

# Regulation of Banking and Payment Agents in Kenya

*Fletcher School Leadership Program in Financial Inclusion:  
Kenya Policy Memo*

Kenya has made significant strides in recent years in extending financial services to its populace. This has been accomplished on the back of the rapid expansion of banks across the country, particularly in rural areas, and the transformational introduction of mobile money transfer services in 2007. However, the battle for financial inclusion remains far from won, and Kenyan policymakers and regulators continue to develop and implement innovative models to expand financial inclusion. To this end, the agent banking model was rolled out in 2010 to enable banks to contract with third-party agents, just as telecommunications companies have been doing since 2007.

This policy memo explores the tensions between the payment agent model run by telecommunications companies and the banking agent model. It starts by outlining the supply and demand sides of Kenya's financial sector. The barriers to financial inclusion, including income, literacy levels, product characteristics, and geographical distance, are articulated. This memo analyzes the geographic distance barrier in special detail. The areas of tension cited by banks include differing requirements for payment and banking agents with respect to business track records, liability, and exclusivity. This memo recommends a review of the requirements for both types of agents to allow for proportional regulation, based on risk and types of services provided.

## PROBLEM STATEMENT

Kenya's current development blueprint, Vision 2030, seeks to graduate the country from a low- to medium-income country by 2030 (Government of the Republic of Kenya, 2007). The vision is underpinned by massively upscaling access to formal

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financial services from current levels of 23 percent to over 60 percent of the bankable (adult) population.<sup>1</sup>

The barriers to financial inclusion identified in national financial access surveys carried out in 2006 and 2009 include costs of financial services (minimum balances and fees), low financial literacy, documentation requirements, distance to financial services locations, and income constraints. Long distances to financial services locations increase the transaction cost to consumers in terms of transport cost and time spent traveling. It is therefore critical that this constraint be addressed in order to expand access to formal financial services.

The rollout of an extensive network of mobile phone payment agents in Kenya since 2007 has, in large part, targeted this challenge. In 2010, with an eye to deepening these initiatives, the Central Bank of Kenya (CBK) issued guidelines to enable banks to offer a broad range of banking services through agents. This framework differs from that for payment agents, which is currently guided by requirements set by telecommunications companies. The Central Bank has also recently issued draft regulations covering payment agents (Central Bank of Kenya, March 2011). Banks have therefore submitted a request to the Central Bank to review the agent banking guidelines in light of the requirements that differ from those of payment agents. An urgent review of this problem by CBK is required to maintain the momentum of the growth of financial inclusion through both payment and banking agents, and to ensure that achieving the Vision 2030 targets is kept on track.

## BACKGROUND

### **Overview of Kenya's financial sector**

#### *Financial access landscape (supply)*

Kenya's financial sector comprises both the formal and informal financial sectors. The formal sector is one of the largest and best developed in sub-Saharan Africa. It is comprised of a number of different financial institutions and independent regulators, each charged with the supervision of their particular subsectors. As of December 31, 2010, the banking sector included 43 commercial banks, one mortgage finance company, two representative offices of foreign banks, 126 licensed Forex Bureaus, five Deposit-Taking Microfinance Institutions, and one Credit Reference Bureau, all supervised by the Central Bank of Kenya (CBK, June 2011). The National Payment System, which is part of the financial system, is also overseen by the Central Bank. Other players include the capital markets, insurance, pension schemes, and savings and credit cooperatives.

#### *Financial access landscape (demand)*

Kenya's financial access landscape has shown marked improvement over the past few years, as revealed by two national financial access surveys conducted in 2006 and 2009 (FinAccess, 2006, 2009). As indicated in Figure 1, access to formal financial services increased from 18.9 percent of the bankable population in 2006 to

