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FINANCIAL INCLUSION AND DEVELOPMENT: RECENT EVIDENCE OF AGENCY BANKING IN KENYA

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ABSTRACT

Global and national-level policy makers have been embracing financial inclusion as an important development priority. Financial inclusion is highly topical globally hence made one of its pillars at the G20 2009 Pittsburgh Summit. By end-2013, more than 50 national-level policy-making and regulatory bodies had publicly committed to financial inclusion strategies for their countries. The World Bank in October 2013 postulated the global goal of universal access to basic transaction services as an important milestone toward full financial inclusion - a world where everyone has access and can use the financial services to capture opportunities and reduce vulnerability. Policy makers have articulated these objectives in the conviction that financial inclusion can help reduce poverty, improve household welfare and spur economic activity. It is recognised that technologies can play a crucial role in this endeavour. In this paper, we assess developments in technologies and deploying agency banking as a strategy adopted by commercial banks to bring on board vast majority of the population in Kenya resulting to a third of banking transaction handled at agency level. This paper is in four parts, starting with the introduction of financial inclusion followed by background of agency banking including exploring how access and use of financial services can benefit the majority of the marginalised people. Methodology is in section three. Literature review summarizes recent empirical impact evidence at the microeconomic, local economy, and macroeconomic levels and how inclusive, low-cost financial systems can generate additional, indirect benefits for other public-sector and private-sector efforts. Data analysis of agency banking in Kenya comes next before conclusions and implications in section six ending the paper. The results show that financial inclusion in Kenya through agency banking model brought lots of marginalised people and communities on the financial platform easing transaction time, reducing vulnerabilities, smoothing consumption patterns and outreaching remotest areas of Kenya, among others.

INTRODUCTION

Vast majority of poor households live and work in the informal economy with less access to productive resources including finance from the formal sector. This has over the years aggravated their condition including difficulties in gaining wage-earning opportunities. They live and work in the informal economy—not by choice, but by necessity. In economic terms, they are consuming households and self-employed firms at the same time; thus consumption and production decisions are intertwined. As a result, they need a broad range of financial services to create and sustain livelihoods, build assets, manage risks, and smooth consumption.

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This manifest a global chain call from policy makers, multilateral organisations and governments to bring finance to the doorsteps of the majority of the population in developing countries who are generally unbanked and under-banked. Empirically, financial diaries literature has illustrated this point by showing how poor families in the informal economies of developing countries actively manage their financial lives to achieve these multiple objectives (Collins, Murdoch, Rutherford, and Ruthven 2009). They save and borrow constantly in informal ways. At any given time, the average poor household has a large number of ongoing financial relationships. Financial management, for the poor, is a fundamental and well-understood part of everyday life. Estimates of the share of the world population living and working in the informal economy averaged between 50 percent and 60 percent (World Bank 2012), across all countries and income groups. The share of informality is considerably higher for poorer countries and poorer income

segments and can reach well over 80 to 90 percent in some developing countries (ILO 2013). The share of informal employment is mirrored in the estimates for financial access. Globally, about half of all working-age adults are excluded from formal financial services (CGAP 2014). For the lowest income quintile, 77 percent are excluded (Demirgüç-Kunt and Klapper 2012). In countries such as Cambodia, the Central African Republic, and Niger only 2–4 percent of all adults have an account at a formal financial institution (CGAP 2014). Kenya recorded 25.4% in 2003 (FinAccess Survey 2013)up to 27% in 2009. Without access to formal financial services, poor families must rely on age-old informal mechanisms: family and friends, rotating savings schemes, the pawn-broker, the moneylender, money under the mattress, among others. At times, these informal mechanisms represent important and viable value propositions. Often, however, they are insufficient and unreliable, and they can be very expensive. Financial exclusion tends to impose large opportunity costs on those who most need opportunity.

