Inclusive Finance for Sustainable Economic Development in Kenya

March 2022
Inclusive Finance for Sustainable Economic Development in Kenya

March 2022

Authored by:
Anzetse Were
Amrik Heyer
Francis Gwer
James Kashangaki
Tamara Cook
Paul Gubbins

The Kenya Financial Sector Deepening (FSD) programme was established by UK Aid 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 with policy guidance from a Programme Investment Committee (PIC). Our aim 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 service providers and other partners across key economic and social sectors. FSD Kenya’s development partners include the Bill & Melinda Gates Foundation, the Swedish International Development Cooperation Agency (SIDA) and UK Aid.
Table of Contents

LIST OF FIGURES AND TABLES iii
ABBREVIATIONS AND TERMINOLOGY iv

1.0 EXECUTIVE SUMMARY 1

2.0 SUMMARY MACROECONOMIC ANALYSIS 3
2.1 Limitations of Kenya’s growth model 7
2.2 Why finance matters for inclusive and sustainable growth and development 8
2.3 Cross-cutting challenges 9
2.4 Opportunities to catalyse a virtuous cycle for sustainable and inclusive growth 11

3.0 PROGRESS ON INCLUSIVE FINANCIAL SECTOR DEVELOPMENT (2016 – 2021) 18
3.1 Policy and regulation 18
3.1.1 Long-term policy 18
3.1.2 Regulatory approach 19
3.1.3 Regulatory reforms 20
3.2 Financial market infrastructure 20
3.2.1 Payments infrastructure 20
3.3 Financial Solutions 27
3.3.1 Progress has been made 27
3.3.2 Usefulness, affordability, and trust 31
3.3.3 Causes of lack of progress - information asymmetry 36
3.3.4 Challenges and promise of digitisation 36
3.3.5 COVID-19 and the future 37

ANNEX 1: DETAILED MACROECONOMIC ANALYSIS 38
List of figures and tables

List of figures

Figure 1: Role of finance in the economy 9
Figure 2: Growth with resilience 12
Figure 4: Growth in use of formal financial services 27
Figure 5: Use of finance by wealth status 28
Figure 6: Regional digital account penetration 28
Figure 7: Gender disparities across service provider 29
Figure 8: Gendered strategies for meeting goals
Figure 9: Source of capital for MSEs 30
Figure 10: Financial access vs. financial health 31
Figure 11: Financial Health 2016 - 2021 31
Figure 12: Growth of digital credit 32
Figure 13: Top 3 solutions used to address shortfalls in day-to-day needs (FinAccess 2021) 32
Figure 14: Cash is still the dominant payment channel 32
Figure 15: % of borrowers exhibiting symptoms of debt stress 32
Figure 16: Solutions use to manage shocks 33
Figure 17: Use of formal, informal and non-financial solutions to invest in future goals 34
Figure 18: Barriers to use of formal finance 35
Figure 19: Cost of banking 36
Figure 20: Users experiencing consumer protection challenges 37

List of tables

Table 1: Snapshot of Kenya’s macroeconomic development since 2016 3
Table 2: Payment statistics (2016 & 2020) 21
Table 3: Significant developments in payments 22
# Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AML/CFT</td>
<td>Anti-Money Laundering/Combating the Financing of Terrorism</td>
</tr>
<tr>
<td>BMGF</td>
<td>Bill &amp; Melinda Gates Foundation</td>
</tr>
<tr>
<td>BRS</td>
<td>Business Registration Service</td>
</tr>
<tr>
<td>CIS</td>
<td>Credit Information Sharing</td>
</tr>
<tr>
<td>CGS</td>
<td>Credit Guarantee Scheme</td>
</tr>
<tr>
<td>COVID</td>
<td>Coronavirus Disease</td>
</tr>
<tr>
<td>CRB</td>
<td>Credit Reference Bureau</td>
</tr>
<tr>
<td>DFI</td>
<td>Development Finance Institutions</td>
</tr>
<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
</tr>
<tr>
<td>FATF</td>
<td>Financial Action Task Force</td>
</tr>
<tr>
<td>FDI</td>
<td>Foreign Direct Investment</td>
</tr>
<tr>
<td>FIRE</td>
<td>Financial Innovation for the Real Economy</td>
</tr>
<tr>
<td>FSD Kenya</td>
<td>Financial Sector Deepening Kenya</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>ICRW</td>
<td>International Centre for Research on Women</td>
</tr>
<tr>
<td>IEA</td>
<td>Institute of Economic Affairs</td>
</tr>
<tr>
<td>IEBC</td>
<td>Independent Electoral and Boundaries Commission</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IREA</td>
<td>International Renewable Energy Agency</td>
</tr>
<tr>
<td>KNBS</td>
<td>Kenya National Bureau of Statistics</td>
</tr>
<tr>
<td>KYC</td>
<td>Know Your Customer</td>
</tr>
<tr>
<td>MFI</td>
<td>Microfinance Institution</td>
</tr>
<tr>
<td>MNO</td>
<td>Mobile Network Operator</td>
</tr>
<tr>
<td>MSE</td>
<td>Micro and Small Enterprise</td>
</tr>
<tr>
<td>MSME</td>
<td>Micro Small and Medium Enterprises</td>
</tr>
<tr>
<td>NPL</td>
<td>Non-Performing Loan</td>
</tr>
</tbody>
</table>
### Abbreviations and Terminology

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>NPS</td>
<td>National Payment System</td>
</tr>
<tr>
<td>P2P</td>
<td>Person to Person</td>
</tr>
<tr>
<td>PIC</td>
<td>Programme Investment Committee</td>
</tr>
<tr>
<td>PSP</td>
<td>Payment Service Providers</td>
</tr>
<tr>
<td>SACCO</td>
<td>Savings and Credit Co-Operative</td>
</tr>
<tr>
<td>SDG</td>
<td>Sustainable Development Goals</td>
</tr>
<tr>
<td>UNDP</td>
<td>United Nations Development Programme</td>
</tr>
<tr>
<td>US</td>
<td>United States</td>
</tr>
<tr>
<td>USAID</td>
<td>United States Agency for International Development</td>
</tr>
<tr>
<td>WEF</td>
<td>World Economic Forum</td>
</tr>
</tbody>
</table>
Chapter 1

Executive summary

Kenya’s progress on inclusive financial sector development over the past five years places Kenya at the front of the curve relative to its peers. But beneath its headline success story, falling financial health and growing disparities in financial usage point to underlying challenges that compromise the ability of financial inclusion to deliver on its promise for inclusive and sustainable growth.

Kenya’s financial inclusion success story has been spurred by the unprecedented speed of mobile money uptake, which enabled millions of unbanked Kenyans to enter the formal financial market and catalysed a thriving tech scene that came to be known as the Silicon Savannah.

FinAccess 2021 estimated that 84% of the Kenyan population had access to at least basic financial services thanks to the near-pervasiveness of mobile money, a remarkable feat that is now considered a replicable fintech model by many other developing nations. The gains in financial inclusion over the years have helped Kenyans bridge short-term liquidity needs and reduced gender gap in access to formal finance, mainly driven by women’s uptake of mobile money for remittances and small business activities. However, while use of digital solutions has increased, cash still accounts for 80% of daily expenses in 2021, showing that there is still a long way to go.

Despite substantial progress on financial access, the data still shows a significant disconnect between access and its outcomes for financial health —defined as the capacity of individuals and households to manage day-to-day, cope with unanticipated shocks, and invest in future goals. For example, in 2021, despite 84% of the population having financial access, the financial health index finds that only 21.8% have the ability to simultaneously manage their finances to secure basic daily needs, be resilient to unexpected shocks and invest in their livelihoods and the future with only 0.4% of those who experienced a shock turning to insurance as their main coping device. This suggests that the supply side is still not meeting the needs of households and firms. Improving incomes and quality of life for households and firms requires us to look beyond financial inclusion, and turn our attention as well to the role of finance in the wider economy. This involves the role of finance in catalysing inclusive growth and access to services at a sectoral and market wide level within and across value chains; as well as enabling macro-level reservoirs of capital and flows of spending to be more effectively directed towards inclusive development goals.

“"The gains in financial inclusion over the years have helped Kenyans bridge short-term liquidity needs and reduced gender gap in access to formal finance, mainly driven by women’s uptake of mobile money for remittances and small business activities. This involves the role of finance in catalysing inclusive growth and access to services at a sectoral and market wide level within and across value chains; as well as enabling macro-level reservoirs of capital and flows of spending to be more effectively directed towards inclusive development goals. ""
Much of this can be facilitated by an enabling policy and regulatory framework and an open and efficient financial market infrastructure. Various elements of what constitutes Kenya’s financial sector policy and regulatory framework has been evolving slowly over time, reasonably developed in some areas while lacking in others. A series of key sector-wide transformational policy initiatives have been the basis for far reaching change in recent years. Notably, the Government’s policy decision to leverage Kenya’s leadership in mobile money has provided the impetus for Kenya’s aspirations towards a digital economy. This has opened the opportunity for rapid transformational impact and an opportunity to accomplish a second leap forward.

On the flipside, Kenya’s sectoral approach to financial regulation has to a degree contributed to institutional gaps and overlaps in some areas including on regulatory coverage, market conduct, and innovation. As the scale of innovation and financial interconnectedness gathers pace, blurring the lines of regulatory jurisdictions, a cross-sector approach and close coordination in policy formulation and regulatory enforcement will be vital going forward.

Many of the building blocks that underpin Kenya’s financial market infrastructure, notably in payments and credit market, are already in place. However, frictions in their deployment, access and usage are holding back better and more efficient outcomes. Differential access to infrastructure such as the credit information system mechanism is thought to be impeding competition, disadvantaging small players and placing high entry barriers on innovators. In payments, acquiring infrastructure is still perceived as a source of competitive advantage even in the face of changing economics. To a significant extent, the status quo reflects the failure of policy to shift incentives in ways required to achieve better and more efficient outcomes. This calls for policy processes to be more strongly coordinated and to leverage the gains from collective efficiency through coordination within the right commercial context if the breakthrough required is to be achieved.

Macroeconomically, Kenya has made key economic gains over the past 5 years in that GDP growth and poverty reduction benefitted rural areas (pre-COVID); digital innovation and readiness remained high; Kenya attracted green, sustainable, start-up and patient investment; and diaspora remittances were remarkably robust and resilient. However, the period in review also saw a considerable weakening in public finances; deteriorating financial health among Kenyans, and weakening export performance. Economic gains were also disrupted by the interest rate cap; a prolonged election period in 2017; and COVID-19 reversed key economic gains especially in poverty reduction. Further, key structural economic weaknesses remain. The main ones being sluggish growth defined by economic dualism; import dependence; and macroeconomic reliance on an erratic agricultural sector which is increasingly affected and vulnerable to climate change shocks, which have become more pronounced. Additionally, inequality remains a key economic reality with regards to income, access to quality social services (health, education and housing) and the persistent marginalisation of women and girls. While digital possibilities are strong in Kenya this space is defined by digital inequality and market concentration especially in the mobile money sector. Finally, despite GDP growth, there is growing informality in the labour force which presents job creation challenges for a growing population dominated by young people.

The COVID-19 pandemic has had diverse effects across the economy and while Kenya’s economy has demonstrated resilience compared to peers, the pandemic has hit some sectors very hard and highlighted the limits of Kenya’s growth model. The lack of formal social security has left vulnerable populations to rely on increasingly depleted savings and assets and leverage social capital to survive. The costs of the pandemic have fallen especially strongly on women, informal enterprises and children, and the World Bank predicts that 2 million Kenyans have been pushed into poverty due to COVID-19. Thus, although economic growth has been consistent, the somewhat underwhelming ‘elasticity’ of poverty with respect to GDP growth as well as findings from in-depth qualitative studies (such as the Kenya Financial Diaries) suggest that the benefits of this growth have been concentrated.

The COVID-19 disruption marks a watershed moment for inclusive finance. In the effort to rebuild the financial markets and the economy more broadly, it will be imperative to rigorously harness as many lessons learnt as possible from the effects of the pandemic, as well as to identify underlying economic dynamics, opportunities, market gaps and prospective constraints to the future development of the country’s financial sector. This calls for concerted effort— a synergy across the entire financial sector—in building back better for a financial sector that delivers value for all Kenyans.
Chapter 2
Summary macroeconomic analysis

Table 1: Snapshot of Kenya’s macroeconomic development since 2016

<table>
<thead>
<tr>
<th>Gains</th>
<th>Challenges</th>
<th>Persistent structural features</th>
</tr>
</thead>
<tbody>
<tr>
<td>• GDP growth and poverty reduction benefitted rural areas (pre-COVID)</td>
<td>• COVID-19</td>
<td>• Sluggish growth and economic dualism</td>
</tr>
<tr>
<td>• High digital innovation and readiness</td>
<td>• Weakening public finances</td>
<td>• Macroeconomic reliance on an erratic agriculture sector</td>
</tr>
<tr>
<td>• Attracting green, sustainable, start-up and patient Investment</td>
<td>• Deteriorating financial health</td>
<td>• Dependence on imports</td>
</tr>
<tr>
<td>• Robust and resilient Diaspora Remittances</td>
<td>• Weakening export performance</td>
<td>• Vulnerability to climate change</td>
</tr>
<tr>
<td></td>
<td>• Interest rate cap and its</td>
<td>• Income Inequality</td>
</tr>
<tr>
<td></td>
<td>implications</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Prolonged election period in 2017</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Low quality social services (health, education and housing)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Marginalisation of women and girls</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Digital inequality and market concentration</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Growing informality in the labour force</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Growing population dominated by young people</td>
</tr>
</tbody>
</table>

The past five years have been defined by key development gains that have positively informed macroeconomic performance and welfare seen in **GDP Growth and poverty reduction benefitting rural areas** (pre-COVID). Growth and poverty trends in Kenya were largely positive, where average annual GDP growth accelerated from 4.2% in 2000-2009 to 5.4% in 2010-2017 and Kenya’s national poverty rate declined by about 1% per year (from 47% to 36%) between 2005 and 2015, resulting almost entirely from rising consumption among the poorest rural households, which are diversifying into informal service-sector activities such as wholesale and retail trade and transportation.¹ This is not to say the growth was equitable or pro-poor, but rather acknowledges this positive element of the characteristics of GDP growth and poverty reduction. Another key gain has been in **digital innovation and readiness** where the technology, telecoms and finance sectors have been strong economic performers, driving innovation, attracting high skilled workers and deepening the country’s capabilities in software development, data science and related computing technologies. The Harvard Business Review classifies Kenya and South Africa as ‘Leading the Way’ in terms of preparedness to exploit digital technology to leapfrog ahead in economic development.² Further, Kenya has one of the most advanced digital infrastructure networks (public and private) in the region with the Kenyan government being the first in Africa to launch a digital ID scheme (Huduma Numba) and develop a digital economy blueprint. Additionally, Kenya is able to **attract green, sustainable, start-up and patient investment**. While the scale of investment into Kenya could be stronger and more stable (FDI inflows to Ethiopia, Uganda and Tanzania *routinely out-perform Kenya*), a closer look at the figures finds that Kenya consistently attracts investment that is green, sustainable and/or better aligned with supporting the growth of young and relatively small private sector players.³ The final significant gain has been robust and **resilient diaspora remittances** which replaced tea and international tourism as Kenya’s main source of foreign exchange in 2017. So far during COVID-19, Kenya is the only African country to record a growth in diaspora remittances. Research from 2015 shows that the profile of Kenyans living and working in the US are highly employed (93% of those in the labour

---


2 Disrupt Africa (2021), *African Tech Startups Fund Report 2020*

3 IRENA (2020), *Global Landscape of Renewable Energy Finance 2020*
Inclusive Finance for Sustainable Economic Development in Kenya
force were employed), 62% are either professionals or work in managerial positions, 27% of the workforce are registered nurses or nursing aides. This profile paints a picture of skilled, essential workers who are likely to be in high demand during the pandemic.

Despite these gains, key macroeconomic challenges that have informed Kenya’s development over the past five years are as follows, the most present being COVID-19. So far, COVID-19 has had diverse sectoral and gendered impacts with women disproportionately affected. The lack of formal safety nets – with Kenya having one of the lowest levels of government relief compared to peer countries – left vulnerable populations to rely on small savings and assets and leverage social capital to survive. Many households have made cuts in food expenditure with this burden falling especially strongly on women, who bore responsibility for household resilience and on whom households increasingly depended for income. The key macroeconomic impacts of COVID-19 have been: (a) Decimation in incomes and a contraction in aggregate demand; (b) Increase in poverty levels; and (c) Very weak overall economic and business activity. A second key challenge was the Interest Rate Cap which was in effect between September 2016 and November 2019 and had problematic impacts on the economy, the banking sector, private sector credit growth (especially to MSMEs), monetary and fiscal policy, and consumers.4 Another key trend of concern has been deteriorating public finances, where fiscal policy has been on an expansionary path since FY 2013/14, juxtaposed with sub-par revenue collection leading to growing and increasingly expensive debt in a context of rampant fiscal leakage.5

There has been a deeper weakening in export performance from 13% (share of GDP) in 2010 to 6% in 2019. This has had implications in terms of forex raising, the current account deficit and the sources of economic growth.6 Finally, the period has seen a deterioration in individual and household resilience even pre-COVID. The percentage of Kenyan adults who were financially healthy, with the ability to meet their basic needs, cope with risk and invest in securing their futures fell to 19% in 2021 from 22% in 2018 (just over a fifth of the population).

