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POLICY BRIEF

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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Unlocking MSME Finance Through Smarter Risk Sharing

Executive Summary

Amid the changing global financial terrain, financial institutions have been in the forefront of adoption and implementation of Environmental, Social and Governance in their pursuit of offering sustainable financing to businesses. This is underpinned on the ability of ESG adoption in unlocking access to green financing from development partners by commercial banks. However, despite commercial bank's pursuit for sustainable financing Micro, Small and Medium-sized Enterprises continue to critically suffer from sustainable financing challenge. Against this backdrop, the study examines how banks' ESG integration affects MSMEs support through entrepreneurial training and lending. The key finding is that banks ESG adoption significantly increases the MSME. Conversely, banks' ESG adoption has a positively but insignificantly effect on MSME lending. The results conclude that banks' training to MSMEs is necessary but not sufficient for increased MSME lending. The finding calls for capacity enhancement among the MSMEs beyond training to create a viable pipeline for absorption of sustainable funding by businesses. Furthermore, is the Fastracking on banks' sustainability tracking and reporting that is crucial for Kenya Green Finance Taxonomy implementation.

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The Centre for Research on Financial Markets and Policy®

The Centre was established by the Kenya Bankers Association in 2012 to offer an array of research, commentary, and dialogue regarding critical policy matters that impact on financial markets in Kenya. The Centre sponsors original research, provides thoughtful commentary, and hosts dialogues and conferences involving scholars and practitioners on key financial market issues. Through these activities, the Centre acts as a platform for intellectual engagement and dialogue between financial market experts, the banking sector and the policy makers in Kenya. It therefore contributes to an informed discussion that influences critical financial market debates and policies.

1. Context and Importance of the Problem

Micro, small, and medium enterprises (MSMEs) are the backbone of Kenya's economy, accounting for almost all registered businesses, close to 40 percent of GDP, and the majority of employment. Yet access to affordable credit remains a structural constraint on their growth. Many MSMEs lack adequate collateral or formal credit histories, and are therefore perceived by banks as risky borrowers. As a result, a large share of viable enterprises remain excluded from formal finance or face prohibitively high interest rates.

To address this persistent financing gap, Kenya and its development partners have increasingly turned to partial credit guarantees (PCGs) as a tool for risk-sharing between lenders and guarantors. In these arrangements, a public or development finance institution absorbs part of the loss if a borrower defaults, thereby encouraging banks to lend to firms that would otherwise be credit-rationed. The expectation is that such guarantees not only expand access to credit but also improve loan affordability by lowering risk premiums.

The National Treasury's Credit Guarantee Scheme (CGS), launched in 2020, represents Kenya's most visible effort to institutionalize this model. Operated through partner banks, the scheme seeks to extend credit to viable but under-collateralized MSMEs. It coexists with several other guarantee programs supported by international development institutions, creating a growing ecosystem of public–private risk-sharing mechanisms. Together, these initiatives reflect Kenya's broader commitment under Vision 2030 and the Bottom-Up Economic Transformation Agenda to strengthen financial inclusion and enterprise resilience.

Yet, important questions remain. Despite the expanding scale of guarantees, borrowing costs for MSMEs remain relatively high, and participation is concentrated among a few large banks. This raises policy concerns about how guarantees are designed, allocated, and priced—and whether their benefits are being transmitted efficiently to the small firms they are intended to serve. Understanding these structural and design challenges is central to advancing the next phase of Kenya's credit-guarantee reforms.

2. Empirical Insights: Methods and Key Findings

This policy brief draws on a unique loan-level dataset of more than 28,000 guaranteed MSME loans disbursed between 2013 and 2024. The data include loan size, sector, collateral status, interest rate, and guarantee coverage ratio, providing one of the most detailed portraits of Kenya's guaranteed credit market to date.

Two complementary models were used to interpret the data. A fractional logit model examined how loan features, collateral, and coverage ratios influence default probabilities. An ordinary least squares (OLS) model then explored how these same factors shape borrowing costs. Together, they capture both the risk-mitigating and price-formation roles of partial credit guarantees.

