CGAP | TECHNOLOGY PROGRAM

Notes on Regulation of Branchless Banking in Kenya

November 2007

Given various pending legislative initiatives, Kenya has an excellent opportunity to establish a regulatory environment that will support the development of a variety of branchless banking models. The Government of Kenya and the Central Bank have shown a strong interest in branchless banking and have expressed their commitment to institute legal and regulatory changes that will support new technology-based products and services and enable increased outreach.

Branchless banking in Kenya is in its early stages, with a limited number of providers that are operational and at least one additional provider expected to enter the market in the very near future. Thus far, these initial forays into branchless banking have been undertaken with the tacit acceptance of the government and financial regulators. As demonstrated by Kenyan regulators' approach to the pioneer of branchless banking in Kenya—mobile phone operator Safaricom and its M-PESA service—the nonbank-based model appears to be free of any financial regulation as long as services provided are not deemed to fall within the definition of banking business under the Banking Act. This is due, in part, to the particular language of the banking law as well as the lack of a legal framework for nonbank e-money issuers and payment service providers. Although Safaricom may avoid taking undue risks—for reasons of self-interest, given the company's well-established reputation and its important backers—the general lack of regulatory guidance and oversight over such activities is problematic and presents the possibility of increased risk to branchless banking customers as well as to the financial sector, generally, if less responsible actors enter the field. Appropriate regulation of e-money issuers and payment service providers would include reporting regulations, minimum capital and liquidity requirements, and restrictions on how e-money proceeds may be held or, for payment service providers, restrictions on permitted investments of funds held pending transfer.

In contrast, the primary hindrance to the use and growth of the bank-based model is the Central Bank's ad hoc approach to outsourcing: the Central Bank approves a bank's use of agents on a case-by-case basis without clear guidance on which activities may be outsourced and without articulated standards or criteria for agents or their oversight. And, although the law and regulations applicable to microfinance institutions (MFIs) are not yet in force, MFIs will face a similar situation.

Finally, although the current regime for anti-money laundering (AML) and combating financing of terrorism (CFT) is thin and generally not problematic for branchless banking, a draft AML/CFT bill would impose burdensome requirements on small-value transactions and remote account openings. Ideally, these requirements will be revised to provide a risk-based approach that will permit both the bank-based and nonbank-based models to thrive.

These notes offer further detail on CGAP's findings as a result of its branchless banking diagnostic assessment in Kenya. Similar notes will be released on Brazil, India, the Philippines, Russia, and South Africa.

BACKGROUND: CGAP, BRANCHLESS BANKING, AND THIS SERIES OF POLICY DIAGNOSTICS

CGAP is a global resource center for microfinance standards, operational tools, training, and advisory services. Its members—bilateral, multilateral, and private donors—are committed to building more inclusive financial systems for the poor. The CGAP Technology Program is a multi-year learning initiative co-funded by the Bill and Melinda Gates Foundation to find and test promising technology solutions to improve access to finance.

CGAP defines branchless banking as the delivery of financial services outside conventional bank branches using information and communications technologies and nonbank retail agents.[1] Because of the potential to radically reduce the cost of delivery and to increase convenience for customers, branchless banking can expand coverage to previously unserved segments of the population. Technology can help a range of market actors push the boundaries of access to finance, including not only banks but also microfinance institutions (MFIs), mobile phone operators, and technology companies.

There are two models of branchless banking. Both use nonbank retail agents, such as merchants, supermarkets, or post offices, to deliver financial services outside of traditional bank branches. In the **bank-based model**, a licensed financial institution delivers financial services through a retail agent who is equipped to communicate directly with the bank, typically using either a mobile phone or a point-of-sale (POS) device. The customer account is maintained with the bank, but it is operated through the agent. In the **nonbank-based model**, a firm, such as a mobile operator or prepaid card issuer, makes uses retail agents to offer customers e-money accounts.[2] Clients exchange their cash for e-money stored in a virtual account on the nonbank's server. The balance in the account can be used to make payments, store funds for future use, transfer funds, or convert back to cash at agents. Commercial banks may be used by nonbanks to hold the net proceeds of e-money issued by the nonbank.

Highlights

- Safaricom's M-PESA service launched in March 2007 as the first e-money product offered by a nonbank in Kenya.
- Banking law and regulations do not set clear standards regarding the ability to use agents to perform banking functions; in contrast, nonbanks are permitted to perform various payment functions virtually unregulated.
- There are good chances for positive change through pending legislative initiatives in banking, microfinance, payment systems, and AML/CFT regulation, and with the commitment by government and the central bank to create an enabling environment for branchless banking.

