Financial Deepening and M4P: Lessons from Kenya and Rwanda[1]

Abstract

Financial inclusion has risen steadily in development circles over the last 10 years to become a key policy objective for donors and governments. In Africa, more than 600 active financial sector projects are currently being carried out by a variety of donors. The increasing amount of public capital coming into the sector suggests the need for a better understanding of what works to promote financial inclusion on the ground, and how to coordinate donor efforts to achieve sustainable results.

This paper looks first at the history of financial inclusion efforts that led to the rise of the M4P approach. The second section outlines lessons from FSD Kenya's experience on the ground, while the third suggests how M4P can be applied in weak and strong markets.

We conclude with some considerations for donors who may want to launch similar M4P financial inclusion programmes in Africa.

KPMG International Development Advisory Services (IDAS) currently oversees two multi-donor financial inclusion programmes in Africa that follow the Making Markets Work for the Poor (M4P) development approach: the **Financial Sector Deepening Trust in Kenya**, and the recently launched **Access to Finance Rwanda**.

These programmes offer some important lessons regarding how M4P can promote sustainable financial inclusion, and how these interventions work best in different markets.

1. Financial inclusion evolution

Early financial deepening theories emphasised the need to increase savings in order to stimulate investment and help emerging economies achieve catch-up growth, with poverty reduction to follow. Evidence to support the effectiveness of this approach has been mixed. It was quickly overtaken by the global microfinance movement, which promotes the benefits of direct financial service provision to the poor. Many financial inclusion promoters now agree that direct access to finance services can improve individual livelihoods amongst the poor by enabling them to manage scarce resources more efficiently, thereby smoothing consumption and protecting against economic shocks.[2]

However, microfinance institutions themselves have achieved limited success in sustainably increasing beneficial financial access for the poor. Critics argue that financing for micro-enterprises that carry minimal productive potential is unsustainable. Microfinance has also been questioned for its inability to offer lower interest rates or reach deeper into remote rural markets. Various

[1] This is one of a series of short pieces from KPMG IDAS Advisors designed to show forward thinking based on our extensive experience, that covers general development topics, fragile states, private sector development, governance, organisational and performance experiences and adaptation to climate change. The series is edited by Julio Garrido-Mirapeix, Head, and Abijah Kanene, Manager – Market Intelligence Learning and Knowledge, IDAS Africa. This paper was written by Rachel Keeler, IDAS Africa Impact and Innovation Manager.

[2] For evidence, see D. Collins, J. Murdoch, S. Rutherford, & O. Ruthven. 2009. "Portfolios of the Poor: How the World's Poor Live on $2 a Day." Princeton University Press.

donor attempts to provide financial services directly to poor consumers – the "poverty banking" approach – have also been limited in scope and impact.

Researchers thus began to search for a better understanding of the relationship between financial services and the poor. Innovative work by Stuart Rutherford in Bangladesh found that even where microfinance institutions moved into underserved markets, they commanded a small share of business compared to other informal services. His work has revealed the poor as discerning consumers, who use a variety of informal products to meet complex financial needs.[3] Some practitioners stress the need to replace informal services with formal inclusion that offers reliability, less risk of loss, and better privacy.[4] However, the continued use of informal options despite the expansion of formal services in markets like Bangladesh and Kenya suggests the need for a multifaceted approach, and emphasises the value of rigorous low-income market research.

In South Africa, the FinMark Trust programme has gained much recognition for introducing the FinScope financial access surveys, which serve as a baseline for policymakers and financial service suppliers seeking a better understanding of low-income consumers. FinMark is also one of a growing number of financial inclusion programmes that operate according to the Making Markets Work for the Poor (M4P) framework. M4P emphasises the need for a more holistic approach to financial market development that addresses the underlying barriers to financial access for underserved groups. M4P programmes aim to sustainably drive rather than distort the market, and tackle questions such as: How can the costs of servicing small accounts for low-income consumers in remote areas be reduced? And, why do banks resist lending to small businesses? These questions point to gaps in the market that can be addressed at three levels:

- **Micro:** at the basic market transaction level, retail providers deliver services to consumers. Developing practical know-how amongst these providers is at the heart of market development.
- **Meso:** retail providers also depend on various industry infrastructure and services. Building capacity among relevant service providers such as credit reference bureaus, auditors, and researchers can enhance market development.
- **Macro:** government policy and regulation define the basic rules of the game within which financial service providers operate. An enabling policy environment reduces the costs and risks of doing business and encourages innovation.