The decline in people’s financial well-being is evident across a broad swathe of the population, urban and rural, farmers and the employed, young and old. Stagnant incomes, inflation and lack of employment opportunities are plausible drivers behind declining financial well-being, but further research is needed: Even prior to the pandemic - in a context of annual economic growth in the 5 percent range - median incomes among Kenyan adults seem to be stagnant. Between 2018 and 2021, the median income among adult Kenyans remained at Ksh 5,000 per month. Sustained inflation has eroded purchasing power. Food prices have increased by 74 percent since December 2014. Food spending comprises over 50% of typical monthly household spending in Kenya. The strain on households is evident in high rates of meal skipping and foregoing of medical treatment when needed. The economic impact of the pandemic is evident in the reduction of wage employment among men and business ownership (among both men and women), pushing greater numbers of men out of the labor force (who are now dependent on transfers) and greater numbers of women into casual work.

Structural macroeconomic features differ from challenges in that these are persistent characteristics of how the economy performs and conducts itself. They also precede and will likely outlast any five-year strategy period as shifting these features is often long-term work that is inherently complex, dependent on many local and global stakeholders, and resource intensive (i.e., time, effort, financing, technical input etc). That said, progress can be made to improve these key structural features, the first of which is sluggish growth and economic dualism. Kenya’s economic performance has been uneven, punctured by volatility, and dependent on undercapitalised, rain-fed agriculture.6 The economy is divided into a small (in terms of employment) but rich formal economy and a large but poor informal economy with limited linkages between the two that can drive economic transformation. Secondly, Kenya remains macroeconomically reliant on an erratic agriculture sector; from 2013-2017, the agriculture sector contributed on average 21.9% of GDP, with at least 56% of the total labour force employed in agriculture in 2017.7 Yet the sector’s performance is weak, erratic and highly correlated with rainfall and thus deeply affected by droughts. Further, real agricultural value-add has declined relative to levels attained in 2006 due to weather related shocks, prevalence of pests/disease and dwindling knowledge delivery systems such as the lack of extension services on adoption of modern technology.8

Additionally, Kenya remains dependent on imports. Although the volume of imports have been

---

5 Parliamentary Budget Office (2021), ‘Evading recessionary pressure under a mounting debt burden: Budget Options for 2021/2022 and the Medium Term’, Government of Kenya
7 Gubbins, P. (2019), Exploring the links between finance, technology and growth in Kenya’, FSD Kenya
declining recently, Kenya is still deeply dependent on imports including for key food items such as sugar, wheat and its products, vegetable oils, and milk.\textsuperscript{9} Additionally, while digital innovation and readiness has been a gain over the past few years, a growing structural feature of this is digital inequality and market concentration. Income remains a key determinant of access and usage of digital devices, broadband and e-services with the affordability of handsets and credit reported as the main barrier to access and usage, followed by basic and digital literacy.\textsuperscript{10} An urban-rural divide also dominates Kenya's digital economy landscape, where rural communities remain underserved by existing digital infrastructure, digital skills initiatives and digital entrepreneurship support networks. Women remain underrepresented in technology and persistent gender gaps remain in relation to mobile internet penetration (4%), awareness of mobile internet (16%), as well as spending on mobile services (29%).\textsuperscript{11} Further, the dominance of vertically integrated players in one market segment such as mobile money, mobile connectivity, content or e-commerce risks consumers being locked into a single network and makes it difficult for smaller players to compete.\textsuperscript{12}

An increasingly important structural challenge is Kenya's vulnerability to climate change and global warming. About 40% of Kenya's GDP and 70% of overall employment is derived from natural resource-related sectors, including agriculture, mining, forestry, fishing, tourism, water supply and energy.\textsuperscript{13} The World Bank puts the projected long-run impacts of global warming on Kenya's GDP at -7.2%.\textsuperscript{14} Income inequality in Kenya remains above the African average, with persistently high levels of poverty and exclusion despite a decline in the poverty rates.\textsuperscript{15} Poverty rates remain above 70% in remote, arid and sparsely populated north-eastern parts of Kenya and women are poorer than men; 30.2% of female headed households are poor compared to 26% of their male counterparts.\textsuperscript{16} This inequality is partially driven by poor quality public services, particularly in health, education and housing. According to the World Economic Forum, a Kenyan born in 2017 is likely to achieve at most 52% of their potential if they survive to adulthood because of gaps in the education and health systems.\textsuperscript{17} The gendered nature of poverty and inequality reflects a persistent structural feature of development which is the continued marginalisation of women and girls evidenced in a myriad ways, from female-headed households being more likely to be poor compared to male-headed ones, cultural norms that limit women’s voice over economic decisions; the gender pay gap; female under-representation in formal waged employment; lower access to formal finance; and market systems in Kenya that are traditionally ‘gender blind’, based on a false assumption of a level playing field, and thus fail to accommodate underlying gender inequalities that impact women’s abilities to compete with men for productive resources and opportunities.\textsuperscript{18}

Kenya’s economy is characterised by economic dualism, with the economy divided into a small (in terms of employment) but rich formal economy and a large but poor informal economy with limited linkages between the two that can drive economic transformation. One result of this is that the past five years have seen growing informality in the labour force. In 2015, the informal sector accounted for 81.5% of total jobs this went up slightly to 82.9% in 2019 but importantly the informal sector created 90.7% of total new jobs outside of small-scale agriculture.\textsuperscript{19} This shift has been informed by numerous internal and external factors that emerged from local and global sources over time. The main result of this shift is that today the bulk of Kenyans earn their living from informal MSE activity, with constrained access to financial and other support, and minimal cushioning against risk. A key factor that informs this is that the population is dominated by young people, 35.7 million Kenyans (75.1%) are below 35 years of age and young adults (18 to 34 years of age) constitute 29% of the total population.\textsuperscript{20} The result is that about 800,000 youth enter the labour market annually and yet they comprise the largest unemployed demographic, often resorting to informal business activity to earn a living.\textsuperscript{21} Factors that prevent the country from effectively supporting and drawing on the strengths of a youthful population include fragmented youth policies and lack

\begin{itemize}
\item \textsuperscript{9} Statista (2021), ‘Import dependency rate for food product in Kenya.’
\item \textsuperscript{13} FSD Kenya (2021), Green Finance Project Design.
\item \textsuperscript{17} World Economic Forum, (2017), ‘The Future of Jobs and Skills in Africa’, WEF.
\item \textsuperscript{18} Hyun, M., Okolo, W. and Munene, A., (2020), ‘Kения Gender Analysis Report’, USAID.
\item \textsuperscript{21} IEA Kenya, (2020), ‘Proposed Actions to Youth Unemployment in Kenya’, UNDP.
\end{itemize}
of coordination; knowledge gaps on the effectiveness and impact of youth initiatives; lack of meaningful youth participation in design and formulation of youth policy; politicisation of youth initiatives; and the mismanagement of public funds including overall lack of accountability on funds targeted at the youth.22

COVID-19 has highlighted Kenya’s underlying vulnerabilities and structural features that have resulted over the years in its relatively sluggish growth, deepening bifurcation and limited progress towards improved household wellbeing and resilience. Inadequate investment in physical and social infrastructure and support systems—as well as weak integration within and between sectors and value chains—has heightened the vulnerability of the economy to shocks such as climate and market shocks as well as pandemics. Similarly, uneven access to safety nets and services including health, education, housing and water etc. have left households to depend largely on informal networks and opportunities which are extremely vulnerable to individual and covariant shocks. At the same time, Kenya has substantial potential resources which could be more effectively mobilised to support a more inclusive and resilient pathway to growth and development. These include its growing digital infrastructure, attractiveness to green investment (including its relatively clean energy and advancement in technology and innovation), strong human capital in certain areas (which is partly what has driven its robust diaspora remittances during COVID-19, with over 60% of Kenyans living abroad working as professionals or in managerial positions), a suitable climate for innovation and entrepreneurship and its strong digital and financial sectors. Kenya’s commitment to the SDGs and its Vision 2030 provide an important foundation in terms of leveraging these assets and addressing underlying challenges to improve access to basic needs and catalyse sustainable and inclusive growth. As Kenya rebuilds its economy in the wake of the COVID-19 pandemic, finance has an important role to play in steering Kenya’s development ambitions in a more inclusive and sustainable direction.

2.1 Limitations of Kenya’s growth model

The COVID-19 pandemic, termed ‘the Great Disruption’ has had diverse effects across the economy. On one hand Kenya’s economy has demonstrated resilience compared to peers. This is linked to Kenya’s diversified economy, robust agricultural production, recovery in key export items, robust diaspora remittances, minimal reliance on the export of energy and metal commodities, as well as government interventions to mitigate the impact of the pandemic. At the same time, COVID has hit some sectors very hard, particularly tourism, accommodation and food services, education, wholesale and retail trade and manufacturing23. These are labour intensive sectors, and manufacturing firms are an important source of formal employment. Sectoral impacts and squeezed demand across the economy have also impacted micro and small enterprises (MSEs) where a large proportion of Kenyans earn their livelihood. A survey of MSEs found that 20% of businesses closed during the pandemic and 45% of the remaining businesses were operating on less than half of their pre-COVID revenues by the first quarter of 2021. Business households also suffered a four-fold increase in food insecurity and substantial depletion of savings and assets.24

Lack of formal safety nets – with Kenya having one of the lowest levels of government relief compared with peer countries25 – left vulnerable populations to rely on increasingly depleted savings and assets and leverage social capital to survive. The costs of the pandemic have fallen especially strongly on women, informal enterprises and children. As income sources diminished, women’s ability to find work, produce, and participate in markets was crucial in sustaining basic needs26. However, their ability to do this has rested primarily on informal social networks and informal enterprise, both of which have been under pressure from depleted incomes, constrained demand and increased competition for scarce jobs. Extended school closures and reduced access to health care have also taken their toll on vulnerable population segments, including those with disabilities and youth.

Even though Kenya has so far weathered COVID-19

“

As With the youngest population in the world, the impact on human capital in Sub-Saharan Africa – through greater food insecurity, school closures and reduced access to health care and nutrition for children and pregnant women – will also have profound effects on development in the long run.

– FSD Kenya 2021

24 FSD Kenya, Annual Report 2020
25 Ibid
better than its peers, the pandemic has inflicted deep economic wounds; for example, the World Bank predicts that two million Kenyans have been pushed into poverty to date.

While the scope and duration of the pandemic was unexpected, its distributional impact was not such a surprise given Kenya’s social inequalities and economic structure. Kenya’s modern growth story has been fueled by the possibilities created by investments in information and communication technologies. Mobile telecoms and broadband internet have supported the emergence in Kenya of a vibrant technology and financial services hub. And widespread access to mobile phones has completely transformed some aspects of economic and social life, such as communications, commerce and inter-personal payments. Increasingly, Kenya’s ability to attract green, sustainable, start-up and patient investment is well aligned with supporting the growth of young and relatively small private sector players, as well as positioning Kenya as a hub for green investment. However, the somewhat underwhelming ‘elasticity’ of poverty with respect to GDP growth as well as findings from in-depth qualitative studies (such as the Kenya Financial Diaries) suggest that the benefits of this growth have been concentrated, rather than dispersed, reflecting the persistence of core structural features.

2.2 Why finance matters for inclusive and sustainable growth and development

Finance is an integral part of economic life and modern financial systems have enabled solutions to a range of social and economic problems, supporting welfare, growth and development in the process. The Kenyan government acknowledges the role of financial services, which are a key sector in the economic pillar of Vision 2030. National objectives under Vision 2030 aim to create a vibrant and competitive financial sector driving high levels of savings and financing the country’s investment needs. The United Nations Sustainable Development Goals (SDGs) recognise the role of financial inclusion under Goal 17 (Strengthen the means of implementation and revitalise the global partnership for sustainable development). The SDGs state that financial exclusion hampers people’s ability to earn, protect themselves in times of crisis, and to build for the future, and that financial inclusion is an enabler and accelerator of economic growth, job creation and development. The SDGs focus on the need for affordable access to and use of financial services that helps families and small business owners generate income, manage irregular cash flow, invest in opportunities, strengthen resilience to downturns, and work their way out of poverty. These align with FSD Kenya’s focus on supporting low-income Kenyans to manage day-to-day, be resilient to shocks and invest in their future. However, the reality is that modern finance has also created and exacerbated problems, such as debt, financial crises and income inequality. In Kenya, with the advent of agent networks, mobile money and digital credit, the promise and risks of modern financial institutions and tools in a low-income setting have become clear, but what remains in question is whether the current trajectory of financial sector development can drive Kenya’s growth in ways that more strongly support shared prosperity.

In understanding the role of finance in underpinning some of the challenges discussed above, it is helpful to consider three nested layers of the economy: micro, meso and macro (Figure 1). The micro layer encompasses the individual firms and households that make up the ‘atomic’ units of the economy. The meso level encompasses the associations of these atomic units into more complex forms of organisation, such as firms linked together loosely in markets or sectors of production, or more tightly in value-chains; and the voluntary associations that individuals and households form such as community savings, investment or welfare groups. Lastly, the macro layer represents economy-wide reservoirs and flows of spending power and capital residing collectively in households, government and firms and used for different ends: private consumption, government spending, investment, and international trade. The financial system operates through each of these layers, with its effects spilling across their boundaries. At the broadest layer, finance influences how large pools of money move through the economy, and at the most granular layer, finance influences how firms and households manage money, risk and raise funds for large purchases or investments.

27 Vision 2030, ‘Economic and Marco Pillar’, Government of Kenya,

28 United Nations Sustainable Development Goals, Goal 17, UN

29 United Nations Sustainable Development Goals, Financial Inclusion, UN
2.3 Macro layer: Creating the foundations for inclusive growth and development

The role of finance at the macro-layer is relevant to the lives of Kenyans in that it creates a foundation for stability, inclusive growth and equitable and reliable access to basic services. Here, public finance, monetary policy and the role of financial intermediation play large in unlocking and facilitating transactions between market actors, are the key pillars. Each of these domains is discussed briefly below:

- **Public finance** relates to how much the Kenyan government spends, on what it spends and how it finances that spending (the mix of taxes and debt). This matters because as a low-income country with limited ability to raise tax-revenue, how the government budget is allocated and whether resources are spent effectively is critical. In Kenya’s context, a key role of government spending is to help provide the basic services, safety nets and public goods that can foster human development, security and an enabling environment for commerce and trade, which together help create the conditions for inclusive and sustained growth.

- **Monetary policy** relates to the operations of the Central Bank of Kenya that manage the money supply and interest rates in order to achieve key macroeconomic goals (such as low inflation and growth). This matters to low-income Kenyans particularly regarding the management of inflation and the value of the shilling, which inform the cost of living, especially the cost of food and other basic goods and services.

- **Aggregate effects of financial intermediation:** Finance is also macroeconomically important to low-income Kenyans in terms of private sector finance. In Kenya this is mainly felt as the aggregate effect of financial intermediation and the provision of liquidity and capital to finance productive activity that creates jobs, employment, and delivers value in terms of the generation and distribution of accessible goods and services to Kenyans, in and through both the formal and informal firms in the economy. The effects of the scale of private finance or lack thereof matters to low-income Kenyans because the more access to finance garnered, the higher the propensity for growth especially at firm and sector level. Therefore, the
chronic and persistent lack of access to finance for household and firm priorities relegates low-income Kenyans to cycles of need and basic survival. The quality of intermediation by formal and informal financial services providers inform the country’s vulnerability to financial crisis, its volatility and the provision of stable, long-term and productive aggregate financing towards inclusive growth.

The meso layer of the economy refers to the association of households and firms in sectors of production (agriculture and mining, manufacturing and industry, and services), value chains, markets or other ecosystems (such as the ‘Silicon Savannah’ technology start-up ecosystem) and community institutions. This layer of the economy is often overlooked, but it is critical as the resources, incentives, norms, formal rules and linkages that operate at this level, shape production possibilities, the flow of knowledge and information, the productivity of Kenya’s workforce, and access to goods and services. Developments and setbacks in this layer of the economy, therefore, have a direct impact on household welfare and on macro-economic outcomes. Debt finance (often embedded in the commercial buy-sell relationships between firms in this layer) plays a key facilitating role in production, while trade and equity finance plays a key role in financing innovation. Financial solutions and low-cost payments infrastructure that facilitates the movement of value across time and space are also crucial to mitigating risk, enabling transactions and streamlining operations through addressing liquidity needs.

The sectoral effects of financial intermediation are also important in this layer of the economy and relates to the role of private financial arrangements in helping market actors reduce the costs of acquiring information, enforcing contracts and making transactions. For example, if financial intermediaries can generate information about firms and managers, they are in a better position to identify the most efficient and valuable production technologies and hence attract and allocate scarce capital to those uses. Effective intermediation also involves monitoring investments after they are made, and influencing corporate governance in ways that maximise the efficiency of resource allocation. In addition, financial intermediaries play a key role in helping to mobilise long-term capital commitments by helping market actors manage and diversify risk, and effectively pool savings. The availability of long-term capital that can overcome investment indivisibilities is especially important for industries (such as manufacturing and energy) that require injections of large sums of money and where returns only materialise after long time horizons. The quality of financial intermediation matters for Kenyans because it can improve the incentives for savings and investment decisions in ways that increase capital allocation to entrepreneurs and firms, supporting growth and job creation in the process.