Background of Agency Banking in Kenya

Kenya's financial sector consists of 43 commercial banks, 9 microfinance banks and 94 forex bureaus. Kenya bankable financially exclusive stood at 25% at end 2013 from 37% in 2009. In line with Government of Kenya Vision 2030 of full financial inclusion, commercial banks and microfinance banks were allowed to operate Agency banking on November 22, 2010 to bank the majority unbanked and under-banked population in the suburbs, rural and remote communities of Kenya with wide range of financial products and services included but not exhaustive of the following:

- Deposits
- Withdrawals,
- remittances,
- Insurance,
- Utilities payments – water, electricity
- Loans repayments
- Mobile top-ups, energy
- Cash payment of retirement and social benefits
- Cash payment of salaries
- Transfer of funds
- Balance Enquiries
- Generation and issuance of mini bank statements

The objectives of agency banking introduction are many but ultimately to bring on board majority of the population who remain unbanked and underbanked in Kenya. The following are key:

- To provide a framework for conducting the Agent Banking Model as an alternative delivery channel – *for offering financial services in an efficient and cost effective manner.*
- To ensure that the agent banking model increases the outreach as well as promote financial inclusion to the unbanked and under-banked population – *without risking the safety and soundness of the banking system.*
- To provide a framework for data and network security, customer protection and risk management.

Agency banking is governed by a guideline showing the detail aspects of agency banking, codes of conduct, permissible and non-permissible activities. The guideline identifies eligible entities to engage in agency banking include the following as shown in Table 1. It expands from sole trading, to partnerships, private and public companies, NGOs and faith-based organisations, etc.

Table 1. Eligible Entities

Limited Liability Companies	Post offices
Sole proprietorships	Non-bank financial institutions like SACCOS and microfinance institutions.
Partnerships Societies	Supermarkets.
Cooperative Societies	Petrol stations.
State Corporations	Telecommunication companies.
Trusts	Courier companies.
Public Entities	Security companies.
Faith-based organizations	Wholesale distributors.
Not-for-profit organizations	Educational institutions
Non-governmental organisations	Any other entity Central Bank may prescribe

Source: Central Bank of Kenya

Agency Banking draws considerable benefits to the bank and the agent in terms of volume of savings mobilisation, increase outreach and output on the part of the commercial banks and commissions for agents. The following lists the benefits accrued to the commercial banks engaging in agency banking.

- Decongest branch networks-Improved direct branch productivity
- Increased revenues-interest and transactional income
- Target a new customer segment and increase market share.
- Good mobiliser of cheap deposits
- Expand the geographical coverage.
- Create a virtual bank without owning the infrastructure-low cost of doing business (no salary, utilities, repair costs)
- Extended banking hours after banks closure, public holidays, Saturdays and Sundays making access to banking services available.
- Take banking services within customer's reach.
- Brand visibility

Benefits to the Agents

- High turnover due to increased traffic –Insurance
- Increased revenue - Float financing
- Enjoy affiliation with bank brand
- Free Training and increased customer base

MATERIALS AND METHODS

This methodology uses an annual number of financial institutions engaging in agency banking and mobile banking using Point of Sale terminal and mobile phone in Kenya. With the increasing deposit mobilisation, market share and increasing geographical coverage annually, many financial institutions became involve as shown in Table 2. The general thrust of this new body of evidence suggests that financial services do have a positive impact on a variety of microeconomic indicators, including self-employment business activities, household consumption, and well-being

(Bauchet *et al*., 2011). The effect on credit and savings mobilisation, micro economic activity, macro level and household are analysed to have an insight into the importance of financial inclusion in Kenya.

Literature

Two main patterns stand out in the impact evaluations of microcredit; small businesses do benefit from access to credit and has enhanced *household welfare* such as an increase in consumption or income in poor households (Banerjee, Duflo, Glennerster, and Kinnan 2010 and 2013; Crépon, Devoto, Duflo, and Parienté 2011; Karlan and Zinman 2011; Angelucci, Karlan, and Zinman 2013). An update of the Spandana study in Hyderabad (Banerjee, Duflo, Glennerster, and Kinnan, 2013), which provides longer-term results of borrowers after three years, did find later-stage improvements in welfare as a result of increased access to microcredit. The study also showed improvements in longer-term welfare indicators, such as education, health, or women's empowerment. However, some studies suggested nuances and found some welfare impacts. A study in Mongolia (Attanasio *et al*., 2011) found greater financial inclusion having greater impacts of individual and group loans on food consumption. The authors see better monitoring in the group setting and, therefore, larger long-term effects as the reason for these results. They hypothesize that "the joint-liability scheme better ensures discipline in terms of project selection and execution, so that larger long-run effects are achieved". A South Africa study that looked at expanding access to consumer credit found increased borrower well-being: income and food consumption went up, measures of decision making within the household improved, borrower's status in the community improved, as did overall health and outlook on prospects and position. Though, borrowers were also more subject to stress thinking of installment payments (Karlan and Zinman, 2010).

