

SME'S ACCESS TO CREDIT, A CASE OF KISII COUNTY – KENYA

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ABSTRACT

The banking sector comprises of 49 institutions, 42 of which are commercial banks, 3 mortgage finance companies, one non-bank financial institutions and one building society as at December 2008, according to CBK annual reports. Despite the long existence of commercial banks in Kenya, local, international and multinational, they have shied away from lending to small-scale businesses. It is a well-established fact that access to finance is a major determinant of economic growth (Beck, Levine, and Loayza, 2000). Therefore, access to finance, which has been one of the core topics in development for quite some time, has emerged on the agenda of nearly all governments. The important policy question is: what measures must be taken to foster access to finance? This study therefore attempted to find out lending conditions by commercial banks that affect small-scale business in Kisii County. The study found out that competition, pricing, Commercial banks tight bank requirement as important factor that affect accessibility of loans by SMEs by commercial banks. The study concludes that Majority of the population are locked out of the formal financial sector due to the many strict requirements and stringent conditions required by the banks for one to open an account or access credit because their information is not captured. Consequently, the study recommends that CBK should influence the interest rate.

Key words: commercial banks, access to finance, SME.

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INTRODUCTION

Most enterprises in the world as well as Kenyan ones face many obstacles for growth especially in finance. Small firms have only 30 percent of their capitals from external sources, while large firms obtain 48 percent of their capital from external finance sources (World Bank, 2004). Kauffman (2005) asserted that Africa's SMEs have little access to finance, which consequently hinder their emergence and ultimate development. Their major resources of capital are their retained earnings and informal savings and loan associations which are irregular, not very secure and have little scope for risk sharing because of their regional focus.

There exist many barriers for SMEs' access to bank loans, such as lack of mortgages, banks' unwillingness to lend to SMEs, problematic tax payment reports, unsound business plans, and high lending rates. Recent studies show that in Sub-Saharan Africa over 80 percent of the adult population lack an account in the early 2000s, well above the world average of 50 percent (Chaia et al., 2011; Honohan, 2008). The Central bank of Kenya has been struggling through its monetary policy committee to mobilize savings by increasing interest on deposits and reducing the bankers interest rate spread (Irungu, 2009). MSEs are generally undercapitalized, suggesting major operational difficulties in accessing credit and pursuing corporate goals.

Kenya has a reasonably sophisticated banking system with 45 licensed commercial banks and 5 representative offices of foreign banks. Commercial banks account for much of the total deposit in the country. The banks that dominate the commercial banking system in Kenya include Equity bank, cooperative bank, Barclays Bank, Kenya Commercial Bank and Standard Chartered Bank. It is critical to develop deep financial markets to cater for small business credit. They have difficulties accessing credit from the financial institutions i.e. a majority of them does not qualify to get loans because of the banks' requirements or due to the lack of information or risks associated with it or because of pricing. Financial deepening is positively associated with macroeconomic stability (low inflation) and an initially underdeveloped financial sector.

(Kimuyu and Omiti 2000) acknowledges the problem of macro level constraints, but emphasizes the greater explanatory powers of the relatively weak MSEs capacities including lack of tangible security and limited human capital. Small-scale businesses are taunted as engine for economic development in most developing countries because of their very nature-as majority of them are

located in the rural areas. Despite the long existence of commercial banks in Kenya- local, international and multinational, most of them have shied away from lending to small-scale business. Consequently, many small-scale businesses have been unable to grow despite their long existence while others have collapsed few years after their establishment.

Statement of problem

Access to credit has been considered as one of the main problems that SMEs have to deal with in order to survive and keep growing. An appropriate combination of access to credit, credit conditions, and adequate financial and operational policies, is the only way to deal with the complex problem of SMEs survival and growth. This study assessed the role of Financial Intermediation in promoting the growth of Small and Medium Enterprises (SMEs) with a special focus on manufacturing businesses in Nairobi. The issue and problems limiting SME acquisition of financial services include lack of tangible security coupled with inappropriate legal and regulatory framework, and limited access to formal financing due to poor and insufficient capacity. Small and Medium Enterprises are usually more credit constrained than other segments of the economy because of high cost of credit, low level of access to information on credit and complicated borrowing procedures.

Literature review.

A number of studies have shown that financing is a greater obstacle for SMEs than it is for large firms, particularly in the developing world, and that access to finance adversely affects the growth of the SME sector more than that of large companies (Beck et al, 2005; Beck et al, 2006). It is, therefore, unsurprising that the international development community has listed SME access to finance as an important policy priority.