Financial health—defined here as the extent to which a person or family can smoothly manage their current financial obligations and have confidence in their financial future—is a key motivating force for household-level decision-making. Financial diaries studies, for example, revealed the great lengths and numerous strategies and devices that low-income Kenyans deploy to manage their many money needs, encompassing three core elements: providing for the day-to-day, building resilience to unexpected setbacks, and pursuing goals. Having the tools to effectively balance these financial needs plays an important part not only in household wellbeing, but also in investments and decisions that underlie social and economic participation. Where the allocation of funds is channelled almost entirely to managing liquidity shortfalls and risk, there is little room for investment in assets and productivity that support capabilities and choice, enabling households and individuals to achieve valued ends. Similarly, the diversification of productive investment to hedge bets and manage risk prevents firms from specialising and maximising their comparative advantage, resulting in a ‘bricolage’ of economic activity.

While financial health is critically influenced by income levels and access to safety nets, the use of financial services and tools can play an important role in shaping money management strategies in ways that either enhance financial health (e.g. incentivising or facilitating greater levels of liquid savings) or detract from it (e.g. high-cost loans that increase debt burden). Since the financial sector plays a central role in determining the types, accessibility, cost and adequacy of financial services and tools available to individuals and firms, as well as shaping the institutions through which these are accessed, it also inevitably shapes financial health outcomes. Building financial capabilities to meet financial needs rests on the usefulness and affordability of financial tools as well as trust that the interests of consumers and providers are protected and secured.30 Customer protection

30 Gubbins, FSD Kenya 2020
31 The capability approach and human development (OPHI)
32 Gubbins, FSD Kenya 2021
33 FSD Kenya 2015 Financial Capability for Wellbeing
regulations and market conduct are a key element here in balancing the interests of individuals and small firms with those of larger scale financial intermediaries, often with higher bargaining power. In this regard, the macro and micro layers of finance in the economy are closely linked and inter-dependent. Similarly, in the absence of a strong and diverse middle layer that supports dynamism and innovation, and coordinates actors in the economy, the financial capabilities of households and firms cannot translate into the productive potential that underpins inclusive and sustainable pathways to growth and development.

2.4 Cross-cutting challenges

There are three key challenges that prevent finance from playing a stronger role in driving inclusive growth in Kenya and whose effects manifest across the three layers of the economy:

• **Weak public sector financing of core services and public goods.** Large segments of Kenya’s population have limited access to basic infrastructure, quality education and healthcare and formal safety nets, leaving many with no other option but to absorb the costs of shocks through increased hardship or the support of social networks. Similarly, inadequacies in infrastructure development and sectoral support services create a substantial drain on growth. The weakness of public finance in Kenya has to do with two factors: scale and quality. On one hand, there is a big gap between available government resources and the needs of a rapidly growing, low-income population; and on the other, the resources that are available are siphoned-off by corruption or spent ineffectively due to limited government capacity and commitment. While development finance plays an important role to play in bridging these gaps, the sector consists of numerous types of players and institutions, each with different mandates and incentive structures, and often poorly coordinated.

• **Chronic under-financing of production and trade by the formal financial sector.** While it has increased modestly, domestic lending to the private sector (as a share of GDP) in Kenya remains low compared to the average for lower middle-income countries. In addition, loans to key sectors such as agriculture and MSMEs represent a persistently tiny share of bank assets, though they absorb large shares of the workforce: informal micro, small or medium enterprises (MSMEs) created over 90% of new jobs in 2019. Only 5.6% of MSMEs cited banks as a source of start-up capital. Instead, informal sources of finance often step in to fill the gap: 84% of MSMEs report using their own funds or funds from family and friends as the main sources of start-up capital. Financing constraints for MSMEs limit investments that could meaningfully expand their production capabilities and growth. As a result, the owners or employees of these MSMEs are not as productive or sheltered from shocks as they could be, resulting in low and volatile incomes. In the absence of income support and other social protection programmes, downturns in the market directly translate to downturns in household well-being, often with dire consequences if social network support is not forthcoming. Another implication of the lack of financing relationships between MSMEs and banks or other formal financial service providers is that there are no direct channels through which the government or development finance institutions can reach these businesses with, for example, emergency credit or grants during a downturn or shock, providing a lifeline to low-income populations who depend on business revenues to make ends meet.34

• **Heavy reliance on a strained informal finance system.** As mentioned previously, informal social networks in Kenya play two main financing roles: (a) Financing a ‘social security net’ for members of the network who require continuous income support to meet basic needs (such as elderly parents) or who have an acute need for funds in the short-run due to emergencies (often health-related) and (b) Financing business and livelihood activities due to the failure of the formal financial sector to reach MSMEs. Despite the central importance of social networks, they are often incomplete or inefficient sources of insurance and investment. The amount and timing of funds that can be secured through them is not certain and they are often unable to pool funds effectively and take advantage of economies of scale. This is due to inherent limitations in the size and coordination of social networks, their selectivity (not everyone has access to social network finance) and absence of formal recourse to underpin trust and security. For MSMEs this means that they often do not receive

---

34 Recent commitments by the Government of Kenya to support MSMEs during COVID-19 such as the MSME Stabilisation Fund (MSF) guarantee scheme are steps in the right direction.
the scale of financing they need to scale operations and create more jobs. As a safety net for individuals and households, social networks get their strength from their diversity: risk is pooled across geography, age and livelihoods, enabling members to manage idiosyncratic shocks. However, in the case of covariant systemic shocks such as COVID-19, lack of external financing means that social networks cannot absorb risks of this magnitude, which also weakens the trust and relationships on which they are founded and undermines their resilience35. In the aggregate, the high volume of income in Kenya that is diverted through social networks in the form of remittances that support consumption—while crucial for survival and wellbeing—suppresses the ability of the financial system to pool savings and finance investment. Developing stronger ties between formal and informal financing has the potential to foster the agency, information and social capital which the informal sector enables, while linking this more closely with larger scale entities such as formal financial institutions which drive economic growth and development.

2.5 Opportunities to catalyse a virtuous cycle for sustainable and inclusive growth

In considering where best to focus strategically in transforming financial markets to catalyse a more resilient and inclusive path to development, it is important not only to assess the gaps but also the avenues where there are feasible opportunities for change. Driven by the financial inclusion agenda, there has been substantial focus on broadening and deepening finance for households, but this has limited potential to deliver the development gains we are seeking in the absence of transformation at the meso and macro layers of the economy. At the other end of the spectrum, despite the critical significance of public finance, catalysing change at this level must inevitably be viewed as a long-term game, dependent on a range of factors that often mitigate against substantive shorter-term gains. Meanwhile, there is both a gap and an opportunity in the middle layers of the economy where finance could play a role in channelling resources more strategically to sectors and value chains with a greater likelihood of generating wider avenues for growth that larger numbers of Kenyans can participate in. While FSD Kenya’s strategy focuses on all three layers, activities will mainly be focused on the middle layer of the economy.

---

35 Guerin et al. (2020)
to embed finance in areas which support improved opportunities for jobs, wellbeing and inclusive, sustainable growth. This is directly relevant to Kenya’s capacity to achieve its ambitions with respect to the SDGs and Vision 2030, which envision sustainable and inclusive growth, and improved ability to meet basic needs.

Particularly in the wake of COVID-19, Kenya’s uneven growth experience and persistent vulnerabilities suggest the critical need for knowledge-resources, infrastructure, technologies and capital investments to flow into economic sectors that can more directly support low-income segments of the economy. These investments would carry the goal of (a) sparking the productivity growth of own-account workers and MSMEs in strategic sectors (e.g. smallholder farmers, or small enterprises in manufacturing), (b) creating jobs accessible to adults with primary or secondary-level formal educational attainment, especially women, and (c) fostering well-being and building human capital (for example, health, education, housing and energy investments that give people affordable access to high quality services that reduce hardship and increase human capital). Together, these would help unlock a positive feedback loop that starts with greater purchasing power amongst low-income ‘majorities’, leading to a higher domestic demand for goods and services that feeds into higher revenues for businesses, greater re-investment in new production capabilities, and greater demand for labour and so on.

Below are some illustrative examples of sectors and strategic drivers that can potentially be leveraged to improve income and access to goods and services for local markets while positioning Kenya more effectively to leverage global linkages and opportunities:

- **Food production:** The experience shaping the rise of Asia’s most successful countries (such as Japan, Taiwan and South Korea) suggests the critical role of agricultural policies (including land reform and extension services) that boost the output of small-scale agriculture to pave the way for the emergence of domestic agro-processing and manufacturing sectors that evolve over time into larger corporations with more advanced capabilities and export competitiveness. In Kenya, targeted agricultural policies and investments could also support broader welfare by helping to lower food prices and reduce food insecurity, while simultaneously supporting the transition to climate smart and gender equitable farming systems. Finance has an important role to play here in catalysing investment to improve sustainable (green) production, streamlining infrastructure to improve agricultural markets and trade—especially digital infrastructure—structuring the flow of funds to enable value to flow more equitably to actors within value chains, especially small-scale producers and women.

- **Housing is an economic sector with strong multiplier effects on employment, consumption and wellbeing:** The impact of decent and secure housing has long lasting impacts on the ability of a Kenyan family to progress in life, providing a foundation for families to increase income generation capabilities and ride occasional shocks, as well as building cohesive and secure communities while promoting gender equality. In addition, the delivery and maintenance of housing provides direct job opportunities particularly for Kenya’s large ‘jua kali’ sector, and recent research demonstrates that the housing sector contributes as much as 14-17% of Kenya’s GDP. Strengthening the housing sector and providing access to affordable, quality housing represents a major opportunity for Kenya in terms of its development vision and a cornerstone to recovery post COVID-19. Indeed, access to better housing contributes directly or indirectly to 16 of the 17 SDGs. Conversely, failure to invest in the housing sector will result in the continued mushrooming of informal settlements, which currently house more than half of Kenya’s urban population, with the attendant health and welfare consequences; and can eventually lead to social unrest. While recognising that housing is a long and complex value chain, financing has an important role in improving access to rental and incremental housing markets that serve the majority of the population (as well as supporting more traditional approaches that promote

36 Particularly with respect agriculture, it is important to balance the imperatives of increased productivity, with the need to support greener and more sustainable small-scale farming systems that generate jobs and opportunities for MSEs (including light manufacture) minimise dependence on chemical inputs which destroy soil health and have adverse effects on human health, and minimise impacts on eco-systems including excess water use and deforestation. Technology and finance have a key role to play in catalysing innovative solutions for decentralised, small-scale green production and agro-processing as well as more efficient distribution systems which minimise wastage.


access to formal owner-occupied housing). The opportunities for leveraging digital platforms to promote efficient land markets and access to credit and insurance products particularly for the informal sector are vast. Greening housing and utilities is also more feasible now, with innovations in production and manufacturing, information, and aligned incentives. In the medium to longer term, therefore, there are substantial opportunities for finance to support the transformation of the housing sector in a more inclusive and sustainable direction.

- **Health and education**: Kenya has invested substantially in its health and education sectors, including access to free primary education and national health insurance with concomitant impacts on human development and jobs. However, the implementation of these policies has yielded mixed results, with continuing de facto costs and barriers to access as well as mixed quality of provision. Meanwhile, the economic and social costs of underexploited human capital are significant. Experience in other countries has demonstrated the critical role of public finance and coordination to develop efficient and equitable education and health sectors. However, given the weaknesses in implementation in emerging economy contexts such as Kenya, leveraging the private sector can demonstrate the effectiveness of new technologies and models for health and education that both fill an interim gap and test new and more effective possibilities for scale which, in the longer-term, could be used to strengthen public provision. In Kenya, low-cost private schools have provided an effective alternative to public education, creating jobs, especially for women, and potentially freeing up public investment to provide high-quality, more specialised secondary and tertiary education. Similarly, with regard to healthcare, standardised models for low-cost facilities and training could take the pressure off provision of low-cost preventative and basic healthcare at scale, freeing up public investment for specialised and complex healthcare needs. While supporting the role of the private sector in driving innovation, it is crucial to strengthen public provision as part of a sustainable and pro-poor social security system. Finance is critical to the allocation and distribution of public funds, and also in driving private sector innovation. Developing financial solutions that improve access to health and education services in a transparent and efficient manner is both a necessity and cornerstone for inclusive, sustainable growth.

Ininvesting in opportunities for growth in sectors that meet basic needs can create jobs and welfare benefits for the majority while improving the resilience of Kenya’s growth. At the same time, it is important to think creatively about how these investments can be structured to harness Kenya’s assets and capabilities, and improve broader outcomes for sustainability and inclusivity. For example, how can growth in sectors which support resilience be structured to harness Kenya’s large informal sector, pull in the productive potential of women and enable them to participate in market development on more equal terms; leverage Kenya’s fast growing digital capabilities and infrastructure; position Kenya to build on its existing capabilities in green energy and natural capital to access growing opportunities for green investment? And how can FSD Kenya cushion these investments through building stronger social security systems that protect economic and welfare gains? Finance has an important role to play in catalysing these drivers through allocation and distribution of financial resources for strategic investment and easing the barriers to transacting and participating in markets, including for underserved segments such as women and MSEs.

- **Micro and Small Enterprises (MSEs)**: MSEs play a significant role in local trading systems, as well as producing goods and services for local markets and contributing to 24% of GDP. Shopkeepers for example, provide a last mile distribution point for hard-to-reach markets, selling goods on flexible terms; leverage Kenya’s fast growing digital capabilities and infrastructure; position Kenya to build on its existing capabilities in green energy and natural capital to access growing opportunities for green investment? And how can FSD Kenya cushion these investments through building stronger social security systems that protect economic and welfare gains? Finance has an important role to play in catalysing these drivers through allocation and distribution of financial resources for strategic investment and easing the barriers to transacting and participating in markets, including for underserved segments such as women and MSEs.

39 According to the “2020 Human Development report, Kenya’s life expectancy at birth increased by 9.3 years, mean years of schooling increased by 2.8 years and expected years of schooling increased by 2.3 years between 1990 and 2019.
40 Health and education sectors are major contributors to employment. Kenya’s reputation for high quality medical training, especially for nurses, has created opportunities for expansion into global labour markets in these sectors.
terms (including offering goods on credit), to low-income households with precarious incomes. With 19% of the population deriving their livelihood through small scale business44, MSEs are also important contributors to household income and resilience through opportunities for income diversification and the potential to increase returns on labour and investment over and above existing alternatives45. Along with agriculture, MSEs are a feminised area of the economy where women dominate, albeit generally at the lower end of the MSE spectrum. Partly due to their informality, however, MSEs continue to face numerous challenges, not least of which is their invisibility and neglect by the public and private sectors. With limited investment in infrastructure, capacity/ skills and efficiency to support their operations, MSEs offset the costs of doing business through leveraging informal arrangements, for example unpaid labour, temporary insecure premises, drawing on social collateral and cultivation of informal relationships and institutions to access capital and markets etc.46. While these informal solutions demonstrate the creativity and agency of micro and small business owners (with concomitant benefits for poverty reduction especially in rural areas), they also constitute a burden on lower income economies and a drag on productivity. Boosting the productivity of MSEs would thus not only support household resilience by providing better access to goods and services and more reliable opportunities for income diversification (especially for women); it could potentially improve the productivity and efficiency of supply chains and value chains, contributing to inclusive growth. Structuring investment in supply chains and value chains around the needs of MSEs while improving their access to appropriate financial solutions, can enable MSEs to participate more effectively in markets and sectoral development.

- **Women’s economic empowerment:** Developing the economy to be more inclusive will rely on strategies which not only improve opportunities for labour and income generation, but which also build capabilities and structures to strengthen the terms on which people participate in markets. This applies especially to women, whose productive potential has been underutilised, and whose labour is mostly under-renumerated and ‘invisibilised’ (e.g. their support to the development and sustenance of human capital through the care-economy), compromising their power and status in households and communities and their contribution to growth.

Given the proportion of women’s work that is oriented towards household consumption and wellbeing, taking the pressure off women’s labour and investments in these areas through safety nets and better access to goods and services is one step towards enabling women to participate in areas of the economy where their productive potential is more valued. Finance can also play a role in creating economic opportunities for women outside the household, helping them access and control more resources and participate more actively in public life. It can help them generate, grow, and protect their assets, elevating their status within households and society, and giving them a bigger say over their lives and the future of their families. Finance can support broader movements towards gender equality by allocating resources more equitably, easing infrastructural and information barriers that impede women’s participation in markets, improving the efficiency of the delivery of basic services and social safety nets, and opening broader pathways for women to earn incomes and build their assets.

- **Digital economy:** The pandemic has illustrated the importance of digital infrastructure, networks and payment systems that connect people with each other, citizens to governments and businesses to customers, enabling safe and affordable transactions and purchases over distance. In Kenya, the rapid diffusion of mobile phones and mobile money accounts among the population has given people a much-improved ability to communicate and transact over distance, giving a boost to commerce and social network remittances, as well as improving access to government services, for instance digitisation of land titling, e-conveyancing, certificates (birth and death) as well as digitisation of government payments, including social safety nets. A next phase of digital development currently underway which has the potential to unlock even greater value involves the adoption of smartphones, internet connectivity and the entry of fintech, ridesharing, social networking and e-commerce platforms. These developments are changing the nature of transportation, trade, retail and finance, but they also carry risks. Privacy concerns, lack of regulation, and market concentration means that there is a danger that large technology companies — rather than workers, customers or local businesses — get the lion’s share of the benefits. Ensuring that digital economies in Kenya evolve in ways that create shared value will depend fundamentally on the norms influencing market conduct, formal rules and the structure of partnerships. There is also the need to make connectivity more affordable and accessible, so that individuals and businesses of all stripes can have the opportunity to benefit.
from digital tools and markets. Digitisation of the economy —underpinned by robust and secure communications networks, affordability, a strong national identification system and clear rules to safeguard customer interests — can support further modernisation of the state and responsiveness to citizen needs, (such as quick and timely cash transfers or stimulus payments in the event of natural disasters or economic downturns), as well as private sector.

