

**DOES A BIGGER COMMERCIAL BANKING
SECTOR BENEFIT THE POOR?**

A MINOR FIELD STUDY IN KENYA

by

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Does A Bigger Commercial Banking Sector Benefit The Poor? – A Minor Field Study in Kenya

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Abstract

Recent evidence suggests that there are serious information asymmetries in the Kenyan financial market. Between 2006 and 2009, the formal and semi-formal financial sectors in Kenya increased a lot. In contrast to what classic economic theories would predict, the informal financial sector experienced a minor increase. This thesis, through interviews in a minor field study, suggests that the informal financial institutions in Kenya have some important advantages compared to the formal ones. Informal lending seems to be operating within informal institutions that serve as enforcement mechanisms of informal agreements. Third party enforcement represented by the police or auctioneers is available to informal lending, which, it may be argued, partly explains the seemingly high repayment ratios in the informal financial sector. Many of the interviewed preferred the informal financial sector because it offers more flexibility in the repayment period of a loan and because the costs of financial services provided by banks were more unpredictable than the informal alternatives.

Keywords: Kenya, institutions, loans, imperfect information, informal, enforcement

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Abbreviations and Acronyms

ASCA	Accumulating savings and credit association
M-PESA	A money transferring facility developed by the mobile phone operator Safaricom
ROSCA	Rotating savings and credit association
SACCO	Savings and credit cooperative

Introduction

In order for an economy to achieve economic growth it is vital that there are enough savings and investments that can foster such growth. Access to financial services for the majority of the people should therefore be of main interest to any government aiming for faster economic growth. The possibility for households and small and medium sized enterprises to save and borrow money is assumed to strengthen their productive assets (Ellis et al., 2011). Financial inclusion, referring to access to financial services also for the poorer segment of an economy's population, has become a popular concept among politicians in developing countries. Economic reforms aimed at increasing the accessibility of banking services are key factors for politicians and are still subject to a lot of research (Beck et al., 2009).

African financial systems, with a few exceptions, are very small both in absolute terms and in relation to their economies' economic activity. Formal banking institutions reach under one fifth of the population in East African countries, leaving the rest to informal finance or none at all (Beck et al., 2009). This share was 21.5% in Kenya in 2009. However, the share using any kind of formal or informal financial service was at 66% in Kenya, which makes the country second best in the whole of Africa (FinAccess, 2011). Access to credit can also allow enterprises and households to be more prepared for income shocks. It can thereby enable lifetime consumption smoothing where fully functioning and accessible insurance facilities are absent, as is often the case in less developed countries (Eswaran and Kotwal, 1990). Another plausible argument for having credit available to everyone is that it will make the poor better able to finance their years in school, years that otherwise would have to be spent working. From this perspective, accessibility to credit may have a positive effect on accumulation of human capital (De Gregorio, 1996). In Kenya, the use of formal credit is more associated with investment purposes than the use of informal credit. One explanation may be that formal financial institutions have better possibilities to offer large amounts of credit (FinAccess, 2011).

The total share of Kenyans using informal financial services hardly changed between 2006 and 2009. The share that used formal and semi-formal financial services rose from 24.3% to 40.5% over the same period. While this has to be seen as a positive development, the use of credit has seen a much more modest expansion. Use of credit from commercial banks increased from 1.7% to 2.3% and the overall use of credit use increased from 6.7% to 7.3%. Another impressive finding is that 39.9% of the respondents in the FinAccess 2009 survey (2011) claimed to be using transaction services, which almost exclusively are dominated by Safaricom's M-PESA service (FinAccess, 2011). The report further shows that 38% of the respondents in 2009 said that they were using both informal and formal financial services. These findings seem to suggest that the informal financial sector has not been outcompeted by the formal financial sector's expansion.

It should be of great interest to find out why the increased use of the formal financial sector has not made people leave their informal sources of finance. As the imperfect information hypothesis stipulates, there might be explanations indicating that the informal financial institutions have some advantages compared to the formal ones. Institutional economics explains the failure of achieving economic growth with lack of good institutions ensuring property rights and credible enforcement of contracts. It has further been argued that, in less economically developed countries such as Kenya, poor formal institutions are partly substituted by informal institutions, such as social networks and interpersonal trust, that can serve to lower transaction costs and increase predictability in the financial markets (Ahlerup et al., 2007). It is therefore plausible to ask whether the continuous use of informal financial services can be explained by the existence of a supporting informal institutional environment. Possibly, the informal financial institutions could then be serving as satisfactory sources of credit and serve as competitive alternatives to the formal financial institutions.

If the informal financial services have succeeded in providing a large part of the Kenyan population with credit and saving possibilities, good enough to be competitors to the formal financial institutions, the latter may have certain things to learn from the informal financial

sector. This thesis makes an attempt to find out about borrowers' and credit providers' experiences of formal and informal sources of finance and provide the reader with some ideas of which advantages the informal financial sector offers to borrowers, how informal lenders overcome classic problems of imperfect information, and why formal financial services may still not be a fully satisfactory alternative for Kenyans' financial demand. Three main questions will be leading the analysis forward and are formulated as follows:

- How is the informal financial sector in Kenya responding as the formal financial sector increases?
- Are there informal institutions available for the informal financial sector to operate within?
- Which are the critical characteristics of the banking sector that prevent people from using their financial services in general and their loan services in particular?

From these answers a discussion is elaborated on how commercial banks could further develop their services to the majority of the Kenyan population.

Method

This thesis is a field study of exploratory character as the aim is to capture the way that the financial sectors work in Kenya but without setting up clear views on exactly how. (See Yin, 2003 for an elaboration of explanatory field studies.) As a point of reference, data from a report on financial access in Kenya in the development between 2006 and 2009 will be used to describe the development of financial institutions in Kenya. This data will be used to answer the first question of this thesis: how is the informal financial sector in Kenya responding as the formal financial sector increases? Interviews have been undertaken to find explanations for this development. The idea was to gain knowledge from people that were considered to be suitable to serve as informants and interpreters of their surroundings. The aim was to find out about the interviewed people's understanding of behaviours and of the way institutions operate as well as their opinions. The interviews were "open-ended" to a fairly large extent (Tellis, 1997) even though they also were following a structure that allowed the interviewer to keep the focus of the discussions on the topics that are the main subject of analysis for this thesis. The interviews were focusing on 1) the current way that organizations and individuals behave and interact in the provision and use of credit and 2) the current way that individuals themselves explain the use of financial institutions in order to get credit. In the search of a better understanding of how the informal financial sector operates, mainly people that are likely to have a close interaction with and a good understanding of the financial sector have been interviewed. It is the author's view that these people have a good enough chance of serving as suitable observers of the reality going on around them and also enough "social capital" to be able to make a personal interpretation and communicate this to the interviewer. The interviewed persons have been 1) employees/representatives/managers of bank head offices, bank branches, bank agencies, micro-finance offices, registered moneylending institutions, groups (e.g. ROSCAs and ASCAs), moneylending shops, and informal moneylending, and 2) borrowers (often running their own shop in the street).

As the interviews were open-ended or semi-structured, the questions prepared for the interviews served as a guidance tool rather than a strict questionnaire. There are three major reasons for why this method was used. The first reason is that the informal financial sector's way of operating, its main advantages compared to the formal one, and people's preferences between the two are still quite unknown to the academic world and in the field of economics. Therefore the interviews were undertaken in a way that was supposed to encourage the interviewed themselves to describe these topics, with as little interference from the interviewer as possible. In retrospect, after having analysed the results from these interviews, it appears as though the multiple-choice answers used by the FinAccess survey failed to cover one very relevant reason why many preferred the informal financial sector, namely that it mostly offered more flexible repayment possibilities of loans compared to the formal one. Secondly, the subject that the interviews were treating was likely to be perceived as sensitive to many as they partly were aimed at collecting information on how the informal market in their near surroundings is operating and what they and others think about it. With awareness of the sensitive nature of the interviews, most persons were approached in a friendly and informal manner and were interviewed in a way that was much like a personal conversation. The third major reason for using open-ended interviews was that by having conversations rather than a set of questions, it was easier to adapt the language to a level that was suitable and understandable to the interviewed person. Many people in Kenya, if not most, do not understand the terminology used by banks such as "interest rate" or "per cent". It is also however important to understand that even though many people in Kenya speak English, it is far from the same English used in for example this thesis, especially as those who speak English in Kenya commonly know at least two more languages (Swahili and the language spoken within their tribal origin).

Guided by the main questions for this thesis, the interviews were attempting to cover four focus areas:

- Use and level of interest rates for loans
- Requirements and securities for loans

- Procedures following failures of loan repayments
- Preferences and the reasons for such preferences in the choice of credit provider

While the data from the FinAccess Report is covering samples from the whole of Kenya, the interviews are covering six out of a total of 47 counties represented in Kenya. Most borrowers and lenders were interviewed during the first encounter between them and the interviewer and they were randomly chosen from areas that were functioning as small shopping areas. The employees of the bank head office as well as informal moneylenders were interviewed through appointments made beforehand. Most interviews were about 20-30 minutes long. In order to keep the interviewed completely anonymous the different types of different financial institutions represented by interviewees have been delinked from the different counties.

