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

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Turin

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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

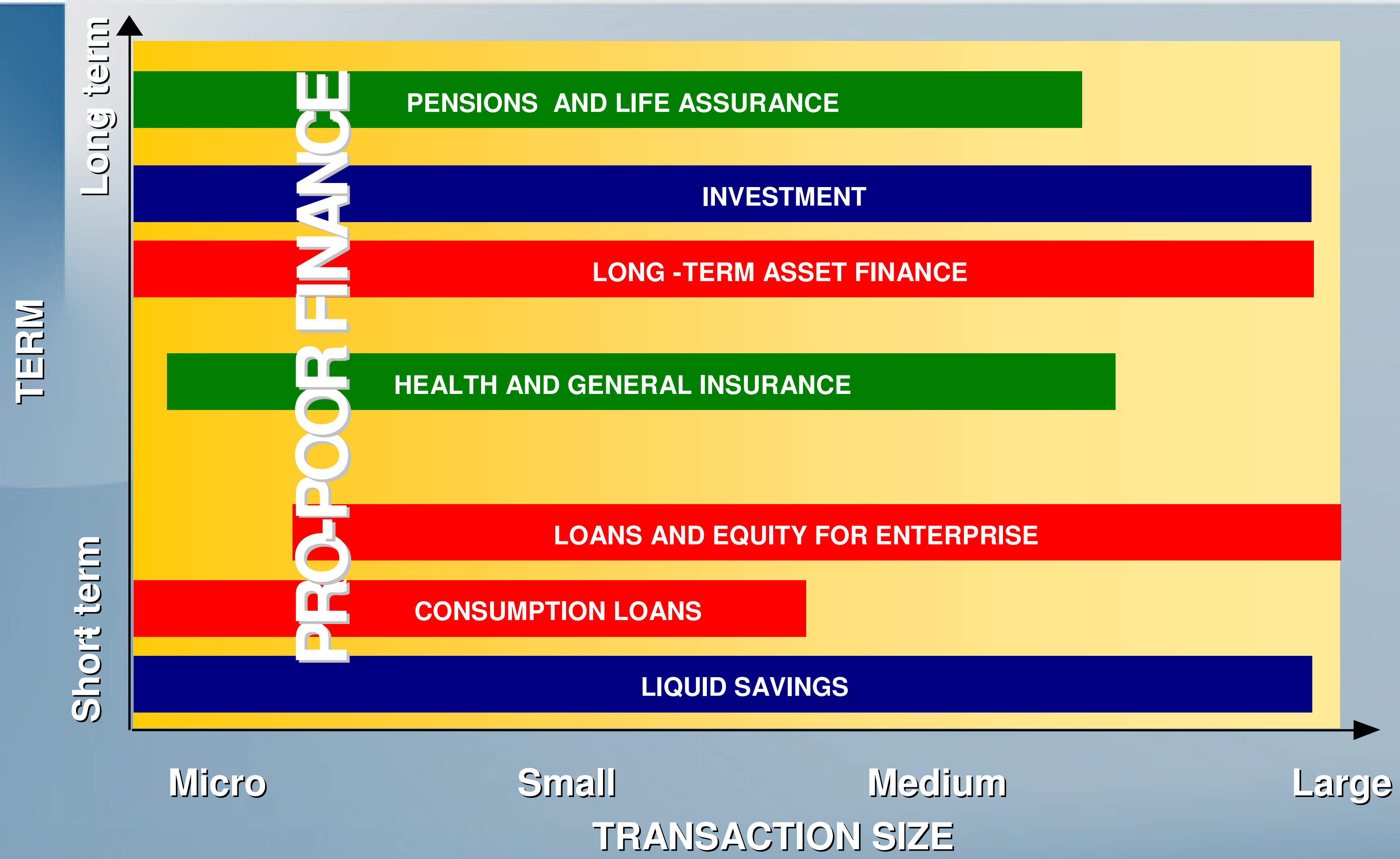