Stylized Patterns in Kenya's MSME Credit and Guarantee Landscape

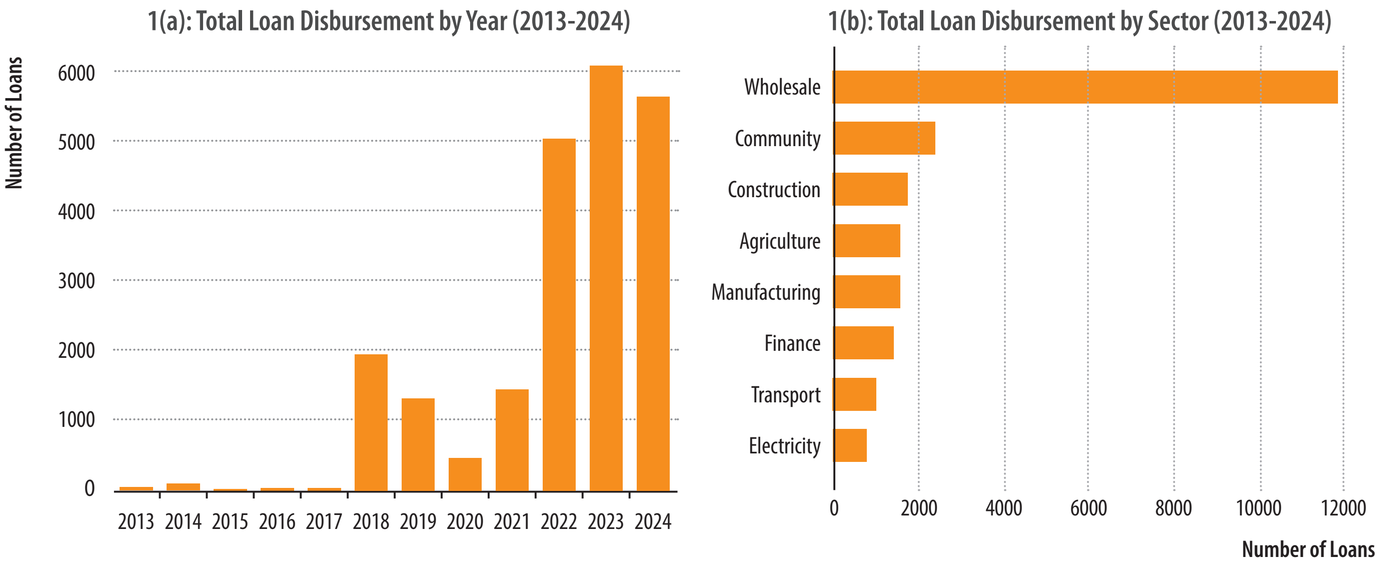
- ***MSME financing remains shallow despite guarantee expansion.***

  Although MSMEs dominate Kenya's enterprise base, only about 17 percent access formal credit, according to FinAccess (2024). The majority still depend on informal lenders or SACCOs. Most guaranteed loans are relatively small—typically under KSh 1 million—indicating that guarantees mainly reach micro and lower-tier small firms rather than medium enterprises.

- ***Guarantee uptake has accelerated but remains concentrated.***

  Guaranteed lending grew steadily between 2013 and 2024, with a sharp increase after 2018 driven by stronger public and development finance participation. As shown in **Figure 1**, lending remains concentrated in a few sectors, mainly wholesale and community services, while agriculture and manufacturing continue to lag. The pattern highlights persistent gaps in credit access and the need to extend guarantees to smaller institutions and underserved sectors.