1. Introduction

From February 22 to March 2, 2007, CGAP conducted a mission in Kenya[3] to analyze the policy, legal, and regulatory environment for branchless banking. This document summarizes CGAP's

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observations.[4] It is based on an analysis of existing and, to the extent available, pending legislation relevant to branchless banking approaches and on the CGAP team's insights from 25 interviews with 56 representatives of a wide range of stakeholders. Interviews were conducted with the Central Bank of Kenya (CBK), the Communications Commission of Kenya (CCK), the Ministry of Information and Communication (MoIC), commercial banks, MFIs, the Kenya Post Office Savings Bank (Postbank), mobile network operators, technology firms, donor agencies, and other knowledgeable parties (list of persons interviewed is appended to this document).

Kenya was selected as the second in a seven-country diagnostic series,[5] because it is in the forefront of nonbank-based branchless banking. Safaricom, a mobile operator jointly owned by Vodafone and the Kenyan government, operates M-PESA, a mobile phone-based payment service that has 500,000 registered users. Banks and MFIs are also exploring business models that use technology channels to reach unbanked clients. Kenyan regulators and policymakers are very interested in branchless banking and have examined other countries' legal and regulatory regimes for these approaches.

2. State of Play: Government Authorities

The Government of Kenya is keenly aware—following the launch in March 2007 of Safaricom's M-PESA service—that the **existing legal and regulatory framework (including banking, payment systems, and telecommunications) does not offer an optimal situation for the development and use of branchless banking models**. In the run-up to the M-PESA launch, MoIC, 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 policymakers and regulators to ensure that (*i*) the regulatory environment is open and clear to foster innovation and growth and (*ii*) regulators are able to engage in adequate oversight to ensure the safe and healthy development of branchless banking. The government is now working on a **Comprehensive Financial Sector Reform and Development Strategy**. Improving access to finance will be one of the strategy's three main pillars; the other two are safety and efficiency.

CBK. Two CBK departments have been involved in this effort. The Financial Institutions Supervision Department is responsible for the prudential regulation of banks and deposit-taking MFIs. Its primary concern regarding nonbank-based models (such as Safaricom's M-PESA service) has been whether the operator (Safaricom) is stretching or even breaking the rules for the business of banking. By contrast, the National Payment System (NPS) Division of the Banking and NPS Department, which focuses on the integrity, effectiveness, efficiency, and security of the payment system, views M-PESA as a payment service provider. The NPS Division appears more willing than the Financial Institutions Supervision Department to permit experimentation with the nonbank-based model of branchless banking.[6] However, it is important to note that because of the lack of a law on the payments system, the NPS Division does not

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currently have the necessary tools (including specific regulations) to supervise the payment system.[7]

With regard to bank-based models, CBK is approving agents on an ad hoc basis. It exercises its approval right in its sole discretion without any clear standards.

There is a strong willingness within CBK (as well as within MoF) to implement necessary **legal and regulatory changes** to facilitate branchless banking. CBK has invited and taken into account comments on all ongoing legislative changes relevant to branchless banking (including revisions to the Banking Act, regulations that will apply to depositary MFIs, the Proceeds of Crime and Anti-Money Laundering Bill, and the new National Payment System Bill).

CCK and MoIC. The telecommunications regulator, CCK, and the National Communications Secretariat (housed in MoIC) agree that the central bank should oversee financial services offered by mobile network operators. CCK has minimal requirements regarding mobile phone operators' involvement in financial services (i.e., listing the specific services in the license). Under the draft Kenya Communications Amendment Bill, 2007, MoIC (a strong supporter of M-PESA from the beginning) would have a regulatory role touching on branchless banking. However, CBK is understood to be primarily responsible for regulating and supervising the payments system.

3. State of Play: Industry

As in most developing countries, access to finance is limited in Kenya. An estimated 19 percent of the adult population have access to formal financial services through banks, with an additional 8 percent served by MFIs and savings and credit cooperatives (SACCOs).[8] Mobile phone penetration is much higher: 55 percent of Kenyans either own a phone or have access via family or friends.

Kenyan banks have limited infrastructure for reaching out to customers. The number of bank branches (542) has only recently started to increase after years of decline. The number of ATMs has doubled in the past two years to more than 700, but the figure of two ATMs per 100,000 people reflects the limited outreach of the Kenyan banking sector.[9] 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. Some banks are connected to both large ATM switches.

Banking is relatively expensive in Kenya. A recent 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 equaled 44 percent of 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.[10] Some banks, especially those targeting the lower end of the market, have started exploring branchless banking models, but most are still at the planning stage.

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Payment Services

The main payment service providers in Kenya today are banks and other licensed financial institutions, notwithstanding the limited number of bank branches. 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 Celtel and software provider Packetstream, has launched a money transfer service facilitated by 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 as a domestic and international money transfer service.

