

**EFFECT OF DEVOLUTION ON FINANCIAL DEEPENING
IN KWALE COUNTY, KENYA**

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DECLARATION

This Research Project is my original work and has not been presented for examination to any other University.

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DEDICATION

I dedicate this project to my beloved late son Abdul Majeed.

TABLE OF CONTENTS

DECLARATION.....	ii
ACKNOWLEDGEMENTS.....	iii
DEDICATION.....	iv
TABLE OF CONTENTS.....	v
ABBREVIATIONS.....	vii
LIST OF TABLES.....	viii
ABSTRACT.....	ix
CHAPTER ONE: INTRODUCTION.....	1
1.1 Background of the Study.....	1
1.1.1 Financial Deepening.....	2
1.1.2 Devolution of functions.....	4
1.1.3 Devolution and Financial Deepening.....	7
1.1.4 Kwale County.....	8
1.2 Research Problem.....	8
1.3 Research Objective.....	10
1.4 Value of the Study.....	10
CHAPTER TWO: LITERATURE REVIEW.....	12
2.1 Introduction.....	12
2.2 Theoretical review.....	12
2.2.1 Keynesian Theory.....	13
2.2.2 The theory of financial intermediation.....	14
2.2.3 The Theory of Financial Liberalization.....	15
2.3 Determinants of Financial Deepening.....	16
2.3.1 Creditor Rights.....	16
2.3.2 Relative price Stability.....	17
2.3.3 Growth of the financial sector.....	17
2.3.4 Domestic Credit to Private Sector.....	17
2.4 Empirical Review.....	17
2.5 Summary of Literature Review and Research Gap.....	21
CHAPTER THREE: RESEARCH METHODOLOGY.....	23
3.1 Introduction.....	23

3.2 Research Design.....	23
3.3 Population of the Study.....	23
3.4 Data Collection	24
3.5 Data analysis	24
CHAPTER FOUR: DATA ANALYSIS AND FINDINGS	26
4.1 Introduction.....	26
4.2 Descriptive statistics	26
4.3 Correlation	27
4.4 Regression.....	28
4.3.1 Co-efficients of the Model.....	30
CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS ...	32
5.1 Introduction.....	32
5.2 Summary of the Findings.....	32
5.3 Conclusion and Recommendations of the Study	34
5.4 Limitations of the Study.....	34
5.5 Suggestions for further Studies.....	35
REFERENCES	36
APPENDIX: List of Financial Institutions in Kwale County.....	41

ABBREVIATIONS

- CDF -Constituency Development Fund
- GDP -Gross Domestic Product
- KNA -Kenya News Agency
- KNBS -Kenya National Bureau of Statistics
- KREP -Kenya Rural Enterprise Program
- KWFT -Kenya Women Finance Trust
- MRM -Multiple Regression Model
- OLS -Ordinary Least Squares
- SMEP -Small & Medium Enterprise Program
- VAR -Vector Auto Regressive
- WAEMU-West African Economic and Monetary Union

LIST OF TABLES

Table 4.1 Descriptive statistics.....	20
Table 4.2 Correlation analysis.....	21
Table 4.3 Analysis of Variance.....	22
Table 4.4 Model Summary.....	22
Table 4.5 Co-efficients of the Regression Model.....	23

ABSTRACT

This study was conducted with the objective of establishing the effect of devolution on financial deepening in Kwale County. Research design in this study was a causal study adopting both descriptive and explanatory designs. A case study was employed and of utmost importance was the fiscal programmes of the county government from the beginning 2013 to mid 2016. Data was collected using secondary means from national and county government offices which formed the basis of the study, the data was then analyzed by carrying out descriptive statistics, correlation analysis and finally the regression model was ran to establish the relationship between financial deepening and the core aspects of the county government that affect it. Data was gathered from the beginning of 2013 to June 2016 for the purposes of doing descriptive statistics and regression analysis. The model was designed to take into account three variables which are; county government spending, employment level and the county government revolving funds. There were forty two months in the period of interest. F test was conducted to find out the reliability of the model by establishing whether there is a relationship between the dependent variable and the independent variables. The null hypothesis was rejected and the alternative hypothesis upheld showing that there is a relationship between financial deepening and independent variables of study. From the relationship in the model, it is evident that the county government's revolving fund has improved access and provision of financial services in Kwale County to a great extent, since it contributes 112.4 units to financial deepening. The study concludes that devolution affects financial deepening and recommends that financial literacy programmes be increased so that more people benefit from the increased financial services and not a repeated few.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

Financial deepening is a term used often by economic development experts to refer to the increased provision of financial services with a wider choice of services geared to all levels of society. It also refers to the macro effects of financial deepening on the larger economy. Conceptually, financial depth is often understood to mean that sectors and agents are able to use a range of financial markets for savings and investment decisions, including at long maturities (access). In other words, deep markets allow savers to invest in a broad range of quality investment and risk-sharing instruments and allow borrowers to likewise tap a broad range of financing and risk management instruments (King and Levine, 1993; Rajan and Zingales, 1998; Chami, FullenkamandSharma, 2009; Goswami and Sharma, 2011). Devolution is defined as the process of transferring decision-making and implementation powers, functions, responsibilities and resources to legally constituted, and popularly elected local governments.

Schumpeter (1911), McKinnon (1973) and Shaw (1973) have recognized that the development of the financial sector has productivity and growth-enhancing effects. Therefore, the relationship between financial development and economic growth has received considerable attention in both developed and developing economies. This concern about financial deepening and economic growth finds its justification in the policy implications that the relationship can bring about, as improved living standards for their citizens as well as increased economic growth rates are the goals sought by many governments. Moreover, recent research findings have indicated that countries with better

developed financial systems tend to have a faster rate of economic growth. As a result, financial deepening has emerged as a strategy to enhance economic growth more so in developing nations such as Kenya.

