

**THE RELATIONSHIP BETWEEN SELECTED SUPPLY SIDE FACTORS AND  
LENDING TO SMALL AND MEDIUM ENTERPRISES BY COMMERCIAL  
BANKS IN KENYA**

**BY**

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## **DECLARATION**

### **Student's Declaration**

I declare that this research project is my original work and has not been presented for a degree in any other university. All references made to works of other persons have been duly acknowledged.

SIGNED.....

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This research project has been submitted for examination with my approval as university supervisor

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## **DEDICATION**

This research project is dedicated to my late mother who despite having no formal education instilled in me a great value for education. It is also dedicated to the late Dr. Geoffrey Griffin who had a lasting impact in my life. I also wish to dedicate this project to my wife, Catherine Nyambura, my mentors Gideon and Lydia Koros, and my nephew John Muriithi, for their inspiration, moral, emotional, and spiritual support during this long journey.

## ABSTRACT

Most research on Small and Medium Enterprises (SMEs) focused on lack of access to credit due to factors inherent with the SMEs, for example opaqueness, information asymmetry, high failure rates, and lack of collateral. SMEs make a significant contribution to social economic and political infrastructure of developed and developing countries. SMEs increase per capita income and output, create employment opportunities and enhance regional economic balance through industrial dispersal. The researcher carried out a study on factors that banks consider before lending to SMEs including: SME sector profitability, relationship with a corporate customer, strategic focus, level of competition, interest rates in the economy, and the cost to serve SMEs. The objective of this study was to determine the relationship between selected supply-side factors and lending to SMEs by commercial banks in Kenya. The study used descriptive research design and this was chosen because it enabled the researcher to generalize the findings to a larger population and allowed analysis of the relationship of variables under study using linear regression. The population of this study consisted of the forty four commercial banks in Kenya. The study collected primary data using a semi-structured questionnaire. Secondary data was collected from the Central Bank of Kenya (CBK) showing the level of interest rates in the economy for the period covering 2004 to 2013. Descriptive statistics such as means, standard deviation and frequency distribution were used to analyze the data. The study found the following: First, that commercial banks found the SME sector in Kenya very profitable and therefore made it a core part of their strategy. Secondly, most banks diversified into SME segment making the sector very competitive. Thirdly, that the interest rates in the market were highly unpredictable. Fourthly, banks found the cost of serving SMEs to be similar to that of serving their other customers due to automation. Fifthly, banks had a very good relationship with their corporate customers but still did lending to non-connected SMEs. The study concluded that equating all independent variables to zero, the level of lending to SMEs by commercial banks was 0.116. Profitability influenced the banks level of lending to SMEs most (at 58%) followed by interest rates (50%). The study recommended that government should prioritize focus on SMEs by: putting in place a legal, judicial and regulatory environment that fully supports SMEs; establishing a SME Bank to provide long term funding; The CBK should review its prudential guidelines to de-emphasize need for fixed collateral and encourage cash flow lending, have SME segment profitability reporting to measure SME contribution to the industry and the economy, and finally together with the banks and other government agencies, to come up with a standard definition of a SME, collate information on SMEs to understand them and make better decisions on the sector.

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## **ABBREVIATIONS**

CBK	Central Bank of Kenya
CBR	Central Bank Rate
CRB	Credit Reference Bureau
FX	Foreign Exchange
GDP	Gross Domestic Product
LDC	Less Developed Countries
M&A	Mergers and Acquisitions
MSEs	Medium and Small Enterprises
MSMEs	Micro Small and Medium Enterprises
NPLs	Non Performing Loans
NSE	Nairobi Securities Exchange
SME	Small and Medium Enterprises
SPSS	Statistics Package for Social Sciences
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organisation

## CHAPTER ONE: INTRODUCTION

### 1.1 Background

The Small and Medium-Sized Enterprises (SMEs) make a significant contribution to the socio-economic and political infrastructure of developed and developing countries as well as the nations in transition from command to market economies Matlay and Westhead (2005). The financing of SMEs has attracted much attention in recent years and has become an important topic for economists and policymakers working on financial and economic development De La Torre et al.,(2008). The interest is driven in part by the fact that SMEs account for the majority of firms in an economy and a significant share of employment Hallberg (2001). Furthermore, most large companies usually start as small enterprises, so the ability of SMEs to develop and invest becomes crucial to any economy wishing to prosper Porter, (2006). Apart from increasing per capita income and output, SMEs create employment opportunities, enhance regional economic balance through industrial dispersal and generally promote effective resource utilization considered critical to engineering economic development and growth Ogujiuba and Ohuche, ( 2004). The “conventional wisdom” argues that the inadequate financing of SMEs is to a significant extent rooted in “supply-side” features including opaqueness, the informality of SMEs, and lack of access to cheaper capital markets due to opaqueness and size. Contrary to the perception that banks in general are not interested in lending to SMEs, most banks do indeed want to serve SMEs and find this segment profitable, especially as margins in other banking markets narrow due to intensified competition De La Torre et al.,(2008).

