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POLICY BRIEF

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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Beyond Interest Rates: How can digital finance and bank capital position unlock MSME Credit?

Executive Summary

MSMEs account for nearly 98% of businesses and 40% of GDP in Kenya, yet remain credit constrained. This study examined how cost of credit, digital finance and bank capital influence MSME loan access and performance. Using FinAccess 2024 data and bank-level panel data (2011–2024), we find that perceived high borrowing costs are endogenous and do not independently constrain access. Instead, firm maturity, size, formalization and digital transaction footprints significantly improve approval rates. Moreover, urban-based enterprises remain advantaged. On the supply side, stronger bank capital buffers support sustainable credit growth. As such, policy reforms need to move beyond interest rate debates to address collateral frameworks, digital inclusion and capital adequacy to expand MSME financing.

Authored by Samuel Tiriongo, Hillary Mulindi, Hesborn Nyagaka and Davis Milimo

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1. Context and Problem

Micro, Small and Medium Enterprises (MSMEs) form the backbone of the Kenyan economy, contributing roughly 40% of GDP and generating majority of new jobs. Despite this central role, access to affordable and sustainable credit remains persistently low.

Figure 1: The Challenges of MSME Financing in Kenya

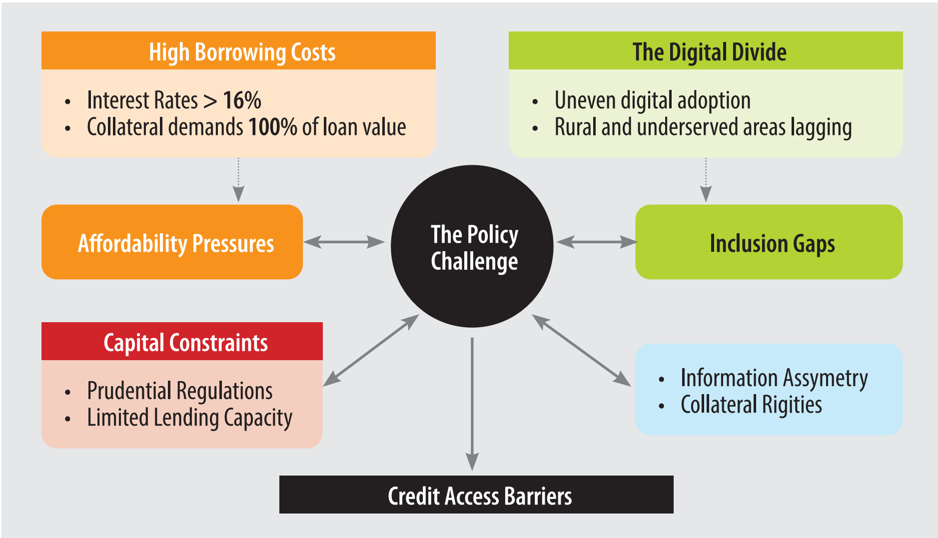
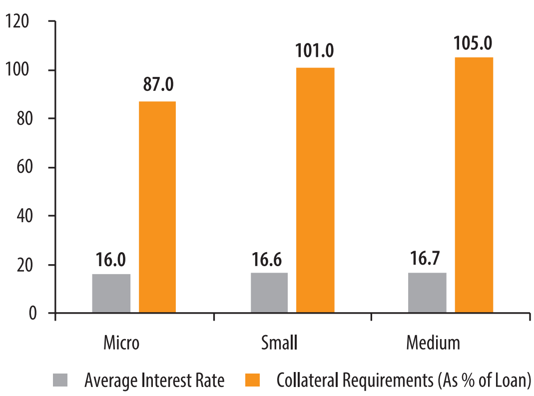


Figure 2: Average interest rate and Average collateral



Source: CBK MSME survey 2024

As shown in **Figure 1**, MSMEs face several financing challenges in Kenya. However, this debate has largely leaned on high lending rates. The CBK MSME Survey in 2024 (**Figure 2**), has shown that Commercial bank interest rates have remained elevated, averaging above 16%, coupled with collateral requirements that often exceeding 100% of loan value, create affordability pressures. Even so, focusing exclusively on pricing masks deeper structural frictions.

Credit rationing, information asymmetry and rigid collateral frameworks systematically disadvantage younger and smaller enterprises. At the same time, digital finance ecosystem has transformed financial intermediation. Mobile money and fintech platforms generate alternative data that can enhance credit scoring and reduce transaction costs. Nonetheless, digital inclusion remains uneven, with rural and less connected enterprises lagging behind.

On the supply side, banks operate under prudential capital requirements that shape risk appetite and lending behavior. In a bank-dominated financial system such as Kenya, capital buffers directly influence the capacity to extend private sector credit, particularly during periods of monetary tightening.

The policy challenge, therefore, is multidimensional. High perceived borrowing costs, uneven digital adoption and capital-constrained banks interact to shape MSME financing outcomes. Understanding these interlinkages is critical for designing reforms that expand credit access without undermining financial stability.