Access to financial services by smallholders is normally seen as one of the constraints limiting their benefits from credit facilities. However, in most cases the access problem, especially among formal financial institutions, is one created by the institutions mainly through their lending policies. This is displayed in the form of prescribed minimum loan amounts, complicated application procedures and restrictions on credit for specific purposes (Schmidt and Kropp, 1987). For small-scale enterprises, reliable access to short term and small amounts of credit is more valuable, and emphasizing it may be more appropriate in credit programmes aimed at such

enterprises. Schmidt and Kropp (1987) further argue that the type of financial institution and its policy will often determine the access problem. Where credit duration, terms of payment, required security and the provision of supplementary services do not fit the needs of the target group, potential borrowers will not apply for credit even where it exists and if they do, they will be denied access. Rand et al's (2008) data in 2002 and 2005 showed that only 39% of the enterprises had applied for a bank loan in 2005; however, 19% of these firms experienced the problem that their total applicants were denied credit.

De la Torre et al (2010) investigate banks' approaches to SMEs in terms of business models and risk management systems. Based on surveys for 48 banks and one leasing company in 12 countries, the authors find that all banks in the sample are interested in serving the SME segment. To do so, almost all have separate organizational units and offer a wide range of products, applying different transactional technologies such as credit scoring or risk-rating systems. Lundvall et al. (1998) show that manufacturing enterprises in Kenya that have limited access to credit also tend to be less productive and can not always move to points of best practice. This indicates that since the MSE sector does not have adequate access to credit, its potential role in transforming the country is unlikely to be realized. Lack of tangible security by MSEs, the limited capacity, outreach and linkages by financial intermediaries and a hostile legal and regulatory framework for financial services are the main constraints.

Financial sectors in most developing countries are characterized by fragility, volatile interest rates, high-risk investments and inefficiencies in the intermediation process (Ndung'u and Ngugi, 2000). Widening interest rate spread is an indicator of the underlying weak institutional and policy set-up of the financial sector. Nonetheless small firms all over the world have faced significant difficulties in accessing funding. Sacerdoti (2005) asserts that faster economic growth will not be possible without a deepening financial system and in particular more support from the banking system. Financial markets in African countries are characterized by imperfect and costly information, risks and market segmentation resulting in credit rationing (Atieno, 2001). This implies that banks find it expensive to grant loans to small businesses even if they are liquid because it is costly to do so.

Ghatak and Guinane (1999) show that when compared to an individual liability contract, entrepreneurial effort will be strictly higher under peer group lending with joint liability, assuming, of course, that monitoring costs are low and social sanctions are effective.

Interest Rate is the main determinate of the amount of money borrowed. Rosen (2007) addressed the relationship between local banking markets and interest rate offered on deposits by the banks. But admits that even though market structure has an important impact on how banks set rates, the impact is very complex and that is why this factor is worth studying in the Kenyan situation.

Sacerdoti (2005) asserts that increased competition decreases the spreads between deposit rates and lending rates. It is reported in Kenya that all major banks are currently having a desk at their branches specifically dedicated to SME financing. The increased competition induces banks with better knowledge of local markets to expand loans to small businesses with beneficial effects on access to credit. Most enterprises in the world as well as Vietnamese ones face many obstacles for growth, especially in finance. The 2005 World Development Report (World Bank, 2004) showed that small firms had only 30 percent of their capitals from external sources, while large firms obtain 48 percent of their capital from external finance sources. There exist many barriers for SMEs' access to bank loans, such as lack of mortgages, banks' unwillingness to lend to SMEs, problematic tax payment reports, unsound business plans, and high lending rates. However, the situation is seen changing for the better in the coming time.

According to Berger, Klapper and Turk-Ariss (2009) establishes that a bank with a higher degree of market power also have less overall risk exposure. Again on the same context, increased competition for deposits lowers bank profitability and destroys franchise value as banks will be offering incentives and giving high interest rates so as to keep or attract depositors. This normally fuels moral hazard incentives putting both the customer and economy at a great risk of failure. It is also a known strategy that competitor banks normally price lower in order to lure the client and use that presented opportunity to establish a strong relationship and later reap the benefits of monopoly and this can also be found in the Kenyan context in the case of Equity bank. We find that the SME segment is a strategic priority for the banks in the region. SMEs are considered a profitable business prospect and provide an important opportunity for cross-selling. Banks consider that the SME lending market is large, not saturated and with a very positive outlook. A number of obstacles are, however, constraining further banks' engagement with the SME segment, including SME-related factors such as the lack of adequate information and

collateral as well as their largely family-owned structures. Another major factor associated to pricing and which leads to a negative perception of banks in most developing economies is the issue of transparency in their fee structure and this has led to a situation where potential consumers shun the formal financial sector in favour of the informal one for both their borrowing and savings needs (Tokle and Tokle, 2000).

