Creating value through
inclusive finance

fsd Kenya

Financing Kenya

2020 hindsight for Vision 2030

By *David Ferrand*

Introduction

Kenya has been feted around the world for its achievements in advancing financial inclusion. And the speed at which access to the formal financial system has advanced has certainly been exceptional. The development of a near ubiquitous mobile phone-based payments system provided the foundations for a further round of fintech innovation. Nairobi has become the Silicon Savannah, heavily focused on financial services, and attracting capital from both commercial and impact investors.

But alongside this digital dynamism, there remains heavy criticism of the financial system. Pricing has been a perennial concern. Questions are being asked about the extent to which the new consumers of finance are adequately protected. Recent survey evidence suggests that the financial health of the average Kenyan has worsened over the last three years. And businesses - especially smaller scale - continue to cite lack of finance as a constraint to growth.

As we come to the end of 2019, we reach the half-way point for implementation of Kenya's long-term national development plan Vision 2030. Can we benefit from a little 2020 hindsight next year as we look forward to how the financial system needs to develop, if we are to accomplish the goals of Vision 2030? While the gains made in financial inclusion have been extraordinary these have not translated into the developmental impacts originally posited. National savings have not reached the levels sought to sustain the required investment for economic transformation. The stark facts suggest that Kenya has yet to create the financial system it needs to achieve its ambitions for national development over the next decade. If this is the case, then what choices does Kenya have and can a bolder path be taken? There are unlikely to be any simple answers to these questions. But we can hope to at least illuminate the way ahead by examining the lessons from past successes and failures.

Kenya's financial sector today

Looking at Kenya's financial sector today, the standout success has been in expanding financial inclusion. Revered around the world for the development of mobile financial services, M-Pesa has become a verb in Kenya for payments. Building on this has been a tremendous burst of innovation. We now have many 'Ms' building on the mother 'M-Pesa' platform. Beyond this Equity Bank has become the exemplar of successful financial inclusion business strategies, Kenya has been among the first markets in Africa to issue green bonds and the Nairobi securities exchange is the fourth largest on the continent. Nairobi already the financial hub for the region is set to establish itself formally as an international

1. Over the last decade there have been three occasions in which the regulator has stepped in to resolve problems in institutions. In August 2015, Dubai Bank – a tier III bank – failed and is now under liquidation by the Kenya Deposit Insurance Corporation (KDIC). This was followed by Imperial Bank (tier II) in October which is still under receivership by KDIC. Finally the following year in April, Chase Bank, was placed under receivership. The largest of the three, Chase was nevertheless still a tier II institution with a market share of only 3% as at the end of 2014 (Central Bank of Kenya, 2015). Most of the bank's assets and liabilities, including the branch network, were acquired by the State Bank of Mauritius (SBM) in 2018.

financial centre.

Alongside the plaudits there have been challenges and criticisms. There have been several banking collapses over the last decade – though none in systemically important institutions.[1] There has been widespread public concern over the price of financial services with the banks bearing much of the brunt of criticism. This culminated in parliament re-introducing interest rate controls in 2016, more than 20 years after they were liberalised. These have only just been repealed. Alongside this there have been growing worries over consumer protection heighted by the new threats from the digital age.

But taking a step back from the headlines and hyperbole where are we today? And where should the financial system be going? Answering this very much depends on your frame of reference. So to be clear my aim today is to try to look at how Kenya's financial sector is doing from the perspective of public policy.

Kenya's national development aspirations

Vision 2030 is the government's formal expression of Kenya's development aspirations. This provides a useful starting point. The primary focus here is on what Vision 2030 says about national aspirations rather than delving deeply into its underlying strategy for achieving them.

A crucial point is that while recognising the importance of growth it is not unduly privileged in Vision 2030 which is based on three pillars social and political alongside economic. In this it is strongly consistent with the international consensus encapsulated in the sustainable development goals. These goals are the natural evolution of the human development approach pioneering by Amartya Sen and others. Recent work by Frances Stewart and others has demonstrated the vital connection between human development and economic growth. In short - we cannot have one without the other. And we also need to keep in mind that the end is not growth but the fulfilment of human aspirations.

Just how important is finance?

So what is the role of finance in achieving this complex and ambitious vision? Judging by the opinions of some of those in the financial sector – the answer is pretty important**.** Lloyd Blankfein the CEO of Goldman Sachs during the global financial crisis responded vigorously to mounting criticism of the financial sector and Goldman Sachs, proclaiming that "we are doing God's work". He justified this by reference to the role of the financial sector in enabling investment to drive economic growth: "We help companies to grow by helping them to raise capital. Companies that grow create wealth. This, in turn, allows people to have jobs that create more growth and more wealth. We have a social purpose." (Reuters, 2009)