Safaricom, one of two mobile network operators in Kenya, launched its M-PESA mobile financial services product earlier this year.[11] M-PESA is a separate e-wallet on the mobile 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. (M-PESA agents are not, in fact, agents in the legal sense 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 or for any claim made against the agent by a third party.)

PesaPoint, an independent ATM network that may be used by customers of partner financial institutions[12] and VISA card holders, has recently developed a "deferred payments service" called WagePoint for companies that pay their employees in cash. The employer provides its employees with magstripe cards, which can be used by the

M-PESA: Not regulated as a bank and not yet as a payment service provider

Before M-PESA's launch in March 2007, Safaricom received a letter from CBK that stopped short of officially approving the product. Based on reports from parties involved (but without having had access to the letter itself), the letter refers to CBK's broad authority to regulate the payment system under the CBK Act and states that Safaricom's M-PESA activities will be subject to the National Payment Systems Bill once it becomes law. The letter reportedly also states that Safaricom should establish a full audit trail for all transactions and abide by the draft AML Bill.

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 proceeds from issuing e-money are held by M-PESA Trust Company Limited in trust for the clients in a pooled account with the Commercial Bank of Africa. Any interest earned on this pooled account cannot benefit Safaricom (without triggering the definition of "banking business"); use of interest proceeds is currently under consideration. Customer claims against M-PESA Trust Company arising from negligence or intentional wrongdoing by the trust company or by Safaricom shall be covered by Safaricom. In addition, caps on the maximum account balance (about US$ 750) and maximum transaction size (about US$ 530) provide CBK with additional comfort because they limit the risks of money laundering and the amount any individual customer could lose in case of insolvency.

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employees to withdraw their salaries either at an ATM on the company's premises or, for a fee, at other PesaPoint ATMs. The employer keeps the aggregate salary amounts in a pooled account with a commercial bank. (The portion of any employee's salary that has not been withdrawn is considered an asset of the employer, meaning the employee faces a risk of loss in the case of financial failure of the employer. It is not clear how this risk is being addressed.)

Banking Activities

Equity Bank, Kenya's largest bank by number of clients (1.4 million), is offering cash-out services at supermarkets but only in combination with the purchase of goods and subject to limitations on how much may be withdrawn in any one transaction. None of the Kenyan banks is currently using agents to conduct both cash-in *and* cash-out services. Typical alternative delivery channels include ATMs (for those customers able to reach an ATM), SMS banking, and Internet banking. The latter two generally allow for limited services (as opposed to payments to third parties).

A few MFIs that are preparing to apply for a license to be a deposit-taking MFI under the new Microfinance Act see branchless banking as an integral part of their growth strategy. One MFI, Jamii Bora, has already equipped all of its branches and field staff with POS terminals and its 150,000 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.

mTranZact, a technology firm, offers a package of services that will allow a bank to offer its customers transactions via any mobile phone network and Visa- and MasterCard-certified POS terminals. The system will allow for the switching of transactions between mobile networks and banks.

4. State of Play: Clients

According to a recent survey, 29 percent of Kenyans send text messages from their mobile phone, 21 percent use "sambaza" (the transfer of prepaid airtime from one phone to another), and 25 percent have heard of doing banking on mobile phones.[13] These figures are much higher in the capital Nairobi (61 percent, 55 percent, and 51 percent, respectively).

5. The Current Legal and Regulatory Framework for Branchless Banking

In Kenya, branchless banking has the potential to increase poor people's access to financial services if, among other important preconditions,[14] regulation (*i*) sets objective and transparent standards regarding the permitted use of agents, thereby increasing the number of service points; (*ii*) eases account opening (both on site and remotely) while maintaining adequate "know your customer" (KYC) standards; and (*iii*) permits a range of players (subject to appropriate supervision) to provide payment services and to issue e-money, thereby enabling innovation from multiple sources.

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5.1 Use of Agents

The Banking Act does not specifically address the issue of banks using agents to carry out banking activities, nor are there any regulations explicitly governing the outsourcing of functions by banks. Instead, **outsourcing is approved by CBK on a case-by-case basis**. The regulations applicable to depositary MFIs also would require CBK approval of all agents. In contrast, nonbank institutions do not face such restrictions.

5.1.a. Definition of Banking Business and Banks' Use of Agents

The Banking Act requires that "banking business" be conducted only by an institution that holds a valid license as a bank. Banking business is defined as having two main elements: the acceptance of money from the public on deposit or on current account *and* the use of this money "by lending, investment or in any other manner for the account and at the risk of the person so employing the money."[15] Further, a bank may transact *banking business* only at its "head office" or any "branch" or "place of business," neither of which may be opened, closed, or moved without the prior approval of CBK.[16] It is unlikely that an agent would be considered a branch given the common interpretation of the term and the application requirements for branches (which include payment of a licensing fee); it is, at best, unclear whether the term "place of business" includes agents.[17]

Notwithstanding the possible legal limitation on an agent conducting "banking business," this limitation would not appear to apply to the outsourcing of deposit taking alone as long as the agent does not loan, invest, or otherwise put the money at risk as part of its agency functions. (There always will be operational risk, such as fraud or theft; however, this risk of loss would not recharacterize the agent's activities.)