Interviews

Counties	No. of lenders	No. of borrowers	No. of other informant	Total no.	Type of financial institution	No. of lenders
Kiambu	4	3	0	7	Bank head office	1
Kilifi	8	4	0	12	Bank agency	9
Kwale	3	3	0	6	Bank branch	1
Mombasa	1	4	0	5	Micro-finance branch	3
Nairobi	5	6	0	12	Registered Moneylender	3
Nakuru	3	3	2	8	Group	1
Total	24	23	2	49	Unregistered Moneylender	2
					Moneylending shop	4
					Total	24

The small number of interviews of lenders undertaken in Mombasa is due to that during those days that had been devoted to these areas, most of the regular businesses were closed due to the public holidays.

It is crucial to be cautious when drawing conclusions from results of a qualitative study, especially as this is an exploratory case study with open-ended questions. To begin with, data collection through interviews implies a great risk of getting biased responses, due to poor questions, choice of interviewees, incomplete recollection and the projection of the interviewer's own beliefs onto the interviewee (Tellis, 1997). The procedure of presenting the findings from the interviews has been as follows. The answers and discussions given by each of the interviewed were collected in a document. The information and opinions were thereafter categorized under different topics that were relevant to the main questions asked in this thesis. The topics were "requirements and securities", "frequency of failure to repay", "procedures when failure to repay", "what people prefer", "gender differences", "informal institutions", "demand and supply of credit", "interest rates", and "development of financial institutions". The data was then gone through once more to create summarized findings and discover patterns for each of the categories. Most of the notes gathered from the interviews have also been put into tables that categorize them according to focus areas in order to enable an overview of the information gathered from the interviews.¹ Quantification of and detailed comparison between the answers have been avoided to a large extent since each interview has been rather different from the other. In some places in the thesis, the author's perceptions are presented, which might not be directly outlined in one of the tables. The findings presented in this thesis are the interviewer's interpretations of a few people's understandings of reality, which hopefully can serve as some interesting examples of an informal sector that economists do not know enough about.

¹ Summary data from the interviews is available upon request to the author (hanna.fromell.721@student.lu.se).

Financial Institutions in Kenya

Formal Finance

The commercial banks in Kenya have grown dramatically over the last years. The number of deposit accounts increased from 2.5 to 6.4 million from 2005 to 2008 and their total value rose from KSh 560 billion to KSh 864 billion over the same period. The number of branches increased from 534 to 887 and the number of ATMs increased from 323 to 1325. Equity Bank, Co-operative Bank, K-Rep and Family Bank have been the main contributors to the increase in accounts, where Equity Bank alone stood for 67% of this growth and the other three together for 13%. However, the growth of savings account alone has not changed much and most of this change is accounted for by transactions accounts. Those respondents saying they were using banks for savings and credit rose from 17.8% to 21.5% from 2006 to 2009. In 2009 the four most used banks, as percentage of the adult Kenyan population, were Equity Bank (11.9%), Co-operative Bank (2.1%), Kenya Commercial Bank (2.0%), and Barclays (1.8%). Postbank has lost a large proportion of its customers, over half of them from 2006 to 2009. It used to serve as the only institution where customers could transact money from any branch. This has however changed and today people can even access their account through their mobile phone with many of the largest banks in Kenya (FinAccess, 2011).

The Kenyan banks have done a lot to be able to reach out to the poor. In 2011, Kenya ranked as number 8 out of 183 countries in the ease of getting credit (Doing Business Report, 2012). Equity Bank has been subject to a lot of international attention because of their success in reaching a large share of the previously unbanked population in Kenyan. They have taken many different measures in order to make themselves more attractive to the poor and those living in remote areas and they have managed to expand into underdeveloped parts of the country to a significantly higher degree than other banks. For example, such measures have been to reduce the requirements for opening a bank account

(now only ID and Photo required) and training staff to communicate with customers in an understandable way (many Kenyans have difficulties with financial literacy and 30-40% in central Kenya do not speak Swahili). Between 2006 and 2009, there was a significant branch expansion by a few banks in Kenya, with Equity Bank in the forefront. The banks have exposed each other to increased competition, which has had a positive effect on access to banking services. In addition, domestic banks have proved to have a larger positive effect on access to bank accounts and have had a greater presence in underdeveloped areas than foreign banks (Allen et al., 2011). Some banks are also providing financial training to their borrowers, where concepts like financial terms and what characterizes good and bad lending are explained. Some banks in Kenya have also started to provide micro-finance services such as group loans. In addition, so-called Bank Agencies have very recently been introduced by a few banks, which are offering basic services such as cash withdrawals and depositing. This is supposed to make banking more easily accessible and take off some of the pressure for the branches that are dealing with very long lines, especially in the case of Equity Bank.

Semi-Formal Finance

Micro-finance institutions represent a rather small part of the total use of financial services in Kenya, where in 2009 this share was 3.4% (FinAccess, 2011). Their main objective is to serve the poor and they are mostly providing group loans to those who do not have the possibility or wish to provide securities for their loans.

SACCOs (savings and credit cooperatives) have been very successful in Kenya and have been highly used for example by people engaged in farming on the countryside or in the matatu business (public transport in Kenya). The latest trend suggests that these cooperatives are decreasing in popularity, representing only 9% of financial service use in 2009. It has been suggested that people tend to turn to the quickly expanding commercial banks, which recently lowered their requirements.

M-PESA has proved to have a positive impact on a person's likelihood to have access to bank accounts and credit. M-PESA has also been argued to be serving as a complement to other financial institutions in Kenya (Allen et al., 2011).

Informal Finance

Four different types of self-help groups can be distinguished in Kenya: Welfare Groups, ROSCAs (rotating savings and credit associations), ASCAs (accumulating savings and credit associations), and investment groups, which all are categorized as informal financial institutions. Both ROSCAs and ASCAs collect money from their members on a regular basis and are used to facilitate savings and lending between members. They are viewed to differ from each other in that ROSCAs redistribute the money to one group member as soon as the money has been collected. ASCAs only redistribute the money through loans to those that apply for them and these loans are normally given at an interest rate. At the end of the year, the money received from the interest rates is redistributed to the members as dividends. Welfare groups are only used to collect money and support members when a particular financial support is needed, to cover expenses for occasions such as funerals and medical care. Investment groups make common investments and may offer financial services such as savings and loans to their members (FinAccess, 2011). "Chama" is Swahili for "group of people" and is the name used for all groups that have some kind of financial activity as one of their main objectives. Chamas are most of the times registered with the Kenya Social Services, as it is illegal to organize regular group meetings without governmental approval. They are still classified by most reports as informal financial institutions. The interviews done for this thesis suggest that most kinds of groups are commonly known as chamas and not ROSCAs, ASCAs etc. The way that a chama operates, whether it seems to be like a ROSCA or something else, is up to each chama to decide upon. Clear definitions of different chamas or groups seem not to be used by most Kenyans.

A person running an unregistered business that lends money is a so-called informal moneylender. The interviewed have often referred to these as “shylocks” or “business men”. Informal moneylenders mostly lend small amounts to people at very high interest rates. Moneylending shops are also doing unregistered lending but do not necessarily do this to earn a direct economic profit. Many shops lend goods that the customers can pay for at a later point in time.

Friends and family are still a common source of credit for many Kenyans. They are however not categorized as a financial institution. Those who solely use their friends and family as their source of finance are instead characterised as financially excluded in this thesis.

How is the Informal Financial Sector in Kenya Responding as the Formal Financial Sector Increases?

This section analyses some of the latest findings on the development of financial institutions as well as the development of interest rates charged by different financial institutions. The intention is to interpret the results and determine whether the informal financial institutions seem to decrease as the formal ones increase. As will be suggested from the presented data, the informal financial sector seems to be decreasing in relation to the formal one but does not seem to be decreasing in absolute terms. This should nevertheless be enough to serve as an indication that the informal financial institutions indeed have some advantages compared to the formal financial institutions.

Theories

McKinnon (1973) and Shaw (1973) have been widely appreciated for their argument, commonly referred to as the financial repression hypothesis, that financial liberalization through the removal of repressive policies is necessary in order to enable economies to realize their true growth potentials. Repressive policies are argued to cause fragmentation, resulting in uncontrolled interest rates and excess demand for credit. Liberalization is believed to expand the formal financial sector and limit the need for the informal one (Fowowe, 2008). Hence, financial deepening is expected to occur with improved efficiency in the formal financial sector. In addition, it is assumed that previously marginalized borrowers would get access to formal finance, interest rate spreads (the difference between the rate of deposit and lending) would be lowered, and financial flows between segments would increase (Steel et al., 1997). One important measure is to remove interest rate ceilings in order to let interest rates rise and encourage savings and investments (Fowowe, 2008). The empirical evidence of growth effects from these kinds of policies has been ambiguous. The liberalizations undertaken in Sub-Saharan Africa have been proved to have little effect

on the formal financial sector. In contrast, the informal financial sector seems to have responded positively to the demand for credit (Steel et al., 1997). More recently developed theories and empirical evidence suggest that it will take more than just purely financial reforms to expand the formal financial sector.

