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POLICY BRIEF

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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Credit Guarantee Schemes And Msme Financing In Kenya: A Firm – Level Analysis

Executive Summary

In Kenya, it is estimated that MSMEs employ over 15 million people and contribute about 30% to the national Gross Domestic Product (GDP). However, despite their pivotal role in the economy, MSME's access to formal credit has been hindered largely by lack of or inadequate collateral. Credit guarantee schemes which provide a third-party credit risk mitigation to lenders through absorption of a portion of the lender's losses on the loans to MSMEs in case of a default have been used to de-risk MSME credit access.

This study seeks to examine the effects of these credit guarantee schemes on Micro, Small and Medium-sized Enterprises (MSME) lending. Specifically, the paper examined the performance of a specified credit guarantee scheme, effect of the credit guarantee scheme on MSME loan default probability and how loan repayment performs across different sectors.

The study utilized bank level data for 2,398 MSMEs under the specified credit guarantee scheme and found out that the credit guarantee scheme improves MSMEs access to formal credit. Furthermore, low default rate was reported based on firm count. Regarding credit guarantee coverage ratio – default probability nexus, this study established existence of moral hazard effect which is statistically significant. However, across different sectors, short run models find credit guarantee moral hazard sectoral bias, largely elevated in agriculture, building and construction, trade and manufacturing sectors. Additionally, default risk was found to reduce with firm age.

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The Centre for Research on Financial Markets and Policy®

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1. Context and Importance

In Kenya, it is estimated that MSMEs employ over 15 million people and contribute about 30% to the national Gross Domestic Product (GDP). However, despite their pivotal role in the economy, MSME's access to formal credit has been hindered largely by lack of or inadequate collateral. Credit guarantee schemes which are simply an arrangement where there is provision of a third-party credit risk mitigation to lenders through absorption of a portion of the lender's losses on the loans to MSMEs in case of a default have been used to de-risk MSME credit access.

Scanty empirical evidence is observed in the African context due to micro data availability, few guarantee schemes and failure in some initiated schemes. The sampled empirical studies do not firmly conclude that credit guarantees promote credit access by the scheme's targeted group. In addition, the studies seem to adopt a general view of the credit guarantee schemes thus, being mute on firm level characteristics such as firm size, age, sector of operation and loan use even though they are likely to significantly affect credit guarantee scheme effectiveness.

Following inconclusiveness on the performance of credit guarantee schemes from the available literature covering various economies, this study seeks to assess their performance by analyzing a specific credit guarantee scheme utilization in Kenya, its quality of portfolio and coverage ratio – default probability nexus. The coverage ratio-default probability helps to substantiate the moral hazard effect of credit guarantee scheme among MSMEs.

2. Methods and results

To determine the performance of the credit guarantee scheme, we examine the level of repeat MSMEs for the scheme in terms of facility enhancement either on coverage ratio or on loan amounts. Then, to examine the effect of credit guarantee schemes on probability of MSME loan default, the study employs a probit model to analyze probability of default for firms given the guarantee coverage ratio, amount of credit and firm level characteristics. The Probit model is preferred to the logit model because the study seeks to model latent behaviour in loan default. Moreover, the probit model assumes the error term is normally distributed.

The results indicate that credit guarantee schemes improve MSMEs access to formal credit and create a moral hazard effect. More specifically, the study established that:

- Using bank level data for 2,398 MSMEs under the scheme, the study found that credit guarantee scheme has improved MSMEs access to formal credit. Out of the total firms covered, 392 firms representing 16.3 percent have sought for facility renewal upon the expiry of the previous facility. Furthermore, 12.4 percent have sought for the enhancement of their previous facility either in loan amounts or in coverage ratio.

- Regarding the portfolio quality, the study established that out of the 2,398 MSMEs analyzed, 198, equivalent to 8.3 percent had defaulted on their loan repayment. This result represents low default on firm count basis implying good credit quality.
- Then finally, concerning credit guarantee – default probability nexus, the study established existence of moral hazard effect, though statistically insignificant. However, sector wise, short run models indicate credit guarantee moral hazard sectoral bias, largely elevated in agriculture, building and construction, trade and manufacturing sectors. On the other hand, default risk was found to reduce with firm age and increases with loan amount.

3. Policy recommendations

The key policy issues arising from the study are:

- Based on the study finding that credit guarantee schemes enhance MSME credit access above the available suitable collateral level, we recommend for provision of incentives for lenders to engage into more or enhanced partnership with credit guarantee institutions.
- The Existence of elevated sectoral moral hazards effect of credit guarantee calls for need for sector differentiated credit scoring models for credit guarantee backed lending as opposed to a standard or vanilla credit scoring model. This is likely to lower default probability. Moreover, the findings form valuable input into the review of credit standards and redesign of current credit guarantee schemes.
- Additionally, the firm-age effect findings point toward a need for financial institutions to train their customers on entrepreneurship, especially young MSMEs.

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