

ANNUAL REPORT

2011



Supporting the development of inclusive financial markets in Kenya



A commercial street in Limuru town, Central Kenya.



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), Agence Française de Développement (AFD) and the Bill and Melinda Gates Foundation.



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Acronyms

AFC	Agricultural Finance Corporation	KCB	Kenya Commercial Bank
AFD	Agence Française de Développement	KCISI	Kenya Credit Information Sharing Initiative
ASCA	Accumulating savings and credit association	KCPA	Kenya Credit Providers Association
AMFI	Association of Microfinance Institutions	KFS	K-Rep Fedha Services Ltd.
CBK	Central Bank of Kenya	KPOSB	Kenya Post Office Savings Bank
CGAP	Consultative Group to Assist the Poor	KSHs	Kenya Shilling
CRBs	Credit Reference Bureaus	KWFT	Kenya Women Finance Trust
DFID	Department for International Development	MFI	Micro-finance institution
DFS	Decentralised Financial Services project	MFMI	Micro-finance Management Institute
DTM	Deposit-taking Micro-finance Institution	MVK	Mobile Ventures Kenya
EAGC	Eastern Africa Grain Council	PIC	Programme Investment Committee
FSA	Financial Services Association	POS	Point of Sale
FEPP	Financial Education and Consumer Protection Partnership	ROSCA	Rotating Savings and Credit Association
FSD	Financial Sector Deepening Kenya	SACCO	Savings and Credit Co-operative
GDP	Gross Domestic Product	SASRA	SACCO Societies Regulatory Authority
GSL	Group Savings and Loans associations	SIDA	Swedish International Development Cooperative Agency
G2P	Government to Person	SME	Small and Medium Sized Enterprise
HSNP	Hunger Safety Net Programme	USAID	United States Agency for International Development
IFC	International Finance Corporation	WOCCU	World Council of Credit Unions
ILRI	International Livestock Research Institute	WRS	Warehouse Receipts System
KBA	Kenya Bankers Association		

DIRECTOR'S NOTE

Background

Kenya's economy in 2011 is estimated to have grown at 4.3% over the year, a decline on the previous year (5.6%) and lower than the forecast rate of 5.3%. Although well below the levels needed to reach the Government's goal of achieving middle-income status by 2030, it was still sufficient to produce a modest increase in gross domestic product (GDP) per capita. Of concern was the deterioration in the macro-economic position with inflation peaking at 20% by the year end. The weakening trade position precipitated by high oil prices and the Euro crisis combined with inflation to produce a sharp decline in the Kenya shilling. The Central Bank Rate (CBR) was raised from 7% to 18% within the last quarter. Although this tightening resulted in a rapid recovery of the shilling, it led to a sharp reduction in the expansion of private sector credit seen over the first three quarters of the year. Despite the challenging environment, the evidence we have suggests that over 2011 Kenya sustained its progress in expanding financial inclusion. Unfortunately technical challenges forced the postponement of the planned 2011 round of the FinAccess survey on retail financial inclusion until 2012. Thus we will not be able to quantify the progress made for another year. Nevertheless the data from leading institutions remain positive.

Objective

This report summarises our views on the developments in the market over 2011 and describes the activities in which we've been involved. As in previous years, we emphasise that our primary aim in publishing this report is to ensure that FSD remains accountable for what we do. We would be delighted to receive responses from readers of this report – letting us know what they think about either the report or the work we do. Constructive criticism is always especially welcome as we seek to improve our programme and its impact.

FSD strategy

Our new strategy (2011 – 2015) seeks to build on the achievements Kenya has made in the recent past and contribute to a dramatic improvement in financial inclusion over the next decade. Although the focus of our activities has necessarily changed as markets have evolved, some elements have remained constant. All FSD's work is essentially aimed at trying to make financial markets work better for the poor. Our goal is not to provide short-run fixes but support sustainable developments in markets which will deliver long-term solutions. We will continue to work hard on our goal of "generating sustainable improvements in livelihoods of poor people through reduced vulnerability to shocks, increased incomes and employment."

FSD's objective must recognise the need for a greater focus on the demand side and the importance not simply of access to financial services but how these services are used. The revised objective is thus:

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.

Theme areas

In the first section of this report we provide a brief overview of our market development approach and our strategy perspectives 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 organised according to our four focal theme areas: (i) future financial system, (ii) poverty impact, (iii) inclusive growth, and (iv) knowledge. The future financial system theme area aims to help stimulate system wide developments which will lead to a dramatic reduction in transaction costs – fundamental to achieving long-term inclusion goals. The poverty impact theme area aims to more specifically address the livelihood needs of the poor. Much of our work here necessarily addresses finance for rural markets. The inclusive growth theme area, building on earlier work, remains focused on developing finance to support the growth potential from the small and medium enterprise (SME) segment. Finally, our expanding knowledge theme area looks to provide insights into how financial markets are really working so that we and our partners can help push the financial access frontier to the next level.

Funding and partners

Of course none of this would be possible without the support of our funders. In 2011 we received the majority of our funding from DFID, SIDA and the Bill and Melinda Gates Foundation. The financial statements in Annex 1 show how these funds were applied and a summary of our portfolio is provided in Annex 2. The table in Annex 3 lists our major partnerships but inevitably it is abbreviated and omits many with whom we interacted indirectly in various ways. Each year, and this year is no exception, I reiterate that FSD's work is entirely founded on partnerships. Whatever impact we have seen in moving towards the goal of a more inclusive financial system in Kenya derives entirely from the achievements of our partners. My thanks to all those we have worked with over the past year. As ever we look forward to doing more together in the coming year.

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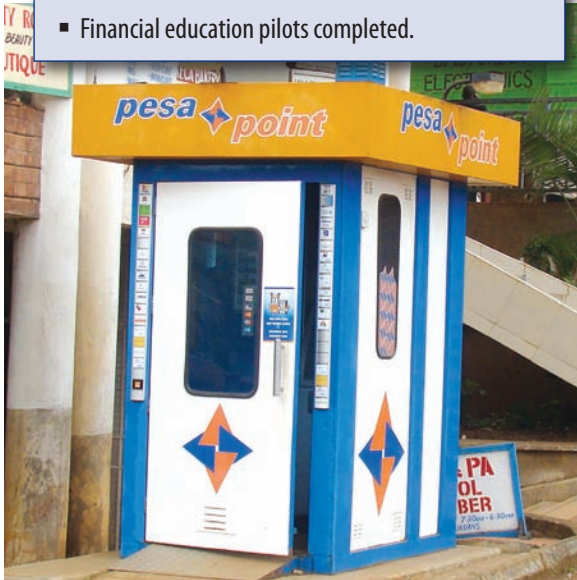
FSD KENYA 2011 HIGHLIGHTS

Programme-wide

- New FSD Strategy launched.
- Centre for Branchless Banking established.

Future Financial System theme

- Hunger Safety Net Programme reaches 60,000.
- Second G2P payments project launched.
- Financial education pilots completed.



Poverty Impact theme

- 7 financial institutions providing weather insurance.
- Savings Groups reach 125,000 members.
- 96 deposit taking SACCOs licensed.



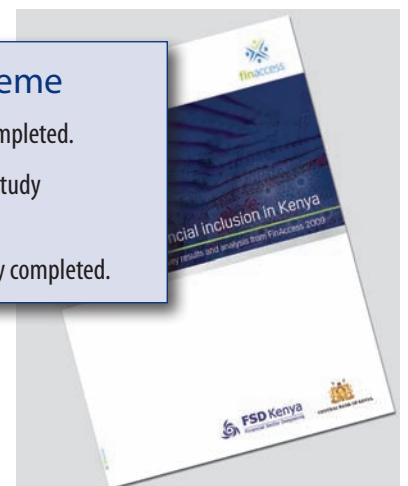
Inclusive Growth theme

- Second credit reference project launched.
- Fifth bank joins supply chain finance project.
- Growth Cap project launched.



Knowledge theme

- FinAccess planning completed.
- Financial Landscapes study completed.
- Cash-lite scoping study completed.



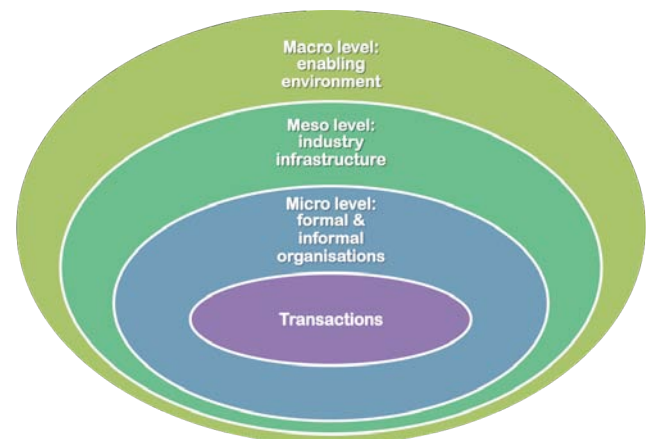
FSD'S APPROACH

The conceptual underpinning of FSD's work derives from the "making markets work for the poor" (M4P) 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 seven years. M4P has been 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*." This approach provides FSD with both its basic rationale and *modus operandi*.

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.

Figure 1: The structure of financial markets



FSD Kenya's goal is to significantly expand access to financial services among lower income households and smaller scale enterprises.

FINANCIAL INCLUSION CHALLENGES



The busy Municipal market in Kitale. Access to appropriate financial resources can enable low income households and micro-enterprises to manage their own resources more efficiently in a way that provides important support to livelihoods.

THE IMPORTANCE OF FINANCIAL INCLUSION

Interest in the developmental impact of the financial system started with concern over its role in the economic development process. Early development theories emphasised the importance of increasing the savings rate as a means to stimulate the necessary investment to achieve catch-up in developing economies. The impact on poverty reduction is assumed to come through the resultant growth. More recently the micro-finance movement has emphasised the direct livelihood impacts of providing financial services to low income people.

