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Bridging The Financial Gap in MSME Financing in Kenya

Salome Wairimu* and Doris Kiragu**

Abstract

Micro, small and medium enterprises (MSMEs) are critical drivers towards the growth of the economy and contribute largely towards poverty eradication and employment. In Kenya, the MSME sector contributes to 40% of GDP, and employs approximately 14.9 million. Yet, this sector continues to experience difficulties in accessing credit from financial institutions. MSMEs' find it difficult to access credit from banks while banks find it difficult to lend to MSMEs due to lack of visibility. Additionally, reliance on informal credit sources in unsustainable. MSME borrowers are often trapped in vicious cycles of indebtedness and predatory lenders hampering firms' long-term performance. As a result, this study seeks to examine the key constraints hindering MSMEs' access to formal financing and their contribution to the financing gap. Similarly, to evaluate policy interventions that can enhance credit availability and bridge the MSME financing gap. The study adopted a logit regression estimation model, with the average marginal effects used to interpret the findings. The results indicate that lenders perceive MSME borrowers as risky and use credit measures like collateral to mitigate these risks. Factors like lack of collateral, guarantors, negative CRB listing exclude MSMEs from access to credit. Therefore, there is need for policies aimed at supporting banks in extending credit to MSMEs' as well as building capacity among the MSMEs in Kenya for their growth and sustainability. .

Key words: *Capital, Competition, Stability, Panel*

**Caritas Microfinance Bank **Consolidated Bank of Kenya*

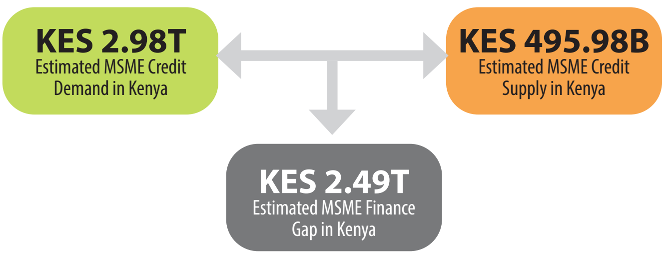
1.0 Introduction

1.1 Introduction and Background

In Kenya, Micro, small and medium enterprises (MSMEs) are critical drivers towards the growth of the economy and contribute largely towards poverty eradication and employment. KNBS', MSME survey in 2016, reported of over 7.41 million MSMEs in Kenya, with approximately 14.9 million employees. This represents a huge share of the working population in Kenya, further underscoring the relevance of this sector in the country. This sector contributes up to approximately 40 % of the national GDP (UNDP;MSEA, 2021). Yet among the major constraints to MSME sector growth has been access to finance. The organic growth of MSMEs in Kenya may be held back by numerous obstacles, key among them access to affordable finance.

There has been a persistent MSMEs' financing gap in emerging and developing countries, that is the percentage of formal MSMEs that cannot or can only partially access credit. A report by G20 Global Partnership For Financial Inclusion (GPFI), (2024) states that, the credit gap in for emerging market and developing economies (EMDEs) in 2019 was estimated to be at USD 5.7 trillion. Similarly, the Alliance for Financial Inclusion, *et.al*, (2020) noted that the MSME finance gap for sub-saharan Africa as reported by IFC was the largest in developing countries at 51%. The financing gap for formal MSMEs in Kenya has been estimated as USD 19.3 billion as shown in **figure 1**, with the total estimated credit demand being USD 23 billion and the estimated credit supply being USD 3.8 billion (World Bank,

Figure 1: MSME Funding Gap in Kenya



Source : World Bank (2025)

