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KBA 6TH ANNUAL BANKING RESEARCH CONFERENCE

Theme: **Intermediation Towards Deepening of Financial Inclusion**

CENTRE FOR RESEARCH ON
FINANCIAL MARKETS AND POLICY®

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KENYA BANKERS ASSOCIATION SIXTH ANNUAL

BANKING RESEARCH CONFERENCE

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Moreover, KBA owns and operates the Automated Clearing House and in partnership with the Central Bank of Kenya has developed initiatives such as such as the Modernisation of Payment Systems (including the Cheque Truncation Project), the establishment of Currency Centres across the country, and the Kenya Credit Information Sharing Initiative.

CENTRE FOR RESEARCH ON

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ABOUT THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

The Centre for Research on Financial Markets and Policy® was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and dialogue regarding critical policy matters that impact on financial markets in Kenya. The Centre sponsors original research, provides thoughtful commentary, and hosts dialogues involving scholars and practitioners and conferences on key financial market issues. Through these activities, the Centre acts as a platform for intellectual engagement between financial market experts, the banking sector and the policy makers in Kenya. It therefore contributes to an informed discussion that influences critical financial market debates and policies.

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This Research Conference Bulletin provides highlights of the papers presented at the 6th Kenya Bankers Association Annual Banking Research Conference. The contributors provide not just the presentations by the authors of the Conference papers but also take on board the views of the discussants of each paper as well as those of the Conference participants. We acknowledge the contributions of Dr. Patrick Njoroge, Governor of the Central Bank of Kenya, whose key note speech set the tone of the conference. We also acknowledge the remarks by the Chairman of the Kenya Bankers Association Governing Council and Chief Executive Officer, Standard Chartered Bank, Kenya, Mr. Lamin Manjang; the Vice Chairman of the Kenya Bankers Association Governing Council and Group Managing Director, NIC Bank Mr. John Gachora (who has also contributed a commentary in this Bulletin); and the Chief Executive Officer of the Kenya Bankers Association, Dr. Habil Olaka (who also presented a research paper at the Conference); their presentations shaped the Conference's discussions). We gratefully acknowledge the authors of the Conference papers (names and affiliations are listed in this Bulletin; the following discussants: Amrik Hayer (FSD Kenya); Peter Muriu (School of Economics, University of Nairobi); Ferdinand Othieno (Strathmore University); Radha Upadhyaya (Institute for Development Studies, University of Nairobi); Lucas Njoroge (COMESA Monetary Institute); and Muniu Muchai (Kenyatta University). Finally we acknowledge the contributions of all the participants of the Conference.

Foreword

By Dr. Habil Olaka*

It is my pleasure to present to you our first *Research Conference Bulletin.* The *Bulletin* documents the highlights of our 6th Annual Banking Research Conference that the Kenya Bankers Associations Centre for Research on Financial Markets and Policy® hosted in September 28th and 29th 2017. There is no doubt that the Kenyan banking industry is both progressive and innovative, two attributes that have underpinned its leadership position in the region. These attributes must mean something to all the segments of the economy, more so the low income households and micro, small and medium enterprises.

These vulnerable segments are often seen to be getting the short end of the stick when it comes to finance. The debate is whether that is perception or reality, given that as a country we have reportedly made tremendous strides in the financial inclusion agenda. We have no straight answer on which of the alternatives in the debate is true. That was the motivation of this year's Research Conference with the theme *"Intermediation towards Deepening Financial Inclusion"* whose deliberations we highlight in this Bulletin.

"Kenya is widely celebrated on the strides it has made in the financial inclusion journey.

Habil Olaka, CEO
Kenya Bankers Association

The Conference presented an opportunity for reflection and stock-taking on this important topic. Kenya is widely celebrated on the strides it has made in the financial inclusion journey. That is not to say that the country is on a perpetual celebratory mode on matters financial inclusion. Two questions are thus motivated: One, why the wide attention? Two, why not wallow in the glory?

We can't deny the fact that in Kenyan, there has been increased usage of technology in furthering the financial inclusion agenda. A cursory consideration of the economy's financial inclusion progress as much underpins the ensuing accolades as it motivates the need for a deeper reflection on whether such inclusion is deep enough as to have meaningful impact at household and firm level.

A cross section of the delegates at the Conference.

Dr. Patrick Njoroge Governor Central Bank of Kenya (left), and Chairman of the Kenya Bankers Association Chairman and Chief Executive Officer of Standard Chartered Bank, Mr. Lamin Manjang

Therefore, the case for examining critically what financial inclusion entails needs to be argued considering that the adequacy or lack thereof of its depth is a function of whether mere contact with a financial institution is a sufficient enough attribute or is only necessary but requires enhancement. This were the sentiments expressed by Dr. Patrick Njoroge, Governor Central Bank of Kenya, in his Key Address to the Conference Participants.

If the sufficient condition is that the households and firms' contact with a financial institution should be a lead to either enhanced savings or access to credit, then there is need to step back and ask: how can the strides in the financial inclusion be widely acclaimed if it happens on the back of stagnating levels of savings and constrained credit access?