- **Usage**

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

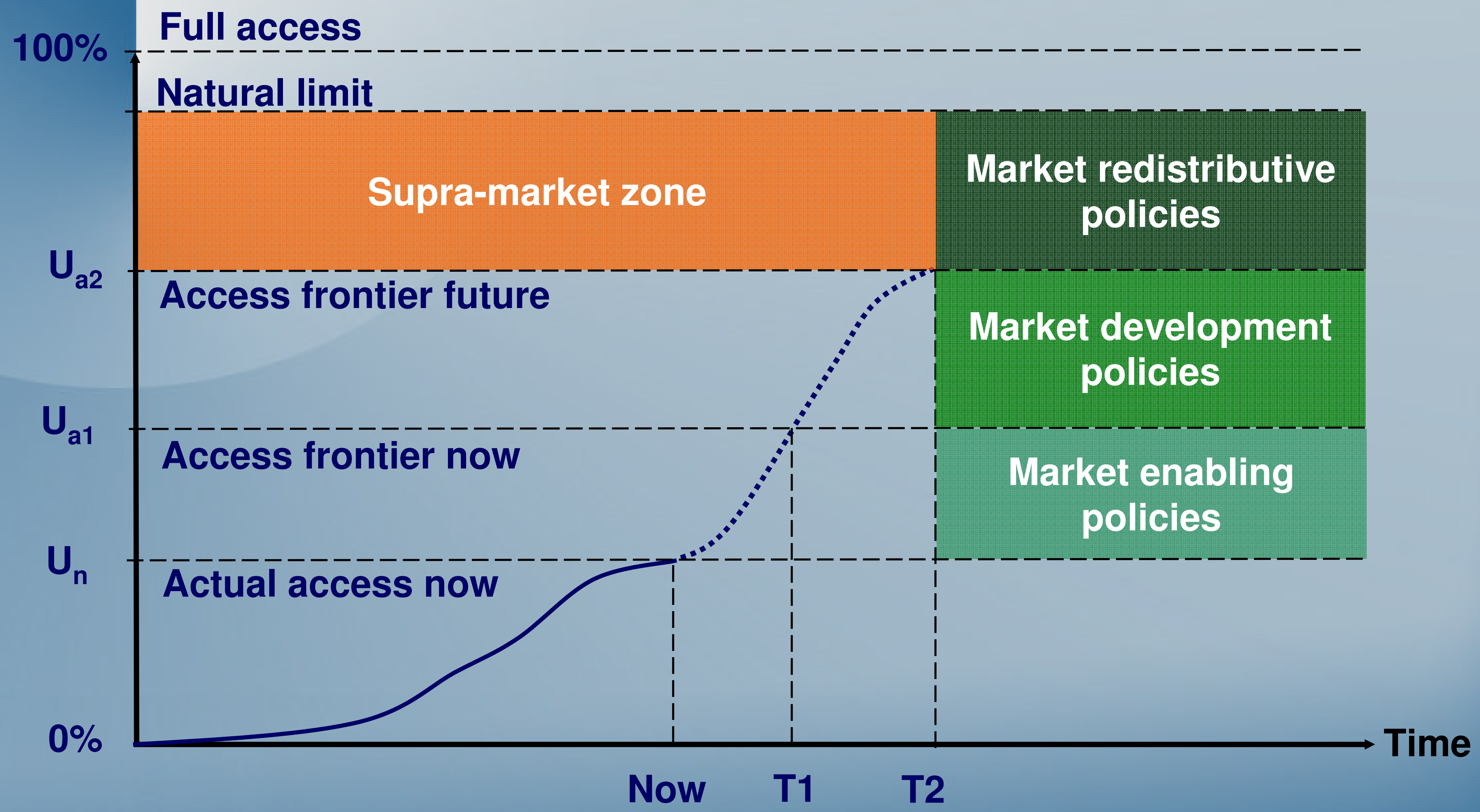
Spectrum of pro-poor finance



Transactions - Savings - Credit - Insurance

Dynamics of market development

The formal access frontier



Porteous (2004, 2005)