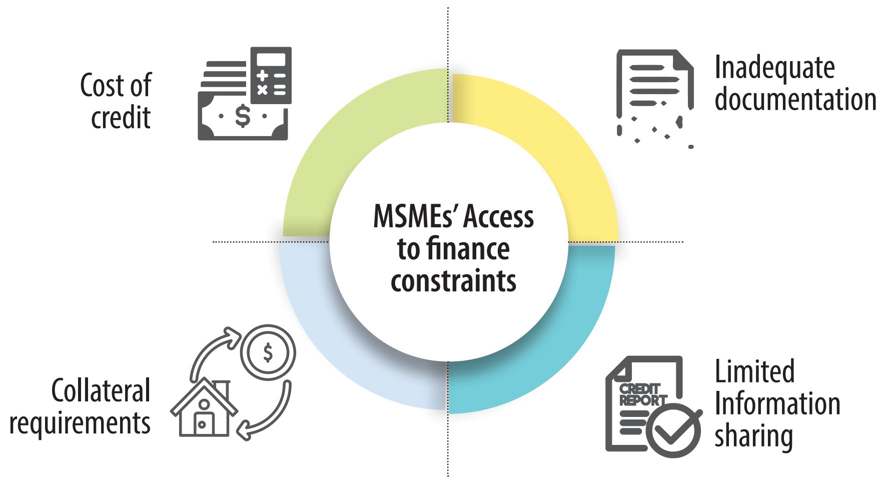
et.al, 2024). Globally, efforts to address this credit gaps have been a priority for both the public sector in terms of government policy and interventions.

In Kenya, access to affordable and convienient financing by MSMEs remains critical for their sustainability and contribution to the country's economy (Central Bank of Kenya, 2025). The banking industry has made efforts to boost bank-led credit advancing to MSMEs through several lending and credit facilitation programs. Despite this, there is a notable level of difficuty in accessing formal finances in Kenya, which has been reported to be approximately 50.7% and 44.6% for commercial banks and microfinance banks in Kenya respectively (KBA & JICA, 2020). FinAccess (2023) report also notes that accessing loans from commercial banks remains among the least preffered sources of financing by MSMEs at 15.9%. The signficance of addressing the contraints towards MSMEs credit access is thus emphasized.

Supply side constaints in access to credit by MSMEs hinder performance of the sector in the economy. Approximately 70% of MSMEs report difficulties in accessing credit from formal financial institutions (Tiriongo, Mulindi, & Njino, 2025).

Tight lending conditions by financial institutions limit the flow of credit to the MSMEs. **Figure 1,** shows some of the common constraints in access to credit ranging from high cost of credit (perceived or actual), credit history, collateral requirements meant to cover the size of their loans,high default rates, lack of proper documentation especially on accounts and business finances and operations, information assymetry, risk taking appetite of the financial institution among others.

Figure 2: Constraints to access to finance by MSMEs'



Source: Author's Illustration

Formal credit access remains limited and highly uneven. Only about 16% of Kenya's roughly 7.4 million MSMEs have access to formal financing (CBK, 2025). MSMEs loans approvals by banks declined by 13% decline with 16% being in commercial bank and 26% in microfinance banks. The decline is associated with rise in interest rates between 2023 and 2024. Notable also is the high collateral requirements by banks further constraining credit accessibility (FSD, 2023).

On the demand-side, MSMEs characteristics play a crucial role in determining access to external financing. Firms' individual characteristics strengthens or weaken their credit worthiness depending on their transparency. As Ndungu et al. (2025) posits, lenders perceive firm's operational efficiency as a proxy for business sustainability and reduced credit risk. Firms that have streamlined supply chain processes, adopt technology in their operations and have effective inventory management are most likely to access bank's credit (Kusi *et al*. 2020). Strick credit appraisal policy and requirements act as a hinderance towards access to finance by MSMEs. However, this is the only assurance that banks have against significant risk of loss when they finance MSMEs.

There exists a critical nexus between MSMEs' demand for external financing and banks' need for reliable information about MSMEs. While MSMEs' heavily rely on banks financing to support their working capital and expand their businesses, banks require accurate and reliable information to assess the credit worthiness and manage the risk for MSMEs financing. However, majority of the MSMEs operate on weak financial records and informal practices resulting to significant information assymetry. Banks are therefore constrained in their ability to lend resulting to persistent financing gap due to credit rationing.