As this *Bulletin* shows, we can only attempt to answer the question. But it will be expecting too much from one conference if one is to imagine that such an attempt will lead to a definitive answer. What is assured though is the opportunity that the conference will provide for reflection.

We believe in developing a pipeline of ideas that buttress our progress and leadership as an industry. Indeed some of the issues that we addressed in our first Research Conference in 2012 have either given rise to practical solutions or have motivated further investigations by other researchers.

As the Chairman of the Kenya Bankers Association Chairman and Chief Executive Officer of Standard Chartered Bank, Mr. Lamin Manjang, observed in his remarks at the Conference, we have deliberately made sure that in developing such pipeline of ideas we drawn the participation of various institutions and not just the banking fraternity. Our objective is therefore to brining various stakeholders around the table so as to address issues of overlapping interest.

Given the diversity of our stakeholders, we do not envisage that we will have a common view to these issues. That is why the KBA Centre for Research on Financial Markets and Policy® collaborates with such institutions as the Central Bank of Kenya, Academia, International Institutions and Think Tanks so as to ensure that there is objectivity even in instances of divergent views.

While what we present here are merely highlights of the Conference, I can attest to the rigour of the underlying presentations, which rigour was not at the expense of business and policy relevance of the research output. We hope to keep alive the debate on this subject; thus all the conference papers will reviewed and initially published under the KBA Working Paper Series *(http://www.kba.co.ke/working_paper.php).*

***Chief Executive Officer**

Introduction

By Jared Osoro*

The Kenyan financial system has drawn global attention on account of two related developments. First, there has been the harnessing of the novelty of technology – especially mobile telephony technology – in a manner that has revolutionised national payments. Second, such novelty has been beyond the payments arena, getting to the intermediation space where technology is a platform for savings mobilisation and credit extension.

These two developments have largely, but not exclusively, been credited for the strides that economy has made in the financial inclusion agenda. Over the past decade the proportion of the financially excluded is estimated to have declined significantly from 41 percent to 17 percent[1].

By the same estimates the share of formal prudentially regulated as well as the formal non-prudentially regulated institutions to financial inclusion has increased, the desirable consequence being the shrinking of informal finance whose proportion has decreased from 32 percent to 7 percent. Is this too good to be true? That is a question that arguable is seldom asked, nearly prompting a "mission accomplished" attitude. But that is a question that no doubt requires deep interrogation.

Such interrogation was the basis of the conference whose deliberations are summarised in this *Bulletin*. Of necessary was the need to answer two key questions:

- One, how can the strides in the financial inclusion be widely acclaimed if it happens on the back of stagnating levels of savings and constrained credit access?
- Two, to what extent is the progress on areas such as the credit cost disclosure regime and the credit information sharing (CIS) mechanism – both aimed at enhancing the financial inclusion agenda – likely to be undermined by the fundamental shift in the credit pricing environment arising from the Banking (Amendment) Act 2016 that introduced the capping of interest rates and a floor on deposit rates?

Of necessary, the analytical work towards addressing these questions had to be cognisant of the following:

- One, the Kenyan financial system is dominated by commercial banks and therefore any developments of either market or policy nature that adversely influence the banking industry will likely harm the financial inclusion agenda;
- Two, even with bank dominance the financial system is interlinked such that shocks in the dominant segment quickly filter into the other segments – insurance, capital markets, pensions and cooperatives. If financial inclusion is given a comprehensive consideration, then such linkages need to be deeply understood so that the question of savings and credit in the inclusion agenda is unravelled.
- Three, the causal relationship between finance (credit and savings) and economic growth is worth revisiting on the back of the new dispensation brought about by the Banking (Amendment) Act 2016. This is because, any adverse outcome to the economy will have the attendant consequence of undermining financial inclusion.

1 The 2016 FinAccess Household Survey on financial inclusion. Nairobi, Kenya: FSD Kenya

Dr. Patrick Njoroge Governor Central Bank of Kenya (Centre) takes a group photo with authors.

This year's Conference therefore provided an analytical platform for conceptualising on these three areas as underpinned by two broad questions earlier posed. The intention was to drilling down in whether the prevailing intermediation platform necessarily leads to the deepening of Kenya's financial inclusion. The Conference highlights are clustered around three areas.

The first area addressed itself to the state of financial inclusion. It has often been taken for granted that once you have access to financial services, you are deemed to be financially included. This one-dimensional consideration is questioned, given that the other dimensions of incision namely usage and quality of financial services are inadvertently subservient.

If usage is as critical as access, and the Conference deliberations pointed as much, then insights on mobile-based decision support systems for low-income earners' credit scoring needs to have the deserved prominence in the financial inclusion conversation. And so should the consequences of the Banking (Amendment) Act 2016.

The second areas interrogated the importance of linkages, both amongst financial sector markets – banks, insurance companies, capital markets, and savings and credit cooperatives – and amongst economies; the latter aspect looked at from the remittances perspective is often analysed from its influence on economy growth. The Conference brought in the fresh angle of the nexus between remittances and financial development and consequently financial inclusion.