- **Green growth**: Kenya is well positioned to become a hub for green investment with respect to its relatively clean energy, a generally supportive political environment for green growth, technology and innovation-driven business development and its considerable natural resource endowments which contribute substantially to both livelihoods and productivity\(^{47}\). A large percentage of the population currently derive their livelihoods from nature-based sectors such as agriculture, aquaculture, and tourism, which collectively make a significant contribution to the country’s GDP. Investing in greening these and other sectors of the economy has the potential to generate new jobs, boost productivity, safeguard business that are dependent on natural resources, and reduce the costs of climate change/natural disasters, pollution, and pandemics. Conversely, failure to curate Kenya’s natural resources effectively as part of its growth, could represent a substantial drag on economic productivity in the medium to longer term and have adverse impacts on wellbeing. The global search for greener forms of investment and consumption puts Kenya in an attractive position for investors who will pay a premium for lower carbon inputs such as renewable energy. Finance has a key role to play in structuring new green investment vehicles and building local capacity to absorb this, as well as incentivising new business models and technology to yield value for greener and more sustainable forms of growth, positioning Kenya competitively with respect to global markets and opportunities.

- **Social security**: Just as it is important to create stronger footholds for Kenyans to climb the income ladder, social security helps protect the gains that families do make. Access to regular and predictable social security schemes can give people the confidence to make concentrated investments with greater upside potential, rather than making diversified investments that minimise downside risks thereby undermining growth. This is especially important for women, whose de facto responsibility for household consumption undermines their potential to develop the linkages and connections that lead to more lucrative economic opportunities. The importance of social security was underscored during the pandemic\(^{48}\). FSD Kenya’s economic inclusion pilot in Marsabit found that long-term access to the Hunger Safety Net (HSNP) cash transfer programme in northern Kenya enabled households in these localities to weather the economic effects of COVID-19 and even experience growth, mainly through the role of cash transfers in sustaining demand and enabling the continuation of economic activity\(^{49}\). Conversely, gaps in the delivery of existing government payments (e.g. Inua Jamii) to vulnerable groups during the pandemic had substantial negative impacts on resilience for affected households. In sum, global data shows the potentially transformative role that well designed social security schemes can play as a foundation for stronger and more inclusive local economies that feed into national growth\(^{50}\). Aside from the continued need for public budgets to introduce effective, universal and responsive programmes, finance has played an important role in broadening access to social security schemes through the digitisation of payments. Meanwhile, there are opportunities to scale initiatives to strengthen financial capabilities and economic inclusion that are enhanced by access to social security and which have particularly important implications for women\(^{51}\).

Through a combination of strengthening sectors which build on local demand for goods and services and absorb labour; provision of stronger social security systems to cushion shocks; and leveraging Kenya’s assets and capabilities (including strengthening the productivity of women and MSEs, leveraging digital infrastructure and innovation, and supporting green growth), there is potential to catalyse a shift in Kenya’s development trajectory to support stronger outcomes for inclusivity and sustainability. This is important in supporting Kenya’s efforts to achieve its targets against the SDGs and the objectives of Vision 2030, while recognising that there may be trade-offs within these frameworks which call for adaptive thinking, especially in the wake of COVID-19. For example, there is increasing recognition that Kenya’s ambitions targets for growth may not be feasible in the face of large-scale shocks such as COVID-19, and may be at odds with its aims to achieve ‘A just and cohesive society enjoying equitable social development in a clean and secure environment’\(^{52}\). Meanwhile, Kenya’s commitments to the SDGs\(^{52}\) are a recognition that the type of growth that FSD Kenya is aiming for needs to


\(^{48}\) Kidd et al. (2020).


\(^{50}\) Thome et al 2016; Athias 2021.

\(^{51}\) Kenya Vision 2030 (Public Version)

\(^{52}\) SDG_2020_Kenya_Report.pdf
be both inclusive and sustainable. FSD Kenya’s strategic aims speak to a more nuanced understanding of growth that is attuned to the imperative of improving the ability of households to meet basic needs (housing, health, education and food) while improving incomes and equality (especially for MSEs, smallholders and women) as well as strengthening equality through more equitable access to mobile and digital infrastructure and services (including social security) and supporting green and sustainable investment. Finance has an important role to play in allocating resources towards the achievement of these outcomes and underpinning more equitable distribution of value across the economy. For finance to be effective however, partnerships and relationships at all levels need to be negotiated and established in the long-term interests of Kenya and its people. The next section will discuss some of the barriers and enablers through which finance has supported-or constrained-these strategic shifts.
An assessment of Kenya’s progress on inclusive financial sector development, especially in relation to financial inclusion, generally paints a positive position relative to its peers. That Kenya has performed strongly with respect to conventional measures of financial access and usage compared to its peers tends to confirm this positive view.

Beyond the narrow focus on access and usage, an argument can be made that an inclusive financial sector is founded on three pillars: an enabling policy and regulatory environment; an architecture that supports effective market function; and financial solutions that are useful, affordable and trusted. The three pillars represent a useful taxonomy but others are possible. The pillars themselves are not exclusive and are sometimes self-reinforcing. For instance, policy and regulation can shift the incentives for providers to develop financial solutions that work in the best interest of their customers.

There is concurrence that much of FSD Kenya’s work is largely encapsulated under the three pillars and this will continue to be the focus in the new strategy period. This is not by default, but rather by design, drawing from FSD Kenya’s objectives and theory of change. As Interventions will be developed to address various elements under the three pillars, it is imperative that this be premised and predicated on an analysis of the performance of the pillars. This will enable an understanding the current position, underlying dynamics, opportunities, market gaps and prospective constraints to the future development of the financial sector.

3.1 Policy and regulation

Under Vision 2030, medium-term planning is set out in a series of five-year plans, with sector ministries responsible for detailed MTPs for each sector. The third (and current) Medium Term Plan (MTP III) covers the period 2018-2022 and is anchored on three pillars: economic, social, and political. Under the economic pillar, MTP III sets out eight priority sectors that have been identified to drive economic growth. Of the eight sectors, agriculture, manufacturing, trade and financial services are the most relevant to FSD Kenya’s work. MTP III further identifies six sectors to drive socio-economic development, of which health, urbanisation and housing, education, gender, youth and vulnerable groups and environment (green component) are relevant to FSD Kenya’s work.

3.1.1 Long-term policy

The National Treasury is responsible for setting the overall policy and guidance for the financial services sector. The third MTP for the financial services sector (FSS-MTP3) (developed with technical and advisory inputs from FSD Kenya) establishes a strategy for the development of the sector. Digital finance is held up as one of the flagship projects of the FSS-MTP3. It is presented as a cross-cutting Government initiative aimed at harnessing the potential of digital finance to contribute to Kenya’s aspirations towards a sustainable digital economy. Whilst the continuation of the current trajectory towards a cash-lite economy will lead to further incremental gains, the digital finance flagship project is presented as an opportunity to accomplish a second leap forward. Pushing Kenya towards digital finance would deliver not only the policy goal of full financial inclusion and a cash-lite payment system, but also opens the potential for rapid transformational impacts. FSD Kenya has developed a draft policy paper for the National Treasury outlining the priority areas for implementation to achieve the policy ambitions.
The establishment of the Nairobi International Finance Centre (NIFC) and a consolidated financial sector regulator, the Financial Services Authority (FSA) have also been identified as flagship projects under the FSS-MTP3. Other projects outside of financial services but tangential to FSD Kenya’s work identified for implementation include: modernising of land registries to facilitate easy access, retrieval and sharing of land information; development of a digital health programme to facilitate health care delivery through digital channels; affordable housing programme; universal secondary school education; gender mainstreaming; the green technologies and innovations programme; climate change governance and coordination, including the establishment of a national climate change action plan and a monitoring framework, amongst others.

### 3.1.2 Regulatory approach

Kenya continues to follow a sectoral approach to financial sector regulation. Five separate financial sector regulators have been set up, each with responsibility for both prudential and some elements of market conduct oversight: Central Bank of Kenya (CBK), Capital Markets Authority (CMA), Retirement Benefits Authority (RBA), Insurance Regulatory Authority (IRA), and SACCO Societies Regulatory Authority (SASRA). Supervision is based on risk-based approaches and to various degrees, internationally recognised conventions or standards. Market conduct supervision across the five regulators exhibits great variation: reasonably developed in some, while lacking in others.

The National Treasury has been leading a process to reform the financial sector regulatory architecture. In 2016, the National Treasury published the revised Financial Services Authority (FSA) Bill that provided for the establishment of an enhanced market conduct framework for the non-bank sector. The Bill addressed institutional gaps in the regulatory coverage of market conduct issues by consolidating the four non-bank sector regulators (CMA, RBA, IRA and SASRA) into a single authority (the FSA) with a statutory cross-functional market conduct mandate. The FSA Bill was approved by the Cabinet in April 2017 but it did not progress to the legislative stage. Nonetheless, it set the foundation for the renewed impetus to address issues of market conduct in the financial sector.

Innovation is increasingly at the heart of Kenya’s financial sector. However, the strong emphasis given to stability by most regulators is sometimes seen as stifling innovation. As the scale of innovation gathers pace with new players entering the fray, the demands on regulators are increasing. At the same time, new players are emerging from non-prudentially regulated sectors, notably mobile network operators (MNOs), while some technologies are blurring the lines between regulatory jurisdictions. In response to the growing demands, the Capital Markets Authority (CMA) in March 2019 launched a regulatory sandbox to stimulate the deployment of technology-based business models with the potential of deepening access to capital markets. CMA has so far received 24 applications and has admitted seven firms to the sandbox. Following CMA’s success, other regulators are looking at developing similar frameworks including the insurance regulator, IRA, that has developed an innovation lab. All these are steps in the right direction. However, taking a cross-sector approach will be vital going forward as emerging technologies will not be within the domain of a single regulator.

There are several areas in which policy and regulation appears to be inhibiting market development in both the financial and real sectors. Notably, the current fiscal regime does not support the effective development of financial solutions such as leasing, factoring and warehouse receipts, all of which have proved efficient at reaching SMEs in other markets. Wider tax policies such as the recent introduction of the Digital Services Tax are not well aligned with the Government’s digital economy ambitions. The requirement of a Personal Identification Number (PIN), which is issued by the tax authority, to open a bank account means that poor households without any form of formal income (for which a PIN may be warranted) are at risk of exclusion for factors beyond their control. KYC requirements for financial institutions and secured transactions rules do not acknowledge that women and the youth disproportionately lack proper identification documents. These are by no means exhaustive, but the overriding imperative is that the lens through which FSD Kenya examines and intervenes in policy and regulation should be broadened beyond the financial sector.

Much of the notable policy initiatives that support real economy sectors have been those related to the Government’s Big Four Agenda. Of these, the affordable housing programme stands-out, with the Government embarking on an ambitious reforms process. Key policy and legislative reforms that are at various stages of
implementation include the establishment of the Kenya Mortgage Refinance Company (KMRC), reduction in the property transfer costs for social and affordable housing, review of the Public Private Partnership (PPP) Act to fast-track project approvals, exemption of stamp duty payment for first-time affordable housing owners, initiation of PPP projects for social housing for the public sector including the police, provision of public land for affordable housing development, amongst others. The early successes of these reforms are already evident with 11 housing projects, comprising approximately 22,000 units, at various stages of construction countrywide.  

3.1.3 Regulatory reforms

In 2016, Parliament passed the Banking Amendment Act (2016), introducing statutory caps on the interest rates charged on loans by commercial banks. The caps only applied to licensed banks, leaving out SACCOs, MFIs and unregulated credit only institutions. The imposition of the caps heightened calls for the National Treasury to address longstanding concerns related to the cost of credit and wider issues related to market conduct in the credit market. Consequently, the National Treasury embarked on a process to develop policy options for a new approach for the regulation of credit markets. This was to be achieved by a single piece of legislation that addressed market conduct issues in the financial services sector including expanding the coverage of unregulated and under-regulated credit providers. The resultant Financial Market Conduct Authority (FMCA) Bill was published in 2018 but failed to progress to the legislative stage.

While the interest caps were eventually repealed in 2019, there remain significant challenges in the credit market which need to be addressed, notably with respect to market conduct, unregulated providers and credit information sharing. In market conduct, the failure to pass either the FSA or FMCA Bills into law means that Kenya still lacks a comprehensive policy, legal and regulatory framework specifically devoted to financial sector consumer protection. Various elements of what may be termed as a framework have been slowly evolving over time. Apart from this gradual process, the current system is characterised by major fragmentations as various elements are scattered across several statutes that set up financial sector regulators, regulations and guidelines. In the banking sector, rules have been put in place for commercial banks via the Consumer Protection Guidelines (2013). There are also separate legislations such as the Consumer Protection Act of 2012 and the Data Protection Act of 2019 which adds to the list of various statutes that touch on different aspects of consumer protection within and beyond the financial sector.

For unregulated, non-bank lenders, there currently does not exist any specific consumer protection legislation, nor any authorities conducting ex-ante market conduct supervision. The issue has been more pertinent for digital credit. Despite some improvements in the conduct of digital lenders, the challenge is growing with the entry of new lower-income consumers with relatively low levels of financial literacy. Since 2019, four Bills have been introduced in Parliament seeking to regulate digital lending through amendments to the CBK Act. Three of those Bills have not progressed beyond the second reading.  

After many false starts, The fourth Bill, the Central Bank of Kenya (Amendment) Bill, 2021, was passed by Parliament and is awaiting Presidential assent. The Competition Authority of Kenya (CAK) has a wider consumer protection mandate that impacts on the financial sector and in 2016 issued new rules on disclosure to providers of financial services to improve transparency. Against this background the FSS-MTP3 requires CAK to develop policy options for a comprehensive financial sector consumer framework.

3.2 Financial market infrastructure

Market infrastructure refers to the components of the financial sector that deliver services and supporting functions that are critical to the smooth and effective functioning of the sector. Well-designed infrastructure can be a source of both financial stability and operational efficiency, with the potential of deepening access to financial services. In the context of an inclusive financial sector, key infrastructure includes those that facilitate access to financial services, those that support an efficient payments market, and those that facilitate access to credit.

3.2.1 Payments infrastructure

The payments system provides a foundational infrastructure which will increasingly shape the future of Kenya’s economy. All retail financial services necessarily ride on the rails of the payment system to

54 https://bomayangu.go.ke/

55 A second reading is the stage of the legislative process where a draft of a bill is read a second time. In most Westminster systems, a vote is taken in the general outlines of the bill before it is sent to the designated committee.

56 As at the time of authoring this paper
some degree. Since payments infrastructure provides a core infrastructure for the financial services market, it is relevant to the three functions of finance of managing day-to-day, dealing with risk, and investing in the future. For MSMEs, the payment system plays a key role in supporting trade within the country, regionally and internationally, with multiple forward and backward linkages to real economy sectors. The impact of the payments system is especially significant in relation to the relatively small-sized transactions in which low-income households and small enterprises are engaged.

The payments market is changing rapidly in Kenya, as elsewhere, due to advances in technology. Mobile phones have become an increasingly attractive channel for the delivery of payments given extensive network coverage and ubiquity of usage. Given this, MNOs are playing an increasingly important role in the delivery of payment services. This includes the direct provision of mobile payments to customers and providing a channel through which banks and other providers reach their own customers. The payments market has also benefited from policy pronouncements to digitise a range of public services, including government payments. This has provided the impetus for initiatives such as the Digital Economy Blueprint, and the implementation strategy, that signals the Government’s commitment to infuse and leverage technology in all aspects of the economy.

Table 2: Payment statistics (2016 & 2020)

<table>
<thead>
<tr>
<th>Variable</th>
<th>June 2016</th>
<th>Dec 2020</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mobile money subscriptions (million)</td>
<td>32.1</td>
<td>32.5*</td>
<td>…</td>
</tr>
<tr>
<td>Number of mobile money transactions (million)</td>
<td>456.6</td>
<td>810.94**</td>
<td>77.6</td>
</tr>
<tr>
<td>Value of mobile money transactions (KShs billion)</td>
<td>1,154.2</td>
<td>5,210**</td>
<td>351.4</td>
</tr>
<tr>
<td>Number of mobile commerce transactions (million)</td>
<td>262.6</td>
<td>591.5</td>
<td>125.2</td>
</tr>
<tr>
<td>Value of mobile commerce transactions (KShs billion)</td>
<td>586.4</td>
<td>3,336.5</td>
<td>468.9</td>
</tr>
<tr>
<td>Value of mobile money P2P transfers (KShs billion)</td>
<td>516</td>
<td>1,031.8</td>
<td>99.9</td>
</tr>
<tr>
<td>Number of registered mobile money agents (000)</td>
<td>161.6</td>
<td>264.3</td>
<td>63.5</td>
</tr>
<tr>
<td>Number of banking agents (000)</td>
<td>53.8</td>
<td>77.6</td>
<td>44.2</td>
</tr>
<tr>
<td>Number of transactions at bank agents (million)</td>
<td>104.2</td>
<td>118.7</td>
<td>13.9</td>
</tr>
<tr>
<td>Value of transactions at bank agents (KShs billion)</td>
<td>734.2</td>
<td>1,073.8</td>
<td>46.2</td>
</tr>
<tr>
<td>Number of ATM outlets (000)</td>
<td>2.6</td>
<td>2.4</td>
<td>-7.6</td>
</tr>
<tr>
<td>Total number of payment cards issued (million)</td>
<td>14.6</td>
<td>11.7</td>
<td>-19.8</td>
</tr>
<tr>
<td>Number of POS machines (000)</td>
<td>30.1</td>
<td>48.0</td>
<td>59.4</td>
</tr>
<tr>
<td>Number of payment card transactions (m)</td>
<td>8.5</td>
<td>6.6</td>
<td>-22.3</td>
</tr>
<tr>
<td>Value of payment cards transactions (KShs billion)</td>
<td>43.3</td>
<td>70.9</td>
<td>63.7</td>
</tr>
<tr>
<td>Volume of EFT transactions (million)</td>
<td>0.85</td>
<td>1.4</td>
<td>64.7</td>
</tr>
<tr>
<td>Value of EFT transactions (KShs billion)</td>
<td>41.6</td>
<td>75.7</td>
<td>82</td>
</tr>
<tr>
<td>Volume of cheques issued (million)</td>
<td>1.5</td>
<td>1.4</td>
<td>-6.7</td>
</tr>
<tr>
<td>Value of cheques issued (KShs billion)</td>
<td>210.9</td>
<td>221.2</td>
<td>4.9</td>
</tr>
<tr>
<td>Remittances (USD million)</td>
<td>160.9</td>
<td>299.0</td>
<td>85.8</td>
</tr>
</tbody>
</table>

*Indicates active subscriptions and not just registered subscriptions! ** As of June 2019
Many of the building blocks and infrastructure that underpin an efficient payments market are already in place. However, frictions in their deployment, access and usage are holding back better and more efficient outcomes. Differential access to infrastructure is thought to be impeding competition, disadvantaging small players and placing high entry barriers on innovators. Acquiring infrastructure is still perceived as a source of competitive advantage even in the face of changing economics. Elsewhere, the structure of the mobile money market points to a concentrated market. Although all the three licensed MNOs have entered the mobile payments market, Safaricom’s M-Pesa still dominates and has an overwhelming market share, accounting for almost 99% of the value of P2P transfers as of March 2021. However, there has been, as yet, no evidence produced to demonstrate abuse of dominance that would require regulatory action.