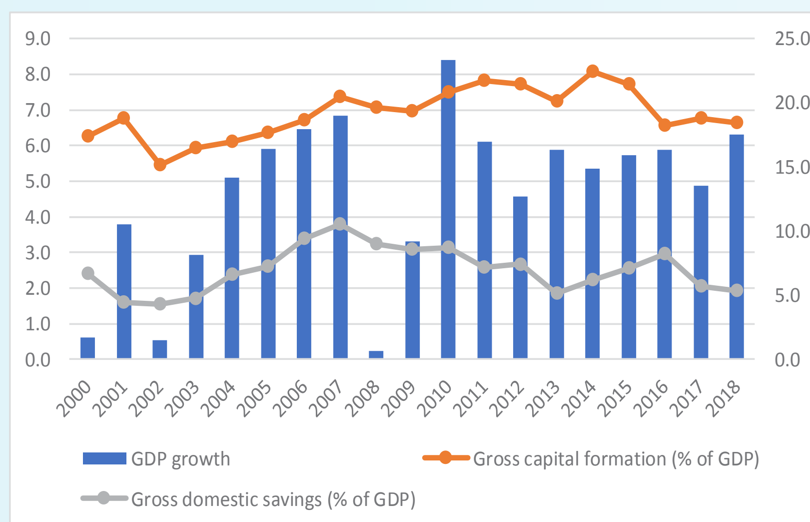
Obviously, there are plenty who have contest this view. According to Matt Taibi, in a now famous article in Rolling Stone magazine argued that [Goldman Sachs] "the world's most powerful investment bank, is a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money." (Taibbi, 2010)

Cross country studies and lots of econometric analysis have come to a broad (though not uncontested) view that financial sector development does indeed contribute to development. But more recently – reflecting on the global financial crisis in particular – a note of dissent has crept it – and it is conceded that you can have too much of a good thing and that some countries - notably Britain and the United States – may have gone beyond that point (Kay, 2016; Tyson & Beck, 2018; Arcand, Berkes, & Panizza, 2012)

The potential role of finance in contributing to economic and social empowerment gave rise to the microcredit revolution which has evolved over several decades to what is today referred to as financial inclusion. So convinced was Mohammad Yunus by the impact of microcredit – drawing on his experience in establishing the Grameen Bank in Bangladesh that he proclaimed that access to credit is a basic human right (Ramesh, 2007).

The problem is that as the evidence has come in, it has become clear that microcredit fell far short of its putative role of a magic bullet which would put poverty into a museum. After several million dollars spent on the best economic research money can buy, the conclusion was that access to credit works very well and quite badly for a few, while for the majority it has very modest to no impact (Banerjee, Karlan, & Zinman, 2015). Which was probably what a reasonably straight-talking loan officer from a microfinance institution could have told you twenty years ago.

Figure 1: Growth, capital formation and savings (2000-2018)



(World Bank, 2019)

What is the role of finance?

We need to take a step back at this point and ask 'what is finance for'? There are various competing taxonomies of the functions of finance. John Kay proposes four simple functions (Kay, 2016):

- ***Payments*** – enabling of market trading either face to face or – and of huge important to both domestic and international trade – over distance
- ***Intermediation between borrowers and lenders*** – *most importantly allowing investment in the economy to generate wealth as Mr Blankfein suggests.*
- ***Management of household affairs*** – *dealing with the need to manage our resources day to day, year to year and cradle to grave*
- ***Managing risk*** – *from the routine events which compromise a business or household – from accidents or price movements to devasting losses from disasters*

These functions are all clearly interconnected. Payments underpin the other three. Without a means to transfer value then intermediation cannot realistically be accomplished. Long-term flows between borrowers and lenders for enterprise financing is intimately tied up with the management of household affairs. The money we put aside to deal with our needs in retirement is often invested in businesses. And risk is critical to both intermediation and management of household affairs.

These elements go to the heart of cooperation in a society. It seems hard to imagine that finance should not be playing a huge role. But the suggestion I want to make is that we need to pay more attention to the *quality* of finance rather than its *quantity.*

Strategic impact of finance on Kenya's recent development

So with that framing, how well has Kenya performed over the last decade? Two crux issues are intermediation and household financial management since these most directly impact on businesses and people.