Commercial banks and other formal institutions fail to cater for the credit needs of small holders in Kenya and this is mainly due to their lending terms and conditions which the entrepreneurs are not conversant with or are hard to be met by the small businesses (Atieno, 2001). Large banks do use quantitative methods on their decision making process while small banks rely heavily on personal interactions with loan applicants. The process being used to collect soft data is very expensive which definitely translates to higher interest rates charged by small banks that rely on such methods, it means that large banks charge lower loan rates and require less collateral than do small banks in general. Though according to Berger and Frame (2005), they state that small banks have a comparative advantage in making loans based on soft information and that studies have shown that stronger bank-borrower relationships are associated with better treatment for borrowers when it comes to lower interest rates and reduced collateral requirements.

Kimuyu and Omiti (2000) demonstrate that age is associated with access to credit. That is, older entrepreneurs are more likely to seek out for credit. younger entrepreneurs are less likely to access loans from banks in Kenya. Age is an indicator of useful experience in self selecting in the credit market. This self selection is an important aspect of decision making styles. Older entrepreneurs also tend to have higher levels of work experience, education, wealth and social contacts. These resources are important in developing key competencies. Therefore, superior age leads to higher levels of entrepreneurial orientation (Lore (2007)).

Formal education is thought to foster conformity and low tolerance for ambiguity and thus is an impediment to entrepreneurship. Education helps to distinguish entrepreneurs who access credit and those who do not (Lore, 2007). In this respect, education increases a person's stock of information and skills. Due to lack of other sources of information in developing countries such as Kenya, education remains the only useful source of new knowledge. Therefore, education may enhance entrepreneurial orientation. Knowledge gained from industry experience provides the

entrepreneur with certain key competencies and inside information needed to recognize and exploit opportunities. Through work experience, people develop information and skills that facilitate the formulation of entrepreneurial strategy, the acquisition of resources, and the process of organizing. Industry experience is also important in reducing risks and uncertainty. Thus, industry experience is expected to be associated with entrepreneurial orientation.

There is some expectation that information gained from training is important in enhancing entrepreneurial outcomes (Bird 1989). Thus, attending seminars, trainings, workshops, symposiums and conferences is expected to lead to favourable entrepreneurial outcomes. Training helps to develop key competencies, motivations and the ability to acquire important knowledge-based resources. Therefore, training is expected to lead into higher levels of entrepreneurial orientation.

Distance of the Bank and Target Market ,According to Degryse and Ongena (2002), lending conditions may depend on the distance between the borrower and the lender and the distance between the borrower and the competing bank. This implies that if there are so many banks within convenient distance to the small businesses, the proprietors will have alternatives to shop around and will have the benefit of learning the requirements of accessing those loans. Ergungor (2007) supports this notion by giving an example of a behavior that is predominantly found amongst small businesses, where a lender connected to the community can easily know whether the account behavior of a business is due to lack of financial knowledge on the part of the lender or lack of viability in the business.

The distribution of banks in a local market may actually affect how deposits are priced (Rosen, 2007); banks with higher number of branches do give lower deposit rates due to the convenience they do offer the account holders. Hannan and Prager (2006) concur with this; they find that organizations that are large geographically offer lower interest rates than their counterparts and these they argue that is a result of having access to alternative sources of funds. Even though the emergence of different options for service delivery like telephone banking and internet banking, customers still consider proximity to branches as a very important factor more so for small businesses who deal mostly in cash and cheques (Heffernan, 2006). The absence of a branch in any locality will raise the monitoring cost of loans in terms of making visits to the

customers and in terms of following up on impaired loans. This will henceforth lead to higher interest rates being levied on loans. The collection of information for purposes of accessing financial services especially loans require the contact between the borrower and the lender and this must be facilitated by geographic proximity. It follows that geographically close lenders would incur lower costs in gathering the necessary information and borrowers would probably receive better loan terms when they are near a bank. The loan rates increase as the distance between the lender and borrower increases because of the cost implications involved Elyasiani and Goldberg (2004).

Pinho (2000) stated that customers may prefer larger networks, which means that larger banks are able to serve their customers with a relatively lower cost and therefore can use this as a competitive advantage by lowering the interest rates on deposits; this will surely increase the number of small businesses who will be attracted to the low costs. Hefferman (2006) states otherwise that banks with more branches offer lower deposit rates and higher loan rates as the customers are forced to pay for that convenience, though he claims that in a Cournot model of Oligopoly, an increase in the number of firms should ultimately contribute towards lowering of prices which translates to higher deposit rates and lower loan rates.