5.1.b. MFIs' and Other Non-banks' Use of Agents

The Microfinance Act governs all persons conducting deposit-taking microfinance business other than those specifically exempted under the Act, such as banks.[18] A deposit-taking MFI must obtain CBK approval before opening or closing any "place of business" (defined in the Microfinance Act to include "agencies").

The Microfinance Act leaves it to MoF to prescribe regulations for nondepositary MFIs. 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.

5.2 Payment Systems Regulation

There is no law in Kenya expressly governing the payment system. Under the Central Bank of Kenya Act, CBK has a broad mandate to "formulate and implement such policies as best promote the establishment, regulation and supervision of efficient and effective payment, clearing and settlement systems."[19] In 2004, CBK published a framework and

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strategy document on the payment system but has not yet issued any policies. The **draft National Payment System Bill** is expected to be finalized soon and forwarded to Parliament. Currently, 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.

Nonbanks may provide local currency payment services if doing so does not ultimately fall under the definition of banking business (see section 5.1.a above). There are no specific customer due diligence or KYC rules for nonbanks that provide payment services although this is expected to change when the new AML/CFT law is passed.

5.3 Regulation of e-Money

Kenya has no laws, regulations or policies dealing directly with e-money. The **draft Kenya Communications Amendment Bill, 2007,** will likely affect e-money issuers although there have been recent discussions about drafting an e-transactions law that would replace the provisions governing e-money and other forms of e-commerce currently contained in the draft communications bill. Notwithstanding these possible new laws, the primary regulator of e-money issuers and transferors will be a financial regulator (which, according to the National Payment System Bill, will be CBK).

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. As mentioned, 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 (in this case 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.

5.4 Foreign Remittances

Foreign remittances can be provided only by authorized banks. In addition, PostBank is licensed to receive only inbound foreign remittances. Western Union and Moneygram use commercial banks and PostBank as agents to receive and send remittances. The requirements applicable to an institution sending or receiving foreign remittances are few: reporting to CBK and being subject to CBK inspection.[20]

5.5 AML/CFT Requirements under CBK Guidelines

The current **AML/CFT regime covers only financial institutions licensed and regulated by CBK under the Banking Act**. Specifically, CBK has issued guidelines on AML/CFT under the Banking Act.[21] CBK drafted similar guidelines for deposit-taking MFIs under the Microfinance Act. (CBK issued regulations under the Microfinance Act in mid-October 2007; however, CGAP has not yet received or reviewed them.) However, this will change if the Proceeds of Crime and Anti-Money Laundering Bill (AML Bill), 2007, becomes law because it would apply to a variety of nonfinancial institutions and

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would, in its current form, present problems for branchless banking.

The existing guidelines for banks make explicit reference to the recommendations of the Financial Action Task Force, the principal international standard setting body for AML/CFT. The guidelines' main elements of customer due diligence (CDD)—essentially the same concept as KYC—for AML/CFT purposes are photo identification (not restricted to the national identity document), proof of residence verified by a referee or a utility bill, and verified employment and/or sources of income.[22] The verification of address by a utility bill (which only few people have and often does not accurately describe the physical address because ofthe lack of street numbers) or a referee (who is also likely to require similar proof of residence) and verification of employment and/or sources of income pose the **risk of restricting access for poorer customers**. In practice, CBK has allowed for some flexibility—for example, permitting introductions by existing customers to serve as a substitute for provision of a utility bill and not requiring evidence of source of income.

There has **been only limited discussion of introducing more relaxed customer identification requirements for small value transactions**. CDD/KYC issues have been raised with regard to branchless banking models operating pooled accounts like M-PESA. As of now, however, only bank customers have been subject to CDD/KYC rules. (Nonbanks operating pooled accounts are not covered under AML/CFT rules applicable to banks.) Individuals are not subject to any CDD/KYC by the bank notwithstanding that they have funds in a pooled account deposited with the bank.

AML/CFT guidelines for banks permit the **possibility of non face-to-face customer verification**,[23] which is of considerable interest from the point of view of extending access to finance beyond those customers and locations served by bank branches. The guidelines seem to allow for some flexibility by not providing a definitive list of identity checks for remote customer identification, and instead simply listing some examples (and also allowing for alternative means of verifying identity). However, the guidelines do require at least two checks with regard to the address and the identity of the customer.