Financial access and inclusive growth

Financial markets play a critical role in the efficient allocation of resources within market-based economies. While the recent crisis dramatically revealed the vulnerabilities of the global financial system and its potential for inflicting economic damage, it also served to highlight the strong dependency of the real economy on the effective functioning of financial markets. A further vital function of financial institutions in a modern market economy, sometimes overlooked, is the efficient transfer of value through payment systems.

Financial inclusion and livelihoods

A richer argument for the importance of financial services to the poor has emerged in the last decade, strongly associated with Stuart Rutherford's pioneering work in Bangladesh. Recent studies show how access to appropriate financial resources can enable low-income households to manage their own scarce resources more efficiently - and especially inter-temporally - in a way that provides an important, sometimes critical, support to livelihoods. The Financial Diaries collected across Bangladesh, India and South Africa revealed how people used a portfolio of savings, credit and insurance, provided both formally and informally, to help manage the ebbs and flows of small irregular incomes, create usefully large sums for household and livelihood purposes and cope with risks. An important insight is that it is the reliability which formal services represent which may provide the greatest contribution to poor users. The Financial Diaries studies help reveal the mechanisms through which financial services impact on livelihoods and suggests a much more complex picture than had been assumed earlier.

Implications

The theory and evidence continues to point to the importance of broader financial inclusion which ensures that all scales of enterprise and households have access to appropriate finance. Kenya's long-term national strategy, Vision 2030, identifies the financial sector as one of the country's core growth pillars. Whilst generally more developed than others in the region, Kenya's financial sector remains far from achieving its full potential. Considerable progress has been made in the last decade but the financial sector in Kenya still only meets a modest fraction of the growing demand from poorer households and micro, small and medium enterprises.

FINANCIAL ACCESS STRANDS

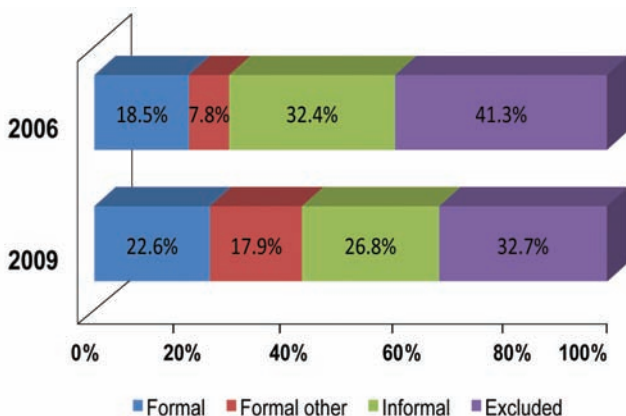
Kenya’s financial system can be usefully divided into three elements: formal, other formal and informal. The demarcation between these categories is primarily an institutional one: the formal are prudentially regulated, while the other formal are simply registered under law and the informal are unregistered. Although legal definitions are used to set the boundaries between these categories, there is more of a *continuum* of formality. In the informal category accumulating savings and credit associations (ASCAs) are usually considerably more complex and formalised in operations than rotating savings and credit associations (ROSCAs).

Table 1: Classification of institutions

Formal	Other formal	Informal
<ul style="list-style-type: none"> ▪ Commercial banks ▪ Deposit taking MFIs ▪ Deposit taking SACCOs ▪ PostBank ▪ Insurance companies 	<ul style="list-style-type: none"> ▪ Unregulated MFIs ▪ Unregulated SACCOs ▪ Mobile payment services 	<ul style="list-style-type: none"> ▪ ASCAs ▪ ROSCAs ▪ FSAs ▪ Shopkeepers ▪ Moneylenders

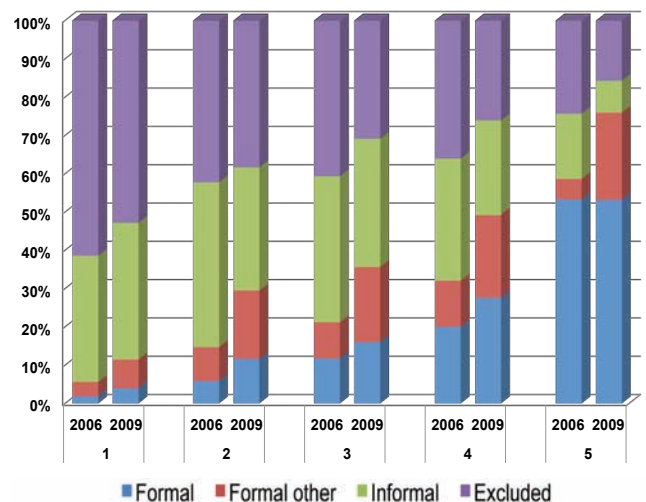
The two FinAccess surveys measuring use of financial services in Kenya, conducted in September 2006 and March 2009, provided the first detailed data on financial inclusion in Kenya and recent developments. During this period, overall financial inclusion increased from 58.7% to 67.3%, corresponding to a drop in financial exclusion from 41.3% to 32.7% (shown in figure 2). There was a large jump in total formal inclusion (formal + other formal) from 26.3% to 40.5% largely driven by the introduction of the M-PESA mobile phone based payments system categorised as ‘other formal’. Meanwhile the use of regulated formal services increased significantly though far more modestly from 18.5% to 22.6%.

Figure 2: Kenya’s financial access strand 2006 and 2009



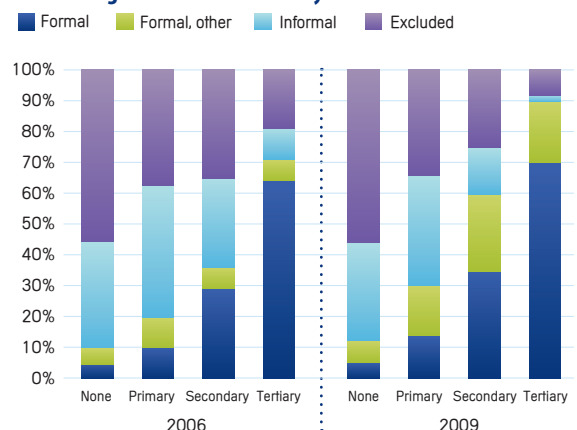
Access by wealth quintile: The usage of services varies very significantly by wealth status as shown in figure 3. Unsurprisingly this shows exclusion increasing with poverty (quintile 1 represents the poorest while quintile 5 the wealthiest). Similarly the use of formal services is greatest among the wealthiest groups and very low among the poorest. However the data clearly shows some encouraging results. The improvements in access have occurred across all groups with an increase in formal inclusion even amongst the lowest income groups at all levels. Interestingly the largest change in formal inclusion occurred in the middle income groups rather than the highest.

Figure 3: Access strand by poverty/wealth quintile



Access by education: Use of financial services increases with education. Only 8.0% of people with tertiary education are likely to be excluded while 55.9% of those with no education are likely to be excluded. Between 2006 and 2009 there was almost no change in inclusion for those with no formal education, thus highlighting the continued challenge of improving access for this group (see figure 4).

Figure 4: Access strand by levels of education



FSD'S IMPACT AND STRATEGY

FSD IMPACT 2005 - 2010

At the programme level, FSD has benefitted from two reviews – an impact assessment and a programme completion report. The impact assessment report was completed in January 2010. The methodology involved a combination of document review and semi-structured interviews with key partners, stakeholders and financial service users. The assessment team considered the direct impacts achieved at each of the levels of FSD activity and concluded that:

- at the macro level, FSD's work has contributed in a significant way to the development of an improved enabling policy and regulatory environment;
- at the meso level, the programme has helped to build significant capacity in the support service market and has also contributed to the shift to a market that is more client oriented.
- at the micro level, FSD's support has helped to enable the transformation and institutionalization of key providers within the sector.

The team also examined the final impact on the ultimate FSD goal of generating sustainable improvements in livelihoods of poor people through reduced vulnerability to shocks, increased incomes, and employment. While the team was not able to derive firm conclusions in terms of the final impact it observed that “the culture of the market has changed to become more focused on reaching poorer clients”.

The FSD programme completion report covered the period 2005-2010 and was prepared in November 2010. The assessment team reviewed progress against targets at the purpose level – which is “to deepen the capacity of Kenya's financial sector to meet the financial needs of poor Kenyans and micro, small and medium enterprises on a sustainable basis”. It concluded that overall FSD has completely achieved its purpose/strategic objective and exceeded the original expectations of stakeholders.

The programme completion report also identified circumstantial evidence of FSD's impact. It concluded that FSD:

- Had become a source of evidence for policy formulation and a source of information for innovators.
- Had made a big contribution in capacity building, as a partner more than a donor.
- Played a major role as a facilitator of dialogue, particularly in helping to smooth the rough edges between different stakeholders.
- Was perceived as a neutral but expert voice in policy dialogue.
- Has become a source of reassurance on risks.
- Is a source of timely and useful technical advice.

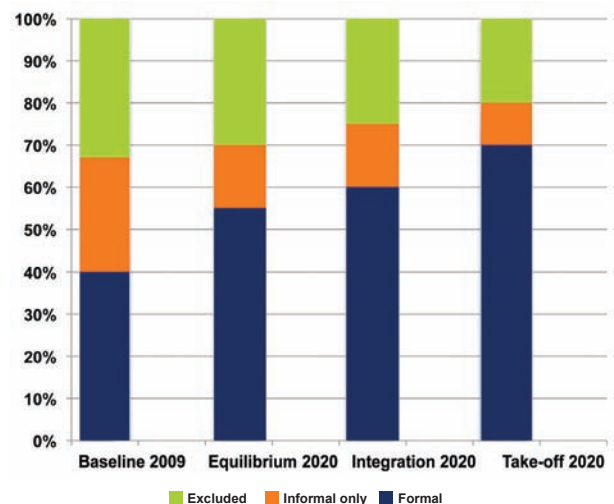


Macro level policy impact: Treasury Permanent Secretary Joseph Kinyua, displays the *Costs of Collateral* reports at the launch event in March 2010.