### **1.1.1 Commercial Banks Lending to Small and Medium Enterprises**

SMEs are defined differently between countries and within sectors. Some of the commonly used criteria are the number of employees, total net assets, sales and investment levels. However, the most common definition used is employment level. Currently the SME department of the World Bank works with the following definitions: Small Enterprises are defined to have up to 50 employees, with total assets and total sales of up to \$ 3 million per annum while a Medium Enterprise is one that has up to 300 employees, having total assets and total sales of up to \$ 15 million per annum Ayyagari et al, (2003). Therefore SMEs are companies that have up to 300 employees and total assets and sales of up to \$ 15 million per annum.

There are a number of reasons for the failure of banks in developing countries to lend more to SMEs including: First, heightened macroeconomic risk and volatility forces banks in LDCs to keep a high percentage of deposits in liquid assets; and there is a higher likelihood of a run on the bank or an economic crisis that triggers a wave of defaults in LDCs forcing banks to maintain substantial liquid assets so that they can withstand a sizable withdrawal of deposits and maintain solvency during periods of economic turmoil. Central banks also impose higher reserve requirements due to this heightened macroeconomic risk and volatility The World Bank, 2001; Levine, Loayza, and Beck, (2000).

Secondly, the legal and judicial environment is deficient and property rights are not adequately protected. It is very difficult to enforce contracts in developing countries. The process is time-consuming, costly and the outcome is not always assured, The World

Bank, (2004). As a result, lenders are not confident that they can get repaid if the borrower defaults. To help ensure that the borrower will repay, lenders impose very high collateral requirements which borrowers often cannot satisfy because they do not have adequate legal title to assets. Thirdly, governments in less developed countries (LDCs) often run large deficits and this drives up interest rates and crowds-out local investment. Banks are able to make a good profit taking in deposits and using them to purchase government bonds, so they are less inclined to search for lending opportunities with SMEs

Fourthly, banks have great difficulty ascertaining which borrowers are good credit risks due to a high degree of asymmetric information. Banks do not know nearly as much about a borrower's operations and likelihood of repayment as the borrower knows. Besides, banks lack reliable information and data about borrowers Berger and Udell, (2004). There is lack of accurate financial statements and financial records that can demonstrate that a borrower has been earning enough revenue to repay a loan. Small firms lack proper accounting procedures and owners frequently mix their business and personal finances so financial statements are unreliable Berger and Udell, (2004). Besides, there are few, if any, credit bureaus that provide lenders with the credit history of prospective borrowers and whether they have repaid prior debts.

Fifthly, parallel to, the reluctance of banks to lend to small enterprises is the reluctance of these enterprises to borrow from banks. The administrative and costly formalities of obtaining bank finance, particularly the time and paper work involved, are a formidable deterrent to smaller businesses. Some of them lack the formal education to cope with the bureaucracy and others, compounded by problems of location and time pressures, have

difficulty in complying with what the institutions require before they grant a credit. In many cases, potential borrowers have to pay for preparation of accounts or special studies on top of the cost involved in the numerous visits to the lending institutions. The transaction costs on the part of a borrower in obtaining a loan from a bank may be proportionally as high as are these costs for the lender.

Sixthly, there is a distinct institutional bias on the part of banks towards lending to the larger corporate sector. In many cases there are links in directorships, joint ownerships and various other common financial dealings between banks and the large enterprises and automatically this induces preference for directing finance to these borrowers.

### **1.1.2 Factors That Commercial Banks Consider When Lending To SMEs**

A survey done by De La Torre et al., (2008) revealed that SMEs have emerged as a strategic sector for most banks – including large foreign banks and not just small niche banks. Contrary to the perception that banks in general are not interested in lending to SMEs, they established that most banks find this segment profitable, especially as margins in other banking markets narrow due to intensified competition. Most banks consider relationship between their big corporate client and an SME very important. Large banks use their relationship with large firms to try and identify and sort out the SMEs that are worth approaching. The market structure is competitive; that is virtually all banks are trying to attract SMEs and more competition is expected in the future as banks get more involved in this segment De La Torre et al.,(2008).

Banks have experienced thin margins in the corporate sector because of strong competition from other financial and non-financial institutions. The high margins of

interest income influenced banks to engage with SMEs and despite the competitive market, banks still see profitable growth prospects in the sector. This is likely to intensify competition in the SME market in the future. Competition has put downward pressure on lending rates leading to an apparent under-pricing of risk in the hottest markets. Finally, the administrative costs of lending to small enterprises are high, which cuts deep into the profitability of such transactions for lending institutions. This is undoubtedly the case and has been borne out in studies.