Customers conducting **domestic and international transfers of funds are not subject to specific CDD/KYC rules**. The CBK Guidelines on Foreign Exchange state only that "the maxim of 'know your customer' must be observed at all times."[24] The main interest of CBK here is to monitor the flows of foreign exchange through the banking system. **Foreign exchange bureaus must identify all their customers** by keeping a record of their passport/national identification. For foreign exchange transactions of US$10,000 or more, CDD/KYC rules also require the verification of employment or other sources of income.[25]

5.6 Other Issues Relevant to Branchless Banking

Level playing field: Because of the lack of a national payment system law, banks and nonbanks engaged in similar activities (e.g., payment services, issuance of payment cards) are subject to widely divergent regulatory regimes. Although banks are subject to

the requirements of the Banking Act and CBK regulations issued thereunder, CBK does not have the authority to regulate or supervise nonbank payment service providers. Consequently, a nonbank offering an e-money product or engaged in payment services may be subject to regulation by nonfinancial regulators (such as MoIC) but will not be regulated with respect to its financial activities (provided that it avoids falling under the definition of banking business under the Banking Act and deposit-taking microfinance business under the Microfinance Act). Nonbanks also are not subject to restrictions on the use of agents. This differential treatment leads to significant risk of regulatory arbitrage.

Although the following two points of further disparate treatment between banks and nonbanks would not likely lead to a risk of regulatory arbitrage, they are important to note. First, the Banking Act requires approval by the Minister of Finance (who has delegated this power to the CBK Governor) for increases in interest rates and other charges.[26] This can be particularly burdensome for branchless banking models that charge various fees for services offered. Second, nonbanks are currently not subject to CDD/KYC requirements (although Safaricom has reportedly been instructed by CBK by letter to comply with provisions of the AML Bill).

E-security and data security in the telecommunication sector will be covered in the Kenya Communications Amendment Bill. If enacted in its current form, the bill will recognize electronic signatures as legally binding and will give the Minister of Information the power to approve the manner and format of affixing an electronic signature. The Minister will also control the processes for ensuring adequate integrity, security, and confidentiality of electronic records or payments. However, because CBK is responsible for the integrity of the payments system, the actions of MoIC will have to be in sync with and subject to the actions of CBK, which will be the primary regulator of the payments system.

Telecommunications regulations require that a mobile network operator offer only the telecommunication services listed in its license. M-banking falls under the definition of telecommunication service in the law and should therefore be listed in the license agreement.[27] However, the primary regulator with respect to a mobile network operator's m-banking activities will be the banking regulator (i.e., CBK).

Consumer Protection is dealt with under several laws in one way or another. A comprehensive consumer protection law is currently being drafted.

6. Areas of Opportunity

6.1 Use of Agents

The lack of standards regarding a bank's permitted use of agents may discourage some banks from pursuing branchless banking. **Fortunately, the Banking Act is currently being revised**, **which provides the government with an opportunity to clarify the language regarding agents**. Because branchless banking through agents is new to the

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Kenyan banking sector, a prudent approach would be to revise the Banking Act to specify the activities that may be conducted by agents (and eliminate the current regulatory requirement of CBK approval of each agent) and to give CBK authority to specify in regulations criteria for agents engaged in branchless banking. A similar approach should be adopted with respect to the use of agents by deposit-taking MFIs.

6.2 Payment Systems Regulation

In most countries, the central bank is responsible for (*i*) formulating and implementing monetary policy (in Kenya, CBK's policies are subject to MoF review) and (*ii*) maintaining stability of the currency and the financial system generally. Typically, all responsibilities of the central bank—including overseeing and ensuring the safety and efficiency of payment systems—emanate from these two objectives. Until recently, the focus of central banks worldwide has been large value payment systems (as opposed to small value/retail payment systems). Central banks are beginning to see advanced technology and increased access at the small value/retail level, resulting in a new and significant flow of funds (small value, large volume) that is changing the center of gravity regarding risk analysis and risk assessment and impacting the two objectives noted above. Central banks worldwide are starting to focus on those who are involved in this new flow of funds.

Kenya is in a position to shape its payments system and the regulation and supervision thereof to focus on both large value and small value payment systems in the National Payments System Bill. Among other things, this law could authorize CBK to set minimum requirements for the establishment and operation of payment service providers (including requirements for minimum capital and liquidity and restrictions on permissible investments), to define reporting requirements, and to conduct on-site inspections. The intensity of regulation should be commensurate with the risks involved. The law should draw a clear line between the provision of payment and banking services (and the line drawn should be consistent with the Banking Act).

Defining a clear legal mandate for CBK, however, is only one necessary step in improving the regulatory framework for payment systems. At least as important will be to increase CBK's capacity to effectively regulate and supervise payment service providers.