A study on Compartamos borrowers in Mexico (Angelucci, Karlan and Zinman, 2013) found general positive picture of the average impacts of expanded credit access on well-being: depression falls, trust in others rises, and female household decision-making power increases." Studies also saw a reduction in the spending on temptation goods, such as tobacco in India, Morocco, and Mongolia and increasing access to microcredit can help households manage cash-flow spikes and smooth consumption. Access to microcredit in Bangladesh also led to a general increase in consumption levels as it lowers the need for precautionary savings (Khandher, 1998). By contrast, for entrepreneurs, access to microcredit can help investments in assets that enable them to start or grow their businesses. Researchers are in fact confirming that access to credit does benefit businesses. There is evidence that microcredit both spurred new business creation and benefitted existing microbusinesses in Mongolia and Bosnia (Attanasio *et al*., 2011; Augsburg, de Haas, Harmgart and Meghir, 2012). Studies found positive effects on a variety of indicators, including the income of existing businesses (India, the Philippines, and Mongolia), business size (Mexico), and the scale of agricultural activities and the diversification of livestock (Morocco). In addition, increasing access to microcredit improved the ability of micro entrepreneurs to cope with risk (the Philippines and Mexico). These findings are more remarkable when one considers that most of these studies investigate the effects of credit simply being offered to the treatment group, rather than the effects of actual credit uptake and usage. There is also recent experimental evidence suggesting that greater flexibility in product design could result in improved impacts (Field, Pande, Papp, and Rigol forthcoming). When borrowers were given a two-month grace period before their first loan payment, they diversified their inventory, were more likely to purchase durable assets, and had higher profits three years later. In their assessment of access to microcredit evidence, Banerjee and Duflo (2011, p. 171) concluded that "as economists, we were quite pleased with these results: The main objective of microfinance seemed to have been achieved. It was not miraculous, but it was working. In our minds, microcredit has earned its rightful place as *one* of the key instruments in the fight against poverty."

In countries across the globe, banks are increasingly using agents to provide financial services to customers. In Brazil, for example, banks use approximately 160,000 agents—many with multiple outlets - to provide financial services to all 5,564 Brazilian municipalities.1 In 2010, bank agents in Brazil handled 3.1 billion transactions (6 percent of all bank transactions), 2.85 billion of which involved the movement of funds. In Pakistan, there are approximately 17,500 bank agents (State Bank of Pakistan, 2011). In the quarter ended September 2011, these agents handled 15.88 million transactions totaling Rs 58,710 million (US$674 million) with an average transaction amount of Rs 2,700 (US$ 42.53). These arrangements, which involve the use of both agents and technology to transmit transactions details, are often referred to as "branchless banking". With agency banking access to credit and savings opportunities are made convenient far away from the a bank branch even in the remotest places. Financial institutions are able to help households manage cash flow spikes and smooth consumption, as well as build working capital. Studies have shown that poor households without access to a savings mechanism, it is more difficult to resist immediate spending temptations.

Studies in rural western Kenya found that access to a new commitment savings service enabled female market vendors to mitigate the effect of health shocks, increase food expenditure for the family (private expenditures were 13 percent higher), and increase investments in their businesses by 38–56 percent over female vendors without access to a savings account (Dupasand Robinson, 2013a). A study on commitment savings in Malawi showed positive effects on business investment, increased expenditures, and crop outputs (Brune, Giné, Goldberg and Yang, 2013). Access to a commitment savings account had positive impacts on female empowerment in the Philippines. Self-reported household decision-making increased, particularly for women with little decision-making power at the baseline, resulting in a shift toward female-oriented durable goods purchased in the household (Ahsraf, Karlan and Yin, 2010). Another instrument that can help poor households mitigate risk and manage shocks is insurance. Recent randomized evaluations in India and Ghana of weather-based index insurance showed strong positive impact on farmers because the assurance of better returns encouraged farmers to shift from subsistence to riskier cash crops (Cole,

et al., 2013; Karlan, Osei-Akoto, Osei and Udry, 2014). In Ghana, insured farmers bought more fertilizers, planted more acreage, hired more labor, and had higher yields and income, which led to fewer missed meals and fewer missed school days for the children. Vulnerability to risk and the lack of instruments to cope with external shocks adequately make it difficult for poor people to escape poverty. Agent banking model increases the outreach as well as promote financial inclusion to the unbanked and under-banked population – *without risking the safety and soundness of the banking system.* It also provides a framework for data and network security, customer protection and risk management. Introduction of technologies evaluations on the impact of payment systems and mobile money remittances show reductions in households' transaction costs and improve their ability to share risk. Jack and Suri (2014) examine the impact of reduced transaction costs of mobile money on risk sharing in Kenya. Using non-experimental panel data, they found that M-PESA users were able to fully absorb large negative income shocks (such as severe illness, job loss, livestock death, and harvest or business failure) without any reduction in household consumption. By contrast, consumption for households without access to M-PESA fell on average 7 percent in response to a major shock.