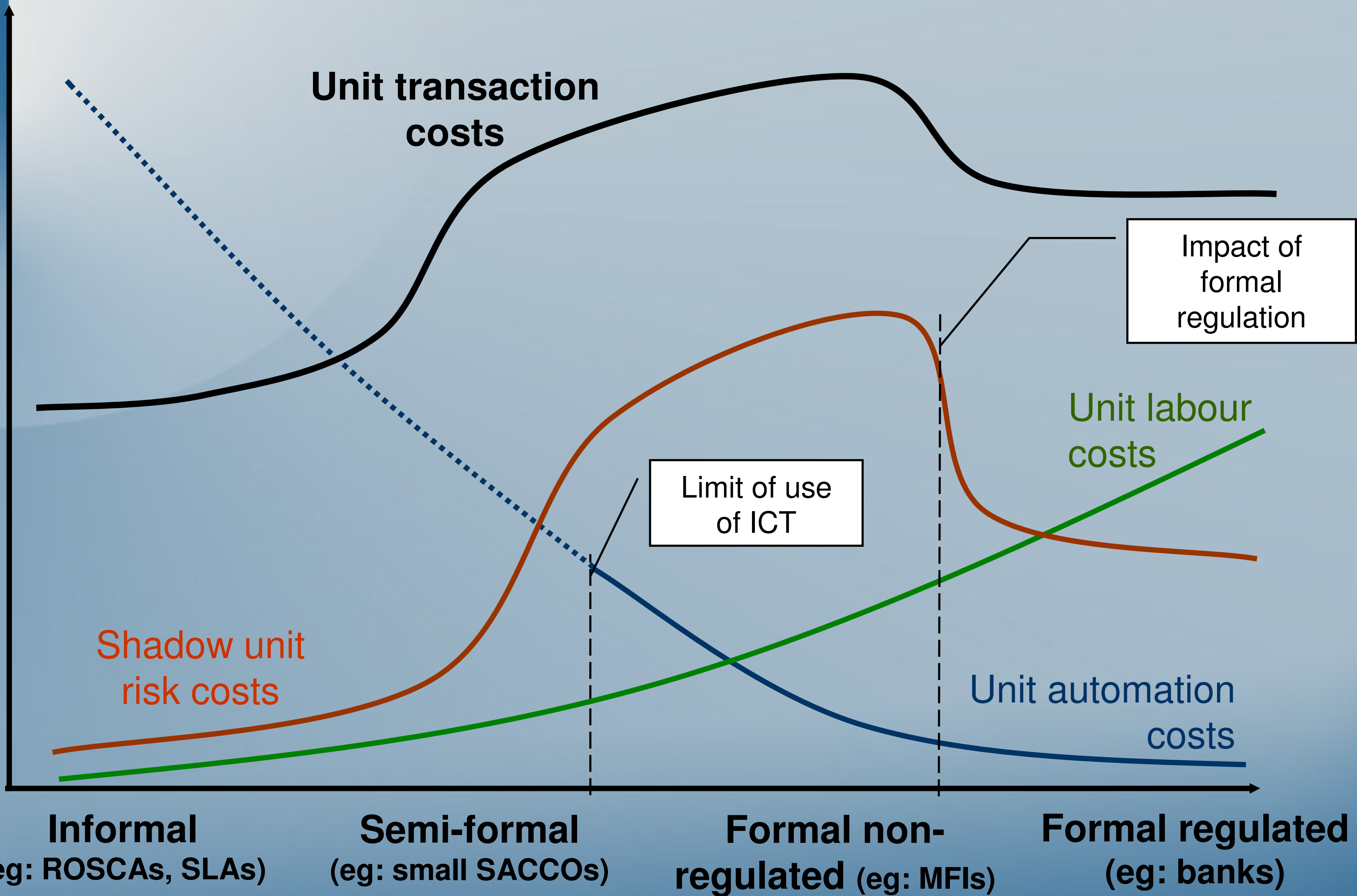
Dynamics of market development

Benefits of formalisation of financial systems

Category	Benefits	Relevance to low income
Transactions	▪ ability to send/receive money over long distances - **network externalities**	▪ **high** – especially for international and national remittances/transfers
Savings	▪ **safety** of deposits – regulation and supervision ▪ guaranteed **liquidity**	▪ **moderate-high** – personalised systems *can* be quite robust
Credit	• greater **risk pooling** • higher loan **amounts** • increased product **flexibility**	• **low** – lower income groups typically don't require large or long term loans
Insurance	▪ greater **risk pooling** ▪ safety - **regulation**	▪ **high** – problem of covariant risk likely to be major problem