The third area explored the subject of financial regulation and inclusion, with stability of the financial system – the core intention of regulation – being the bridge. There is recognition that financial inclusion is a strategic agenda. Accordingly, the Conference examined, albeit in a general context, the subject of strategic leadership and strategic implementation in Kenya's commercial banks. Preceding the three area was an incisive perspective on regulation and financial stability by John Gachora, Vice Chairman of Kenya Bankers Association Governing Council and Group Managing Director of NIC Bank.

**** Director, Centre for Research on Financial Markets and Policy®***

Some members of the KBA Governing Council at the conference.

Perspectives: Financial Regulation and Financial Stability

By John Gachora*

It is an obvious observation that regulation is meant to assure stability in the financial market, with the belief that such stability will then lead the market to respond to the needs of the population. Built into regulation is the inherent idea that the supply side (banks and other financial markets players) need stability and a level playing field. The demand side (the population) needs certain protections and transparency as enablers of their entry into the financial inclusion circle.

It is however not obvious whether the link between regulation and financial inclusion is sequential or cyclical. By sequential I mean a relatively neat process whereby regulation leads to Stability, and stability leads to increased inclusion. By cyclical, I mean an iterative process. The cyclical scenario is underpinned by the argument that inclusion necessitates a higher risk appetite that necessitates more regulation to assure stability, and the cycle continues.

What is regulation in the first place? People tend to talk about regulation quite generally. However Researchers are not generalists! Regulation takes a few forms. There are two commonly known forms of regulation. One is prudential regulation, which entails creating oversight on the type and amount of risk a financial institution is placing on itself. The other is market conduct regulation, which entails creating oversight on the process and ways in which financial institutions distribute their products in the market place.

But there is regulation that is less talked about: structural regulation; this which limits the range of activities that may be carried out by the financial institution. The premise of structural regulation is to reduce the risk of bank failure by prohibiting banks from getting involved in activities which are judged by policy makers to be 'too risky'.

For such distinction to make sense, ones understanding of the financial system needs to take into account a number of factors:

One, there is a very strong relationship amongst financial market players. There is no any other sector where market players rely on one another more than in financial services. Therefore, regulating an entity in, for instance the banking sector, means you are looking at how stable it is and how such stability will lead to the stability of the whole system.

During the global economic crisis, investor Warren Buffet remarked that it is only when the tide is down that we can tell who is swimming naked. When it comes to banks, when the tide is down, all of you are swimming naked. The collapse and aftershocks of even a small bank in a country, will be felt by all industry players.

Two, the relationship between finance and economic performance is well understood. It is a causal relationship, with finance leading to economic growth; but the relationship can run both ways.

What is less understood is what people look for when assessing whether finance appropriately supports growth. The wrong way to look at this relationship is whether finance is creating jobs or increasing the state's coffers. Arguably, the right way to look at is whether we are seeing more payments, increased levels of intermediation increased, improved personal finance management, and improved risk management.

Three, financial regulation generally looks at the right direction and thus supports growth. But whenever there is a crisis such as the global financial crisis of 2007-2009, populism leads for a push for more regulation. It can be argued that in the history of finance, a crisis has never occurred due to limited regulation. In other words, there is no case of throwing regulation at every crisis; instead there is a case careful structural financial reform that seek to obviate crises.

Experience the best teacher

The financial architecture and market outcomes, especially after the 2007–09 financial crisis have brought out the brilliance and sometimes the exuberance in the thought process. There are those who rightly argue that markets are not perfect, prominently Robert Shiller, the Yale University renowned Economist and the man who coined the term Rational Exuberance in a so-titled book but which was popularised by former Fed Chairman Alan Greenspan in a speech.

But there are those who have made an entire career on the perfect markets hypothesis such as Chicago University Economist Eugene Fama. Yet both Shiller

> The relationship between finance and economic performance is well understood. It is a causal relationship, with finance leading to economic growth; but the relationship can run both ways.
>
> John Gachora,
> Group MD, NIC Bank

and Fama shared the Nobel Prize in 2013! What does that tells us? It tells us that people have different attitudes towards signals.

As early as 2005, Raghuram Rajan, then Chief Economist at the IMF but subsequently governor Reserve Bank of India, asked a simple question: "Has financial development made the world riskier"? His answer was an emphatic yes. Embedded in Rajan's argument are three things:

- One, technology is never static: look at our case with mobile technology and finance;
- Two, big regulation goes round in cycles: there was Glass – Steagall Act of 1933 that separated commercial banking from Investment banking; its finally repeal in 1999 through the Gramm-Leach-Bliley Act, and there were attempts to bring it back, under the so-called Dodd-Frank Act.
- Three, new institutions emerge, notably private equity funds, hedge funds, shadow banks.

But was Rajan's argument taken as gospel truth? Actually, no! Rajan's point was dismissed by many including the likes of Larry Summers, the former President of Harvard University and Clinton's Treasury Secretary.

Summers, a former Chief Economist of the World Bank, thought that Rajan had an attitude problem; indeed that his arguments were a classic case of Luddite fallacy – "sometimes used to express the view that those concerned about long term technological unemployment are committing a fallacy, as they fail to account for compensation effects".