To a significant extent, the status quo reflects the failure of policy to shift incentives in ways required to achieve better and efficient outcomes. As a starting point, the increasing intersection between payments and telecoms (MNOs) means that policy needs to be more strongly coordinated if the breakthrough required is to be achieved. A case in point are the separate regulations and guidelines governing the deployment of agent networks under the Payments Act for bank agents and the Communication Act for telco agents. Mobile money wallet interoperability was introduced in April 2018, allowing customers to send money directly from a mobile wallet to a receiver’s wallet outside their network in real-time and at the same cost as intra-wallet transfers. While a step in the right direction, there is more to be done. First, the user journey for sending money outside one’s network is less than ideal with all the MNOs offering the service either through a mobile application or USSD and not on the SIM Toolkit menu. Second, the absence of a central switch requires MNOs to pre-fund their accounts to ensure liquidity. Third, interoperability at the agents’ level is yet to be implemented, requiring agents to maintain separate floats for each provider. Lastly, wallet interoperability offers limited functionality for merchant payments as a user within an MNO network is still unable to pay into a till of a separate network.

Effective market function in the payments market is not simply about the rules, but how these are applied and impact on market participants. It is also about leveraging the gains from collective efficiency through coordination within the right commercial context. In Kenya, PSPs have typically been vertically integrated, frequently operating in closed-loop networks with tight control of the value chain. Connectivity is usually through bilateral rather than multilateral arrangements, which is far from ideal especially for smaller players and new entrants.

### Table 3: Significant developments in payments

<table>
<thead>
<tr>
<th>Date</th>
<th>Milestone</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>NPS Act enacted</td>
</tr>
<tr>
<td>April 2013</td>
<td>Presidential directive for Government digital payments</td>
</tr>
<tr>
<td>April 2014</td>
<td>Government digital payments taskforce and secretariat established</td>
</tr>
<tr>
<td>August 2014</td>
<td>NPS regulations published</td>
</tr>
<tr>
<td>September 2016</td>
<td>Value of P2P transfers in a single quarter cross the KShs 1 trillion mark</td>
</tr>
<tr>
<td>December 2014</td>
<td>e-Citizen gazetted as Government payments portal</td>
</tr>
<tr>
<td>2016</td>
<td>Significant rise in the use of agents as a payments channel</td>
</tr>
<tr>
<td>July 2017</td>
<td>Social payments to citizens over 70 years (Inua Jamii) launched</td>
</tr>
<tr>
<td>2017</td>
<td>PesaLink launched, offering real-time P2P interoperability for banks</td>
</tr>
<tr>
<td>2018</td>
<td>Significant reduction in the cost of P2P payments</td>
</tr>
<tr>
<td>March 2018</td>
<td>Enrolment to choice payment model for social payments introduced</td>
</tr>
<tr>
<td>April 2018</td>
<td>Mobile wallet interoperability launched</td>
</tr>
<tr>
<td>November 2018</td>
<td>M-Pesa global launched, enabling remittances through mobile money</td>
</tr>
<tr>
<td>2019</td>
<td>Huduma Namba registration initiated</td>
</tr>
<tr>
<td>March 2020</td>
<td>P2P transfers below KShs 1,000 zero-rated to encourage cashless payments as a COVID-19 containment measure</td>
</tr>
<tr>
<td>December 2020</td>
<td>Fees for P2P transfers below KShs 1,000 reinstated</td>
</tr>
<tr>
<td>January 2021</td>
<td>Draft NPS Vision and strategy published</td>
</tr>
</tbody>
</table>
Notwithstanding, some progress has been made. The Integrated Payments Services Limited (IPSL), a wholly owned subsidiary of the Kenya Bankers Association (KBA), was established in 2017 to facilitate the integration of retail payments between banks. IPSL’s first market offer is PesaLink, a real-time P2P solution for making payments up to KShs 999,999 between bank accounts. Following the early successes and the demonstration effect provided by IPSL, the Payments Association of Kenya (PAK) was established in 2017 to coordinate the development of rules to support automated clearing houses (ACHs) that underpin interoperability across major payments streams. However, PAK’s operations were halted by in 2019.

Far greater impetus will be achieved by implementing the proposed new strategy for the National Payments System, a draft of which was published by CBK in December 2020. The draft strategy sets out the vision for Kenya’s NPS over the period 2022-2025 and proposes four strategic objectives that will guide implementation of initiatives over the strategy period: usefulness; security; innovation; and, an enabling environment.

### 3.2.2 Credit markets infrastructure

Credit markets have become relatively diverse. Access to credit has moved from traditional players who intermediate public funds (deposits) to relatively new players that employ different business models, from licensed SACCOs to non-deposit taking MFIs that loan against their own funds. Besides the diversified supply side, the channels for providing credit have changed significantly, most notably the entry of digital credit. A distinct development has been the influx of entrants from outside the prudentially regulated sectors. The changing landscape is further reflected in the demand side. In 2021, digital borrowing was already the largest source of loans by volume, and the third largest by value (after banks and SACCOs/MFIs).77 Social and mutual finance is important for managing liquidity and investing in productive activity and assets. Informal credit sources from social networks, shopkeepers etc., are a lifeline for liquidity management and are the main competitors to low-value digital loans, while Chamas, SACCOs and MFIs serve smaller segments of the population with higher value loans which are highly valued for investment in assets and production.

Yet in comparative terms, access to appropriate credit remains challenging for both households and MSEs, particularly higher value loans which support production and growth and are backed by access to reliable sources of income and investment (a real-economy challenge). Preliminary work to address structural constraints to accessing credit has thus far only yielded modest progress. Reflecting the frustrations with the slow progress in reforms, Parliament introduced interest rates controls in 2016 to address the issue perceived.

At the core of the credit market is the infrastructure that supports market functioning. Several elements are especially important from an inclusion point of view: credit information sharing; collateral registry and risk sharing facilities. The way in which these elements perform is shaped by a combination of rules and supporting functions.

---

77 FSD Kenya. (2019). Digital Credit Focus Note.
3.2.2.1 Credit information sharing

The credit information sharing mechanism in Kenya is evolving. Amendments to the CRB regulations in 2014 paved the way for the broadening of data sources for CRBs to include participation by non-bank credit providers, who, in the regulations, are referred to as third-party credit providers. While this strengthened the predictive value of CRB data, the absence of a structured framework for admitting the third-party credit providers and inadequate oversight over the data submission process has compromised the robustness and credibility of CRB data. From a structural perspective, several challenges have been identified. These include selective updating of credit data to CRB; partial submission of loan portfolios; the burdensome process of submitting data to multiple CRBs and varied error logs issued by CRBs for the same data, amongst others. On the demand-side, the wrongful use of the CIS mechanism as a tool to exclude borrowers by focusing on negative credit data has been flagged. To address these challenges, CBK constituted a technical working group (TWG) in 2017, of which FSD Kenya was a part of, to identify proposals aimed at reforming and streamlining the CIS mechanism.

Among the challenges identified by the TWG were the difficulties in applying the Data Specification Template (DST) to non-traditional forms of credit such as digital loans. To address this challenge, the TWG developed a revised DST (Version 4) aimed at improving the completeness, uniformity and comparability of shared data. Among the changes introduced in the revised DST were the introduction of daily submissions of credit information to CRBs and the introduction of standard validation checks to enhance data acceptance rates by CRBs. CIS Kenya, an industry association championing the CIS mechanism, subsequently developed a data validation and submission tool to support the seamless and simultaneous submission of data by credit providers to the CRBs.

In April 2020, CBK published the new CRB regulations that introduced additional reforms. Key features include the introduction of a minimum threshold of KShs 1,000 for negative credit information submitted to the CRBs, the inclusion of regulated deposit-taking SACCOs in the CIS system and the requirement for credit providers to subscribe to and adhere to an industry code of conduct. At the same time, CBK withdrew the approval granted to third-party digital lenders to participate in the CIS mechanism, pending a fresh vetting process. Later in October 2021, CBK, following a Presidential directive, issued a moratorium suspending the listing of negative credit information for borrowers with loans below KShs 5m for a period of one year. The moratorium is expected to have negative effects in the market and disproportionately impact negatively on the small businesses it is ostensibly meant to protect.

3.2.2.2 Movable collateral registry

There are two primary purposes of a movable collateral registry. The first is to enable creditors to register their interest in a movable asset pledged as security by a borrower to secure a loan. The second is to provide a mechanism for creditors to establish priority rights over a movable asset pledged as collateral to multiple creditors. A movable collateral registry thus seeks to ensure that creditors’ interests in a security are correctly captured and prioritised. The downstream effect is that borrowers can leverage their movable assets as collateral to access credit.

In 2017, the Government overhauled the legal framework governing movable collateral through the enactment of a new Movable Property and Security Rights Act, 2017 (MPSR Act, 2017), the enactment of the associated MPSR regulations and the creation and launch of a new electronic collateral registry. The movable collateral registration system, comprising the new legal framework and registry, is implemented by the Business Registration Service (BRS) under the Office of the Attorney General and Department of Justice. The overall aim of these reforms was to create an efficient, effective and robust framework for borrowers, notably SMEs, to use movable and intangible assets to obtain credit from a wide range of lenders in an efficient and effective manner. FSD Kenya played a prominent role in the reforms process.

According to a 2013 World Bank study, countries that have implemented collateral reforms have increased access to finance for SMEs by 8%, increased working capital from banks by 10%, reduced interest rates by 3%, and increased loan tenures by six months.58 This impact can only be achieved if the primary users of the new system (a wide range of lenders, borrowers, legal and credit professionals, businesses, and the public) are able to access and use the legal framework and e-registry efficiently. While the Kenyan registry is operating, it has been less than efficient for several reasons. Primarily, the technical and operational functioning of the system remains a challenge, resulting

in under-utilisation. The supporting functions, especially
the capacity of various parties from the users (and
the administrators) of the system to members of the
judiciary required to adjudicate on cases touching on
secured transactions remains weak.

All is not lost. There is widespread acknowledgement
that the collateral registry and the overarching
framework needs further improvements to make it
genuinely transformational. Leveraging the impetus for
change, FSD Kenya is coordinating efforts by BRS and
the Kenya Bankers Association (that represents banks
who are the most active users) to identify the pain points
from a user perspective and the technical aspects of the
system that require re-configuration.

### 3.2.2.3 Credit guarantee scheme

Kenya’s experience with state-driven market substitution
has not been successful in accomplishing long-term
national development objectives. In the financial sector,
state-owned financial institutions have not been able
to provide an efficient solution to resource allocation
or effectively catalyse the development of new
industries. As such, the current policy for the financial
service sector reflects a private sector-led approach
to economic development with the Government providing
an enabling environment without direct participation in
the market. However, there is a compelling argument
for the Government’s intervention in markets to address
longer term systemic constraints. In the Kenyan
context, the importance of MSMEs to access finance
is widely recognised by policymakers as necessary to
facilitate development objectives. Over the years, the
Government has instituted various reforms processes
aimed at addressing various elements that constrain
MSME finance. Yet, access to finance remains a
disproportionately challenging task for MSMEs. The
COVID-19 pandemic has further compounded this
challenge.

Credit guarantee schemes, where designed
appropriately, can be an effective mechanism for
overcoming some of the market failures in credit
markets. Where banks face difficulties in assessing
the credit risks posed by smaller firms, such schemes
provide a mechanism for risk transfer and diversification
by covering part of the default risk hence lowering
the lenders’ risks. Where banks have higher collateral
requirements, the scheme can provide borrowers with
guarantees, allowing the bank to lend at a lower rate
without high collateral requirements to cover the risk.
Some schemes have also been designed to contribute
not only to deepening access to credit but also to
impact knowledge by providing training and facilitate
technology transfers to MSMEs. Such programmes are
particularly important in ensuring that constraints on
both the supply side and demand side are addressed,
the latter being crucial for ensuring the productive use
of credit.

Premised on this, the Government in 2019 initiated the
process, after previous false starts, of establishing a
credit guarantee scheme as a step towards enhancing
SMEs’ access to credit. A feasibility analysis initially
recommended a public-private partnership model
for implementation with the Government taking a
minority 20% stake and private investors taking up the
rest. However, the advent of the COVID-19 pandemic
necessitated expediency in establishing a mechanism
to support MSMEs impacted by the pandemic.
Consequently, a policy decision was made to establish
a liquidity support mechanism, the MSME Stabilisation
Facility (MSF) as an interim measure with the possibility
of conversion into the long-term credit guarantee
scheme. The facility aims to stabilise the market and
protect jobs, maintaining current access to finance to
MSMEs impacted by COVID-19. The facility is jointly
implemented by CBK and the National Treasury.

Following the policy decision, the National Budget for
the 2020/2021 fiscal year appropriated KShs 3 billion
as start-up capital for the establishment of the CGS.
At the same time, amendments to the Public Finance
Management (PFM) Act were enacted by Parliament
and assented to by the President, empowering the
Cabinet Secretary for the National Treasury to issue
guarantees to credit provided to MSMEs under the MSF.
The regulations were issued to guide the
operational side.

The MSF has so far entered into a risk-sharing agreement
with seven Participating Financial Institutions (PFIs) to
cover 50% of potential losses associated with MSME
loans with a maximum exposure of 25% of the original
loan amount.

### 3.2.2.4 Land registry and related reforms

Land remains one of the most favoured form of collateral
yet its ownership is often skewed against women.
This is due to several factors, ranging from socio-
economic factors, cultural norms, relatively lower levels
of education and income, amongst others. As such, it
is important to highlight some of the reform initiatives
in the land sector that hold the potential of closing the
gender gap when it comes to women’s ownership of
land.

The Ministry of Lands and Physical Planning has since
2013 been engaged in efforts to digitise the land registries
and develop an electronic land information system. The
legislative reforms process that underpins this process is
already underway, with the Land Registration (Electronic
Transactions) Regulations, 2020, already published.
Relatedly, the Business Law (Amendment) Act, 2020\textsuperscript{59} was enacted in March 2020 and effectively amended various laws including the Law of Contract, Survey Act Cap 299, Stamp Duty Act Cap, Registration of Documents Act, and the Land Registration Act to allow for electronic signatures as a mode of execution of documents and electronic filing of documents, including land documents. This will make it possible for persons that are geographically distant to execute and file documents at the land registries remotely. The process to digitise the 57 land registries countrywide marks a departure from the largely manual-based system of storing land records that was characterised by inefficiency, fraud, and long service delivery times. The Ministry of Lands has signalled that the transition to the digital platform, the National Land Information System (NLIS) will be finalised by December 2021.

Other land reforms introduced through various legislative amendments aimed at improving the efficiency and reducing the cost of land transactions include: the removal of the requirement to obtain consent from the government with respect to leasehold transactions, removal of the requirement to present a land rent clearance certificate and the land rates clearance certificate when registering an interest in land; amendment of the Stamp Duty Act to allow for electronic stamping of documents; the amendment of the Survey Act to allow for parties to deposit their documents electronically into a survey portal as well as electronic processing and authentication of documents; the introduction of online land searches; tracking of land documents including registration and valuation through text messages; waiver of land search fees and title registration fees; reduction of time for registration documents to three days from the initial seven; and the simplification of land registration process from 12 to five steps.