[3] Stuart Rutherford. 2010. "The Poor and their Money: Microfinance from a twenty-first century consumer's perspective." Practical Action.

[4] Jake Kendall. 2010. "A Penny Saved: How do savings accounts help the poor?" Financial Access Initiative.

Financial inclusion best practice guidelines now reflect the M4P approach:

- Stimulate market competition and encourage provision of a broad range of services by a diverse group of FSPs
- Build cost-reducing financial market infrastructure to expand access and encourage usage
- Stimulate informed demand and supply
- Create an enabling environment through appropriate regulation and policy
- Limit government intervention and subsidies, while promoting government commitment to reform
- Focus on knowledge creation, data collection and ensure M&E along the way.

2. Lessons from Kenya and Rwanda

What has been the success of M4P financial inclusion programmes on the ground? Since 2002, the Department for International Development (DFID) has rolled out a number of financial inclusion programmes across Africa according to the M4P approach. KPMG IDAS Africa provides financial oversight for two of these:

The **Kenya Financial Sector Deepening programme (FSDK)**, was established with support from DFID in 2005 to stimulate wealth creation and reduce poverty by expanding access to financial services for lower income households and smaller scale enterprises. According to the M4P approach, the programme works with a range of financial institutions, business service providers and support institutions. Kenya's financial services market is relatively well-developed. Competition is strong amongst a diverse group of service providers that have moved deeper into the low-income market over the last five years, in part thanks to FSDK interventions. From 2006 to 2009, overall financial inclusion increased from 58.7% to 67.3%.[5] Gains have come from the introduction of mobile money and the responding rollout of branchless agency banking models by commercial banks competing for the mass market space. Kenyan regulators have also been instrumental in introducing appropriate regulations to facilitate low-income banking and strengthen SACCOs and MFIs.

Access to Finance Rwanda (AFR): Following the success of the FSD Trust in Kenya, DFID established Access to Finance Rwanda (AFR) in 2010. The AFR programme is structured much like FSD Kenya, with supervision by KPMG Rwanda, and seeks similar outcomes according to the M4P approach. The new initiative comes at a key time for Rwanda, where unmet demand by the poor for financial services is high, and the government has identified financial inclusion as a key driver of pro-poor economic development. In 2008, 52% of Rwandan adults were completely financially excluded, and only 14% had access to formal banking services. 91% of Rwandan adults generate their own income through micro-enterprise. Most of these are subsistence farmers, many of whom live in remote rural areas.[6] Finding ways to reach these consumers with appropriate financial services presents a huge challenge. AFR is faced with a small, underdeveloped economy where viable partners are few, market failures are many, and the culture of traditional market-distorting aid remains strong.

[5] FinAccess Surveys 2006, 2009. Financial Sector Deepening Kenya.

[6] Finscope Rwanda, 2008. Access to Finance Rwanda.

The following analysis reviews some of the lessons learned on the ground through the successful FSD Kenya programme, and explores how these insights may apply to implementing M4P access programmes in other African markets such as Rwanda.

2.1 Catalysing Market Change through Competition and Innovation

Financial markets function best with a healthy level of competition. Competition drives costs down and encourages firms to develop a broad range of financial services. In markets where competition to reach low-income consumers is thin, M4P initiatives can "crowd in" better services by reducing barriers to entry and demonstrating the commercial viability of innovative new products for the poor.