Those who opposed Rajan argued that compensating effects will take care of risks created by technology and other financial developments. So what do we learn here? Perhaps that there is no agreement upon which we can truly learn from the experience of others. That new developments while introducing risks, create new opportunities. That this new opportunities compensate for the said risks.

Closer to home, perhaps this says that the long term equilibrium should take care of outsized profits that banks have been accused of angling for in the rate cap debate. That with free competition and survival risks, banks would in effect embark on a competitive race towards a more affordable loan regime.

In there lies a research agenda: examining how the post-financial crisis debate around regulation will have an effect on financial inclusion. But even as we ponder over matters regulation and financial inclusion, we should lose sight of the fact that we have borderless finance.

Just like we have doctors without borders, and journalists without borders, we are confronted with the challenges of finance without borders – this comes with benefits such as allowing domestic investments to be funded by external savings and therefore bridging the domestic savings gap. Today technology has made this even easier. Through companies such as Tala, Branch and Mkopa, money raised in Silicon Valley can easily find its way to the deepest and remotest corners of our republic. But is also comes with risks.

Are there regulatory issues to this aspect of the financial system? Indeed there are. Think about short-term flows (hot money!) leading to liquidity pressure. That is when there is a realisation that liquidity is a public good. Ponder on cross-border expansion of institutions and the attendant risks. All these point towards the possibility of trade-offs. How the financial system navigates these trade-offs is an optimisation problem that research can help us unravel.

***** Group Managing Director of NIC Bank*

The State of Financial Inclusion

This section presents highlights of three conference papers that interrogated the state of financial inclusion in Kenya. The papers are motivated by the consideration that:

- Measurement issues on matters financial inclusion have at best been insufficiently analysed, the reason why financial access and financial usage attributes have been taken to mean the same thing;
- Product development on the back of technology needs to be stretched beyond individuals to include groups that are now increasingly becoming a common feature in emerging enterprises amongst low-income households; and
- There is a possibility that new policy developments, especially credit pricing regulation, could negative the gains in financial inclusion when comprehensively defined beyond access to include usage.

Financial Inclusion: How Do You Know That You Are There?

By Jared Osoro and David Muriithi (Kenya Bankers Association Centre for Research on Financial Markets and Policy®)

Jared Osoro, KBA makes his presentation

This paper's core objective is to shed a spotlight on a question that is seldom asked, either because it is considered mundane or some limiting assumptions are made about the subject. The question is: at what point does one consider oneself to be financially included?

As the paper argues, if you base your definition on ones ability to transact, access savings and credit as a 2016 study by the Bank for International Settlement (BIS) does, then even a touch point with a financial service provider will be construed to mean that one is financially included.

Apparently, this fairly general definition underpins the determination that Kenya has made great strides in the financial inclusion journey. According to the *2016 FinAccess Household Survey*, over the past decade the proportion of the financially excluded is estimated to have declined significantly from 41 percent to 17 percent.

While this trend is commendable, it call for curiosity on the nature of financial inclusion. The core of this study is therefore the argument that there is need to distinguish between access and usage of financial services, two dimensions that are combined to constitute financial institution. The paper thus contends that access, while necessary, is not a sufficient condition unless it leads to enhanced usage.

For enhanced usage, the paper argues, there has to be recognition that financial service providers are linked. As empirically determined, there is strong evidence of interconnectedness of the markets as a customer who has for instance has an insurance product will mostly likely have a bank account. But such interconnectedness is influenced by the dominant segment of the financial system.

But there is more to the dynamics of financial inclusion that necessitates much deeper perspectives. For instance, banks are perceived as the most trusted financial services providers for transactions and play largely a custodial role.

However, customers are more likely to seek enhanced financial services such as investment advice either based on their own financial knowledge and instincts or from their social circles. This points to the argument that an accurate appreciation of what meaningful financial integration entails going beyond the cursory considerations in at least three respects.

First, it is a fact that financial innovations largely through mobile technology seek to address the inefficiencies that have dominated cash-based systems which have led to increased collaborations between financial service providers. While this is a necessary step, it can only be seen as an input to the utilisation of services by financial service providers such as banks, insurance companies, Micro Finance Institutions (MFIs) and Savings and Credit Cooperative Organisations (SACCOs).

Second, financial inclusion is income sensitive, with the probability of being included through usage of banking, insurance, MFI and Sacco services increasing as income levels rise. This presents a dilemma: if financial inclusion is income constrained and income is financial inclusion constrained then there is a less debated vicious cycle that needs to be broken.

The pursuit for mechanisms to break this cycle leads to analyses on the influence of factors such as cost of the financial services – which would include the cost of travel to a financial service provider.

Third, breaking the poverty trap, even when facilitated by financial inclusion is no guarantee for enhanced benefits arising from finance. That is because there is a possibility that gains in poverty reduction do not necessarily lead to a reduction in informality, in which case the ability to access a cross range of financial services would still be limited. That means that a household would be emerging from the poverty trap but still remain trapped in informality.