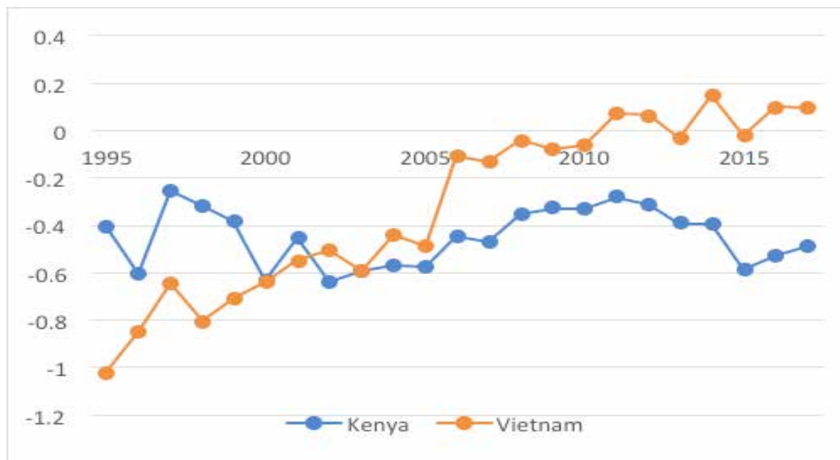
Growth and investment

The obvious area we expect impact is on growth. Kenya's growth rate in the last decade has improved, averaging 5.6% per annum in the decade to 2018 against 3.6% in the decade before (**figure 1**). But it is also certainly well below the target of 10% pa set in Vision 2030. From a financial sector perspective the key function we are looking at here is intermediation – mobilising finance for investment. And the investment ratio is somewhat below the level sought in Vision 2030 of 30-32%. Crucially the average savings rate remains below 10% against a target range of 25-28%. By comparison Vietnam has managed an investment ratio of 26% which is matched by its savings rate.

Economic complexity

But this approach suggests a somewhat too static approach to growth. We know growth cannot just appear in response to a level of financial resourcing. Productivity improvement is at the heart of unlocking inclusive, sustainable

Figure 2: Economic complexity index, Kenya vs Vietnam (2000-2018)



(The Growth Lab at Harvard University, 2019)

growth. Work done by Harvard University's Growth Lab has demonstrated the importance of increasing national capabilities and know-how in order to improve productivity (Hausmann, et al., 2013). This generally happens incrementally – countries build on their existing capabilities in order to enter new economic sectors.

The Growth Lab has created the Economic Complexity index in order to measure a country's productive capability (the index is based on data for product exports but this correlates strongly with services). The chart here shows that Kenya has made very limited progress over the last two decades.

Meanwhile taking Vietnam as a comparator the difference is stark. Vietnam has managed consistently higher GDP growth over the same period. It is now better positioned for sustaining future growth. The Economic Complexity index not only correlates strongly with GDP growth but it is strongly predictive of future expansion. While there are clearly many other variables at work here driving economic complexity, in aggregate it at least raises the question of whether resources are being allocated optimally. In other words is the quality of finance adequate?

Financial inclusion

Turning to financial inclusion, the story from a quantity perspective seems unequivocally positive. The direction of travel has been so rapid that the prospects of full financial inclusion now appear well within reach. Indeed so successful has Kenya been that at least in relation to access the question we now need to focus on is what are the implications for those left behind?[2]

The Brookings Institution, in its latest report confirmed Kenya's pre-eminence in its Financial and Digital Inclusion Program: "For the third year in a row, Kenya ranked at the top of the ... scorecard, driven by its robust commitment to advancing financial inclusion, widespread adoption of mobile money services among traditionally underserved groups, an increasingly broad range of mobile money services (including insurance and loan products), and an enabling regulatory environment for digital financial services." (Lewis, Villasenor, & West, 2017)

But the crux question is what are the implications for impact on household financial management, the function we are seeking to address here? This is about managing resources over multiple cycles: the day-to-day management of vital consumption expenditure, annual variations and between years and the entire life-cycle from birth, education through rearing a family to retirement and indeed for many leaving a legacy to the next generation.

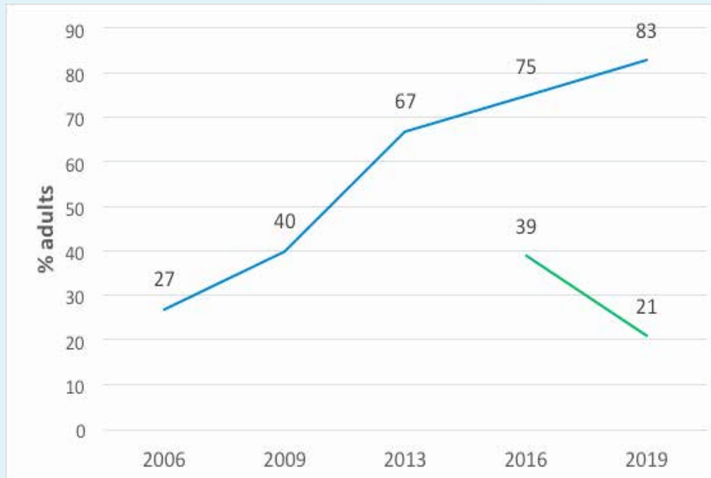
This is generally about achieving three things:

- ***shifting resources through time –*** sometimes through saving and sometimes through borrowing;
- ***taking advantage of opportunities*** to invest in oneself through education, acquire crucial assets (such as a house) or in enterprise – either one's own or someone else's
- ***coping with the many uncertainties of life:*** illness, accident, robbery and death

The positive news is that we do see

2. No country in the world has managed 100% coverage yet. Of these a small percentage simply freely and knowingly elect not to use financial services (and whether that has a detrimental impact on their livelihoods is surely secondary to their right to choose to not use). But a small percentage remain hard to reach. As the significance of financial inclusion to wider economic and social inclusion grows then we need to be more concerned with the potential for this to be a factor in magnifying marginalisation