ACCESS SCENARIOS

FSD's future strategy is based on analysis of what the future could look like. We have looked at the various ways in which the financial sector could evolve by considering three potential scenarios: (a) Equilibrium – domination of the low value retail payment space by a single player (b) Integration – technology driven integration of formal and informal systems and (c) Take off – towards a “cash lite” scenario by using a demand pull from government payments and effective regulation to ensure that competition drives down the cost of electronic money.

Figure 5: FSD scenarios



FSD STRATEGY 2011 - 2015

Kenya's financial markets are clearly undergoing rapid and far reaching changes which open up real prospects for a significant further increase in financial access. This could lead to very considerable impacts on the livelihoods of the poor. The market dynamism we see creates opportunities for much greater leverage in what we do. In defining FSD's future strategic direction our emphasis has been on understanding how FSD's strategy needs to respond to the emerging context over the next five years and what we can offer which is different from the past.

THE NATIONAL POLICY FRAMEWORK

While FSD operates as an independent Trust, its role is not to become an independent institution developing its own unique vision and strategy. It is not an NGO; rather it should be seen as a special purpose vehicle established to effect the policy objectives set by government and development agency funders. The Government's long term policy, Vision 2030 provides the overarching policy framework for FSD. In essence Vision 2030 seeks to establish a path by which Kenya can achieve middle-income country status by 2030. The financial sector is identified as one of the priority sectors through which this can be achieved.

FSD GOAL AND OBJECTIVE

Although there have been significant changes in markets over the last six years and changing perspectives on how the financial sector (and micro-finance in particular) impacts on development aims, there is no change in the basic rationale for FSD. The goal, unchanged since inception, will continue to remain as:

To generate sustainable improvements in the livelihoods of lower-income households through reduced vulnerability to shocks, increased incomes and employment.

FSD's objective must recognise the need for a greater focus on the demand side and the importance not simply of access to financial services but how these services are used. The revised objective is thus:

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.

FSD has not in the past defined what constitutes 'lower income'. Although difficult and potentially contentious it is nevertheless helpful from a practical perspective to articulate a working definition. For the purposes of the strategy a working definition of "lower income" is taken to refer to the bottom three wealth quintiles. Government data suggests this encompasses all those below or close to the poverty line. As figure 3 on page 7 shows, the poorest (quintile 1) are more likely to be financially excluded than the wealthiest (quintile 5).



The Central Bank Governor Prof Njuguna Ndung'u (right) at the press briefing following the launch of FSD's Strategy 2011-2015 on 16th September 2011. On the left is Dr Geoffrey Mwangi, the Economic Secretary in the Ministry of Finance, who delivered the keynote speech.

STRATEGIC PRIORITIES

There is considerable ambition contained within the strategic objective. Achieving this objective demands that we focus our scarce resources and capabilities on the real opportunities for FSD to influence the trajectory of future market development. Achievement of a radical change in the fundamental cost structure of retail formal financial service provision is now a real possibility.

FSD's first strategic priority is thus to influence the evolution of markets towards the 'take off towards cash-lite' scenario driven by the effective exploitation of technology. Nevertheless despite the dynamism there remain huge swathes of the population and economy which are underserved or not reached at all. This points to the second strategic priority for FSD: focussing on how the specific financial management needs of underserved and excluded households and businesses can be addressed in order to maximise impact.

FINANCIAL SECTOR DEVELOPMENTS

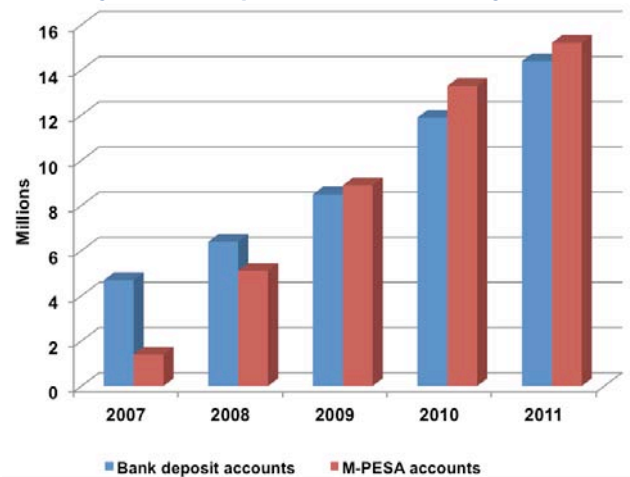


A shop in Eastlands, Nairobi operating as a Kenya Commercial Bank (KCB) agent. KCB Mtaani is a new agent banking service. Mtaani is a Swahili word which means “where you are”.

RETAIL LEVEL

Bank outreach: The commercial banks continued their aggressive drive for new bank accounts. The total number of deposit accounts increased over the year from 11.8m to 14.4m, an increase of 22% in a year. Equity Bank with over 6.5m accounts as at the year end, accounted for 46% of the accounts in the banking system. In addition Co-operative Bank, Kenya Commercial Bank (KCB) and Barclays have passed the million account threshold with Family close to this number.

Figure 6: Bank deposit and M-PESA accounts growth



Agent banking: There is continued interest from banks in the agency-banking model. As at September 2011, 10 banks had been given approval by CBK to roll out agent-banking networks and a total of around 8,000 agents had been approved – an impressive performance in the less than two years since agent banking was given regulatory approval.

Mobile banking and payments: The mobile banking space continues to be dominated by Safaricom’s M-PESA service. It has a customer base of 15.2m and 35,000 agents nationwide and accounts for the majority of the mobile transfers. There were also a number of innovations in 2011. Mobile Pay Ltd launched their Tangaza service which operates across any mobile phone provider. Airtel, Standard Chartered Bank and MasterCard established a payments service. Family Bank set-up a mobile payment platform to enable payment of rent by tenants. Orange Money offered a new product which will enable subscribers to send or receive money without relying on SIM cards.

Deposit taking micro-finance institutions (DTMs): The number of deposit taking microfinance institutions increased from 2 to 6 with 4 new licenses being issued to Uwezo, Remu, SMEP and Rafiki from late 2010 to the end of 2011. As at year end the DTMs had 1.4 million deposit accounts and 0.51 million loan accounts with the market leaders Kenya Women Finance Trust (KWFT) and Faulu Kenya having 88% of deposit accounts in the DTM sub-sector.

INDUSTRY-INFRASTRUCTURE

Cheques: In late 2011, CBK and the Kenya Bankers' Association (KBA) launched a new cheque truncation system, which will enable commercial banks to exchange cheques electronically. This is expected to reduce the cheque handling costs and improve efficiency in payments by reducing the time taken to process cheques.

Credit reference: During 2011, CBK licensed the second credit reference bureau, Metropol. In addition the Ministry of Finance has proposed amendments to the legislation to permit banks to share positive consumer information.

ATM interconnection: Through a taskforce instigated by PayNet, the operator of the third party PesaPoint ATM network, there has been agreement among a number of banks to start rationalising ATMs. Some notable progress has already been attained in this with the linkage between KCB, CFC Stanbic and PayNet enabling their customers to use a wider range of ATMs.

Mobile payments interconnection: In a provocative move, mobile network operator (MNO), Airtel, proposed that all mobile based payment systems should fully interconnect with a zero interchange fee. Unsurprisingly Safaricom responded defensively. A taskforce, formed under the Office of the Prime Minister, examined the issue and did not support the proposed opening up of the system. Even if Airtel's opening gambit was somewhat ambitious it nevertheless served a useful purpose of putting the issue of the interconnection of mobile payments on the table.

POLICY AND REGULATORY

Comprehensive Financial Sector Reform and Development Strategy

(CFSRD): The Ministry of Finance (MoF) released the final draft of this new national financial sector strategy paper which covers the period 2013 - 2017. It covers most of the detailed areas for action which FSD has identified as relevant to achieving significant progress in expanding financial inclusion.

Prudential guidelines: CBK has continued to work on a major overhaul of the prudential guidelines for commercial banks regulated under the Banking Act. These are set to encompass a number of reforms including mandating standards on interest rate disclosure and amendments to bank agent guidelines.

Anti-money laundering and combatting the financing of terrorism

(AML/ CFT): An AML law came into effect in June 2010 but the AML Advisory Board was only established in September of 2011. The Financial Reporting Centre (FRC) to which all regulatory agencies will report on AML/CFT has yet to be established. Pending the establishment of the FRC, CBK introduced guidance on combating financing of terrorism activities.



Members of Kirinyaga Farmer's SACCO Society wait to be served by Esther Wambui at the Kerugoya branch. The SACCO was among the larger ones licensed in 2011.

SACCO regulation: All of the estimated 230 deposit-taking SACCOs were expected to apply for licences from the SACCO Societies Regulatory Authority (SASRA) by end of June 2011. 96 SACCOs, mainly the bigger and better managed and governed ones, had received licences by the close of the year.

Consumer protection: A new consumer protection bill which requires high ethical and operations standards from traders was tabled in August 2011. In addition the Ministry of Finance has signalled its intention to develop specific legislation for consumer protection in the financial sector.

Regulation of the payment system: The National Payment Systems bill was passed by Parliament during the year. This provides the legal framework within which to establish effective regulation of the payments system. Crucially from the perspective of access, it will allow the introduction of a formalised regulatory structure for new technology based payments systems.

Bank agent regulation: A question remains over the use of exclusive contracts with agents, proscribed under the current guidelines. The guidelines do not apply to the M-PESA system (since it is not tied to a regulated bank) and most of M-PESA's agents are subject to an exclusivity clause. However, the larger agents such as the big supermarket chains (Uchumi and Nakumatt), banks and PesaPoint ATMs are already serving as agents for others including Airtel Money and Yu Cash. Whether the industry will be best served by allowing or encouraging individual agents to provide services for multiple providers or to seek interoperability with low interconnect charges remains to be seen.

DTM licensing: As noted above, to date six deposit-taking micro-finance institutions (DTMs) have been licensed under the micro-finance law. A few other MFIs/DTMs are reported to be in the process although the number of those licensed is not expected to increase substantially.