3.2.2.5 Digital identity and KYC infrastructure

To a large extent, Kenya’s financial legal and policy framework is built around generic international standards, including international approaches to AML/CFT. The Proceeds of Crime and Anti-Money Laundering Act (enacted in 2009) follows international FATF guidance on requiring financial institutions to take strong due diligence and KYC approach in dealing with customers, requiring Government-issued identification such as national IDs, birth certificates, passports, and so on. This has been applied across the board, without due regard to (a) the impact of these requirements on groups that are not yet able to obtain such identification documents, (b) where household circumstances make these forms of KYC unviable, e.g. child-headed households, (c) where it is prima facie evident that application of the full standards or legal requirements would immediately deny needy households or beneficiaries essential government services, e.g. cash transfers or food aid. There has been an attempt by KBA and FSD Kenya support to develop a framework for tiered KYC. Initial discussions have centred on exploring a range of options—looking at other countries such as Mexico—to include a system where some form identification can be obtained from beneficiaries that can be authenticated by local administration, use of very targeted, or purpose-specific accounts that can be used for receiving various forms of government transfers. The policy proposal is currently being reviewed by CBK.

Relatedly, Kenya has embarked on a process to digitise the national identification system through the rollout of the National Integrated Identity Management System (NIIMS). The digital identification system is anchored in legislation and requires all citizens and foreign residents above six years of age to register for a personal identification number, popularly known as ‘Huduma Namba’. The Huduma Namba is linked to the Kenyan civil registration and vital statistics (CRVS) registers of births, marriages and deaths; and it is possible to determine when the person associated with a particular Huduma Namba is deceased. Anyone resident in Kenya is to be registered, whether they are Kenyan citizens or not. The Huduma Namba system will however only cover natural persons, leaving out legal persons – companies, Government ministries, departments and agencies (MDAs) and other formal organisations.

The Government has already rolled out the collection of biometric data as part of the registration process and has already issued some digital IDs. However, the process was challenged in court in on the grounds that (a) the collection of biometric data was raised concerns relating to privacy rights and the potential abuse of personal data in the absence of a data protection law (that has since been passed), (b) the absence of extensive public participation on the exercise, and (c) concerns over the inability to digitally register individuals that currently lack IDs which poses a risk of further marginalising them. The High Court, where the petition challenging the process was filed, allowed for the continued implementation of the process on condition that an appropriate and comprehensive regulatory framework is put in place to safeguard individual rights.

\footnotesize{\textsuperscript{59} \url{http://kenyalaw.org/kil/fileadmin/pdfdownloads/AmendmentsAct2020/BusinessLawsAmendmentAct2020.PDF}}
The above notwithstanding, the draft digital finance policy paper proposes that the Huduma Namba should be developed into Kenya’s universal financial digital identity to enable all consumers, businesses and financial service providers to participate in the future digital financial system. The draft policy further proposed the expanded coverage of Huduma Namba to include businesses and calls for the development of the necessary supporting legislation and regulatory mechanism to mandate and enable the secure sharing of electronically held data across the financial sector, including KYC data.

3.3 Financial Solutions

3.3.1 Progress has been made

The ultimate objective of establishing an enabling environment and building open infrastructure for finance is the creation of financial solutions that work for the real economy, enabling effective participation of actors at all levels including women and MSEs. Since the establishment of FSD Kenya, there have been numerous initiatives to take advantage of the opportunity presented by advanced digital infrastructure and regulators who were at best proactive in their attitude to innovation, or at least non-interventionist. This has created significant gains for financial inclusion, supported by an enabling environment for digital infrastructure and basic solutions. However, the effect of the COVID-19 pandemic, covered in detail in the preceding section, has created significant setbacks for these nascent efforts, with potentially far-reaching impacts for inclusive financial sector development.

Over the past decade, real progress has been achieved in access to finance, monitored through the FinAccess surveys which FSD Kenya initiated in 2006. In 2006, 58.7% of the population had some form of access to formal or informal solutions. In 2021 this had risen by over 40 percentage points to 88%. More importantly perhaps is the finding that those who have access only to informal financial services stood at only 4.7%, way down from the 32.1% in 2006, demonstrating the widening of people’s financial portfolios with more choices available. Meanwhile, financial exclusion reduced from 41% in 2006 to 11.6% in 2021. Similarly, there have been substantial gains in access across population groups, with business owners now on a par with the employed in terms of formal financial access; a closing gap between men and women (from 13 percentage points in 2006 to 4 percentage points in 2021) and the poorest showing the highest rate of increase in formal uptake, mainly driven by mobile money.

Figure 4: Growth in use of formal financial services: The rising tide has lifted all the boats...

% adults (18+) currently using formal financial services by population subgroups 2006 - 2021

---

Average annual rate of growth in formal inclusion

Poorest have the highest rate of increase in formality

---
At the same time, the early gains in financial access are largely plateauing, and there are substantial gaps across population segments in terms of usage and value, suggesting persistent and even deepening inequalities. For the poorest, formality is mostly just a digital wallet used to receive or send remittances, and there is still a large gap between rich and poor in access to bank accounts (73% of the richest have access to a bank account vs 19% of the poorest). Meanwhile, the poor now make up 71% of the excluded, up from 47% in 2006, suggesting that gains in financial access have mostly served the middle and wealthier layers of the population.

**Figure 5: Use of finance by wealth status** (richest 20% and poorest 40%; 2006 - 2019 2006-2021)

**Figure 6: Regional digital account penetration**

Use of finance still varies across the country, with central Kenya showing much more intensive use of formal/digital finance than other areas. This is partly due to infrastructural constraints but is also driven by liquidity (income) as well as lack of relevance of finance for more rural and remote populations.
The gap between men and women in access to formal finance has closed over the years, mainly driven by women’s uptake of mobile money for remittances (social network finance) and small business activities. However, there are persisting gendered disparities in usage of services, especially banks.

**Figure 7: Gender disparities across service provider**

The relationship between gender and financial inclusion is still underpinned by the formal/informal divide, with men more likely to earn their income through formal employment and women still largely operating in the informal economy and with greater reliance on social capital to support economic and social goals. Partly because of this, women are still more likely to turn to mutualised (still largely informal) financial solutions, which combine social and financial value, to meet their financial needs, and the formal/informal divide deepens with age. At the same time, formal tools have penetrated the informal economy, particularly through digital payments, which are extensively used as an infrastructure for social network finance. The relevance of mobile money for social and informal transactions is a major driver of uptake of formal finance by women.

**Figure 8: Gendered strategies for meeting goals**

*use of formal and informal finance to meet financial goals*

**Source:** FSD Kenya
MSEs do use formal finance, especially savings, to support their working capital needs. Interestingly, despite the wide uptake of digital credit by businesses, formal borrowing is ranked as relatively unimportant as a source of operating capital. Again, we see a gendered divide in use of finance for working capital, with male-owned MSEs much more likely to turn to formal savings and women-owned MSEs more likely to turn to informal savings and social networks.60

**Figure 9: Source of capital for MSEs**

Main source of operating capital for MSEs

<table>
<thead>
<tr>
<th>Loans</th>
<th>Source</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>From a group/chara</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>From family/friend/neighbor</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>Personal loan/business loan from a bank/microfinance bank</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>At a Sacco/Savings and Credit Cooperative Society</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td>From mobile banking</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td>Through mobile money provider</td>
<td>11%</td>
<td></td>
</tr>
<tr>
<td>Through mobile banking</td>
<td>7%</td>
<td></td>
</tr>
<tr>
<td>As a group or charity</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>Kept in a secret hiding place</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>From other sources of income investments</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td>At a Sacco/Savings and Credit Cooperative society</td>
<td>2%</td>
<td></td>
</tr>
<tr>
<td>At microfinance institution</td>
<td>1%</td>
<td></td>
</tr>
<tr>
<td>Given to a family or friend to keep</td>
<td>1%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Savings</th>
<th>Source</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taking goods and services on credit from a shopkeeper</td>
<td>0.32%</td>
<td></td>
</tr>
<tr>
<td>Hire purchase</td>
<td>0.27%</td>
<td></td>
</tr>
<tr>
<td>Generated from another business</td>
<td>6%</td>
<td></td>
</tr>
<tr>
<td>Sale of assets</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Profit/income/capital from the business reinvested</td>
<td>4%</td>
<td></td>
</tr>
<tr>
<td>Income from savings</td>
<td>1%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Trade credit</th>
<th>Source</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reinvest/other business</td>
<td>15.5%</td>
<td></td>
</tr>
<tr>
<td>Formal savings</td>
<td>11.4%</td>
<td></td>
</tr>
<tr>
<td>Informal savings</td>
<td>9.6%</td>
<td></td>
</tr>
<tr>
<td>Social network</td>
<td>12.1%</td>
<td></td>
</tr>
<tr>
<td>Formal borrowing</td>
<td>12.6%</td>
<td></td>
</tr>
<tr>
<td>Informal borrowing</td>
<td>6.0%</td>
<td></td>
</tr>
<tr>
<td>Personal</td>
<td>5.7%</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income investments</th>
<th>Source</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assistance (gift from family/friends/ community, with no repayment)</td>
<td>24%</td>
<td></td>
</tr>
</tbody>
</table>

**Figure 10: Main source of operating capital for MSEs by gender**

In sum, despite substantial progress on financial access, the data still shows a significant disconnect between access to finance and its outcomes for financial health, suggesting that the supply side is still far from adequate in meeting the needs of households and firms.

---

60 Through Kenyan Eyes: relevance of formal and informal finance for men and women in Kenya
Inclusive Finance for Sustainable Economic Development in Kenya

Figure 11: Financial access vs. financial health

Uptake of formal and informal financial solutions (% adults 2006 - 2021)

<table>
<thead>
<tr>
<th>Year</th>
<th>Formal</th>
<th>Informal</th>
<th>Excluded</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>29</td>
<td>63</td>
<td>12</td>
</tr>
<tr>
<td>2009</td>
<td>33</td>
<td>41</td>
<td>11</td>
</tr>
<tr>
<td>2013</td>
<td>57</td>
<td>41</td>
<td>11</td>
</tr>
<tr>
<td>2016</td>
<td>67</td>
<td>68</td>
<td>12</td>
</tr>
<tr>
<td>2019</td>
<td>83</td>
<td>62</td>
<td>12</td>
</tr>
</tbody>
</table>

Percentage of adults classified as financial healthy (2016-2021)

<table>
<thead>
<tr>
<th>Year</th>
<th>2016</th>
<th>2019</th>
<th>2021</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>39%</td>
<td>22%</td>
<td>19%</td>
</tr>
</tbody>
</table>

3.3.2 Usefulness, affordability, and trust

Understanding the myriad factors behind the gap between financial access and financial health is paramount if policies and strategies are to effectively deepen inclusive finance and support the development of financial solutions which underpin poverty reduction and inclusive growth. Although access to formal services has risen, the use of formal finance to meet financial needs is still relatively low. Among many participants in the major areas of the real economy, perceptions persist regarding the high cost, unattainable collateral requirements, lengthy bureaucracy associated with securing formal finance, exacerbated by a lack of trust in formal solutions. Meanwhile, the usefulness of existing formal solutions in meeting financial needs is still far from optimal, leaving informal instruments to fill the void.

Usefulness: To be useful, financial solutions must help users manage day to day, deal with risk and invest for the future.

Managing day-to-day

The gains in financial inclusion over the years have perhaps been most relevant in helping Kenyans to bridge short-term liquidity needs, and this is where we see the strongest levels of financial health. Through digital payments enabling low-cost transfers across social networks over distance, digital wallets creating secure mechanisms to temporarily store value, and low-value digital loans adding to the choice of financial instruments available to lower-income households, digital offers are oriented to meeting this need. Financial Diaries data suggests that users of mobile banking solutions (dominated by M-Shwari) value these lines of liquidity to the extent that they pay them off before other creditors.

Figure 12: Financial Health 2016 - 2019

Financial Health Index: ability of Kenyans to manage day to day, cope with risks and invest in their futures


62 COVID-19 affected the prioritisation of loan repayments, with evidence that shopkeepers, landlords and friends and family were increasingly prioritised over formal financial providers (FSD Kenya COVID-19 Diaries (a) FSD Kenya COVID-19 Diaries (b)).
population. Meanwhile, there has been a huge increase in the value flowing through digital accounts, even during COVID-19 when the wider economy saw a significant contraction.

**Figure 13: Growth of digital credit: Value of disbursement of digital credit (KShs Billion)**

At the same time, the importance of digital finance in helping Kenyans to manage day-to-day and bridge their short-term liquidity needs is significantly dependent on a well-ingrained social infrastructure which has been established over decades. Indeed, the top device used to bridge liquidity needs is friends and family finance, wherein digital tools have acted as an enabler of low-cost transactions. This underlines the importance of seeking solutions that bridge the formal/informal divide to maximise value, especially for lower-income populations and women.

**Figure 14: Cash is still the dominant payment channel**

Despite the increasing usage of digital solutions, it should be noted that cash still accounts for the preponderance of transactions, with 81.6% of daily expenses still paid in cash in 2021, and significant use of cash to receive payments related to livelihoods across most livelihood segments other than the employed.

**Figure 15: Top 3 solutions used to address shortfalls in day-to-day needs (FinAccess 2021)**

It could be inferred that the increase in usage of financial services implies that they are useful and therefore improve the welfare of the users. This is however not always the case. Financial solutions delivered over digital channels, for example, expose users to potential cybercrime, and issues around data privacy among other risks. The expansion of digital lending applications, which took advantage of a regulatory vacuum, have resulted in high interest rates, increased defaults, and regression of access due to unselective CRB listings, as well as raising concerns over increased risk of overindebtedness.

**Figure 16: % of borrowers exhibiting symptoms of debt stress**
Dealing with risk

Individuals and businesses deal with unexpected occurrences on a regular basis. Risk of income reduction through loss of formal employment, health emergencies, and death are typical shocks that can derail livelihoods, curtail growth and push individuals and families into poverty. Other than a few examples like the National Health Insurance Fund (NHIF), the formal financial sector in Kenya has been unable to provide adequate solutions to dealing with these emergencies, and solutions have been found informally through working more, sale of assets, chamas, savings groups, and social networks. Formal financial solutions to deal with risk are utilised by only 22% of the population. Insurance is used by only 2% to deal with shocks. Overall in 2021, the financial health index finds that only 19% of the population have the ability to address shocks.

Figure 17: Solutions use to manage shocks

Managing shocks

| Source: FinAccess 2021 |

Investing for the future

Economic independence requires households and entrepreneurs to secure and improve their income streams. For households, this means having access to financial tools such as pensions that support their consumption in old age, having financial solutions that support investments in assets such as housing, and being able to use financial tools to boost productivity through business and farming, as well as investing in education and skills. For entrepreneurs, the ability to invest in the future entails having access to financial solutions that support investment and growth, enabling businesses to engage in more or diverse income generating activity.

Across households and MSEs, formal savings have played a role in helping to meet goals, testimony to the importance of developing effective savings solutions. The data also underlines the importance of loans from mutual institutions such as SACCOS, MFIs and chamas in supporting business development and asset acquisition for specific population segments – SACCOS consistently emerge as the most highly valued financial institution for users, although their user base still remains relatively small (10% in 2021).

The figure below shows that formal finance solutions play a relatively significant role in supporting the goals and aspirations of Kenyans.
Affordability

Although progress has been made in the expansion of interoperable, low-cost digital infrastructure e.g. Agents, ATM, payments, etc., competition in the formal financial sector has not driven costs to a level where most households and enterprises perceive they can afford on a regular basis to utilise formal solutions for their benefit. Digital credit providers, taking advantage of weak regulatory oversight, have consistently over-priced their solutions, in some cases at usurious levels endangering sustainability of livelihoods and enterprises.

Perceptions among Kenyans regarding the affordability of formal financial services is a big driver of usage.

Figure 19: Barriers to use of formal finance

<table>
<thead>
<tr>
<th>Affordability</th>
<th>Banks</th>
<th>SACCO</th>
<th>Mobile money</th>
<th>Mobile bank account</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferences</td>
<td>8.8</td>
<td>21.2</td>
<td>15.7</td>
<td>63.7</td>
<td>2.8</td>
</tr>
<tr>
<td>Eligibility</td>
<td>6.7</td>
<td>4.7</td>
<td>38.0</td>
<td>8.2</td>
<td>1.5</td>
</tr>
<tr>
<td>Proximity</td>
<td>3.1</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Knowledge/literacy</td>
<td>1.5</td>
<td>53.8</td>
<td>0.0</td>
<td>0.0</td>
<td>27.7</td>
</tr>
<tr>
<td>Trust</td>
<td>0.6</td>
<td>17.6</td>
<td>1.9</td>
<td>4.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Service quality</td>
<td>0.3</td>
<td>2.6</td>
<td>0.8</td>
<td>3.1</td>
<td>0.0</td>
</tr>
</tbody>
</table>
This is particularly so for banks, where the cost of running a bank account for most mainstream banks is beyond the reach of many.

**Figure 20: Cost of banking**

Cost of running an account for 1 year

Expected expenditure on banking services for a prototypical bank customer (one with preferences that resemble those observed in national survey data on bank account usage) who is exposed to the prices associated with 22 different accounts.

More recently, Kenya’s Financial Diaries during COVID-19 reported similar scenarios, where the retreat of formal lenders such as NCBA and KCB due to rising NPLs blocked relatively reliable users from access to credit, despite histories of lending and borrowing built over time. More generally, there is evidence of reluctance to deepen the use of digital channels due to concerns over increased exposure to what is perceived as a largely extractive formal system; this is compounded by lack of awareness of the potential gains from digital profiles which open up access to other formal services-like credit- and markets for goods and services. Lastly, persistent and growing issues around security — particularly fraud — have weakened trust in digital channels and infrastructure, and may compromise the effectiveness of digital channels in deepening use.
3.3.3 Causes of lack of progress - information asymmetry

Solutions for the real economy challenges faced by households and businesses come about when there is full information about the nature of the challenge and the adverse effect this has upon the target population. This information allows the innovation of bespoke solutions. The experience of FSD Kenya’s Financial Innovation for the Real Economy (FIRE) project has been that there is little useful open data on the demand side that has been collected and stored consistently, which can be utilised in the innovation process. Without the right information and proper analysis thereof, all are left with the classic problem seen quite often in the Kenyan financial sector: solutions looking for problems to solve.