Barriers to market entry

- Information asymmetry
- High risk associated with serving low-income clients, SMEs or small farmers
- High cost of servicing small accounts or remote rural areas

In Kenya, following support from FSDK to transform from a building society to a full-service commercial bank, Equity Bank has demonstrated that it is possible to reach millions of low-income clients with affordable transaction accounts. Coupled with competition from Safaricom's M-Pesa mobile money service, this example has pushed other banks further down market where they are exploring innovative agency banking. Despite the quick success of M-Pesa, building the platform's now 27,000-agent network involved huge up-front costs. Early support from DFID and continued support from FSDK ensured that Safaricom was willing to take the risk of rolling out the pioneering programme.

However, supporting partners at the micro level also carries some risk of market distortion. In some ways, donor support that sped up market entry for Equity and M-Pesa has given both companies a first-mover advantage over their competitors. Kenya is now struggling to promote an interoperable agent network because of Safaricom's control over the mobile money market (although that position also stems from Safaricom's large share of the overall telecoms market), and FSDK is exploring ways to promote further branchless banking innovation to avoid a low-level trap where M-Pesa dominance causes market stagnation. FSDK is also considering how to use subordinated debt instead of grants as a way to reduce market distortions while sharing the risk of product innovations with individual companies.

M-Pesa: Financial Inclusion's Poster Child

Safaricom's M-Pesa mobile money platform has become something of a poster child for financial inclusion. However, critics are quick to point out that M-Pesa's success was the result of a perfect storm, while other countries have struggled to get mobile money off the ground. Even so, the experience offers important lessons:

- National markets are unique: The less successful rollout of M-Pesa in Tanzania has revealed, for example, that Tanzanians have less use for urban-rural money transfers than Kenyans. This points to the importance of market research and the need to understand the complex financial habits and demands of low-income consumers.
- While business models are country-specific, innovative ways of thinking about the poor as consumers can quickly transcend borders. Even if they haven't gotten it right yet, that companies and policymakers across Africa are working to replicate mobile money and agency banking models suggests a paradigm shift that will lead to better services down the line.

2.2 Supply-Side Capacity Building

M4P programmes can encourage greater entry to the low-income market and product innovation by building financial service provider capacity to reach the unbanked. Various FSDK-supported projects highlight lessons for success:

Go beyond in-house training: Isolated in-house training for better product development by a single service provider has led to staff poaching and limited success.

Promote public knowledge: Successful programmes have combined in-house training with public dissemination of lessons learned through toolkit resources and research. FSDK's own focus on knowledge creation through surveys like FinAccess has also been highly successful in building supply-side capacity in the market.

Promote a market for business development services: These service providers are often missing in emerging markets. Programmes that integrate training for business development consultants ensure that capacity building continues beyond donor support, especially in strong markets where financial institutions providers may be willing to pay for these services once their credibility and effectiveness has been established. Unfortunately, commercial viability of technical assistance is threatened in weak markets where aid prevails.

Build enabling market infrastructure: Often supply-side constraints are more external than internal. Suppliers may not be able to increase loans to SMEs until credit reference bureaus are in place. Basic financial transaction costs will remain high until an efficient national payments system have been developed. FSDK experience shows that research-backed collaboration with policymakers is the best way to address these challenges.

REACHING THE POOREST: working with Informal Providers

Many financial inclusion programmes emphasise expansion of formal services. However, experience in Kenya and Rwanda reveals the importance of informal providers – such as accumulating or rotating savings and credit associations (ASCAs and ROSCAs) – to reaching very poor and remote clientele, as well as ensuring access to a variety of services for many consumers.

In 2007, 53% of Kenyan adults belonged to at least one informal financial group. Even as the availability of formal and semi-formal services has grown, surveys show that Kenyans continue to use informal services alongside new products, reaping the unique benefits of both. Informal services are seen as providing social benefits that formal services lack. They also offer more affordable solutions than formal options for the poorest consumers. In Rwanda, where the financial market is less developed than in Kenya, and formal services still struggle to reach remote rural clients, working with informal providers may be even more important. Reliability of community-based solutions is spotty: in Kenya, a striking 56% of ROSCA and ASCA members have experienced personal savings losses. However, this points to the need for M4P programmes to work with informal groups to improve governance.