6.3 Regulation of e-Money

The issuance of e-money is a complicated and sophisticated concept that should be supported by a clear and detailed legal and regulatory framework, including clear lines regarding the role of the banking regulator (as primary regulator) and other regulators (e.g., regulator of telecoms) and safe and secure modes of transacting e-commerce. There appears to be agreement in Kenya that CBK will be the primary regulator of nonbank e-money issuers.

International experience suggests that nonbank e-money issuers do not need to be subjected to the full weight of the banking law. An issuer of e-money that can be used only by a limited number of merchants or by members of a corporate family (a "closed"

network) may not require *any* financial regulation or supervision. (For example, in the United Kingdom, a closed network e-money issuer can be exempt from regulation by the FSA if the "purse size"—the e-money balance—is limited to €150.) However, an issuer of e-money that can be used in multiple places (an "open" network) does warrant appropriate regulation and supervision. The risks of nonbanks issuing e-money can be minimized by stipulating certain specific regulatory requirements, such as per-customer transaction and maximum e-money balance. In addition, to minimize risk of loss of customers' funds, operators can be subjected to minimum security standards and required (*i*) to put e-money proceeds in a segregated bank account held in trust for the benefit of the customers and (*ii*) to hold a sufficient proportion of funds in liquid forms to mitigate liquidity risk. To minimize AML/CFT risk, there can be transaction limits for individual accounts. To address consumer protection issues, providers can be required to offer customer grievance redress mechanisms.

6.4 AML/CFT

The AML Bill was published on April 5, 2007. If enacted as published, Kenya will have a specialized AML/CFT regime covering not only banks, but also other financial institutions and designated non-financial businesses and professions. The bill defines the term "financial institution" broadly. It includes, among other things, any person or entity (*i*) accepting deposits and other repayable funds from the public, (*ii*) transferring funds or value, by any means, including both formal and informal channels, and (*iii*) issuing and managing means of payment (including e-money). Payment service providers, domestic and international money transfer companies, and e-money issuers would be covered under this law.

Under the terms of the bill, all actors that fall within the broad definition of "financial institution" or "designated non-financial businesses or professions" will have to undertake customer due diligence on new and also existing customers. Acceptable means of identification for CDD/KYC purposes are left to the Minister of Finance to prescribe in regulations, which leaves room for alternative means of identification for poorer customers. The bill does not address whether customer identification may be done remotely (e.g., through an electronic communication channel) or whether it may be done by an agent on behalf of the financial institution. Ideally, the bill or the regulations adopted thereunder would permit remote account opening (as the banking regulations currently do) and the use of agents to check customer identification.

For branchless banking models with a large number of relatively small transactions, the bill's requirement to keep records of all transactions for at least seven years will be difficult (or at least costly and unnecessarily burdensome) for nonbanks to comply with. Moreover, according to the bill, the records must contain sufficient evidence to identify each customer's name, physical and postal addresses, and occupation or source of income. To enable branchless banking to thrive, the law should include, for small-value transactions, flexibility regarding the requirements to evidence identity, physical address, and source of income, and to maintain records for an appropriate amount of time that

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www.cgap.org/technology | technology@cgap.org | 1818 H Street NW | MSN P3-300 | Washington DC USA 20433

facilitates audit and law enforcement requirements, but that is not overly burdensome for providers.

After the AML law is enacted, CBK will have to ensure there are no conflicting regulations issued under the Banking Act and the Microfinance Act. (Draft regulations under the Microfinance Act did not provide for non face-to-face customer identification. If the regulations that were issued in October 2007 were similarly drafted, this will need to be changed to enable MFIs to engage in branchless banking through agents.)

7. Conclusion

The table below provides a summary of the barriers to branchless banking observed via CGAP's Kenya Branchless Banking Diagnostic and recommendations for resolving them.

Barriers	Recommendations
1. Lack of clarity regarding use of **agents** by banks, deposit-taking MFIs, and nonbanks doing branchless banking	**Banks**: amend the Banking Act and prudential regulations to permit outsourcing of cash handling and other specified activities by agents, eliminate the regulatory requirement of CBK approval for each agent, and give CBK authority to establish general guidelines for the industry and specify criteria for agents and banks' oversight responsibilities. **MFIs**: similar amendments to the MFI Act and regulations for depositary MFIs to remove the requirement that agents be subject to CBK's prior approval, explicitly state which activities may be outsourced, and implement set general guidelines and criteria **Nonbanks**: pass a National Payment System bill that permits payment system providers to use agents for cash handling **All**: Minister of Finance to issue regulations permitting CDD to be performed by agents under the Proceeds of Crime and Anti-Money Laundering Bill.
2. Lack of risk-based flexibility under Proceeds of Crime and **Anti-Money Laundering** Bill	Revise Proceeds of Crime and Anti-Money Laundering Bill to establish risk-based rules by combining reduced account balance and transaction volume limits with: - permission to do non-face-to-face account opening with agents conducting document check and/or clients providing personal data remotely via electronic channels, and - flexibility regarding identity, physical address, and source of income, and to maintain records for an appropriate amount of time that facilitates audit and law enforcement requirements, but is not overly burdensome for providers Once AML Law is passed, Minister of Finance should: - devise risk-based KYC standards for low-value accounts and issue guidelines Once AML Law is passed, CBK should: - resolve any conflicting regulations under the Banking and Microfinance Acts

