ANNUAL REPORT

2016



FSD Kenya
Financial Sector Deepening

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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Creating value through financial inclusion

DIRECTOR'S FOREWORD

2016 marked the first year of FSD's fourth strategy for the period 2016 to 2021. The financial landscape in Kenya has evolved in ways far beyond the vision of FSD at our inception in 2005. Although the long-term goal was always to help create a pro-poor financial sector in Kenya, the path to achieving this was far from clear. What is clear today is that access only represents a milestone, albeit a significant one, on the path to creating a pro-poor financial system. As we look ahead to the next five years, it is now also clear that achieving real impact on poverty through financial market development is far more complex than assumed.

In February 2016, the Central Bank of Kenya, the Kenya National Bureau of Statistics and FSD Kenya jointly released the fourth FinAccess Household Survey that measures the financial inclusion landscape – access, usage, quality and impact – in Kenya. The 2016 survey provided the first ten-year perspective on Kenya's financial landscape. Overall, the expansion in the reach of the financial system has been impressive. The proportion of the population excluded from any form of financial service has dropped from over 40% of the adult population to about 17% between 2006 and 2016. Access to any form of formal financial service has dramatically increased from about 27% to over 75%. Today, the idea of a fully inclusive financial system, while still some way from being achieved, no longer seems fanciful.

Despite these accomplishments, the evidence suggests that the developmental impact at the household and business level is considerably more modest than initially envisioned. The extent to which the poor are able to participate in and benefit from markets is highly contingent. Weak market development combined with specific structural impediments can result not only in reduced impact but sometimes even negative outcomes for the poor. This requires FSD to carefully consider where and how it works in the future.

In thinking about how finance can impact on poverty it is clear that there can be both direct and indirect pathways. The markets in which poor people operate shape their opportunities – employment prospects, supply of goods and services, demand for the goods they produce and so forth. A narrow understanding of financial inclusion – as being simply about finance used by low income households – perpetuates a limited and ultimately ineffective development paradigm. Inclusive finance needs to be understood as not only about finance which can be directly used by the poor to take advantage of opportunities to enhance their livelihoods but also to enhance the opportunities created by the local economies in which they live.

FSD's new programme builds on the identified needs and opportunities for effective intervention. Our work will focus on creating value through financial inclusion by concentrating on four key areas of market development: long-term policy and research, regulation, industry infrastructure and innovation. FSD cannot, however, take on all the challenges even within just these priority areas. Where other partners are better placed to undertake work, FSD will simply seek to remain informed but in the background. In other cases, FSD will engage with others where there are opportunities for mutual leverage.

There are multiple outcomes with very different prospects for financial inclusion in a rapidly changing market such as Kenya's. Although some aspects of FSD's future programme can be clearly defined today, developing credible solutions to the strategic challenges and how impact on poverty will be achieved is a learning process. FSD is set to take on this challenge by striving to become a thought leader in understanding the opportunities and constraints in the market and working with stakeholders to help define a vision of how it can and should develop. The potential for finance to become a more effective tool for stimulating development and poverty reduction is stronger than it has ever been.

David Ferrand
Director

OUR APPROACH

The conceptual underpinning of FSD's work is the "making markets work for the poor" (M4P) approach, which emerged as an increasingly influential development paradigm over the last decade.

M4P is "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 systemic constraints and bring about large-scale and sustainable change." This approach provided the original impetus for the establishment of FSD Kenya and has guided our activities for the past twelve years. Making markets work for the poor starts with an interrogation of how markets are currently working, where the poor are situated within them and what will determine future development trajectories. Looking at the market system as a whole helps us understand the current state and potential future of financial inclusion in Kenya.

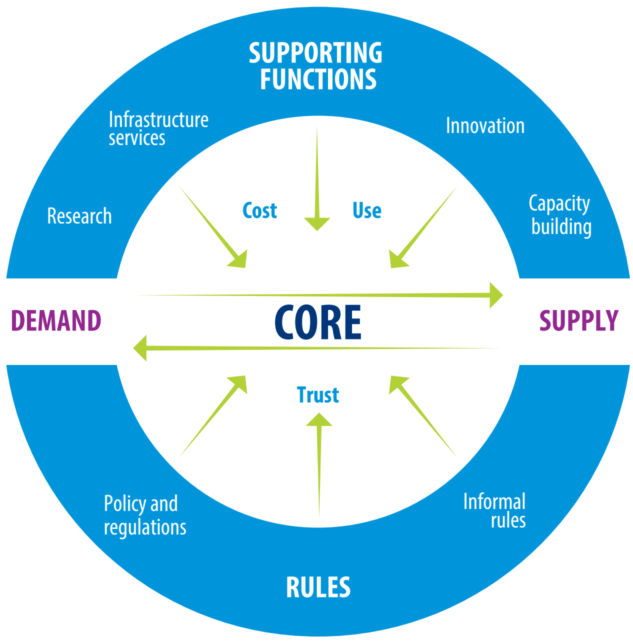
Figure 1: Elements of the market system

- The starting point is the ***core*** function of markets: transactions between supply and demand. The basis of any transaction is the creation of value for those engaging in it. From the perspective of the demand side, the first question to consider is the application of the financial service: what ***use*** does it offer? If financial services are to become truly accessible to most Kenyans, affordability is critical. ***Costs*** will need to reduce further. Finally, the participants in a financial transaction need to ***trust*** that the other party will honor its side of the deal.

- The ability of financial services to create value through offering useful solutions to real world problems at an affordable price underpinned by confidence in the outcomes is shaped by the market's supporting functions and rules.

- The ***supporting functions*** include: (1) industry infrastructure such as credit information sharing systems, payment systems, security depositories and collateral registries; and (2) service markets most notably the ability to outsource functions to specialist players to exploit scale and specialisation efficiencies.

- Although much attention tends to be focused on the formal ***rules*** of the game (laws and regulation together with enforcement), the informal rules (habits and norms, attitudes and mental models) play an equally significant role.