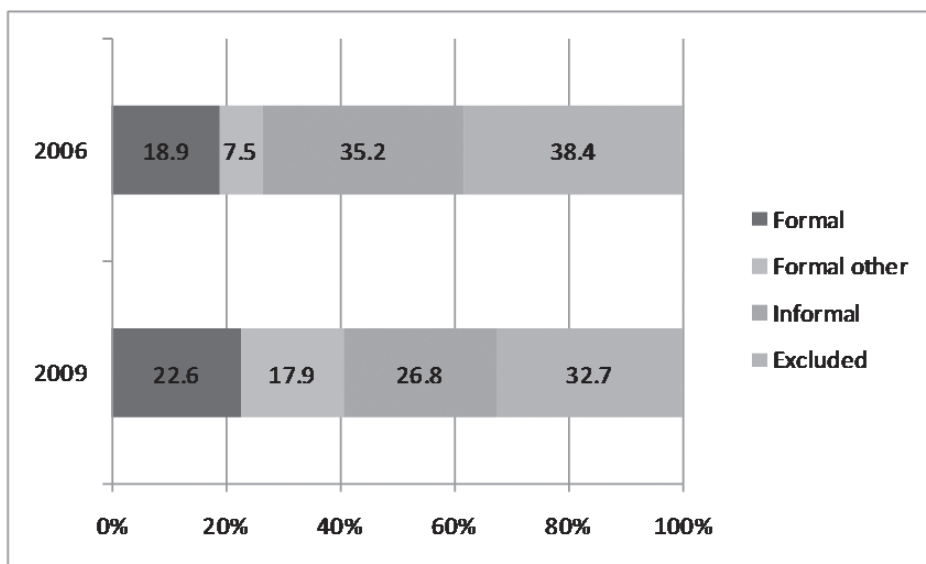


Figure 1. Financial Access Strand in 2006 and 2009

Source: FinAccess (2009)

22.6 percent in 2009.<sup>2</sup> The number excluded from any formal or informal financial service decreased from 38.4 percent in 2006 to 32.7 percent in 2009.

### Barriers to financial inclusion

The key challenges and barriers to financial inclusion as revealed in the 2006 and 2009 surveys (FinAccess, 2006, 2009) and various related studies are as follows:

Low income continues to be the main barrier to expanding access, with 61.8 percent of the unbanked citing income-related barriers as the key reason for exclusion.

Non-income-related access barriers—such as documentation and qualifications, product characteristics, literacy levels, gender and cultural values, and geographical distance—together constitute the second most important reason for being unbanked.

While all of the above listed barriers are important, this memo will focus primarily on the geographical distance barrier.

### Initiatives to address distance/financial services outlets constraints

#### *Growth in bank branches and ATMs*

To reduce the distance to financial services, commercial banks have massively expanded their branch and ATM networks in the last five years, as indicated in Figure 2.

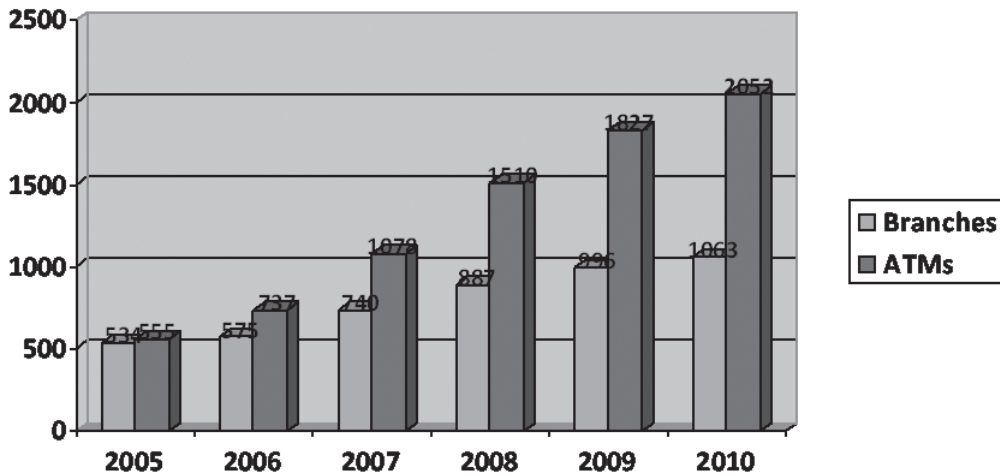


Figure 2. Kenyan Banking Sector: Branches and ATMs, 2005 to 2010

Source: Central Bank of Kenya

The number of bank branches expanded from 534 in 2005 to 1,063 at the end of 2010, a 99 percent increase. The ATM network increased from 555 in 2005 to 2,052 in 2010, a 270 percent increase.

Bank branches have also expanded significantly in rural areas, as depicted in Figure 3. The number of rural branches has expanded by 150 percent, from 181 in 2005 to 447 at the end of 2010. Urban branches, on the other hand, have expanded by 75 percent, from 353 in 2005 to 616 at the end of 2010.