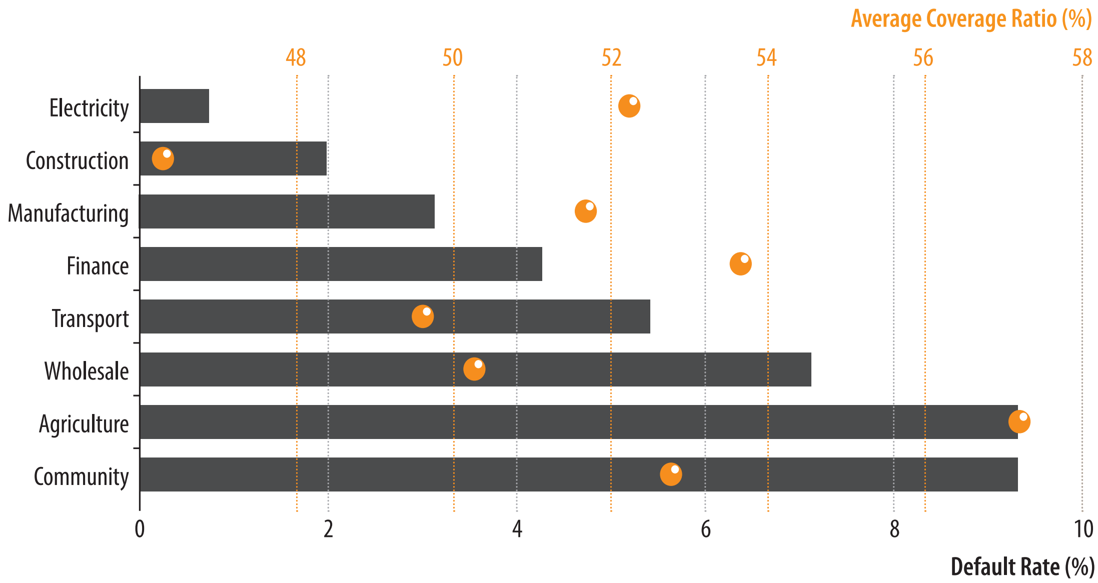
Figure 1: Trends in Guaranteed Lending and Sectoral Concentration under Kenya's Partial Credit Guarantee Program, 2013–2024



- ***Defaults are concentrated in risk-intensive sectors.***

  Default rates vary sharply across industries. Agriculture and community services record the highest incidence—around 9 to 12 percent—compared with 5 percent in manufacturing and 4 percent in energy. Higher coverage ratios in high-risk sectors (averaging 52 percent versus 47 percent elsewhere) show that guarantees have been used to offset structural risk, though with exposure to volatility. This pattern highlights the need for risk-based pricing and stronger portfolio diversification to safeguard guarantee funds while maintaining access for riskier but economically important sectors. (See Figure 2.)

Figure 2: Sectoral Patterns of Default and Guarantee Coverage



Note:
Blue bars show the average default rate for guaranteed loans in each sector between 2013 and 2024. Orange markers indicate the average share of each loan covered by the guarantee (coverage ratio).

- ***Borrowing costs remain high and uneven.***

  Borrowing costs and default risks vary widely across facility types. Term loans attract the highest rates at 26.4 percent and the highest default rate of about 10 percent, while guarantees and bonds are priced lowest at 7.8 percent with minimal defaults. The strong link between risk and pricing indicates that banks adjust rates according to perceived credit risk, yet the wide dispersion suggests limited pass-through of guarantee benefits to borrowers. Overall, guarantees seem to reduce lender exposure more than they ease borrowing costs for higher-risk MSMEs. (See Figure 3.)

- ***Collateralization Remains High Despite Guarantees***

  Across sectors, the majority of guaranteed loans remain collateralized, with shares exceeding two-thirds in manufacturing, construction, and trade. This pattern shows that guarantees are being used alongside—rather than in place of—traditional security instruments. The approach provides comfort to lenders and mitigates portfolio risk but limits the scheme's capacity to expand credit access for firms lacking tangible collateral. The persistence of collateral requirements, even under a guarantee framework, suggests that financial institutions continue to rely heavily on asset-based lending practices rather than risk-based credit assessment.

