Update on Regulation of Branchless Banking in Kenya

January 2010

Note: This update of CGAP's 2007 "Notes on Regulation of Branchless Banking in Kenya" incorporates research conducted by CGAP in January 2010 regarding relevant legal and policy changes through the end of 2009. It is one of 11 similar country updates produced by CGAP as a part of the work plan of the Access through Innovation Sub-Group of the G-20 Financial Inclusion Experts Group. However, CGAP alone is responsible for its content. Corrections may be forwarded to yseltzer@cgap.org.

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1. Introduction

Safaricom, a joint venture of the Kenyan government and Vodafone, pioneered branchless banking in Kenya with its M-PESA mobile-phone based payment service, launched in March 2007. M-PESA has achieved tremendous growth: as of January 2010, it has 14,700 agents and approximately 9 million users and has facilitated approximately KSh 300 billion in person-to-person transfers since it began business less than three years ago. However, Safaricom and other providers' subsequent early forays into branchless banking were undertaken in an absence of legislation governing payment systems, e-money, bank agents, consumer protection, and anti-money laundering and combating the financing of terrorism (AML/CFT). Legislative initiatives in banking, microfinance, payment systems, and AML/CFT signal policy makers' keen interest in creating an enabling environment for branchless banking. These initiatives include (i) a 2008 regulation permitting microfinance deposit-taking institutions to use agents; (ii) a 2009 amendment to the Banking Act that permits banks to appoint agents to take deposits and perform other activities (to be followed by detailed regulations); and (iii) passage by Parliament in late 2009 of an AML/CFT bill, which applies to both bank and nonbank institutions. Unfortunately, the new bill poses potentially burdensome requirements on small-value transactions and remote account openings. In addition, a National Payments Systems bill is expected to enter the Parliamentary process in 2010.

2. Sector Overview

As in most developing countries, access to finance is limited in Kenya, although the picture has improved significantly over the past few years. In 2007, an estimated 19 percent of the adult population had access to formal financial services through banks, with 8 percent served by microfinance institutions (MFIs) and savings and credit cooperatives (SACCOs).[3] According to a 2009 survey, an estimated 40.5 percent of adults in Kenya were "formally" served, with the term "formal" including services by banks as well as nonbank financial institutions (such as MFIs and SACCOs), Postbank, and insurance companies.[4] According to the survey, "usage of non-bank financial institutions has more

[1] The 2007 "Notes on Regulation of Branchless Banking in Kenya" was based on an analysis of existing legislation and regulations relevant to branchless banking approaches and on the CGAP research team's insights from interviews with a range of stakeholders. The original diagnostic assessment was carried out under the auspices of CGAP's Technology Program, which is co-funded by the Bill & Melinda Gates Foundation. The Kenyan diagnostic assessment was one of seven that provided evidence for CGAP & DFID's Focus Note 43, *Lyman, Timothy, Mark Pickens, and David Porteous. 2008. "Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance."* Washington, D.C.: CGAP & DFID, January."

[2] In September 2009, the G-20 called for the establishment of a Financial Inclusion Experts Group with two subgroups, one of which is the ATI Sub-Group. CGAP is a member of an experts group assembled to assist the ATI Sub-Group in its work, which includes updating information previously published on the policy and regulatory framework for branchless banking in various developing countries.

[3] FinAccess, *Results of a National Survey on Access to Financial Services in Kenya,* 2007 (see www.fsdkenya.org/finaccess).

[4] FinAccess National Survey, June 2009. According to the survey, there are an estimated 300 deposit accounts in commercial banks per 1,000 adults in the country. For context, in high-income countries there is an average of more than 2,000 accounts per 1,000 adults. Id.

than doubled from 7.5 percent in 2006 to 17.9 percent—this can be mostly attributed to the new M-PESA service provided by Safaricom."