#### *Mobile/payment and banking agents*

One of the most significant initiatives in addressing access to financial services in Kenya has been the development of mobile money transfer services. Safaricom, Kenya's leading mobile operator, launched the M-PESA money transfer service in 2007. M-PESA has experienced viral growth in its first four years, gaining over 15 million subscribers and more than 20,000 agents.<sup>3</sup> The introduction of mobile financial services has helped to more than double the use of non-bank financial institutions, from 7.5 percent of the bankable population in 2006 to 17.9 percent in 2009 (FinAccess, 2009). The attraction of mobile financial services such as M-PESA is their extensive reach all over Kenya, including in villages and slums (Klein, 2011).

The amendment of Kenya's Banking Act through the Finance Act of 2009 permitted banks to use third parties (agent banking) to provide certain banking services on their behalf. The Central Bank subsequently issued guidelines on agent banking, in May 2010 (CBK, May 2010). The guidelines require banks to seek CBK's approval for the agent network, as well as approval for specific agents, and to clearly specify the services to be provided by the agents. It is the institutions' responsibility to vet the suitability of the agents in keeping with the guidelines. As

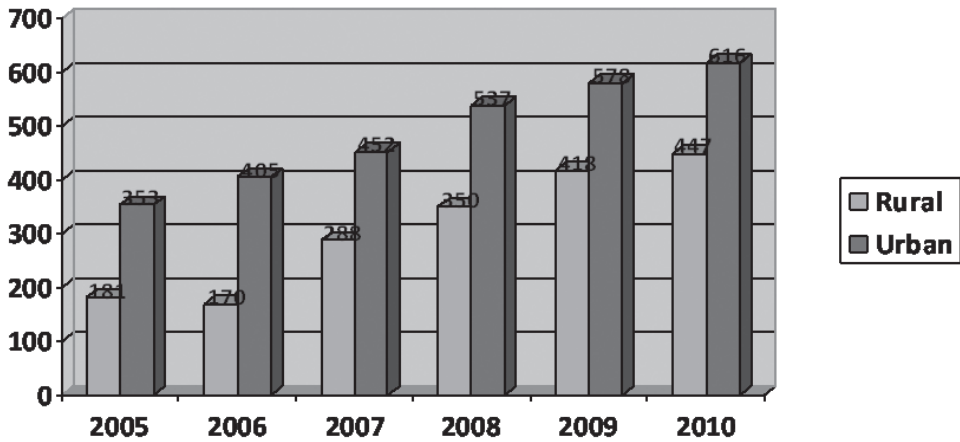


Figure 3. Kenyan Banking Sector: Branches Distribution, 2005 to 2010

Source: Central Bank of Kenya

of December 2010, CBK had granted approval to five institutions to engage agents. Of these, two institutions had appointed a total of 8,809 specific agents, including telecom-related agents and individual specific agents, spread across the country (CBK, June 2011).

#### *Representations by banks on a regulatory framework for banking agents*

Following the rollout of agent banking in May 2010, banks have made proposals to the Central Bank on possible areas of revision of the Agent Banking Guidelines. This is based on their experience on the ground, as well as on the various frameworks for payment agents contracted by mobile phone operators. The contracting of payment agents is currently guided by the requirements of individual telecommunication companies. However, the Central Bank has recently issued a request for comment on draft regulations on e-money and retail payment systems (CBK, March 2011), which are intended to apply to payment agents.

In summary, the banking sector argues that three issues warrant special examination:

- Payment agents are generally required to have at least a six-month track record in an existing business before being contracted. Conversely, the Agent Banking Guidelines mandate an 18-month track record for banking agents.
- The Agent Banking Guidelines explicitly place liability for the agents' actions on the bank. The liability of telecommunications companies with respect to liability for payment agents is not explicit.
- Banking Agents cannot be exclusive and can serve more than one bank. For payment agents, this is not explicit, and there are payment agents that exclusively serve one telecommunications company.

The banking sector argues that the Agent Banking Guidelines should be amended to allow for a tiered approach in order to create:

- Payment agents whose requirements would be less rigorous and be similar to those of telecommunications agents that offer only cash-in and cash-out services
- Banking agents whose requirements would remain as per existing agent banking guidelines but would be able to offer a broader range of services beyond payments, including origination of deposit and loan accounts.

