch of an alternative dispute resolution (ADR) centre, with the support of Kenya's Judiciary. By early 2015, there were signs of good progress; all of the disputes brought to the ADR centre had been resolved before escalating to the courts.

A number of partnerships were formed during the year and publicity events were conducted with the Consumer Federation of Kenya, the Higher Education Loans Board and the Credit Bureau Association of Kenya. We expect these initiatives to continue to raise the profile of CIS in the future.

The second phase of the CIS project ended in December 2014. FSD will continue to support the CIS under a broader credit market development project that was developed and approved just before the end of the year.

# Community-based finance

## ▶ SACCO

Our SACCO reform work concluded at the end of the third quarter of 2014, with most targets met and some exceeded. The project's objective was to develop the capacity of deposit-taking SACCOs to meet the requirements of the new regulatory framework. 85% of SACCOs with so called 'front office savings activities' – providing withdrawable deposits services – were licensed in the project period, exceeding our target of 70%.

With 10.8% of the adult Kenyan population using SACCOs and 4.0% specifically using them for credit (compared with 3.6% using bank credit), SACCOs clearly remain an important part of the Kenyan financial services sector. A quarter of users do not currently have access to any other form of financial services. They are typically members of rural, agriculture-based SACCOs. These 'frontier' SACCOs present an opportunity for deepening financial inclusion to smallholder agriculture farmers.

To improve community-based finance offerings, we are investing in three key areas:

- ▶ Reforming Savings and Credit Cooperatives (SACCOs)
- ▶ Supporting the formalising of a fully sustainable Financial Services Association (FSA) network
- ▶ Scaling up savings groups

## ▶ FSA

FSAs are rural savings and credit organisations owned, financed and managed by rural communities, usually in areas with poor infrastructure and limited economic potential. Although similar to some smaller SACCOs, they have proven especially important in areas without either cash crop production or large-scale employers – the traditional driver of SACCO formation. Initially, FSD anticipated the launch of new FSAs, but our focus has shifted to addressing the regulatory challenge. Although member driven the scale of many FSAs, which mobilise deposits from members, now demands regulation. Tangible progress has been made during the year toward agreeing on a viable roadmap for regulation of FSAs to safeguard the members' funds.

▶ 85% of SACCOs with so called 'front office savings activities' were licenced.

▶ 10.8% of the adult Kenyans use SACCOs.

## ▶ SAVING GROUPS

Savings groups offer a simple financial mediation model in which people come together and contribute an agreed minimum savings during each meeting. At the end of 2014, FSD was working with its key partners CARE and Catholic Relief Services to promote the formation of groups, improve transparency, security and develop appropriate linkages to formal financial providers. In total, we have supported the creation of over 14,000 groups so far. Even in northern Kenya where outreach is most challenging, results continue to be encouraging, with the numbers marginally exceeding projections.

New technology offers new ways to strengthen operations. An 'e-recording' application has been successfully developed and piloted with groups. Running on the ubiquitous Android smart phone mobile operating system, the app allows groups to automate their bookkeeping

reducing errors and the potential for fraud while storing the data safely in the cloud. This also opens up the potential to link with formal financial institutions. FSD has, for example, been working with Postbank and CARE Kenya to pilot an 'M-Chama' solution, allowing groups to save their surplus funds with a formal institution. Finally, FSD has also been experimenting with a form of e-learning. Another Android application has been developed to help train prospective savings group members on how to form and operate their group. It is expected that some groups may now be able to form entirely unassisted while others will require less support from trainers.

## Community-based finance

### WHY SUPPORT SAVING GROUPS?

In the past, group savers in Kenya triple-padlocked their money in a metal box. At the end of a group meeting, one person kept the box, while the keys were all given to separate individuals, so that one would need four people's buy-in to open it. FSD's m-linkage programme is working to enhance the security of group funds, and to make the money work harder for savers, rather than just sit in a box. Digital savings solutions provide financial records for people. This information will in turn help to link informal financial mechanisms to formal ones, enabling the formal banking sector to provide low-income people with better banking solutions. It has long proven difficult for banks to lend safely to small community based groups. In large part this relates to the problem in assessing the credit risk of a group and monitoring it effectively. With digital records this becomes radically easier. Caution is still necessary however — experience suggests that it is the personal relationships between group members which binds the groups together and provides the motivation to repay loans.