The low access figures are likely due in large part to the fact that banking is expensive in Kenya. A 2007 survey of barriers to banking, using data from 62 countries, indicates that minimum balances required by Kenyan banks are quite high. The average minimum balance in Kenya equals to 44 percent of gross domestic product (GDP) per capita, versus the 62-country average of 8 percent. Annual fees in Kenya are also high, at 2 percent of GDP per capita versus 0.38 percent.[5]

In addition, Kenyan banks have limited infrastructure for reaching out to customers. As of December 2008 there were 876 bank branches and 1,424 automated teller machines (ATMs).[6]

While 40.5 percent of adult Kenyans are served by formal financial institutions, an even greater percentage (47.5 percent) own a mobile phone (up from 26.9 percent in 2006). Just as the population is skewed toward urban and away from rural areas,[7] so too is mobile phone ownership: in urban areas the percentage of mobile phone ownership rises to 72.8 percent, and to 80.4 percent in Nairobi, specifically. The use of mobile phone services has also increased: 37.1 percent of adult Kenyans send airtime (versus 20.6 percent in 2006), and 43.1 percent send text messages (versus 29.2 percent in 2006). Mobile Internet access country-wide is 4.5 percent, and in Nairobi it is 19.2 percent. ATM usage nationally is 13.4 percent.[8] While the number of landlines decreased from 300,000 to 250,000 in the period of 1999 to 2008 (in part due to rampant theft of copper wires and alleged corporate sabotage), mobile phone subscriptions have gone from virtually 0 to 17 million.[9]

The Government of Kenya is keenly aware that the existing legal and regulatory framework (including banking, payment systems, and telecommunications) is not optimal for the development or long-term growth of branchless banking models. (Many, however, believe that Safaricom benefited from the *lack* of regulatory structure, arguing that regulations drafted in a vacuum, without any experience of branchless banking, would have been too strict and confining.) And although M-PESA is thriving (still in a largely unregulated environment), prior to the launch and in M-PESA's first year, Safaricom benefited from having the Government of Kenya as its majority owner and Vodafone, a significant international mobile network operator (MNO), as its minority owner (with 40 percent). There is little doubt that this assisted Safaricom in its initial stages and gave the Central Bank of Kenya (CBK) some comfort as well. It would have been a different situation had the first mobile phone financial service been a small start-up with unknown or financially insignificant owners.

Notwithstanding Safaricom's credentials, in the run-up to the M-PESA launch, the Ministry of Information and Communications, the Ministry of Finance (MoF), and CBK met to discuss the legal and policy implications of the M-PESA model. The varying reactions of the different government authorities to M-PESA illustrated the need for coordination among policy makers and regulators to ensure that (*i*) the regulatory environment does not

[5] Beck, et al., "Access for All: Barriers to Banking Access and Usage," draft, World Bank, 2007.
[6] http://www.fsdkenya.org/pdf_documents/09-02-19%20Survey%20on%20bank%20charges.pdf
[7] Out of a total population of approximately 38.5 million, 78 percent live in urban areas, 22 percent in rural, according to World Development Indicators.
[8] FinAccess National Survey, June 2009.
[9] William Jack and Tavneet Suri, "Mobile Money: The Economics of M-PESA," October 2009.

hamper innovation and growth and (*ii*) regulators are able to engage in adequate oversight to ensure the safe and healthy development of branchless banking.

2.1 Safaricom's M-PESA and Other MNOs as Payment Service Providers

Safaricom launched M-PESA, the first mobile phone payment service in Kenya, in March 2007.[10] Since then, two other MNOs have entered the market: Zain (with its product Zap) and Essar Telecom Kenya (with its product yuCash). In addition, Telecom Kenya, owner of the Orange brand in Kenya, has applied to CBK to approve its mobile money transfer service. Having three (soon likely to be four) mobile payments services makes Kenya unique in developing markets.