1.2 Motivation of the study

Persistent constraints in accessing formal bank credit arising from stringent requirements and information asymmetry have affected the bank's ability to and willingness to lend to the MSME sector (Beck *et al*. 2016; Macdonald, 2024). As a result, MSME find it difficult to meet the requirements like collateral, documentation or business records, credit records and other disclosure standards that are need by regulated banks leading to exclusion despite the high demand for external credit.

Consequently, MSMEs resort to alternative sources of credit which are largely informal, and unregulated. While these sources offer quick and convenient access to funds, studies show that they are often highly priced and predatory. These lenders are characterized by excessive interest rates, short repayment periods, opaque pricing structures, and very aggressive recovery mechanisms (Omondi, 2022). In addition to this, MSMEs frequently engage in multi-borrowing across these alternative sources to meet their working capital needs and also to service existing debts and these leads to them being trapped in vicious cycles of over-indebtedness and financial distress (Kariuki & Namusonge, 2024).

This study is motivated by the need to address the structural constraints that limit MSMEs access to affordable formal credit from banks. By assessing how these constraints affect bank financing to MSMEs, the study seeks to identify mechanisms through which these constraints can be mitigated. Addressing these barriers has the potential to unlock sustainable formal credit for MSMEs in Kenya and to reduce overreliance to predatory lenders. Promoting responsible bank-led financing will support long-term growth and sustainability of MSMEs in Kenya.

1.3 Research Objective

1. To examine the key constraints in bank lending that hinder MSMEs' access to external financing in Kenya

2. To propose policy interventions and strategies that will reduce these constraints and improve MSMEs' access to formal bank credit.

1.4 Research Questions

What are the key constraints hindering MSMEs' access to bank financing in Kenya, and how do these constraints contribute to the financing gap?

1.5 Significance of the Study

The study will evaluate strategies and policy interventions that can enhance credit availability and bridge the MSME financing gap.The findings of this report will be relevant to financial institutions on ways to enhance their role as suppliers of credit. Similarly, the findings will be intends to recommend policy measures that will drive ease of formal credit access in Kenya.

1.6 Summary

The paper has the following sections: Section one which has the introduction to the study, motivation of the study, objectives and questions and the significance of the study. Section two contains the literature review, the theoretical and empirical studies on MSME access to formal finance. Section three contains the data variables and methodology used in the study. Section four contains the findings and discussions and finally section five contains the policy recommendations.

2.0 Literature Review

2.1 Credit rationing theory

The credit rationing theory (Stiglitz and Weiss, 1981) explores this phenomenon by stating that banks may deny credit to some borrowers such as MSMEs, even though they are credit worthy due to their perceived high risk and lack of collateral requirements. Credit rationing occurs in two aspects that is the adverse selection effect and the incentive effect. Higher interest rates may deter safer, low-risk borrowers, who are less likely to default and are unwilling to pay elevated rates. Alternatively, banks are left with riskier borrowers and this increases chances of delinquency. This implies that potential customers might be excluded from accessing bank credit. In this case, banks result to alternative screening devices which are non-price related to be able to distinguish between high risk and low risk customers for instance availability of collateral, prior credit history, business records. These screening may lead to exclusion of potential MSMEs to formal bank financing.

2.2 Asymetric Information Theory

The asymetric information thoery (Akerlof, 1970), highlights that each party of an economic transaction needs to possess sufficint information of knowledge about the other partyto be able to make an accurate decision. This reults in adverse selection and moral hazard problems. Information imperfection occurs when one party to a transaction has more information than the other party. In this case, for both parties, that is the lender and the borrower, depend on availability of information is crucial for decision-making. Banks are able to assess the creditworthiness of an MSME borrower with access to adequate information for instance their prior credit history, availability of collateral which will reduce delinquency. Borrowers on the other hand, are able to assess information about the lender like pricing, collateral and other loan requirements. This allows them to borrow from the best lender in the market and to avoid predatory lenders. In Kenyan context, the challenge of inadequate borrower information is largely highlighted as a barrier to bank credit. Maesaroh *et al*. (2023) posit that information asymmetry is more pronounced in developing countries than developed countries, thereby heightening perceived risks and further constraining lending to MSMEs.