Figure 3: Financial inclusion and financial health (2006-2019)



(FinAccess, 2019)

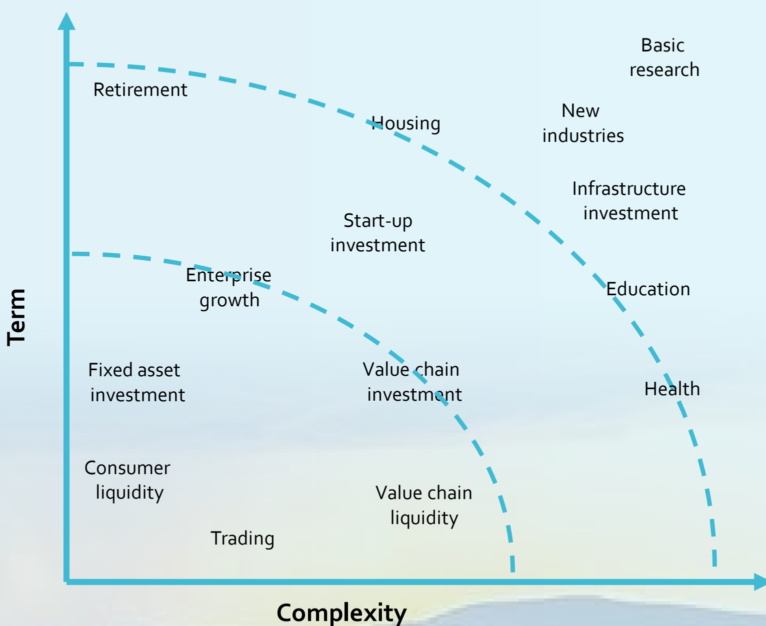
evidence of how financial inclusion has been impactful. A longitudinal study of M-Pesa, for example, revealed that it enabled households to manage risk better – due to their strong connectedness to social networks.

Financial health

A more holistic measure of impact is provided by the concept of financial health. FSD Kenya has developed an index based on the FinAccess data set which assesses the extent to which people are able to manage day to day, cope with risk or invest in future goals (Gubbins, 2017). While we only have data for two periods the results are not hugely encouraging (FinAccess, 2019). Between 2016 and 2019 financial inclusion continued to improve but we see financial health worsen (**figure 3**). Now we must accept that there are many other factors at work here. These are ultimately based on subjectively reported measures. But GDP per capita grew during this period. This tends to suggest that the benefits from this growth are not reaching the majority.

Probing a little further we find that utilisation levels of many formal financial services are still relatively limited (FinAccess, 2019). When it comes to dealing with the practical challenges of financial management, the current generation of formal financial services are still simply not sufficiently useful. In summary while we are making strong progress on quantity, there seems a way to go until we achieve the quality of service provision needed.

Figure 4: Drivers of uncertainty in finance



Re-examining finance

This rapid review of the state of play in Kenya suggests that there is a case for thinking carefully about whether we are on the right trajectory for creating the financial system we need. We need to step back a little again. If we are falling short why is this? What are the drivers of the challenge in finance? We've seemingly done well in Kenya but it is clearly insufficient.

Where are the challenges?

There are many financing problems we need to address in order to deliver the outcomes we're looking for in terms of growth and impact on people's lives. Uncertainty is the underlying practical problem in any financing arrangement – this is the core problem that finance has to address. What are the prospects that value will be generated? We can look at two major drivers of uncertainty: first, what time period are we financing over and second, what is the degree of complexity inherent (**figure 4**).

The time element seems reasonably intuitive – providing a consumer with a short-term or ultra-short-term loan is a relatively tractable problem. But financing retirement is much longer-term and harder to accomplish successfully.

Complexity derives from a number of factors. A key driver is how many firms or people are involved in realising value. How many things have to go right for the finance to be successful? What we have illustrated thus far is at least from a transactional point of view relatively simple – involving bilateral arrangements. But add more players and the complexity and uncertainty increases. Where we get to a level where we are necessarily involving very large numbers of participants – and most pertinently where there are public goods involved the complexity becomes very high.

There are broadly two ways in which we can tackle the uncertainty problem: First, we try to develop better ways to predict the future – in banks, insurers and investment companies considerable attention is paid to developing models to reveal the future through loan appraisals or behavioural scoring, actuarial modelling and sector or company research. Second, we use institutions to shape the future – norms, contracts, regulations and laws prescribe what should happen in the future. The strength of institutions can be measured by the extent to which they are enforced and do, in fact, shape the future. We can think of the capacity of the financial sector in addressing these problems of uncertainty in the form of a 'financial frontier' – the limit at which it is able to provide viable solutions.

The financial system encompasses multiple elements

Looking at all this complexity begs the question of how comprehensive financing is achieved anywhere. But we are probably asking too much of the formal financial sector. And here we need to distinguish between the financial system and the financial sector. Too often these are conflated.