## ANALYSIS

### **Policy considerations**

#### *Vision 2030 financial sector targets*

Under Kenya's current development blueprint, Vision 2030, a more efficient and competitive financial sector is expected to drive savings and investments for sustainable and broad-based economic growth. The central policy objectives of the long-term strategy for the financial sector include improved access and deepening of financial services and products for a much larger proportion of Kenya's populace (Government of the Republic of Kenya, 2007). The goals for the financial sector are to raise savings and investment rates from 14 percent to 25-30 percent of GDP by 2030, and to increase bank deposits from 44 percent to 80 percent of GDP by 2012 (Government of the Republic of Kenya, 2008).

#### *Scaling-up of agent networks*

The ambitious targets under Vision 2030 require massive expansion of access to financial services for Kenyans. Identified constraints to accessing financial services, particularly distance to financial services points, will need to be addressed. The proliferation of mobile money services in Kenya and the demonstrable success in enhancing access to financial services provides key lessons. The success, particularly of the pioneering M-PESA service, has been partly attributable to its wide network of agents (Dittus and Klein, 2011; Klein, 2011; Mas and Radcliffe, 2011).

The effect of a large network of participants, particularly for M-PESA, has contributed to its success. A similar network effect will be critical for banking agents to get to scale and to have a significant impact on access to second-generation financial services for savings mobilization and credit. The current mobile money services offered by mobile operators are largely focused on first-generation payment services, although linkages with commercial banks are increasing.

#### *Proportionate/risk-based regulation*

The Kenyan financial landscape presents a unique ecosystem of both banking and payment agents (Tarazi and Breloff, 2011). The proposals by banks in the earlier part of this memo are to some extent illustrative of the tensions between the two models, particularly given the head start afforded the telecommunications compa-

nies with payment agents. This begs the question of whether the regulatory regime for both types of agents should be the same.

To determine the appropriate regulatory framework, financial services that enhance financial inclusion need to be unbundled. The key components could include exchange of different forms of money (virtual money for cash), storage of money for safekeeping (without payment of interest), transfer of money from one person/entity to another, and investment of money (intermediation) (Dittus and Klein, 2011).

The model will then require varying degrees of regulation based on risk, which is lowest with the exchange of different forms of money and highest with intermediation. This suggests differing intensity of regulation with “light touch” regulation at the basic exchange of forms of money to intensive prudent regulation at the intermediation end. Accordingly, it is useful to unbundle the banking and payment agents in Kenya along these lines and recommend proportionate regulation.

### **Policy choices**

#### *Retain status quo*

One choice is to maintain the status quo. Doing so would not entail any changes in the existing regulatory framework for banking and payment agents. Rather, it would mean taking a “wait and see” approach, allowing market forces to deal with the unlevel playing field for banking and payment agents. Although this approach represents the easiest course of action, it runs the risk of slowing Kenya’s rapid progress toward financial inclusion. More importantly, it could deter the achievement of the ambitious financial sector targets set out under Vision 2030, especially if banking agents do not scale-up rapidly to benefit from network effects.

#### *Amend regulatory framework for payment and banking agents*

Amending the regulatory framework for both payment and banking agents is another option. This would require more work but would ensure that Kenya’s financial inclusion momentum is not only maintained but possibly accelerated. Extensive networks of banking and payment agents would be complementary, with payment agents offering first-generation financial services and the banking agents providing second-generation financial services.

### RECOMMENDATION

The Central Bank of Kenya should review and amend the regulatory framework for banking and payment agents by unbundling the services offered. A tiered approach should be adopted in the Agent Banking Guidelines to incorporate payment agents (“cash merchants”), as well as full-fledged banking agents. The regulatory regime for “cash merchants” under both regimes (Agent Banking and Draft E-Money Guidelines) should be reviewed to ensure proportionate regulation. The regime for payment agents should be less rigorous than that of banking agents, as

they would only provide basic payment services. The key areas to be considered in both guidelines for review should be:

- Harmonization of track record and documentation requirements for both banking and payment agents
- Clarity on the liability of institutions contracting payment and banking agents
- Exclusivity of agents

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1. "Bankable population" refers to adults over age 18.
  2. Formal financial services refer to use of a commercial bank, postal bank, or insurance product. The "formal other" designation refers to use of services from non-bank financial institutions such as savings and Ccredit cooperatives, microfinance institutions, and mobile financial services. The informal strand uses informal financial services such as accumulating savings and credit association, rotating saving and credit association, and groups/individuals. The excluded do not use any formal/formal other or informal financial services.
  3. Central Bank of Kenya statistics.