2.3 Financial intermediation theory

In the long run, financial institutions play a crucial role facilitating credit access by firms. The financial intermediation theory (Gurley and Shaw, 1960), emphasizes the role of financial institutions and how they are expected to channel funds between savers and borrowers. They mobilize savings and allocate them efficiently to productive sectors in the economy. Therefore, banks are expected to stimulate economic growth by enabling MSMEs to carry out their functions through facilitating access to finances. Tiriongo et al. (2025) emphasizes the need for eefective financial intermediation through better risk management and reduced transaction costs to enhance credit accessibility to MSMEs.

2.4 Empirical Review

One strand of empirical literature has attributed MSMEs' bank finance gap to the risk aversion of banks when it comes to financing MSMEs. Bank credit policies tend to be tougher for MSME borrowers compared to other borrowing sectors like corporate sector. Banks tend to view the MSME sector extremely risk prone.

Brixiova *et al*., (2020), analyzed firm-level data from 42 African countries and highlighted in light of MSME bank credit, large ticket loans require less collateralization and are characterized with longer maturities and better pricing compared to small ticket loans. Majority of MSMEs in Africa are under the micro enterprises category and by the nature of their size they are automatically excluded from accessing bank credit due to stringent bank credit policies.Similarly, Troilo *et al.*, (2025), cites over-reliance on collateral as a common barrier to MSME financing as banks seek protection against default. This is specifically common among small sized firms who are perceived as riskier and with incosistent cash flows compared to larger firms. The study calls for expansion of what can serve as collateral and neccesitates for a reliable collateral registry, use of governement guarntees in lieu of collateral and use of fintech to reduce information asymmetry to improve credit access to MSMEs.

Small organised sectors and micro unorganized sectors have limited options of financing therefore they depend largely on bank credit to meet their requirements (Bhattacharya, 2013). However, information asymmetry is more severe for small firms as there is low level information available to the external lender, hence credit MSME are more credit rationed than larger firms, (Athaide& Pradhan, 2020). Bhattacharya (2013), argues out a case of credit retrogression due to structural bottlenecks. The study potrays banks as baised towards advancing large ticket credit to corporate borrowers which are low-priced as compared to unknown multiple small ticket MSME borrowers across the country. The bias has been attributed to risk aversion of bankers, ease in bulk-lending and familiarity with the profiles of big tickect borrowers. These structural bottlenecks constrict credit to MSME sector.

On the other hand, credit constraints to MSMEs maybe due firm characteristics. Beck *et al.* (2006), shows that fir individual characteristics like age, size, and ownership are reliable predictors of credit constraint. Kira and He (2012) demonstrate that factors like the size of the firm, profitability, and owner education influence the ability of a firm to secure a bank loan. Posits that cash profit, asset base, long-term borrowings and capital stock indicate credit constraint of an MSME, (Athaide& Pradhan, 2020)..

Another strand of literature explores a case of discouraged borrowers where by they would have good credit quality but lack the necessary confidence to apply for formal credit. This is characterized by high rejection rates and delays in advancing loans to MSMEs leading to reduced applications. Sarda and Baruah (2021), cite high loan application rejection rates due to unpromising projects, lack of business knowledge, borrower having multiple financiers, negative credit history and officially invalid documents by the borrower. Similarly, delays in disbursements of loans are attributed to returned applications for rectification, changes in business ventures as suggested by the bank, confused beneficiaries about utilisation of the fund and shortage of manpower to handle priority sector lending.

However, some MSMEs may prefer funding themselves internally as compared to seeking external financing. Mittal and Raman (2022), explore financing gap that restrict MSMEs from borrowing through formal channels. They conclude that the financial constraints that contribute towards knowledge gap, supply gap and empathy gap extend the unwillingness of firm ownersto borrow through formal channels. This further confirms the influence of the pecking order theory on MSME financial structure.