The literature on financial deepening and economic growth has mostly dealt with the causality issue between the two concepts with two main hypothesis: the first one, the supply-leading hypothesis argues that financial deepening drives economic growth through the presence of efficient markets while the second, the demand-leading hypothesis posits that economic growth is a response to the expansion of financial markets and progress. However, one thing that can be deduced from these different hypotheses is the positive contribution of financial development to the economic growth process, with an essential role played by financial intermediaries. The main view being that the increased availability of financial instruments and institutions reduces transaction and information costs in an economy. According to Endogenous growth literature, well-developed financial systems support the growth process through savings and investments. They help households and firms grow trade and raise investments by mobilizing savings, ensuring that these funds are allocated to the most productive use, spreading risk and providing liquidity so that firms can operate efficiently (Benston and Smith, 1976; and Tobin, 1963).

1.1.1 Financial Deepening

Financial depth is a concept usually understood to mean that; sectors and agents are able to and indeed use a range of financial markets for savings and investment decisions, including at long maturities. This is the element of degree of access to finance. That the

financial intermediaries and markets are able to and actually deploy larger volumes of capital and larger turnover, without necessitating large corresponding movements in asset prices. This happens when the market is liquid (Chami, Fullenkamp and Sharma, 2009).

Shaw (1973) defined financial deepening as: the accumulation of financial assets at a faster pace than the accumulation of non-financial wealth and output. Levine, (2005) gave a broader definition by explaining that financial deepening occurs when financial markets (primary, secondary and retail), instruments (deposits, loans, foreign exchange, bonds and debt securities) and stakeholders (banks, contractual savings institutions, companies) interact to reduce the costs of contract enforcement, transaction and information in order to perform five main functions namely: i) facilitate goods and services exchange (e.g. payment services), ii) mobilize and pool savings of a large number of investors iii) acquire and process information about the companies and the potential investment projects and therefore allocating public savings to the most productive uses, iv) follow investments and exert corporate governance, and v) diversify and reduce liquidity risk and inter-temporal risk (Levine, 2005; King and Levine, 1993).

It also means that the financial sector is able and does create a broad menu of assets for risk sharing, a purpose that is providing opportunity for hedging and diversifying. Deep financial markets allow investment in a broad range of high quality assets and risk sharing instruments. A deep financial market also allows borrowers to similarly tap into a broad range of financing and risk management instruments (Goswami& Sharma, 2011). Financial deepening will be measured by the number of financial institutions that has been set up in the counties as to support the insurgence of county governments.

1.1.2 Devolution of functions

Devolution is a form of decentralization. It is simply defined as the process of transferring decision-making and implementation powers, functions, responsibilities and resources to legally constituted, and popularly elected local governments. Devolution in Kenya is based on the supremacy of the Constitution, sovereignty of the people and the principle of public participation. Devolution is one of the concepts in the Constitution that has brought about a complete overhaul in Kenya's system of governance. This is because it is a new aspect in the Kenyan governance system. The need for Devolution has been seen in many countries and it is informed by the need to have power sharing, checks and balances in governance and the decentralization of resources (KNA, 2015).

Scholars have advanced political and economic rationales in support of decentralization of delivery and financing of public goods. These arguments provide theoretical basis for devolution and other frameworks of decentralization. Political scientists present three major rationales for decentralization. First, they argue that decentralization enhances democracy by bringing government closer to the citizens. Second, by establishing different tiers of government, decentralization provides mechanisms for protecting democracy through vertical checks and balances. Third, by distributing authority and responsibility for fiscal management and public service delivery, minorities are given a stake in the system and this helps in conflict management.

The key economic rationales for decentralization are well articulated by Musgrave (1959) and Oates (1972). They argue that decentralization may improve governance in public service provision by improving the efficiency of resource allocation. Further, they

observe that sub – national governments are closer to the people than the central government and as a result have better knowledge about local preferences. Local governments are therefore better placed to respond to the diverse needs of the local people. In addition, decentralization narrows the social diversity and subsequently the variation in local preferences. This reduces the opportunities for conflicts among different communities. Tiebout (1956) notes that decentralization promotes competition among the sub – national governments and thus enhances the chance that governments will respond to local needs. As a result, countries are able to attain higher levels of efficiency in the allocation of public resources.

Our country had lacked devolution for two reasons. First, the introduction of regionalism, popularly known as ‘Majimboism’, in 1963 under the Kenya independent Constitution, did not last long. The first government of the independent Kenya, under the leadership of Jomo Kenyatta, amended the constitution soon after the independence in 1964, effectively scrapping the regional governments and replacing them with the central – controlled Provincial Administration and the local government system. Second, the governments established under the Local Government Act cap 265 of the laws of Kenya were not granted significant political, administrative and fiscal powers. Instead, central government retained control of the local governments through the administration officers (hired by the same central government).

Many as the genesis of the country’s governance and economic management problems see this highly centralized Executive control of the country’s public affairs. During the constitutional conference in 2003, devolution was advocated by some groups as one way of reducing the overly centralized power of the executive. There was, however, no

consensus on the forms of devolution that the country should adapt. For example, there was no agreement on the levels of devolution that were appropriate for effective governance. In addition, there were differences of opinion with regard to how the fiscal powers should be distributed between the central government and the sub – national units.

