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THE CENTRE FOR RESEARCH ON FINANCIAL MARKETS AND POLICY®

# Discouraged Borrowers and Access to Finance: Evidence from Kenyan SMEs

## Executive Summary

*This brief focuses on the incidence and determinants of credit rationing and borrower discouragement among Kenyan SMEs. Only about onequarter of firms report no financing obstacles, while the majority face constraints of varying severity. Younger, informally registered, femaleowned, and unaudited firms are significantly more likely to be constrained, consistent with informational opacity and limited collateral. Credit application patterns indicate extensive selfexclusion: roughly threequarters of SMEs do not apply for loans despite plausible financing needs, citing anticipated rejection, high interest rates, collateral requirements, or other perceived deterrents. Among those who apply, approval rates exceed 90 percent, suggesting that effective rationing arises mainly from preapplication barriers rather than lender denial. These findings indicate that frictions—limited transparency, weak disclosure, and elevated borrower risk perceptions—play a central role in suppressing SME participation in the formal credit market. Policies that expand collateral substitutes, strengthen credit information systems, and support financial reporting could alleviate these frictions and broaden access to credit.*

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## 1. Introduction

**Access to finance is macrocritical for Kenya's SMEs—central to growth, jobs, productivity upgrades, and resilience.** Under information opacity and weak enforcement, credit markets do not clear by price: higher rates worsen borrower selection and risktaking, lenders cap quantities, and collateral screens imperfectly when assets are illiquid (Stiglitz and Weiss, 1981; Bester, 1985; Besanko and Thakor, 1987). Monitoring and verification costs further compress supply (Townsend, 1979; Williamson, 1986, 1987). An increasingly important extensivemargin channel is discouragement: firms selfexclude when they anticipate rejection or view terms as prohibitive, meaning exclusion often occurs before any application (Kon and Storey, 2003; Beck and DemirgüçKunt, 2006). Kenya's high account ownership—about 90.1 percent of adults—shows that basic financial access is widespread, yet credit frictions persist, underscoring that the challenge lies not in account access but in graduating into formal credit.

Empirical patterns align with these mechanisms. Larger firms access more credit; very young firms and stagnant older firms are disadvantaged; womenowned firms face penalties; audited disclosure and formalization reduce opacity; and sectoral risk matters more than location (McCarthy, Lok, and Morrissey, 2015; Kallandranis and Drakos, 2021; Yu, 2021; Beck, DemirgüçKunt, and Maksimovic, 2005). Kenya's facts echo these regularities. The country has about 7.4 million MSMEs employing roughly 14–15 million people and contributing about onethird of GDP. As at end2024, banks reported approximately 0.89 million MSME loan accounts totaling KSh 784.4 billion—about onefifth of total credit. Microenterprises hold around 80 percent of accounts but only 11 percent of portfolio value, while mediumsized firms hold over 60 percent of loan value with under 10 percent of accounts. Average MSME borrowing costs were about 16.4 percent in banks and 26.3 percent in microfinance banks, and MSME NPLs were approximately KSh 150 billion—nearly onefifth of total NPLs—indicating persistent price and nonprice rationing. Reforms are underway: the Movable Property Security Rights framework and collateral registry aim to broaden eligible collateral, while digital credit provider licensing seeks to curb predatory practices and enhance transparency. However, these gains have yet to significantly ease constraints for smaller, assetlight firms.

This policy brief uses Kenya's 2018 World Bank Enterprise Survey to quantify the prevalence and severity of financing constraints across firm age, size, formality, female ownership, transparency, sector, and region; to decompose exclusion into discouragement versus rejection; and to estimate the determinants of application and, conditional on applying, approval. The results show that threequarters of firms report financing obstacles; only onequarter apply for credit; most nonapplicants cite high interest, collateral requirements, application complexity, or expected rejection; yet most applicants receive full or partial approval. This indicates that preapplication discouragement—not postapplication denial—is the dominant margin of rationing, consistent with supplyside evidence of high rates and stringent collateralization.