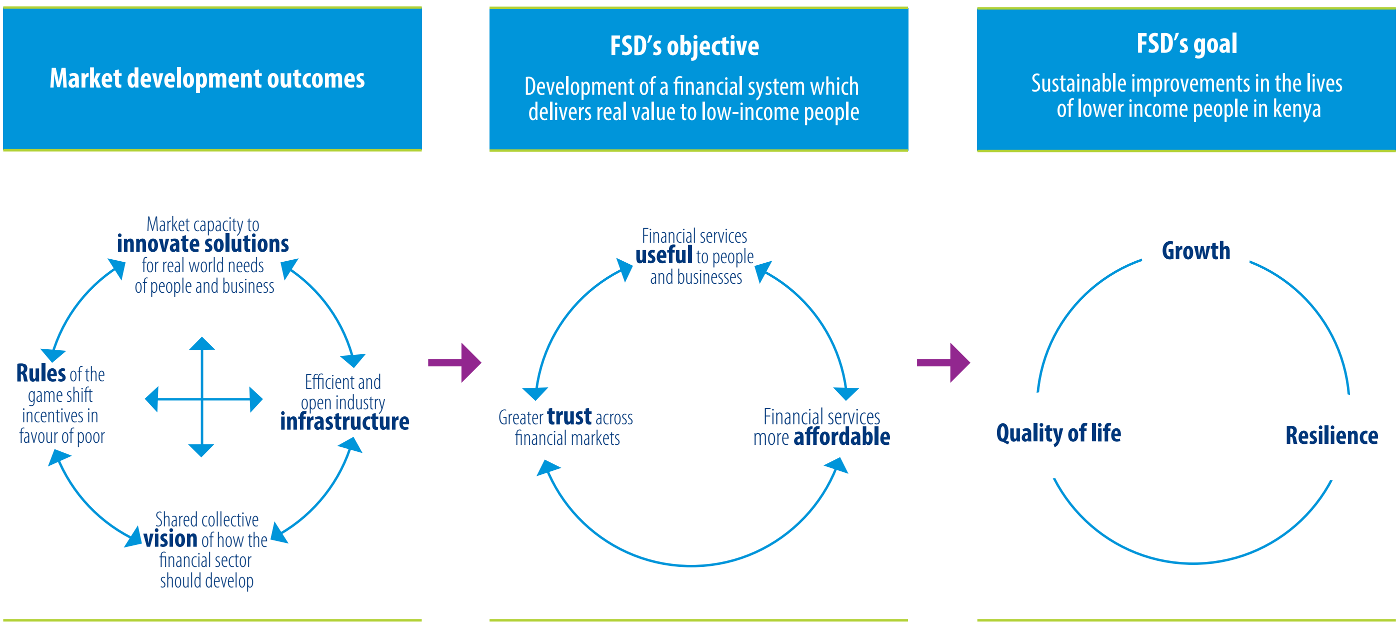
OUR STRATEGY

Kenya's national development objectives as articulated in Vision 2030, the Government of Kenya's long-term plan, is to "create a globally competitive and prosperous nation with a high quality of life by 2030". Vision 2030 emphasises that all Kenyans should enjoy a high quality of life. The link between financial market development and poverty reduction is the sole rational for the FSD programme.

In looking to the future, we need to ask what constrains the sector from making a transformational impact on lower-income markets. Our new six-year strategy for the period 2016 to 2021 focusses on all three core elements through which value is created by financial inclusion: use, cost and trust. There has long been an implicit assumption that the only important constraint is cost.

This certainly remains a significant factor but it is unlikely to be sufficient. Reiterating our approach to market development, we believe that realizing the promise of inclusion depends on developing financial solutions which address real world problems. In other words, we need financial services which do useful things for people and businesses. Low levels of utilisation of many services often reflect that the current services are not especially useful. They also need to be underpinned by a stronger degree of trust. Addressing these three elements we believe is the key to developing a financial system which delivers real value to low-income people. The result should be sustainable improvement in their lives through facilitating growth, improving resilience and allowing people to make more choices which directly improve their quality of life.

Figure 2: Creating value through financial inclusion

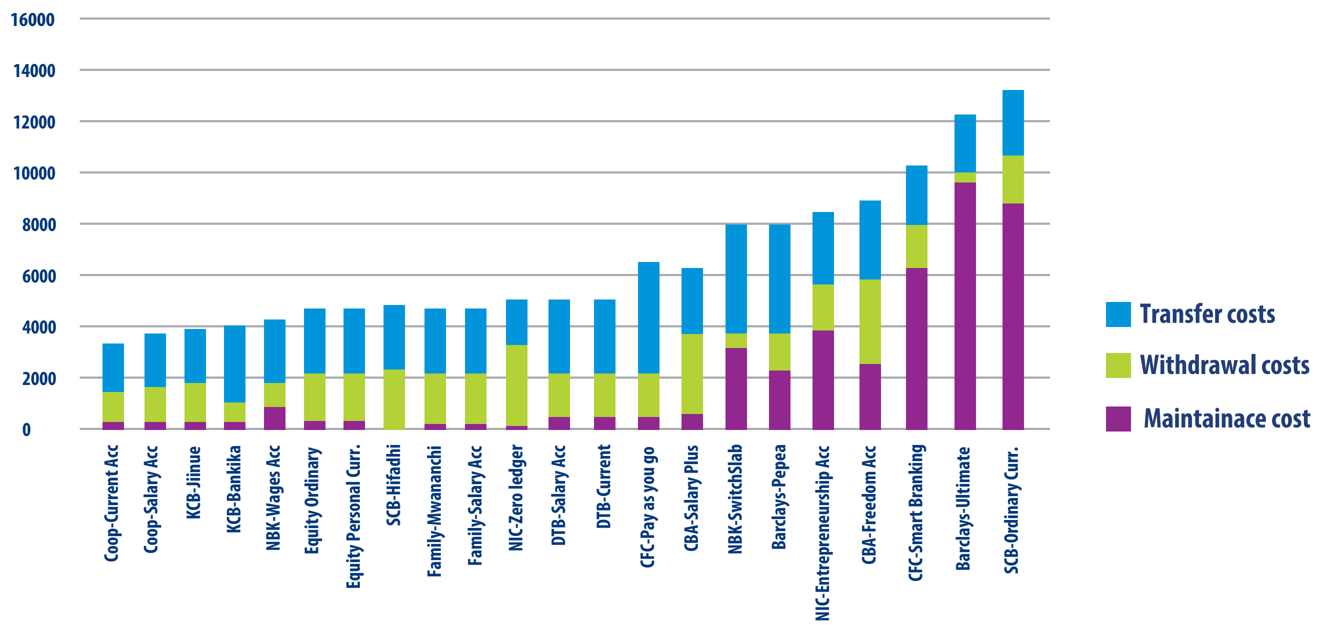


FINANCIAL INCLUSION: WHERE ARE WE?

Cost: A mystery shopping study conducted by FSD Kenya on Kenya's 11 largest banks revealed great diversity in the annual cost of running a bank account. A customer who withdraws twice per month, transfers money once a month[1] and pays for basic account maintenance (e.g. ledger fees, mini-statements, card replacements, etc.) can pay between KSh 3,629 to KSh 13,460.

As shown in figure 3, the major difference between accounts depends on the fixed "account maintenance" costs. While many banks offer a pay-as-you-go option for their key retail accounts, some offer only premium solutions with relatively higher monthly ledger fees.

Figure 3: Yearly costs for running selected bank accounts (KSh)



On the lending side, a new law introducing interest rates controls became effective in September 2016. The law puts a ceiling on lending rates by banks and financial institutions at 4% above the Central Bank Rate (CBR), coupled with a floor on term-deposit rates equal to 70% of the CBR. The new law also introduced a minimum fine of KSh one millon if a bank contravenes these provisions and a jail term for the bank's chief executive. The new law was aimed at delivering cheaper credit to households and small businesses that previous measures have failed to do. However, experience from other countries suggest that such controls can have negative effects that fall disproportionately on poor households and small businesses, the same group the controls are intended to benefit the most. The scale of the effects on Kenya's banking sector are yet to clearly emerge but there is already some evidence of a contraction in private sector credit which can be linked to the introduction of these caps.

Data subsequently released by CBK on the average lending rates on all loans and product segments show that banks have adjusted their lending rates downwards, reflecting compliance with interest rates controls. The weighted average lending rate for the banking sector stood at 13.7% in December 2016, a marginal decline from 13.8% in September when interest rates controls were effected but significantly down from 18.2% in June 2016 and 17.8% in March 2016.

[1] These transactions baskets were weighted using demand-side data and include different channels (e.g. agents, over-the-counter, ATMs) as well as different payment platforms (bank-to-mobile, electronic fund transfers, real-time gross settlements, etc.)

Usage: The percentage of Kenyans not using any form of financial service declined from 25.1% in 2013 to 17.4% in 2016. Inclusion was driven by mobile money services, used by over 71% of adults, and by mobile banking services such as M-Shwari, Equitel and KCB-M-Pesa. Just a few years after their introduction, mobile banking services are already used by 17.5% of Kenyans and have become the most common banking solution among youth (see figure 5). In 2016, there was also an increase in the percentage of adults using informal savings groups (41.4%) and insurance products (24.3%) mostly attributed to increasing uptake of statutory insurance, notably the National Hospital Insurance Fund (see figure 4).