Devolution has brought visible development in Kwale County, with most projects started by former MPs complete. The entire Kinango constituency, which has seven wards, does not have a single stalled project. Through the work of committed committee, the fund had constructed dispensaries, dormitories, laboratories and police posts. And there are no stalled projects. A good number of projects which include dispensaries, maternity wings, school laboratories and dormitories, were either complete or half-way to completion. A mirror of Matuga Constituency (KNA, 2015)

There have been a lot of misconceptions on devolution which needs to be cleared noting that devolution is a new system in Kenya. This prompted the Kwale County government to urge development partners to come up and hold trainings and help infrastructure development which geared towards making devolution a success in Kwale County. Training geared towards assisting the members of county assemblies understands their roles, responsibilities, and functions in the development of Kwale County and making devolution success. The training also builds strong legislative base that protects the inter-governmental relationship between the counties and the national government (KNA, 2015)

Devolution, including other forms of decentralization, however, may not always lead to

improved governance and economic development performance. For example, devolution may reduce the ability of the national government to redistribute resources and therefore the ability to assist the less developed sub – national units. In addition, devolution may lead to the capture of local governments by the political elites, especially if devolution rules and systems are not well designed, and hence allow the local politicians to use the local resources to consolidate their hold on to political power through patronage(KNA, 2015).

1.1.3 Devolution and Financial Deepening

Junaid et al. (2005) dissatisfied with centralized approaches to delivering local public services, a large number of countries are decentralizing responsibility for these services to lower-level, elected governments. Most countries have benefited from devolution in terms of service delivery, as the service delivery depends on the relationships of accountability of different actors in the delivery chain. Devolution introduces a new relationship of accountability-between national and local policymakers-while also altering existing relationships, such as that between citizens and elected politicians. The various instruments of decentralization-fiscal, administrative, regulatory, market and financial-can affect the incentives facing service providers, even though they relate only to local policymakers. With this, financial deepening is made possible and thus it can be ascertained that devolution directly affects financial deepening (Namoi, 2012)

Through the establishment of County Governments in Kenya, it is expected that devolution to improve the governance framework for pro-poor policies. The County governments should be more familiar with local needs, circumstances and costs than national ones. Accordingly, they are also in a better position to distribute

resources(Namoit, 2012).

1.1.4 Kwale County

Kwale County is a county in the former Coast Province of Kenya. Its Capital is Kwale, although Ukunda is the largest town. Kwale is a county served by various microfinance institutions that include among others Kenya Women Finance Trust (KWFT), Yehu, SMEP, Juhudi and the Kenya Rural Enterprise Program (KREP) which aim to provide access to financial services to their members especially to women entrepreneurs for farming activities, animal husbandry and retail enterprises. The institutions offer group loans with a small portion of individual lending Group loans using two main approaches: the group based consists of groups of from 5 to 30 members. (Kiiru, 2010) Recently Kwale County has seen growth in the number of financial institutions that offer financial services. As banks have pitched camp amongst them the Kenya Commercial Bank, Bank of Africa, Diamond Trust Bank, Co-operative Bank and Equity Bank. This has been due to the vibrancy of the hotel industry in the County.

1.2 Research Problem

A well-developed financial system is instrumental in attaining sustainable and balanced growth. Such a system increases the availability of funding by mobilizing idle savings, facilitating transactions and attracting foreign investments. Such markets can achieve improved allocation of financial resources and enhanced risk management, transparency and corporate governance practices. Moreover, developed financial systems can ease the availability of some credit to more opaque businesses, such as first-time or low-income (and low collateral) borrowers or small- and medium-sized enterprises (SMEs). In short,

financial development can serve to improve not only the growth prospects but also the distribution of economic opportunities.

Devolution has brought major changes in most counties in Kenya. Kwale is a county that was mainly served by microfinance institutions. However in the recent years, Kwale County has seen growth in the number of financial institutions that offer financial services. More banks have been established and already existing banks have opened more branches. With the county government receiving revenue from the national government and having the power to make its own decisions, it is expected that more money circulate in the county and that financial development of the county is enhanced. Government economic stimulus programs are meant to enable the people to have more knowledge and accessibility to funds that would enable them to conduct their business. This study was to establish how the county government of Kwale since its formation has enhanced financial deepening, utilized public spending effectively to the benefit of the people of Kwale, how the resources are allocated in the county to ensure equity and that people's lives have generally improved.

Literature for devolution and financial deepening is scarce in Kenya. Mukundi (2013) studied the relationship between financial deepening and gross domestic product in Kenya using a case of the listed firms at the Nairobi Securities Exchange, the study found out that there was a significant close relationship between financial deepening and GDP growth. Ndung'u (2014) did a study to analyze the Impact of Devolution on Economic Development Potentialities in Kenya while using Brazil as a case study; it was found out

that devolution can foster economic development. Sindani (2013) studied the impact of financial sector deepening on economic growth in Kenya using 44 Banking institutions and found out that there was a significant impact of financial deepening on economic growth. However there is no documented study that seeks to establish the role of devolution on financial deepening in Kwale County, Kenya. Therefore this study seeks to fill this gap by answering the question, what effect does devolution have on financial deepening in Kwale County.

1.3 Research Objective

To establish the effect of devolution on financial deepening in Kwale County

1.4 Value of the Study

This study is significant to scholars and other researchers; to government policy makers and to investors. In the scholarly field much research has focused on how investment affects GDP growth. Other studies have focused on how financial liberalization affects economic growth in other countries other than Kenya. This study will provide findings of the role of devolution on financial deepening in Kenya. The findings will therefore provide input for further research or discussions that will find the study relevant.

This study will be useful to government and economic policy designers. It is the objective of the Kenyan government to stimulate double digit economic growth rate. Policy designers need to have precise information that can help them come up with policies that can stimulate economic growth through the financial markets. The policies can produce the greatest results if it is known which aspects of the financial market should be tackled

in order to generate economic growth and, therefore, development. This study will be significant for it will not only find out the role of devolution on financial deepening in Kwale County but in Kenya.