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3. Lack of regulation of **payment systems** and nonbank issuers of **e-money**	National Payment Systems Bill should provide for CBK to establish appropriate minimum requirements for payment service providers on: - entry into the payment space (minimum capital, liquidity) - oversight (CBK authority to inspect, require reporting) - safety (rules on investment of funds received from public, AML/CFT compliance) CBK should have adequate enforcement powers; intensity of regulation should be commensurate with risks

[1] CGAP uses the word "agent" to refer not only to the standard agency relationship (i.e., the agent contracts with a principal, which assumes liability for losses other than those attributable to the agent's negligence or willful misconduct) but also to a third-party service provider or other similar relationship although it may involve liability arrangements different from what is standard in an agent-principal agreement.

[2] There are various definitions of e-money, including the following from the European Union's Electronic Money Institutions Directive (2000): "monetary value as represented by a claim on the issuer which is: (i) stored on an electronic device; (ii) issued on receipt of funds of an amount not less in value than the monetary value issued; (iii) accepted as a means of payment by undertakings other than the issuer." The UK's implementation of the Directive does not include the following words from clause (ii) "of an amount not less in value than the monetary value issued." Perhaps the most widely accepted definition requires that the electronic store of value be on a device *in the customer's possession*.

[3] CGAP Policy Advisory Consultant Stefan Staschen and CGAP staff member Mark Pickens conducted the field portion of the mission, with technical input and logistical support from MicroSave's David Cracknell and Mary Ngugi.

[4] Stefan Staschen, Mark Pickens, and CGAP Policy Advisory Consultant Kate Lauer authored the Notes. The Kenyan law firm of WALKER KONTOS provided advice on the interpretation of various laws, regulations, and bills mentioned.

[5] The other countries are Brazil, India, Pakistan, Philippines, Russia, and South Africa.

[6] In its August 2004 strategy paper on the Kenya payment system, CBK stated that it "is encouraging the population to move to non-cash payment instruments such as payment cards and electronic money." Kenya Payment System (Framework and Strategy) August 2004, p. vii.

[7] The term "payments system" is used in a broad sense to include all payment mechanisms and players involved in payment activities, including, among other players, service providers to the payment system (e.g., SWIFT), payment service providers, etc.

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

[9] Mwaura, Steve. CBK presentation at the *Making Finance Work for Africa* conference organized

by the World Bank. March, 2007. Nairobi.

[10] Beck et al. (2007) "Access for All: Barriers to Banking Access and Usage" Draft, World Bank.

[11] Safaricom developed this product in cooperation with Vodafone, which owns a 40 percent interest in Safaricom. (The remaining 60 percent is held by the Kenyan government.) The M-PESA product is soon to be rolled out in other countries in which Vodafone has a presence. Other services are planned, including international money transfers (in cooperation with Citigroup), salary and utility payments, merchant payments in stores, and government social payments.

[12] PesaPoint is accessible to SACCOs and will also be accessible for depositary MFIs.

[13] FinAccess (2007).

[14] The two primary preconditions aside from regulation are (*i*) development of successful business models and (*ii*) understanding and addressing factors affecting customer adaptation.

[15] SEC. 2(1) of the Banking Act. Arguably, if an agent does not take the legal and financial risk of loss of deposited funds (with the bank retaining the risk), then the agent is not itself engaged in banking business.

[16] There appears to be a difference between the letter of the law and the actual application, because CBK states it does not, in practice, require approval of ATMs. Rather, CBK requires only *notice* of ATM openings and closings. There are conflicting opinions regarding whether an ATM constitutes a "place of business."

[17] The Banking Act defines the term "branch" as referring to any premises other than the head office at which a bank transacts business in Kenya. SEC 2(1). "Place of business" is not defined in the Banking Act. The banking regulations' application instructions for opening a place of business imply that an agent is a "place of business." (See CBK/IF 11-1, para. 3; CBK/IF 11-2, para. 3.) However, the term "agency" is used by CBK and by the banking sector to refer to ATMs and nonbranch locations where a bank may place an employee to conduct a limited range of transactions for a limited number of days or hours per week as opposed to the more typical use of the term, which would refer to a contractual arrangement between a principal and a third-party agent.

[18] SEC. 3(3) of the Microfinance Act. 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.