FUTURE FINANCIAL SYSTEM THEME AREA



A PesaPoint ATM in Limuru town, Central Kenya. PesaPoint provides third party ATM solutions to many banks and SACCOs, effectively sharing this costly infrastructure and helping to improve access.

During 2011 the formal financial system theme area was reconfigured as Future Financial System theme area in line with the new FSD Strategy 2011–2015. The focus of this theme area is to achieve a significant and sustainable reduction in end-to-end transaction costs in accessing the retail formal financial system. If achieved this could transform the financial landscape by providing a platform on which a whole range of financial services can be provided at very low cost by the formal system to reach the excluded. Under the Future Financial System theme area FSD's initiatives are geared towards payment systems, branchless banking, G2P payments development, consumer protection, improving financial capabilities, and improving retail capacity.

2011 Highlights

- Hunger Safety Net Programme reaches 60,000.
- Second G2P payments project launched.
- Financial education pilots completed.

PAYMENT SYSTEMS / INTEROPERABILITY

Improving the interoperability of the retail payments system is a core aim for FSD. There are significant network economies associated with payment systems: much as with a telephone service the utility of a payment solution increases with the number of users on the system. If rival systems do not connect to one another the value is reduced for all users, unless there is a single system which is used by all. In the latter case the question of market dominance and the impact on competition is raised. There are two aspects to connecting retail payments systems: the technical ability for the systems to work with one another and the costs associated with it. The establishment of global standards makes it relatively easy to accomplish the former. However the latter is driven by the strategic objectives and business models of competing players with varying market power. These are not necessarily fully aligned with the interests of the industry collectively and consumers more broadly. FSD has been working with various market players, industry bodies and policymakers to examine how the public policy interest can be best addressed. The Kenya Bankers' Association (KBA) started an initiative during the year to explore options for improving interoperability within the sector. An industry driven approach offers the promise of identifying a workable solution which balances the competing needs and interests of the various players. FSD is providing technical support to KBA.

CENTRE FOR BRANCHLESS BANKING

During 2011, FSD launched a new industry focused Centre for Branchless Banking (CBB). The Centre will work with industry and policymakers to identify and exploit opportunities to advance inclusion through branchless banking approaches. Given recent successes in the market there is considerable appetite for private sector led investment in branchless banking in Kenya. The problem faced by many investors whether existing players (notably banks and telecommunication companies) or start-ups is more about what to

invest in and how to implement. Similarly there is no lack of interest in policy circles and there is a growing awareness that the institutional framework established through law and regulations will play a vital role in enabling future developments. Again the gap is in understanding how to shape the future framework. There are no blueprints from other markets because there are no relevant comparable examples. The Centre's offer to the market will be founded on the generation and practical application of knowledge.

G2P PAYMENTS DEVELOPMENT PROJECT

The G2P project primarily supports the Hunger Safety Net Programme (HSNP) - which is described in detail on page 14. Under the project, FSD also continued to support the Orphans and Vulnerable Children (OVC) cash transfer programme. FSD also participated in wide-ranging sector review of safety nets in Kenya led by the World Bank. During the review FSD was responsible for the element dealing with payments and financial flows. The recommendations will contribute to the long-term objective of strengthening the use of the financial system to deliver social protection payments in Kenya. A follow-on government payments programme was designed towards the end of the year. This programme builds on the success of the initial work to now look at providing 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.

CONSUMER PROTECTION

Modest progress was made in strengthening consumer protection. A qualitative study was developed with CBK in order to establish the usefulness of the last FSD/CBK consumer publication on bank charges and lending rates to the average current and prospective bank customer. There was considerable enthusiasm among consumers questioned for the idea of being provided with help in trying to understand pricing practically. However the report was too complex for the ordinary consumer to understand and the concept of a bundled product especially difficult to understand. With the increased attention being given to the issue of pricing following the tabling of a legislative amendment in parliament to control interest rates, there is an opportunity presented to move this initiative forward. Lack of transparency in pricing not only constrains effective price based competition but it also makes it difficult to track the consumer price of financial services. A new initiative to develop more effective tools to communicate with consumers is envisaged under a new financial capability project addressing the needs of poorer users.

INCREASING FINANCIAL CAPABILITIES

Good progress was made during 2011 on the Financial Education Project. The Financial Education and Protection Partnership (FEPP) continued to thrive and now has 73 organisations participating. The FEPP brings together public and private sector institutions with a keen interest to promote the financial literacy agenda. The FEPP also launched a website (www.fepkenya.org) with information to assist members in developing financial literacy programmes.



An Equity Bank and M-PESA agent in Kitui. Branchless banking is expected to improve access to financial services, especially in rural areas.

To ensure an effective reach to consumers, the FEPP invited representatives from the media to participate in development of a communication strategy. FEPP has also supported and partnered with 13 public service institutions to develop a national led curriculum. The four pilot projects finally started to reach maturity during the year. Equity Bank's pilot, in collaboration with Kenyatta University, extended to 332 student trainers and reached 5,249 youths in 8 provinces out of the targeted 8,000 youths. In addition, 2,842 university students were reached. The Faulu pilot implementation plan proceeded well and 30,809 consumers were trained against a target of 50,000. Plan Kenya launched the Child Savings Kenya training program in Kisumu and 70 primary school teachers received training and embarked on establishing savings clubs in their schools. On the Elewa Pesa pilot, the study noted a positive change in the respondents' behaviour as evidenced by the increase in the proportion of the respondents that began using a budget plan regularly.

IMPROVING RETAIL CAPACITY

During 2011, FSD continued its support to the Kenya Post Office Savings Bank. A comprehensive review commissioned by FSD was completed to (i) assess the impact of FSD's earlier support on the bank, (ii) examine the strategic options faced in an increasingly competitive market and (iii) determine whether there is any potential for further engagement by FSD. The review concluded that the new business model which FSD supported in the earlier phase projects had been critical in re-positioning the bank to improve its services and compete in an increasingly competitive market. Nevertheless the bank has the opportunity to move further into the lower income unbanked and underserved segments not targeted as aggressively by other institutions. Postbank's ability to reach these clients is likely to depend on creating a low cost and accessible channel. The new agent model which Postbank has introduced (with support from the Gates Foundation and the World Savings Bank Institute) requires research and analysis to better understand its sustainability and scalability. This will be undertaken within the new Centre for Branchless Banking.

SPOTLIGHT: HUNGER SAFETY NET PROGRAMME

HSNP is a long term (2008–2017) social protection programme in Kenya, funded by UKaid from the Department for International Development in partnership with the Ministry for Development of Northern Kenya and other Arid Lands (MoDNKAL). It is worth a total of £80 million. The aim is to reduce extreme poverty, tackling hunger and vulnerability. Simultaneously the Government, DFID and other development partners are seeking to move towards a national social protection framework in Kenya.

The unconditional bi-monthly cash transfers of KShs 2,150 provides a safety net that will cushion the extremely poor and vulnerable in the larger Northern Kenya districts against chronic shocks of prolonged drought and other hardships. These efforts also go toward assisting Kenya achieve its Millennium Development Goals of reducing extreme poverty and hunger by 2015 together with the social pillar of the Vision 2030.

The programme has an overall goal of delivering regular unconditional cash transfers to up to 300,000 chronically food insecure people in Mandera, Wajir, Marsabit and Turkana.



Communities in the north of Kenya are benefiting from a social protection scheme under the Hunger Safety Net Programme (HSNP). Payments to recipients are made through a network of Equity Bank agents (typically local shop keepers) with point of sale devices (POS) in a convenient location for the recipients.



Having a safety net allows people to invest in new productive activities. Mr Paulo Kopito (above) was able to start a grain shop in Kalokol, Turkana. Photo by Philip Natapar (HSNP Secretariat).

FSD took on responsibility for the management of payments in 2009. Through a competitive process Equity Bank was selected to provide the payment services. Payments to recipients are being made through a network of agents with point of sale (POS) devices in locations convenient for the recipients. These HSNP pay points are typically local shopkeepers who have cash available from day-to-day business activities. Where there is no power a solar panel is used to charge the POS device. The payment recipients are issued with cards to access their payment. Payments to participants in the programme are made every two months. Agents simply swipe the card through the POS device, which then validates the identity of the bearer with a fingerprint scan. Once confirmed, cash is paid out from the till of the agent who immediately receives a corresponding credit to their account with Equity.

Strong progress was made on the programme over the year. An extra payment was made in October in response to the devastating drought in the region. The benefit amount was increased from KShs 2,150 to KShs 3,000 from cycle 16 in November. The number of beneficiaries under the programme continued to increase with nearly 60,000 carded by the end of the year. This number is expected to increase in 2012 with the inclusion of beneficiaries from the sub-locations which had been selected as control groups for the HSNP randomised control trial. Equity Bank had established 133 active pay points by the year end.

Magala's story

It takes two days travel by road from Nairobi to Mandera County in the north-eastern region of Kenya – a distance of 1,100km. Mandera forms part of a large semi-arid frontier that stretches from the Somali boarder in the east, to Ethiopia and Sudan in the north. The dry climatic conditions and terrain are pretty harsh. Over the years, this has had a tremendously negative impact on the area's productivity and overall economic development of its people.

Magala Ibrahim Omar, 60, lives in Lamaded sub-location, one of the 14 that comprise Mandera East. She's one of the many people whose lives have been dramatically turned around by the HSNP cash transfers. Unlike many women in this region who are generally quiet and reserved, Magala is cheerful and willing to open up about her story. Through the local chief, Mohammed Kahiya who acted as her interpreter, she narrated her life before being enlisted into the HSNP two years ago.

"My husband and our children lived from day to day with no idea where our next meal was going to come from. I remember clearly the day we were called to a village 'baraza' by the chief and the 'women for peace' came to talk to us about HSNP. I was not convinced that we would be getting cash transfers every two months. This sounded like a fantasy." Magala's name was put forward by the people in her village as one of the most vulnerable beneficiaries since they all knew that she and her family of six children and fourteen grandchildren lived in abject poverty.