The Capital Market Institutions and the Banking sector will appreciate the adoption of the county governments system. As a result they will put efforts in ensuring serious partnerships with the county governments which can positively impact on the financial sector environment and in turn help strengthen economic growth. This will happen if there is accurate research done to establish the effect of the county governments' activities on economic growth.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter provides the literature review of this study. The chapter discusses theories behind the relationship between financial deepening and devolution. Further, the chapter discusses past empirical studies concerning the relationship between financial deepening and devolution.

2.2 Theoretical review

The Keynesian theory, the theory of financial intermediation and the theory of financial liberalization are all discussed in the theoretical review. The study was anchored on two major theories which were useful. The theory of financial intermediaries suggests that financial intermediaries can overcome a market failure and resolve an information asymmetry problem by transforming the risk characteristics of assets. These asymmetries in credit markets arise because borrowers generally know more about their investment projects than lenders do. Information failures lead to specific forms of transaction costs and financial intermediaries appear to overcome these costs, at least partially. The notion of transaction costs encompasses not only exchange or monetary transaction costs but also searches, monitoring and auditing costs (Benston and Smith, 1976). The theory of financial liberalization pioneered by Mac Kinnon (1973) and Shaw (1973) advocates for the liberalization of the financial sector as an effective way to accelerate growth the theory suggests that the liberalization of financial markets allows financial deepening which reflects an increasing use of financial intermediation by savers and investors as well as the monetization of the economy. The theory is based on the premise that the

higher the real rate of interest, the greater the degree of financial deepening, the more saving there will be, and financial saving will be allocated and invested more efficiently than if saving is invested directly in the sector in which it takes place, without financial intermediation (Thirlwall 2005). The McKinnon-Shaw theory of financial liberalization suggests a complementary relationship between the accumulation of money balances (financial assets) and physical capital accumulation in developing countries, leading to economic growth.

Muia (2008), In devolution responsibilities, resources and authority are transferred from higher levels of government to lower levels as one way through which the governed participate in governance. The central government cedes some powers to clearly defined sub-national geographical units (Katsiabuni, 2003). According to Manor (1999), in the administrative devolution there is a set of policies that transfer the administration and delivery of social services like education, health, social welfare, or housing to the sub-national units. Devolution is characterized by high autonomy and downward accountability. The sub-national entities are not directly accountable to central government though they have to work within set statutes and rules (Oloo, 2006)

2.2.1 Keynesian Theory

Although financial deepening concepts were brought into salience with the seminal work of McKinnon (1973) and Shaw (1973), these ideas can be found in the Keynesian theories. In the Keynesian theory, financial deepening occurs due to an expansion in government expenditure. In order to reach full employment, the government should inject money into the economy by increasing government expenditure. An increase in government expenditure increases aggregate demand and income, thereby raising demand

for money. This disequilibrium is resolved by reducing private investments resulting from higher interest rates. Since higher interest rates lower private investment, an increase in government expenditure promotes investments and reduces private investments concurrently (Dornbusch & Fischer 1978).

McKinnon and Shaw came up with a rival hypothesis that depicts a positive relationship between interest rate and financial deepening. According to them, developing countries have repressed economies with ceilings on interest rates and limitations in credit availability which impose restrictions on growth. The Post-Keynesians have developed a sequential analysis in which saving appears as a byproduct of the income creation process. Thereby setting up the sequence finance-investment saving-funding, which they have used to demonstrate the logical antecedence of investment in relation to saving and to develop an alternative view of the role of banks, saving and financial markets in the growth process (Chick, 1998 ; Davidson, 1996).

2.2.2 The theory of financial intermediation

The theory of Financial Intermediation advocates that financial intermediaries play a crucial role of intermediation in the growth process by transferring financial resources from the net savers to net borrowers, thus influencing investment and thereby economic growth. The theory suggests that financial intermediaries can overcome a market failure and resolve an information asymmetry problem by transforming the risk characteristics of assets. These asymmetries in credit markets arise because borrowers generally know more about their investment projects than lenders do. Information failures lead to specific forms of transaction costs and financial intermediaries appear to overcome these costs, at least partially. The notion of transaction costs encompasses not only exchange or

monetary transaction costs Tobin(1963) but also searches, monitoring and auditing costs (Benston and Smith, 1976).

The work of Schumpeter (1911) supports the view that well-functioning financial intermediaries can promote the overall economic efficiency. By pooling and allocating funds, financial intermediation promotes entrepreneurship and innovation which are necessary components for economic development. Gurley and Shaw (1960) supported the view that financial intermediaries are an opportunity to enhance borrower's financial capacity in the savings and investment process. Thus, the higher the intermediation level in the financial sector, the higher the savings mobilized and higher would be investments, which in turn will increase the level of economic growth. In the same way, according to Goldsmith (1969), the financial structure of an economy accelerates economic performance to the extent that it facilitates the migration of funds to the best user, i.e., to the place in the economic system where the funds yield the highest social return". The opinion of Greenwood and Jovanovic (1990) is in line with this view; they argue that financial intermediation promotes growth because it allows a higher rate of return to be earned on capital, and growth in turn provides a means to implement costly financial structures.

2.2.3 The Theory of Financial Liberalization

Financial Liberalization refers to the process of liberalizing the financial sector of a country with an aim to create a favorable environment to increase the money demand in the economy. This is assumed to take place in two ways; (i) By increasing the financial

resources to lead the supply-induced demand for money (ii) By creating suitable environment to make investments in the economy. The theory of financial liberalization pioneered by Mac Kinnon (1973) and Shaw (1973) advocates for the liberalization of the financial sector as an effective way to accelerate growth. The theory suggests that the liberalization of financial markets allows financial deepening which reflects an increasing use of financial intermediation by savers and investors as well as the monetization of the economy.