M-PESA is a separate electronic wallet on a mobile phone that can be used (*i*) to deposit and withdraw money at an M-PESA "agent" and (*ii*) to send money and buy prepaid airtime via SMS. "Agents" include Safaricom dealers and other retailers with distribution networks, such as petrol stations.[11]

There is no minimum account balance; the maximum account balance is KSh 50,000 (approximately US$650).[12] The maximum daily transaction value is KSh 70,000 (approximately US$910). As noted, as of January 2010, M-PESA has 14,700 agents across Kenya and approximately 9 million users,[13] and it has facilitated KSh300 billion (approximately US$3.6 billion) in person-to-person transfers since it opened for business.[14]

Although M-PESA involves accepting repayable funds from the public, Safaricom structured the product in such a way that it falls outside the definition of "banking business." Specifically, the float is held by M-PESA Trust Company Limited in trust accounts with two commercial banks that pool client funds (a third bank is to be appointed soon). Any interest earned on this pooled account cannot benefit Safaricom (without triggering the definition of "banking business"). Safaricom has had discussions with CBK regarding what to do with the interest. Customer claims against M-PESA Trust Company arising from negligence or intentional wrongdoing by the trust company or by Safaricom are covered by Safaricom.

M-PESA has had extraordinary success notwithstanding, or perhaps in part due to, the absence of a governing framework. CBK did not formally approve M-PESA, stating in a private letter (based on reports from parties involved), that M-PESA would be subject to the National Payment Systems Bill once it became law. The letter reportedly also stated that Safaricom should establish a full audit trail for all transactions and abide by the draft AML Bill.

Safaricom held its initial public offering in June 2008. Twenty-five percent of the company is now floated on the exchange, with the government maintaining a 35 percent stake, and

[10] Safaricom is the dominant player in the MNO market. It had 80 percent of the market in 2008 although that percentage had dropped slightly in 2009.
[11] M-PESA agents are not, in fact, agents because they are not authorized to act on behalf of Safaricom. Rather, they are independent providers of a Safaricom service. Safaricom's standard agreement specifies that Safaricom is not liable for any loss to the agent nor with respect to any claim made against the agent by a third party. Notwithstanding this, thus far Safaricom has been responsive to customer complaints regarding M-PESA agents.
[12] The USD/KES exchange rate used for conversion was 76.75 as published by Bloomberg, 5 February 2010. This rate is used throughout the document to convert the KSh figures as cited into US$.
[13] According to Safaricom CEO Michael Joseph as quoted in Bloomberg, "Safaricom, Equity Bank Join for Cardless Withdrawals (Update 1), 14 January 2010.
[14] http://www.marsgroupkenya.org/multimedia/?StoryID=277363

Vodafone holding the remaining 40 percent.[15] Safaricom's shares are listed on the Nairobi Stock Exchange. In a creative move to promote use of M-PESA services, Safaricom used M-PESA to pay out a portion of dividends to shareholders in 2009. Specifically, "the company paid a combined dividend of KSh 945 million to its 818,000 shareholders for the year to March 31, 2009 through four modes—M-PESA, cheque, electronic funds transfer, and real time gross settlement system. About 180,000 shareholders were paid KSh 57 million through [M-PESA], representing six per cent of the dividend pay out."[16]

In January 2010, Safaricom partnered with Equity Bank. Equity Bank is Kenya's biggest lender by number of accounts, with 4.3 million in total, representing nearly half of the bank accounts in the nation.[17] Under the terms of the agreement, Safaricom customers can withdraw money from (but cannot deposit at) Equity's ATMs. An important feature of the arrangement is that any M-PESA customer can withdraw money from Equity's ATMs regardless of whether they are a customer of Equity. Withdrawal amounts range between KSh 200 and KSh 35,000. Equity has 550 auto branches in Kenya, and the partnership will increase both access for M-PESA customers as well as help mitigate liquidity problems presented when M-PESA agents do not have cash on hand. The withdrawal fees will be the standard KSh 25–170 (approximately US$0.32–US$2.22) charged by M-PESA.[18]

Essar Telecom Kenya Limited launched its yu mobile phone service in mid-2009 and its yuCash mobile money transfer service in December 2009. Essar is implementing yuCash through its agent partnerships with Equity Bank. The infrastructure is provided by Obopay, which is active globally in mobile banking and payments technology.

Zain Kenya launched its mobile money service Zap in March 2009, and as of January 2010, it reported a customer base of approximately 400,000 and total person-to-person transaction volume of close to KSh 1 billion. Zap has a current network of 6,000 agents, though its outreach is poised to expand. In January 2010, Zain announced that it would partner with mortgage lender Housing Finance. Zap customers will be able to withdraw *and* deposit at Housing Finance's 10 branch locations. Housing Finance benefits from an income stream from an increasingly diversified range of business activities as well as the opportunity to cross-sell its established products.

