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Towards a Framework for Sustainable Bank Financing of Small and Micro Enterprises (SMEs) in Kenya

Executive Summary

Data from the Central Bank of Kenya show that, in the 12 months to December 2024, the banking sector generated approximately 35.3% of its overall lending-related income from the MSME sector, almost half of which was from small and microenterprises (SMEs). During the same period, banks and microfinance institutions extended less than 20% of their combined credit to SMEs. This paper explores reasons for the suboptimal lending by banks to SMEs using an analytical framework that draws from the literature and lending practices in different contexts. The major reason for low SME lending by banks is perception of higher risks which has made the banking sector: (i) demand high collateral from SMEs, (ii) offer less credit to SMEs than they need, and (iii) apply higher credit standards when evaluating SMEs. In turn, SMEs, out of bad experience with banks (and other lenders), have become discouraged from seeking credit from them, opting instead for retained profit and, the usually more expensive, informal lenders.

Experiences in Kenya and other banking markets show that banks, regulatory agents, and other interested market participants such as development banks, philanthropists and governments have attempted to address the credit squeeze on SMEs using many approaches including (i) relationship lending, which allows banks to acquire, over time, proprietary qualitative (soft) information on the SMEs and their owners which they can combine with hard information from loan application documents to make better informed decisions about them (SMEs), (ii) blended finance, and (iii) guarantees and interest subsidies, to lower the risk of default (derisking) of the SMEs, (iv) application of the securitization concept to mobilize additional funds to support SME lending, (v) adoption of value chain finance and aggregation strategies to reduce the risk of default and, hence, to ease bank demand for collateral, and (vi) SME capacity building through upskilling on financial literacy, business and financial management, proposal preparation, and developing pitch decks, to enable more of them (SMEs) to qualify for bank loans.

Given these findings, the study recommends several interventions that, when undertaken, may increase bank lending to SMEs. The interventions include suggestions for several policy and regulatory changes such as (i) amendments to the agency banking regulations and guidelines to enable bank agents to gather soft (qualitative) information about SMEs and pass it on to bank loan officers to facilitate better decisions, (ii) adoption of Islamic blended finance principles especially to finance SMEs that operate on the principle of 4Zeros-SS, and (iii) amendments to the securitization law to facilitate securitization of SME loans and SMEs' future cash flows to mobilize additional finance to support SME lending.

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1. Context and Findings

In Kenya, small and micro enterprises (SMEs) account for over 90% of private sector businesses, contributing 24% of GDP and 93% of total labour force. However, lack of finance has been a key impediment to SMEs' growth in the country as recent surveys show that only about 53% of them have access to credit. Because of the difficulties of getting finance, SMEs are forced to rely largely on their internal finance (e.g., retained profits) which is insufficient, supplemented by the often more expensive informal credit. This constrains their long-term growth and survival. Given these observations, this study sought to explore innovative approaches for motivating banks to address the SME financing gap. Deploying an analytical framework that relies on theoretical and empirical literature the paper documents several reasons explaining the financing gap, including:

1. Banks consider SMEs to be riskier than larger and more established businesses, because:
   - SMEs often deal in a small number of emerging product or service lines for which there may be no established market niche.
   - Although possibly knowledgeable in one aspect of the enterprise (e.g., formal training in "mechanics"), SME owner-managers may have limited ability in other areas that are crucial for successful business operation (e.g., financial management).
2. Banks find it difficult to obtain reliable information about trading activities of SMEs. Why?
   - Small enterprises often have limited or no trading and/or financial history.
   - Because of limited formal training in business sciences, small business owner-managers struggle to prepare business proposals that are adequately informative about their current business operations and possible future performance.
3. Because of the problem of unreliable information about SMEs, banks apply more stringent credit standards when evaluating SME applicants than with larger firms, which often disqualifies many SMEs. Additionally, when SMEs qualify for the loans, banks charge them higher interest rates because of the higher uncertainty associated with SME lending.
4. To increase the safety of the money lent to SMEs, banks regularly ask for security (collateral) from small businesses. However, because SMEs typically possess more soft assets (the entrepreneur's innovative ideas) than hard assets (e.g., machinery), many of them struggle to raise the security demanded by banks.
5. Banks offer less credit to SMEs than the amount that they (SMEs) require and at interest rates that maximize banks' profits rather than those that SMEs are willing to pay for the loans that they are denied.

