Making financial markets work for the poor: 
*From theory to praxis*

BDS Seminar 2005
Turin

David Ferrand
FSD Kenya
Making financial markets work in Kenya

1. Conceptual issues
2. Understanding the market in Kenya
3. An incomplete vision of the future
4. Actions
5. Emerging lessons

praxis (n) Action, practice; specifically the practice of a technical subject or art … arising out of the theory of it. (Oxford English Dictionary)
Conceptual issues
Conceptual issues: definitions

When do financial markets work for the poor?

- **Accessibility and appropriateness**

  Access, price and conditions together comprise ‘the deal’ offered to poor people by markets. [Making markets] … is about enhancing the nature of the deal (Gibson, Scott & Ferrand, 2004)

  - Conceptually clear but difficult to operationalise

- **Usage**

  1. *Usage by poor people is increasing over time*
  2. *There are alternatives available* (Porteous, 2004)

  - Readily measurable
  - Usage of what? formal – semi-formal – informal
Dimensions of access

*Spectrum of pro-poor finance*

Transactions - Savings - Credit - Insurance
Dynamics of market development

The formal access frontier

Porteous (2004, 2005)
## Dynamics of market development

### Benefits of formalisation of financial systems

<table>
<thead>
<tr>
<th>Category</th>
<th>Benefits</th>
<th>Relevance to low income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Transactions</strong></td>
<td>- ability to send/receive money over long distances - network externalities</td>
<td>- high – especially for international and national remittances/transfers</td>
</tr>
<tr>
<td><strong>Savings</strong></td>
<td>- safety of deposits – regulation and supervision guaranteed liquidity</td>
<td>- moderate-high – personalised systems can be quite robust</td>
</tr>
<tr>
<td><strong>Credit</strong></td>
<td>- greater risk pooling</td>
<td>- low – lower income groups typically don’t require large or long term loans</td>
</tr>
<tr>
<td></td>
<td>- higher loan amounts</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- increased product flexibility</td>
<td></td>
</tr>
<tr>
<td><strong>Insurance</strong></td>
<td>- greater risk pooling</td>
<td>- high – problem of covariant risk likely to be major problem</td>
</tr>
<tr>
<td></td>
<td>- safety - regulation</td>
<td></td>
</tr>
</tbody>
</table>
Dynamics of market development

Cost barriers to formalisation?

- Unit transaction costs
- Unit labour costs
- Unit automation costs

Informal (eg: ROSCAs, SLAs)
Semi-formal (eg: small SACCOS)
Formal non-regulated (eg: MFIs)
Formal regulated (eg: banks)

Impact of formal regulation

Limit of use of ICT

Shadow unit risk costs
The structure of markets
An institutional perspective

Macro-level: the enabling environment

Meso-level: industry/sector supports

Micro-level: retail providers
- eg: banks, MFIs, SACCOs

Transactions
- eg: credit reference, business services, research

eg: policy, legislation, regulation, supervision
Understanding the market in Kenya
# Background

**A very short historical overview**

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Events</th>
</tr>
</thead>
</table>
| **1900 – 1963** (colonial period) | - Monetisation of economy gathered pace in early colonial period  
- Major commercial banks (eg: Barclays, Standard opened in Kenya)  
- Kenya Post Office Savings Bank started in 1910 |
| **1963 – 1989** (post-independence) | - Nationalisation/state banks established soon after independence  
- Development finance institutions (DFIs) established  
- Financial crises in non-bank financial institutions  late1980s |
| **1990s - 2003** | - Financial market liberalisation  
- Rapid growth of financial co-operatives (SACCOs)  
- Emergence of NGO micro-finance industry  
- Further banking crisis in mid 1990s, mounting bad debts in state institutions |
| **2003 - current** | - Financial sector reform programme initiated; major decline in interest rates  
- Joint donor working to support market based reform programme |
## Snap-shot of the financial sector