2.2 Banks and Other Payment Service Providers

Aside from the three MNOs discussed in Section 2.1, the main payment service providers in Kenya today are banks and other licensed financial institutions, notwithstanding the limited number of bank branches. Many banks have their own ATM switch. In addition, there are two larger ATM switches: Kenswitch, which was set up by a consortium of smaller banks, and PesaPoint, an ATM network discussed below. Some banks are connected to both large ATM switches.

Equity Bank, with 4.3 million accounts, is Kenya's largest bank by number of accounts. Equity is offering cash-out services at supermarkets, hotels, restaurants, and an assortment of other consumer outlets, but only in combination with the purchase of goods and subject to limitations on how much may be withdrawn in any one transaction. There is no fee charged to customers for the purchase of goods and services. There

[15] http://www.cellular-news.com/story/36602.php
[16] Business Daily Africa, "Safaricom plans cashless dividend payment option," 21 January 2010.
[17] Bloomberg, "Safaricom, Equity Bank Join for Cardless Withdrawals (Update1), 14 January 2010.
[18] www.safaricom.co.ke/fileadmin/template/main/downloads/Mpesa_forms/18th%20Tariff%20Poster(c).pdf

is a fee of KSh 25 (approximately US$0.32) for cash withdrawal. None of the Kenyan commercial banks is using agents to conduct both cash-in *and* cash-out services. However, agents of Postbank (fully owned by the Kenyan Government) accept cash and pay out cash on behalf of Postbank.

Foreign exchange bureaus licensed by CBK also can provide payment services, such as foreign exchange spot transactions, telegraphic transfers, bank drafts, and third-party checks.

A few new branchless banking services have recently sprung up in the area of money transfers. K-Rep Bank, in partnership with mobile service provider Zain and software provider Packetstream, has launched a money transfer service facilitated by point-of-sale (POS) terminals and with mobile phones facilitating data transfers. Both Postbank and the Postal Corporation of Kenya (PCK) are rolling out POS terminals in post offices, which will allow for easy money transfers. Every active Postbank customer will be converted to a card-based system. PCK offers PostaPay, a domestic and international money transfer service.

A few MFIs that are preparing to apply for a deposit-taking license under the new Microfinance Act see branchless banking as an integral part of their growth strategy. Jamii Bora has already equipped all of its branches and field staff with POS terminals and its 250,000 members with magstripe cards. This technology allows for real-time settlement of all transactions through Jamii Bora's own POS switch, although there is no interoperability with other institutions.

3. Current Legal Framework for Branchless Banking

3.1 Agents

Banks' Use of Agents. In November 2009, Kenya amended the Banking Act to include provisions on financial institutions' use of agents to provide banking services. Prior to the 2009 amendment, the Banking Act did not specifically address the issue of banks using agents to carry out banking activities, nor were there any regulations explicitly governing the outsourcing of functions by banks. Instead, CBK approved such arrangements on a case-by-case basis.

The amended law establishes "agency" as "an entity contracted by an institution and approved by the Central Bank to provide the services of the institution on behalf of the institution, in such manner as may be prescribed by the Central Bank."[19] Further detail on the manner in which agents may be engaged is to be provided in regulations to be issued by CBK. The draft regulations have already been published on CBK's Web site for comment,[20] and CBK has engaged industry stakeholders to discuss details of its proposed regulations in conversations and meetings.

As drafted, the regulations facilitate the use of third-party agents by banks to provide banking services, but present a cautious approach to the expansion of agent models. Banks will need to obtain annual approvals from CBK as to the overall use of agents. They will also need to provide CBK with details about engaging particular agents, including names, locations, pre-existing commercial activities, a sample contract, and the

[19] Finance Bill, 2009, Section 52.
[20] See http://www.centralbank.go.ke/downloads/acts_regulations/draft_agentbanking_proposal.pdf

services to be rendered. Furthermore, banks will need to obtain CBK approval before closing any agent locations and will be permitted to do so only for particular reasons or offenses, in the interests of reputation and service continuity.