Literature highlights the importance of financing MSMEs in an economy. In a study by Abdisa and Hawitibo (2021), that focused on 13 Sub-saharan African countries, credit constraints significantly reduce firm's investment and affects their performance negatively. Similarly, Berton, Colombo and Quas (2023), find out that large firms that access loans that are guaranteed experience growth in sales, create more jobs and and tend to survive for a longer period in the market. Gur, Babacan, Aysan and Suleiman (2023) reported that access to formal financing especially for smaller firms determines their survival especially during periods of unprecedented shocks.

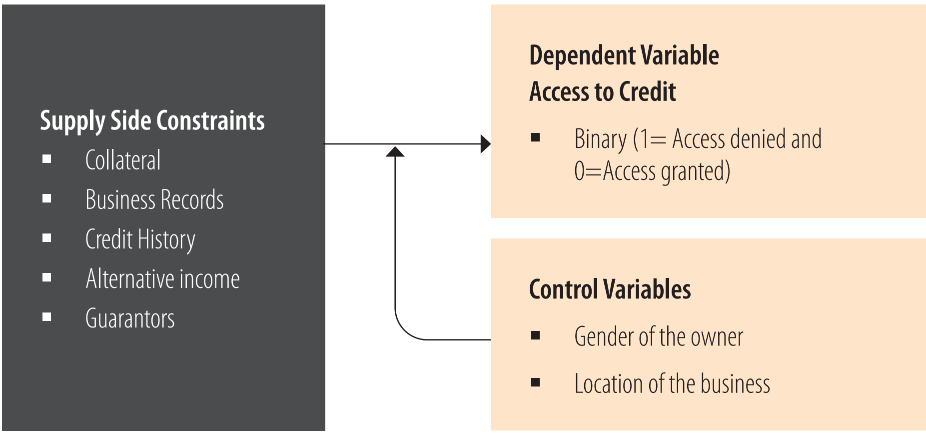
Some studies have explored various interventions on enabling access to finance by MSMEs. Kiring'a, Ndede and Wekesa (2021), tests the role of relationship based lending in easing access to finance from financial institutions by banks. The results highlight a positive and statistically significant relationship between the two. In a market that is characterized by information asymetry, relationship based lending enables financial institutions to gather adequate information about the MSME and thus they are able to offer products that meet the specific business needs.

In their study, Mwirigi, Gakure and Otieno (2019), explore strategic approach to access of finance by addressing collateral challenges. They recommend the expansion of movable collateral regimes, and the strengthening of credit guarantee schemes as mitigation to collateral related constraints. The study also focuses on gender- sensitive product design by financial institutions for targeted groups.

Prior studies indicate a mixture of outcome as some lean towards supply side credit constaints while other lean towards demand side credit constraints to MSMEs' access to bank credit. In other cases, it's a matter of self exclusion driven by frustrating credit application processes.

2.5 Conceptual Framework

Figure 2: Conceptual Framework



Source: Author's Illustration

3.0 Research Methodology

3.1 Data Description and Overview of MSMEs Characteristics

The paper utilizes cross sectional secondary firm-level data drawn from *FinAccess Household's Survey* in 2024. This data is relevant to this study as it depicts a granular understanding of the experiences that Kenyan MSMEs face while accessing credit. This study leverages on the prior collected data to unravel the constraints that limit access to credit by Kenyan MSMEs.

The study considers a population of 3,296, which includes all firms in the survey whose main source of livelihood is their own businesses. The sample size was 406 business with loan applications to a commercial bank. The use of firm-level data was preferred as it anchors the study on more granular data.

3.2 Model Specification

The dependent variable, access to bank credit, is defined as a binary outcome where the outcome is (1) if the loan was denied; otherwise (0). The model tests the likelihood of being denied a credit based on a set of explanatory variables. The study adopts the maximum likelihood method of estimation where it yields values for unknown parameters that maximize the probability of obtaining observed set of data (Hosmer, 2013). To achieve the objectives of the study, three models were estimated.