We need to look at the system in terms of at least four components (and I make no claim that this is the definitive taxonomy – there may be better ways to classify). These are:

- the formal financial sector,
- informal financing,
- state finance and
- embedded finance.

This provides a potentially much richer set of solutions to the four functions discussed earlier and dealing with the challenges just outlined. Interestingly even in the world's most financially advanced (or financialised) economies all four are found.

The first three of these categories are at least in broad terms probably familiar to everyone and need little discussion. Embedded finance I apply to forms of finance which are undertaken formally but by non-financial organisations. This therefore includes two important and ubiquitous forms of financing: (i) self-financing *within* a firm (or other organisation) – say through retained earnings and liquidity and (ii) *between* firms – typically in tightly linked supply-chains. Both forms of financing are of considerable significance.

The boundaries between these categories is perhaps rather less well defined than might appear. How much formal (or informal) influence must the state have to have over a financial institution before it is defined as part of the 'state finance' category (as distinct from the private financial sector). Suffice it to say that while definitions can be (and are) used to establish boundaries, there are inevitably shades of grey.

The supposition has long been that informal financing represents a necessarily less efficient form of financing. However we know that informal finance continues to play a major role in Kenyan financing despite the expansion of the formal sector. But it is also enormously significant in early stage finance even in the world's most advanced economies. There are of course some nefarious reasons for the persistence of informal finance. The lack of visibility of informal transactions is useful in supporting illicit flows. But there are many more positive reasons. Where people know

one another very well – far better than a third party – there can be significant transaction cost advantages. This is particularly important in a country like Kenya where many people and businesses continue to operate in the informal sector.

Embedded finance doesn't tend to receive much attention. Outgrower schemes in which a large buyer finances production by smallholder farmers are well known and work well if there are strong and mutually beneficial relationships. There are signs that embedded finance may be becoming much more significant with the rise of platforms. The world's two largest e-commerce platforms, Amazon and Alibaba have both started to provide finance to small and medium enterprises using the platform. They have direct access to critical business data enabling them to provide appropriate liquidity financing which a bank would struggle to achieve.

Re-thinking the future

Recognising that we are looking to build a financial sector which is just one part of a much wider financial system, may be helpful in meeting Kenya's aspirations. What are the implications for build the financial system that Kenya needs to accomplish its vision? At the outset it is vitally important to be realistic. In thinking about the next decade of financial sector development we need to look at what has been accomplished in the last in Kenya to guide us. And indeed – with all due caution – the many decades prior to that and the experience of the rest of the world. This must not limit our ambition but rather help us think more clearly about how to get there.

Proposition #1: The financial system needs to solve real-world problems

My first proposition is that the financial system needs to solve real-world problems. This could be regarded as either a tedious statement of the obvious or economic heresy depending on where you stand. My intention is more the latter than the former.

There is a huge rush in Kenya towards expanding short-term consumer lending fuelled by ICT. Does this solve real-world problems? Yes - sometimes. But sometimes it creates new and worse ones. If a family's problem is that it is too poor then giving them the ability to shift the timing of small amounts of consumption is only exceptionally going to address that problem. What does this mean? A balance is needed.

On one-hand there is the danger of heavy-handed paternalism – whether emanating from a regulator, the financial sector or a social network – which limits people's ability to make choices. Results from the field show time after time that the real experts on 'living on little' are not generally to be found in government departments, banks or development agencies but among the poor themselves who have first hand experience of doing it.

But we now know enough from practical experience that people are neither omniscient nor always positioned to make the best choices – especially when faced with the stresses created by trying to address the apparently insurmountable challenges of poverty. They could do with a little help. A lending app sitting next to an online betting app on a phone is not an instrument of empowerment; we know practically that for many young people it will ultimately limit choices not increase them.

So how do we achieve this? The answer is not simply through regulation – though that will have a role to play. Rather it is a question of enlightened self-interest. The long-term sustainability of financial institutions is based on the sustainability of their clients – whether businesses or people. If financial services are simply extracting value from their customers rather than helping them create real value then this cannot be sustained in the long-term. The most dramatic proof of this is found in pyramid schemes with which Kenya has unfortunate first-hand experience. But unsustainable consumer lending is on the same spectrum; as demonstrated by banking collapses around the world. South Africa's microlending business is one obvious exemplar from the continent

Long-term finance business strategy is about creating value for customers. The illustrations of this are all around us. Equity Bank's astonishing success was founded on trying to solve simple problems for their customers – or members as they prefer to see them. This is perfectly illustrated by one of their earliest customer

solutions. The nature of the tea business is such that growers receive their payments in two parts – on delivery and when the final market price has been determined and settled. This creates a household liquidity problem for smallholders who still need to live while waiting for the so-called 'bonus'. Equity Bank introduced a very simple lending offer in tea growing areas which allowed tea farmers to borrow against their deliveries and allow repayment from the bonus. Nothing too elaborate here, simply solving a simple real-world problem.