With the support of technologies, studies identify an increase in remittances received both in number and value and a greater diversity of senders. M-PESA also facilitates increased risk-sharing among networks of friends and family. Two other studies (Blumenstock, Eagle, and Fafchamps 2012; Batista and Vicente 2012)also find an increased willingness to send remittances as a result of access to mobile money; however, they did not examine welfare implications. The impact of a cash transfer program delivered via mobile phone (Aker, Boumnijel, McClelland, and Tierney 2011) showed reductions in both the cost of distribution for the implementing agency and the cost of obtaining the cash transfer for the program recipient. The recipients' cost savings resulted in diversification of expenditures (including food), fewer depleted assets, and a greater variety of crops grown, especially cash crops grown by women.

Financial access also improves local economic activity. Several settings over the past decades have offered an opportunity to assess the impact of financial access at the local economy level. A study using state-level panel data in India provides evidence that local differences in opening bank branches in rural unbanked locations driven by requirements of the Indian regulator between 1977 and 1990 were associated with a significant reduction in rural poverty (Burgess and Pande 2005). However, the expansion ultimately proved unsustainable due to high bank loan default rates during the 1980s leading to the demise of the rural branch expansion program after 1990. In Mexico, research (Bruhn and Love 2013) showed that the rapid opening of Banco Azteca branches in more than a thousand Grupo Elektra retail stores had a significant impact on the region's economy, leading to a 7 percent increase in overall income levels relative to similar communities where no Banco Azteca branches had been opened. Households were better able to smooth consumption and accumulated more durable goods in communities with Banco Azteca branches (Ruiz, 2013). At the same time, the proportion of households that saved declined by 6.6 percent in those communities, suggesting that households were able to rely less on savings as a buffer against income fluctuation when formal credit became available. At the macroeconomic level, the evidence has to rely on cross-country comparisons. The well-established literature (Levine 2005 and Pasali, 2013) suggests that under normal circumstances, the degree of financial intermediation is not only positively correlated with growth and employment, but it is generally believed to causally impact growth. The main mechanisms for doing so are generally lower transaction costs and better distribution of capital and risk across the economy. Broader access to bank deposits can also have a positive effect on financial stability. However, there are some caveats. Some research indicates that the positive growth impact from financial intermediation does not hold in economies with weak institutional frameworks (Demetriades and Law, 2006), such as poor or non-existent financial regulation, or in extremely high-inflation environments (Rousseau and Wachtel, 2002). Evidence also indicates that the positive long-run relationship between financial intermediation and output growth co-exists with a mostly negative short-run relationship (Loayza and Ranciere, 2006).

More recent work following the global financial crisis also suggests that the relationship between financial depth and growth might not be linear, but shaped like an inverted "U"—i.e., at very low levels of financial intermediation and at very high levels, the positive relationship disappears (Cecchetti and Kharroubi, 2012). Bivariate relationships indicate that inequality as measured by the Gini coefficient increases as countries progress through early stages of financial development (measured by private credit and bank branch growth), but it declines sharply for countries at intermediate and advanced stages of financial development (Jahan and McDonald, 2011). One interpretation is that higher income segments initially benefit more from deeper financial intermediation, but as it progresses, poorer segments benefit, too. Regressions that account for country characteristics and address potential reverse causality show a robust negative relationship between financial depth and the Gini coefficient (Clarke, Xu and Zhou, 2006). Moreover, financial depth was associated with increases in the income share of the lowest income quintile across countries from 1960 to 2005, and countries with higher levels of financial development also experienced larger reductions in the share of the population living on less than $1 per day in the 1980s and 1990s (CGAP, 2015).