Policy priorities are threefold—and should be sequenced to address discouragement first. First, reduce borrowing frictions by standardizing required documentation, publishing clear turnaround and fee disclosures, and enforcing fairpricing rules across both bank and digital lending channels. Second, broaden collateral and share risk for assetlight firms by deepening adoption of the movable collateral registry (receivables, inventory, equipment) and scaling risksharing instruments. Third, strengthen information and inclusion infrastructure—richer positive

data for credit bureaus, interoperable einvoicing and receipt systems, and robust digitalcredit oversight—to lower verification costs. Crosscutting measures should close gender gaps and derisk vulnerable sectors. Importantly, Kenya's public Credit Guarantee Scheme remains modest in scale, with cumulative disbursements of only KSh 6.2 billion by end2023—less than 1 percent of MSME credit—highlighting the need for targeted expansion to meaningfully support firsttime borrowers.

## 2. Review of related literature

The literature on SME finance converges on a common analytical foundation: persistent information asymmetries generate involuntary credit rationing, and the extent of rationing is mediated by firm attributes and the quality of supporting institutions. Canonical models show that higher interest rates can adversely select borrowers and induce riskshifting, preventing markets from clearing even in competitive environments (Stiglitz & Weiss, 1981). Collateral can partially mitigate informational frictions, yet its effectiveness declines when assets are illiquid, weakly enforceable, or of low recovery value (Bester, 1985; Besanko & Thakor, 1987). High verification and enforcement costs—common in settings with slow judicial processes and limited registry coverage—further restrict the supply of credit (Townsend, 1979; Williamson, 1986, 1987). These mechanisms jointly create structural constraints that market forces alone cannot resolve.

Crosscountry evidence reveals substantial heterogeneity in credit access. Smaller, younger, and femaleowned firms consistently face higher constraints, whereas formalization, audited financial statements, and accumulated credit histories reduce informational gaps. Firms operating in manufacturing and urban areas tend to benefit from stronger financial ecosystems compared with those in services, agriculture, and rural locations. Relational lending, business associations, and thirdparty certifications act as partial substitutes for collateral, and exporters gain reputational advantages in foreign markets. At the same time, innovation—while raising future growth potential—tends to weaken collateral positions, increasing lender uncertainty (Berger & Udell, 1998; Aterido, Beck, & Iacovone, 2013; McKenzie & Woodruff, 2008; Fafchamps & Schündeln, 2013; Hall & Lerner, 2010; Manova, 2013; McCarthy, Oliver, & Song, 2015; McNamara, O'Donohoe, & Murro, 2020; Yu, 2021). Across these studies, a consistent theme emerges: institutional capacity—rather than firm demand—largely determines how effectively lenders can distinguish risk from noise.

A growing body of work highlights discouragement as a critical extensivemargin mechanism. In many developing economies, a substantial share of creditconstrained firms never apply for loans due to anticipated rejection, perceived procedural complexity, or expected collateral shortfalls. These discouraged firms frequently outnumber formal rejections, implying that applicationbased metrics significantly understate exclusion (Kon & Storey, 2003; Brown, Ongena, Popov, & Yesin, 2011; Han, Fraser, & Storey, 2009; Wernli & Dietrich, 2022). Discouragement reflects not only firmlevel perceptions but also systemic features—opaque lending processes, weak contract enforcement, inconsistent collateral practices, and limited transparency around lender criteria.

For African—and particularly Kenyan—SMEs, these constraints are amplified by thin asset bases, informality, and gaps in credit information systems. The emerging policy message is clear: easing rationing requires complementary interventions that lower information and monitoring costs, broaden the scope and enforceability of movable collateral, strengthen credit information architecture, and address discouragement directly. In the Kenyan context, this implies focusing not only on expanding supplyside financing instruments but also on enhancing the visibility and credibility of SMEs within the financial system. The "quiet margins" of the credit market—where nonapplicants remain unobserved—represent a large reservoir of unrealized entrepreneurial investment and are likely where welldesigned reforms can have the highest marginal impact.