"I remember the registration process taking three months. It seemed like a lifetime before I received my first cash payment of KShs 2,150," she explains. Since then, these have been consistent and she has received her transfer every cycle without any problems.

As her story unraveled, Magala explained to the chief that she would like us to take a short walk to show us something. With growing curiosity, we followed the Chief and Magala to a place near River Dawa where Magala proudly displayed her thriving 'shamba'.

Fortunately for Magala, her family owned some land next to the river. They had worked this land into a farm comprising of small plots or 'basins' that could be easily irrigated from the nearby river. A previous intervention programme in the village had provided diesel-powered water pumps to each household. However, Magala's family was so poor they could not afford to purchase the diesel needed to power the water pump. Thanks to the HSNP payments, Magala and her family have over time farmed the whole piece of land into 100 basins, nearly the size of one acre.

Magala is now able to irrigate her farm once every month using pumps supplied by the government through the Ministry of Arid Lands and the local farmers' co-operative. From this one acre, Magala harvests 10 bags of maize and one bag of peas. She then sells the fodder to livestock owners in her village earning KShs 20,000 from the fodder alone. She grows a fast growing maize variety known as DH4, which is harvested every 90 days. From a person eking out a daily subsistence without any income, Magala now earns a total of KShs 50,000 every three months from her farm. Magala confidently states that she has gone from a desperate destitute to a farmer who has reclaimed her dignity. "I can now help other poor women in my village. In fact I recently introduced two of them for registration into the HSNP programme," she adds cheerfully.



Magala Ibrahim Omar stands proudly in her thriving maize farm in Lambaded sub-location of Mandera East.

POVERTY IMPACT THEME AREA



Muramati SACCO, Nairobi branch. FSD Kenya has continued to support the SACCOs sub-sector through the SACCO reforms and SACCO Fund projects.

As per the 2009 demographic census, 63% of the adult Kenyan population lives in the rural areas. Results of the FinAccess 2009 demand side survey show that 35.9% of this rural population had no access to any form of financial service. Rural finance and working with semi-formal and informal providers, thus remains a priority for FSD in its endeavour to build inclusive financial markets.

Under the poverty impact theme, FSD's initiatives are mainly geared towards reducing the risk inherent in financing agriculture, promotion of community based financial intermediation models, and strengthening the SACCO sector.

2011 Highlights

- 7 financial institutions providing weather insurance.
- Savings Groups reach 125,000.
- 96 deposit-taking SACCOs licensed.

SUPPORT TO AGRICULTURAL FINANCE

With at least 75% of Kenyans being directly or indirectly dependent on agriculture, FSD has a significant level of effort focussed on identifying ways of making financial services available to this sector. FSD's support has been provided through three key projects - weather insurance, the value chain finance centre, and warehouse receipts.

Weather insurance: Adverse weather remains one of the primary risks in agricultural production. FSD has designed an index-based weather insurance project in partnership with the Rockefeller Foundation, the World Bank and the International Livestock Research Institute (ILRI). Following promising pilots in 2010, the emphasis during 2011 has been on creating an enabling environment and building the sectoral capacity to deliver.

During the year, five pay-outs were made to compensate farmers and pastoralists for drought effects on wheat, maize, coffee, sorghum and livestock in Narok, Machakos, Meru, Kibwezi and Marsabit respectively. The beneficiaries received pay-outs equivalent to 83% of the total collected premiums. This was occasioned by a severe drought across the country in 2011. Overall, the project has worked with 3,279 beneficiaries who have bought insurance covering assets worth KShs160m.

Value Chain Finance Centre: Rigorous, quantitative analysis of agricultural value chains offers considerable promise for identifying more effective ways to finance smallholder production. During the year FSD in partnership with USAID's Financial Inclusion for Rural Microenterprise (FIRM) project started work to establish a value chain finance centre whose objective is to strengthen agricultural value chains through development of appropriate and sustainable finance.

Warehouse receipts: FSD has been working with the East African Grain Council to develop a sustainable warehouse receipts system (WRS). The main impediments to the use of warehouse receipts as instruments of title for security/collateral by financial institutions have been unreliable collateral management and the lack of an enabling legislative framework. A draft warehouse receipts system/commodity exchange policy document was developed during the year. The WRS regulations have also been drafted and will be refined once the legislation is in place.

BUILDING FINANCIAL INCLUSION THROUGH COMMUNITY BASED FINANCE

According to FinAccess 2009, informal service providers such as Accumulating Savings and Credit Associations (ASCAs) and other community based service providers were the only form of financial services accessible to 26.8% of Kenyan adult population. Additionally, another 23.3% of those with access to the formal and semi-formal service providers were also using informal service providers. Due to the significant contribution to financial inclusion, FSD continues to promote these community based service providers. In the past year, support has been provided to Savings Groups (SGs) and Financial Services Associations (FSAs).

Savings Groups support: SGs are a simple financial intermediation model where members of a group (usually between 10 and 30) contribute an agreed set amount of savings during regular meetings. The support to savings groups is described in detail in the spotlight on page 18.

FSA support: FSAs are relatively sophisticated community based institutions providing a range of financial services – savings, credit and money transfer – to their members. With front office services, flexible products and membership reaching several thousands, FSAs truly represent village banks. FSD has been working closely with the K-Rep Group over the last four years to create a specialist management services firm, K-REP Fedha Services (KFS), to support FSAs and transform them into sustainable financial institutions. To ease oversight and support business growth, FSD is supporting automation of the 44 FSAs currently under the management services network serving about 122,000 members. Research evidence shows that FSAs are highly valued by members for the ability to put aside small amounts to smooth cash flows and meet lump-sum demands such as paying school fees for children or acquisition of basic assets such as livestock.

STRENGTHENING THE SACCO SECTOR

SACCOs remain an important contributor to financial inclusion in Kenya, with 9.1% of Kenyans using them by 2009 compared with 3.4% of those using microfinance institutions and 22.6% using banks. FSD has continued to support the SACCOs sub-sector through the SACCO reforms and SACCO Fund projects.



Kibwezi sorghum farmers Mr and Mrs Julius Kiminduu (centre) receive their crop compensation cheque from Jubilee Insurance Regional Claims Manager Mbugua Gathige (left) on 16th June 2011. With them is the Kambo location DO, Ooko Anyumba. Several crop and one livestock payouts took place in 2011.

SACCO sector regulatory reforms: As per the SACCO Societies Act 2008, all the deposit-taking SACCOs were to apply for licenses by 17th June 2011. The SACCO Societies Regulatory Authority (SASRA) had licensed 96 SACCOs by the end of the year and was in the process of reviewing applications from the rest of the applicants. FSD is supporting SASRA to undertake due diligences of the remaining SACCOs to determine whether they will meet the requirements for licensing and are able to transition to full compliance within the four-year period stipulated in the law. FSD has also provided support towards SACCO automation, standardising accounting and reporting, and awareness creation regarding the new regulations.

SACCO Fund: Since 2008, FSD has been providing support to eight large rural SACCOs, through the SACCO Fund project. The aim of the project was to develop demonstrations to other deposit-taking SACCOs on how to go about achieving compliance with the regulatory framework and the benefits of doing so. Overall, results from the projects have been mixed. Initially, in the absence of regulation, SACCOs had few incentives for change and hence despite the technical support provided by the project there was little change. Support to the last three SACCOs coincided with the introduction of the SACCO law and the related regulations and this rendered impetus to reforms, leading to better performance.

SPOTLIGHT: SAVINGS GROUPS PROJECT

Savings Groups (SGs) are a simple financial intermediation model where members of a group contribute an agreed set amount of savings during regular meetings. The funds are then lent out to members based on demand. In broad terms, the primary target markets for savings groups (SGs) in Kenya are the financially excluded (approximately a third of the adult population based on FinAccess 2009 data) and those who only use the very basic rotating savings and credit association (ROSCA) methodology (roughly a quarter of the adult population).

FSD Kenya has been supporting savings groups since 2008 through the Community Savings & Loans (COSALO) project in partnership with CARE. The project has been highly successful. In the 8 counties that the project has worked in, a total of 5,662 groups comprising of close to 150,000 members were active as at December 2011.

The two main lessons drawn from these efforts were:

- It is possible to bring down the cost of starting groups. While the cost of the initial pilot, prior to FSD's involvement, was \$75 per member and the rates reported globally are \$25-40 per member, the average cost in 2010/2011 was \$9 per member.
- Replication of the groups is the norm. A study of 54 groups selected from 2,500 groups showed that three quarters of the groups had replicated (created new groups) and on average each group had created an additional two groups.



Members of Omiro savings group during a meeting in Rachuonyo, Nyanza Province.



A COSALO franchisee Judy Angaya (standing) meeting the "Umbrella" group in Western Kenya. The Umbrella group is so named because the umbrella is symbolic of the protection that the group gives them. They keep an umbrella opened in front of the group at every meeting. Photo credit: Paul Rippey.

SGs clearly present strong potential for financial inclusion particularly for lower-income quintiles. Furthermore the success of the project in rolling out groups at a cost of <\$10 per member now enables us to think seriously about how to achieve scale.

In 2011 FSD launched a new project to continue the Savings Groups work. The primary focus of the project is to develop savings group models to a stage at which a scale-up programme impacting significantly on financial exclusion at a national level becomes viable.

The project's main components include: (i) refining delivery channels : supporting CARE to reduce the amount of direct investment from FSD in group formation; (ii) improving savings groups methodologies: supporting the development and testing of technology driven innovations and business models to improve the products and management of groups; (iii) developing a national scale-up framework: working with the SG working group (SGWG) and SaveNet (a representative network of organizations implementing SGs at small scale) to develop a national-level scale up strategy for Kenya; and (iv) poverty impact assessment: using the progress out of poverty index (PPI) methodology to understand the impacts of the SGs on members' households.