# Digital innovations



## UNLOCKING POTENTIAL FOR CHANGE

Kenya stands at a crossroads with respect to financial inclusion. Although enormous progress has been achieved in the last five years, technology has the potential to significantly expand and deepen financial access. There is strong evidence to suggest that cost remains a major constraint to the adoption and use of formal services. Digitization has the ability to significantly reduce costs, both in terms of the price faced by users from providers and the costs of accessing service points. Digital innovations have the potential to change the way that financial solutions are delivered and used.

Given recent successes in the market there is considerable appetite for private sector led investment in digital financial solutions in Kenya. The question many investors, both existing players and start-ups, face is what to invest in and how to implement their choice. In 2014, we expanded our innovation team to support private sector initiatives, in order to develop and roll-out radical new financial management solutions for low-income households. This has led us to forge a number of new partnerships, while continuing our relationships with existing partners.

We are working on turning existing data on agriculture into inputs for credit scores and exploring how that might translate into a commercial proposition. We are also working with agriculture dealers to improve the



*“We’re looking at the intersection of customer needs and commercial possibilities. Imagine a venn diagram of the two. 15 years ago, the cross-over would have been tiny. Largely because of technology, the two circles are coming together and overlapping in ways they didn’t before. Kenya is perhaps further ahead in this than any other country in the developing world”*

Tamara Cook, Head of Digital innovations

delivery of finance to farmers. In collaboration with FarmShop, which integrates fragmented agricultural supply chains, FSD is hiring a credit expert to analyse FarmShop’s existing data. The expert will explore potential partnerships with financial providers for lending to farmers. Work is underway to identify the challenges and the opportunities of implementing a crop and livestock public-private partnership programme (PPP). The main agenda is to understand how the private sector side would like to engage with the PPP. To unlock the potential for innovation in Kenya, we are also supporting start-ups and innovators in their incubation of ideas.

# Government payments

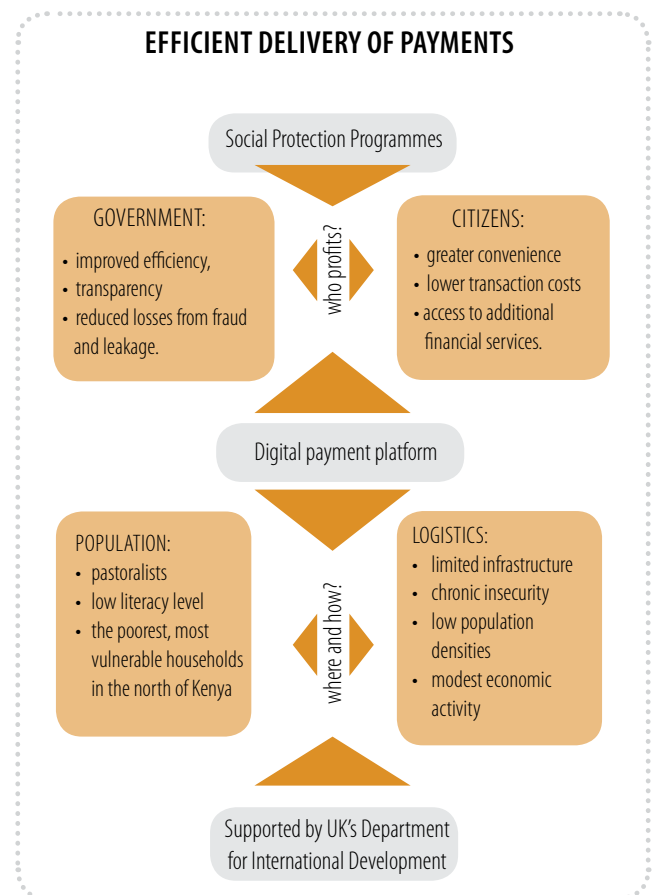
The government of Kenya is the largest single user of payment systems in the economy, and it has already pledged to move towards an entirely electronic payments platform. This presents a major opportunity to drive a shift towards a cash-lite economy. Our emphasis in 2014 has therefore been on designing an effective digital payment platform and the necessary legal and regulatory framework to support it. For the government, digital payments translate into improved efficiency, transparency and reduced losses from fraud and leakage. And for citizens, it means greater convenience, lower transaction costs and access to additional financial services.