Figure 3: Borrowing Costs and Default Risks Across Facility Types

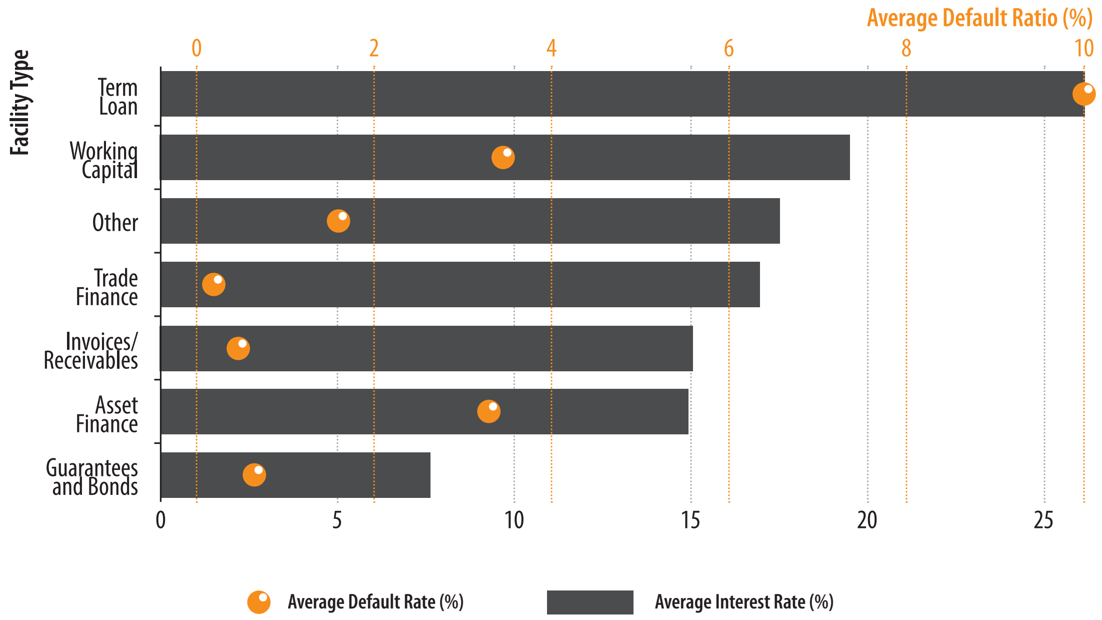
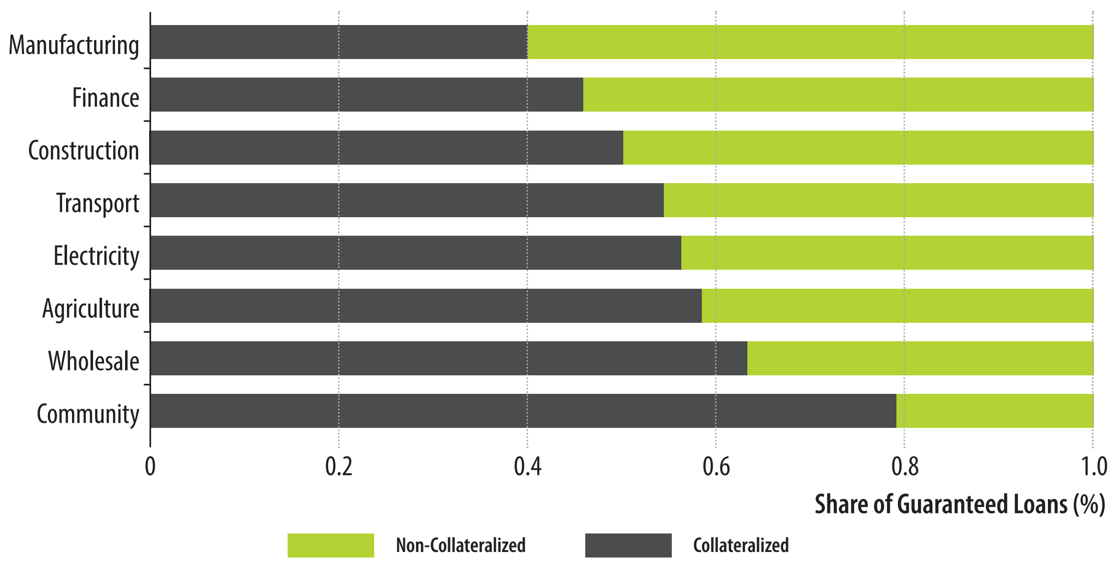