Ultimately, the paper hold that we should declare individuals to be financially included only if they are making use of available financial services and not just because they can access the service. And if the two-level measure is adopted, then is worth to revisit whether those considered to be financially included in Kenya using current yardstick are deservedly classified as such.

Gaps from the Cap: Implications for Financial Inclusion in Kenya

By Samuel Tiriongo (University of Dar es Salaam) **and Rogers Ochenge** (University of Nairobi)

This paper's objective is to quantify the credit gaps arising from the August 2016 amendment of the banking act – the Banking Amendment Act (2016). This is arguably an ambitious objective considering that the law that introduced a cap on the lending rates and a floor on interesting earning has been in effect for slightly more than a year.

While there is fast literature on the pros and cons of interest rates regulation, it is debatable whether the experiences of one jurisdiction can be replicated in another, cognisant that the nature of regulation may not be the same. Nonetheless, a priori it could be expected that credit flow to the private sector, and especially to those segments whose risk profile is above the level of the cap, will be adversely affected.

As the paper argues, there is risk concentration as banks will prefer some customers over others but at the same time might increase risk in this segment depending on the product offered. It is evident that liberalised markets allow for more product diversity and segmentation and create room for more income streams for financial institutions.

But there is a possibility that regulation can drive unfavourable customers to seek expensive, unregulated and informal alternatives which could threaten financial stability and would also be counter-intuitive in a liberalised market. And all these have implications on financial inclusion to the extent that they influence the flow of credit.

When the interest rates were introduced, credit grew at a rate of 4.7 per cent which was lower than the 18 per cent recorded at the beginning of the year and 21.2 per cent posted in July 2015, before the deceleration begun. On a sector basis, household loans, which are largely personal loans, experienced the largest decline in credit flow of about five per cent or about Sh27 billion followed by agriculture at 4.9 per cent.

As the paper notes, the declines were significantly larger than their historical average cyclical adjustments. Notably, some banks have already indicated the intention to stop issuing unsecured personal loans which were key contributors of household debt.

The paper has to contend with the challenge of attribution, in essence demonstrating that the credit trends are directly and substantially influenced by the new law. This is especially considering the short period that the law has been in place.

On that basis, the study presents some stylised facts that tries to support the attribution argument. But even then the paper's inferences would be reinforced taking into account the fact that banks operate in a competitive environment with incomplete information. This would be translated to how their limited options which include increasing lending but could also increase non-performing loans (NPLs) or increasing investments but at the risk of increasing overheads.

Rogers Ochenge

Similarly, the inferences of the paper would benefit from the inclusion of the market response to the new law in the form of banks reorienting their capital structure as they seek to limit the extent to which the law would lead to market failures.

But if the market failures make the Kenyan economy's banking system lag behind those of peer economies, then that will be a clear pointer to the caps widening the credit gaps both at the domestic level (actual versus optimal) and international (actual versus peers').

Credit Risk Analysis for Low Income Earners

By Davis Bundi (University of Nairobi)

Davis Bundi makes his presentation.

> **The findings point to the need for more tailored products towards women, albeit with the support of more analytical work why there is a perception of low uptake of women-targeted products**.
>
> Davis Bundi, University of Nairobi

This paper is motivated by the consideration that low income earners are financially excluded due to the limited credit access, thus being caught in the income and informality traps. The objective of the paper is therefore to explore the potential of mobile technology as a platform for analytics to support lending to low income households as groups rather than individuals.

According to the study, mobile technology can be harnessed to collect such households' socio-economic data in order to provide mobile micro-credit. This would be anchored on a mobile-based decision support system for credit scoring, classification and peer-group lending for the low-income earners in Kenya.

Using data from *FSD-Kenya financial diaries* data, the paper clusters customers into randomly selected peer groups of men only, women only, mixed groups, and individuals in a 280 households sample size. The study addresses the limitation of assuming static behaviour and instead deploys analytical tools that allow for behavioural changes over time. This leads to interesting insights regarding differences in credit scoring.

Notably, the study finds that:

- Peer groups exhibited stronger credit scores and quality than individual households as they had higher financial stability than individuals due to the presence of social collateral. This is explained by the fact that peer selection reduced moral hazard and information asymmetry;
- Women only peer-groups outperformed the men only peer groups. This is explained by the fact that women have horizontal social networks while men embrace vertical ones;
- Low income earners tend to maintain long-term relationships which bolsters their social capital.

These findings point to the possibility of there being opportunity for intensive data utilisation towards strengthening mobile credit scoring system as a way of mitigating credit risks. They also point to the need for more tailored products towards women, albeit with the support of more analytical work why there is a perception of low uptake of women-targeted products.

As is noteworthy, group lending strategy has been used previously by banks to grow their lending especially to women. By pooling together under a group, individuals would be able to access more credit than they could as individuals. This is because most of them do not channel their transactions through the phone or bank account and also lack assets to use as collateral.

Women would potentially be the greatest beneficiaries of such product as it would rely on social collateral rather than physical security which is mainly controlled by men. Women are more reliant on each other, giving them more social collateral than men.