Figure 4: Access to formal and informal financial services (% of adults)

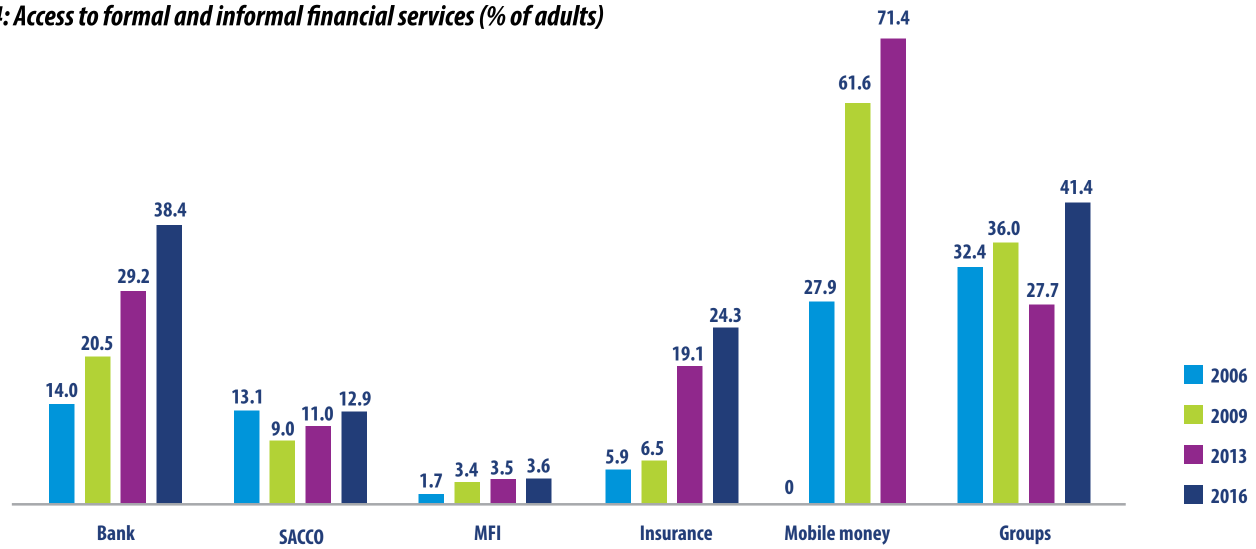
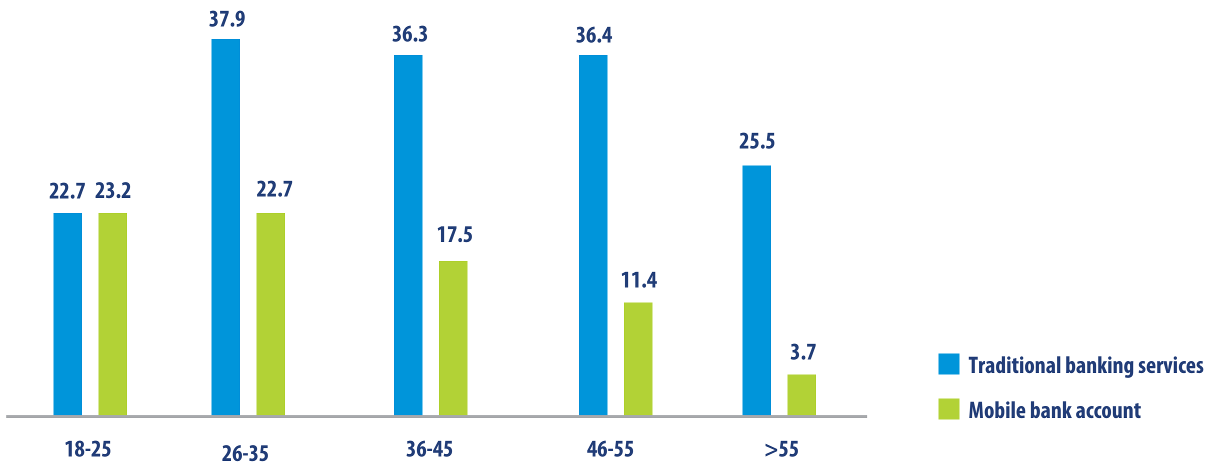


Figure 5: Usage of traditional and mobile bank accounts by age group



The increasing levels of inclusion are reflected in supply-side data. The number of deposit accounts in commercial banks increased to 40.1 million in the third quarter of 2016 from 36.5 million in December 2015. This was mainly driven by accounts opened through mobile phone platforms and increasing usage of bank agent networks. According to the CBK, 23.8 million transactions were conducted through bank agents in the third quarter of 2016. Customer deposits grew by 2.3% from KSh 2,627 billion in June 2016 to KSh 2,687 billion in September 2016. Mobile money continued to be a major driver of financial inclusion last year. Usage of mobile money payments grew by 36% in 2016 to a record level of 1.5 billion transactions, compared to 1.1 billion transactions in 2015. This amounted to a value of almost KSh 3.4 trillion. The gross number of customers recorded – which includes multiple usage and dormancy – has continued to grow, reaching 35 million in December 2016 compared to 29 million in December 2015. The number of agents grew from 143,9461 to 165,908 during the same period. Data from the CBK shows that customers use mobile money services more frequently at an average of 4.2 times per month by December 2016, and for smaller transaction sizes, which decreased from KSh 2,486 in December 2015 to KSh 2,167 in December 2016. The mobile money market continues to be very concentrated. Over 84% of transactions and 65% of subscriptions are done through Safaricom's M-Pesa.

Figure 6: Trends in mobile money transactions

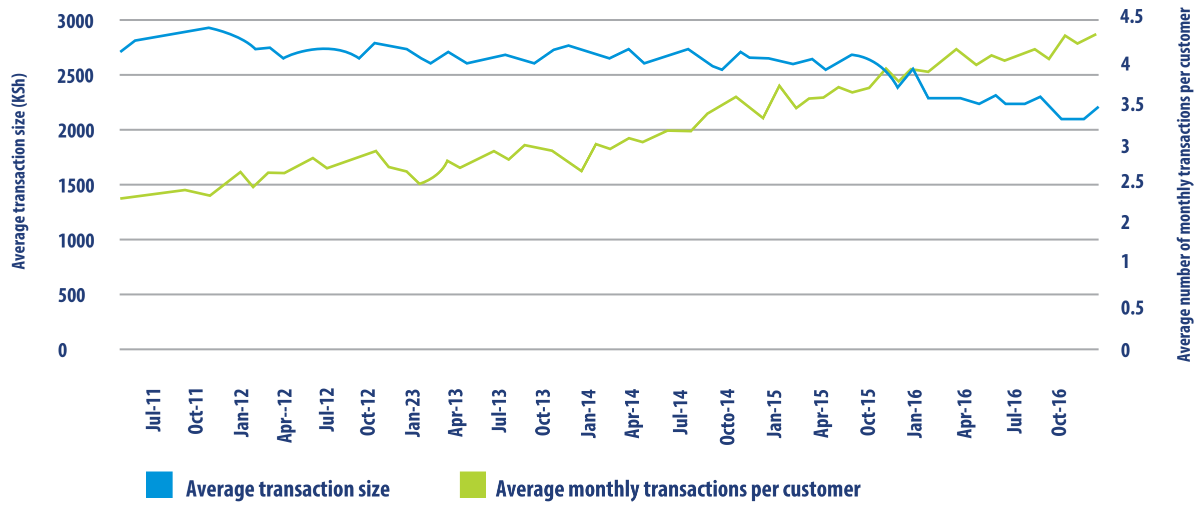


Table 1: Structure of the mobile money market in the third quarter of 2016

	Agents	Subscriptions (million)	Number of transactions (million)	Value of transactions (KSh billion)	Mobile commerce transactions (million)	Mobile commerce (KSh billion)	Person-Person transfers (KSh billion)
M-Pesa	114,282	20.7	326.1	851.1	183.0	359.5	389.1
Airtel money	16,377	5.9	9.1	10.8	9.1	10.8	4.6
Orange money	20,694	0.2	0.0	0.2	0.0	4.2	0.3s
Equitel [2]	-	2.1	2.1	219.6	55.8	77.1	80.8
Mobikash	16,749	1.8	0.8	0.1	0.0	0.1	0.2
Tangaza	1,596	0.5	-	-	-	-	-
Total	**169,698**	**31.1**	**400.7**	**1,081.1**	**247.9**	**447.4**	**474.5**