Applying the imperfect information hypothesis, the informal financial sector is assumed to have a comparative advantage, which makes it more efficient in markets where contract enforcement and information costs are normally high for the formal financial sector. These costs cause wide differences across lenders in terms of screening, monitoring, and enforcement of loans. Moral hazard and adverse selection make lenders pursue non-price rationing and keep interests low despite an excess demand for credit. Equilibrium will therefore consist of credit rationing and inefficiencies. If the legal system fails in providing an entrepreneurial climate with low transaction and enforcement costs, the formal financial sector may be unwilling to enter the remote areas (Steel et al., 1997). The informal financial sector has been shown to be using specialized techniques better suited for areas where markets are fragmented. Generally, it is difficult to receive information on smaller clients, and they are often regarded as risky by formal financial lenders and do therefore oftentimes have difficulties in finding willing lenders. However, the informal lenders rely on personal, social and business relationships in their collection of information about potential borrowers (Steel et al., 1997). Evidence from Sub-Saharan Africa suggests that some major dilemmas still prevail in the informal financial sector, such as limited possibilities of providing insurance of the inter-community level and the monopoly power that causes inefficiently high spreads of the loans (Steel et al., 1997).

Many small and medium sized enterprises find the informal financial sector either too expensive or insufficient since it cannot satisfy their total demand for credit. At the same time they are oftentimes not considered creditworthy by the formal banks, which leaves the market with an unsatisfied demand for credit (Steel et al., 1997). Aryeetey et al. (1997) show that for the four countries that they analyse (Ghana, Malawi, Nigeria, and Tanzania), the formal financial sector responded modestly, if at all, whereas the informal financial sector

responded dynamically to the increased demand of credit that was realized by the liberalizing reforms undertaken in the four countries. They further show that fragmentation existed, where formal and informal lenders were polarized at extreme ends of the market, with little overlap of clientele. Risk adjusted returns were not comparable across segments and the higher informal interest rates were more likely due to the existence of a monopoly in the informal financial sector (Aryeetey et al., 1997).

Ghate (1992) argues along the same lines as Aryeetey et al. (1997) and Steel et al. (1997) by suggesting that informal financial institutions have comparative advantages. He argues somewhat differently concerning the complete segmentation of financial markets. Ghate shows that for financial markets in Asia, the informal financial sector is an important component in the provision of financial services to poor and that they do have the opportunity to make higher profits than the formal financial institutions due to their market power realized from the use of different techniques. He however concludes that formal financial institutions compete with the informal ones over some parts of the clientele normally covered by the informal financial sector (Ghate, 1992).

Development of Financial Institutions in Kenya

There are several positive figures presented in the FinAccess Report 2009 on the development of the use of finance from 2006 to 2009. To begin with, Kenya has the lowest share (34%) of excluded people compared to all other countries in Africa, except for South Africa. The share of the Kenyan population that used formal and semi-formal financial services rose from 26.3% to 40.5% over the three-year period (FinAccess, 2011).

The total share of the population using semi-formal financial services doubled from 16.3% to 36% and the total share that used formal financial services increased from 18.5% to 22.6% from 2006 to 2009.

The use of SACCOs decreased significantly from 2006 to 2009, from 13.1% to 9%. The data indicate that most of the people leaving SACCOs stay in the financial sector and seem to choose Equity Bank and Postbank as replacements. Micro-finance institutions have increased in scale, from 1.7% to 3.4%, even though they still represent a rather small share of the financial sector in Kenya. The major increase of the use of semi-financial services was constituted by the increased use of transaction services. These have almost exclusively been dominated by the M-PESA, a money transferring facility developed by the mobile phone operator Safaricom. A total of 39.9% of the respondents claimed to be using this service in 2009. Through this service, customers can transfer money between themselves, pay bills and deposit money in their own M-PESA account with their own phone. M-PESA was not included in the 2006 survey, as the service had then only just started (FinAccess, 2011).

Classifications of Financial Institutions

Formal: banks, building societies, Postbank, insurance companies

Semi-formal: SACCOs, micro-finance institutions, government institutions, M-PESA

Informal: ROSCAs, ASCAs, groups of friends, local shops, employers, buyers, informal moneylenders

The report shows that 38% of the respondents in 2009 said that they were using both informal and formal financial services. In addition, out of all using formal financial services in 2009, 58.8% replied that they also were using informal financial services, a figure that had increased from 56.4% in 2006. This trend was even stronger for users of semi-formal finance, where the share of these users that also used informal financial services increased from 37.7% to 47.2% (FinAccess, 2011). Recalling the implications of the financial repression hypothesis, these findings are important, as they seem to suggest that the informal financial sector has not been outcompeted by the formal financial sector's expansion. Rather it appears as if it serves as a complementing source of finance, considering the fact that the share of the population using informal financial services (calculated on a mutually exclusive basis) shrank from 35% to 26.8% from 2006 to 2009. At the same time the total use of informal financial services has increased slightly, from 37.5% to 38.7%.

The sizes of the shares of men and women that were financially excluded in 2009 were about the same. However, women were to a larger extent excluded from the informal financial sector compared to men. In 2009, 14.8% of men and 39.6% of women were members of ROSCAs. The same kind of finding is true for the membership of ASCAs in the same year, where the shares were 3.9% and 8.2% for men and women, respectively (FinAccess, 2011).

While the increase of the formal and semi-formal financial sectors has to be seen as a positive development, the development of credit use from these sectors has gone through a relatively modest expansion: from 6.7% up to 7.3%. The use of credit from commercial banks alone increased from 1.7% to 2.3%. The single most common credit source was that categorized as shop/other supplier, which counts as informal credit and increased from 22.8% to 24.3%. The second most used source of credit was family and friends (FinAccess, 2011).

The Kenyan Interest Rate and Differences Between Financial Institutions

As banks are left to operate freely, without government interruption, one might suspect that as banks start to expand, an increased competition together with realized economies of scale would push interest rates downwards, which surely has been argued before. (See for example Mallett and Sen, 2001 or Berger and Hannan, 1989.) Just as described above, the financial repression hypothesis would assume that the interest rates would become lower than those provided by the informal financial lenders since formal financial institutions are assumed to be more efficient than informal ones (Roe, 1990).

However, there is evidence that Kenya's market is dealing with issues of imperfect information on credit holders. It has been argued that to overcome these issues, lenders have been using the interest rate as a screening device to distinguish good borrowers from bad ones. This can therefore have a positive effect on the interest rate, leaving those with lower possibilities of profits on their investments unable to borrow. This is however a technique

that has been argued to have the opposite effect of that intended by the lender. Higher possibilities of profits from investments are often associated with having a high volatility in investment returns but in fact a lower expected return than those investments that have lower possibilities of profits. It has been argued that the use of the interest rate as a screening device attracts the high-risk investors who tend to have a lower expected return than the low-risk investors (Stiglitz, 1981). In other words: the payoff to the lender may decrease as the interest rate is higher and thereby the risk of the funded projects increases.

In the period before the time when Kenya had undertaken some major liberalization measures, the interest rate spread was strongly affected by governmental policy. Expansionary fiscal policy together with tightening monetary policy created inflation that necessitated an allowance of the interest rate to increase. Evidence suggests that in the post-liberalization period the interest rate spread slightly widened. When the inflationary pressure decreased again, the banks did not reduce interest rates on loans due to a higher risk caused by non-performing loans. In addition, they lowered the interest rates of deposits, which pushed the interest rate spread within the banking sector to a higher level than the one in the pre-liberalization period. An explanation for this inefficiency remaining within the bank industry is that there is not enough incentive for the banks to invest in information capital and tackle the issue of asymmetric information since the enforcement of financial contracts is too poor (Ngugi, 2001).

Monetary policy through the lowering of the central bank interest rates is generally used to encourage a decrease of banks' interest rates on loans. Recent research suggests that the interest rates from commercial banks have responded very slowly to changes in the financial market such as inflation levels, credit risks and profit margins, which normally should encourage banks to lower their interest rates. Misati et al. (2011) find that the interest rates' pass-through from policy rates to commercial bank rates is sticky both in the short and long run, with a delay of between 11 months and 2 years for a full adaptation of the interest rates in the banking sector. They also get a result of a mere 0.34 rate of transmission for both the deposit and the lending rates. The authors conclude that their results indicate that there are

inefficiencies in the Kenyan money market and that monetary policy therefore becomes less effective (Misati et al., 2011).

As of June 2008, the commercial banks' average savings deposit rate was estimated to be 4.48% and the corresponding lending rates to be 14.06%. As of November 2011, savings deposit rate had shrunk to 1.41% and the lending rate increased to 18.48%. The Central Bank rate, as per 1 Dec 2011, was 18% and the annual average inflation rate measured in Nov 2011 was 18.93%.

The average interest rate for a consumer loan by Equity Bank rose from around 14%-16% in March 2011 to around 23%-25% in November the same year. Their interest rate for group loans rose from 18% to 24% during the same period. Considering that Equity Bank is the commercial bank that reaches out to most people (in 2008 they had reached out to 3.2 million persons and the bank accounted for 80% of the growth in bank accounts from 2005 to 2008 (FinAccess, 2011)), this development is quite remarkable and could be expected to have a big impact on many people's choices of financial institutions.