Unfortunately, tension remains between commercial viability and deep market outreach. FSDK's Decentralised Financial Services programme has shown that "the very cost structure and focus that allows rural financial institutions to reach out so far are the very limitations to strong governance, management and systems that might allow scale." For this reason M4P programmes may want to seek a diversified portfolio of partners with both commercial winners and outreach winners.

2.3 Understanding Demand

It is often said that financial inclusion is limited by lack of financial literacy amongst the poor. However, experience on the ground reveals that the poor can be quite discerning consumers. Many of them are already using a variety of products to meet their financial needs. Experience shows that better financial inclusion begins by understanding these existing habits and identifying unmet demand.

Focus on market research and appropriate product design: in Rwanda and Kenya, the Finscope and FinAccess surveys have been vital resources for suppliers seeking a better understanding of market demand. FSD-Kenya finds that where uptake of basic formal financial services has been slow, this is due to a mismatch between product features and client needs rather than a lack of financial literacy. Suppliers should thus focus on making products that are easy to use and understand.

Heed market signals: Much can also be learned from how consumers use current products in the market. In Kenya, financial inclusion promoters are investigating why low-income clients do not use M-Pesa to save. Market feedback suggests that M-Pesa may be too liquid for consumers seeking commitment mechanisms. Could sub-accounts in an "M-Pesa wallet" address this need?

Financial education is important as a baseline and for credit products: consumers interviewed by FSDK reported that they learn best by testing new products. Even so, financial literacy programmes can provide an important baseline of knowledge in emerging markets. Capacity building to help SMEs write better business plans and loan applications is an important form of financial education that is not readily replaced by "learning through doing". Likewise, in Rwanda, lenders report over-indebtedness of consumers who take on credit without understanding how to manage it, pointing to the need for financial education in the form of consumer protection initiatives.

3. Applying M4P in different markets

		Strong Markets (Kenya)	Weak Markets (Rwanda)
Macro	Policymaker competence	Competent and proactive regulators facilitate innovations such as mobile money and agency banking. Constructive relationships with stakeholders promote market development.	Often policymakers are unwilling or unable to write or enforce timely or relevant regulations. (Rwanda is a unique here, with competent policymakers and robust enforcement.)
Meso	Business development services	Potential for commercial provision of business development services once credibility has been established.	Few service providers exist in the market. Culture of aid means FSPs may be reluctant to pay for support services.
	Market infrastructure	Better developed, although still in need of support: national payments systems and credit bureaus are not yet well-established.	Many systems must be built from scratch, but with the benefit of learning from mistakes in other markets
Micro	Programme focus	Transition away from direct support for micro-level players as financial markets develop.	Focus on micro-level work, although macro and meso are also important to market development.
	Opportunity costs	FSPs face competing priorities and will often invest where they see less risk or higher returns instead of serving poor clients, rural consumers or small businesses.	Where poverty is high and inclusion low, opportunity costs of reaching marginalised consumers are lower because the up-market pie is so small.
	Facilitation role	Hands-off market facilitation is somewhat easier where strong markets have greater momentum and viable partners are many.	Gaping holes of inactivity plague the market and viable partners are few, which limits the scope for light-touch facilitation.
	M&E	Results may be seen more quickly where the private sector is more dynamic, however attribution of results to the programme intervention may be more difficult with many factors at work.	Measurable results take longer, as the programme works through extra market development phases. Attribution of results may be easier, although other market drivers are always present.
	Culture of Aid	The Kenyan government relies more on its own tax revenues and less on aid, while the strong private sector relies less on government support or direction. This makes it easier to promote market-driven solutions.	Rwanda suffers from an economic culture that emphasises subsidies and public intervention, which constrains the promotion of a private sector mindset. That means banks may be less willing to pay for business support services, the government expects donors to provide public goods, and