Kenya's poster-child of financial innovation, M-Pesa, was similarly based on solving a real-world problem: enabling Kenyans working away from their families typically in urban areas get money back to support their physically distant relatives still living in rural areas.

A more recent illustration is from the energy field. The development of solar technology has made scalable solar solutions a viable option for people living in areas beyond the power grid. But low-income people cannot afford the capital outlay for the solar devices even though the depreciation on the equipment (with the running costs being met by God) is significantly lower than the cost of kerosene – the usual alternative. M-Kopa (and others) have developed a pay-as-you-go financing solution enabling people to gradually buy a device as their cashflow permits. This is an example of embedded finance – the distribution of solar (and other devices) is driving the financial services. This has enabled over 400,000 devices to be acquired to date. And the value created is not only in providing access to a cheaper form of light, it is also significantly healthier and reduces carbon emissions (GOGLA, 2019).

Proposition #2: Diverse problems need diverse solutions

My second proposition follows directly from the first. As we look at the real-world challenges Kenya faces what stands out is the diversity. And the reality is that much of the economy and society in Kenya looks a lot more like the bottom of the picture below than the top. It is hard to believe but this picture was not created but is actually a photograph from a drone over Loresho suburb in Nairobi.

Figure 5: Loresho suburb in Nairobi

(Miller)

Kenya's challenges are not the same as the G7 countries or indeed the BRICS. We are looking for rapid change at a different point in history.

E.F.Schumacher was famous for espousing 'small is beautiful' referring to economic organisation and the size of firms. But in fact his argument was much more nuanced than is commonly appreciated. He was calling more for a rebalancing. He observed that if there had been an over emphasis on small-scale, he would have been arguing in favour of large-scale (Schumacher, 1973). This seems pertinent here.

Kenya already has very considerable diversity across its formal and informal financial sectors encompassing:

- formal institutions (banks, insurers, investment firms, pensions),
- mobile payment providers and a rapidly expanding range of fintech built on it,
- financial co-operatives and micro-finance institutions, and
- informal groups and mechanisms.

Within each of these there is a surprising degree of diversity. And within the other two categories discussed earlier, state finance and embedded finance, there is also considerable diversity. FinAccess data shows that people have responded to the advent of an increasing range of financial solutions not by and large by abandoning the old ones in favour of new but by expanding their portfolios (FinAccess, 2019). Studies of business financing suggest a similar story. The providers of financial solutions range widely. Informal sources are an important source of start-up capital not only to the very many informal enterprises in Kenya but also the modern businesses.

Why do we need this diversity? In short, these varying sources have widely varying strengths and weaknesses. Social networks can provide remarkably useful information about some aspects of individuals. These social networks are now being digitised at breakneck speed explaining the growing potential of platform providers in finance. Suppliers and buyers often know a great deal about the businesses up and down stream from them in value chains. Meanwhile banks can provide the scale of finance necessary for business growth and investment. Capital markets help to lengthen the tenor and take investment risks. And governments can make long-term commitments and bear uncertainty that the private sector cannot.

But this is just looking at what various sources of finance can do. We also need to consider incentives and motivations. Here the question of ownership is crucial. Financial service providers which are owned by their users have been a feature of financial systems worldwide from at least the eighteenth century. They have been a part of the Kenyan financial landscape in the form of financial co-operatives since 1964. Today Kenya's SACCOs form the largest financial cooperatives movement on the continent. The incentives of SACCOs are necessarily different from a commercial bank. They exist not simply to make a profit but to serve the wider interests of their member-clients. From the perspective of the member-clients there is a benefit in not needing to pay returns to shareholders. The relationship between SACCOs and their members is usually different from that between banks and clients. This has implications for managing credit risk. Leveraging the social bonds and embeddedness within local communities has enabled SACCOs to lend where banks have feared to tread. Well managed SACCOs have proved a highly effective way of intermediating funds in key sectors which banks have struggled to serve – notably agriculture

This isn't to overlook the problems seen in the SACCO sector. Just as there can be principal-agent problems in the banking sector so there can be in co-operatives. As the organisation grows the challenges the member-owners overseeing the management team increases. The introduction of prudential regulation to the sector has been an essential step.

Financial service associations or FSAs are an interesting innovation in the form of the financial mutual which have quietly grown over the last decade. Member owned and located in some of the remoter rural areas in Kenya, FSAs perhaps most closely resemble the notion of a village bank. The problem of increasing the sophistication of what services can be offered has been tackled by a novel solution. K-Rep Fedha Services is a highly specialised business services provider which enables FSAs to outsource their management and operations – enjoying the efficiencies that creates – while members retain ownership at a local level. Research has convincingly demonstrated the role of local financial institutions in stimulation local economic development. The KFS-FSA model includes a strong

degree of tacit oversight helping to provide a cost-effective way to mitigate the problems of institutional capture.