Access to bank credit registered a decline in the first three quarters of 2016 compared to 2015, with CBK data suggesting a general decline in the disbursement of new loans to the private sector. Year-on-year growth of banks' credit to the private sector decreased to a low of 0.2% in the third quarter of 2016. This probably reflects the effects of the turmoil in the banking sector in 2015 and 2016 when two local banks were placed under receivership by CBK and interest rates controls were introduced.

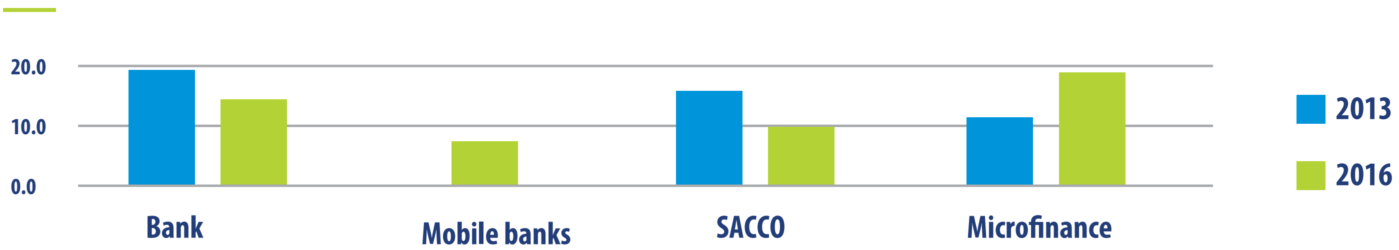
The government's commitment to providing the enabling environment for the growth and development of the lending sector gained impetus. The National Treasury published a bill (which has now been passed) to establish the legal and regulatory framework for the use of movable property as collateral for credit facilities. The Movable Property Security Rights (MPSR) Act includes provisions for establishing an electronic asset registry to facilitate the registration of notices relating to security rights in movable property. This will unlock the use of movable

[2] Equitel is wholly owned by Equity Bank and its customers are served by Equity Bank agents.

properties owned by small businesses as collateral in securing bank credit and facilitate the deepening of credit markets. The scope of credit information sharing (CIS) was expanded by the Finance Act (2016) which amended both the Banking Act and Microfinance Act. The amendments now allow banks and microfinance banks to share full-file credit information with SACCOs and utility companies. Previously, SACCOs and utility companies submitting borrowers' information to credit information bureaus were prohibited from viewing information submitted by banks. The amendments corrected this asymmetrical access to borrowers' data. Similar amendments to the SACCO Societies Act are before Parliament.

Trust: The 2016 FinAccess Household Survey suggested a general improvement in the level of perceived pricing transparency in the formal financial sector, with a decrease in the percentage of bank customers and SACCO customers reporting unexpected charges. An opposite trend was observed in the microfinance industry, where the percentage of customers reporting unexpected charges increased from 11.8% in 2013 to 18.5% in 2016 (see figure 7 below).

Figure 7: Percentage of customers reporting unexpected charges in 2013 and 2016



The Competition Authority of Kenya (CAK) is currently undertaking a market enquiry to establish behavioural biases that impact consumers' ability to access and assess relevant information from banks. This is expected to address transparency issues in traditional banking channels. CAK issued a separate directive targeting mobile financial services (MFS). The directive requires all providers of MFS to disclose the price of their services to consumers during transactions on the same channel as the transaction. This is a major milestone that addresses inadequacies in the disclosure of pricing of MFS where providers in most cases failed to disclose applicable charges or only disclosed charges after the transaction had been initiated and executed. The new regime is expected to contribute to a downward shift in prices as consumers become aware of the cost of transactions.

At an institutional level, there were renewed efforts to strengthen the governance structures of deposit taking SACCOs. The SACCO Societies Amendment bill (2016) was introduced in parliament with provisions that include the introduction of 'fit and proper' tests for SACCO board members. These will be set by the SACCO Societies' Regulatory Authority (SASRA) and will also include mandatory continuous or minimum professional development training and certification for board members. Once passed, the new changes are expected to impose stricter controls in a sector that has developed significantly over the last few years with increased complexity and size of institutions.

OUR PORTFOLIO

FSD Kenya's work to support the development of a financial system which delivers real value to low-income people by addressing the barriers of usefulness, affordability and trust is organised into four focal areas of work. It starts with creating a clear, shared, long-term vision in Kenya for the financial services sector and its developmental role. This will help shape the specific rules of the game for the market – laws and regulation – and the evolution of financial sector infrastructure. The ability of market players to deliver real value will be determined by the incentives and opportunities created by the rules and infrastructure. But it also depends on improving the market capacity to create better financial solutions to real world problems. The following pages will illustrate key initiatives in each area.

AREA	Long-term policy and research	Regulation	Industry infrastructure	Innovations
MARKET DEVELOPMENT OUTCOMES	Shared vision across stakeholder groups of how the financial system should develop to support national development objectives and specifically the reduction of poverty.	Supportive policy and regulatory environment in which the formal rules that govern the financial system shift incentives in favour of low-income consumers and smaller-scale enterprises.	Efficient and open finance industry infrastructure supporting increased competition, expanded services and lower costs.	Market capacity and incentive to innovate financial solutions for real world problems of poor households and economies of the poor.

BROADENING COLLATERALISED LENDING

Small and medium enterprises (SMEs) are the key to unlocking Kenya's economic growth but without finance, they're languishing. Stuck in the grey area between the formal and informal sector, SMEs are perceived as risky. Since they don't usually have the fixed assets banks require as collateral, such as land or buildings, they are not getting financed.