In other words, by lowering financial market frictions, domestic savings are increased and foreign capital is attracted. The theory is based on the premise that the higher the real rate of interest, the greater the degree of financial deepening, the more saving there will be, and financial saving will be allocated and invested more efficiently than if saving is invested directly in the sector in which it takes place, without financial intermediation (Thirlwall 2005). The McKinnon-Shaw theory of financial liberalization suggests a complementarity relationship between the accumulation of money balances (financial assets) and physical capital accumulation in developing countries, leading to economic growth.

2.3 Determinants of Financial Deepening

2.3.1 Creditor Rights

The power of creditors backed up by appropriate regulation and efficient law enforcement is clearly important for credit growth, as it facilitates repossession of assets of delinquent borrowers, reduces the cost of monitoring the quality of borrowers' assets, and improves the precision of initial screening of borrowers.

2.3.2 Relative price Stability

The importance of creditor rights protection stems from the intrinsic inability of lending institutions to establish with certainty the quality of borrowers' assets in the future. Less predictable future quality of assets necessitates more intensive screening and monitoring of borrowers and increases the likelihood of default, inflating the costs associated with screening, monitoring, and repossession. Thus a less risky macroeconomic environment is likely to contribute significantly to development of deeper financial markets.

2.3.3 Growth of the financial sector

Oleche and Mutiiria(2015) Financial sector growth refers to the increase in financial contracts and markets, growth of intermediation and increased number of financial services offered in the financial sector. It also describes the positive transformation of institutions, policies, instruments and markets in the financial sector. This growth can be measured by financial intermediation, which is a key economic activity in the country. Financial intermediation is the process by which lending institutions take deposits from their customers and use them to advance credit to borrowers. Profit is made by these institutions by charging a higher lending rate than the deposit rate.

2.3.4 Domestic Credit to Private Sector

Financial resources provided to the private sector, such as through loans, purchases of non equity securities, and trade credits and other accounts receivable that establish a claim for repayment is major indicator of financial sector growth hence financial deepening.

2.4 Empirical Review

Empirical studies suggest that financial deepening has different effects on economic

growth depending on the financial deepening indicator used, the period of the study and the data sets that vary from panel data across countries, sub regions to individual countries.

King and Levine (1993) conducted a cross country analysis as well as a pooled cross country, time series study using Barro's endogenous growth models to examine the link between financial development and economic growth. The measures of financial development was done using several indicators such as the ratio of liquid liabilities of banks and nonbank institutions to GDP(M2/GDP), ratio of bank credit to the sum of bank and central bank assets, ratio of private credit to domestic credit and ratio of private credit to GDP. They found that, the average level of financial development for the period. 1960-89 is very strongly associated with growth.

Bwire and Musiime (2006) investigated the connections between financial development and economic growth in Uganda during the period 1970-2005 through the use of modern multivariate technique and Granger causality test. They found significant evidence that, financial sector reforms adopted in the early 1990s have generally had positive contributions to the real GDP of Uganda. In addition the study concluded that, financial development was necessary, but not a sufficient condition for stimulating economic growth.

Odhiambo (2008) using time series of the period 1968–2002 and adopting a dynamic causality model investigated the causality between financial development and economic growth in Kenya. The study used broad money (M2), currency ratio (CC/M1) and credit to private sector as proxies of financial development. The results suggested that causality between financial development and economic growth depends on the proxy used for

financial development in Kenya, and that causality on the balance runs from economic growth to financial development.

Wolde-Rufael (2009) examined the casual relationship of financial development and economic growth in Kenya using a quadvariate Vector Auto Regressive (VAR) framework, in which exports and imports were included as additional variables. Three measures of financial development namely: Liquid Liabilities, calculated as the liquid liabilities of banks and non-bank financial intermediaries (currency plus demand and interest-bearing liabilities) over GDP. The second indicator, Private Credit, is defined as the credit issued to the private sector by banks and measures general financial intermediary activities provided to the private sector. The third, Commercial-Central Bank it proxies the advantage of financial intermediaries in channeling savings to investment, monitoring firms, influencing corporate governance and undertaking risk management relative to the central bank.

Khasiani and Makau (2010) refers to CDF as a major boost to development in the rural areas and as a means of central government reallocating more revenue particularly to the business entities implementing the projects at the local level. It has created efficiency in delivery of services in certain areas but it has also increased the burden of the exchequer. In most cases decreased cost effectiveness has been observed due unaccountability, duplication of activities and lack of financial capacity by managers of the CDF funds and poor prioritization of the projects.

Jalil, Wahid and Shahbaz (2010) investigated the relationship between development of

the financial sector and economic growth. They used time series data for the period 1965-2007 and set the estimation strategy under the ARDL model. The variables used for financial deepening were liquid liabilities to nominal GDP (M2/GDP), credit to private sector to nominal GDP; Commercial/Central Bank asset ratio. The researchers found a positive monotonic relationship between financial development and economic growth for South Africa. Trade openness and per capita real capital were found as the other important determinants of economic growth.

Onwumere, Ibe, Ozoh and Mounanu (2012) examined the impact of financial deepening on economic growth from a Nigerian perspective and adopted the supply-leading Hypothesis. The researchers used variables such as broad money velocity, money stock diversification, economic volatility, market capitalization and market liquidity as proxies for financial deepening and gross domestic product growth rate for economic growth. Their study adopted a multiple regression model (MRM) and revealed that broad money velocity and market liquidity promote economic growth in Nigeria while money stock diversification, economic volatility and market capitalization did not within the period studied (1992-2008).