Controlling for other relevant variables, almost 30 percent of the variation across countries in rates of poverty reduction can be attributed to cross-country variation in financial development (Beck, Demirgüç-Kunt, and Levine 2007). Financial inclusion seems to reduce inequality by disproportionally relaxing the credit constraints on poor people, who lack collateral, credit history and connections. Studyby Han and Melecky (2013) also suggests that broader financial inclusion can coincide with greater financial stability, though sorting out the lines of causation between those two sets of variables remains a challenge. It seems plausible, however, that greater access to bank deposits can make the funding base of banks more resilient in times of financial

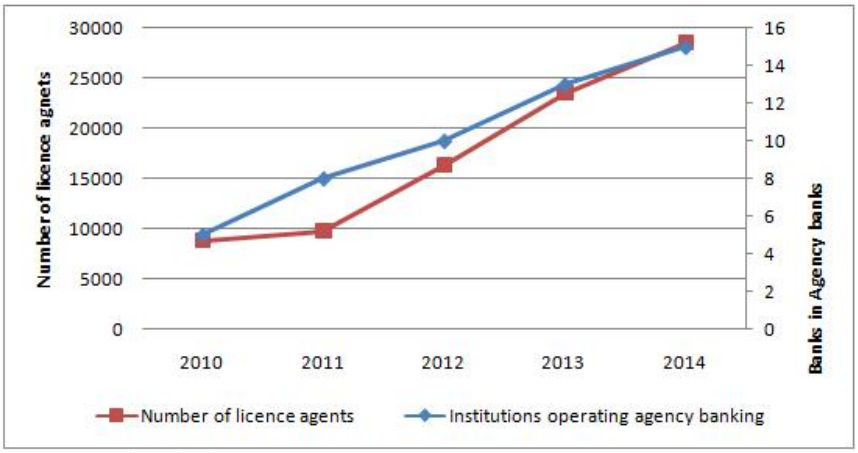
stress. The authors stress that policy efforts to enhance financial stability should thus not only focus on macro-prudential regulation, but also recognize the positive effect of broader access to bank deposits. In addition to the direct economic benefits, two recent developments suggest benefits for other government and private-sector efforts that might arise from inclusive low-cost financial systems that reach larger numbers of the population. First, policy makers increasingly recognize that a financial market that reaches all citizens allows for more effective and efficient execution of other social policies. For example, financial inclusion improves the payment of conditional transfers such as when parents are rewarded for ensuring their children get recommended vaccinations or for sending their daughters to school. Because of the potential cost savings, a number of countries are switching their government payments to electronic means to improve targeting of beneficiaries and reduce transactions costs.

In Brazil, the *bolsafamilia* program (a conditional cash transfer program that serves 12 million families) reduced its transaction costs from 14.7 percent of total payments to 2.6 percent when it bundled several benefits onto one electronic payment card (Lindert, Linder, Hobbs, and de la Briére, 2007). A low-cost financial system helps governments better execute other social policies. Whether those payments can in turn lead to a virtuous cycle of including more citizens in the financial system, and keeping them there, is not yet clear. Second, financial innovation that dramatically lowers transaction costs and increases reach is enabling new private-sector business models that help address other development priorities. In Kenya, where mobile money services such as M-PESA reach more than 80 percent of the population and agency banking constituting a third of total bank transaction, a wave of second-generation innovative businesses and uses is emerging on the M-PESA infrastructure.

The presence of a ubiquitous, low-cost electronic retail payment platform increases the viability of new business models that need to collect large numbers of small amounts. This may also help address other development priorities. For instance, M-Kopa in Kenya or Mobisol in Tanzania have created micro leasing for off-grid, community-based solar power—an example of innovation in the context of climate-change adaptation. Similar advances in technology are being made with respect to water services to low-income households and communities. So far, this type of leverage has by definition occurred only in geographies such as Kenya or Tanzania where low-cost electronic retail payment systems have reached critical scale and no studies have been conducted as to the possible household welfare impact due to access to these types of novel services.

Data Analysis

The north of Kenya is very volatile to drought annually requiring Government of Kenya and development partners such as World Food Programme, Oxfam, Save The Children and Catholic Relief Services supporting communities with food aid. However, the distribution becomes costly, inefficient and abused year in year out. The CEO, Equity Bank Dr James Mwangi offered to distribute the cash equivalent of the wheat and flour to the target families through their extensive branch networks to buy rice and maize as they form the staple food of most Kenyans. Cards were designed to capture persons identification, biometric finger prints, PIN/TIN numbers, GPRS locations, county and region. This was able to eliminate risk of diverting aid and reduce costs of delivery. This has set the foundation for mobile and POS agency banking in Kenya by Equity Bank. Today, Equity has 170 branches, 12,500 bank agents and 8.2 million customers across Kenya The total, number of agent outlets in Kenya grow from 8809 in 2010 to 28,151 in July 2014 as shown in Table 2 and Figure 1 below.