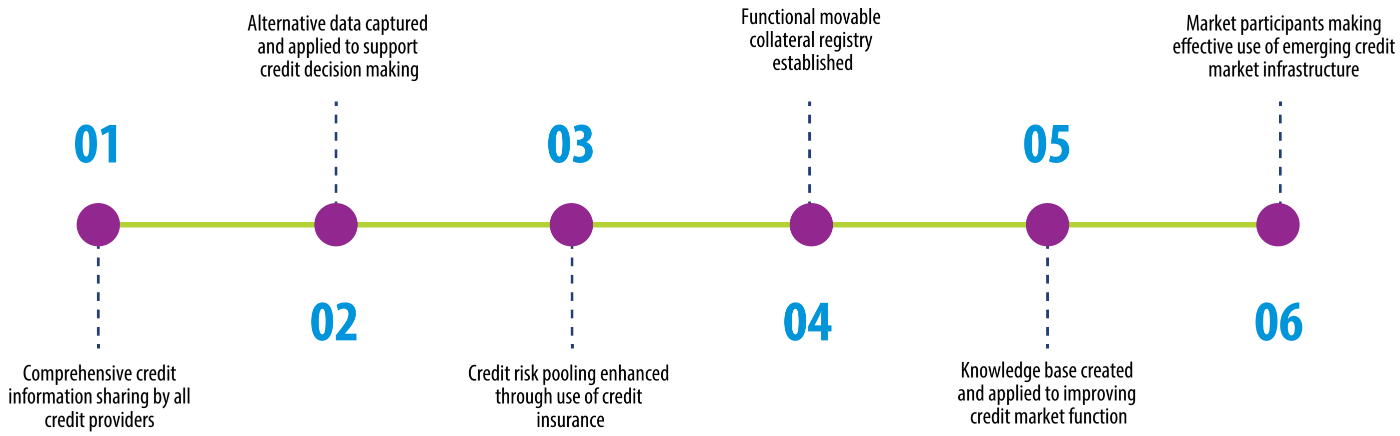
Where financial institutions accept movable collateral, they have to perform a security perfection process which involves searching, valuing, and registering their security interest in an asset. Right now, this process is done manually and in multiple registries i.e. the chattels', companies' and the hire purchase registries. This means that the process is lengthy and prone to errors and the costs involved are passed on to enterprises. Banks are also required to write down part of their core capital when they accept movable collateral. These factors contribute to movable assets not often being accepted as collateral.

Thanks to the government's ongoing reform, this problem is being solved. FSD's credit market development project has been seeking to strengthen Kenya's credit market by providing technical advice on how to improve the enabling framework to support the use of moveable collateral.

Drawing on this advice, the government and stakeholders developed the 2016 Movable Property Security Rights (MPSR) Bill, which received cabinet approval. The bill creates a single registry for moveable property security rights, a one-stop-shop where financial institutions can both search and register their priority over an asset.

In 2016, the government also began establishing an electronic registry to automate the process. Allowing formal and informal credit providers to access the registry electronically will both eliminate manual errors and reduce costs. These reforms will increase access to credit and encourage innovative financial solutions, invigorating Kenya's financial marketplace. There are still hurdles to implementation such as the training needed for participants to properly utilise the registry. But FSD, recognizing the critical role of SMEs in Kenya, is committed to supporting the implementation of these reforms and unlocking SME's access to finance.

The credit market project outputs



APPLYING DATA TO DEVELOPING THE MARKET

FSD Kenya has long supported the generation of data on financial inclusion but its potential practical value has not been fully exploited. Together with the Central Bank of Kenya (CBK) and the Kenya National Bureau of Statistics (KNBS), FSD developed the FinAccess Household Survey and FinAccess geospatial census. Together, they provide comprehensive and reliable information about Kenya's financial access landscape that can guide the industry. For FinAccess to be sustainable and productive both policymakers and the private sector must drive continued research and the use of market data. FSD's vision is to see a long-term public private partnership able to address the needs of all stakeholders.

A 2015 study commissioned by FSD[3] showed that, despite knowledge of the datasets, there is minimal awareness of their value for commercial and policy objectives. So, this year, FSD committed to building awareness of their value. First, FSD's research and innovation teams spoke to industry players to find out how data and analysis could be useful. FSD found it could add value in business strategy, competition analysis, customer segmentation, performance management of retail outlets (especially agents) and identification of untapped market opportunities. Several forums, meetings, workshops and conferences were organised to showcase FinAccess data and develop concrete applications for market expansion and policy. The data was also made available on the FSD website with readable, easy-to-use interactive data visualisations.

A workshop hosted by insight2impact (i2i) and FSD Tanzania in October 2016 further showcased the value of spatial data for the financial sector. Presenters showed how to drive evidence-based decisions in key performance indicator (KPI) measurement, product design and implementation to increase its use. The true power of spatial data lies in its capacity to provide a holistic view of the market. Being able to see financial access points in relation to infrastructure, services, population density, income levels, livelihoods (agricultural value chains, retail outlets, manufacture etc.), potentially boosts the power of the industry to develop and market better solutions to real world needs. FSD Kenya is also partnering with policy makers and the private sector to create an open reporting framework for location data on financial outlets which will provide regular updates of geospatial points at minimal cost.

Still, much more needs to be done for datasets to reach their full potential. A 2016 market diagnostics study found that even though the market information landscape in Kenya is nascent, there is an industry-wide desire to improve data uptake.[4] Major barriers include limited data availability and accessibility, weak analytical and system capacity, and a lack of institutional readiness to shift to a data-driven culture. To help, FSD is designing a new project to support the development of a sustainable market information landscape that will support financial inclusion.

[3] Forster, D. (2015). FinAccess sustainability recommendations. FSD Kenya

[4] Taylor, D. (2016). Learnings from data landscaping exercise. FSD Kenya

ENHANCING TRANSPARENCY TO INCREASE COMPETITION

Information is the life blood of markets. Improved transparency can help directly strengthen price-based competition. FSD has just concluded a two-year study illuminating the costs of banking services in Kenya. Two rounds of mystery shopping surveys, in 2015 and 2016, measured the costs of basic transactions such as opening, running, and closing bank accounts. The price index report summarising this data has three objectives: (i) assess the price transparency in the market; (ii) identify actionable recommendations to incentivise private sector solutions and government policies that increase market transparency and affordability; (iii) develop affordability indicators that measure the cost of basic bank transactions.

Results of the mystery shopping study

There were three clear observations across all the bank branches visited:

1. There was significant confusion over the cost of different banking products and services and clear information was surprisingly hard to get. Our mystery shoppers had to make up to six visits per bank as well as consult tariffs posted at branches and on websites, to understand the cost of a transaction. The majority of bank staff knew the cost of basic transactions, such as withdrawal and ledger fees, but not of more complicated transactions such as bank to mobile transfers, the difference between banking apps and Paybill functions, the cost of salary processing fees and the cost of inward transfers if the remitting bank is different from receiving bank.
2. In most instances, this opacity did not seem intentional. Instead, it stemmed from a lack of standardised, organised information. In several instances, staff of the same bank in different branches, and in some cases even at the same branch, gave conflicting costs for the same transactions.
3. Bank staff recommended certain accounts based on a customer's income rather than the customer's needs. Most enquiries on available accounts were followed by a discussion of the shopper's income source and level. If the shopper indicated he or she was salaried, then a salary account that attracts charges was recommended even in cases where a charge-free account was available. If the shopper asked for a specific tariff-free account, the bank staff would still make some effort to sell a charged account.

Affordability of bank services: results from analysis of bank tariffs and charges

FSD collected data on tariffs and charges to track prices and measure affordability. The resulting price index report uses "baskets of transactions" to calculate the costs of banking services. Some of these baskets are straightforward while others required different weightings between channels and platforms. The overall finding is that there is large heterogeneity in the pricing of financial services. The table below shows that opening an account can cost as little as KSh 155 and as much as KSh 5,660. Withdrawing money twice a month can cost from KSh 354 to KSh 2,878.

Table 2: Average costs for basic bank transactions [5] (KSh)

	Min	Average cost	Max
Opening an account	155	1,322	5,660
Withdrawing money (twice per month – 24 per year)	354	1,702	2,878
Transferring money (once a month – 12 per year)	1,979	2,577	4,168
Account maintenance costs (yearly)	99	2,085	9,585
Closing an account	495	1,002	1,815
Switching an account	760	2,324	6,155
Running an account (yearly)	**3,629**	**6,436**	**13,460**

[5] See figure 1 for more details on the costs of selected bank accounts

UNLOCKING OPPORTUNITIES FOR THE POOREST

When drought was declared a national emergency in Kenya this year, a third of people in many of northern Kenya's counties were acutely malnourished. Using bi-monthly cash transfers, the Kenyan government's Hunger Safety Net Programme (HSNP) has played a crucial role in reducing extreme hunger and vulnerability in the country's north. This helps address the urgent needs of the extreme poor but it only offers one step on the path to escaping poverty.