Nguena and Abimbola (2013) investigated the implication of financial deepening dynamics for financial policy coordination in the West African Economic and Monetary Union sub-region (WAEMU). They adopted a hypothetical-deductive theoretical approach and an empirical investigation in both static and dynamic panel data econometrics. The study recommended the implementation of a financial policy directed at increasing the level of savings rate, GDP per capita growth rate and density. It also recommended the reduction of the level of reserves in the sub-region.

Oenga (2013) did a study to evaluate the Management of Constituency Development Fund In Kenya: A Case Of Nairobi County. The study revealed that majority of the respondents were aware of the CDF projects and that. The study concludes that there is a positive association between effectiveness of CDF management with implementation, monitoring, accounting/recording and stakeholder effect.

Waiyaki (2013) carried out an assessment of the relationship between financial development, economic growth and poverty in Kenya for the 1997-2012 period. The study attempted to determine the direction of causality between financial development and economic growth as well as the effect of financial development on economic growth with a focus on the banking sector, and the stock market in Kenya. The variables used included broad money supply M3, credit to private sector, bank deposits, stock market capitalization, stock market turnover and volume of stocks traded. The study used OLS method under the PARCH model. The findings show that some financial development variables such as M3 and credit to the private sector did not lead to growth while bank deposits did during the period of the study

2.5 Summary of Literature Review and Research Gap

From the theoretical and empirical review, it is expected positive and significant coefficients of the independent variables lead to an increase in the dependent variable. The literature so reviewed deals with financial deepening and economic growth but has not delved into the relationship of financial deepening and devolution. Waiyaki (2013) established that financial deepening did not lead to a direct increase in the economic

performance. Wolde-Rufael (2009) showed a direct relationship between financial deepening and economic growth.

The foregoing formed a basis of this study. Devolution being a new phenomenon in Kenya, the study was to explore the relationship between financial deepening and devolution. The case study design was used.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This chapter contains the methodology which was used to carry out this study. It describes the research design, data collection and the data analysis techniques.

3.2 Research Design

Research design in this study was a causal study in nature which involved an investigation of what causes change in the dependent variable when the independent variables change Chandran (2004), this study adopted both descriptive and explanatory designs. Causality in this study was most preferred because the study attempted to investigate what effect devolution has on financial deepening in Kwale County. First, the study described the trend in both devolution and financial deepening in Kwale County. Secondly, an explanatory approach explained whether devolution had any effect on financial deepening.

The independent variable is the presumed cause, and the dependent variable is the potential effect. In the context of this study, devolution (represented by county government spending, level of employment of the Kwale residents and usage of the county funds were the independent variables while their implication on the financial system of the county formed the dependent variable.

3.3 Population of the Study

This is a case study. Of utmost importance was the fiscal expenditure of the county government from the beginning 2013 to mid 2016. That is average monthly employment statistics from 2013 to mid 2016, the average monthly government emolument of the

revolving fund from beginning 2013 to mid 2016 and the county government spending from beginning 2013 to mid 2016.

3.4 Data Collection

The study used secondary data. The data was obtained from national treasury website on the amount of money allocated to Kwale County over time, disbursements to the county Government from the exchequer from beginning 2013 to June 2016. County employment statistics was collected from county public service board offices for the period between 2013 to mid 2016 and the county government disbursement of revolving funds was collected from the department of trade and cooperatives.

3.5 Data analysis

STATA was used to conduct descriptive statistics and regression. F test was used to test whether the independent variables reliably predict the dependent variable and the R-Square was done to establish the percentage of variation in the dependent variable that can be explained by the independent variables

The Regression Model is as follows;

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where:

Y = Financial deepening - the dependent variable,

α = the constant term – the value of financial deepening when independent variables equal to zero,

β_1, β_2 and β_3 = Coefficients of the independent variables,

X_1 = County Government Expenditure,

X_2 = Level of Employment,

X_3 = Usage of County Revolving funds,

ε = the error term

CHAPTER FOUR: DATA ANALYSIS AND FINDINGS

4.1 Introduction

In this chapter, the findings of the data analysis are presented. Data was collected from the county government's offices and the Treasury's website. The variables of interest were financial deepening represented by registered financial institutions as the dependent variable and county government spending, county employment statistics and disbursement of county revolving funds as the independent variables.

4.2 Descriptive statistics

Data was collected from beginning of 2013 to mid 2016 on a monthly basis giving a total of 42 entries per variable in the analysis model. A summary of the collected data was conducted and below are the results;

Table 4.1 Descriptive statistics

Variable	Obs	Mean	Std. dev
Fd	42	614.6331	195.5656
Ge	42	4421.182	708.2965
Es	42	1084.069	265.0419
Rf	42	64.48048	13.43906

Source: Research Data, 2016

The count of data is 42 as per the observed count column (obs), this means that all the variables that were under study had all the data for the specified months under review, variable column shows the subjects that were used in the analysis. Mean shows the average of the data in the data set; financial deepening has 614, government expenditure has 4421, employment has 1084 and revolving fund has 64 as the average of the data in the data set. Standard deviation shows how far items are spread from the mean; financial deepening is spread by 195, government spending by 708, employment by 265 and

revolving fund by 13 from the mean of the data set. We can deduce from the statistics that all the intended data for the months were collected and that the deviation of the data from the mean is not that significant.

4.3 Correlation

Correlation analysis was done between the variables to establish the relationship that exists between the variables. Of most important was to establish the relationship that exists between the dependent variable and independent variables which will be a precursor of the expected relationship in the variables. The analysis gave the following output;

Table 4.2 Correlation analysis

	Fd	Ge	Es	Rf
Fd	1.000			
Ge	0.7678	1.000		
Es	0.7806	0.9887	1.000	
Rf	0.7944	0.9953	0.9967	1.000

Source: Research Data, 2016

The relationship between FD and GE is 0.77, which is a strong positive relationship showing that when government expenditure increases we expect financial deepening to also increase. The relationship between FD and ES is also positive and the effect between FD and RF is positive too. The correlation output shows that we expect to have a positive relationship between the dependent variables and the independent variables.