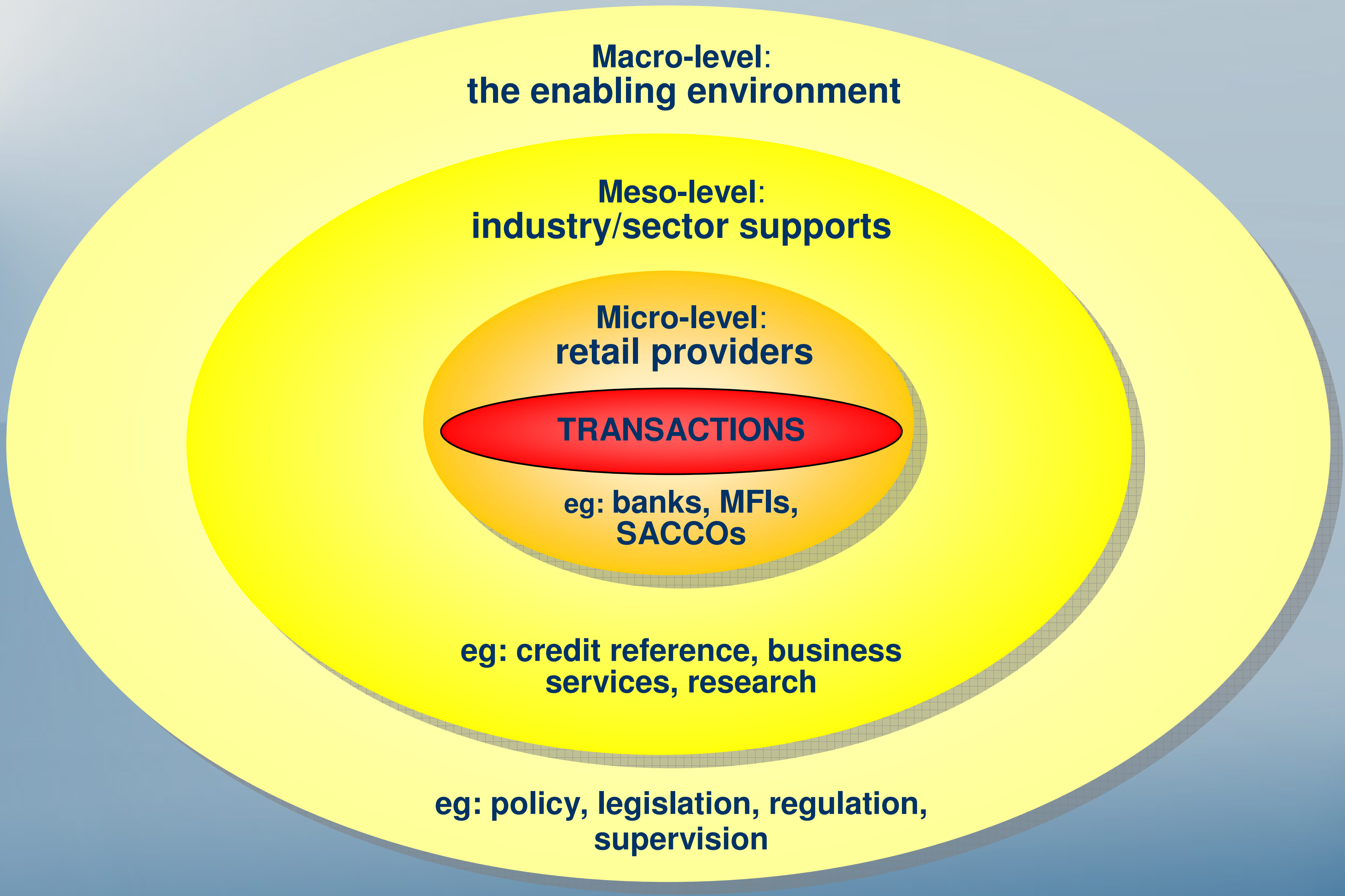
Dynamics of market development

Cost barriers to formalisation?