Figure 4: Collateralization of guaranteed loans by sector



Econometric Insights

The underlying study used a fractional logit model to estimate default probabilities and an Ordinary Least Squares (OLS) model to assess borrowing costs. The fractional logit approach, suitable for proportion data, examined how loan, sectoral, and guarantee features influence default risk, while the OLS model captured pricing behavior. Results show that higher guarantee coverage modestly lowers default risk, especially in high-risk sectors such as agriculture and community services, though collateral remains the strongest predictor of repayment. In the pricing model, both guarantees and collateral reduce interest rates, but their interaction indicates a substitution effect—the benefit of a guarantee diminishes once a loan is already secured.

Overall, guarantees help reduce lender risk but have limited impact on lowering borrowing costs. Stronger incentives for lenders to pass on risk-sharing benefits and a move toward risk-based coverage could improve both efficiency and inclusion in MSME finance.

3. Conclusion and Policy Recommendations

Kenya's partial credit guarantee system has proven effective in expanding MSME lending and reducing defaults, especially in high-risk sectors such as agriculture and community services. Yet, its full potential to lower borrowing costs and broaden inclusion remains unrealized. The uniform 50 percent coverage, fixed fee structure, and limited oversight constrain the scheme's ability to adapt to varying borrower risk profiles and to incentivize banks to pass on the benefits of risk sharing. Guarantees have therefore succeeded in protecting lenders but have done less to transform MSME access to affordable credit.

To strengthen the developmental impact of guarantees and align Kenya's system with global best practice, a shift toward smarter, risk-based design and stronger institutional governance is required.

1. **Adopt differentiated, risk-based coverage ratios:** Move away from a single coverage level toward a tiered structure that reflects borrower and sector risk. Higher coverage (70–80 percent) should support women, youth, start-ups, and agriculture, while standard segments retain moderate levels (40–50 percent). This mirrors the adaptive frameworks used by Korea's KODIT and Chile's FOGAPE, which balance outreach and fiscal sustainability.

2. **Introduce risk-based and performance-linked fees:** Guarantee fees should reflect portfolio quality and lender performance, rewarding prudent lending and deterring moral hazard. Variable pricing mechanisms—used successfully in Chile and Korea—can sustain the fund's capital base while encouraging responsible intermediation.

3. **Strengthen the pass-through of risk-sharing benefits:** Guarantee participation should be conditional on demonstrable reductions in lending rates or expanded outreach to underserved clients. Linking renewals or rebates to pricing transparency would ensure that MSMEs, not just banks, benefit from the guarantee's risk mitigation.

4. **Institutionalize governance and autonomy:** Transforming the National Treasury's Credit Guarantee Scheme into an independent, professionally managed entity under the oversight of the Central Bank of Kenya would enhance credibility, accountability, and operational efficiency. International experience shows that institutional independence—such as in KODIT and Morocco's TAMWILCOM—builds market confidence and improves fiscal discipline.

5. **Build an integrated national guarantee framework:** Kenya's guarantee landscape spans multiple actors, including the Treasury CGS, African Guarantee Fund, and DFI-supported programs like ARIZ and DFC. Establishing a coordinated platform would harmonize eligibility rules, enable data sharing, and reduce duplication, ensuring a coherent, system-wide approach to MSME risk-sharing.

6. **Enhance transparency and performance monitoring:** Regular public reporting on sectoral coverage, loan performance, and pricing outcomes will strengthen accountability and provide feedback for adaptive program design. Benchmarking against international CGS evaluation standards will help ensure both additionality and fiscal prudence.

In conclusion, Kenya's Credit Guarantee Scheme stands at a pivotal point. By embracing risk-based design, institutional independence, and transparent governance, the scheme can evolve from a narrow credit support tool into a cornerstone of inclusive, market-based MSME finance—fully aligned with the goals of Vision 2030 and the Bottom-Up Economic Transformation Agenda.

4. Selected References

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