To support the major digitisation drive that is underway, led by the National Treasury, FSD Kenya has engaged international experts to examine a wide range of other countries where government payments have been digitised. Based on their findings, we have arranged study tours for Kenyan government officials to visit and speak to their counterparts in Colombia and the United States. Implementation of the new platform will move ahead in the coming year.

*“Why is FSD engaged in social protection? The Hunger Safety Net Programme serves as a poster child for how the private sector can deliver payments efficiently and leave an audit trail. It’s an example of how to deliver social protection with minimal leakage and fraud”*

Victor Malu, Head of Future Financial Systems, FSD Kenya

An important entry point to develop digital payments in Kenya has been the creation and rapid expansion of social protection programmes. We played a lead role in establishing a digital payment solution for the Hunger Safety Net Programme (HSNP), implemented by the Ministry of Northern Kenya during the pilot and Phase II now being implemented under the National Drought Management Authority under the Ministry of Devolution. This programme, which receives major financial and operational backing from the UK’s Department for International Development, seeks to provide a dependable social cash-transfer system to support the livelihoods of the poorest and most vulnerable households in the north of Kenya. The logistical challenges of providing banking services in the northern counties are formidable. There is very limited infrastructure, chronic insecurity, low population densities and modest economy activity. Populations targeted by HSNP have never used formal financial services before, and literacy levels are low. Many are pastoralists, shifting location through the year to find grazing for their herds. Equity Bank has rolled out an agent-based system as per FSD’s specifications to support payments, allowing financial services to



be cost-effectively brought closer to communities. Results have been encouraging with large numbers of those targeted already included and successfully paid on a regular basis. The success of HSNP helped to establish the case for moving towards the use of the formal financial system for payments under all social protection schemes.

FSD has seconded a technical adviser to the National Social Protection Secretariat to support the development of appropriate electronic payment solutions. Kenya Commercial Bank will soon be providing bank accounts to deliver social payments to beneficiaries of all the other government social protection programmes including the Orphans and vulnerable Children (OvC) programme, the Older Person Programme, Persons with Severe Disabilities and Urban Food Subsidy. In the long term, we hope it will become viable to offer beneficiaries a choice, so that they select the financial service provider most convenient to them.

Alongside this, many other poor households will be provided with bank accounts so that emergency cash payments can be made to provide rapid support when conditions become a threat to life in these chronically weather dependent areas. In 2014, HSNP’s payment service provider, Equity Bank, opened over 100,000 new bank accounts to support HSNP payments. The initiative is now scaling again, with at least another 200,000 accounts to be opened in 2015.



## Payments platform

### PROMOTING INTEGRATION TO LOWER COSTS

The costs of moving funds around present a significant barrier to the uptake of financial services among low-income households in Kenya. The platform that determines these costs, the payments system that exists within the financial sector, is therefore extremely important for financial inclusion. Working towards Kenya's goal of becoming a cash-lite economy, FSD is helping to develop a robust, stable, efficient, low-cost payments platform that is capable of supporting all financial service providers. The goal is one single platform, which integrates all major retail channels in a robust, fully interoperable system and results in low transaction costs. Our aim is to see the benefits of this passed on to consumers in the form of low prices and ready accessibility with safety remaining a key objective.

Kenya passed a major milestone in 2014 by operationalising the National Payments System Act 2011 in August and promulgating the necessary regulations. This now provides the basis for regulation of Kenya's fast developing payments industry. The Central Bank of Kenya had adopted a far-sighted and measured approach, allowing innovation to flourish with a light-touch to oversight before looking to identify potential risks and regulatory responses.