## 3. Findings and Discussions

### 3.1 Perceived Financing Obstacles and Firm Heterogeneity

Access to finance is a pervasive constraint for SMEs: only 25.5 percent report no obstacle, 74.5 percent face at least some constraint, and 23.8 percent cite major or severe obstacles. Constraints vary systematically by firm attributes. Young firms are most exposed—35.7 percent of firms under three years report finance as a major obstacle versus 23.2 percent for 3–5-year firms and 19.5 percent for older firms—while 27.0 percent of mature firms report no obstacle compared with 17.9 percent of young firms. Informality amplifies exclusion: major obstacles are 26.7 percent among informal firms versus 19.4 percent among formal, and only 18.9 percent of informal firms report no obstacle versus 26.2 percent of formal. Gender gaps persist: female-owned firms more often report moderate (27.8 percent) and major (21.2 percent) obstacles than male-owned (21.6 and 19.6 percent). Transparency reduces frictions: unaudited firms report higher major (22.2 percent) and very severe (6.6 percent) obstacles than audited firms (19.6 and 2.8 percent). Policy signals are clear: lower information and collateral frictions (credit registries, movable-asset finance, risk-sharing), incentivize formalization and audited disclosure, and deploy targeted inclusion instruments for young, informal, and women-owned firms.

### 3.2 Credit Applications, Discouragement, and the Dynamics of Rationing among SMEs

Credit market participation is low—only 24.6 percent of SMEs applied for finance, while 75.4 percent did not—signaling widespread self-exclusion. Among non-applicants, 59.9 percent reported no need, but sizeable shares cited high interest (11.7 percent), collateral requirements (5.6 percent), complex procedures (3.7 percent), and fear of rejection (3.6 percent). For firms that did apply, outcomes were largely favorable: 79.5 percent were fully approved and 12.6 percent partially approved, with 2.5 percent rejected, 1.7 percent withdrawn, and 3.8 percent pending. The binding constraint therefore lies before application, not after. Policy should convert non-applicants into applicants by reducing borrowing costs through risk-sharing mechanisms and process frictions.

**Table 1: Credit Applications, Non-Application Reasons, and Loan Outcomes among SMEs**

| Category | Sub-category | Statistics |
|---|---|---|
| Applied for new loans/credit (n=972) | Yes | 24.6% (239) |
| | No | 75.4% (733) |
| Reasons for not applying (n=733) | No need for a loan (sufficient funds) | 59.9% (439) |
| | Application procedures too complex | 3.7% (27) |
| | Interest rates unfavorable | 11.7% (86) |
| | Collateral requirements too high | 5.6% (41) |
| | Loan size/maturity insufficient | 2.6% (19) |
| | Did not think it would be approved | 3.6% (26) |
| | Other | 11.9% (87) |
| | Don't know (spontaneous) | 1.1% (8) |
| Loan outcomes (n=239) | Approved in full | 79.5% (190) |
| | Approved in part | 12.6% (30) |
| | Rejected | 2.5% (6) |
| | Withdrawn | 1.7% (4) |
| | Still under processing | 3.8% (9) |

### 3.3 Credit Applications and Rationing Dynamics by Firm Characteristics

***Diagnostic.*** Participation in formal credit markets is low: only 24.6 percent of SMEs applied; 75.4 percent did not. Application propensities vary systematically. Age shows a "mid-life dip" with 37.0 percent of firms under three years applied, 17.1 percent at 3–5 years, and 25.1 percent above five years. Informality does not suppress demand uniformly: informal firms applied slightly more than formal firms (25.8 vs 24.5 percent), suggesting necessity-driven demand. Perceived constraints correlate with application: 16.4 percent among firms reporting no obstacle, rising to 31.1 percent at moderate and 30.4 percent at major obstacles, then easing to 28.6 percent at very severe constraints—evidence of discouragement at the extreme. Female-owned firms applied more than male-owned (29.4 vs 20.5 percent). Audited disclosure is strongly associated with application (26.8 vs 16.1 percent).

***Interpretation.*** The binding margin is pre-application. Firms apply when needs rise, but extreme perceived obstacles trigger self-exclusion. Younger firms test markets; 3–5-year "survival-stage" firms face a squeeze; older firms benefit from reputation and collateral accumulation. Audits mitigate opacity and raise application likelihood. Gender gaps in networks and collateral likely drive higher application need among women-owned firms.