### **1.1.3 The Relationship Between The Selected Supply Side Factors and SME Lending**

Most studies done dwelt on demand side factors affecting the level of banks lending to SMEs. Demand side factors concentrate on the SME specific factors that dissuade banks from lending to them and include opaqueness, informality of the SMEs, absence of financial statements, lack of collateral, and information asymmetry De la Torre et al., (2008) and Berger and Udell, (2004). Supply side factors relate to factors internal to the banks themselves and the environment they operate in and they include: the legal and judicial environment that is deficient and does not protect property rights, the heightened macroeconomic volatility forcing banks to maintain higher cash reserve with the Central Banks, internal factors relating to assessment of SME credit especially in the absence of financial statements that can predict the future repayment ability of the SME.

Other supply side factors include the bank own strategy towards the SME segment, the level of profitability, the level of competition, the cost of lending to the SME segment as compared to lending to the corporate segment, the level of interest rates in the economy, and finally the relationship SME customer has with a large corporate customer of the

bank since this relationship helps the bank to get a lot of information regarding the SME De La Torre et al., (2008).

#### **1.1.4 Commercial Bank Lending to SMEs in Kenya**

A number of factors affect the growth of African SMEs, including the business environment and the quality of the labour force. However, a crucial element in the development of the SME segment is access to finance, particularly to bank financing, given the relative importance of the banking sector across the continent. African SMEs are more financially constrained than in any other developing region. Only 20 percent of SMEs in Sub-Saharan Africa have a line of credit from a financial institution compared, for example, with 44 percent in Latin America and Caribbean, and only 9 percent of their investments are funded by banks versus 23 percent in Eastern Europe and Central Asia Calice(2012). The study found that the SME 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 SME lending market to be 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. Macroeconomic factors, business regulation, the legal and contractual environment, the lack of a more proactive government attitude towards the segment, some areas of prudential regulation are some bank-specific factors are also perceived to negatively affect the SME lending market in East Africa. Nonetheless, banks have adapted to their

environment and developed mechanism to cope with it through innovation and differentiation.

Most banks have dedicated units serving SMEs, to which they offer largely standardized products though the degree of personalization is growing. And albeit advanced transaction technologies based scoring and risk-rating systems remain relatively underdeveloped, banks are gradually automating their risk management frameworks to achieve efficiency gains Calice (2012). The findings were broadly akin to those of similar studies in other geographical contexts, suggesting that banks in the region have enthusiastically embraced the SME segment and are making substantial investments to develop their relationship with SME clients.

Kariuki (1995) studied on bank's credit access in Kenya and established that SMEs were faced with higher nominal interest rates at higher inflation rates in the latter half of the 1980s. Moreover, the explicit transaction costs of borrowing were found to be high in relation to interest costs.

In 2007, there were about 2.2 million MSMEs in Kenya of which 88 percent were non-registered Cowan et al ( 2007). Out of the non-registered group, only 23 percent had bank accounts, and only 10 percent had ever received credit from a formal source. Less than 20 per cent of SMEs in Kenya had ever received credit from formal financial institutions. Access was limited due to challenges in assessing SME risk in a cost-effective manner. Lenders in Kenya address this risk-assessment problem either by not lending to SMEs at all or by requiring collateral and charging high interest rates Microfinance Risk

Management L.L.C. report prepared for Financial Sector deepening (FSD) Growth Fin, (2008).

Collateral serves as important incentive acting upon borrowers to avoid defaulting on loans and a means by which borrowers can signal their credit worthiness to lenders Lehman and Neuberger,(1999). In Kenya, some banks do not accept collateral from some SMEs in rural areas. Even for urban-based SMEs, this condition is a severe constraint. Besides, SMEs lack collateral required by commercial banks Ochieng, (1998).

## **1.2 Research Problem**

SMEs claimed that it is very difficult to get loans, especially from commercial banks Levy, (1993); Ayyagari, Beck and Demirguc-Kunt, ( 2007). These small business owners' feel that commercial banks are not sympathetic to their needs Buerger and Ulrich, (1986). Those who own big businesses can easily get loans from financial institutions and commercial banks, this is because those who own big businesses generally bring more income to the bank and carry less risk Turnbull and Gibbs, (1987). De La Torre et al.,(2008) found that there is great interest on SMEs by commercial banks mainly as a result of the perceived profitability of the SME sector where most banks consider this sector to be profitable in various countries studied in Latin America, Caribbean, Europe and Sub-Saharan Africa.