*"We're looking forward to a time where it will be possible to move money not just from bank account to bank account but also to your mobile or digital wallet and vice versa seamlessly. It's a move to integrate payment systems and to reduce the overall cost of transacting. We call it cooperation - competing with cooperation. Because there are some areas where through cooperation we can achieve a win win for all players."*

Victor Malu, Head of Future Financial Systems

FSD has been supporting the Kenya Bankers' Association in its efforts to improve interoperability within the banking system. While the initial focus was on more efficient switching of payments between banks, the scope has now expanded to look at how other financial service providers can be included, such as mobile-based services.

A payment system management body, will be established to provide the basis for oversight and management of the payment system. FSD organised learning tours to the US and UK so that Kenya could benefit from their experiences in improving payment system interoperability. As 2014 drew to a close, Kenya's banks were in the final stages of procuring the Kenya Inter-Parties Transaction Switch. The switch will allow low value retail payments to be made in real-time between banks. Among the first applications will be a new bank account to bank account payment service. This will provide convenience to many, increase competition in the retail payment market and encourage users to retain value in electronic form.

## Financial report



FSD closed the year with a surplus of KSh 1,512m, 5% below the budgeted surplus of KSh 1,600m. Efforts were made to drive down the level of cash holding where it presented no risk to committed funds. As a result, FSD accepted scheduled funding from SIDA. Other funding was received from Gates foundation (KSh 350m), and the Central Bank of Kenya (KSh 8.2m) to co-fund the FSD FinAccess project. DFID funding was rescheduled to 2015. Other income included restricted funding for FSD Africa (KSh 506m) and the HSNP project (KSh 3,109m). FSD earned a total of KSh 114m in interest income from the cash held on fixed deposit while also recognising a further KSh 9.3m as exchange gains during the year tied to the weakening of the Kenya shilling against major currencies.

### PROJECT EXPENDITURE

Total programme expenditure for the year was KSh 4,397m (-13% below budget). Most projects were within budget. The FSD Africa project was a notable exception, spending at a considerably greater rate than predicted and in line with its current primary funder DFID's desire to see activity increase rapidly. Management expenditure was KSh 38m (-20%) below budget for the year due to lower spending on procurement and administration costs.

#### Project expenditure

## KSh 4,397 million

(-13% under budget)

The **formal financial system** theme was KSh 692m (-17% below budget). While the HSNP project has made major progress since payments to beneficiaries began during the year, the number of beneficiaries with bank accounts has remained below projections. 23% of targeted beneficiaries did not have valid national identity cards and hence could not have accounts opened. The policy project

incurred above average spending, with a high level of engagement by the National Treasury resulting in several activities registering higher expenditure than budgeted.

**Poverty impact** expenditure was KSh 151m (-44% below budget). Delays to the FSA transformation III project due to regulatory issues account for KSh 39m of that, while the envisaged follow on SACCO project has been deferred.

#### Formal financial system

## KSh 692 million

(-17% under budget)

**Inclusive growth expenditure** was KSh 43m (-28% under budget). Credit reference spending has been reducing over time partly due to the success in attracting financial participation from the lending industry. Slow deal-flow constrained spending under the SME finance innovations fund project. Variance was moderated by higher spending on GrowthCap (39% above budget) as the project gained momentum.

**Knowledge expenditure** was 50m (-30% below budget) for 2014. There was low spending in the quarter on the FinAccess 2011 project (-73%) as it is now in the data analysis phase being undertaken by partners on a pro bono basis. FinAccess business was -74% below budget as it faced delays due to problems with the sampling framework.

**Management expenditure** for the year was KSh 38m (-20% under budget). The cost saving was mainly as a result of significantly lower spending on administration costs (-44% below budget) and procurement (-86%) while labour costs were only just below (KSh 6.3m, -5%). Overall management represented 3.6% of total expenditure during the year.