Information also enables transactions. For large scale uptake of solutions, the demand side needs substantial information about the institution, its credibility and longevity to engender trust. Transaction-related information is also required to enable potential users to make informed decisions about the applicability of the solution to their reality. For instance, information such as price and tenor can be used to recalculate business models. Users and providers need to trust that their interests will be protected, which also requires information to effectively monitor and regulate sectoral development and secure individual transactions. The absence of such information leads to unfortunate situations like pyramid schemes where individuals have repeatedly lost large amounts of money.

The information asymmetry problem is familiar in many markets. Dealing with this problem in the financial market —where trust is fragile and once broken is extremely hard to recover — underlines the critical role of information in the development of an inclusive, trustworthy and innovative financial sector. Two potential drivers of financial solutions’ innovation and usage stand out; namely digitisation and the support to an institutionally diverse financial sector. Firstly, the digitisation of transaction data can be a rich source of demand side market information that can be used in developing innovative solutions. The development and rollout of digital infrastructure has enabled progress that a decade ago might have been thought of as impossible. Secondly, supply side institutions play a role in sourcing and utilising demand side data. Most MSEs and low-income households get the finance they require from mutuals and similar forms of social finance. These need to be taken seriously as models for making finance work for the poor. These forms of finance are more clearly aligned with the needs of the market and can help address the incentive problems associated with finance.

3.3.4 Challenges and promise of digitisation

As the infrastructure for digitisation spreads, it has become easier to collect, store, and analyse data. Telcos and banks now possess vast amounts of data on the financial habits of Kenyans. This data is however siloed and not available for widespread use by fintech and other solution developers. The unequal distribution of this data presents a challenge. On the demand side, access to digital channels and infrastructure is not equal. On the supply side, there is a monopoly over data, and only a few providers possess the capability to access
Inclusive Finance for Sustainable Economic Development in Kenya

As we digest the fallout from COVID-19, there will be an opportunity and a need to steer the development of the financial sector to recover the gains we have made to date in inclusive financial sector development.

Incentives for digitisation are still a major challenge to efforts to acquire and use data in the innovation process. Many efforts at digitising financial transactions require internet access, which is expensive and sporadic, particularly in remote and rural areas. Many potential users do not want to share their data under the impression that it will somehow benefit their competitors. Users also fear that their data will be used to extract rather than add value. Digitising as a process is far from straightforward and many input devices including phone applications are labour intensive, disincentivising their use. Many would-be beneficiaries have little time to master unwieldy devices or get side-tracked to enter every transaction on some device. Data entry needs to develop to be non-intrusive.

### 3.3.5 COVID-19 and the future

The ongoing COVID-19 pandemic has had a profound effect on the population of Kenya, and it will require more research to understand the implications of this for financial sector development. Much of this has been referred to elsewhere in this paper so will not be repeated. Formal sector jobs were lost and may not return. Tourism and hospitality have been particularly badly affected. The effect of sudden and prolonged loss of income has resulted in a steep fall in consumer demand that has had a ripple effect on the use of financial services. Mutual finance and MFIs, as well as informal finance such as chama merry go rounds and table banking, have been undermined in part because they relied upon financial as well as social collateral to ensure churn. Cohesion of groups has been affected by lockdowns and social distancing protocols.

As we digest the fallout from COVID-19, there will be an opportunity and a need to steer the development of the financial sector to recover the gains we have made to date in inclusive financial sector development, and grasp existing and new opportunities to build back better. Finance has under-achieved on its promise and potential to support the real economy and create avenues for growth which embrace all population segments, including MSEs and women. As we leverage the unique moment that COVID-19 has presented, it is vital that we address these shortcomings and push strongly for a financial sector that delivers value not just for the privileged few, but for all.
Annex 1: 

Macroeconomic analysis

Key macroeconomic gains

The past five years have been defined by key development gains that have positively informed macroeconomic performance and welfare as follows:

- **GDP Growth and poverty reduction benefitted rural areas (pre-COVID):** Growth and poverty trends in Kenya were largely positive, where average annual GDP growth accelerated from 4.2% in 2000-2009 to 5.4% in 2010-2017 and Kenya’s national poverty rate declined by about 1% per year (from 47 to 36%) between 2005 and 2015 (KNBS, 2018a), resulting almost entirely from rising consumption among the poorest rural households which are diversifying into informal service-sector activities such as wholesale and retail trade and transportation.64

- **Digital innovation and readiness:** The technology, telecoms and finance sectors have been strong economic performers, driving innovation and attracting high skilled workers and wider investment to Nairobi.65

  In addition to creating good jobs that in turn create the demand for services and jobs in other sectors (such as construction for housing and office space, restaurants, hospitality as well as legal and business services), the growth in the technology and skill intensive ICT and financial sectors are deepening the country’s capabilities in software development, data science and related computing technologies which could theoretically position it to take advantage of adjacent fields like artificial intelligence and robotics in the future.

  In terms of digital preparedness, the Harvard Business Review currently classified Kenya and South Africa as leading the way in terms of preparedness to exploit digital technology to leapfrog ahead in economic development.66

  Kenya has one of the most advanced digital infrastructure networks (public and private) in the region - a result of early liberalisation of the telecom sector, improvements to its national backbone, as well as strategic regulatory interventions to support an enabling environment. Further the Kenyan government was the first in Africa to launch a digital ID scheme (Huduma Numba) and develop a digital economy blueprint.

- **Attracting green, sustainable, start-up and patient investment:** Although the scale of investment into Kenya could be stronger and more stable (FDI inflows to Ethiopia, Uganda, and Tanzania routinely out-perform Kenya), a closer look at the figures finds that Kenya consistently attracts investment that is green, sustainable and/or better aligned with supporting the growth of young and relatively small private sector players. With the exception of large single-ticket investment items into dirty sectors such as oil (Tullow Oil), the bulk of investment into Kenya is linked to the services sector (health, ICT), bolstering agricultural production, green sectors (e.g. solar) and start-up/patient as follows:

- **Equity Financing:** Kenya leads Africa in annual equity funding for tech start-ups in Africa.
• **Start-up financing:** Kenyan start-ups raised a record amount of funding in 2020, securing a combined total of US$191,381,000 (27.3% of Africa’s total investment) and the largest amount of funding ever achieved by a single country. The record was previously also held by Kenya, when in 2019 the country’s start-ups netted US$149,145,000. Kenya investor activity is much more evenly distributed than other African countries. Sectors that attracted the largest share are fintech, e-commerce, e-health, logistics, energy and agri-tech sectors.

Funding raised by African Tech Startups

- **Kenya:** USD 191,381,000
- **Nigeria:** USD 150,358,000
- **S. Africa:** USD 142,523,000
- **Egypt:** USD 141,397,000
- **Ghana:** USD 19,897,000
- **Morocco:** USD 10,306,000

(Source: Disrupt Africa (2021), African Tech Start-ups Fund Report 2020)

• **Renewable investment:** UNEP states that Kenya secured investment of $1.4 billion into renewable energy 2018, the highest on record split almost equally between geothermal ($486 million), wind ($476 million) and solar ($467 million). While in 2019, Kenya saw investment into renewables fall 45% to $727 million, the trend in investment into off-grid renewable energy commitments places Kenya as a top recipient consistently between 2007-2019:

Top recipient countries and cumulative investment in off-grid renewables, 2007-2019

<table>
<thead>
<tr>
<th>Rank</th>
<th>Country</th>
<th>Total country-specific commitments during 2007-2019 (USD million)</th>
<th>Share of country-specific commitments</th>
<th>Sub-region</th>
<th>Access-deficit country</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Nigeria</td>
<td>203.3</td>
<td>24%</td>
<td>West Africa</td>
<td>Yes</td>
</tr>
<tr>
<td>2</td>
<td>United Republic of Tanzania</td>
<td>112.4</td>
<td>13%</td>
<td>East Africa</td>
<td>Yes</td>
</tr>
<tr>
<td>3</td>
<td>India</td>
<td>85.9</td>
<td>10%</td>
<td>South Asia</td>
<td>Yes</td>
</tr>
<tr>
<td>4</td>
<td>Rwanda</td>
<td>73.4</td>
<td>9%</td>
<td>East Africa</td>
<td>No</td>
</tr>
<tr>
<td>5</td>
<td>Kenya</td>
<td>72.7</td>
<td>9%</td>
<td>East Africa</td>
<td>Yes</td>
</tr>
<tr>
<td>6</td>
<td>Myanmar</td>
<td>64.8</td>
<td>8%</td>
<td>Southeast Asia</td>
<td>Yes</td>
</tr>
<tr>
<td>7</td>
<td>Uganda</td>
<td>39.3</td>
<td>5%</td>
<td>East Africa</td>
<td>Yes</td>
</tr>
<tr>
<td>8</td>
<td>Guatemala</td>
<td>38.8</td>
<td>5%</td>
<td>Latin America</td>
<td>No</td>
</tr>
<tr>
<td>9</td>
<td>Côte d’Ivoire</td>
<td>28.2</td>
<td>3%</td>
<td>West Africa</td>
<td>No</td>
</tr>
<tr>
<td>10</td>
<td>Zambia</td>
<td>19.0</td>
<td>2%</td>
<td>Southern Africa</td>
<td>No</td>
</tr>
<tr>
<td>11</td>
<td>Mozambique</td>
<td>11.4</td>
<td>1%</td>
<td>Southern Africa</td>
<td>Yes</td>
</tr>
</tbody>
</table>


This dynamic is particularly important given that between 2010-17 Kenya was the third fastest electrifying country after Cambodia and Afghanistan.

• **Robust and resilient diaspora remittances:** Remittances have replaced tea and international tourism as Kenya’s main source of foreign exchange. In addition, they have had a significant impact on the expenditures of poor households by contributing to poverty alleviation and reduced inequality as well as improved household savings and human capital development in Kenya. During COVID-19, Kenya was the only African country to record a growth in diaspora remittances.
The Central Bank of Kenya (CBK), in collaboration with the Kenya National Bureau of Statistics (KNBS) and the Ministry of Foreign Affairs (MFA), is conducting an online Diaspora Remittances Survey which may provide more insights on the resilience of diaspora remittances. However, according to FinAccess 2019, only 4% of adults in Kenya receive international remittances, meaning remittances do not translate into a stimulus or safety net for low-income households.

Key macroeconomic challenges

Macroeconomic challenges that have informed Kenya’s development over the past five years are as follows:

- **COVID-19**: The COVID-19 pandemic, termed ‘the Great Disruption’ hit the global economy in 2020. Whereas 2020 was defined by divergent impact within and between economies, 2021 will be defined by multispeed and divergent recovery in the global and local economy. In 2020 it became clear that the economic impact of COVID-19 in Kenya has had diverse and specific effects on demographic groups and sectors. On one hand macroeconomically Kenya has demonstrated resilience compared to peer economies in particular. This is linked to Kenya’s diversified economy, robust agricultural production, recovery in key export items, robust diaspora remittances, little reliance on the export of energy and metal commodities, as well as government interventions to mitigate the impact of the pandemic. The sectoral impact of COVID-19 has been pronounced, particularly on the tourism, accommodation and food services; education; wholesale and retail trade, and; manufacturing. Whereas 2020 was defined by divergent impact within and between economies, 2021 will be defined by multispeed and divergent recovery in the global and local economy. Lack of formal safety nets—-with Kenya having one of the lowest levels of government relief compared with peer countries—-left vulnerable populations to rely on small savings and assets, and to leverage social capital to survive. Of particular importance were shopkeepers and landlords who extended goods on credit and absorbed rent arrears, as well as redistributive networks among friends and family circuits. However, the strain on the informal economy could not be sustained for an extended period, and cuts in food expenditure were soon evident (over and above pre-COVID levels, where a third of the population reported missing meals sometimes or often over the course of the year (FinAccess 2019). Within household economies, burdens fell especially strongly on women, who bore responsibility for household resilience and on whom households increasingly depended for income. Given the depletion of formal sector jobs and the contraction in labour markets, women’s lower-waged labour was more competitive than men’s. At the same time, households experienced an increased burden of care, with children no longer able to go to school and with reduced access to healthcare. The key macroeconomic impacts have been: (a) Decimation in incomes and a contraction in aggregate demand; (b) Increase in poverty levels; and (c) Very weak overall economic and business activity.
**Interest Rate Cap (Sept. 2016-Nov. 2019):** On September 2016, a law on interest rate controls, which imposed a ceiling for lending rates at four percentage points above a “reference rate” and a floor on deposits at 70% of the “reference rate” received unanimous support from Parliament. The reference rate was subsequently clarified to be the Central Bank Policy Rate (CBR) and the law was later modified to remove the floor on deposits. The act was repealed in November 2019. Below are the highlights of the impacts of the interest rate cap:

### Multidimensional effects of the interest rate cap

<table>
<thead>
<tr>
<th>The economy</th>
<th><strong>Cost economic growth per year</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>IMF estimates that GDP growth would have been higher by 0.25-0.75% per year without the cap.</td>
</tr>
<tr>
<td></td>
<td>CBK: Reduced lending to Medium Enterprises (MSMEs) from the credit market by the commercial banks is estimated to have lowered growth in 2017 by 0.4% points.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>The economy</th>
<th><strong>Negative effect on formal financial inclusion</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Low income individuals are perceived as highly risky; spurring the growth of informal lending and /or increasing the cost of bank services through higher fees and commissions.</td>
</tr>
<tr>
<td></td>
<td>Agriculture: The uncertainty inherent in rain-fed agricultural production could also contribute to high risk in this sector, hence low credit supply to this sector.</td>
</tr>
<tr>
<td></td>
<td>Household lending: Reduction to this segment negatively informed the capacity of Kenyans to meet personal needs.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Private Sector Credit Growth</th>
<th><strong>Exacerbated reduction in lending to the private sector</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>While credit growth in Kenya had been slowing since September 2014, the gap hastened this trend; average decline of aggregate private sector credit of about 2.3-3.5%.</td>
</tr>
<tr>
<td></td>
<td>At about 25% in July 2014, slowly reducing, aggressive decline post-cap to a low in July/August 2017, then slow improvements in credit growth.</td>
</tr>
<tr>
<td></td>
<td>2019: Private sector credit growth improved, averaging 4.2% in the ten months to October, compared to 3.4% in a similar period in 2018, but remained below the five-year average of 11.2%.</td>
</tr>
<tr>
<td></td>
<td>Lending to agriculture, trade and financial services particularly hard hit, although lending to construction sector continued to grow at a very rapid pace (see the effect of exposure to that sector now in its contribution to NPLs).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Private Sector Credit Growth</th>
<th><strong>A shift of credit away from the private and towards the public sector</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Credit to the private sector went through a sharp decline in real terms and as a share of GDP.</td>
</tr>
<tr>
<td></td>
<td>At the same time, lending to the public sector increased sharply (growth of over 25% during the same period), helping finance a larger fiscal deficit.</td>
</tr>
<tr>
<td></td>
<td>These developments reflect reduced financial intermediation rather than a crowding out story, given that T-bill rates remained broadly unchanged following the implementation of interest controls.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Monetary and Fiscal Policy</th>
<th><strong>Fiscal effects: Government debt more attractive</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Because: (a) Higher creditworthiness and lower risk relative to average private sector borrowers; (b) no need for borrower screening; (c) no administrative costs for loan servicing; (d) no requirement for additional capital for nonperforming loans; and (5) the ability to easily sell government securities in the market (a liquidity premium).</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Monetary and Fiscal Policy</th>
<th><strong>More bank lending to government</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>This is evidenced by the faster growth in allocations to government securities by 16.1% as of Q1 2019.</td>
</tr>
<tr>
<td></td>
<td>May have fostered laxity in spending control by government because they knew their debt was super attractive.</td>
</tr>
<tr>
<td></td>
<td>Over-exposure to government debt by banking sector- Banks remain the highest government debt holders at 54.39%.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Monetary and Fiscal Policy</th>
<th><strong>Inversion of monetary policy</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The introduction of interest rate controls has made it difficult for the CBK to adjust the monetary policy rates in response to economic developments.</td>
</tr>
<tr>
<td></td>
<td>Expansionary monetary policy is difficult to implement since lowering the CBR has the effect of lowering the lending rates and as a consequence, banks find it even more difficult to price for risk at the lower interest rates, leading to pricing out of even more risky borrowers, and hence further reducing access to credit.</td>
</tr>
<tr>
<td></td>
<td>Contractionary monetary policy, so as to reduce inflation and credit growth for example, then raising the CBR would have the reverse effect of increasing the supply of credit in the economy since banks would be able to admit riskier borrowers.</td>
</tr>
</tbody>
</table>
Disproportionate exposure by small banks
- The share of bank loans to micro, small and medium-sized enterprises (SMEs), higher risk borrowers—was significantly higher for small banks.
- Share for small banks SMEs was about 40%, much higher than that of large banks at 13%.

Shrinking of the loan book of small banks
- The outstanding stock of credit of small banks declined by about 5% in the 12 months to September 2017.
- Maybe because small banks have been disproportionately hit because they rely more strongly on higher-risk/higher-return borrowers, such as SMEs.
- With most of the lending to this segment at rates above the ceiling on the lending rate, small banks seem to have restricted credit to these borrowers; ironically, bigger banks then moved into this niche SME lending segment.