	Strong Markets (Kenya)	Weak Markets (Rwanda)
		consumers may be less inclined to repay loans.
Knowledge transfer	Knowledge is exchanged across multiple strong market segments including ICT, agriculture, financial services, regulators, private sector, donors and NGOs. Lessons also flow between strong markets.	Rwanda is adopting Kenyan successes such as agency banking, and learning from mistakes such as the lack of interoperability in Kenyan agent networks.
Human Resources	Relatively higher education levels and a pool of experienced "re-pats" make local staff and qualified consultants easier to find. As a regional hub, Nairobi presents opportunities for many productive partnerships.	Education in Rwanda is perhaps 15-20 years behind Kenya with lower repatriation rates, which limits staffing options and productive partnerships. However, M4P programmes have a greater role to play in promoting a private sector mindset and critical thinking about economic challenges.
Economies of Scale	To achieve synergies across the micro, meso and macro levels, M4P programmes manage a large portfolio of projects. In 2007, just two years after launching, FSDK was working with 50 direct partners. The programme now manages 30 projects.	Programme scale may be more difficult where viable partners are fewer, putting project staff and systems in place takes longer, and widespread market gaps make short-term results elusive.

4. Considerations for donors

Importance of synergy

One of the keys to FSDK's success and scale has been the ability to leverage lessons learned and credibility gained by working at the micro level to promote appropriate policy reform at the macro level, or build industry infrastructure at the meso level, and vice versa. Achieving synergy across these levels is necessary to promote overall market development. Programmes that focus on one area only will be less able to effect systemic change.

Value for money

Market development requires time, intellectual rigour, and multifaceted interventions – not necessarily large budgets. Microsave, an FSDK supported capacity building project for MFIs, has caused a "paradigm shift" in microfinance thinking and practice, and significantly influenced at least 50 financial service providers. Its total budget over nine years was US$10.8m. Knowledge-based programmes will be human resource intensive. However, FSD-Kenya has shown that overhead can be kept low relative to programme scope through leveraging market partnerships and strategic outsourcing.

Bringing donors together

Donors that fund FSDK talk about having a trusted partner on the ground, a seat at the table with other stakeholders, and the ability to leverage a small amount of funds to achieve market-wide change. Donors agree on programme strategy and procedures up front and do not earmark funds or micromanage, allowing FSDK's technical team to carry out efficient and effective projects. Because FSDK was able to build up significant credibility through its early work, the programme now enjoys significant trust and leeway from its funders, while the funders benefit from FSDK's strong market reputation that gives them the opportunity to influence a range of public and private sector actors.

Working with, not for governments

As holistic market development programmes, both FSD-Kenya and AFR have written programme strategies in line with government financial inclusion goals. However, unlike heavily funded multi-donor basket funds that have shown limited success in supporting government plans, the FSDs take an efficient, independent approach. Governments are consulted as valuable partners, but work is carried out by engaging the private sector directly and does not depend on public action.

Measuring impact

Taking a holistic, long-term approach to market development makes impact assessment difficult. Attributing change to specific interventions is also hard for M4P programmes that work with many partners in a dynamic market system. To address these challenges, FSDK executes projects in phases according to theoretical impact pathways and assesses along the way. This iterative approach allows for flexibility, creativity and learning. Impact assessment should avoid over-claiming – both what financial inclusion can do for poverty reduction and how much change can be attributed to the specific programme – while recognising that market development gains are often long-term, intangible, and greater than the sum of their parts.

M4P is not a panacea

Carefully crafted interventions can push financial providers deeper into underserved markets. However, private sector players will continue to face competing priorities for investment. The rise of impact investing will ensure that more funds are channelled along double and triple bottom lines to benefit marginalised consumers. But for many investors, profit and traditional risk-reward ratios will remain the driving force. Important advances can be made by strengthening service providers already geared toward the poor, or by demonstrating the profitability of pro-poor products. But this will not always be the case. Experience has sometimes shown a trade-off between commercial viability and the ability to reach the poorest clientele. Taking an M4P approach does not promise that all of these challenges can be overcome. It simply ensures that interventions will be commercially minded and sustainable, and where possible, encourage markets to work better for the poor.

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