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POLICY BRIEF

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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

Unlocking MSME Credit - Sector Specific Insights from Kenya

Executive Summary

This study examines the sector-specific drivers of MSME credit allocation in Kenya, focusing on Trade, Real Estate and Transport & Communication sectors, which collectively receive over 70% of bank MSME loans. Despite the MSME sector's substantial contribution to GDP and employment, access to credit remains limited. Using quarterly panel data from 2012 to 2024 and applying sectoral ARDL models, the analysis shows sectoral heterogeneity in credit responses to liquidity, interest rates, non-performing loans (NPLs) and sectoral economic performance. Key findings suggest that targeted, sector-specific credit interventions are needed to unlock MSME finance sustainably

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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) play an improtant role in Kenya's economy, contributing more than a third to GDP and accounting for over 85% of non-farm employment forming the core of job creation across both urban and rural areas. Recognizing their potential, the Kenyan government has set a policy target to expand MSMEs' GDP contribution to 60%. However, persistent financing constraints have impeded this ambition.

Despite their economic importance, access to finance remains one of the most significant barriers to MSME growth and sustainability. Only 20–23% of MSMEs have access to bank financing which is a reflection of structural limitations such as lack of collateral, poor documentation, limited credit histories and banks' perceived high-risk profiles of the MSME segment. The financing gap is estimated at KES 2.5 trillion, underscoring the urgency for both policy and market-based solutions.

A closer look at available credit data reveals that this challenge is not uniform across sectors. More than 60% of MSME credit is concentrated in three key sectors: Trade, Real Estate and Transport & Communication. However, credit allocation to these sectors has varied significantly in the wake of regulatory shifts and macroeconomic shocks. Trade tends to attract the largest share of MSME loans but remains highly vulnerable to credit tightening due to rising NPLs. Real estate, despite high capital needs, shows weak alignment between credit allocation and sectoral output. Transport & communication, while dynamic and responsive to economic shifts, is the most sensitive to cost of credit and regulatory changes.

This sectoral disparity in credit access is particularly problematic given the diverse capital needs, risk profiles and growth patterns of MSMEs operating in different industries. Yet, existing credit policy and risk assessment frameworks remain largely aggregate in nature therefore failing to account for these sector-specific dynamics. The result is an inefficient allocation of capital, underutilized lending capacity among banks and an uneven landscape of financial inclusion.

The challenge is further compounded by historical and regulatory factors. The 2016–2019 interest rate cap regime, introduced to protect borrowers from high lending rates, had unintended consequences for MSMEs. This policy-induced distortion in credit markets disproportionately hurt MSME lending in sectors that depend heavily on relationship banking and require flexible risk-based pricing.

Moreover, Kenya's credit infrastructure, while improving, still lags in enabling differentiated risk assessment. Until recently, limited coverage of credit bureaus and inconsistent financial records among MSMEs made it difficult for lenders to segment risks appropriately. This led to an overreliance on collateral and risk avoidance by banks, especially during periods of economic uncertainty such as the COVID-19 pandemic.

In this context, this study seeks to respond to a critical policy and research gap: understanding how sector-specific drivers influence MSME credit allocation. Unlike previous studies that treat MSME lending as a homogenous block, this paper introduces a disaggregated analysis using panel data and ARDL models for the three dominant MSME sectors. By doing so, the study provides evidence on how sectoral GDP (as a proxy for demand), NPLs, bank liquidity and interest rates shape MSME credit patterns across different industries. It also evaluates the effect of the interest rate cap as a structural policy shock.

This more granular approach has important policy implications. As Kenya rolls out KESONIA and embraces risk-based pricing, its national credit information system and enhances its digital finance ecosystem, understanding the heterogeneity of credit dynamics at the sector level is vital. This will enable regulators to design smarter interventions, support banks in adopting data-driven risk pricing models and inform blended finance programs that can target underserved MSME segments more effectively.

Ultimately, unlocking MSME credit in Kenya will require a shift from aggregate-level policy tools to sector-sensitive strategies that reflect the real-world conditions under which MSMEs operate. This study contributes to that shift by offering timely evidence on what drives credit supply in Kenya's most MSME-intensive sectors and how these drivers interact with policy and market structures.