FSD Kenya partnered with CARE International Kenya to initiate a graduation pilot project to help 1,200 recipients of HSNP in Marsabit's Laisamis sub-county achieve sustainable livelihoods. The pilot is based on the BRAC[6] graduation model which offers cash stipends, savings, skills training, asset transfer, and constant coaching and mentoring. The BRAC model has had positive livelihood outcomes on the very poor around the world[7] by pairing short-term emergency solutions with support to provide a longer-term impact.

CARE and FSD Kenya's market-based approach aims to achieve more scalable solutions than conventional graduation programmes. In this pilot, instead of a cash or in kind asset transfer, the project will offer a tailored credit solution at competitive rates to kick start micro businesses. A tailored solution is needed because existing options fall short: stock products from commercial providers don't meet the needs of low-income household businesses; informal savings groups have inadequate capital to meet all members' needs and give short loan repayment periods. Appropriate commercial credit based on viable income generating activities can potentially be sustainably offered by the market. Combined with other push and pull factors that address the constraints faced by low income households in taking up opportunities for productive engagement for their livelihoods, it may be more cost effective, sustainable and therefore scalable. Conventional graduation programmes are costly, ranging from US$ 1,452 to over US$ 5,000, per person, which makes them difficult to scale. FSD is already in conversation with a commercial bank interested in developing a tailored solution for typical HSNP recipients.

In February 2016, CARE Kenya set up a project team who then recruited and trained community members to coach and mentor project participants on strengthening savings groups and training participants on commercial literacy and business skills. Later in the project, participants will take up commercial credit solutions based on use of these skills.

FSD also undertook a baseline using a household economy analysis framework, a market assessment and modelling of income-generating activities to better understand the market. One example of the utility of this research was the finding that while small livestock trade is a major economic activity in Laisamis, the market's development is hindered by weak demand, incomplete historical market price data, poor mobile phone coverage, inadequate financial services, and low investments in effective disease control. Effectively addressing these challenges will require collective effort by national and county governments, financial service providers and telecommunication companies. The project is engaging with the Marsabit county government in establishing a web-based data collection platform to collate price information on the goat trade. While drought in the area is inevitable, CARE and FSD Kenya will continue working together to help ensure that short term help is paired with long-term solutions.

[6] BRAC, formerly Bangladesh Rural Advanced Committee, is a leading Bangladesh based NGO which has established an international programme.

[7] Banerjee, A., Duflo, E., Goldberg, N., et al. (May 15, 2015). A multifaceted program causes lasting progress for the very poor: Evidence from six countries. Science Vol. 348 (6236). New York: American Association for the Advancement of Science.

PESALINK

Sharing infrastructure has the potential to enhance the efficiency of the financial system, increase competition and expand financial inclusion. Over the past four years, FSD has supported the Kenya Bankers Association (KBA) in its endeavors to set up a national payments and settlement switch which will underpin a cost-effective payment system, protect consumers and create a level playing field.

The switch makes possible PesaLink, an interbank service that enables customers to transfer funds from one bank account to another instantly. PesaLink will be integrated into all 43 banks in Kenya and is later expected to integrate with mobile wallets, microfinance institutions, SACCOs and payment aggregators.

The service is run by a newly established company, Integrated Payment Services Limited (IPSL), a fully-owned subsidiary of the Kenya Bankers' Association (KBA). PesaLink will be available to bank customers across channels including mobile phones (on both basic and smart phones), internet banking, agent banking ATM and at bank branches. Customers will be able to send as little as KSh 10 and as much as KSh 999,999. Banks can also set lower maximum limits based on the channels used and the customer's risk profile.

The project experienced steady progress over the past year including installation of all the information technology infrastructure and system configuration so 16 banks could advance to the final pilot testing phase. Another 22 banks are completing their user acceptance testing and will advance to pilot testing. The development of PesaLink's brand and the marketing campaign were completed in 2016. Several workshops were held with the banks to develop branding and train staff to use PesaLink. The first drafts of the multilateral agreement, clearing rules and service level agreement and recruitment of the IPSL team were also concluded during the year.

FSD has sought to encourage this important initiative throughout its development. First, by convening the initial meeting to discuss interoperability and then by commissioning the study that led to the banks agreeing to set up a switch. This involved supporting the development of the strategy and business case, providing technical support, project management and product development inputs, and organising the study tours and workshops to build consensus. FSD also supported the interchange fee determination process that was crucial to the development of PesaLink. The service will be officially launched in 2017 when 70% of the banks complete pilot testing.

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Complete the entire process in 45 seconds

FINANCING HEALTHCARE

Faced with a medical emergency, over half of Kenyans would not be able to raise even a fraction of most major medical costs,[8] a problem that for many Kenyans is a matter of life and death. In 2016, FSD Kenya partnered with the PharmAccess Foundation's Mobile Health Research Lab, which researches how mobile technology can improve healthcare access. Field research identified three major barriers to quality healthcare:

- lack of access to facilities;
- the double financial burden as most healthcare costs are born not by the individual, but by their friends and family; and
- infrequent and unreliable financial support from family and friends.

We conducted three experiments to address these challenges and demonstrate that effective healthcare financing improves the health of low-income households and frees up financial resources. While these experiments are limited in scope and the results are not yet statistically significant, there are indicators that digital solutions can help finance healthcare in Kenya.

The cashless clinic targeted both patients and healthcare facilities in urban, informal settlements. It offered incentives such as a 10% discount, free airtime and cash grants to influence the use of digital payments in healthcare facilities. In the cashless experiment, the healthcare facilities that were incentivised earned 8% more, possibly because of increased efficiency and a reduction in cash-handling losses. Better cash-flow records have the added advantage of unlocking access to credit which supports growth.

> *It (the cashless clinic experiment) has increased revenues. Initially if a patient didn't have enough cash they requested to go withdraw. Most were never coming back. Now, however, the patient pays directly to the till.*
>
> An administrator in one of the clinics that participated in the experiment.

The M-Transport voucher, piloted by FSD Kenya and PharmAccess, targeted expectant mothers in Makueni. The pilot informed a similar experiment in Samburu in 2016 developed by PharmAccess, the Safaricom Foundation, and the county government. Using Safaricom's Surepay, an M-Pesa based mobile health wallet, patients received free transportation to health care facilities. Free transport increased hospital births in spite of strong traditional preferences for home deliveries. The M-Transport voucher appeared to have a net positive effect on deliveries in healthcare facilities. Approximately 57% of the participants said it was easy to use and about 93% said they would use it to save if the feature was available.

FSD used a **mobile-based remittances platform** that targeted urban, middle-class Kenyans who send healthcare remittances to their relatives to influence the frequency and size of remittances. It was observed that while people do send money to relatives and dependants for healthcare, the amount and frequency is low. While it is difficult to change people's habits, we believe that easy-to-use mobile remittances would increase their amount and frequency.

These experiments have already inspired and improved commercial products, such as Carepay's decision to integrate our findings into their M-Tiba mobile health wallet. FSD will continue this experimentation into 2017 in an attempt to continue inspiring innovative digital solutions that tackle healthcare financing.

[8] http://fsdkenya.org/blog/kenyas-health-financing-challenge/

CREDIT FOR SMALLHOLDER FARMERS THROUGH AGRO-DEALERS

Farmers may be the second-largest contributor to Kenya's economy but when it comes to financing, they are left high and dry. Only 4% of the national credit portfolio goes to agriculture. Low rates of funding are caused by inappropriate products, high risk aversion by providers and consumers and a lack of data that compounds both problems. Over 90% of produce is sold in cash in informal markets meaning most farmers lack the financial records lenders require to assess their ability to repay loans.