George Owuor's story

George Owuor Omolo is 42 years old and has two wives with 6 children. He hails from East Yimbo, Othachi sub location. He is a fisherman who operates in Mageta Island on Lake Victoria and has been in the fishing industry for the last 4 years. He mainly deals with 'pengo' (the small Nile perch fish). He stays with one wife in Mageta Island while the other wife stays at home in Othachi.

His earnings were meagre, less than KShs 300 per day, and were therefore not adequate for his family needs. When the COSALO Project was launched in Mageta Island in September 2011, George joined Tata Serious COSALO group. The group was trained by Pius Onyango, a Community Based Trainer based in Mageta. He says he thereafter started saving aggressively. During the group's saving days, he could save from KShs 300 to KShs 500 per week.

After three months, he took a loan of KShs 10,000 which he used to purchase 8 sets of fishing nets for the small Nile perch. He leased out his nets to other fishermen who paid him KShs 400 per day. He repaid the loan within the stipulated period and took another loan of KShs 20,000. This time round he used the loan to open a fish mongering business for his wife. This enabled her to buy fish in large quantities to sell in Siaya, Luanda, and Kisumu. George also buys fish and sells to fish processors. His working capital runs between KShs 25,000 - 40,000. He attributes his success to COSALO which provided him with skills on how to save and seek credit. Due to this remarkable change in George's life, his wife decided to join Umoja GSL group. George is able to meet his basic needs and other needs for his family. His family seems to be more contented and cohesive than before. He says he now has a 'bank' which is friendly and convenient.



George Owuor (on the right) selling fish to traders.



Mama Pesila, a member of the Mapambano self-help group displays eggs for sale from her chicken rearing business.

Mama Pesila's story

Mapambano self-help group is in Migen location in Nandi south district. The group was enrolled in COSALO I project in January 2010 with 24 members who bought shares of KShs 200 each. They've increased to 30 members who also deal in local poultry keeping, tree nursery, tree planting and onion cultivation.

Mama Pesila, 58 and a mother of four, joined the group in 2010 after a friend told her about COSALO. She used to struggle paying her children's school fees and there were times they would stay home after being sent away from school for non-payment. Since joining Mapambano, Pesila has managed to buy two local dairy cows and 15 local chickens. From the sale of her milk and eggs, she now earns an income of about KShs 600 per day which helps meet her family obligations. She has managed to plaster her house using credit from the group and pay her children's school fees regularly. One is in high school while the other three are still in primary school.

The Mapambano self-help group used to have a problem with a meeting venue but they now meet regularly in her house. "I've found inspiration and encouragement associating myself with the group and I wish similar groups would be extended to all women in the country," she says.

INCLUSIVE GROWTH THEME AREA



A CRB Africa staff member prepares to share a credit report with a bank customer during a sensitisation visit to Mombasa in March, 2011.

The Government of Kenya has recognized the critical role SMEs play in employment generation and income growth in its centrepiece strategy, Vision 2030. Through the comprehensive financial sector reform and development (CFSRD) strategy of 2011, the government has committed itself to overcoming the major policy constraints to increased access to finance by SMEs.

FSD has been supporting these objectives through its Inclusive Growth theme area by concentrating on credit bureau implementation, SME financial product development, capacity building and knowledge generation.

2011 Highlights

- Second credit reference project launched.
- Fifth bank joins supply chain finance project.
- GrowthCap project launched.

CREDIT BUREAU IMPLEMENTATION

Credit information sharing has significant potential to reduce transactions costs in SME finance. The FSD supported Kenya Credit Information Sharing Initiative (KCISI) has successfully raised the profile of credit information sharing with both banks and the wider public. All banks are now submitting negative information to two bureaus, the second of which, Metropol Ltd, was licensed in 2011. The successful completion of the first phase of this project was confirmed by a positive project completion report which made recommendations that FSD's support for the project continue. The end of project review was published and widely disseminated among key stakeholders.

A key highlight of the year was the hosting of a two day conference entitled "The state of credit markets in East Africa" which was a success. Following the progress made in the first phase, FSD initiated a second phase that kicked off in October 2011. This new phase will seek to move banks to full file information sharing, introduce other credit providers into the system and ensure greater understanding of credit information sharing across all providers.

During the final quarter of the year, the project team was extensively involved in the development of a roadmap for the Association of Microfinance Institutions (AMFI) that would see DTMs and major credit-only MFIs participate in sharing credit information in 2012. AMFI's board approved this roadmap.

Credit Information Sharing

A good credit record builds good credit terms



A creative metal artisan in Nairobi works on his next piece. Small businesses such as these are set to benefit from GrowthCap, a project under FSD's Inclusive Growth theme, that seeks to overcome constraints facing financial institutions in the development and delivery of appropriate SME centered products and services.

SUPPLY CHAIN TRADE FINANCE FACILITY

The ongoing Supply Chain Trade Finance Facility, SSCTF, was designed to support the development of transactional finance models that provide working capital for suppliers to large corporate buyers. Commercial Bank of Africa this year joined ABC, Chase Bank, NIC and DTB in signing Memorandum of Understandings (MOUs) with FSD. All of these institutions are at various stages of developing and piloting an invoice discounting product. The project also partnered with Coca-Cola and Equity Bank to develop a mobile based platform for payments and supply chain management for Coca-Cola's SME retailers. The project has been extended until June 2012 and will be combined with GrowthCap, our new flagship SME finance capacity building project.

SKILLS DEVELOPMENT – GROWTHCAP

GrowthCap was designed and approved in the second quarter of 2011. The human capacity building challenge in the development of appropriate SME finance products and services goes beyond specific technical skills. Personnel in the financial services industry also require a deeper understanding of and empathy with SMEs. FSD's experience from earlier work in this area shows that the impact of training dissipates rapidly if there is no opportunity to practically apply and develop the skills and ideas acquired. This necessarily requires drawing institutional partners into the programme with the simultaneous benefit of increasing the likely practical impact on the market. Drawing heavily on the lessons from the highly successful MicroSave programme in microfinance, the aim of the GrowthCap project is to increase the client centred skills needed in the financial sector to serve the growing SME market.

KNOWLEDGE GENERATION

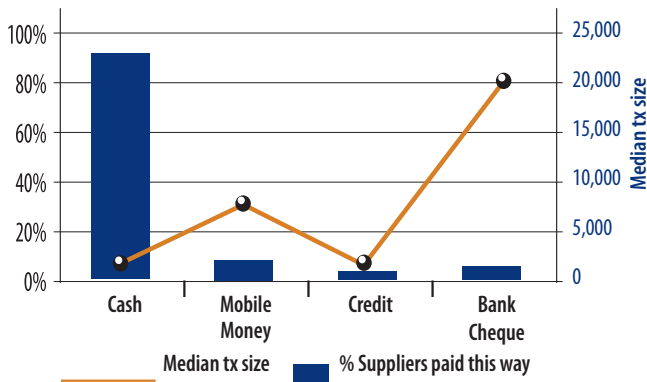
FSD has been at the forefront of knowledge generation in the specific constraints and issues affecting SME finance and developing a clear understanding of the market. In 2011, FSD began working on the design of a FinAccess Businesses to address the gap in our understanding of finance for business in Kenya.

NORTHERN KENYA INVESTMENT FUND

FSD financed a feasibility study into a proposed investment fund for Northern Kenya (and other arid lands) in conjunction with the Ministry of Northern Kenya along with USAID and CARE. Completed in 2011, the comprehensive review of potential projects and value chains in the region gives some guidance to FSD and others on the case for proceeding with a larger project in the region. It has been well received in some quarters and a decision by FSD on how to proceed will be taken after a stakeholder workshop is held early in the new year.

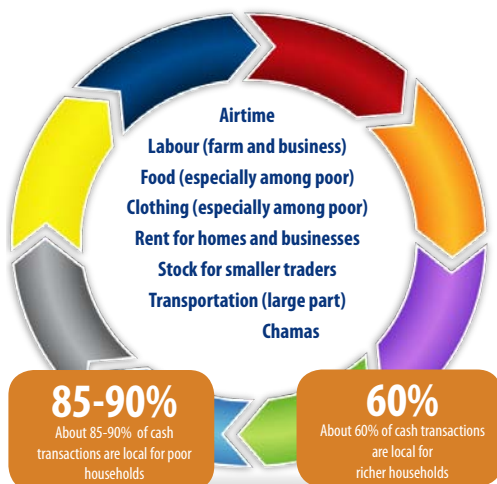
KNOWLEDGE THEME AREA

Figure 7: Median transaction size vs frequency in payment



The cash-lite scoping study titled “Time for Cash to Cash Out ?” revealed some important findings. Figure 7 above shows that local cash transactions dominate the transaction profiles of most consumers. Figure 8 below shows that most purchases by number are done in cash but these tend to be lower value. Mobile money and cheques tend to be used for larger purchases. As a result non-cash transactions dominate in terms of value transacted.

Figure 8: Local cash transactions dominate the transaction profiles of most consumers



In 2011, the Knowledge theme area underwent an ambitious expansion. The expanded scope is a response to the growing strategic importance of research in delivering FSD’s mandate to support pro-poor market development and policy formation. The expansion of our research capacity is already enabling us to significantly expand our three main knowledge programmes: FinAccess, Impact Research and the Centre for Branchless Banking.

2011 Highlights

- FinAccess planning completed.
- Financial landscapes study completed.
- Cash-lite scoping study completed.

FINACCESS

A substantial amount of investment in 2011 was devoted to capacity building of the FinAccess management team, with a view to enhancing the quality and sustainability of the survey. The capacity building workshops were highly appreciated by all participants (Central Bank of Kenya, Kenya National Bureau of Statistics (KNBS) and FSD). These workshops have contributed to a tight planning process leading up to the drafting of the new questionnaire and the procurement of the research house, as well as developing our skills as individual professionals

The third FinAccess survey (after 2006 and 2009) was due to take place in 2011. Extensive planning was done for the survey (now referred to as the FinAccess Retail - Demand Survey). An expert review was conducted of the survey instrument culminating in a structurally improved, shorter questionnaire, which also gives more attention to the quality of access and usage, consumer protection and emerging sectors such as branchless banking. A successful procurement process was completed in mid 2011. Despite all the pieces being in place however, we were not able to undertake the survey in 2011 due to delays in the KNBS-NASSEPV listing process.