**Table 2: Credit Application Patterns across SME Characteristics**

| Category | Sub-category | Yes (%) | No (%) |
|---|---|---|---|
| Overall | Total sample | 24.6 | 75.4 |
| Firm Age | Under 3 years | 37 | 63 |
| | 3–5 years | 17.1 | 82.9 |
| | Above 5 years | 25.1 | 74.9 |
| Formality | Not formally registered | 25.8 | 74.2 |
| | Formally registered | 24.5 | 75.5 |
| Self-reported perceptions on credit constraints | No obstacle | 16.4 | 83.6 |
| | Minor obstacle | 22.2 | 77.8 |
| | Moderate obstacle | 31.1 | 68.9 |
| | Major obstacle | 30.4 | 69.6 |
| | Very severe obstacle | 28.6 | 71.4 |
| Ownership | Female-owned | 29.4 | 70.7 |
| | Male-owned | 20.5 | 79.5 |
| Audited Financials | Not audited | 16.1 | 83.9 |
| | Audited | 26.8 | 73.2 |

### 3.4 Discouraged Borrowers and the Determinants of Non-Application among SMEs

Non-application reflects discouragement more than denial: among SMEs that did not apply for credit, 59.7 percent reported no need, while 11.7 percent cited high interest, 5.6 percent collateral requirements, 3.7 percent application complexity, and 3.4 percent fear of rejection. Deterrents intensify with perceived constraints—interest concerns rise from 4.9 percent among unconstrained firms to 17.9–18.5 percent among constrained firms; collateral deterrence climbs from 2.0 to 24.0 percent. Heterogeneity is material: female-owned firms report higher rejection concerns (5.1 vs 2.4 percent) and greater sensitivity to collateral; unaudited firms report higher collateral deterrence (8.0 vs 4.9 percent) and rejection fears (6.2 vs 2.8 percent); very young firms are most interest-sensitive (17.7 percent), survival-stage firms show the highest rejection fears (7.6 percent), and older firms report lower concerns (11.3 percent interest; 3.1 percent rejection). Informality amplifies exclusion—rejection is 12.1 vs 2.7 percent, "other" barriers 19.7 vs 13.0 percent, and fewer report no need (45.5 vs 60.1 percent). Policy signal: counter discouragement with transparent pricing and simplified processes; expand collateral substitutes and guarantees; target women-owned and young firms; and incentivize formalization.

### 3.5 Loan Approval Patterns and the Dynamics of Credit Rationing among SMEs

***Diagnostic.*** Approval rates for applicant SMEs are high (82.6 percent full; 13.0 percent partial). Rejections are low (2.6 percent) and withdrawals rare (1.7 percent). Outcomes deteriorate as perceived constraints intensify: full approvals fall from 94.9 percent (no obstacle) to 60.0 percent (very severe), while partial approvals rise to 30.0 percent and rejections to 10.0 percent. Female-owned firms match full approvals (82.7 percent) but withdraw more (3.2 percent) and are less often rejected (1.6 percent) than male-owned (3.9 percent).

Audited firms fare better (83.4 percent full; 2.0 percent rejected) than unaudited (77.4 percent; 6.5 percent). Age effects are pronounced: 3–5-year "survival-stage" firms show the weakest outcomes (50.0 percent full; 33.3 percent partial; 16.7 percent rejected), while >5-year firms perform best (85.6 percent full; 1.8 percent rejected). Informality shifts outcomes toward partial approvals (18.2 percent) with near-zero recorded rejections.

***Interpretation.*** The binding margin for exclusion occurs largely **before** application (discouragement), but **within** applicants, rationing manifests as partial approvals and higher rejection where obstacles are severe. Audited disclosure mitigates information risk. The "valley of death" at 3–5 years reflects thin collateral, short track records, and tighter screening. Higher withdrawal among female-owned firms points to adverse term negotiations and hidden costs rather than outright denial.