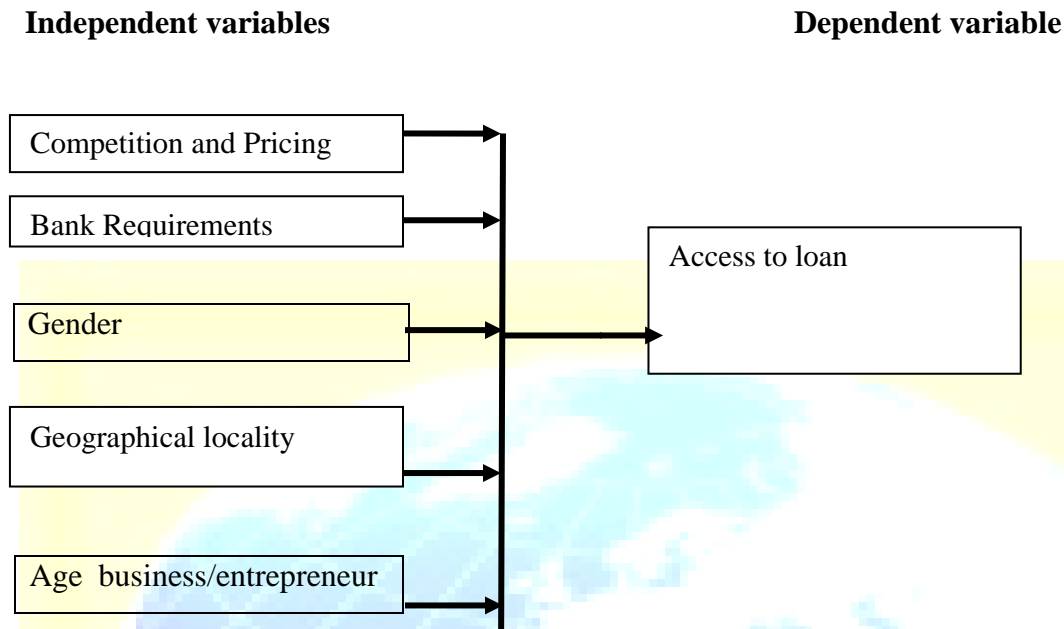
Kim and Vale (2001) found out that less fear by borrowers as a result of non-existent lock-in effect caused by denser branch network would increase the aggregate loan demand because customers know that they can always approach an alternative lender without incurring much cost. Again the more branches there are the higher the quality of loans and that is why banks with many branches do attract many borrowers because they know many branches mean reduced adverse selection and moral hazards.

On the other hand it is a fact that full service branches impose significant costs on the banks and this must be covered through revenues generated which implies that branch dependent customers may be forced to incur additional costs as branches are increasingly consolidated (Atieno, 2009). Ergungor (2007) in his study of relationship of branch presence and accessibility to credit in low income neighborhoods found out that favorable effects of branch presence get stronger as the branch gets closer to the neighborhood. Ergungor (2007) goes ahead and proposes that for banks

to prudently lend to small businesses that have informational opaque problems, and then they must do relationship lending which calls for branch presence near the location of those small businesses. This will assist in alleviating the problem of credit rationing as the soft information can be collected at very lower costs. This is because the type of information that relationship lending depends on can only be reliably collected and processed locally. This is the reason why in the Kenyan situation, small businesses have resorted to Rotating Savings and Credit Associations (ROSCA) because they have soft information about their members, unlike the big banks who rely on hard data like financial statements that are hardly prepared by the small businesses to do transactional lending (Atieno, 2009).

Atieno (2001) indicated that income level, distance to credit sources, past credit participation and assets owned were significant variables that explain the participation in formal credit markets. Hussein (2007) also indicated that farm households are more likely to prefer the informal sector to the formal sector with respect to flexibility in rescheduling loan repayments in times of unexpected income shocks. Quick credit, all times access, freedom of deployment, repayment flexibility and lower transaction costs are the advantages of the informal sector which have made them almost indispensable, particularly to small farmers. The demand of purchase of machinery and land or buildings motivates the probability of obtaining bank loans. Proportion of establishment's working capital financed from non-bank financial institution, moneylenders, friends and relatives. The purchases on credit from suppliers and advances from customers account for a small part (12.01%). Small businesses are perceived as low credit worthiness, so banks often require these borrowers to pledge collateral to guarantee their later payment. However, the property of small businesses often does not satisfy the lenders.