If the draft regulations are adopted, a range of entities will be permitted to be agents, subject to two requirements: an agent must be a commercial entity (this criterion could be satisfied by sole proprietorships or by a partnership) and must have carried out commercial activities for at least two years.[21] Also, banks will remain ultimately responsible and liable for the actions of the agent and for all compliance responsibilities with technical specifications (e.g., two-factor authentication, real-time coded transmission, ability to generate an audit trail) and under AML/CFT, privacy, and other areas of law. Finally, banks are not permitted to engage an agent on an exclusive basis.

As the regulations are currently drafted, agents will be able to offer a range of services, including cash-in/cash-out, disbursement and repayment of loans, bill payments, balance enquiries, mini-statements, collection of account-opening paperwork and loan applications, and mobile phone airtime top-ups. However, agents will not be able to open accounts or appraise loans on behalf of banks nor will they be permitted to exchange foreign currency. Agents will also not be permitted to charge customers fees.

As this is a new approach to banking, the draft regulations include a number of minimum requirements to ensure an appropriate level of consumer protection, including: mechanisms to enable customers to identify agents; the issuance by agents of receipts for all transactions; a free channel to lodge complaints and speedy complaint settlement process; and confidentiality protections.

<u>MFIs' and Other Nonbanks' Use of Agents.</u> The Microfinance Act governs all persons conducting deposit-taking microfinance business other than those specifically exempted under the Act, such as banks.[22] The 2008 CBK regulations applicable to deposit-taking MFIs (referred to as DTIs) provide that DTIs can engage agents to provide microfinance services, but only with the prior written approval of CBK. Such applications must include the reasons for opening the agency or outlet, a copy of the agency agreement, and security features of the location.[23]

With respect to non-depository MFIs, the Microfinance Act leaves it to the Ministry of Finance to prescribe regulations. Given that such institutions are not subject to any restrictions under the Microfinance Act itself, the ability of a credit-only MFI to use an agent depends on the common law of agency. Regarding other nonbanks' use of agents, there are no specific restrictions under applicable Kenyan law.

3.2 AML/CFT

In December 2009, Kenya's Parliament passed the Proceeds of Crime and Anti-Money Laundering Bill (AML Bill). The President has not signed the Bill yet, and the Finance Minister has not indicated when it will come into effect.

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[21] The list of eligible entities includes post offices, shops or retail outlets, pharmacies, supermarkets, Internet/communication centers, financial institutions (e.g., SACCOs or MFIs), courier companies, wholesale distributors, and other similar entities.
[22] Microfinance Act, Section 3(3). The Act also exempts from its application financial institutions (essentially defined as nonbank deposit-taking institutions formed as companies), mortgage finance companies, building societies, and the Kenya Post Office Savings Bank.
[23] The Microfinance (Deposit-Taking Microfinance Institutions) Regulations, 2008, Section 12.

The AML Bill establishes the Financial Reporting Centre as Kenya's Financial Intelligence Unit to receive and analyze reports of unusual or suspicious transactions, draft the regulations required thereunder, and generally work with other bodies to identify proceeds of crime and combat money laundering.[24] The Finance Minister is authorized to adopt regulations on various matters, including for identification and verification particulars and record-keeping requirements.[25]

The AML obligations under the AML Bill apply to financial institutions and designated nonfinancial businesses and professions (collectively referred to as "reporting institutions"). The term "financial Institutions" is defined to include "any person or entity, which conducts as a business, one or more of the following activities or operations—(a) accepting deposits and other repayable funds from the public; … (d) transferring of funds or value, by any means, including both formal and informal channels; … (e) issuing and managing means of payment (such as credit and debit cards, cheques, travellers' cheques, money orders and bankers' drafts, and electronic money); … (m) money and currency changing."[26] The term "designated nonfinancial business or profession" includes specifically identified professions as well as any other activity or operation specified by the Minister by notice in the Gazette. (The previous AML/CFT regime covered only financial institutions licensed and regulated by CBK under the Banking Act.)