Kenya Women Finance Trust, one of the few major micro-finance institutions operating in Kenya, is mainly focusing on loans to women with small businesses. They charge 19% interest for individual loans and 17% for group loans. Jamiibora Bank offers both individual loans and group loans. Their micro loans of amounts under KSh 100 000 are given at an interest rate of 22% whereas those between 100 000 and 500 000 have an interest rate of 16%. Their individual loans are at 28%. The three small registered moneylenders that were interviewed charge 10%, 15% and 25% per month respectively (which translate to 314%, 535%, and 1,455% yearly interest rates respectively). Informal moneylenders charge between 10%-50% interest per month (314%-12,975%, yearly interest rates), where 30% per month has been the most commonly mentioned figure. For the interviewed informal moneylenders, it is important to avoid the reckless borrowers, which they do by getting to know the person and maybe taking high enough securities. Interviewed borrowers have explained that when people need large loans, they go to other financial institutions with

lower interest rates. High interest rates therefore might persist because loans given out by informal moneylenders are fairly small and are provided to so few that the business becomes very small-scale.

SACCOs are overall those among the financial institutions that offer the lowest interest rates on loans. For a two- to four-year period, they commonly charge an interest rate of around 12%. For loans on short-term scale the charge is 1.5%-5% per month, which is about 120%-180% calculated as a yearly rate (Waweru, 2011).

In contrast to many informal financial institutions, banks, micro-finance institutions, and SACCOs offer interest rates that are not several times higher than the rates set by the Kenyan Central Bank. Among these, micro-finance institutions and banks seem to be quite close to these rates, especially now that commercial banks have started to offer micro-finance loans as well. The SACCOs, on the other hand, charge significantly lower interest rates on loans. For all these formal and semi-formal financial institutions, there is a clear difference between their interest rates and the ones offered by the informal financial institutions. Therefore, it is reasonable to assume that we must look elsewhere for an explanation of why people still seem to find that the informal financial institutions are good providers of financial services.

Interpretation of the Empirical Evidence

Let us go back to the financial repression hypothesis arguing that as liberalization takes place and banks are left to operate without restrictions, the banks will start to expand at the cost of the informal financial sector. This is assumed since the banks are expected to become more efficient due to competition and economies of scale, which will push the interest rates downwards. The above presentation shows that the use of informal financial institutions did not decrease between 2006 and 2009 despite some pretty impressive expansion in the use of formal and semi-formal financial services. Therefore it seems like the formal financial sector has not been able to out-compete the informal financial sector. The same trend applies to the

use of credit. Formal credit experienced a relatively large increase but was still in 2009 representing just a small share of total credit. The informal use of credit showed a less impressive increase but remained on a much higher level than that of the formal financial sector. One possible explanation for this development, considering the theories presented above, is that the informal and formal financial sectors might be operating in separated markets, where an increasing formal financial sector has no effect on the informal one. In this case, one might expect that the formal financial sector indeed has become more competitive, within its own clientele, and that the interest rates for the formal financial institutions have declined, which has caused the expansion of the formal financial sector. The informal financial sector is at the same time believed to have a monopolistic power and to be charging excessive interest rates on loans. The above presented data shows that people are using both informal and formal financial services at the same time. This stands in contrast to the assumption of non-competing financial sectors argued for by Aryeetey et al. (1997) and Steel et al. (1997).

It appears as if a fairly large part of the Kenyan population is seeing advantages in both formal and informal financial services and that these in fact are much closer to being competing services than what can be concluded from the results of Aryeetey et al. (1997) and Steel et al. (1997). This is just what is argued by Ghate (1992) who claims that the informal financial sector will continue to grow in absolute terms in response to increased demand but will likely decrease in relation to the total financial sector.

From the above presentation of the interest rates charged by different financial institutions, it seems like the formal financial sector is still struggling with some inefficiencies judging by the high interest rate spreads. Commercial banks' interest rates have been kept on a high level even as they have started to compete heavily on the large unbanked clientele still existing in Kenya. Between June 2008 and November 2011, the average interest spreads did in fact increase from an already high level of 9.58 percentage points to 17.07 percentage points. This should suggest that there still are some major issues of imperfect information on the clientele. The interest rates charged by the formal and semi-formal financial institutions

nevertheless appear to be significantly lower than the ones charged by the informal financial institutions. A significant share of the Kenyan population is using both informal and formal financial services and the interest rates seem to be a lot lower for the formal ones. An analysis of the interest rates charged by different financial institutions therefore seems to be inadequate as an explanation of why the informal financial sector remains. What then can explain the continued use of informal financial services? Alternative explanations are explored in the following two chapters.

Are there Informal Institutions Available for the Informal Financial Institutions to Operate Within?

In the above section it was concluded that the use of formal financial services has increased a great deal but that the use of informal financial sector has remained high. Many have indicated that they have been using financial services from both the informal and the formal financial sector. The above section also showed that it is likely that there are factors other than the interest rate that must serve as key explanations for the way people make their choices of financial service providers. Something must make the informal financial institutions attractive enough to be able to compete the way that they seem to be doing with the formal financial services. Turning to institutional theory, we learn that enforcement mechanisms are crucial for people that make investments and sign contracts. This section elaborates on this finding and investigates whether a reason for the informal financial sector's attractiveness may be that there exist institutions that support and enforce contracts and agreements made in an informal context.

Theories

It has been proven that institutional quality is crucial for economic growth and that security of property and contract rights are strongly correlated with economic growth. The argument is resting on the assumption that investments are driving economic growth and that for investments to occur, people need to feel secure about the contracts that they enter. Functioning and trusted institutions that ensure that laws are respected and that contracts are honoured are therefore needed in order for people to enter contracts and realize their investments that may lead to economic growth. Therefore it should be in the government's interest to protect and define the rights of both parts entering a contract (Clague et al., 1999).

The argument of the importance of institutions can be applied to the financial sectors available to people in Kenya. First of all, investments (financed by loans) must have the possibility to generate profit and this profit cannot be too uncertain. Therefore it is important to the borrower that the lender sticks to his part of the contract. For the lender, it is important to know that his money will be returned. He needs to know that there is someone who can enforce the repayment if the borrower neglects his obligations.

In an ideal world described by a classic economic theory loans would be provided by formal financial institutions and lenders and borrowers would feel completely sure that the other party would honour the contracts. There would be laws binding them to their agreements and a court system that may punish anyone who would default on their part of the contracts. There are two main features confirming that this ideal world does not exist in Kenya. One is that these institutions that people are assumed to be able to rely on are not so strong in Kenya. In 2011, on the indicator of how well a country is enforcing contracts, Kenya ranked 126 out of the 183 countries, which is a rather poor score (Doing Business Report, 2012). The second feature is that there are many financial agreements between two parties which are made informally, which therefore are not applicable to the formal institutions that are supposed to enforce contracts and assure people's rights as stated in the law.

The argument that it is crucial for people to trust that their agreements will be honoured by the other part is valid in the informal world as well. What we do not know much about is which kinds of responses to these needs that have been developed by the informal financial sector. There are economists who argue that informal institutions can serve as a response to a lack of formal institutions. This may trigger the question of whether such informal institutions, serving as enforcement mechanisms of contracts and agreements of informal character, have been developed in Kenya.

Using North's definition of institutions of being "the humanly devised constraints that shape human interaction" (North, 1990), it can be argued that institutions can come in many

different shapes. Arguably, a contract enforcement institution can be fundamentally built on core human values such as morality, personal trust and reputation, where something as basic as the threat of feeling ashamed can serve as a reason not to dishonour a contract (Greif, 1997). An informal institution or a convention is a social norm that often leads to good outcomes. It is stable because people wish to be socially accepted in their social environments (Raiser, 1997). Social capital has been argued to become more important when institutions are weak and much less so where formal institutions are stronger. Weak formal institutions can in fact be completely substituted with informal ones such as social networks and interpersonal trust. Different kinds of self-enforcement mechanisms tend to develop and replace the formal institutions, when these are not sufficient enough to provide securities to parties entering contracts (Ahlerup, 2007). Economic sociologists have even argued that personal trust is the most important institution able to enforce contracts where personal relations and structures function as foundation for building such trust and discourage misbehaviour (Granovetter, 1985).

Greif (1997) argues that in most societies other than the Western ones, there are “collectivist” systems present that may serve to enforce contracts, which mostly use personal reputation and trust as enforcement means. However, they are mostly viewed to function in groups where the members have features such as religion or ethnicity in common. Especially interesting for this thesis, the author argues that in some cases, these alternative systems are more efficient than formal ones. The formal institution may be able to observe a person dishonouring a contract but unable to verify the same action. In the case of an informal institution, it is often enough to have identified the action by observation and the collective can then choose to punish the person if it so wishes (Greif, 1997).

It has been argued that when the formal legal institutions are insufficient in enforcing agreements between people, private order institutions will develop to fulfil this need. It may be unreasonable to assume that all details in a contract can be decided beforehand by a formal institution. Therefore, institutions of private ordering are central for the forming of contracts (Williamson, 1985). This approach still accepts that the existing legal framework is

of importance. It suggests that the legal framework will continue to guide the way that cases are judged but through a less direct way than it would have with fully functioning formal institutions in place (Greif, 1997). Gow et al. (2000) argue along the same lines and explain that incomplete contracts can be preferred to strict ones. Both parties may find it better to leave some flexibility in order to be able to adapt to unknown future events. The authors show that in the absence of external enforcement mechanisms a contract can become self-enforcing where both parties will do better in honouring than dishonouring the contract (Gow et al., 2000). In fact, flexibility has been argued to make informal contract enforcement more efficient as those that are not completely controlled by a contract can adapt their actions as circumstances change (Greif, 1997).