The importance of diversity can perhaps be best seen when it is lost. Building societies were the UK's leading mutual form, whose origins go back to the late 18th century – created to enable their members to build homes. The UK moved in 1986 to allow building societies to de-mutualise. This was driven by the policy aim to create a more competitive market based financial system. Societies representing two-thirds of the assets of the building societies movement elected to demutualise. All have ended up as part of very large commercial banking groups.

The story of Northern Rock starkly illustrates the cost. Comprised of societies which had been in existence for nearly 150 years, Northern Rock de-mutualised in 1997 and floated on the London Stock Exchange. It dramatically shifted from its conservative business model and pursued aggressive expansion writing ever more highly geared mortgages it financed through securitisation and which helped fuel the UK's unsustainable housing asset bubble. A mere ten years later the model unravelled in the 2007 financial crisis and the UK experienced its first bank run in 150 years. In order to avoid the very real risk of massive systemic impact, the Bank of England stepped in and the bank was nationalised.

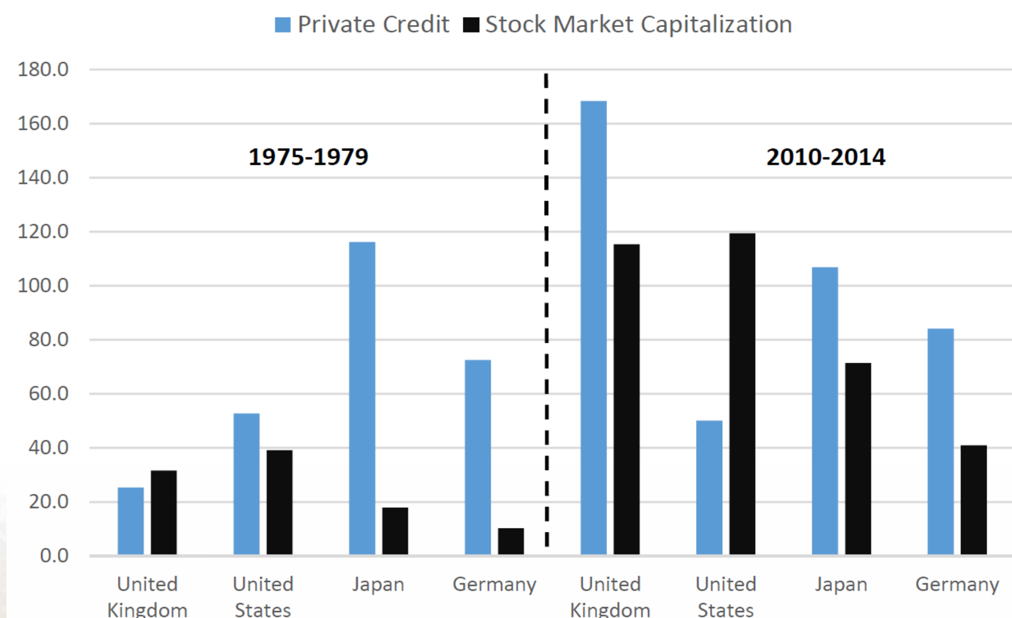
Proposition #3: The future is open

This can be understood in two ways: First, the future of the financial system in Kenya can take many paths, second, that one of these paths could be to create an open financial system.

Developments this century have made the idea of a convergence in economic and social models intellectually unfashionable. Francis Fukuyama's 'end of history' appears nowhere in sight today. However this notion of convergence seems strangely persistent in relation to the financial system. The supposition appears to be that the end of financial history is the Anglo-American model, notwithstanding its manifest fragilities.

But the notion that there is one model is simply not supported by the facts. We can compare some very simple headline data on proxies for the relative roles of bank versus market financing in the world's largest financial systems (**figure 6**). First, we see just how relatively bank led Japan and Germany are compared with the UK and US. Second, how much change there has been over a relatively short period.

Figure 6: Structure in leading financial systems

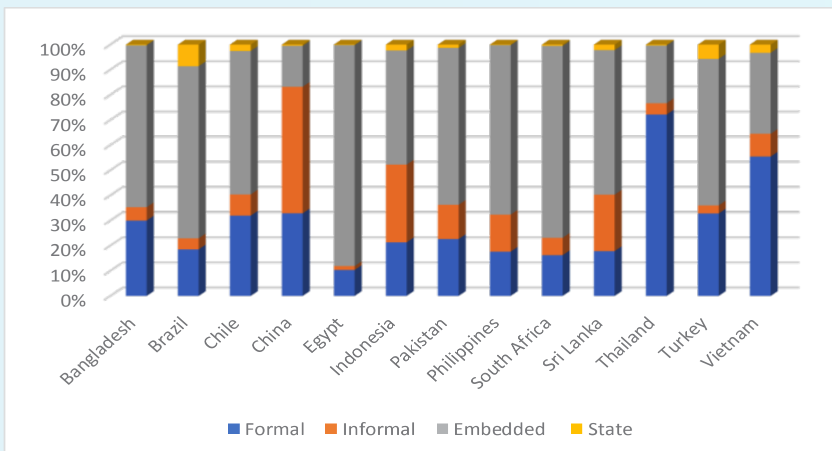


(Allen, Gu, & Kowalewski, 2017)

Figure 7 shows the relative significance of the four sources of finance (discussed earlier) to investment by enterprises surveyed in a number of emerging economies. Again the striking point is the sheer diversity in the numbers we see here between countries. It is especially notable how different the patterns is between the two highest growing economies represented here - China and Vietnam.