While exploring the myriad of opportunity that the paper's findings highlight, it provides a basis to further examine point towards the implication of reporting regulatory developments such as the International Financial Reporting standards (IFRS) 9 that requires more aggressive recognition of potential loss from lending.

The study provides the appropriate grounding for further interrogation of how horizontal and vertical linkages affect networking in mixed peer-groups and possibly lead to a determination of optimal peer group sizes.

Linkages and Financial Inclusion

This section presents highlights of two conference papers that explored the role of linkages in financial inclusion in Kenya. The papers are underpinned by the consideration that financial market players do operate in silos; nor do economies. Therefore the linkages or lack thereof amongst financial firms and resource flows to households through, for instance, remittances would potentially influence the financial inclusion agenda.

Do Migrant Remittances Matter for Financial Development in Kenya?

By Roseline Misati (African Institute for Remittances), **Ann Kamau and Abdinasir Hared** (Central Bank of Kenya)

This study introduces a new dimension to the analysis of remittances. Unlike many studies that seek to draw the nexus between remittances and economic growth or remittances and foreign exchange reserves, the paper seeks to provide a link between remittances and financial development.

Financial development in the context of this study is a necessary condition towards enhanced financial inclusion, with the latter only enabled but realised if it is a deliberate policy agenda. Embedded in the study therefore is the argument that to the extent that remittances influence financial development, they have a contributory effect on financial inclusion.

Remittances have played a significant role in consumption smoothing amongst households but have also evolved into financing SMEs, which ultimately feeds into poverty reduction. This affects financial inclusion as there is increased financial access through both formal and informal channels.

Remittances to Kenya have steadily increased at an average annual rate of 14.3 per cent in the last one decade, rising from USD 934 million in 2011 to USD 1.73 billion in 2016, constituting 2.5 per cent of GDP. Kenya is one of the top eight highest remittance recipient countries in Africa after Nigeria, Egypt, Morocco, Tunisia, Ghana, Algeria and Senegal.

Highest cash inflows come from the United Kingdom, United States of America and Africa, constituting about 34 percent, 30 percent and 17 percent of total flows, respectively. These numbers indicate where focus should be laid in terms of bilateral agreements to ease and enhance remittance flows as well as where the private sector, especially commercial banks, mobile companies and online remittance platforms, would concentrate to attract more remittance flows and enlarge their market territory.

The study's analytical tools are deployed on several financial development indicators, including private sector credit, number of mobile transactions, value of mobile transactions, number of mobile agents and number of bank accounts; it establishes a long run of these parameters with remittances, implying therefore

Roseline Misati.

that at a high level remittances have a contributory effect on financial development.

These results indicate that higher levels of remittances provide opportunities for broadening financial channels with higher number of bank accounts while enhancing savings and exposing unbanked recipients to existing and new financial products.

The study acknowledges that the embracing of mobile technology reduces costs by eliminating physical barriers and traditional methods of channelling remittances; mobile money transfer heralded as a cheaper and easier mode of money transmission in the local scene. Interestingly though, only 2 percent of remittances are through mobile-based channels. Thus, international transfers have not been fully exploited since mobile technology has a wider reach even in the rural areas to increase financial access.

The study indicates that there could be a policy window for the government to leverage on remittances since they are more resilient than official development assistance (ODA) and even Foreign Direct Investments (FDI). This is an important discussion point because there are merits and demerits of remittances exceeding FDI; the study has not explored on this matter.

Overall, there is a policy window for the Government to leverage on remittances as a tool of financial inclusion particularly through continued expansion of the regulatory space that accommodates wider usage of international mobile remittance transfer channels.

Similarly, commercial banks have an opportunity to create banking products targeting Kenyans working abroad in order to tap into their wealth and increase their participation in the financial sector.

Intra-Market Linkages in the Financial Sector and their effects on Financial Inclusion **By Caspah Lidiema** (United Nations)

Caspah Lidiema.

This paper is anchored on the premise that the financial inclusion agenda is well served if looked at in a comprehensive manner that duly recognises the linkages amongst the various sub-components of the financial system. The study therefore embraces the assumed linkages between the banks, insurance and capital markets.

Theoretically, these intra-market linkages are assumed to exist; the import of the study is to explore the empirics of its existence, grounding it on issues considered critical to the wider population - prices, availability of financial services or quantity.

Commercial banks in Kenya are the main driving force of the financial sector, accounting for the largest share of the assets of all financial institutions. This is mainly due to the absolute size of the commercial banks, and their relative importance as the principal institutions in the flow of funds between savers and borrowers. The banks also support other segments in the financial system through their balance-sheet transactions and off-balance-sheet transactions.

In light of the possible linkages, the study traces the linkages using bank credit, monthly net insurance premium paid, the Nairobi Stock Exchange 20 Share Index (NSE 20) and monthly lending rates. According to the paper, there is significant market interactions with the primary shock transmission moving from banks to other financial market players.

This translates to how monetary policy reverberates across the entire financial services sector. It further pointed that positive credit shocks have a positive impact on the lending rate and in capital market performance which could be deduced to mean that banking mechanisms tend to reward increased loan uptake at cheaper prices and that created cash spillovers to investing in other segments of the financial industry.