Informal Enforcement Mechanisms

Some of the people interviewed have described informal groups that lend money to their members to be flexible with the repayment period. For the cases where the group has taken a loan from a financial institution outside their own, a person's failure of repaying their loan in time results in that the other members have to step in until the person can get hold of the money himself. As has been confirmed by interviewees, flexibility in the repayment period is true also for the informal moneylenders. Some have explained that in the case of inability to repay a loan at the agreed date to an informal moneylender, the interest rate is applied anew for the extended period. A few have said that some moneylenders also add an additional fee or interest rate as a punishment for the delay.

There may be many economic incentives for a borrower not to default on a loan from an informal moneylender. As described by one informal moneylender, the borrower can get better deals as trust has been built. Most informal moneylenders start with a small sum and gradually increase the loan amount as the loans get successfully repaid. One informal moneylender said that loans never were given out to those that had defaulted or to friends of those who have defaulted. If the borrower defaults and gets his items sold, it may become more expensive since the item generally is worth more than what they get sold for. In

addition, the items are generally worth more than the amount of the loan. It has been claimed that the informal moneylender takes the whole sum gained from the sale of the items without giving any of the difference to the borrower.

Group dynamics and peer pressure can also constitute a strong informal enforcement mechanism as argued by the above presented theories. Most people have referred to economic reasons rather than the feeling of shame or social pressure from the group that make them repay their loans. The group members know where everyone in the group lives and have the possibility to go to their home and collect items should a borrower default on their loan. The phenomenon that group members know each other and people around the neighbourhood may act as a mechanism that makes a person's credit history known to future possible lenders. An example was given of how a person who defaults in one group risks getting excluded, not only from that specific group but from any other group that he or she is a member of once these groups hear about the default. Some people when interviewed have expressed that it can be difficult to enter a group, as you have to know one or several of the members first. Therefore, it is probably a quite serious consequence for people if they default on a loan and get excluded from the group. Finding a new group might not be easily done when the people he knows consider him as someone who defaults and the people that he does not know would not be willing to form a group with him for that particular reason.

Third Party Enforcement

Even though there seem to exist important self-enforcing mechanisms in loan contracts, several people have explained that other enforcement mechanisms that are available to the lender if the borrower fails to repay his loan. Three different concrete alternatives of third party enforcement mechanisms available to the informal financial service providers can be identified from the interviews done for this thesis: police, auctioneers and others that work without any form of registered business.

Most interviewed people that were asked about the use of police by informal financial institutions replied that the lenders used the police in serious cases where the borrower refused to repay his debt. The informal moneylenders claimed that they most of the time had no reason to involve the police as they managed to enforce the loans themselves. In the case of a person refusing to repay however, the police could be contacted to solve the case. If a written contract existed between the borrower and the lender, this was used for the police to try to determine what would be their “verdict”. If no contract could be shown, the police would use other ways to assure themselves of how much the borrower owed the moneylender, for example by having the borrower confess to the lender’s accusations. As the lenders providing the loans do not have registered businesses, the contracts would not apply by law and the police would not be able to assist without also investigating the case of unlawful lending. However, the informal moneylenders have been discussing the contracts and how people can dishonour them in different ways and what kind of laws different defaulting actions would be breaking. Consequently, the laws still seem to be used as a basis for what should be considered as criminal offences within contracting of loan services. The interviewees have explained that most informal moneylenders have developed some kind of personal contact with the police and have to pay them on the side if they want them to assist in getting their contract enforced.

Auctioneers are often used when defaulters use personal items to repay their loans. The auctioneer has been described to be able to forcefully go to a defaulter’s home or business to bring things to sell in order to assist the lender in getting his money back. However, many have also said that the auctioneers do not have the same enforcing power as the police do. Auctioneers have been argued to take things and sell them if both parties have agreed on it. In contrast to the power of the police, it has been said that the auctioneer always needs to see the contract of the loan and also needs the borrower to sign an agreement saying that he accepts that the auctioneer will sell some of his belongings in order to repay the lender.

A few in Nairobi have also confirmed that there are yet other ways available to moneylenders to enforce loans. There are people who are operating completely unofficially

and outside the law with assisting people in getting their money back. These people may use violence against those in debt in order to make them pay. The people describing these “enforcement people” confirmed that they are not that uncommon and that informal moneylenders indeed are using them.

However, these external enforcement mechanisms have been described to work well only for one of the two contracting sides. Some borrowers have expressed that there is no one to turn to if they feel that the informal moneylender has treated them unfairly. One person described the police to be extremely corrupt, and in most kinds of disputes where the police stepped in those who had the most money to bribe the police often got their way.

Most of the interviewed people said that loans are almost always repaid eventually and that third party enforcement mechanisms hardly ever have to be used. As argued by institutional economic theory, the mere knowledge of the *possibility* to use these enforcement mechanisms might make people more willing to honour their agreements. The borrowers know that the outside option would be more costly to them.

Far from all groups are using third party enforcement mechanisms. Many of them seem to enforce the loans themselves. There are many features described by the interviewed that may serve as strong incentives to not default on a loan in a group. The members know where everyone in the group lives and can get what they need from the borrowers home or business. A defaulting borrower risks getting excluded from the group and losing his source of credit. The members may tell others in the area about the default, making it difficult to find a new group to become a member of. Another explanation could be that the members of a group often are friends or co-workers and may have a stronger feeling of trust and peer pressure of honouring contracts among themselves. Moneylenders seem to have a rather different, less personal, relationship to their borrowers, which might make them more dependent on third party enforcement mechanisms.

Cultural Differences

The coastal areas have a large population of Muslims. There is a clear tendency of that people are using different sources of credit in this area judging from the results of the interviews. Most people claimed not to know about informal moneylenders. Interest rates were not used according to many, either because they were borrowing from friends who never charge interests or because they borrowed goods instead of money, where interest did not apply in direct terms. Many Muslims believe that accepting and paying interest rates are against their religious views.

The people who expressed dislike of the use of interest and who claimed that they did not know about any informal moneylenders gave the impression that they rather kept their financial business to themselves and close family members and friends. Interviewed from other parts of the country have appeared to be more open comparing the pros and cons of different alternatives of financial institutions in order to make the most economically wise decision available to them at the time. In contrast, some people on the coast seemed to be less aware of different financial institutions that they could use and many of them seemed not to be bothered about this fact.

It is however difficult to draw any conclusions about which kinds of informal institutions, if any, that exist among these people. The common standpoint has been that no external mechanism is used to assist enforcing repayments of loans. One possibility may be that their religion and culture serve as a very important one. Possibly, such strong informal institutions, building on trust, norms, and ethics, may have a significant impact on the way people trade and sign contracts with each other, making third party enforcement mechanisms unnecessary and unwanted.

Implications of Findings

There are strong indications from the interviewees' responses that there indeed are informal institutions that exist alongside the relatively weak institutions available in Kenya. The main findings that witness such existence can be summarized as follows:

- There is often a common understanding from the informal providers of credit and the borrowers that the repayment period is flexible in that it can be negotiated when the borrower has a good reason to extend the loan.
- The borrowers are allowed to get larger sums of credit from a moneylender if they prove to be trust-worthy. They risk getting rejected by the same moneylender in the future if they ever default on a loan. Defaulting on a loan becomes expensive as the borrower can lose items worth a lot more than the due repayment sum.
- If defaulting on a loan from or through a group, the members will be able to find the borrower since they know everyone very well. The borrower risks getting excluded from the group. The group members will tell everyone in the area about the default. Finding a new group to lend from is difficult.
- There are possibilities to enforce contracts through police officers, auctioneers and others operating completely outside the legal system

It seems that one cannot make general assumptions about what terms one can get a loan for in the informal world, which might be argued to be an important deficiency for the attractiveness of the informal financial sector. However, judging from the findings presented in this chapter, once the terms and conditions have been negotiated between two parties, both parties will most likely do what they can to honour the contract. This should still imply an important form of security and predictability that is crucial for investments and economic development.

Another interesting point can be made from two of the findings from the interviews. First, the above presentation of the informal institutions that play a central role in the use of informal credit suggests that trust is a key component for contracts to be made in an informal context. Secondly, most people who have commented on the differences in the use of groups between men and women have said that women trust each other more than men do and that women therefore like groups much more than men. The argument stressed here is that trust is necessary for the use of the informal financial groups. The empirical finding of the higher use of informal financial groups by women compared to men could therefore possibly be explained by the fact that the women have an important informal institution making this alternative more attractive as a source of finance than it does to men. However there seem to be other informal institutions with enforcement character present in groups as well. As presented above, the economic arguments for why it makes sense for a person to honour a contract in an informal context appear to be very strong in groups. Groups come in many different forms. Therefore, the combinations of the importance and weight of different informal financial institutions, serving as enforcement mechanisms, may differ across groups.