In 2011 planning also continued for two other FinAccess surveys. The FinAccess Retail - Supply Side survey could not be started due to resource constraints and is now planned for 2012. Planning for a new FinAccess survey on SMEs - FinAccess Business - also began in 2011.

IMPACT RESEARCH

During 2010, FSD embarked on an impact research programme for selected areas of projects within its project portfolio. This is aimed at developing a better understanding of the causal pathways by which FSD projects impact on markets. In 2011 three impact studies were undertaken:

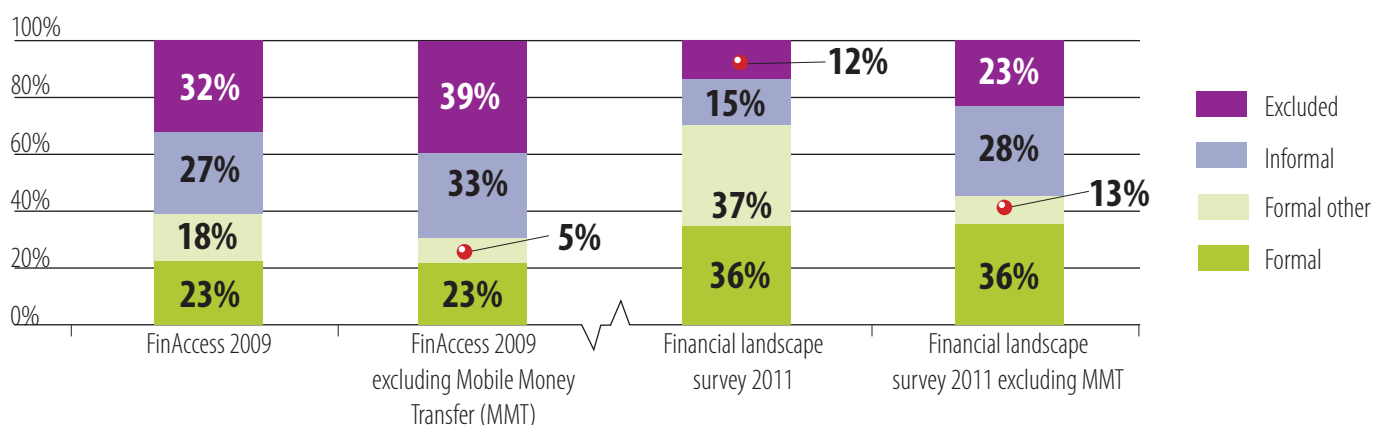
- The Financial Landscapes study was completed. The report, a meso level study of the patterns and drivers of supply and demand, highlights the significance of social networks and reciprocity in financial intermediation. The report suggests that formal services, especially banks, need to tap into and leverage on the reciprocal and flexible nature of informal institutions to capture a greater market share.
- Work began on a study of a new Trade Credit product developed in partnership with Equity Bank. The study follows an experimental design, and is expected to yield important results for enterprise financing at the lower end of the spectrum.
- The Savings Groups study is well underway and beginning to yield exciting results. We have conducted an ambitious census of all new group members under our new partnership with CARE. The census collects basic data on group members as well as the Grameen Foundation's PPI (Progress out of Poverty) indicators which will give us a measure of poverty status and thus outreach. Also under the savings groups, a scoping study on group replication rates was completed in November 2011.

CENTRE FOR BRANCHLESS BANKING

A highlight of 2011 was the creation of a new centre within FSD, the Centre for Branchless Banking (CBB). The Centre aims to position FSD as a leading think tank on branchless banking evolution in Kenya, combining research, policy development and support to innovation. The CBB is at the core of FSD's new strategy: to support the development of a 'cash-lite' financial system in Kenya. The CBB kicked off in October 2011, and research activities are already well underway:

- The most ambitious of these is a national Financial Diaries study which will take place over one year in 2012/13. The study is expected to yield invaluable information on consumer behaviour and financial management, giving us insights into the cash flows of low-income households, usage of financial instruments, mediums of transaction (e.g. cash vs electronic) and the ways in which these are deployed to meet livelihood needs.
- A scoping study on cash eco-systems was undertaken in the last quarter of 2011 and yielded fascinating insights into the volumes, frequencies and directionality of cashflows in a selected community, identifying opportunities for electronic platforms.
- Planning for a major research project on agency banking is also underway and the study will be conducted in 2012.
- The applied research wing of the Centre got off to a good start, with four product development and testing projects in the pipeline, in partnership with established providers and innovators.

Figure 9: Access strands - Financial Landscapes study



FINANCIAL COMMENTARY

FSD was able to continue supporting its ongoing projects and launch innovative new projects due to strong support from funders. 2011 was a pivotal year as it marked the start of new funding under the strategic plan 2011–2015 as well as the launch of some large projects.

FUNDING

FSD signed fresh funding agreements with the main donors during the year. This now provides funding for FSD activities to the end of the year 2015. As a result, the Trust closed the year with a higher level of funding compared with previous years. Significant funding was received from the UK's Department for International Development (DFID) 81%, Swedish International Development Agency (SIDA) 9%, the Bill and Melinda Gates Foundation and the Kenya Government. Due to a significant increase in funding for the HSNP program, the proportion of FSD's funding that is restricted has increased from 53% in 2010 to 68% in 2011.

Table 2: FSD Funding in 2011

SOURCE	KSh (m)*	%
UNRESTRICTED		
DFID Kenya	267	16.8
SIDA	139	8.7
Bill and Melinda Gates Foundation	71	4.5
GOK - Ministry of Industrialization	34	2.2
Sub-total unrestricted	512	32.2
RESTRICTED		
DFID - HSNP	1,029	64.7
GOK - Ministry of Finance	22	1.4
DFID/CGAP	13	0.8
National Bureau of Economic Research	11	0.7
The Rockefeller Foundation	4	0.3
Sub-total restricted	1,079	67.8
TOTAL	1,591	100.0

* Columns do not add up due to rounding.

PROJECT EXPENDITURE

FSD's total expenditure on projects grew from KShs 872m in 2010 to KShs 1,301m in 2011, representing a 49% increase (see Financial Statements in Annex 1). This is mainly attributable to higher level of spending on the HSNP. The Future Financial System theme area is the largest theme in terms of spending and accounted for 85% of total project expenditure during the year. Spending under Poverty Impact declined from 16% in 2010 to 10% of

total expenditure in 2011, reflecting the conclusion of major projects. Though new projects were initiated within 2011, they were at the initial stages of implementation and hence low levels of spending. Expenditure on the Inclusive Growth theme area remained at about 2%, while, expenditure under the Knowledge theme area rose from 1% in 2010 to 4% in 2011. Also in line with the new strategy meso level projects account for 93% of total project expenditure compared to 87% in 2010. This shift is expected to continue as FSD focuses on industry-wide financial sector projects as envisaged in its new strategy.

ADMINISTRATIVE EXPENDITURE

FSD management costs increased by 42% in absolute terms during the year mainly as a result of the higher expenditure on staff costs. This was driven by increased programme activity. The proportion of administration costs to total expenditure however declined from 7.4% in 2010 to 7.1% in 2011. As has been the case in the past, the Trust has maintained strict control over administration expenditure to ensure that available resources are utilised efficiently.

Figure 8: Growth in project investments

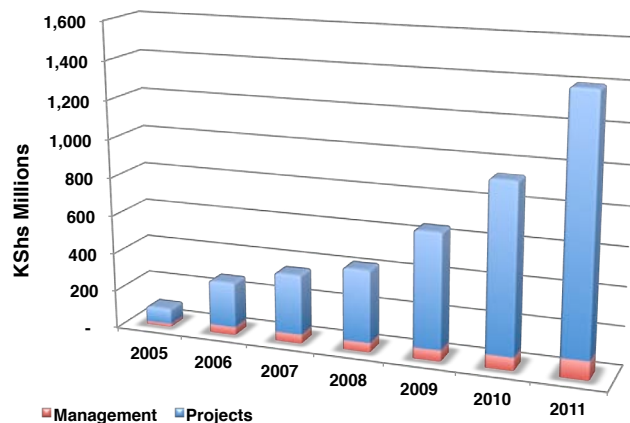
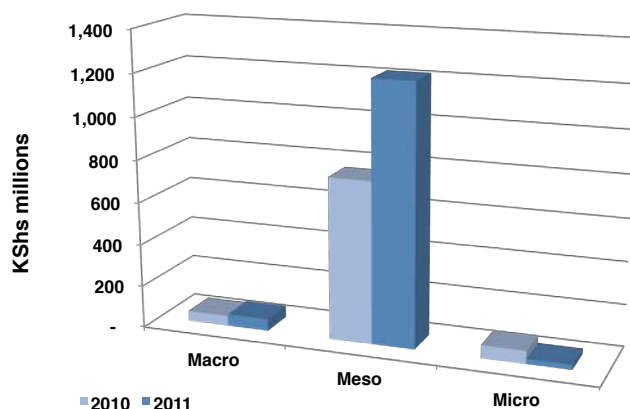


Figure 9: Breakdown of spend by level



Annex 1

FINANCIAL STATEMENTS

INCOME AND EXPENDITURE STATEMENT
FOR THE YEAR ENDED 31ST DECEMBER 2011

	2011	2010
INCOME	KShs Millions*	KShs Millions*
Grants	1,591	1,146
Other income ¹	0	1
Finance income ²	24	14
TOTAL INCOME	1,615	1,161
EXPENDITURE		
PROJECT EXPENSES		
Core projects ³	223	274
Designated projects ⁴	1,079	598
	1,301	872
ADMINISTRATIVE EXPENDITURE	99	69
TOTAL EXPENDITURE	1,400	942
FINANCE COSTS⁵	89	5
TOTAL COSTS	1,489	937
SURPLUS FOR THE YEAR	125	224

* Columns do not add up due to rounding.