<table>
<thead>
<tr>
<th>Category</th>
<th>Institutions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Formal, regulated</strong></td>
<td>45 commercial banks</td>
</tr>
<tr>
<td></td>
<td>2 mortgage finance companies, 1 building society</td>
</tr>
<tr>
<td><strong>Formal, non-regulated</strong></td>
<td>1 Post office savings bank</td>
</tr>
<tr>
<td></td>
<td>107 Savings and credit co-operatives: 20 large (&gt; 10,000 members) 87 medium (1 – 10,000 members)</td>
</tr>
<tr>
<td></td>
<td>42 Microfinance institutions: 4 large (&gt; 10,000 clients) 38 medium (1 – 10,000 clients)</td>
</tr>
<tr>
<td></td>
<td>9 Hire purchase (HP) companies</td>
</tr>
<tr>
<td></td>
<td>4 State owned development finance institutions (DFIs)</td>
</tr>
<tr>
<td><strong>Semi-formal</strong></td>
<td>2,557 small SACCOs (&lt;1,000 clients)</td>
</tr>
<tr>
<td></td>
<td>71 financial service associations (FSAs)</td>
</tr>
<tr>
<td></td>
<td>12 managed accumulating savings and credit associations (ASCAs)</td>
</tr>
<tr>
<td><strong>Informal</strong></td>
<td>Accumulating savings and credit associations (ASCAs)</td>
</tr>
<tr>
<td></td>
<td>Rotating savings and credit associations (ROSCAs)</td>
</tr>
</tbody>
</table>
Access to a bank account

Coverage of adult populations

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>EU average</th>
<th>South Africa</th>
<th>Kenya (estimated)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Coverage of adult populations</td>
<td>100.00%</td>
<td>100.00%</td>
<td>80.00%</td>
<td>20.00%</td>
</tr>
</tbody>
</table>
A fragmented formal market

*Competition, state involvement and regulation*

- Weak **competition** within banking system
  - Sustained **high returns** among international banks (Barclays, Standard ROCE >40% for last two years)
  - **Low returns** in many other institutions (2004 industry avg. ROCE 16%)
  - Political intervention in state-owned institutions – **banks** and **DFIs**

- **Past regulatory failures**
  - successive **banking crises**
  - high levels of **non-performing loans** accumulated (peaked at >30%)
  - SACCOs **unregulated** but growing and **taking deposits** (largest 3 SACCOs would rank in top 20 banks by assets)

- **Weaknesses in lending environment**
  - commercial justice system, collateral registries, company registry
  - no credit information exchange

- **Gap** between **actual access** and **access frontier**
Solving financial needs
Multiple solutions across market segments
Market development

Evidence of success: Equity Bank Ltd

- **Five fold growth** in less than 5 years in clients to exceed \( \frac{1}{2} \) million
- Average deposit $170, average loan outstanding $500
- Return on shareholders funds >20% (year to May 05)
- Meeting all **prudential requirements** comfortably

![Growth in number of deposit accounts](chart.png)
Market development

Evidence of success: 3 MFIs achieved profitability

• Kenya Women Finance Trust
  – Average loan outstanding $260
  – Over 75,000 loan clients
  – Financial self sufficiency 108%
  – Portfolio at risk (>1 day) 4%

• Faulu Kenya
  – Achieved financial self sufficiency
  – Issued first micro-finance bond (with enhancement) on NSE

• K-Rep Bank
  – Kenya’s first micro-finance bank
An incomplete vision of the future
Financial sector reform in Kenya

Supporting broad based growth

Broad based economic growth

Financial sector reforms

Efficiency  Access  Stability
The start of a vision

*Putting market development into practice*

- Economic Recovery Strategy (ERS - Kenya’s PRSP), commits to **private sector led growth**
- Broad agreement that **financial market development** should be **private sector led**
- Target of **20% increase** in access within 5 years (roughly 1 million Kenyans)
- Agreement on the need for a **financial sector strategy**
- **Kenya remains some distance from a clear vision**
Towards a vision

*Elements of an emerging strategy*

- **Building the formal core**
  - Developing *competitive* pro-poor financial markets
  - *Consolidation* to produce small number of *efficient, large scale providers*