The use of police is very much in line with the neoinstitutional view that the legal framework will be operating as a guiding shadow. This can be argued for as the informal moneylenders interviewed appear to be quite well informed about the laws that concern the writing and commitments of contracts and refer to these laws in the case of involvement of the police. This is not that far away from Greif's (1997) argument that despite the absence of good institutions, the legal framework will still, but indirectly, be functioning as a basis or a shadow of rules that people will operate under.

As suggested above, the interviewed on the coast who were Muslims may have strong informal institutions among them that build on trust, norms, and ethics. They claimed that the police, auctioneers or other external people never were involved with their businesses or the solving of their personal disputes. Let us recall the way groups seemed to have many different informal institutions in place that also may explain why the groups appear to prefer

dealing with enforcing defaulting borrowers themselves. Maybe the Muslim community on the Kenyan coast is operating under similar kinds of informal institutions as those developed in groups. It is not unlikely that many of them have a wide personal network among those belonging to the same religion. Therefore the same features as associated with these groups may affect them, where people know where the borrower lives and the borrower's reputation can easily be spread to other lenders. Hence, an economic aspect can still be very much true just as for the group. It would be highly irrational for someone knowing that they will experience serious consequences to default on a loan. Therefore, sufficiently strong informal institutions may eliminate the need for third party enforcement.

It seems there are several institutions available in the informal financial sector that make people willing to enter contracts. As such, the informal financial sector could possibly be a quite strong one that stands as a competitor to the formal financial sector. Considering the importance of functioning institutions, the fact that informal credit often is more expensive than formal credit might just not be reason enough for people to be willing to completely change their choice of financial service provider.

Which are the Critical Characteristics of the Banking Sector that Prevent People from Using Their Loan Services?

Since the question of the banking sector's way of operating and what would truly make people use them could be analysed from many dimensions and could draw on quite big proportions, this section does not attempt to give a complete perspective but approaches this question from the view of those that the banking sector attempts to reach out to. Results that mainly will be presented are those obtained from the interviews done for this thesis as well as from the FinAccess Report 2009. The FinAccess Report has focused on perceptions about banks and other formal financial institutions in general whereas the interviews done for this thesis have mostly been focused on opinions about lending services by different institutions, including informal lenders. This should not be seen as too much of a problem since most financial institutions demand that a borrower should have had some economic activity with them for a while (most commonly savings). Thus, opinions about a financial institution in general may be assumed to be relevant to a person's perception and ability to use that same financial institution's credit services too. This section is divided into five main categories of perceptions about banks plus a concluding part of the main results.

Interest Rates and Costs

The FinAccess Report finds that 22.8% and 35.6% of the unbanked and banked people respectively consider the banks' fees to be too high. When asking for the reason why those that had not taken a loan had not done so, only 4.9% answered "do not want to repay with an interest". Those that answered "there is a lot of bureaucracy" and "do not have a bank account" were 14.5% and 10% respectively, out of which some may have been referring to the charges associated with financial services. When asked why they had not been saving money with a bank, 80.3%, answered "no money" and 13.9% answered "nothing left over".

Only 3.3% answered “too expensive” (FinAccess, 2011). In sum, interest rates and costs do not seem to be the greatest concern to most people when they evaluate the banking services.

None of these results stand in contrast to what the interviewees have been claiming. However, concerning interest rates and costs, the summarized findings from the interviews point to a slightly different view, which is poorly covered by the results from the FinAccess survey. From the interviews it appears that most people seem to think that the interest rates on loans charged by the *informal* financial institutions are the ones that are too high. A few people have commented on the interest rates charged on loans by banks and said that they have become unacceptably high over the last months. They have blamed the higher rates on the overall state of the economy (recall the exceptionally high inflation and interest rate set by the central bank at the end of 2011). Most people have recognized that the banks have significantly lowered their charges for banking services. Despite the overall positive attitude to the attempted lowered interest rates and charges by the banks, many remain sceptical towards the banks because of a worry about the charges and the interest rates. Many people have expressed that what the bank one day claims will be the charges and interest rates associated to a specific service may very well change in the near future. Some have explained how after having taken a loan by a bank, the borrower may get called to come back to the bank several times and pay new charges that have not been mentioned by the bank before. Some have even explained that saving with a bank is so risky that you may just as well end up with less money than you started off with from all the charges. This is the reason given for why it does not make sense to save unless you have a lot of money that can render a high enough return from the interest rate. However, this critique of the banks should not be presented without comparing the same perceptions about other institutions. The use of SACCOs decreased significantly between 2006 and 2009. The analysis provided in the FinAccess Report, 2009, suggests that the decrease is partly due to a perception that money with a SACCO is less secure than with a bank. The interviewed have confirmed this finding by expressing that they believe their money is less secure with a SACCO than with a bank. A feeling of uncertainty seems to be true also for the Micro-finance institutions, of

which the use has increased but is still on a very low level (FinAccess, 2011). Many of the interviewed have expressed that people do not like being responsible for others' losses and are not that fond of borrowing from formal financial institutions together with a group. However, no comments have been made indicating that the informal lenders do not stick to their word about the cost of loans.

Time Consuming

60% of the respondents of the FinAccess survey thought that the banks had too long queues, which was a more common opinion by the banked (83.2%) than the unbanked people (53.6%). 4% of the respondents who had not taken a loan replied that they “do not have time” and 14.5% said that “there is a lot of bureaucracy”, which also may serve as an indicator of time for some respondents.

The interviewed in Nakuru County described the situation for many of the poor employed in large plants. The employees received their salaries through a bank account that they were forced to have. They did not actually want a bank account and if they needed to borrow money they often borrowed from informal moneylenders. These employees associated bank services with time consuming services and unpredictable costs. They expressed that they were working all days and had no time to go to the bank, less so stand in long lines and be forced to return every so often to follow through a loan contract. An interviewed person from another county also raised this concern by saying that, as the bank agencies had started to open, the shopkeepers had started to use banks for depositing their revenues. The agencies, as opposed to the bank branches, could assist them quickly and allow them to be back at work in a couple of minutes.

When people were asked why informal moneylenders were being used, many answered that they had the advantage of being able to offer money fast. The banks were often associated with long processes before a loan could be accepted.

Unfamiliarity and Financial Illiteracy

Only 45% of the unbanked compared to 75% of the banked expected to be treated with respect in the bank according to the FinAccess survey. 7% of the respondents that were not currently saving money with a bank answered that it was because they did not understand how to save. 8% of the unbanked gave a reason such as illiterate, lack of knowledge about bank products or language barrier for not using bank services.

Some of the interviewed have explained that many people have difficulties in understanding the terms and conditions offered by the banks and that people for that reason prefer signing a contract that is simple and understandable. Many of the interviewed have been comparing the interest rates charged by informal financial institutions that commonly charge monthly interest rates with those charged by formal financial institutions, which are measured on a yearly basis. As an interest rate of 30% per month charged by an informal lender translates to a 2330% yearly interest rate, the degree of miscalculation from assuming that interest rates can be compared regardless of the time that they refer to may become very serious. Many interviewees that have been talking about interest rates are not referring to per cent but rather to the actual sum that is added to the loan, which also might be an indication that they do not understand the concept of per cent. This ought to make it very difficult to understand the prices at which banks offer money. Another person explained that it is for the reason of financial illiteracy that most people do not go to banks but have started to visit the agencies, as they are able to explain things in an easier manner.

Banks are for the Rich

47.7% of the respondents in the FinAccess survey think that banks are for the rich people. This is partly confirmed through the interviews done for this thesis since many have expressed that they do not have enough money to make it meaningful to be saving with a bank. They seem however not to think that the banks' intention is to reach out only to the

rich. Many have said that banks used to be for the poor but that they now believe that this situation has changed a lot over the recent years.

Lack of Flexibility

The FinAccess Report does not touch upon the subject of lack of flexibility with the contracts signed with the banks. However, this may be one of the most important contributions of this thesis. Many interviewees have described friends and family, chamas, SACCOs, and informal and formal moneylenders as being flexible with repayment periods of loans. They are considered to be willing to renegotiate the terms if the borrower asks for it. The normal procedure when someone gets into difficulties in repaying a loan in time is that the terms get renegotiated so that the loan can be extended. Not until later will the lender start asking for items to sell and only in very rare cases are third party enforcement mechanisms used in order to have the loan repaid. One person said that most people who are not employed, and therefore do not have stable incomes, cannot be sure of how much money they will make in the close future. Banks have been described to not listen to someone who has had an especially difficult situation that for an informal lender would have justified an extension of a loan. Many borrowers have expressed concerns about the strict repayment schedules that are associated with banks. One interviewee said that many persons prefer to get a loan from a SACCO instead of a bank since they will not “harass” the borrower in case of inability to repay the loan in time.

Conclusion

The main conclusion from the results is that many people have recognized a change in banks’ attempts in reaching out to the poor but still are sceptical about taking loans from commercial banks. The main reasons for remaining sceptical are categorized as follows:

- The perception among borrowers is that banks do not stick to their word about costs of loans.

- Many still do not feel that they understand the terms and conditions offered by banks.
- Getting a loan from a bank is considered to be associated with time consuming processes, that hard working people may not be able go through.
- Flexibility of the repayment period, which seems better through the informal financial sector, is crucial to many borrowers.