[19] SEC. 4A(1)(d) of the Central Bank of Kenya Act. It is important to note that the Act vests CBK with policy-making authority but does not explicitly provide CBK with regulatory or supervisory authority.

[20] SEC. 6 of the Guidelines on Foreign Exchange.

[21] Guideline on Proceeds of Crime and Money Laundering (Prevention) CBK/PG/08.

[22] Ibid, Paragraph 4.3.1.1.

[23] Paragraph 4.4 of the Guideline on Proceeds of Crime and Money Laundering (Prevention).

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[24] Paragraph 1.3 of Guidelines on Foreign Exchange.

[25] SEC. 6.1(k), 11.4 and 11.5 of Foreign Exchange Bureau Guidelines, 2006.

[26] SEC. 44 of the Banking Act, Legal Notice No. 34 and 35 of 2006.

[27] SEC. 2(1) and SEC. 34 of the Kenya Communications Act, 1998.

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List of Persons Met

Organization	Participants	Designation
Jamii Bora Trust	Ingrid Munro, senior staff and members	Managing Trustee
Kenya Commercial Bank	Tom M. Kahigu	Senior Manager, IT Systems Integration
	Andrew G. Kimani	Senior Manager, IT Banking Systems
	Emmanuel Mzaza Mwazighe	Senior Manager, IT Change
	Emmy J. Kiptugen	Senior Manager, Client Support
	Edward K. Bittok	Head, Business Systems Re-Engineering
	Adow Mohamed	Network Support Engineer
Central Bank of Kenya	Cassian J. Nyanjwa	Assistant Director, Financial Institutions Supervision Department
	Elizabeth Onyonka	Financial Institutions Supervision Department
	John K. Birech	Assistant Director, External Payments & Reserves Management Department
	Chris Gacicio	External Payments & Reserves Management Department
	Stephen Mwaura	Banking Services and National Payment Systems Department
Price Waterhouse Coopers	Charles Muchene	Partner
	Kang'e Saiti	Senior Manager
Bank Consult	Mike Davidson	Consultant
Intertrans Services	Albert Shitakha	Consultant
Equity Bank	Samuel Kamiti	Head of Alternative Business Delivery Channels
	Papius Muhindi	Head of Risk Management
	Allan M. Waititu	Head of Operations

Organization	Participants	Designation
Technology Associates	Girisch Nair	Group Chief Executive
	Mesam Rizvi	Director
Safaricom	Susie Lonie	M-Pesa Project Manager
	Pauline Vaughan	Head of M-Pesa for Kenya
Kenya Post Office Savings Bank	H. Kenozwa Omumia	Head of Information & Communication Technology Department
	Anne W. Karanja	Director, Operations & Business Development
	David N. Gatawa	Senior Manager, Change
	Abraham Koech	Strategic Planning
	Benson Wanyoike	Customer Relations
Celtel	Bernard K. Makasi	Leader, Business Development
Communications Commission of Kenya	Charles J. Njoroge	Director, Competition Tariffs & Market Analysis
	S. K. Kibe	Director, Frequency Spectrum Management
	Rachel Alwala	International Liaison
Faulu Kenya	Lydia Koros	Chief Executive Officer
	Anne Kimani	Head of Internal Audit & Transformation Manager
	George Maina	Head of Business Development & Operations
National Communications Secretariat	James Kulubi	Communications Secretary
	C. O. Ngesa	Communications Economic Expert
	J. N. Kariuki	Communications Technology Expert
Ministry of Information and Communication	Bitange Ndemo	Permanent Secretary
K-Rep Bank	Kasaine ole Pertet	Chief Information Officer

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Organization	Participants	Designation
Association of Microfinance Institutions	David Nzioka	Technical Advisor
Craft Silicon	Geraldine Okeeffe	Director, Global Implementation & Support
	Rakshit Bolar	Director, Sales & Marketing
Co-operative Bank	Samuel Mutungi	General Manager, Operations Division
	Peter Gocho	Manager, Settlement Department
Kenya Bankers Association	J. K. Wanyela	Executive Director
Stanbic Bank	Kenneth Kanyarati	Head of Compliance
	Dennis Ndino Ndurungi	Manager, Operations Support
Standard Chartered	Joseph S. Nambuchi	Manager, Control & Support Technology and Operations
Commercial Bank of Africa	Mike Bristow	Executive Director
	Chege Thumbi	General Manager, Operations & Service Delivery
Health Data Systems Ltd.	Isaiah Okoth	Chief Executive Officer
	Muriuki Njeru	Managing Director
Financial Sector Deepening Trust	David Ferrand	Technical Director
Paynet/Pesa Point	Ron Webb	Group Technical Director
Consumer Information Network	Samuel Ochieng	Chief Executive Officer

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