4.4 Regression

The effect of county government functions on financial deepening was analyzed by regression of the registered financial institutions in Kwale County against county fiscal programs. The objective was to establish the effect of devolution on financial deepening in Kwale County. F test was also calculated to determine whether the variables are significantly different from zero. R^2 test shows the percentage to which the dependent variable is significantly different from zero, a lower R^2 means that increase in financial deepening is not explained by variables in the model but other factors not taken into consideration. The regression analysis gave the following output;

Table 4.3 Analysis of Variance

Source	SS	Df	MS	F
Model	1176821.34	3	392273.778	38.10
Residual	391269.206	38	10296.3212	
Total	1568081.54	41	38245.8913	

Source: Research Data, 2016

The above table shows analysis of variance, the first part shows the source of variance. The total variance is portioned into the variance that can be explained by the model and the variance which is not explained by the model as residual. The sum of squares and the residual add up to the total variance, reflecting that the total variance is portioned into model and residual variance.

For the Model, $1176821.34 / 3$ equal to 392273.778 . For the Residual, $391260.206 / 38$ equal 10296.3212 . These are computed to enable compute the F ratio. The F Value,

which is the Mean Square Model (392273.778) divided by the Mean Square Residual (10296.3212), yielding $F=38.10$. The p value associated with this F value is very small (0.0000). Since the p-value is smaller than 0.05 we conclude that the independent variables reliably predict the dependent variable.

Table 4.4 Model Summary

Number of Obs	42
F(3,38)	38.10
Prob >F	0.0000
R-squared	0.7505
Adjusted R-squared	0.7308
Roots MSE	101.47

Source: Research Data, 2016

Number of obs is the number of observations used in the regression analysis.

R-Square is the proportion of variance in the dependent variable (financial deepening) which can be predicted by the independent variables (county government functions). This value indicates that 75% of the variance in financial deepening can be predicted from the activities of the county government.

Adjusted R-square as a predictor is added to the model, each predictor will explain some of the variance in the dependent variable simply due to chance. One could continue to add predictors to the model which would continue to improve the ability of the predictors to explain the dependent variable, although some of this increase in R-square would be simply due to chance variation in that particular sample. The adjusted R-square attempts to yield a more honest value to estimate the R-square for the population. The value of R-square is .75, while the value of Adjusted R-square is .73.

4.3.1 Co-efficients of the Model

Table 4.5 Co-efficients of the Regression Model

Fd	Coeff.	Std. Err.	t	P> t	95% Conf. Interval
Ge	.987289	.2520178	3.92	0.000	1.497471
Es	2.500333	.7997298	3.13	0.003	4.119301
Rf	112.4945	24.3191	4.63	0.000	63.26303
Const	436.4488	254.9525	1.71	0.095	-79.67544

Source: Research Data, 2016

The first column at the top shows the dependent variable (**fd – financial deepening**) and the dependent variables below it (ge - government spending, es- employment statistics and rf- revolving fund). The last variable (cons) represents the constant. **Coef** are the values of the regression equation for predicting the dependent variable from the independent variables. The regression equation is presented in the methodology as:

$$\mathbf{Y \text{ Predicted}} = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \epsilon$$

Where;

1. X_1 is government fiscal expenditure (ge)
2. X_2 is county government employment statistics (es)
3. X_3 is county government revolving fund (rf)

From the output we can then form the model as below with its coefficients;

$$Y = 436 + 0.98X_1 + 2.5X_2 + 112.4X_3 + \varepsilon$$

This estimate explains the relationship between the dependent variables and the independent variables. An increase in one unit of government fiscal expenditure leads to an increase in 0.98 units in financial deepening. An increase in one unit of county government employment leads to an increase in 2.5 units of financial deepening and an increase in one unit of county government revolving fund leads to 112.4 units of financial deepening.

The analysis shows that the activities of the county government affect financial deepening to a very great extent. The coefficients used in the model are all statistically significant hence they form good predictors of the dependent variables.

CHAPTER FIVE:SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This study was conducted with the objective of establishing the effect of devolution on financial deepening in Kwale County. This chapter looks at the summary of the findings, limitations of the study, conclusion and recommendations and suggestions for further research.

5.2 Summary of the Findings

F test was conducted to find out the reliability of the model. The null hypothesis was rejected and the alternative hypothesis upheld showing that there is a relationship between financial deepening and independent variables of study. This is a very important aspect of the analysis for establishing the reliability of the model. From the findings on R^2 , it shows that the variation in financial deepening is explained seventy five percent by variation in the variables that have been included in the model. It means that, only twenty five percent of variation in the dependent variable is explained by other factors other than the variables that were included in the model.

T tests were also done on the coefficients of the model to establish that they are statistically different from zero; the test shows that all the variables are greater than zero and hence can be reliably used in the model. Correlation analysis and the coefficients output demonstrate a strong positive relationship between financial deepening and the county government fiscal programs. This means that when the independent variables are increased, we expect to see an increase in the dependent variable. If the County

government increases its spending, the amount of money in circulation in the county increases leading to increased financial activities. It is evident that all chosen variables lead to increase in financial activities as they all have positive relationship with the dependent variable.

From the model, the effect of revolving fund on financial deepening is the highest at 112; this means that for a single increase in the amount of money allocated to the revolving fund, financial deepening will increase 112 times. The revolving funds requirements are less stringent than the loans offered by financial activities, this has enabled women and youth start up ventures which keep their money with financial institutions and also improve their credit rating.