The structure of markets

An institutional perspective



Understanding the market in Kenya

Background

A very short historical overview

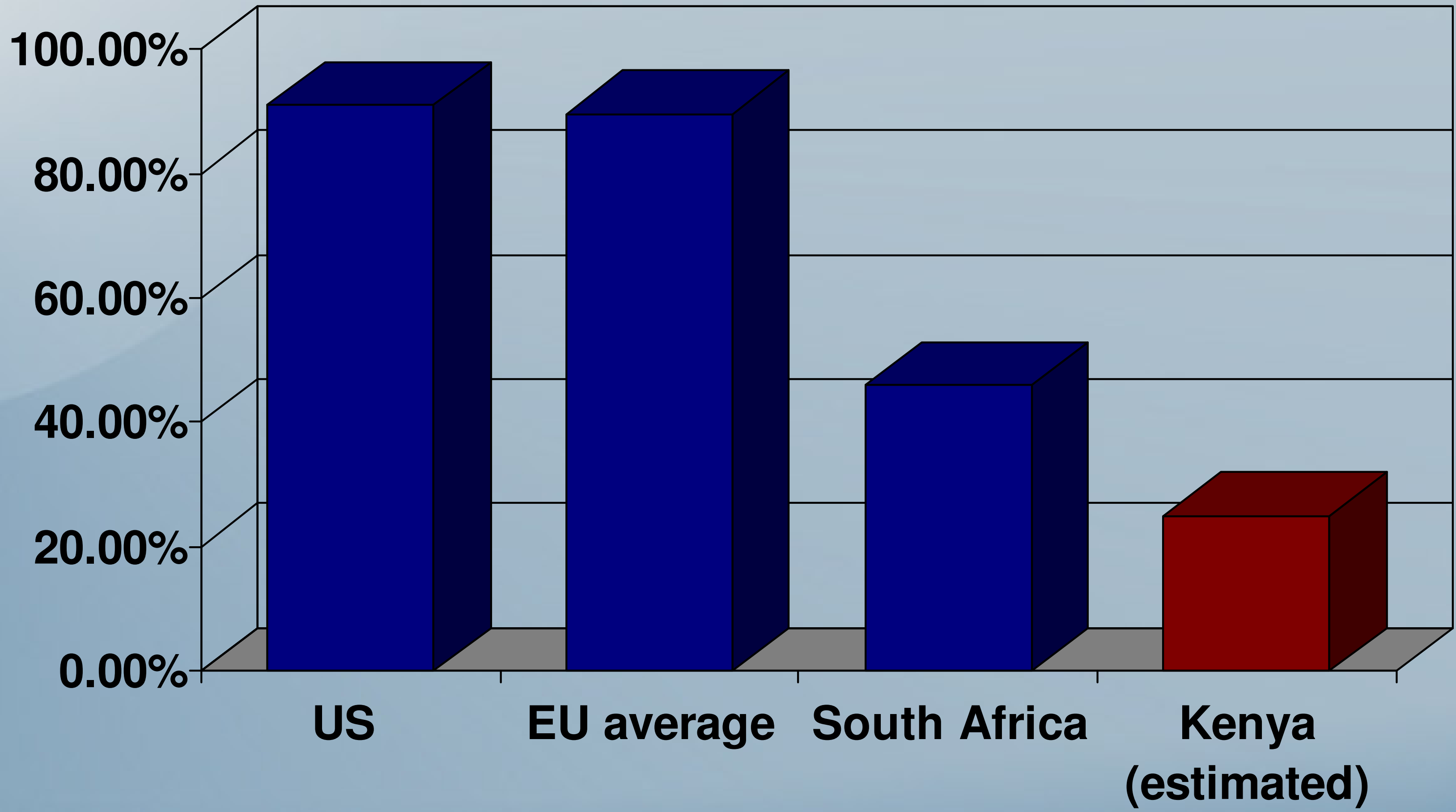
1900 – 1963 (colonial period)	▪ Monetisation of economy gathered pace in early colonial period ▪ Major commercial banks (eg: Barclays, Standard opened in Kenya) ▪ Kenya Post Office Savings Bank started in 1910
1963 – 1989 (post-independence)	▪ Nationalisation/state banks established soon after independence ▪ 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

Category	*Institutions*
Formal, regulated	▪ 45 commercial banks ▪ 2 mortgage finance companies, 1 building society
Formal, non-regulated	▪ 1 Post office savings bank ▪ 107 Savings and credit co-operatives: (SACCOs) — 20 large (> 10,000 members); 87 medium (1 – 10,000 members) ▪ 42 Microfinance institutions (MFIs) — 4 large (> 10,000 clients); 38 medium (1 – 10,000 clients) ▪ 9 Hire purchase (HP) companies ▪ 4 State owned development finance institutions (DFIs)
Semi-formal	• 2,557 small SACCOs (<1,000 clients) • 71 financial service associations (FSAs) • 12 managed accumulating savings and credit associations (ASCAs)
Informal	▪ Accumulating savings and credit associations (ASCAs) ▪ Rotating savings and credit associations (ROSCAs)