- **Extending** the frontier
  - *Technology* driven innovations
  - Risk market *integration*

- **Integrating** the financial system
  - Bringing *non-regulated formal providers* within regulatory reach
  - Linking *large numbers* of *semi-formal providers* into *formal system*

*But*

- dilemmas in the *supra-market zone*
The supra-market zone

Challenges of market redistributive policies

- Political economic realities
- Problem of state intervention
  - poor record of state intervention
  - fiscal costs – competing priorities
- Antithetical to market development approach?
  - subsidies can discourage expansion of the frontier
- Inadequate information
  - where is the supra-market zone located?
  - informal provision and the needs of the poorest?
Actions
Supporting market development

Tools to implement a market making strategy

- **Financial and legal sector technical assistance project (FLSTAP)**
  - Government of Kenya Programme
  - Funded by World Bank and DFID
  - Focus on macro-level/enabling environment
  - High level government engagement

- **Financial Sector Deepening Trust (FSD Kenya)**
  - Independent trust funded by development partners
  - Industry focussed
  - Committed to market making approach
  - Uses multiple instruments: from subsidies to investment
### Building the formal core

*Moving towards the access frontier*

| Enabling environment | • **institutional reforms** commercial justice system, registries, credit reference agencies  
| Industry infrastructure | • **resolution** of state owned banks  
| | • strengthening of financial **regulation** and **supervision**  
| | • **household survey** of levels of access to financial services in Kenya  
| | • **MicroSave** project – creating the know-how to develop market led microfinance  
| Retail capacity | • **human capacity development** – training and capacity to train  
| | • **technical assistance** to major retail providers  

*macro-level*

*meso-level*
# Extending the Frontier

*Innovations to push the access frontier*

<table>
<thead>
<tr>
<th>Enabling Environment</th>
<th>legislative and regulatory working group to assess needs for new technologies (e.g., cell phones)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry Infrastructure</td>
<td>index based weather and commodity price insurance studies to ascertain the viability of commercial products for smallholder agriculture</td>
</tr>
<tr>
<td></td>
<td>sme finance action research programme to develop know-how for financing small and medium enterprise</td>
</tr>
<tr>
<td>Retail Capacity</td>
<td>new technologies - cell-phone based payments systems</td>
</tr>
<tr>
<td></td>
<td>innovations challenge fund targeting innovations from the industry in products and delivery channels</td>
</tr>
</tbody>
</table>
## Integrating the financial system

*Reaching across the frontier*

<table>
<thead>
<tr>
<th>Enabling environment</th>
<th>new SACCO bill, regulations and regulatory agency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry infrastructure</td>
<td>new micro-finance deposit taking bill</td>
</tr>
<tr>
<td>Industry infrastructure</td>
<td>strengthening business service providers to support SACCOs</td>
</tr>
<tr>
<td>Industry infrastructure</td>
<td>decentralised financial systems project developing sustainable community based financial organisations</td>
</tr>
<tr>
<td>Industry infrastructure</td>
<td>financial services associations (FSA) investment in creation of FSA business service companies</td>
</tr>
<tr>
<td>Retail capacity</td>
<td>technical assistance to transforming micro-finance institutions</td>
</tr>
<tr>
<td>Retail capacity</td>
<td>smaller institutions capacity building fund to target SACCOs and MFIs</td>
</tr>
</tbody>
</table>
Emerging lessons
From theory to praxis
Emerging lessons from Kenya

• Early days
  – Improving information vital
  – Weak understanding of the vision for semi-formal institutions

• Implementation
  – Appropriate mechanisms for intervention appears key
  – Effective donor co-ordination likely to be major factor
  – Capacity in policy makers/government

• Political economy
  – Dealing with the ‘supra-market’ remains a challenge
  – Political commitment linked to pace of change
Thank you

Some discussion issues…

• When are markets working for the poor?

• Evolutionary versus revolutionary market development processes

• The supra-market debate

• Political economy of making markets