A Logistic model is adopted in this study, given the dependent variable is a binary which represents a firm's success or failure of accessing external finance, as it effectively models probability outcomes in the presence of limited dependent variables (Greene, 2018). The multis-stage approach is crucial for testing the stability of results across different levels of model complexity.

The functional form of the model is specified in Equation 1, where the model assumes that the probability of being denied access to a loan by a commercial bank is determined by a set of explanatory variables.

$$Logit\ (P\iota = ln\left(\frac{P}{1-P}\right) = \beta o + \beta 1 X i + \beta 2 X i + \cdots\cdots + \beta \kappa X i + \varepsilon i$$
$$\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots.\ Equation\ 1$$

The fitted model is as follows:

$$Logit\ (Access\ to\ bank\ crediti = ln\left(\frac{P}{1-P}\right) = \beta o + \beta 1 collaterali$$
$$+\beta 2\text{Income}i + \beta 3\text{Business Records}_i + \beta 4\ Guarantori + \beta 5\ CRB\ Listing_i$$
$$+\beta 7\text{Location}i + \beta 8 Genderi + \varepsilon i\ \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots.\text{Equation 2}$$

3.3 Operationalization of Variables

Table 1: Shows the definition of Variables adopted in the study.

Symbol	Name	Measurement
Dependent Variable		
Y_i	Access to Bank Credit	Binary (1= Access denied, 0= Otherwise)
Independent Variables		
X_1	No Collateral	Binary (1= No collateral, 0= Otherwise)
X_2	Income	Binary (1= No alternative source of income, 0 = Otherwise)
X_3	Business Records	Binary (1 = Did not keep proper business records, 0 = Otherwise)
X_4	Guarantor	Binary (1 = Had no guarantor, 0 = Otherwise)
X_5	CRB Listing	Binary (1 =Negatively listed on CRB, 0 = Otherwise)
Control Variables		
X_5	Business Location	Dummy (1 = Rural, 0 = Urban)
X_6	Gender of the Owner	Dummy (1 = Female, 0 = Male)

4.0 Results and Findings

4.1 Descriptive Statistics

The study covered firm-level cross sectional data for the year 2024 resulting to stat 406 observations. Descriptive statistics represented in Table 3 indicate the mean of access to bank credit of the study was 0.1379 with a standard deviation of 0.34. The mean of the variable of lack of collateral has 0.1232 with a variation of 0.2211. Availability of business records has a mean of 0.6897 signifying the informality of the businesses sampled. Lack of alternative income exhibited a mean of 0.1946 indicating that a large number of observations relied on their business as a source of income. Availability of peer guarantors has a mean of 0.3202 implying that majority of the observed business owners lacked peer guarantors. CRB listing has a mean of 0.5911indicating that majority of the business were not negatively listed by credit refence bureaus.

Table 3: Descriptive Statistics

Variable	Obs	Mean	Std. Dev
Access to Bank Credit	406	0.1379	0.3453
Lack of Collateral	406	0.1232	0.2211
Lack of Alternative Income	406	0.1946	0.0815
Availability of Business records	406	0.6897	0.2537
Lack of Guarantors	406	0.3202	0.1763
Negative CRB listing	406	0.5911	0.2361

4.2 Access to Credit Results

The Logit regression model was used to estimate the empirical model. The Average Marginal Effects (AME) will be used to interpret the findings of the logit regression model. The average marginal effects tell us how much the probability of the outcome changes for a small change in the predictor, holding all other variables constant. In this study, the predicted variable is the access to bank loans, while the predictors are lack of collateral, lack of alternative income, businesses with no business records, lack of guarantors, negative CRB listing, and perceived cost of credit. The model was moderated by the following variables; the location of the business, and gender of the business owner.

Regarding the probability of accessing a bank credit without collateral, lack of collateral by a borrower increases the chances of being denied bank credit by 0.09 percentage points. In relation to this, lack of a peer guarantor was found to increase the probability of exclusion of borrowers from bank credit by 0.357 percentage points. This is consistent with practice since lack of collateral means heightened risk of default.