Disproportionate effect on revenue and profits
- While all three bank tiers have suffered significant drops in RoE, the controls have again been particularly damaging for the small banks, whose profits were already below the industry average.
- Smaller banks have witnessed declining top-line revenue, leading to increased operational inefficiency, and operating losses; this has led to depleted capital, spurring an increase in the consolidation activity in the banking sector.

Spurred consolidation in the sector:
- Smaller banks that have been struggling to operate were/are being acquired, merging or forming strategic relationships with larger banks in order to leverage on the synergies created.

Increased focus on Non-Funded Income (NFI):
- Non-interest income to total income stood at 28.4% in September 2016, and has risen to the current average of 36.0%, for listed commercial banks that have released their Q1 2019 financial results.

Cost-cutting
- Banks also stepped up cost-cutting efforts by increasing the use of alternative channels especially mobile money and digital banking to improve efficiency and reduce costs.
- This led to the closure of branches and staff layoffs.

Collapse of bank credit to SMEs
- The stock of credit to SMEs dropped by around 10% in just one year.
- Lending to other types of borrowers (such as households or large corporates) continued to increase at a rate similar to the one prevailing before the introduction of the caps.

Fewer and bigger loans
- There was a reduction in the number of borrowers since the introduction of the lending caps (by about 27%), and the average loan size has increased (by about 47%).
- There is no evidence that the high-risk borrowers that have been cut off by the banks have been able to find alternative sources of finance.

Reduced transparency
- Lenders instituted non-interest charges, such as fees, to compensate for lower income from loans which made it more complicated for customers to understand the total cost of borrowing.
- Bank profits are increasingly coming from fees and less from interest income on private sector lending.

Reduce loan tenure
- The average loan tenure declined by 50% to from 36-48 months prior to the introduction of the cap to 18-24 months after the cap.
- Due to bank's increasing their sensitivity to risk, thereby opting to extend only short-term and secured lending facilities to borrowers.

Turn to unregulated lending
- As access to bank credit is curtailed, potential borrowers turned to informal and/or unregulated lenders such as certain digital lenders and informal lending, who often charge much higher rates and are not subject to supervision.
- FinAccess: 8% increase in use of digital loan apps, digital loans are mainly used for dealing with day-to-day needs; increase in informal borrowing from shopkeepers and social network.

Deteriorating public finances: Kenya’s Fiscal Policy has been on an expansionary path since FY 2013/14; Government development spending has been increasing especially on mega-infrastructure projects in road, rail and energy, with the aim of supporting economic growth hence the expansionary fiscal policy. However, revenues have been underperforming and hence this expenditure has, over time, been financed through increasingly expensive debt. The past five years have been defined by deteriorating performance in all three pillars of fiscal policy as indicated below:

Key features of fiscal policy (2013-2021)

Expenditure

- Sub-optimal division of expenditure: Recurrent expenditure as a share of GDP increased from 14.8% in 2013/14 to 16.3% in 2019/20 whereas, development expenditure as a share of GDP declined slightly from 6.2% to 5.9%. One of the main components of increasing recurrent expenditure was interest payment on domestic and external debt.
- Fiscal Leakage: The growth in expenditures has been driven by infrastructure development which is the sector where there is the highest leakage of resources. The Leakage and misapplication of resources has constrained the economic impact of resources allocated to counties as the budget is unable to achieve intended results.

Revenue Generation

- Declining revenue to GDP ratio: Revenue as a share of GDP has been declining from 17% in 2013/14 to 14% in 2019/20. The largest decline is in Income Tax and VAT (Income tax and VAT alone contribute about 78% of total tax revenues collected annually in Kenya).
- Failing to hit revenue targets: Over the last four financial years, the National Treasury has set increasingly unrealistic revenue targets. The deviation between actual tax revenue and printed revenue estimates increased from 5% in 2016/17 to 21% in 2019/20.

Debt

- Fiscal Deficit: The actual fiscal deficit including grants averaged 7.6% in the period FY 2013/14 to FY 2019/20 compared to an average target of 4.0% during the same period, representing a 3.6% deviation.
- Public Debt Stock: Public debt stock amounted to KShs. 7.12 trillion as at the end of September 2020, accounting for 65.6% of GDP up from about 40% of GDP in 2013. In the current financial year, debt is forecasted to reach KShs. 7.8 trillion and will account for approximately 69% of GDP and 67% of the total debt ceiling.
- Debt repayments: Interest payment on debt as a share of tax revenue doubled between 2013/14 and 2019/20. Interest payment on domestic debt as a share of tax revenue increased from about 14 to 23%. On the other hand, interest payment on external debt increased from about 2% to 9%. Debt service (Debt principal and interest payments) will cross the KShs 1 trillion mark in FY 2021/22 and will be domestically driven.
- Debt Composition: Kenya’s debt portfolio has gradually increased borrowing from concessionary debt to expensive commercial domestic and external debt.
- Guaranteed Debt: As of June 2020, guaranteed debt amounted to KShs. 165.2 billion, reflecting a 276% increase since June 2015. This increase is as a result of increase in commercial debt and bilateral credit.

(Source: Parliamentary Budget Office, 2021)

- **Weakening export performance**: Kenya’s exports have been on a steady decline over the past decade, from 13% (share of GDP) in 2010 to 6% in 2019. This reduction is driven by the relatively slower growth in the value of all the principal domestic exports. Between 2010 and 2019, the GDP share of tea and horticulture exports, which accounted for about 36% of Kenya’s domestic exports decreased by 1.7% and 1% respectively. Exports of coffee and chemicals which accounted for 12% of exports also had a similar downward trend over the same period.

Value of Selected Domestic Exports as a Share of GDP

(Source: Parliamentary Budget Office, 2021)

- **Deteriorating individual/ household resilience**: Already in 2018, the percentage of Kenyan adults able to meet their basic needs, cope with risk and invest in securing their futures fell to 22% (just over a fifth of the population) from 39% in 2016 (FinAccess 2019). This is partly driven by exposure to shocks, which, in the absence of safety nets and insurance mechanisms, can send households into a poverty spiral. In 2018, over a third of adults reported that their households had experienced a major shock in the past year, with the most prevalent being health shocks, inflation and climate-related shocks.
Inclusive Finance for Sustainable Economic Development in Kenya

Persistent structural macroeconomic features

- Prolonged election period: The general elections were held on 8 August 2017, incumbent President Uhuru Kenyatta was re-elected. However, this result was contested by the main opposition leader and party in the Supreme Court which subsequently annulled the election results because of “irregularities”. The unprecedented decision from the Supreme Court cancelling the result did not attribute any blame to President Kenyatta’s party or campaign. Fresh presidential elections were ordered and held in October 2017. The opposition leader, Raila Odinga, pulled out of the re-run and urged his supporters to boycott it. The election re-run was conducted and on October 30, the IEBC declared Kenyatta the winner of the elections. This prolonged election period exacerbated the negative economic effect of elections, where the economy registers lower growth rates and economic performance during an election year.

- Macroeconomic reliance on an erratic agriculture sector: From 2013-2017, the agriculture sector contributed on average 21.9% of gross domestic product (GDP), with at least 56% of the total labour force employed in agriculture in 2017. Yet the sector’s performance is weak, erratic, and highly correlated with rainfall and thus deeply affected by droughts, such as the extended period of drought in large areas of Kenya which reached its peak in 2017, resulting in more food insecurity, increased burden to households resulting from the greater time and effort required to get to water sources and declining crop harvests. Further, real agricultural value-add has declined relative to levels attained in 2006 due to weather related shocks, prevalence of pests/disease and dwindling knowledge delivery systems such as the lack of extension services on adoption of modern technology.

- Dependence on imports: Although the volume of imports has been declining recently, Kenya is still deeply dependent on imports. The influx of imported goods in the country presents cheap alternatives to consumers, inhibiting manufacturing and other sectors from thriving.70 Kenya also relies on imports for key food items such as sugar, wheat and its products, vegetable oils, and milk.

Sluggish growth and economic dualism: Kenya’s economic performance has been uneven, and its growth has been punctured by volatility, evidence of Kenya’s vulnerability to external and domestic shocks and importantly its continued dependence on undercapitalised, rain-fed agriculture.67 Kenya’s average rate of 4.9% per year since 2000 is slow, compared to a group of 13 regional and global peers with similar GDP per capita in 2000.68 Between 2000 and 2017, most of its regional neighbours grew faster, for example Ethiopia grew at an average rate of 9.5% per year, Rwanda at 7.3% and Uganda and Tanzania at 6.5%. From this perspective Kenya is under-performing and has been hobbled by domestic and international shocks.

- Dependence on imports: Although the volume of imports has been declining recently, Kenya is still deeply dependent on imports. The influx of imported goods in the country presents cheap alternatives to consumers, inhibiting manufacturing and other sectors from thriving.70 Kenya also relies on imports for key food items such as sugar, wheat and its products, vegetable oils, and milk.

Kenya’s economic performance has been uneven, and its growth has been punctured by volatility, evidence of Kenya’s vulnerability to external and domestic shocks and importantly its continued dependence on undercapitalised, rain-fed agriculture.67 Kenya’s average rate of 4.9% per year since 2000 is slow, compared to a group of 13 regional and global peers with similar GDP per capita in 2000.68 Between 2000 and 2017, most of its regional neighbours grew faster, for example Ethiopia grew at an average rate of 9.5% per year, Rwanda at 7.3% and Uganda and Tanzania at 6.5%. From this perspective Kenya is under-performing and has been hobbled by domestic and international shocks.

- Dependence on imports: Although the volume of imports has been declining recently, Kenya is still deeply dependent on imports. The influx of imported goods in the country presents cheap alternatives to consumers, inhibiting manufacturing and other sectors from thriving.70 Kenya also relies on imports for key food items such as sugar, wheat and its products, vegetable oils, and milk.

Inclusive Finance for Sustainable Economic Development in Kenya

- **Vulnerability to Climate Change**: About 40% of Kenya’s gross domestic product (GDP) and 70% of overall employment is derived from natural resource-related sectors, including agriculture, mining, forestry, fishing, tourism, water supply and energy. This heavy dependence of the country’s economy and people on natural resources is the underlying reason for the high vulnerability of the same to the vagaries of climate change and climate variability. In addition, local environmental degradation impacts negatively on the country’s socio-economic development, as is witnessed in the rising costs of water treatment, declining agricultural productivity and production and therefore increasing food imports as well as increase in the cost of health. These are not only increasing human vulnerability and health insecurity, but also draining the country’s economic resources. Further, the expansion of human activities into marginal areas leading to clearance/destuction of natural habitats such as forests and wetlands has been a major driving force behind land degradation throughout the country. The continuous loss of biological resources translates into loss of economic potential and options for commercial development. Often, the impacts of local environmental degradation such as deforestation are intertwined with those of climate change create a vicious cycle. The World Bank puts the projected long-run impacts of global warming on Kenya’s GDP at -7.2%.

- **Income inequality**: UNDP points out that there is persistent high level of poverty and exclusion despite a decline in the poverty rate from 46.6% in 2005-2006 to 36.1% in 2015-2016. 73 Poverty rates

---

71 FSD Kenya (2021), Green Finance Project Design
72 FSD Kenya (2021), Green Finance Project Design
remain above 70% in remote, arid and sparsely populated north-eastern parts of Kenya. Income inequality levels have not decreased significantly in recent years. Kenya’s Gini coefficient of 44.57 is above the 2013 sub-Saharan African average of 43.8 and poverty is with the latest KIHBS results showing that 30.2% of female headed households are poor compared to 26% of their male counterparts. 75

• **Inequality in access to basic services.** There continues to be persistent inequality in access to health, education and housing in Kenya, with these inequalities often being mutually reinforcing. In terms of health, despite considerable health gains over the last decades, marked geographical and socio-economic inequalities in health have persisted in Kenya regarding reproductive, maternal and childcare, preventive care and immunisation, urgent care, inpatient and outpatient care utilisation. 76 Poverty levels are strongly associated with demand and availability of high quality, formal health care services. Poorer households more commonly rely on public care providers or use lower standard, often unlicensed, private care facilities, and the quality of service providers is lower in poorer areas. 77 Impoverished or lower socio-economic status individuals face larger barriers to accessing needed care services. Issues with care accessibility are exacerbated by low coverage of health insurance across Kenya favouring individuals who are wealthier, formally employed and have higher educational achievement.78

• In terms of education, while Kenya’s adult literacy rate is among the highest in Africa, Kenya’s rate of adult primary school completion is lower than in Ghana and Tanzania. 57.8% of all Kenyan adults above the age of 24 have completed primary education and only 14.4% of adults aged 25 and older have completed secondary education; far below rates found in other countries with comparable poverty rates. 79 Income inequality particularly affected enrolment in secondary education, with an enrolment ratio of greater than 100% for the top 20%, but only 44.6% among the bottom 20%. According to the World Economic Forum Future of Jobs and Skills in Africa Report, a Kenyan born in 2017 is likely to achieve at most 52% of their potential if they survive to adulthood because of gaps in the education and health systems.

• In terms of housing, most of the housing stock in Kenya is contained in sub-optimal conditions (either overcrowding, lack of access to water and sanitation, or very poor construction materials). In Nairobi alone, 60% of the population is housed in informal settlements, due to the ‘affordable’ rents in such structures, and proximity to work. The scale of the housing deficit is staggering; the FSD Network strategy estimated that Kenya requires nine million housing units over the next 20 years, requiring an investment of KShs 4.5 – 9 billion (using modest delivery costs of KShs 0.5 million to 1 million per housing unit). 80

• **Marginalisation of women and girls.**81 Female-headed households (single, divorced, and widowed women) are more likely to be poor compared to male-headed ones in Kenya and cultural norms limit women’s voice over economic decisions (such as related to investments, production, inheritance, and land and asset ownership). Women’s labour-force participation rate (LFPR) is high at 71% (men’s LFPR is 77%), but there are significant regional differences. Almost 50% of men and 30% of women are paid or waged employees, with women being paid just more than half of what men receive for similar jobs. Women are underrepresented in formal waged employment and more than half (54%) of micro small and medium enterprises (MSMEs) are owned by women; however, women-run enterprises earn 43% lower profits than those that men run. Women’s access to formal finance in Kenya is low at 12.3%. More women (31%) than men...
Inclusive Finance for Sustainable Economic Development in Kenya

(20%) rely exclusively on mobile money accounts, such as M-Pesa. Additionally, market systems in Kenya are traditionally gender blind, based on a false assumption of a level playing field, and thus fail to recognise and accommodate underlying gender inequalities that impact women’s abilities to compete with men for productive resources and opportunities.

- **Digital inequality and market concentration**: Income remains a key determinant of access and usage of digital devices, broadband and e-services (both public and private) in Kenya – with the affordability of handsets and credit reported as the main barrier to access and usage, followed by basic and digital literacy. An urban-rural divide also dominates Kenya’s digital economy landscape, where rural communities remain underserved by existing digital infrastructure, digital skills initiatives and digital entrepreneurship support networks. Equally, women remain underrepresented in technology, and persistent gender gaps remain in relation to mobile internet penetration (4%), awareness of mobile internet (16%), as well as spending on mobile services (29%). Further, while competition in the telecoms market has helped drive down prices, key market segments could benefit from greater competition, which would, *inter alia*, help boost access to connectivity and new digital financial services. The dominance of vertically integrated players in one market segment such as mobile money, mobile connectivity, content or e-commerce can have spillover effects in other market segments as consumers become locked into a single network and smaller players have difficulty competing. This presents a challenge to the long term dynamism of Kenya’s digital economy and a drag on investment, innovation and consumer welfare. Finally, the World Bank scores Kenya at 23 out of 100 for preparedness in terms of its ICT skills base, a sobering number on which to build a digital economy. This highlights the need for a not only thorough and equitable upskilling, but also a quick one if Kenya is to provide the domestic brain power required to exploit the available capital.

- **Growing informality in the labour force**: From the early 1990s, Kenya’s labour force has become increasingly informal in nature.

---

**Formal and informal employment in Kenya (1981-2018)**

(Source: Ahmed, A (2019), ‘Inter-industry gender wage differentials in Kenya’, University of Nairobi)
In 2015, the informal sector accounted for 81.5% of total jobs. This went up slightly to 82.9% in 2019 but constituted 90.7% of total new jobs created in the economy outside of small-scale agriculture.

This shift has been informed by numerous internal and external factors that emerged from local and global sources over time. The main result of this shift is that today the bulk of Kenyans earn their living from informal Micro and Small Enterprise activity.

- **Kenyan population is dominated by young people:** 35.7 million Kenyans (75.1%) are below 35 years of age and young adults (18 to 34 years of age) constitute 29% of the total population.

- The result is that about 800,000 youth enter the labour market annually and yet they comprise the largest unemployed demography, often resorting to informal business activity to earn a living. Factors that prevent the country from effectively supporting and drawing on the strengths of a youthful population include fragmented youth policies and lack of coordination; knowledge gaps on the effectiveness and impact of youth initiatives; lack of meaningful youth participation in design and formulation of youth policy; politicisation of youth initiatives; and the mismanagement of public funds including overall lack of accountability on funds targeted at the youth.

**Source:** KNBS (2020), Economic Survey 2020

---

**Figure A6: New jobs Created, 2015-2019**

![Chart showing new jobs created in Kenya from 2015 to 2019.](chart_image)

**Source:** KNBS (2020), Economic Survey 2020

---

**Figure A7: Kenya population pyramid, 2019**

![Population pyramid showing the age distribution in Kenya in 2019.](population_pyramid_image)

**Source:** KNBS (2020), ‘2019 Kenya Population and Housing Census: Volume III’

---

88 Ibid.