¹ Other income constitutes all non grant incomes.

² Finance income includes interest earned on FSD funds.

³ Core/non designated projects are projects funded by donors through unrestricted funds. Unrestricted funds have no conditions regarding the projects they can fund.

⁴ Designated projects are funded by donors through restricted funds. Restricted funds can only be used on the project specified by donors.

⁵ These are exchange losses incurred on revaluation of foreign currency held by FSD.

**BALANCE SHEET
AS AT 31ST DECEMBER 2011**

	2011	2010
	KShs Millions*	KShs Millions*
ASSETS		
Non-current assets		
Property and equipment	3	3
Intangible asset work in progress	1	1
Total non-current assets	4	5
Current assets		
Grant receivable ¹	-	11
Loan advance ²	-	77
Receivables	5	2
Contract advances	1	0
Fixed deposits	236	201
Bank and cash balances	853	518
Total current assets	1,095	809
Total assets	1,098	813
RESERVES AND LIABILITIES		
Reserves: Accumulated fund	584	458
Non-current liabilities		
Deferred income	-	-
Current liabilities		
Unexpended projects fund	426	281
Deferred income	-	0
Accruals	29	18
Tax liability ³	60	55
Total current liabilities	514	355
Total reserves and liabilities	1,098	813

* Columns do not add up due to rounding.

¹ 2010 accounts were restated to reflect a grant receivable from DFID which was received after the end of the year.

² Refers to future incomes expected from an asset donation by an FSD donor.

³ FSD has applied for tax exemption on some tax categories. This amount is the accrual of these taxes pending finalization of the tax exemption application.

Annex 2

FSD KENYA'S PORTFOLIO

Project		Objective	Approved (KShs m)	Progress as at December 2011	Actual or expected impact
Theme 1: Future financial system					
Policy and regulatory	Scenario building	Develop a scenario building process to address the question: "How to enhance the uptake and usage of non-traditional and electronic channels to deliver financial services."	9.0	On-going	Systemic
Financial education and consumer information	Consumer info II	Improve the generation and dissemination of consumer information on financial services to improve competition and consumer choice.	6.2	On-going	Systemic
	Financial education	Determine the overall vision and agenda for a programme of financial education in Kenya and pilot initiatives to test ways to most effectively deliver financial education.	63.0	On-going	Systemic
Payments	G2P Payments development project	Catalyse the expansion of private sector driven payments systems to allow the delivery of social payments under proposed new programmes and significantly expand access to appropriate financial services for low-income Kenyans	3292.0	On-going	Systemic - the long term aim is to exploit G2P payments to provide a demand driver for service expansion
Direct retail capacity	Kenya Post Office Savings Bank (KPOSB) III	To exploit Postbank's new business model to significantly increase outreach to lower-income groups in rural areas.	6.0	On-going	Expected to reach large numbers of low-income households
Theme 2: Poverty impact					
Agricultural finance	Index-based Weather Insurance	Develop and demonstrate the market viability of index-based insurance products to reduce the impact of weather risk on smallholder farmers and pastoralists in Kenya	83.9	On-going	Significant numbers will only be reached in a second phase project - this first phase represents a proof of concept.
	Warehouse Receipts System	Establish and promote a viable and sustainable warehouse receipts system	30.0	Work on legislation started - extension likely to be required.	Low - only 8,000 farmers targeted in this first phase project.
	Value Chain Finance Centre	To strengthen agricultural value chains through developing appropriate and sustainable finance	96.9	On-going	Impact from the first phase project is likely to be limited but the aim will be to scale-up subsequently.
Community based financial services	Group Savings and Loan association development	Develop the GSL system to the stage at which a scale-up programme aiming to impact significantly on financial exclusion at a national level becomes viable.	100.0	Complete	High. Reached 146,000.
	Decentralised Financial Systems III	Expand the supply of financial services in rural areas through the rollout of robust decentralised financial systems	60.0	Complete	Targeted expansion was 90,000 over the project period.

FSD KENYA'S PORTFOLIO CONTINUED

Project		Objective	Approved (KShs m)	Progress as at December 2011	Actual or expected impact
	FSA Transformation project II	Demonstrate sustainability at the regional level and expand the network of commercial FSA management services, laying the foundations for full sustainability of the system	75.0	Complete	High. Reached 122,000.
	Savings groups scale-up I	To develop savings groups models to a stage at which a scale-up programme impacting significantly on financial exclusion at a national level becomes viable.	250.0	On-going	Systemic - immediate expected outreach over 120,000
Technology	EasySave	To develop a commercialisable savings and loan scheme targeting low income rural people based on the M-PESA payments platform.	23.8	On-going	The immediate impact was very limited but if taken up by others could be significant.
SACCO reforms	SACCO Fund II	Support to institutional strengthening of SACCOs with a view to strengthening governance, financial stability and operations to comply with the new regulatory framework	60.0	Complete	Aim was to produce demonstration models of reform. Actual impact moderate given targeting of larger institutions.
	SACCO regulations implementation (SACCO reg III)	Support planning for the SACCO sub-sector reforms in line with the new regulatory framework.	7.0	Complete	Systemic
	SACCO sub-sector reforms	Develop the capacity of the SACCOs sub-sector to meet the requirements of the new regulatory framework	162.4	On-going	Systemic- working with about 230 SACCOs targeted for regulation serving over 1.5m
Theme 3: Inclusive growth					
Credit information	Credit reference	To support the creation of an effective credit information sharing environment in Kenya that has a markedly positive impact on access to finance especially by small and medium enterprises (SMEs).	44.3	Complete	Systemic
	Credit reference II	To support the development of an effective full file credit information sharing (CIS) environment in Kenya (SMEs).	123.4	On-going	Systemic
Product and industry development	Supply chain trade finance support	To support the financial sector in the introduction, piloting and scale up of structured working capital supply chain finance products for small and medium enterprises.	70.0	On-going	Outreach for already identified interventions likely to be < 10,000.

Project		Objective	Approved (KShs m)	Progress as at December 2011	Actual or expected impact
Skills Development	GrowthCap – SME finance capacity building initiative	To build the capacity of the financial sector to provide high quality SME centred financial products and services.	260.0	On-going	Systemic
	Theme 4: Knowledge				
	FinAccess 2011	To continue the development of FinAccess as a comprehensive, reliable and sustainable mapping of the financial landscape in Kenya, measuring household demand and supply.	67.6	On-going	Systemic
	Impact Research	To provide evidence of the impact of FSD on its goal to generate sustainable improvements in the livelihoods of lower income households through reduced vulnerability to shocks, increased incomes and employment.	78.0	On-going	Systemic
	Centre for Branchless Banking (CBB)	To stimulate the development of branchless banking in Kenya as a means to deepen and expand financial inclusion.	270.0	On-going	Systemic
New directions					
	Micro-insurance market analysis	To conduct a demand-side, supply-side and regulatory analysis to map the insurance and micro-insurance landscape in Kenya and identify the drivers of and challenges to market development.	6.0	Complete	Systemic

Annex 3

FSD KENYA'S PARTNERS 2011

Government/ regulators	<ul style="list-style-type: none"> ▪ Ministry of Finance ▪ Ministry of Co-operatives Development and Marketing ▪ Ministry of Home Affairs ▪ Ministry of Agriculture ▪ Ministry of Industrialisation ▪ Ministry for the Development of Northern Kenya 	<ul style="list-style-type: none"> ▪ Central Bank of Kenya ▪ Insurance Regulatory Authority ▪ Kenya Bureau of National Statistics ▪ Kenya Meteorological Department ▪ SACCO Societies Regulatory Authority (SASRA) ▪ Women Enterprise Fund
Financial service providers	<ul style="list-style-type: none"> ▪ FINA Bank ▪ Equity Bank ▪ ABC Bank ▪ Commercial Bank of Africa (CBA) ▪ NIC Bank ▪ Diamond Trust Bank ▪ Chase Bank ▪ Kenya Commercial Bank (KCB) 	<ul style="list-style-type: none"> ▪ Kenya Women Finance Trust ▪ Faulu Kenya Ltd ▪ K-Rep Fedha Services Ltd ▪ Kenya Post Office Savings Bank ▪ Blue Shield Insurance ▪ APA insurance ▪ Co-operative Insurance Company ▪ Mobile Ventures Kenya (MVK)
Non-profits/ industry associations	<ul style="list-style-type: none"> ▪ Kenya Bankers Association (KBA) ▪ Association of Micro-finance Institutions (AMFI) ▪ East Africa Grain Council (EAGC) ▪ Centre for Financial Regulation and Inclusion (CENFRI) ▪ CARE Kenya ▪ International Livestock Research Institute (ILRI) 	<ul style="list-style-type: none"> ▪ Mediae ▪ Plan International ▪ Oxfam GB ▪ HelpAge International ▪ Save the Children UK
Development partners	<ul style="list-style-type: none"> ▪ DFID ▪ SIDA ▪ The World Bank ▪ AFD ▪ CGAP ▪ FSD Tanzania ▪ International Labour Organisation (ILO) 	<ul style="list-style-type: none"> ▪ FinMark Trust ▪ World Council of Credit Unions (WOCCU) ▪ International Finance Corporation (IFC) ▪ Rockefeller Foundation ▪ Bill and Melinda Gates Foundation ▪ USAID's Financial Inclusion for Rural Microenterprises (FIRM)
Consultants	<ul style="list-style-type: none"> ▪ Development Alternatives Incorporated (DAI) ▪ ShoreBank Consulting ▪ Investeq Capital ▪ Bankable Frontier Associates ▪ MicroSave ▪ Paul Rippey 	<ul style="list-style-type: none"> ▪ Oxford Policy Management ▪ Microfinance Management Institute (MFMI) ▪ Accenture Development Partnership (ADP) ▪ Synovate ▪ Pipal Ltd ▪ Inspired International

Towards a new financial frontier



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