2. Methods and Results

The study uses micro-level and bank-level evidence. MSME data are drawn from FinAccess 2024, while bank financial statements and macroeconomic indicators cover 2011 - 2024. The analysis was done in four steps as illustrates in **Figure 3.**

First, a control-function Probit model adopted corrects for endogeneity in perceived cost of credit. The results show that perception alone does not significantly reduce loan access once endogeneity is addressed. However, the age of the MSME exhibits a U-shaped relationship with credit access. That is, younger firms face initial exclusion but improve as they mature. Firm size and formalization significantly increase approval probabilities. Moreover, female-owned firms show higher likelihood of obtaining bank loans.

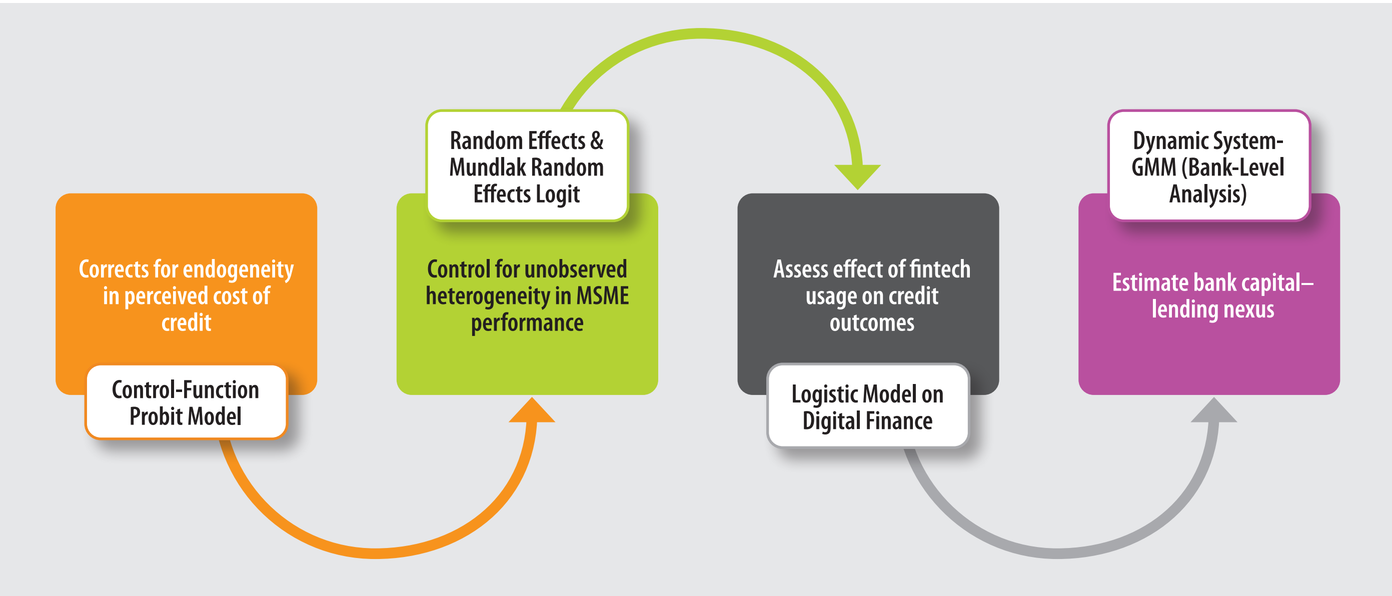
Second, MSME performance is estimated using Random Effects and Mundlak Random Effects Logit models to account for unobserved heterogeneity. The apparent positive association between perceived high cost and performance disappears once heterogeneity is controlled. This isa clear indication of survivorship effects rather than causal impact.

Third, a logistic model assesses digital finance usage and credit outcomes. Enterprises using fintech for business and financial transactions are significantly more likely to obtain approval. Digital footprints appear to reduce information asymmetry, supporting intermediation theory. Additionally, enterprises located in urban areas have a higher approval probability, thereby revealing persistent spatial disparities.

Fourth, the bank capital - lending nexus is estimated using a dynamic System-GMM framework. Results confirm that stronger regulatory capital ratios anchor sustainable private sector loan growth. The inclusion of squared capital terms tests for threshold effects, suggesting that insufficient capital constrains lending, while adequate buffers stabilize credit expansion during monetary shocks.

In conclusion, the study findings demonstrate that MSME credit outcomes reflect interacting demand and supply forces. Structural firm attributes and digital engagement matter more than cost perception alone, while bank capital adequacy remains central to sustaining credit supply.

Figure 3: Analytical process



Source: Authors' Illustration

3. Policy Recommendations

- Reform collateral and credit infrastructure. Modernize movable collateral registries and risk-based lending frameworks to reduce excessive collateralization and improve access for younger firms.
- Scale responsible digital finance. Promote interoperable digital credit ecosystems and strengthen consumer protection to leverage alternative data without fostering over-indebtedness.
- Balance capital regulation with growth objectives. Maintain adequate capital buffers while adopting countercyclical tools that prevent procyclical credit contractions to MSMEs.

4. Reference

1. Tiriongo et. al (2026). "Cost of Credit, Digital Finance and Bank Capital: Implications for MSME Lending and Performance in Kenya", *KBA Working Paper Series Volume 6.*

Kenya Bankers Association
13th Floor, International House, Mama Ngina Street
P.O. Box 73100– 00200 NAIROBI
Telephone: 254 20 2221704/2217757/2224014/5
Cell: 0733 812770/0711 562910
Fax: 254 20 2221792
Email: research@kba.co.ke
Website: www.kba.co.ke

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