FSD Kenya partnered with Farm Shop, a social enterprise with a franchise network of agro-dealers, to address the credit problem. Together, we developed a lending methodology and data collection mechanism to create credit scoring for farmers. First, Farm Sshop granted franchisees loans in the form of a credit period for goods purchased. In turn, franchisees issued farmers loans in the form of farm inputs. Since Farm Shop's franchisees know their farmers personally, they have existing information on which to base lending decisions. From that, the farmers were categorised into four groups based on their risk profiles. Initial evidence shows high success rates with 97% of farmers repaying their loans within the specified period. To ensure sustainable data collection, FSD developed and tested infrastructure including a point-of-sale system currently piloting in ten franchises.

The second phase of the project will provide additional data by increasing the lending franchisees from three to ten. This will then be used to refine the lending methodology and partner with a financial service provider could allow the solution to scale to the over 15,000 agro-dealers across Kenya.

HUMAN PERSPECTIVES: DEMAND-SIDE INSIGHTS ON VALUE

Arguably, the real innovation of Kenya's mobile money system in finance was not putting banking on a phone. It was bridging the gulf between formal financial services and the informal reality of Kenyans' financial lives. Borrowing and lending between friends, family, shopkeepers and associates are part of the everyday fabric of finance in Kenya but traditional formal providers rarely take them into account.

In 2015, FSD published the summary report from a landscaping study of the development of financial markets in three places in Kenya: Nyamira, Kitui and Kariobangi. The study, conducted with the University of Bath, was a follow up to the 2010 study: The Rift Revealed, about the gulf between formal and informal financial services in Kenya.

Studies show M-Pesa helps people better manage shocks in the short-run by expanding support networks and making transactions within them more efficient,[9] reducing poverty in the long run.[10] The combination of an accessible mobile money system and the spread of agency banking suggests the use and impacts of financial services should be increasing. However, the 2015 landscapes study revealed that there had been very little change in the use of formal or informal services since 2010.

To better understand the gulf between supply and demand, FSD and the University of Bath consulted existing research which largely concluded that formal providers and their clients view finance in very different ways. Formal financial providers focus on traditional functions of finance: providing intermediation, managing risk and facilitating payments while maximizing profits. In contrast, low-income users view finance through a social perspective, tending to highlight six roles of finance:

- helping build supportive relationships that can be leveraged in times of need;
- building a future for one's family, especially through education and land;
- making money 'work' rather than sit idle;
- supporting the growth of local community;
- strengthening repute and identity – for example through a successful savings group or being a 'member' of Equity Bank; and
- supporting personal learning and empowerment – for example, in a savings group you can learn over time to be a successful financial manager even if you sometimes fail along the way. Formal banks don't have the flexibility to support this capability curve.

Providers like Equity and services like M-Pesa and M-Shwari have tapped into these values and achieved outstanding success but the next wave of innovation needs to go further. How can the financial sector share the risks of investing through equity-based models? Can innovations like block chains deliver the security of formal transactions with the flexibility of social interactions? How can technology enable formal providers to accurately assess risk and negotiate terms with their clients? Perhaps most importantly, in an age where digital identities shape relationships between corporate providers and low-income clients, how can low-income users retain control over their financial lives?

These are the questions FSD will explore with a new webpage titled 'human perspectives,' which will bring a demand-side voice into industry and policy debates. The webpage will have FSD's research, including the landscapes studies, and videos and infographics sharing the perspectives of low-income Kenyans. These perspectives are important, as we look beyond current solutions to the next big step in innovation for the poor.

[9] Jack, W., & Suri, T. (2014). Risk sharing and transactions costs: Evidence from Kenya's mobile money revolution. The American Economic Review, 104(1), 183-223

[10] Jack, W., & Suri, T. (2016). The long-run poverty and gender impacts of mobile money. Science, 354(6317), 1288-1292).

LONGER-TERM PERSPECTIVES ON THE ROLE OF FINANCE THROUGH FINANCIAL DIARIES

FSD Kenya's core belief is that financial markets can indirectly and directly support poverty reduction. But the biggest barrier is a relatively thin understanding of how financial services help people get out of poverty, and stay out. A more thorough understanding is needed of what affects the economic status of poor households in order to catalyse pro-poor changes in the market.

FSD originally commissioned the Kenya Financial Diaries to learn how low-income Kenyans earn, spend and manage their money. It changed the way we understand how households use financial resources to create opportunities and cushion themselves from unexpected setbacks.

Still, FSD Kenya wanted to know more:

- how are additional or new financial devices deployed in the face of changing financial needs?
- how does poverty change and what role do financial services play?
- how do financial attitudes and goals change over time and what does that means for how people manage their money?
- how do new products and technologies get incorporated into household portfolios?

To answer these questions, FSD Kenya partnered again with Bankable Frontier Associates (BFA), who designed and oversaw the first study. The research team revisited and interviewed 94% of the 298 original households. Methodologically, a simpler approach was taken: rather than interviewing respondents bi-weekly for over a year, the second study consisted of a single visit with a single questionnaire. It updated the family's income sources and financial devices, documented what new shocks they faced and asked respondents to reflect on the changes in their lives over the past two to three years. In this way, the study yielded updated quantitative data as well as open-ended qualitative data to illustrate more complex dynamics.

Self-assessments of changes in economic well-being were mostly positive or neutral: 49% felt they were better off and 18% felt their situation had stayed the same but 33% felt they were worse off. There was a fairly strong correlation between subjective assessments of well-being and changes in poverty status. Among respondents who left poverty and felt subjectively better off, 42% attributed it to growth in an existing business or a new business, 15% to a reduction in the number of dependents and 15% because of new employment. Among those who entered poverty and felt worse off, 18% cited school fees and 18% cited unemployment.

Overall, the findings from the qualitative research point to the important, but not transformative, role of financial services in transitions out of poverty. What enables transformation is growth, when larger sums can be invested to unlock new opportunities. Low-income Kenyans are using an increasingly diverse array of formal and informal solutions for short term liquidity and money management needs, such as mobile money wallets, 30-day digital loans, shop credit, social networks and savings groups. But, access to investible sums in the KShs 10,000 to KShs 100,000 range are hard to come by. Without sufficient protection, high risk bets that fail can leave respondents worse off. Making financial services in Kenya a more powerful force for upward mobility may require helping households build or access larger sums of money while protecting them from the risks of investment.

FSD'S 2016 ANNUAL LECTURE

FSD Kenya began the annual financial inclusion lecture series in 2015 to mark the first decade of world-leading financial sector innovation in Kenya. The second lecture titled, "The increasingly titled savannah: consumer protection and competition in Kenya's expanding financial sector", was delivered by Rafe Mazer, a financial sector policy expert at CGAP.

KEY FINANCIAL RESULTS

Income

FSD ended the year with a surplus of KSh 1,088 million. As expected, FSD did not receive core funding during the year as the entire core fund for the strategy had already been disbursed in prior years. FSD also recognised incomes from restricted funding for the Hunger Safety Net Programme (KSh 2,623 million). In conformity with international financial reporting standards, and as has been the case in the past, these funds are recognised as income only when expenses are incurred. Additionally, FSD earned a total of KSh 85 million in interest income from the cash held on fixed deposit.

Expenses

Total programme expenditure for the year was KSh 3,541 million (7% below budget) including unrealised foreign exchange loss of KSh 67 million due to depreciation of the British Pound following Brexit. Management expenditure was KSh 2,162 million (33% below budget) for the year due to lower spending on administration costs and office procurement.