2. Methods and Results

The study utilizes quarterly panel data from Q1-2012 to Q4-2024, covering three MSME-intensive sectors: Trade, Real Estate and Transport & Communication. To capture both short-run dynamics and long-run equilibrium relationships, the research employs sector-specific Autoregressive Distributed Lag (ARDL) models. The models are suitable for data with mixed integration orders (I(0) and I(1)) and are effective in small sample sizes

The dependent variable is the natural logarithm of credit extended to MSMEs in each sector. Independent variables include sectoral GDP (proxy for credit demand), non-performing loans (NPL) ratios (proxy for credit risk), banking sector liquidity ratios (proxy for supply-side constraints), weighted average lending interest rate (proxy for cost of credit) and an Interest rate cap dummy variable (policy shock: Q3 2016 to Q3 2019)

The results show sector-specific heterogeneity in the responsiveness of MSME credit to these variables:

- In the Trade sector, credit allocation is strongly influenced by sectoral GDP, reflecting a demand-driven pattern. However, the sector is vulnerable to short-run NPL shocks.
- Real Estate lending is largely decoupled from sectoral output and is significantly constrained by banking sector liquidity. This suggests that credit to this sector is supply-driven and more sensitive to systemic financial conditions.
- The Transport & Communication sector shows the highest sensitivity to interest rates and policy shocks, with credit flows adjusting rapidly to macro-financial changes. This indicates a high degree of financial responsiveness but also vulnerability.

Across all sectors, liquidity ratios exhibit a consistent negative relationship with MSME credit. This indicates that even in times of surplus liquidity, banks may prefer risk-free lending over MSMEs thus emphasizing the need for incentives or guarantees to redirect credit to productive enterprise sectors.

The interest rate cap period is found to have significantly constrained MSME credit flows, especially in transport and real estate. This underscores the adverse effect of blunt policy tools on access to finance for risk-perceived segments like MSMEs.

3. Policy Inferences

The findings of the study yield several important policy inferences:

- Targeted Sectoral Interventions: MSME financing interventions should be customized by sector. For Trade, sector-specific credit guarantees and risk-sharing facilities should be introduced to buffer against short-run NPL shocks. For Real Estate, long-term financing mechanisms such as infrastructure bonds or public-private refinancing schemes should be prioritized to ease liquidity constraints. For Transport & Communication, concessional finance and interest rate subsidies can help stabilize credit access.
- Shift from Blunt to Risk-Based Credit Policies: The adverse impact of the interest rate cap highlights the need to move away from uniform rate controls toward differentiated, risk-based lending frameworks. With improved credit infrastructure through risk-based pricing and KESONIA, banks should be encouraged to price credit according to borrower risk.
- Leverage Digital and Alternative Credit Channels: Policymakers should promote digital lending models that use alternative data sources such as mobile money and utility payment histories. Ecobank Ghana's experience with mobile-based credit scoring can be replicated. Furthermore, Islamic finance tools like mudaraba or musharakah can help diversify MSME financing, especially for microenterprises hesitant to take on debt.
- Strengthen Credit Risk Infrastructure: MSME creditworthiness can be enhanced by fully integrating KESONIA with digital platforms, expanding the movable collateral registry and improving property titling. These tools will allow banks to extend more credit with better risk management and reduce reliance on traditional collateral-heavy methods.
- Promote Data-Driven Policymaking: Regulators and financial institutions should regularly assess sector-level credit allocation trends to ensure alignment with economic development goals. Disaggregated credit data should inform credit guarantee programs and sector support interventions.

In conclusion, unlocking MSME credit in Kenya requires a multi-dimensional approach that is data-driven, sector-sensitive, and digitally enabled. This study provides a robust empirical foundation to support such an approach and calls for collaborative policy action among regulators, banks, and development partners.

References

Unlocking MSME Credit - Sector Specific Insights from Kenya - Stephanie Kimani (2025).

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