Source: Central Bank of Kenya

Figure 1. Growth of Agency banking in Kenya, 2010 - 2014

Table 2. Trend and Status of Agency Banking Uptake in Kenya

	2010	2011	2012	2013	2014*
Financial Institutions operating Agency banking services	5	8	10	13	15
Number of licensed agents	8809	9748	16333	23477	28515
Number of transactions undertaken by bank agents (million)	0.82	8.76	30.01	42.06	110.85
Value of transactions undertaken by bank agents (USD, millions)	1.21	507.12	1768.57	2746.51	6952.16

Source: Central Bank of Kenya

- As at end- July 2014

Table 2 shows the trend of agency banking in Kenya reporting 5 commercial banks operating agency banking services in 2010 growing to 10 in 2012 to 15 as at end July 2014 including major players like Family Bank, Equity Bank, Chase Bank, Kenya Commercial Bank (KCB), Co-operative Bank, DTB, FCB and Postbank. The number of agents also expanded from 8809 in 2010 to 28515 in July 2014. The number of transactions undertaken by bank agents leveled at 110.85 million constituting 34% of overall bank transactions in July 2014 from 30.01 million and 0.82 million in 2010 and 2012 respectively. Value of transactions also leveled at USD 6951.16 million at end July 2014 from USD 1.21 million, USD 507.12 million, USD 1768.57 million and USD 2746.51 million in 2010, 2011, 2012 and 2013 respectively.

Conclusion/Implications

Global and national policy makers are committing to advance financial inclusion. Financial services are a means to an end, and financial development must take into account vulnerabilities and possible unintended negative consequences. However, recent evidence using rigorous methodologies generally confirmed the convictions that inclusive and efficient financial markets have the potential to improve the lives of citizens, reduce transaction costs, spur economic activity, and improve delivery of other social benefits and innovative private-sector solutions. Using recent evidence on three different economic levels, first at the microeconomic level, it assesses the evidence of how the use of different financial products affects the lives of the poor. Studies show that small businesses benefit from access to credit, while the impact on the borrower's broader welfare might be more enhanced. Using od technologies and agency banking strategies households to save and manage cash flow spikes, smooth consumption, as well as build working capital. Access to formal savings options can boost household welfare. New types of payment services can reduce transaction costs and seem to improve households' ability to manage shocks by sharing risks. Research also suggests that financial access improves local economic activity.

At the macroeconomic level, the empirical evidence shows that financial inclusion is positively correlated with growth and employment. There is general consensus in the past several studies that believe in underlying causal impact. The main mechanisms they cite for doing so are generally lower transaction costs and better distribution of capital and risk across the economy. Evidence of amore preliminary nature suggests that broader access to bank deposits can also have a positive effect on financial stability that benefits the poor indirectly. In addition to the direct economic benefits, two recent developments suggest benefits for other government and private-sector efforts that might arise from inclusive low-cost, financial systems that reach a larger number of the population often left out. First, financial inclusion can improve the effectiveness and efficient execution of government payment of social safety net transfers as shown in Equity Bank of Kenya food aid distribution, which play an important role in the welfare of many poor people. Second, financial innovation can significantly lower transaction costs and increase outreach, which is enabling new private-sector business models that help address other development priorities.

In line with the global initiatives of greater financial inclusion, stakeholders in Kenya's financial sector formally embark on agency banking services in November 2014. As shown in Table 2, the number and value of transactions have grown tremendously over the years through to July 2014. For smooth operations of agency banking services, it is required that an effective IT platform and system software are put in place, train agents, sensitisation campaigns to financially educate the public on issues relating to agency banking. It important to note that agency banking risk profile is quite low as transactions are real time and can only take place if the agent's float (funds at operating account) at the financial institution is healthy and the network system is active. The service is endorsed by the Government and peoples of Kenya, Central Bank of Kenya, the International Partners and the banking sector of Kenya. At end December, 2013, 85% of Equity Bank's[1] customers never visited its bank branch hall and services are provided at the most remotest places in Kenya, hardly with any form of road network. In summary, the accumulating body of evidence supports the assessments that developing inclusive financial systems is an important component for economic and social progress on the development agenda. The implications for positive and greater for policy makers in developing countries address financial exclusion of the majority of the population for job creation,

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