Access to a bank account

Coverage of adult populations



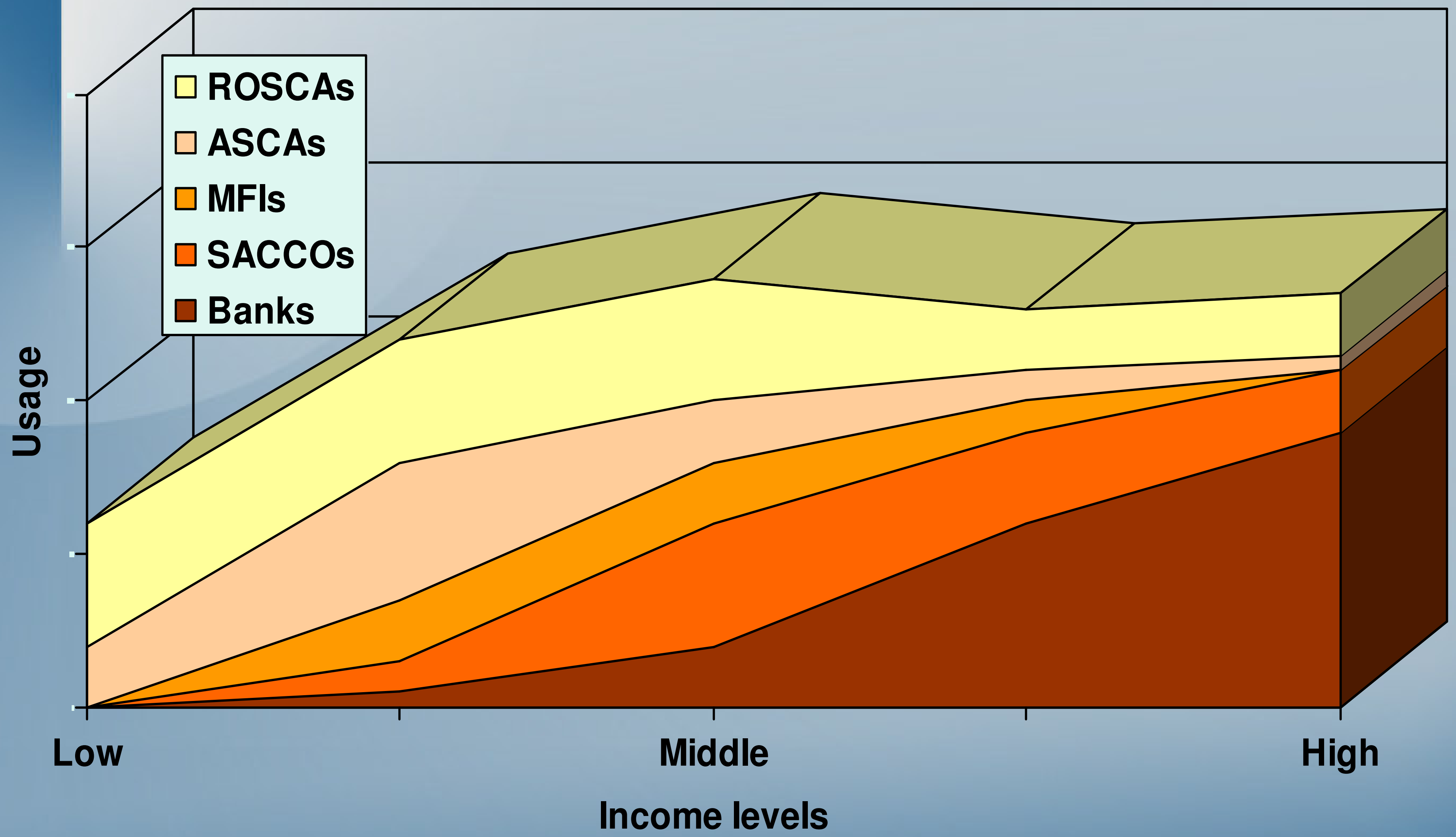
A fragmented formal market

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

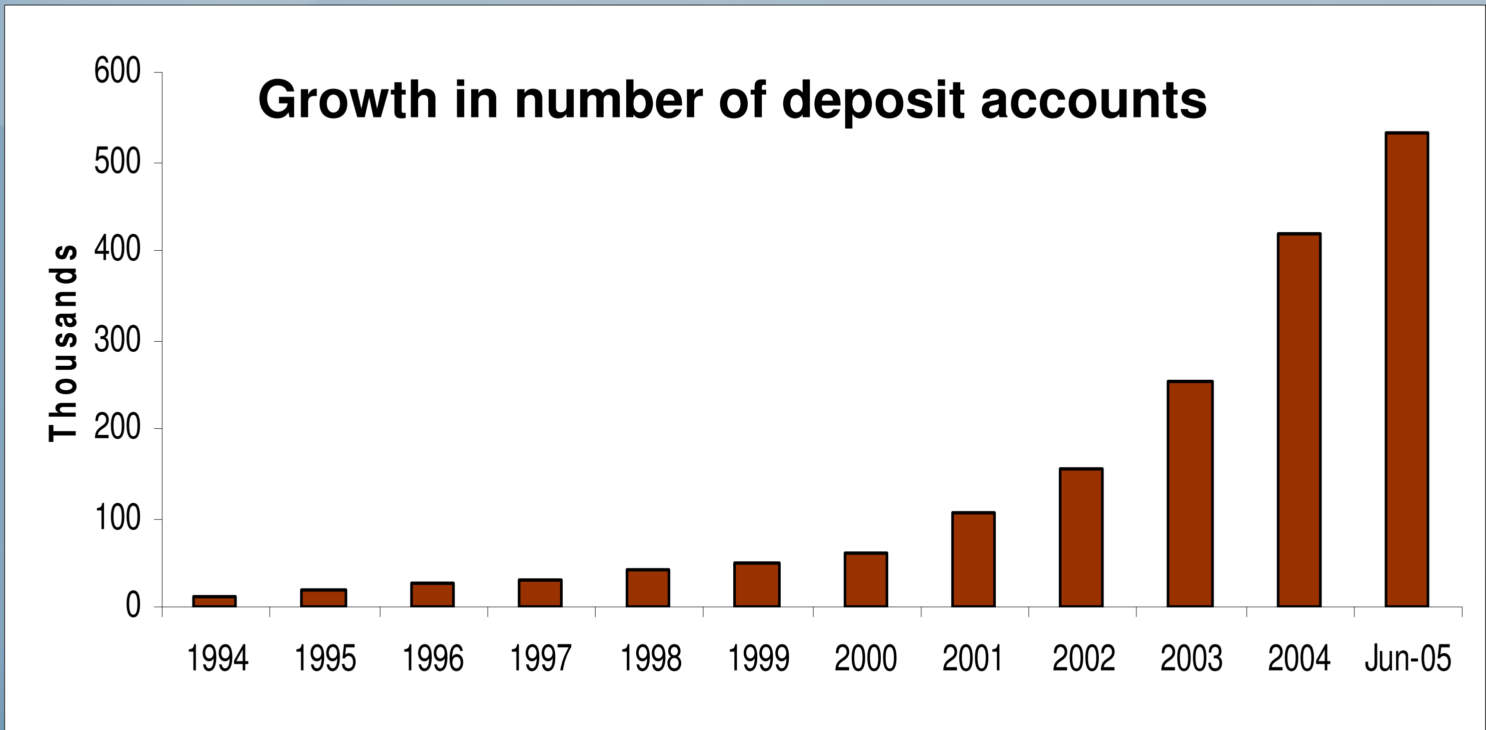
Multiple solutions across market segments



Market development

Evidence of success: ***Equity Bank Ltd***

- **Five fold growth** in less than 5 years in clients to exceed **½ million**
- Average deposit **$170**, average loan outstanding **$500**
- Return on shareholders funds **>20%** (year to May 05)
- Meeting all **prudential requirements** comfortably