6. Banks interested in increasing lending to SMEs build relationships with them and use the information gathered over time about them to make decisions to grant them more credit. In some cases, banks exploit technological advances to help them convert the information they have about SMEs into useful information to better understand the risks of lending to SMEs and to assist in their decision-making processes; and
7. Because of their previous bad experiences with banks, many SMEs get discouraged from approaching banks to ask for loans.

2. Policy Implications

Several policy suggestions can be gleaned from the study's findings as follows:

1. Review agency banking regulations

Since its introduction in Kenya in 2009, agency banking has realized substantial growth, with cumulative value of transactions since 2010 of KES 11.56 trillion. However, the growth in agency banking has not had notable impact on SME credit. A Central Bank of Kenya (CBK) report attributes the weak performance partly to increased competition from alternative lenders, such as SACCOs. Because of their intimate knowledge of borrowers, SACCOs are in a better position than banks to get better quality information about SMEs. Thus, one way to promote bank lending to SMEs is to "equalize" them with SACCOs, by relaxing agency banking requirements, for example, to allow bank agents to gather qualitative information about SMEs and to share the information with bank loan officers for improved decisions. Specifically, it would be useful if CBK could amend the agent banking guidelines to:

- Make it a legal requirement that all aspiring bank agents be capacitated in loan appraisal before they are granted the agency contract/license, and,
- For purposes of executing this requirement, develop a working legal definition of SME, which should, among others, speak to the size of the loan being applied for.

2. Broaden blended finance applications

A novel application of the blended finance concept has recently been proposed, which incorporates Islamic finance principles. In the new model, a private sector financier (e.g., a bank operating on Sharia-banking principles) provides commercial finance to the borrower, with an Islamic social fund such as *Zakah*, *Waqf*, *Sadaqa*, and *Qard* and a public sector facilitator providing additional capital to derisk the SME. Because of the zero-interest charge resulting from this structure, the proposed design is particularly appropriate for financing ESG-compliant SMEs operating on the principle of *4Zeros-SS* (zero-waste, zero-emissions, zero-interest, zero-foreclosures, and service to society) to hedge their performance from the negative effects of the additional costs of doing business that they are likely to incur.

To implement this new blended finance approach, it is recommended that:

- The government of Kenya considers developing an institutional framework to guide the creation and application of the Islamic bended finance structure.
- The Capital Markets Authority considers an amendment to the regulatory framework on investment companies specifically to facilitate Islamic funds.
- Alongside the policy/regulatory changes, CBK should consider developing a set of implementation guidelines covering blended finance principles in general and Islamic blended finance specifically.

3. Consider securitization of SME loans

Under the envisaged securitization, a bank (the originator) bundles a package of SME loans into a pool, which it sells to capital market investors via a special purpose vehicle (SPV) formed for that purpose. Through securitization, banks can mobilize additional funds form the capital market to facilitate SME lending. However, the implementation of a securitization program must be preceded by regulatory provisions that specifically address, and lay the groundwork for, their application to SMEs. This therefore calls on CBK and Capital Markets Authority to amend various regulations to:

- Make adequate provisions to, for example, back the securitized assets adequately with high quality assets to protect capital market investors in the securitized portfolios.
- Mitigate barriers to issuance and investment in the securitized assets (e.g., high operational costs for issuers and investors), improve transparency in the issuance process, supervision and investor protection.
- Adjust the prudential framework for banks to better account for risks and safeguard financial sector stability; and to remove disincentives for institutional investors (e.g., insurance and asset management firms) to participate in the securitization market.

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