Employment has an effect of 2.5 percent on financial deepening; this can be translated as an increase in use of financial institutions through salary accounts and increased borrowing by the employed persons due to improved credit rating. Therefore, for every employed person, there is a 2.5 increase in the use of financial facilities.

The model further shows that government spending has an effect of 0.9 on financial deepening. The government has been banking with various banks in the county, this has increased their asset base and the capability of them opening other branches or agents, this leads to increased provision of financial institutions and financial services. Government spending improves physical amenities which in return increase financial transactions and services.

5.3 Conclusion and Recommendations of the Study

The objective of the study was to establish how the functions of the county government have changed provision of financial services in Kwale County. From the relationship in the model, it is evident that the county government's revolving fund has greatly improved access and provision of financial services to the people of Kwale County. The analysis shows that increased county government spending will spur the growth of financial institutions and more so the use of revolving funds which would have direct financial benefits to the people.

The study therefore recommends that, the county government should increase its efforts in its programmes to empower the people of Kwale financially so that they may be able to have their own start ups.

The county government should also encourage expansion of business ventures using commercial banks loans especially with the advent of control of interest rates that was passed into law; this would greatly improve financial deepening and promote local investments.

The study also recommends that County governments should come up with legislation and deliberate efforts to support the establishment of more financial institutions. More financial literacy programmes should be done so that more people can access financial services and not a repeated few.

5.4 Limitations of the Study

Retrieving data from the county government was difficult as most data is not well archived. It took a lot of time in organizing the data into a useful format.

5.5 Suggestions for further Studies

Further research can be done to determine the County Assembly's role on financial deepening, studies can be conducted to establish whether the laws that the county assemblies make, enhance distribution of resources by the county government to the lowest level possible. To find out if regulations made by the assemblies ensure proper checks and balances so that all units of the county government are subjected to comprehensive audit and to ensure that money that are intended to benefit the people are used appropriately.

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APPENDIX: List of Financial Institutions in Kwale County

ACTIVITY DESCRIPTION	BUSINESS NAME
SMALL FINANCIAL SERVICES	YEHU MICRO FINANCE
SMALL FINANCIAL SERVICES	YEHU MICRO FINANCE
FINANCIAL SERVICES	KENYA WOMEN FINANCE TRUST
FINANCIAL SERVICES	FRIEND FOR LIFE (K) LTD
ATM SERVICES	CO-OPERATIVE BANK OF KENYA
SMALL FINANCIAL SERVICES	TELKOM KENYA LIMITED
MEDIUM FINANCIAL SERVICES	AFRICAN RETAIL TRADERS
FINANCIAL SERVICES-ATM	KENYA COMMERCIAL BANK
S/FINANCIAL SERVICES	TELKOM KENYA LIMITED MALL
ATM	CO-OPERATIVE BANK
MICROFINANCE	KENYA WOMEN FINANCE
SMALL FINANCIAL SERVICES	JUBILANT KENYA LIMITED
SMALL FINANCIAL SERVICES	KWALE TEACHERS SACCO LTD
SMALL FINANCIAL SERVICES	KWALE TEACHERS SACCO LTD
SMALL FINANCIAL SERVICES	KWALE TEACHERS SACCO
FINANCIAL SERVICES	KENYA WOMEN FINANCE TRUST
FINANCIAL SERVICES	KENYA WOMEN FINANCE TRUST
MEDIUM FINANCIAL SERVICES	AGRICULTURAL FINANCE
BANKING SERVICES	EQUITY BANK LIMITED
FINANCIAL SERVICE	YEHU MICROFINANCE TRUST

M/FINANCIAL SERVICES	KENYA WOMEN FINANCE
LARGE FINANCIAL SERVICES	BARCLAYS BANK LIMITED
LARGE FINANCIAL SERVICES	EQUITY BANK LIMITED
FINANCIAL SERVICES	KENYA COMMERCIAL BANK
FINANCIAL SERVICES	COMMERCIAL BANK OF AFRICA
FINANCIAL SERVICES	FIDELITY BANK
FINANCIAL SERVICES	DIAMOND TRUST BANK
FINANCIAL SERVICES	CO-OPERATIVE BANK
FINANCIAL SERVICES	NATIONAL BANK OF KENYA
FINANCIAL SERVICES	KENYA WOMEN FINANCE TRUST
L/FINANCIAL SERVICES	KENYA COMMERCIAL BANK
LARGE FINANCIAL SERVICES	FAMILY BANK LTD
LARGE FINANCE	IMPERIAL BANK LTD
LARGE FINACIAL SERVICES	IMPERIAL BANK LTD
LARGE FINANCIAL SERVICES	IMPERIAL BANK LTD
LARGE FINACIAL SERVICES	IMPERIAL BANK LTD
FINANCIAL SERVICES	MWANGAZA
INDEPENDENT TECHNICAL	KANDO LTD
INDEPENDENT TECHNICAL OPERATOR	EVELYN W.
GENERAL BUSINESS OFFICE	DARAD SHOPPING CENTRE
BOOKING OFFICE	MOLU TRAVEL SERVICES
FINANCIAL SERVICES	YEHU MICROFINANCE

SECURITY SERVICES FIRM	AGAPE SECURITY SYSTEMS
SMALL BANK	DZOMBO FINANCIAL SERVICES
S/FIRM SERVICES	JANET NZUKI
M/FINACIAL SERVICES	PLATINUM CREDIT LTD
S/FINANCIAL SERVICES	QUEENSBURY MANAGEMENT
SMALL PROFESSIONAL SERVICES FIRM	LUKORE FINANCIAL