**Table 1**  
**Income statement**

**FOR THE YEAR ENDED 31<sup>ST</sup> DECEMBER 2014**

	2014	2013
	KSh millions*	KSh millions*
<b>INCOME</b>		
Grants	4,091	2,258
Other Income	1	10
Finance Income	186	80
<b>TOTAL INCOME</b>	<b>4,278</b>	<b>2,348</b>
<b>EXPENDITURE</b>		
<b>PROJECT EXPENSES</b>		
Core projects <sup>2</sup>	587	446
Designated projects <sup>3</sup>	3,620	1,101
	<b>4,207</b>	<b>1,547</b>
<b>ADMINISTRATIVE EXPENDITURE</b>	158	145
<b>TOTAL EXPENDITURE</b>	<b>4,365</b>	<b>1,692</b>
<b>FINANCE COSTS<sup>4</sup></b>	-	23
<b>TOTAL COSTS</b>	<b>4,373</b>	<b>1,715</b>
<b>SURPLUS FOR THE YEAR</b>	<b>(80)</b>	<b>633</b>

\* Columns do not add up due to rounding.

<sup>1</sup> Finance income includes interest earned on FSD funds.

<sup>2</sup> Core/non designated projects are projects funded by donors through unrestricted funds. Unrestricted funds have no conditions regarding the projects they can be used on.

<sup>3</sup> Designated projects are funded by donors through restricted funds. Restricted funds can only be used on the project specified by donors.

<sup>4</sup> These are exchange losses incurred on revaluation of foreign currency held by FSD.

# Financial report ... continued

Table 2

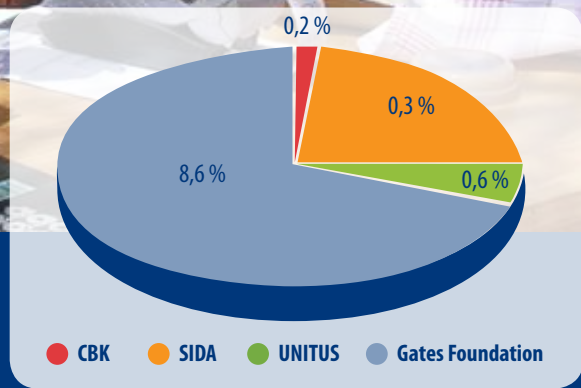
## Balance sheet

AS AT 31<sup>ST</sup> DECEMBER 2014

	2014	2013
<b>ASSETS</b>	KSh millions*	KSh millions*
<b>Non-current assets</b>		
Property and equipment	13	16
Intangible asset work in progress	3	3
Long term loan	38	32
<b>Total non-current assets</b>	<b>54</b>	<b>51</b>
<b>Current assets</b>		
Receivables	11	9
Contract advances	0	0
Short term deposits	1,405	2,051
Bank and cash balances	1,828	2,400
<b>Total current assets</b>	<b>3,244</b>	<b>4,460</b>
<b>Total assets</b>	<b>3,298</b>	<b>4,511</b>
<b>RESERVES AND LIABILITIES</b>		
<b>Reserves</b>		
Accumulated fund	1,591	1,671
<b>Current liabilities</b>		
Unexpended projects fund	1,599	2,685
Accruals	34	81
Tax liability <sup>1</sup>	74	74
<b>Total current liabilities</b>	<b>1,707</b>	<b>2,840</b>
<b>Total reserves and liabilities</b>	<b>3,299</b>	<b>4,511</b>

\* Columns do not add up due to rounding.

<sup>1</sup> This amount is an accrual of taxes on which FSD has applied for exemption from the government pending finalization of the exemption application.