The results from the FinAccess Report and the ones from the interviews done for this thesis do not contrast each other much. One ought to be careful when comparing the results from these two sources of information as two very different methods of gathering the information from the interviewees have been used. Some similarities and differences may however be considered. The time-consuming aspect of loans provided by banks is confirmed both by the FinAccess survey and the field study interviews. The FinAccess Report finds that 8% of the unbanked gave reasons why they were not using any formal financial services indicating that they did not understand the services being offered by banks. Some have said that many are afraid of going to banks, as they do not understand most of the financial language used. In addition many interviewees' ways of referring to interest rates strongly indicate that they do not understand what interest rates really mean and how different rates can be compared with each other. This latter finding may further suggest that people are using financial language as if they fully understood it, but may have gotten a few things wrong that may have major impact on the factual situation; more than 8% do not understand the services offered by the banks. In the discussion of people's views of fees and interest rates charged by banks, the FinAccess Report may have missed an important common opinion that was captured through the interviews. Banks' interest rates and fees seem not to be considered as a very big issue by many people, which is what both the survey and the interviews seem to suggest. However the interviews indicate that a major problem perceived by many borrowers is that these fees and interest rates are unpredictable and tend to change a lot. The unpredictability seems to make many reluctant to take loans from banks since they are afraid that they will be charged much more than initially promised. Another important

finding seemingly missed by the FinAccess Report is that flexibility in the repayment period is a crucial advantage to the informal financial sector, which banks do not offer. Interviewees have explained that the inability of banks to listen and to extend a loan makes many go to the informal financial institutions when they need a loan.

How Can the Banking Sector Improve?

It has been suggested that imperfect information brings major difficulties to traditional banks, which other types of financial institutions are more likely to overcome. Today there are commercial banks that have started to use alternative methods to overcome the increased risk implied by lending to people on whom little information is available. Equity Bank has been the most successful bank in reaching a high number of Kenyans and more underdeveloped areas and has also been a bank in the forefront of the introduction of innovative methods. Allen et al. (2011) show that Equity Bank has a larger positive effect on financial inclusion than all other commercial banks operating in Kenya. This section will use Equity Bank as a point of reference when discussing banks' strategies and possible improvements.

A number of rather innovative methods introduced by Equity Bank should be of interest to look at here. The bank has started to use "flexible collateral" such as using the employer as security for salary advances or personal belongings for those self-employed as alternative means for poor people to secure their loans. To promote their services but also to increase Kenyans' knowledge about financial concepts, the bank is arranging financial training and education days as well as group discussions and surveys. Mobile bank branches in the form of trucks have been used to offer the services of deposits and loans. The IT system used by Equity Bank enables the branches, ATMs and mobile banking channels to be linked centrally. Data collection and management has thereby been facilitated and each branch has collected information on savings and checking, deposits and consumer lending (Stanford, 2007). The bank has also recently started up a network of bank agencies around the country. Services like cash withdrawals and depositing, bank statements, and account opening are offered by these. No loans can however be provided by the bank agencies.

Main Findings

Recalling the findings presented in the previous chapter, it should be of interest to banks to ensure that they can respond to such expressed opinions with attractive financial services. It may however also be useful to take a closer look at other financial institutions that have managed to better tackle those issues that the banking sector still is struggling with. This thesis has also presented possible key features that make the informal financial institutions successful. It is the author's hope that the banks may develop methods inspired by such key features.

One informal institution claimed to be of great importance is the use of trust and knowledge about each other in groups. Evidence from micro-lending institutions confirm that there are ways, even for formal financial institutions, to get around the issues of moral hazard by using a group-based approach where local knowledge on individuals and peer pressure among the group members are used (Atieno, 2001). Also banks are using this fact well and have started to offer micro-finance services to poor.

The expressed dislike of risking losing a lot of money seems to make some reluctant to borrow and save with banks through groups. A similar disadvantage with banks suggested by the interviewees is their lack of flexibility in the repayment period of loans. Maybe banks could find a way that would imply flexibility of repayment period to borrowers in groups but not make the group members responsible for the whole loss in case of a default. For example the banks may consider the option of sharing the costs with the other group members in case of a default (the incentive of making their fellow group members repay their loans could remain also if group members still were forced to cover half of the loan).

As discussed above in this thesis, groups come in many different forms and so it seems that also the importance of different informal financial institutions differs between different kinds of groups. As explained by some interviewees, the banks and micro-finance institutions that offer group loans have very clear rules of how things are supposed to be administrated

within the groups that they lend to. Perhaps there are important informal institutions that normally exist in groups that are lost when the group starts operating under a bank. If so, it should be of interest to find out whether these could be recaptured somehow, or even provided by the bank instead. One way of enabling groups to fully use their own “natural” informal institutions might be to involve group members in the decision of how their specific group would function.

Another response to the findings from this thesis could be to use key persons’ local knowledge to identify creditworthy people in order to be able to provide individual loans to poor. Considering the seemingly low default rate on loans by registered and informal moneylenders, the newly introduced bank agencies may serve as a good start to this. It has been suggested that the formal financial sector should start using the informal financial providers’ local knowledge and start using this as an advantage (Ghate, 1992). Not that far from this argument, it has also been argued that individuals should be used to provide their private information to a third party, who would use it for informal contract enforcement (Milgrom, et al., 1990). Today, the agencies are primarily used to reach out to the poor and become more accessible and also more familiar to those who “fear” the banks. Although this surely has a positive impact on the use of banking services, it might also be a good idea to use the agents as a means to let the poor reach the bank. Most agents have said that they know most people who come to their agencies and that they also have a good idea of who would be a creditworthy customer and who would not. Perhaps it is possible for the bank to use this local knowledge by letting the agents themselves provide the bank with information about loan applicants and thereby get closer to the low default rates experienced by local moneylenders. One interviewed agent expressed the idea that they could be given the authority to be part of the decision making process of whom should be given a loan. One person thought it could be good for the credit committees working in the branches to receive more information from the agents on the individual in question. Another agent said that his customers in fact had been asking about why he had not been given the possibility to provide loans. He claimed that he even knew the families of his customers and that he

therefore certainly would be able to provide the branches with useful information about his customers.

Some of the agents interviewed have been providing different answers about the services offered by the bank that they represent. Most of them have not had any written information to offer. It would probably be helpful to make sure that the agents are better informed and can provide clear and easy to understand information to their customers. If bank agents communicated information in accordance with the bank branches, maybe it would be possible to change some people's views that banks tend to first give certain information about the terms and conditions of their services and then, at a later stage, change them. It should be pointed out that the service of bank agencies is a very new process where almost all agents interviewed had started their business in 2011. Another aspect of importance is that the agents are themselves responsible for seeing that enough revenues are made by their agencies. There have been agents who already have had to close down the service due to too little activity. This may make serious investments at an initial phase risky. An Equity Bank representative has explained that a system is being put in place in order to allow agents to provide loans with the help of communication with the branches. However, there appear to be no plans as of yet to start using local knowledge like above reasoning suggests.

In order to make people's credit history accessible to formal lenders, the so-called Credit Reference Bureaus, supervised by the Central Bank of Kenya, started operating in the country in early 2010 (MixMarket, and Central Bank of Kenya, 2011). If used correctly, the start-up of such institutions can hopefully imply that risks associated with loans to poor can be reduced. This is especially so as imperfect information seems to be of great concern to formal financial institutions in Kenya, as argued earlier in this thesis.

Discussion

The findings from this thesis suggest that the informal financial sector still serves as an important source of finance for many Kenyans. As earlier presented, the findings from the FinAccess Report stand more in favour of Ghaté's (1992) way of explaining the interaction between the informal and formal financial institutions than that of Aryeetey et al. (1997). The two different types of institutions seem to partly reach out to a shared clientele that is willing to use services from both types of financial institutions. In fact, this is also supported by the findings from the interviews made for this study. Some have explained that the type of financial institutions chosen depends on the size of the loan wanted and how fast the money is needed. Small amounts and fast cash can easily be accessed from an informal moneylender, who on the negative side charges very high interests. For bigger loans and where more planning is possible to do, the banks were considered as a better option. An additional point that can be made here is that a first look at the impressive increase of the different formal financial institutions might give a too positive image of this development. Much of the increase in the use of the formal and semi-formal financial sectors has in fact been accounted for by the high use of M-PESA. M-PESA offers no loan services and no savings accounts with interest (Mbiti and Weil, 2011). The total increase of both the formal and semi-formal financial sectors is therefore not so much an indication of people that have started to save and use a lot of credit, which is what the main economic growth arguments are stressing to be of crucial importance for economic growth.

An analysis of the introduction of M-PESA and the way that different financial institutions are using this service may however suggest that the seemingly unchanged popularity of the informal financial services might start to decrease. M-PESA service seems to serve as a complementing facilitator for money transactions both for the informal and the formal financial sector. The informal financial sector picked up on M-PESA quickly and is now using it for providing and repaying loans. This has even enabled informal moneylenders to provide a loan in a few minutes after a request has been made. This has much likely

benefited the informal financial sector's attractiveness compared to the formal one. There are good reasons to assume that the formal financial institutions are much slower in picking up on the use of mobile services, such as the time it takes to change big data networks and to make customers feel comfortable with a new service. Banks have also just started with developing their own mobile services. With this reasoning it is possible that the formal financial sector will catch up with the advantage of mobile finance that was so quickly seized by the informal one. In a longer time-perspective, the M-PESA service may therefore enable the formal financial institutions to become bigger and better competitors to the informal financial sector.