The study concluded that bank credit is seen to have a positive impact on capital market performance and other lending markets. It is also evident that interest rate shocks transmissions affected all markets including the foreign exchange. These findings point to other discussion points that feed into other related aspects that are outside of the study scope.

For instance linkages are not only justified through shocks but also by examining the evolution of the entire financial system such as banks having investment banks subsidiaries and underwriting functions which enables them to provide varied services under an umbrella group. This speaks to there being a tendency for co-evolution of the financial markets where growth of banking industry is linked with the growth in capital markets. Ultimately, how the linkages as established by the study leads to enhanced financial inclusion needs further empirical support.

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>
> Caspah Lidiema, United Nations

Regulation and Financial Inclusion

The last section of the Bulletin presents highlights of four conference papers whose thrust hinge on the consideration that regulation is meant to assure stability which then buttresses financial inclusion. The tone of these papers is set in the perspectives of John Gachora that are part of this Bulletin.

Regulation could be linked to asset quality; it would also inform strategy and risk taking behaviour. The papers highlighted here attempt to draw a line on how these aspects have implication on financial inclusion.

The Nexus between Financial Inclusion and Financial Stability: Credit, Savings and Asset Quality of Kenyan Banks

By Caroline Kariuki, Gillian Kimundi and Steve Makambi (Strathmore University)

Does expanded financial inclusion come with the risk of financial instability? This is the question that this paper seeks to interrogate. As more people enter the banking sector arena on the demand side, it changes the composition of the financial system with regard to the transactions, clients and risk profile; this could result in information asymmetry with banks having little understanding of the new borrowers.

Kenya banking sector has experienced rapid customer growth in the last decade with the number of deposit accounts growing more than tenfold to 41.2 million from 3.3 million in the last 10 years while loan accounts jumped to 7.8 million from less than a million over the same period.

This growth came at a time when the Central Bank of Kenya had implicitly made it part of its policy agenda to promote expansion of access to banking services. Banks were risking going to areas previously viewed as unproductive as infrastructure projects opened new regions of growth.

Given that the pursuit of financial stability is no longer a policy option but a compulsion, this study seeks to investigate the nexus between bank-based financial inclusion and asset quality using panel data from Kenyan banks from 2001-2015.

At the core of the study is the intention to identify whether there might be latent dimension in financial inclusion influencing financial stability given that reduced financial stability translated to increased systemic risk and the likelihood that banking sector will reduce their credit provisions and hinder financial inclusion.

The paper postulates that financial inclusion has the potential to pose risks to the stability of the financial system. The paper's framing is that the benefits of financial inclusion have to confront the fact that they come with the possibility of changes in the nature of the risks faced by the banking sector in terms of market participants' behaviour.

It is therefore imperative that the nature and design of financial products as well as the policy makers' reactions is aimed at seeking the "right type of financial inclusion". These leads to the ultimate question of whether financial institutions have the quality and capacity to supervise the financial services.

Gillian Kimundi.

The study's empirical determination indicates that: credit growth has a positive significant effect on the non-performing loan ratio, albeit with a lag, causing a decrease in asset quality; there is a negative concurrent relationship between deposit growth and the non-performing loan ratio, pointing to higher stability with higher deposit levels; and increase in the non-performing loan ratio indicates a negative contemporaneous effect on credit growth which implies that contractions in the supply side when there was a decrease in asset quality are observed.

Thus, higher non-performing loan tend to deter banks from loan issuance. In addition, banks are increasingly liaising with credit reference bureaus (CRBs) to track their customers' credit histories and reward those with good scores. Overall, the research implies that banks would have to keen in addressing information asymmetries between banks and borrowers as well as promote alternative platforms for financial services access.

For regulators, they should continue to calibrate "friendly" regulations that promote efficiency, stability and encourage alternative banking innovations. But even as that may be the case, the study inspires the need to recognise that financial instability may arise from other sources such as reputational, operational, liquidity and profitability.

Influence of Financial Regulation in Kenya on Financial Inclusion: A Case Study of the Banking Industry in Kenya

By Deborah Momanyi (KCB Group)

Deborah Momanyi.

This study seeks to contribute to the understanding of the link between financial regulation and financial inclusion on the back of developments of the recent years that have seen technological advancements that have led to product diversification as well as consolidations that have made some entities one-stop shop financial services providers.

In this regard, argues the paper, regulations are needed to diagnose and remedy situations that are pro-financial inclusion to maintain the delicate financial stability balance to propel economic growth. It so doing, it analyses the "three sides of the finance" coin: stability, regulation and inclusion.

Deploying both qualitative and quantitative analyses, the study establishes positive a positive correlation between the financial inclusion variables of access, quality, usage and regulation. If that association is strong enough then it would motivate the need for a regulatory frameworks that encourage financial inclusion in order to enhance financial stability.

At the same time, the study implicitly suggests, stability doesn't have to assured only through external regulation; financial institutions should see it as an imperative to create an environment that will build trust so that diverse clientele, especially the unsophisticated, would see then as the resort for advice.