Fig 1 Conceptual Framework



From the above figure 1, loan accessibility is determined by competition and pricing this is affected by factors like interest rate given by the various financial institutions. Bank charges and fees charged on loan, number and the size of the bank and market share.

For any financial institution to lend out any financial assistance , the customer or borrower are asked to follow certain bank requirement , this include terms and conditions of the financial institutions. Geographical distribution of the financial institution plays an important role as far accessibility of loans are concerned, this geographical distribution is influenced by the number of branches in the outskirts, banks infrastructure and the distance of the banks and the target market.

Commercial bank lending sets the objectives, standards, and parameters that guide loan officers in granting loans and management of the loan portfolio. The lending policy provides a framework within which the credit risk arising from lending will be originated and managed in order to minimize the risk of financial loss. Gitman (1992) identified three important aspects in a sound lending which include: credit terms, credit standards, and collection procedures. In addition, credit is usually granted following the bank’s stated guidelines namely; interest rate, credit limit, and loan period (Apegu, 2005).

RESEARCH FINDING AND DISCUSSION

The study sought to find out the factors which affect the accessibility of the loans by SMEs in Kisii County. The study established that competition influence the demand for loans because with more competition, firms may invest more often in orders to improve their position relative to other competitors and therefore need more loans. However, banks should base their decision to grant a loan on harder information, in particular, on figures that are observable in the SME's balance sheet. For access to loans GNI is insignificant and inflation has a negative impact. Cost of credit is a major determinant of credit accessibility. It was the position of this research that low cost of credit would ease credit accessibility among the SMEs and vice versa. Competition and pricing was important factor since it determined by interest rate being levied on loans both the banks and consumers as it can attract or push away customers who want to borrow. Penalty charged by banks' on loans influences the decision to take a loan, this is an implication that before you borrow any amount he or she is required to produce a security, so that incase you fail to pay the bank can take the security and sell it to recover their money back. The study established that there was a significant relationship between the bank competitions and pricing on the accessibility of the loans. Ninety-four percent of the banks in the sample demand collateral from their SME borrowers. Collateral requirements for SME loans are higher than for consumer loans, because SMEs' credit risk is usually more difficult to. SMEs are also considered riskier than other segments for half of the banks surveyed. Moreover, regulatory collateral requirements, which are usually a function of the size of the loan, contribute to explain why SMEs have to post more collateral relative to retail clients.

The study established that pricing of interest rate plays an important role, Interest rate determine the amount of money borrowed. Hannan (2006) asserts that in response to change in the competitive environment, any combination of loan rates and fees will really involve the movement of prices in the direction that either benefits the borrower or harms the borrower. Sacerdoti (2005) agrees that increased competition decreases the spreads between deposit rates and lending rates.

The study asserted that geographic locality has a relationship on loan credibility. Ergungor (2007) supports this notion by giving an example of a behavior that is predominantly found amongst small businesses, where a lender connected to the community can easily know whether

the account behavior of a business is due to lack of financial knowledge on the part of the lender or lack of viability in the business. Hannan and Prager (2006) asserted that they find that organizations that are large geographically offer lower interest rates than their counterparts and these they argue that is a result of having access to alternative sources of funds. The study also found out that access to loan as a dependent factor was determined by factors like forms of prescribed minimum loan amounts limit their accessibility in terms of loan borrowing, complicated application procedures restrictions on credit for specific purposes limited access to lenders and credit duration influence loan accessibility to loan.

Conclusion

The study established that bank loan officers may be influenced by the gender of the entrepreneur, favoring males over females, in evaluating loan application. This indicate that male dominate in borrowing this could have been attributed by the fact that majority of them have bank account in this commercial banks unlike women who accesses their loan through micro – finance and women. Small businesses rank land, buildings, and personal assets and then machinery and equipments in descending order of importance in types of collateral, while large and medium businesses rank machinery the second position. The transaction between businesses and banks still bases on collateral, not trust, so banks have not built up a framework of credit business score. If businesses are not frequent or close customers, banks will request businesses to pledge collateral. The study also found out that a majority of the population are locked out of the formal financial sector due to the many strict requirements and stringent conditions required by the banks for one to open an account or access credit.

Recommendation

The government should control the interest rate regime. Lenders need to develop low interest products targeting SMEs this would enhance credit accessibility among the entrepreneurs. The commercial banks should eliminate restrictive practice of requiring customers to open an account before being granted loans. This strategy is frequently employed by the big banks due to the power of their balance sheet which puts them in a position to lend huge amounts that cannot be accessed in the small banks. This practice normally leaves the customer with no option but to

either shy away from the formal banking sector or to limit the level of doing banking. The commercial banks should not discriminate women when granting loans.

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