Under the Bill, all reporting institutions are required to monitor and report all complex, unusual, suspicious, large, or other transactions, including all cash transactions exceeding US$10,000 or its equivalent.[27] The following information must be collected by reporting institutions (and the records held for at least seven years) with respect to each person opening an account or conducting a transaction or on whose behalf a transaction is conducted: name, physical and postal address, and occupation (or where appropriate, business or principal activity).[28] The requirements of physical and postal address will be a challenge for people living in slums and informal settlements as well as those living in housing estates, which typically do not have street names, especially those in low-income neighborhoods. However, relaxed requirements for small-value transactions could be created pursuant to guidelines issued pursuant to the law.

When verifying customer information, the reporting institution must take reasonable measures to satisfy itself as to the true identity of the applicant, including requiring the customer to produce an official identity record, such as a birth certificate, national identity card, driver's license, passport, or other official means of identification.[29] Currently, these identification documents are widely available, and most people engaged in small-value transactions have them. Furthermore, identification validation is not required for transactions completed after the initial verification.[30] However, and not insignificantly, the Bill requires all reporting institutions to undertake CDD on its existing customers when the Bill comes into force.

[24] AML Bill, Part III.
[25] AML Bill, Section 130.
[26] AML Bill, Section 2.
[27] AML Bill, Section 42 and Schedule 2.
[28] AML Bill, Section 44(3).
[29] AML Bill, Section 43(1). The law mandates the identification, registration, and issuance of identity cards to Kenyan citizens age 18 or older. The current national identification card system in Kenya is paper based. The Ministry of Immigration and Registration of Persons intends to introduce a new generation card system, known as Third generation Card System, that will be electronic and plastic based.
[30] AML Bill, Section 43(7).

As noted, reporting institutions must keep records of each person opening an account or conducting a transaction. The record of identification can be satisfied by either "a copy of the evidence or such information as would enable a copy of it to be obtained."[31] This requirement could prove a challenge for account opening in remote locations. Institutions must also record, for each transaction, the nature, time, and date of the transaction; the type and amount of currency involved; the type and number of any account involved; and the name and address of the institution's officer, employee, or agent who prepared the record.[32] These records must be kept for at least seven years from the date of the relevant business or transaction.[33]

In contrast to current AML/CFT regime for banks, which permits the possibility of nonface-to-face customer verification,[34] the bill does not contain any such provision but does defer to current "custom or practice" when determining what constitutes reasonable measures for purposes of CDD.

3.3 E-Money

Kenya has no laws or regulations dealing directly with e-money.

The adoption of e-payment regulations, which would govern e-money issuers, is linked to the passage of the National Payment System Bill, which would be the basis of their authority. It appears likely that this bill, which has been under discussion for several years, will finally enter the Parliamentary process in 2010, although the speed of passage remains uncertain. The precise nature of regulation would be linked to the scope of the bill, but the expressed intent of CBK is to move to risk-appropriate regulation of the nonbank e-money issuers. (The primary regulator of e-money issuers and transferors will be CBK, according to the National Payment System Bill.)

In the absence of any legal framework, the issuing of e-money by a *licensed financial institution* does not appear to raise any issues with CBK. With regard to nonbanks, CBK's current approach seems to depend on whether the activities involved in e-money issuance fall under the definition of "banking business" in the Banking Act or "deposit-taking microfinance business" in the Microfinance Act. A nonbank can avoid falling under the definition of banking business by not lending, investing, or otherwise placing at the risk of such nonbank institution the funds mobilized (i.e., the e-money proceeds). It is likely that the same conclusion will apply to the definition of deposit-taking microfinance business, although the definition is less easy to interpret.

3.4 Payment systems

As noted, a draft National Payment System Bill is expected to be finalized soon and forwarded to Parliament. (Drafts have been circulating for several years. However, it is expected that the bill will enter the parliamentary process in 2010.) In the absence of a payment system law, CBK's Payment Systems Division has the authority to ask for information from nonbank payment service providers, but it does not have the power to inspect them.

[31] AML Bill, Section 44(1)(b).
[32] AML Bill, Section 44(1) and (3).
[33] AML Bill, Section 44(4).
[34] Guideline on Proceeds of Crime and Money Laundering (Prevention), Paragraph 4.4.