Income statement

FOR THE YEAR ENDING 31st DECEMBER 2016*

	2016	2015
INCOME	KSh millions**	KSh millions**
Grants	2,623	6,894
Other income	-	1
Finance income[1]	85	101
Total income	**2,708**	**6,996**
Expenditure		
Project expenses		
Core projects[2]	690	779
Designated projects[3]	2,623	5,690
Total project expenses	**3,314**	**6,469**
Administrative expenditure	162	212
Total expenditure	**3,475**	**6,681**
Unrealised foreign exchange losses	67	-
Total costs	**3,541**	**6,681**
Surplus/(deficit) for the year	**(834)**	**333**

* These are draft figures subject to final audit.
** Columns do not add up due to rounding.

[1] Finance income includes interest earned on FSD funds.

[2] 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.

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

Balance sheet

AS AT 31st DECEMBER 2016*

	2016	2015
ASSETS	KSh million**	KSh million**
Non-current assets		
Property and equipment	12	12
Intangible asset work in progress	-	3
Long term loan	38	38
Total non-current assets	**50**	**54**
Current assets		
Receivables	9	15
Short term deposits	615	924
Bank and cash balances	1,134	1,576
Total current assets	**1,758**	**2,515**
Total assets	**1,808**	**2,569**
RESERVES AND LIABILITIES		
Reserves		
Accumulated fund	1,088	1,924
Current liabilities		
Unexpected projects fund	562	543
Accruals	83	27
Tax liability[1]	75	75
Total current liabilities	**720**	**645**
Total reserves and liabilities	**1,808**	**2,569**

* These are draft figures subject to final audit.
** Columns do not add up due to rounding.

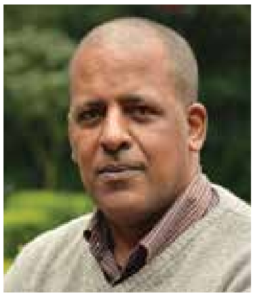
[1] This amount is an accrual of taxes on which FSD has applied for exemption from the government pending finalization of the exemption application.

FY2016 FSD Staff

Management

David Ferrand
Director

Felistus Mbole
Head, Poverty impact



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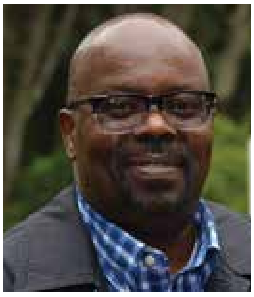
Head, Inclusive growth



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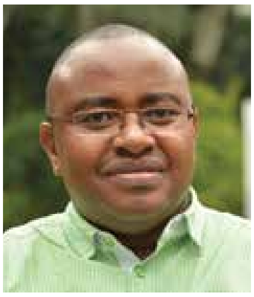
Poverty impact



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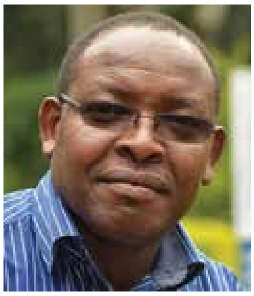

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Gitau Mburu
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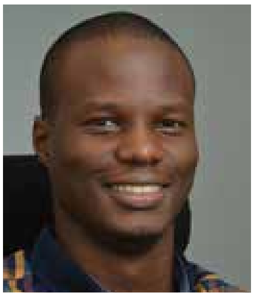

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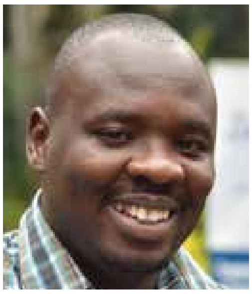
CiFi lead



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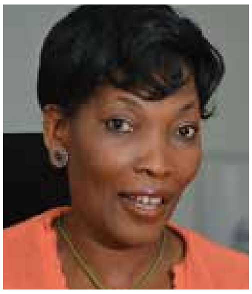

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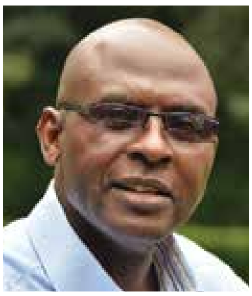
Technology officer



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Winnie Mokaya
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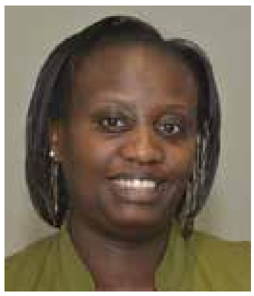

Hilda Githaiga
Programme assistant

FSD PARTNERS IN 2016

Funders

Department for International Development (DFID)
Swedish International Development Agency (SIDA)
Bill & Melinda Gates Foundation

Government / regulators

Central Bank of Kenya (CBK)
Capital Markets Authority (CMA)
Competition Authority of Kenya (CAK)
Insurance Regulatory Authority (IRA)
Kenya Institute of Curriculum Development (KICD)
Kenya Institute for Public Policy Research and Analysis (KIPPRA)
Kenya National Bureau of Statistics (KNBS)
Kenya School of Monetary Studies (KSMS)
Ministry of Agriculture
Ministry of Devolution and Planning
Ministry of Industrialisation and Enterprise Development
Ministry of Labour, Social Security and Services
National Drought Management Authority (NDMA)
National Hospital Insurance Fund (NHIF)
National Treasury
Office of the Attorney General (OAG)
Retirements Benefit Authority (RBA)
SACCO Societies Regulatory Authority (SASRA)

Finance service providers

ACRE Africa
Airtel
AMACO Ltd
APA insurance
Central Depository & Settlement Corporation (CDSC)
Century Microfinance Bank
Chase Bank
CIC Insurance Ltd
Citi Group
Commercial Bank of Africa (CBA)
Co-operative Bank of Kenya (Co-op)
Equity Bank
Family Bank
Financial Services Association (FSA)
Heritage Insurance Company
Integrated Payments Services Limited (IPSL)
Jubilee Insurance Company
Kenya Commercial Bank (KCB)
K-Rep Fedha Services (KFS)
Kenya Orient Insurance Ltd
Kenya Post Office Savings Bank (KPSOB)
Kopo Kopo
Metropol Credit Reference Bureau
M-Changa
Pesa Zetu
Rafiki Microfinance Bank
Safaricom
Transunion Credit Reference Bureau
UAP Insurance Company Limited
Umati Capital
Unaitas SACCO Society Limited (Unaitas)

Non-profits / industry associations

Association of Kenya Insurers
Association of Microfinance Institutions (AMFI)
CARE Kenya
Catholic Relief Services (CRS)
Credit Information Sharing (CIS) Kenya
GSM Association (GSMA)
HelpAge International
Kenya Bankers Association (KBA)
Mercy Corps
PharmAccess Foundation
Strathmore Business School (SBS)

Development partners

MercyCorps (AgriFin accelerator programme)
Consultative Group to Assist the Poor (CGAP)
FSD Africa
FSD Tanzania
insights2impact facility (i2i)
International Finance Corporation
International Labour Organization (ILO)
MasterCard Foundation
Rockefeller Foundation
World Bank Kenya

Learning institutions

Institute of Development Studies, University of Nairobi
Kenyatta University
Trinity College - Dublin
University of Bath

Non-finance private sector partners

Agrilife Ltd
Carepay
FarmDrive Ltd
FarmShop
Hello Doctor
IBM Kenya
Inclusivity
M-KOPA Solar
PharmAccess
SCOPEinsight
ThinkBusiness
Well Told Story

FSD Kenya
Financial Sector Deepening

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