**Table 4: Loan Outcomes and Rationing Patterns across SME Characteristics (% of Applicants)**

| Category | Sub-category | Approved in full | Approved in part | Rejected | Withdrawn |
|---|---|---|---|---|---|
| Overall sample | All firms | 82.6% | 13.0% | 2.6% | 1.7% |
| Credit Constraints | No obstacle | 94.9% | 2.6% | 2.6% | 0.0% |
| | Minor obstacle | 92.7% | 3.6% | 1.8% | 1.8% |
| | Moderate obstacle | 78.9% | 16.9% | 1.4% | 2.8% |
| | Major obstacle | 72.7% | 21.8% | 3.6% | 1.8% |
| | Very severe obstacle | 60.0% | 30.0% | 10.0% | 0.0% |
| Female Ownership | Female-owned | 82.7% | 12.6% | 1.6% | 3.2% |
| | Male-owned | 82.2% | 13.9% | 3.9% | 0.0% |
| Audited Financials | Not audited | 77.4% | 16.1% | 6.5% | 0.0% |
| | Audited | 83.4% | 12.6% | 2.0% | 2.0% |
| Firm Age | Under 3 years | 70.0% | 10.0% | 10.0% | 10.0% |
| | 3–5 years | 50.0% | 33.3% | 16.7% | 0.0% |
| | Above 5 years | 85.6% | 11.0% | 1.8% | 1.5% |
| Formality | Not formally registered | 81.8% | 18.2% | 0.0% | 0.0% |
| | Formally registered | 82.5% | 12.6% | 2.9% | 1.9% |

### 3.6 SME's Propensity of Credit Access

Probit estimates of SME credit access indicate that firm size strongly raises the probability of obtaining external finance (marginal effect +0.029, $p<0.01$), while firm age shows a modest negative effect (–0.038, $p<0.10$), implying disadvantages at very early and very late stages. Female ownership significantly lowers access, pointing to persistent gender gaps. Common information-quality proxies—audited accounts, certification, association membership—are directionally positive but statistically imprecise in this sample,

suggesting that current disclosure practices and incentives are too weak to shift lender behavior. Sectoral risks matter with food processing and tourism facing markedly lower credit probabilities, consistent with volatility, weaker collateral, and cyclicality. Geography is largely neutral once firm and sector are controlled for; one county exhibits a positive premium, indicating localized supply-side advantages. Policy should expand instruments that reduce appraisal and monitoring costs for smaller firms, deploy targeted guarantees and concessional lines to close gender gaps, tailor risk-based collateral and insurance for volatile sectors, strengthen credit information and audited disclosure with clear incentives, and replicate high-performing local models where measurable access premiums exist.

## 4. Conclusion and Policy Implications

Evidence from Kenyan SMEs shows that credit constraints stem less from postapplication rejection than from preapplication discouragement. A relatively small share of firms applies for credit; yet among those that do, most receive full or partial approval. This pattern is consistent with extensivemargin rationing documented across developing economies, where perceived barriers—rather than formal denial—drive exclusion from formal finance.

Firm characteristics remain central. Larger firms exhibit higher access, while financing likelihood follows an inverseU shape with respect to age: very young firms lacking track records and older firms experiencing stagnation face elevated constraints. Female ownership continues to carry a measurable penalty. Standard information proxies—such as audited accounts, business certifications, or association membership—exert limited influence on lender decisions, suggesting that collateral, relationship depth, and perceived cashflow volatility remain the dominant screening instruments. This aligns with broader regional findings where enforceability and relationshipspecific information override thirdparty documentation.Sectoral differences are substantial. Food processing and tourism face tighter supply conditions, reflecting higher volatility or seasonality in revenues, whereas location effects largely dissipate once firmlevel and sectoral characteristics are taken into account. Geography, therefore, is not a primary determinant of access aside from isolated countylevel advantages.

Three policy implications follow. First, reducing borrowing frictions—including simplifying loan procedures, improving transparency of creditworthiness assessments, and clarifying collateral requirements—can meaningfully shift firms from discouragement to application. Second, expanding collateral substitutes and strengthening risksharing mechanisms for assetlight firms is essential; instruments such as movableasset registries, partial credit guarantees, and cashflowbased lending frameworks can lower lender risk. Third, strengthening information and inclusion infrastructure—including richer credit data, interoperable digital records, and systems that improve lenders' ability to forecast cash flows—can enhance screening capacity and reduce reliance on collateral alone. Taken together, these measures target the institutional foundations of SME credit exclusion and address the extensivemargin discouragement that constrains Kenya's entrepreneurial growth.

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