Success can clearly take different paths.It is also surprising how divergences can be accomplished so readily. Kenya and Nigeria had roughly similar levels of financial inclusion back in 2006 though Nigeria's GDP per capita was more than double Kenya's. Since then Kenya's inclusion levels have taken off while Nigeria appears to have plateaued at an inclusion level of just below 50% (**figure 8**).

Figure 7: Sources of finance for investment across enterprises in select emerging economies



(FinAccess, 2019; EFInA, 2018)

Figure 8: Financial inclusion in Kenya and Nigeria

(FinAccess, 2019; EFInA, 2018)

Mobile money has been the driver of Kenya's success. It is instructive to note that unusually among bank regulators on the continent, in 2007 the Central Bank of Kenya adopted a 'test and learn approach' allowing a mobile network operator driven solution to emerge. By contrast the Central Bank of Nigeria steadfastly maintained its insistence on a bank-led approach.

So finally let us turn to the notion of an open financial system. The technology of information is in the engine room of financial services. And it scarcely needs repetition here that Kenya and the rest of the world is in the midst of an information technology revolution which is driving change at an unprecedented pace. Every aspect of information is undergoing change: from the collection of data, through its interpretation and processing to its application and dissemination.

The economies of scale inherent in the first generation of computer technology were a major force driving bank consolidation – at least in the retail space. Technology has changed again and that is no longer the case. Indeed being saddled with large-scale legacy technology is proving something of a handicap to banks facing competition from nimble footed fintech challenger banks.

An open financial system is premised on harvesting the possibilities this creates. It enables us to exploit the full breadth of options from a diversified financial system. We need not be limited by:

- the constrained product models of commercial banks,

- the threat to small community based financial groups of covariant risk,
- the resource constraints of new growth sectors which limit embedded financing; or
- the inability of the state to respond effectively to the market.

Rather it could allow creative solutions which can combine the strengths of all of these sources and mitigate the weaknesses.

Open finance is absolutely not about another round of deregulation. Ironically as we've seen this led to a more closed than open system in the western economies which drove it. We need to be on our guard against concentration. The much-vaunted super-platforms – exemplified by Alibaba and Amazon – offer a huge potential opportunity to finally tackle the challenge of financing small and medium enterprise effectively – the holy grail of development finance for five decades. But the prospective market power they wield could precisely destroy openness. Closer to home our current proto-super-platform – M-Pesa already wields enormous influence as to who plays and who does not in our emerging digital finance ecosystem.

The first steps needed to enable the creation of an open financial system are already being seen around the world. New institutions – rules of the game – and shared infrastructure are needed. In the UK, the open banking initiative has translated the principle that people and businesses should own their own data into practical mechanisms to allow data sharing within the financial system. This is already stimulating a new wave of fintech innovation offering new financial solutions. The India stack provides a new digital infrastructure combining layers which provide digital identity, payments, contracting and records on an open basis. Many jurisdictions are experimenting with regtech and sandboxes to develop regulatory regimes which will encourage innovation while protecting consumers, businesses and the economy against new threats.

But is this open financial network really possible? The extraordinary degree of concentration seen in technology with the rise of the super-platforms driven by network economies gives rise to a healthy degree of scepticism. But there is an example of an open network which operates at enormous scale and which involves the public and private sectors and ordinary citizens. Its operation is underpinned by crucial rules and standards. And it is constantly innovating and evolving. But it is either owned by no one or perhaps rather everyone. It is called the internet.

Our aim is not 'utopia' which, as Thomas More who coined the term pointed, out means 'no place' (More, 1518). Rather it is 'eutopia' – which simply mean a 'better place'. What a difference 'e' can make.

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About FSD Kenya

The Kenya Financial Sector Deepening (FSD) programme was established by the UK's Department for International Development (DFID) programme in 2001 to support the development of financial markets in Kenya. In 2005 we were constituted as an independent trust under the supervision of professional trustees, KPMG Kenya, with policy guidance from a Programme Investment Committee (PIC). Our aim today is to help realise a vision of an inclusive financial system to support Kenya's goals for economic and social transformation. We work closely with government, financial services industry and other partners across key economic and social sectors. The core development partners in FSD Kenya are currently the Bill and Melinda Gates Foundation and the Swedish International Development Agency (SIDA).

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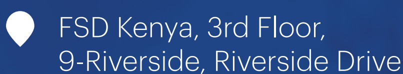
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