Businesses negatively listed by credit bureaus are likely to be denied credit facilities by 0.062 percentage points. This implies that there is heavy reliance on past credit history by lenders as they emphasize the behavioral characteristics of the borrower.

On the other hand, availability of business records affects accessibility to bank credit. From the study, lack of good proper business records heightens the probability of denial from bank from application by 0.045 percentage points. Banks often require proof of consistent cashflows by businesses for confidence and continuity of business. Similarly, alternative sources of income has been found to boost the probability of acquiring a bank loan as lack of presents a probability of denial of bank credit by 0.09 percentage points.

On the control variables, the location of the business was found to influence the probability of accessing bank credit by 0.13 percentage points. It was easier for businesses located in rural areas to access bank credit compared to those in urban areas. In addition to this, the gender of the owner of the business was found affected the probability of getting a bank loan by 0.326 percentage points. Female business owners had a higher probability of accessing formal credit compared to male entrepreneurs.

Table 4: Logit Regression Results

Variable	AME	Std. Error
Lack of Collateral	0.0009	[0.0046]
Lack of Alternative Income	0.0982	[0.0373]
Availability of Business records	0.0458	[0.0340]
Lack of Guarantors	0.0357	[0.0472]
Negative CRB listing	0.0621	[0.3931]
Business location	0.0134	[0.2251]
Gender of the owner	-0.0326	[0.0351]

5.0 Summary of Findings, Conclusion & Policy Implication

5.1 Summary of Findings

The study sought to examine the key constraints faced by MSMEs in accessing bank lending. To this effect, an empirical model was estimated that is the logit regression model. The model entailed an explanatory variable consisting of supply-side variables and demand side variables. The model results indicate that supply side variables which majorly consists of banks credit policies affect the access to bank credit by MSMEs.

Specifically, over collateralization and guarantor requirements exclude MSMEs from bank lending. This finding could infer to stickiness in credit policies by lenders especially when appraising loan applications by small sized borrowers. Collateral requirements could also imply that the notion of perceived riskiness of the MSME sector by lenders hence justifying their need to cover their investment against high rates of default.

Negative credit listing of the borrower increased the probability of exclusion from bank credit. The need for information sharing necessitated for listing of borrowers' credit history in the credit reference bureaus. Time may have proven this as counterproductive based on the fact that negatively listed borrowers are more likely to be denied access to bank credit based on their prior credit history. The findings of this study could imply the need to alternative credit scoring engines that embed past history and futuristic behavior in assessing a borrower's credit behavior.

The need for businesses to have proper and reliable business records as it affects the probability of acquiring bank credit. This result could imply that lenders need to ascertain the sustainability of the business before extending credit to the borrower. In addition to this, business records and plans outline the projections and future projects of the business. This could boost the lenders' confidence towards the borrower especially on utilization of funds borrowed and loan repayments.

5.2 Conclusion

Stringent supply side credit requirements are found to exclude MSMEs from accessing bank credit in Kenyan context. The findings of this study are consistent with prior study findings on the perception of the riskiness of the MSME sector and strict credit requirements by lenders for MSME borrowers. Lack of collateral, guarantors, proper business records and negative CRB listing exclude MSME borrowers from accessing bank credit.

5.3 Policy Implication

Based on the study findings, addressing supply side constraints could potentially unlock bank credit to the MSME sector. Thus, it is important for policy makers to provide guidance on possible course of action towards addressing these issues.

It is important for to expand the partial credit guarantee scheme to all regulated banking institutions that is commercial banks and microfinance banks. This will lower the risk for lending institutions who are willing to lend to MSMEs but are constrained due to the perceived risky nature of the MSMEs.

There is need to for policies aimed at alleviating structural constraints. This could include strengthening of the movable property rights to broaden the scope of assets that can be used as collateral. This will accommodate the nature of MSMEs in Kenya and expand their collateral choices.

The paper calls for institutional-centered capacity building and financial literacy program. The focus being to build capacity around formalizing MSMEs in Kenya. The impact-based programs will guide business owners towards sustainable businesses like proper record keeping, project planning.

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