**Table 3**  
**Funding summary (2014)**

	2014	
	KSh millions*	%
<b>Unrestricted</b>		
CBK	8.269.878	0,2
SIDA	120.828.397	3,0
Bill and Melinda Gates Foundation	350.026.725	8,6
Unitus	22.857.596	0,6
<b>Sub-total</b>	<b>501.982.596</b>	
<b>Restricted grants</b>		
DFID – HSNP	3.109.490.533	76
DFID – FSD Africa	479.501.578	11,7
<b>Sub-total restricted</b>	<b>3.588.992.111</b>	
<b>Total</b>	<b>4.090.974.707</b>	<b>100</b>

# FSD staff

## Management



David Ferrand  
Director



Felistus Mbole  
Head, Poverty impact



James Kashangaki  
Head, Inclusive growth



Victor Malu  
Head, Future financial systems



Amrik Heyer  
Head, Knowledge



Tamara Cook  
Head, Digital innovations



Benson Ngao  
Finance manager

## Poverty impact



Kuria Wanjau  
Project manager, Savings groups



Wanjiku Karanja  
Assistant project manager,  
Poverty impact



Henry Njoroge  
Project assistant, Savings groups

## Knowledge



Geraldine Makunda  
Project manager, FinAccess



Silas Ochieng  
Project manager, Research



Edoardo Tololo  
Research economist



Ciliaka Gitau  
Research associate, Impact

Future financial system



Juliet Mburu  
Project manager, Platform project



Gladys Kingori  
Assistant project manager,  
Platform project



Milka Chebii  
NSPS payments specialist



Gitau Mburu  
Policy specialist



Francis Gwer  
Policy analyst



Plounne Oyunge  
Project manager, GP2 payments

Inclusive growth



Ulla Balle  
Partnership manager,  
GrowthCap



Michael Njeru  
Project officer, Inclusive growth



Duncan Oyaro  
GrowthCap associate



Grace Mungai  
GrowthCap associate



Esther Nyauncho  
GrowthCap associate

# FSD staff ... continued

Digital Innovations



Paul Gubbins  
CiFi lead



Nambuwani Wasike  
Research associate, CiFi



Michael Mbaka  
Senior project manager



Emmanuel Khisa  
Project manager, Cash-lite experiment



Tim Mukata  
Innovations lead



Mutua Mulanga  
Business analyst, RII



Eva Adongo  
Innovations specialist

Administration



Dancan Muhindi  
Communications officer



Lydiah Kioko  
Senior programme officer



Fausto Njeru  
Finance officer



Rebecca Etuku  
Office administrator



Nancy Atello  
Programme officer



David Njomo  
Office assistant

# FSD portfolio

Project	Objective	Status - December 2013
<b>Theme 1: Future financial system</b>		
Centre for branchless banking (CBB)	Stimulate the development of branchless banking in Kenya as a means to deepen and expand financial inclusion	Complete
Government payments II (core expenditure only)	Provide financial sector solutions to a range of government payments as a means to encourage the development of a cash-lite economy and expand financial inclusion	Ongoing
Payments platform	Support the development of an open robust payments platform that integrates all major retail payment channels in Kenya and results in low transaction costs	Ongoing
Policy support facility	Assist the government in establishing and implementing policies and the legal framework needed to drive a long-term, national improvement in financial inclusion	Ongoing
<b>Theme 2: Poverty impact</b>		
SACCO sub-sector reforms	Develop the capacity of the SACCOs sub-sector to meet the requirements of the new regulatory framework	Ongoing
Savings groups scale-up: phase II	Develop and implement the infrastructure for a roll-out of savings groups impacting on national levels of financial inclusion	Ongoing
FSA transformation III	Support the creation of a fully sustainable FSA network within the current financial sector prudential regulatory framework	Ongoing
Financial graduation	Combine financial service provision with social safety nets and other supports to provide a ladder out of poverty for the poorest	Planning
<b>Theme 3: Digital innovations</b>		
Retail innovations initiative (RII)	Stimulate the practical development of business cases and solutions that accelerate financial inclusion and uptake	Ongoing