Another important institution that we are still waiting to see the results from is the existence of information sharing credit bureaus that opened in 2010. It is likely that these institutions will have a positive effect for banks and their ability to reduce their lending costs. This should make them a stronger competitor to the informal lenders that already can be argued to have an informal information sharing institution in place, namely the social network consisting of people living in the same local area.

The reasons for people to honour contracts in the Kenyan informal financial sector seem to be both of economic and social character. Predictability on a one to one basis for both parties of the honouring of a specific agreement is even more important when there are no regulations and standards of charges and interest rates in place provided by financial institutions. This seems often to be the case in the informal financial sector, where the willing borrower becomes unable to make an exact evaluation of which financial services are available to him. The institutions of private ordering that allow for people to write contracts in an open way and just the way they find optimal seems to be present in the Kenyan informal financial sector. This is in line with what is argued by Williamson (1985). Interviewees have expressed a great concern about banks' lack of understanding in the case of a default on a loan. Therefore, the institutions of private ordering could serve as very important key components in the analysis of how the informal financial sector has advantages compared to the formal one.

Many of the interviewed have explained that there are only rare occasions of complete defaults on loans. A game theoretic approach could explain the honouring of contracts with a continuous game scenario where it is optimal for both the lender and the borrower not to cheat and where it is directly economically hurtful for both parts to dishonour them. Gow et al. (2000) suggest that contracts can be self-enforcing, which may just be the explanation for the low default rate suggested by so many of the interviewees. Most loans in the informal financial sector involve a borrower and a lender that live in the same area and share much of the same social network with each other. The lender needs a good reputation for his business and has therefore an economic incentive in honouring his part of the contract. The borrower on his side does also have his reputation to protect, as he probably will get difficulties in getting new loans if he defaults and other lenders find out about this.

The awareness of that there is a possibility of enforcement in case of a dishonouring of a contract also appears to be of importance for both the borrower and the lender. The use of third party enforcement mechanisms is not governed on a formal legal level but it is nevertheless somewhat predictable, available and used as an informal source of reference to a fairly large extent. As argued earlier in this thesis, the use of these enforcement mechanisms is actually following the country's laws to a fairly large extent. It is by referring to the laws that the borrower and lender can argue their case to a policeman involved in a dispute about a loan. Perhaps is this as close to formal institutions we can get, where they still are informal and supervising informal activities. These informal institutions seem to serve as a strong response to the formal enforcement mechanisms available to the formal financial institutions and thereby constituting a functioning solution for the informal financial sector.

Groups tend to differ a lot in the way that they are operating and what kind of members they have. From the interviews of different borrowers that have been using different kinds of informal financial services, it seems like the use of third party enforcement differs between different kinds of financial institutions. From considering the difference between different constellations, in which third party enforcement seems to be needed and those ones that do

not have a need for this kind of enforcement, an interesting point can be made that should be of interest to the analysis of the need of formal institutions. When strong informal social institutions are in place, such as for most groups and among some Muslims interviewed at the Kenyan coast, third party enforcement mechanisms appear not to be used. Considering that they probably could use them if they wanted to, this might suggest that third party enforcement of formal kind also may be unnecessary (or at least unwanted) for many informal financial institutions.

Women have been described as “restricted” to the informal financial sector more than men. However, such a statement implicitly assumes that everyone prefers saving and borrowing from a formal financial institution and if they only had the possibility to do so, they would leave the informal financial sector in favour of the formal one. Let us return to the following conclusion made earlier in this thesis. Women have been shown to be using groups a lot more than men, which might partly be explained by the fact that women trust each other more than men do (as suggested by many interviewees) and trust has been argued to be one of the key components in a functional group. Following this argument, it might be a possibility that these women actually do prefer these groups as their primary financial institution. Another fact that may support this thought is that there is no difference between men and women on the level of complete financial exclusion. For the financially excluded, it might be more correct to assume that they are indeed “restricted” from financial services, due to their lack of money needed for savings.

As many have explained, the informal financial institutions can only offer smaller amounts of credit and whenever a larger loan is needed, people try to turn to banks instead. Considering the dramatic difference in interests charged by formal and informal lenders, larger loans would indeed fast become very expensive. The informal institutions identified in this thesis may become vulnerable if they are taken to a large scale. It is foremost their local way of being formed and maintained by people sharing the same social networks that make them strong.

Up to this point, there have been many arguments presented for why contracts written by a borrower and an informal moneylender are likely to be honoured by both parties. However, many of the interviewed have said that most people that go to moneylenders for a loan are unhappy to do so. It is when a person is in desperate need for money that they can see no other way out but to turn to an informal moneylender who will charge a very high interest. Thus, it seems to be extreme poverty and lack of other means of getting money that make people use informal moneylenders. It may be reasonable to assume that a very poor person has difficulties in saving even small amounts of money and for this reason cannot join a group to borrow money from. Therefore the fact the contracts are honoured cannot be allowed to serve as the only measure of a financial institution's ability to serve the poor.

In the end, we do need formal institutions for economic development. Assuming that transaction costs can be reduced through formal institutions, the costs associated with borrowing from banks should be reduced which should make it possible to reach more people with cheaper financial services. The increased number of customers should also have a reducing effect on the price of credit by the effect realized from increased economies of scale. Hence, as information and identification of individuals become more accessible and transaction costs get reduced, together with stronger institutions that can enforce contracts and reinforce the law, the more classic economic argument of why the formal financial sector is cheaper and therefore better for the poor, becomes more applicable.

So to start with, the banks need to have accessible enforcement channels in place that make them at least as good as the informal ones. Until then however, it will probably be difficult for the banks to reduce their risks and thus also their costs so much that the poor will consider them as fully satisfying options for their financial services and thereby choose to completely leave their informal financial institutions. Another major obstacle faced by the banks, as can be concluded from the interviews, is that many Kenyans are not financially literate. When people have major difficulties in understanding the terminology used by banks they will be reluctant to use their services. As stated above, banks in Kenya have started to educate people about their services and about key concepts in finance. However, it

would be desirable to have the public education making sure that all Kenyans learned some basic financial concepts in school. Banks, and thereby the poor through increased access to finance, could then benefit from this. Finally, to the question if a bigger banking sector benefits the poor. The finding of this thesis is that many poor still do not feel that they are willing to use banking services, and in particular loan services. If formal institutions in Kenya can manage to provide a financial environment where information is easily accessible and contracts can be effectively enforced, and if the banks manage to continue to adapt according to the needs of the poor Kenyans (for example those presented in this thesis), *then*, the banking sector could probably be better for the poor.

Conclusion

Between 2006 and 2009, the formal and semi-formal financial sectors in Kenya increased a lot. In contrast to what classic economic theories would predict, the informal financial sector did not decrease but rather experienced a slight increase. In addition, a large part of Kenyans claimed to be using both formal and informal financial services. Other factors appear to be as relevant or sometimes even more relevant than the level of interest rate. Interest rates on formal loans are found to be a lot lower than in the informal financial sector, even though interest rate spreads still are very high. Other explanations are instead suggested for the persistent use of the informal financial sector.

Informal institutions are found to be functioning as enforcement mechanisms in the informal financial sector. This is an important finding since institutions that can enable contracting and thereby investments have been shown to have significant positive impact on economic growth. The members of financial groups such as ROSCAs know each other well and there are many reasons why it would be unwise for someone to default on a loan. Interviewees have explained that defaulters risk being excluded from the group, thereby getting a bad reputation among the people in the local area and as a result having difficulties in joining new groups. Interviewees have also described how informal moneylenders may use third party enforcement mechanisms such as the police if a borrower defaults on a loan. The police will have to be paid “on the side” but appear to always be willing to assist if a dispute over a loan occurs.

The data from the FinAccess Report 2009 as well as the interviews for this specific thesis present information on peoples’ perceptions about the banks in Kenya. These findings provide some suggestions on why the informal financial services still seem to be attractive to many Kenyans. The most important disadvantages of the banks given by those that are voluntarily unbanked are lack of respect from the banks and lack of safety of their money. Looking at disadvantages given by all respondents, long queues, lack of respect and perceiving banks as primarily being for rich people were the three most common answers.

High interest rates and high fees, however, were not given by as many as their main reasons for being unbanked. Many of those interviewed for this thesis expressed an uncertainty attached to the costs of services provided by the banks that has made some choose services from the informal financial sector instead. An additional important finding is that banks are viewed to be firm and unwilling to listen to the borrower concerning flexibility in the repayment schedule of a loan. The importance of flexibility has been brought up by many interviewees as a major issue for those that cannot predict their income to a high enough certainty.

As a concluding remark, there are findings in this thesis that suggest that the informal financial sector has important advantages in dealing with imperfect information, which serves as a major dilemma for most formal financial institutions operating in Kenya. As formal institutions seem not to have provided a financial environment that can reduce transaction costs for banks, the banks might need to take a closer look at how the informal financial institutions are dealing with these problems in order to further improve their services.

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