The study's findings provides an analytical entry point to assessing the direction of causalities between regulation and inclusion. As financial inclusion requires the safe access of financial services to the disadvantaged in society, it would be necessary to include the theory of change in the conceptual framework for it would assist in measuring impact of inclusion beyond outputs such access and usage to outcomes that entails and how it affects the behaviour and welfare of the financially included.

At a broader level, the study also points to the need to look at regulation from a broad perspective. This would include aspects such as price regulation (such as the interest caps as introduced by the Banking (Amendment) Act 2016), anti-money laundering (AML) and cyber security.

These aspects of regulation need to be seen on the back of how they play in an environment characterised by technology drive provision of financial services, agency banking model and other such delivery channels that potentially influence inclusion.

That this study subjects regulation and inclusion to an empirical assessment speaks to the need for policy makers to rely on data analytics, not just intuition, in making financial regulations if such regulations are to achieve desired goal of deepening financial inclusion.

Deepening Financial Inclusion and Stability of Commercial Banks in Kenya: Synergies and Trade-offs

By Salome Musau, Stephen Muathe and Lucy Wamugo

Following the global financial crisis of 2007 – 2009 and the 2015 – 2015 instability in the local banking industry, there has been a push for commitment towards financial stability alongside financial inclusion to become part of the regulatory agenda in the banking industry. The argument is that stable financial system that is able to facilitate the performance of an economy, and if policies are appropriate a financially inclusive society.

As going concerns, banks will require stability to continue to flourish as well as increase their reach through various channels, technology being a key component in the recent past. Consequently continued

Salome Musau.

profitability is required for banking institutions to sustain the provision of financial services.

Some schools of thought hold that high levels of financial inclusion is associated with increased stability and increased financial access is also associated with increased savings mobilization and contributes to credit creation. Others contend that increased financial inclusion could lead to increased financial instability, especially with unknown customers with low literacy and therefore potentially bringing on board high risks. This presents a possible trade-off that is the subject of this paper.

The study shows that as banks increase their delivery channels, they enhance their risk management capabilities, hence their ability to contain their credit and liquidity risks. As the paper observes, financial inclusion can be attained through increasing customer base and boosts deposits and loan books. Such increase need not come at the cost of increased non-performing loans that may lead to credit and liquidity risks.

A deeper appreciation of the potential trade-off between stability and inclusion necessitates the recognition that there is a difference between financial inclusion and deepening. Equally, two other factors are instructive in ascertaining the existence or lack thereof if such trade-off.

One is the need to appreciate the likely effect of the interesting rates capping law on the market evolution dynamics from an inclusion dimension. The other is the recognition of the importance of the increased customers' digital preferences, agent banking and mobile money platforms have also contributed to banks reviewing the brick and mortar business models.

Strategic Leadership and Strategic Implementation in Commercial Banks in Kenya

By **Habil Olaka** (Kenya Bankers Association), **Peter Lewa & Peter Kiriri** (USIU-Africa)

Strategic leadership, particularly in the finance sector, is a pertinent subject as it is as the country's economic growth and development crucially depends on the financial stability of financial institutions. Such stability is a core ingredient to ensuring that the financial system serves the inclusion objective.

The objective of this paper is to analyse the influence of strategic leadership and implementation of strategy in commercial banks in Kenya. Various studies have been conducted on both strategic leadership and strategic management; however few studies have linked the two concepts and their influence on business performance particularly in the Kenyan banking sector.

The Kenyan banking sector has seen relatively good performance despite several banking failures between 1980s-2010s. This could partly be attributed to the regulatory measures. But it could also be attributed to effective implementation of strategy in individual banks.

The critical components of strategic leadership analysed in this study are strategic direction, core competencies, human capital, social capital, corporate culture, ethical practices and strategic control. These components are investigated to show their influence on the implementation of strategy in commercial banks in Kenya.

Strategic implementation is derived from a composite measure based on the balanced scorecard - financial, customer perspectives, internal process and learning. It should be noted macroeconomic factors were the control variables to show complexity of the business environment.

All the components analysed show a positive relationships with effective implementation of strategy. The study recommended that top leadership should direct efforts towards providing strategic direction of the organisation to achieve corporate goals and remain competitive. Further, the strategic leaders have to establish a balance between strategic and financial controls in order to directly influence the strategy implementation.

Dr. Habil Olaka.

Conference Pictorial

Dr. Patrick Njoroge, Governor Central Bank of Kenya gives the Keynote address.

Joshua Oigara, KCB Group CEO, Jared Osoro, KBA Director of Research and Policy and Jan Mikkelsen IMF Resident representative for Kenya.

A cross section of the delegates.

Mr. Lamin Manjang, KBA Chairman and Chief Executive Officer of Standard Chartered Bank makes opening remarks.

Mr. John Gachora, KBA Vice Chairman and Managing Director of NIC Bank makes opening remarks during the second day of the conference.

A participant asks a question during the Q&A session.

Gillian Kimundi responds to questions during the Q&A session.

Delegates register their attendance at the registration desk.

David Muriithi of KBA makes a contribution during a Q&A session.

Amrik Hayer, FSD Kenya discusses a paper during the conference.

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