# FSD portfolio



Project	Objective	Status - December 2013
<b>Theme 4: Inclusive growth</b>		
GrowthCap – SME finance capacity building initiative	Build the capacity of the financial sector to provide high quality SME centred financial products and services	Ongoing
Credit reference II	Support the development of an effective full file credit information sharing environment in Kenya that improves access to finance especially among small and medium enterprises	Complete
SME finance innovations fund	Catalyse innovative SME finance solutions through direct investment in non-traditional approaches and players	Ongoing
Credit market development	Strengthen credit market functioning in Kenya through the development, expansion and exploitation of supporting infrastructure	Ongoing
<b>Theme 5: Knowledge</b>		
Centre for insights into financial inclusion	Establish and apply the knowledge base to underpin realisable solutions to improving the financial capabilities of low-income people	Ongoing
FinAccess retail	Continue the development of FinAccess as a comprehensive, reliable and sustainable mapping of the financial landscape in Kenya, measuring household demand and supply	Ongoing
FinAccess business	To develop a comprehensive mapping of the market for business financial services in Kenya	Ongoing
FSD Impact research II	To understand the impact of FSD Kenya's projects and programme on the development of financial markets in Kenya and the consequent impact on the livelihoods of lower-income households	Ongoing
<b>New directions</b>		
FSD Africa	Establish a regional programme to work with FSD country programmes in building the capacity of financial service providers, facilitating skills, knowledge and technology transfers and increased coordination between markets	Ongoing
Housing finance	To undertake a detailed market landscaping and diagnostic analysis of finance for affordable housing in Kenya	Planning

# FSD Kenya's partners 2014

<b>Government/ regulators</b>	<ul style="list-style-type: none"> <li>▪ Capital Markets Authority (CMA)</li> <li>▪ Central Bank of Kenya (CBK)</li> <li>▪ Competition Authority of Kenya (CAK)</li> <li>▪ Insurance Regulatory Authority (IRA)</li> <li>▪ Kenya Institute of Curriculum Development (KICD)</li> <li>▪ Kenya National Bureau of Statistics (KNBS)</li> <li>▪ Kenya School of Monetary Studies (KSMS)</li> <li>▪ Ministry of Agriculture</li> <li>▪ Ministry of Devolution and Planning</li> </ul>	<ul style="list-style-type: none"> <li>▪ Ministry of Industrialisation and Enterprise Development</li> <li>▪ Ministry of Labour, Social Security and Services</li> <li>▪ National Drought Management Authority (NDMA)</li> <li>▪ National Treasury</li> <li>▪ Retirements Benefit Authority (RBA)</li> <li>▪ SACCO Societies Regulatory Authority (SASRA)</li> </ul>
<b>Financial service providers</b>	<ul style="list-style-type: none"> <li>▪ Century Microfinance Bank</li> <li>▪ Chase Bank</li> <li>▪ Commercial Bank of Africa (CBA)</li> <li>▪ Equity Bank</li> <li>▪ Family Bank</li> <li>▪ Kenya Commercial Bank (KCB)</li> </ul>	<ul style="list-style-type: none"> <li>▪ K-Rep Fedha Services Ltd (KFS)</li> <li>▪ Kenya Post Office Savings Bank (KPOSB)</li> <li>▪ Kopo Kopo</li> <li>▪ Jubilee Insurance</li> <li>▪ Metropol Credit Reference Bureau</li> <li>▪ M-Changa</li> <li>▪ Transunion Credit Reference Bureau</li> </ul>
<b>Non-profits/ industry associations</b>	<ul style="list-style-type: none"> <li>▪ Kenya Bankers Association (KBA)</li> <li>▪ Association of Kenya Credit Providers (AKCP)</li> <li>▪ Association of Micro-finance Institutions (AMFI)</li> <li>▪ Catholic Relief Services (CRS)</li> <li>▪ CARE Kenya</li> </ul>	<ul style="list-style-type: none"> <li>▪ HelpAge International</li> <li>▪ Strathmore Business School (SBS)</li> </ul>
<b>Development partners</b>	<ul style="list-style-type: none"> <li>▪ International Labour Organization (ILO)</li> </ul>	<ul style="list-style-type: none"> <li>▪ International Labour Organisation (ILO)</li> <li>▪ Financial Sector Deepening (FSD) Tanzania</li> <li>▪ FinMark Trust</li> <li>▪ International Finance Corporation (IFC)</li> <li>▪ Rockefeller Foundation</li> <li>▪ Financial Inclusion for Rural Microenterprises (FIRM)</li> </ul>