Market development

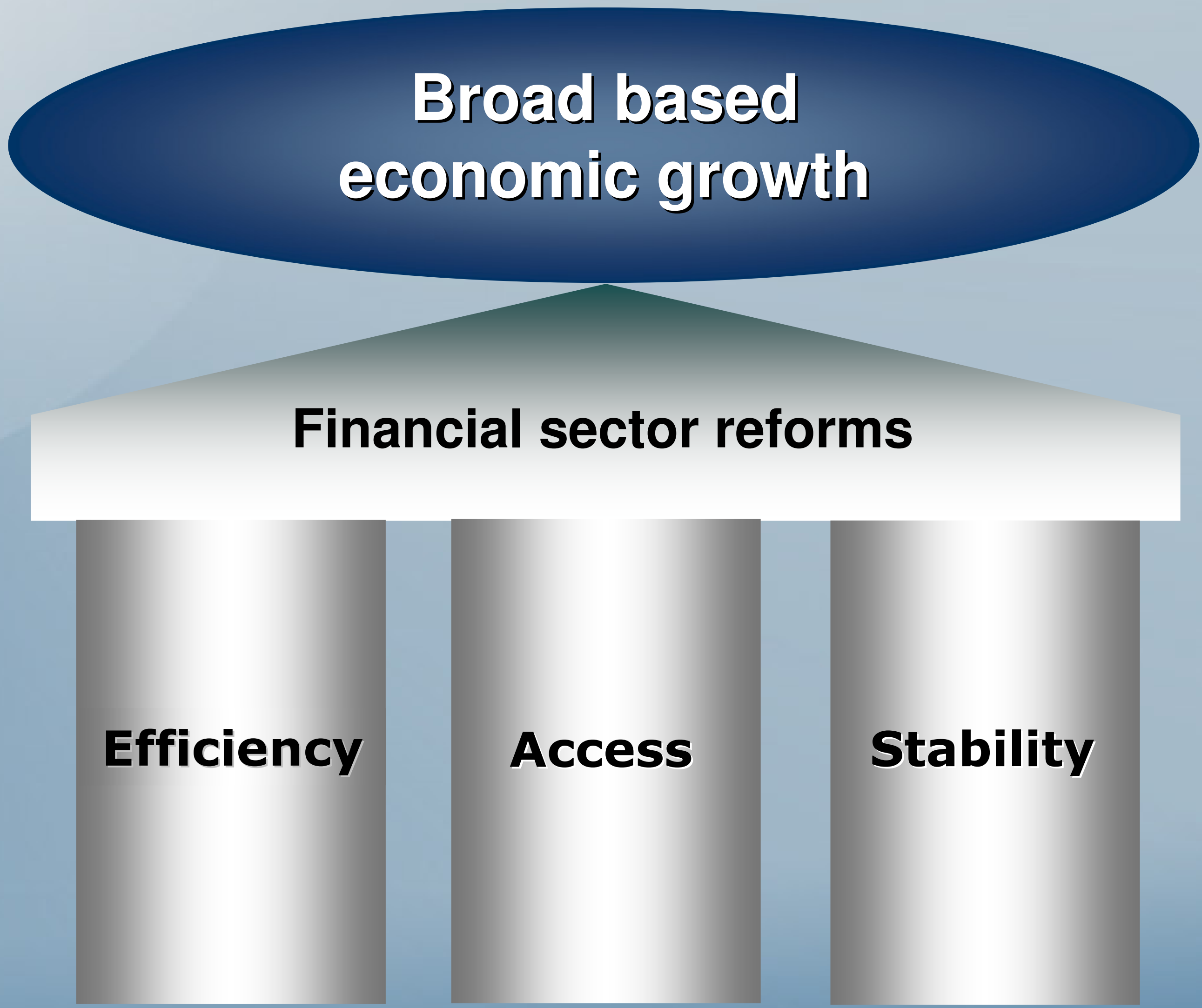
Evidence of success: ***3 MFIs achieved profitability***

- **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



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

Extending the frontier

Innovations to push the access frontier

Enabling environment *macro-level*	▪ **legislative and regulatory working group** to assess needs for new technologies (eg: cell phones)
Industry infrastructure *meso-level*	▪ **index based weather and commodity price insurance studies** to ascertain the viability of commercial products for smallholder agriculture ▪ **sme finance action research programme** to develop know-how for financing small and medium enterprise
Retail capacity *micro-level*	• **new technologies** - cell-phone based payments systems • innovations **challenge fund** targeting innovations from the industry in products and delivery channels

Integrating the financial system

Reaching across the frontier

Enabling environment *macro-level*	▪ new **SACCO bill, regulations** and regulatory agency ▪ new **micro-finance deposit taking** bill
Industry infrastructure *meso-level*	▪ strengthening business service providers to support SACCOs ▪ **decentralised financial systems project** developing sustainable community based financial organisations ▪ **financial services associations (FSA)** investment in creation of FSA business service companies
Retail capacity *micro-level*	▪ **technical assistance** to transforming micro-finance institutions ▪ **smaller institutions capacity building fund** to target SACCOs and MFIs

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*