Banks are willing to consider lending to an SME based on the relationship the SME has with one of the Bank's large corporate customers since the bank can get more information regarding the SME from the corporate customer. The other factor is the strategic focus on SME that the Bank attaches with most banks considering SMEs their core strategy and

seeming well positioned to expand their links with SMEs. The level of competition in the other segments that the banks operate in influences their engagement with SMEs while the level of prevailing interest rates in the economy also affect this engagement. When there is very high competition in the corporate and retail segments then banks will be forced to look for new growth areas in the SME segments, the banks find lending to SMEs more costly than lending to corporate customers and tend to lend more to corporate customers than SMEs De la Torre et al., (2008).

Olomi, (2001) established that the survival rate of SMEs was significantly low. Therefore due to doubts about the possibility of growth in SMEs, financial institutions inclined to tighten their requirement to approve financing and required a lot of information about the investments Omar, (2008). Rukwaro (2001) carried out a survey on credit rationing by banks and their influence on the operations of small and micro enterprises. Mwindi, (2002) looked at the relationship between interest rates charged by commercial banks and performance of Micro and Small Enterprises in Nairobi. Mokogi (2003) looked at the economic implications of bank lending to MSEs. Mudiri (2003) studied credit management techniques applied by financial institutions offering micro credit in Kenya and established that the MSES experienced tremendous growth in their businesses in terms of sales, fixed assets, net income, savings, number of employees and space occupied by the businesses.

In spite the importance of the topic, relatively little research exists on SMEs financing from a supply-side perspective Calice(2012). While there are studies that have advanced our understanding on factors affecting SMEs financing on the demand side both in the country and a handful of other countries where case studies have been done, there is a

significant gap in existing knowledge on the supply side of commercial banks financing to SMEs especially in Kenya. Therefore, this study intends to look at how selected supply side factors influence a commercial banks lending decision to SMEs and will endeavour to fill that gap.

### **1.3 Research Objectives**

The objective of this study was to determine the relationship between selected supply-side factors and lending to Small and Medium Enterprises by commercial banks in Kenya.

### **1.4 Value of the Study**

The study fills the gap in academic literature by contributing to the existing theoretical knowledge on SME financing by commercial banks considering some selected supply side factors. In addition, future academicians, policy makers and knowledge seekers will use this study as a foundation for further researches that remotely relates to the relationship between selected supply side factors and lending to SMEs by commercial banks in Kenya.

The study will be important to SMEs owners/managers. First, it will help to improve their knowledge of how banks assess their credit requests. Second, such an understanding will assist them on how to take remedial actions prior to approaching banks for financing. Thirdly, with such knowledge, both commercial banks and SMEs owners will be in a position to understand SMEs and bank requirements better and take remedial actions prior to approaching banks or SMEs for financing.

## **CHAPTER TWO: LITERATURE REVIEW**

### **2.1 Introduction**

This chapter summarised the information from other researchers who had carried out their research in the same sphere of SMEs financing and lender decision making. The study specifically covered the theoretical discussions, conceptual framework and research gap.

### **2.2 Theoretical Framework**

There are various theoretical models on the financing of firms, starting from the traditional concept of Modigliani and Miller (1958) regarding the financial behaviour of firms. Since then a number of theories have been postulated regarding the financial behaviour of firms. Different theories have explained the financial behaviour of enterprises, taking into account their different characteristics and problems. However, most of the existing theoretical frameworks address the needs of large firms. Thus, the main ground upon which capital structure theory was initially developed concerned the large listed firms Zingales,(2000).

#### **2.2.1 Asymmetric Information**

Stiglitz and Weiss (1981) revealed that one of the most important theories that focused on SMEs financing analysis was the credit rationing theory. In their formulation, they argued that agency problems and information asymmetries are the major reasons why SMEs

have constrained access to finance. They noted that only SMEs knew their real financial structure, the real strength of the investment and the effective intention to repay the debt, that is, firms had superior private information. Hence, the bank manager made decisions under asymmetric information, and operated under a moral hazard and adverse selection risk. The two explained the choice among different financing sources under conditions of asymmetric information and credit rationing.

### **2.2.2 Credit Rationing Theory**

Alfo and Trovato, (2006) explained that asymmetric information led to credit rationing conditions by modifying the risk-return distribution; this fact encouraged banks to refuse advancing capital for investments and produced divergence between capital demand and supply. Constrained accesses to finance derived from financial institutions' credit rationing behaviour were not efficient because managers worked under conditions of asymmetric information. This resulted into less profitable investments being financed while more profitable investments were left out resulting into adverse selection and moral hazard risks. Therefore, asymmetric information explained asymmetric distribution of credit among firms with identical characteristics.

A firm accepted to invest only in riskier projects that produced higher income levels to be able to cover up debts. This resulted into the fact that the lender could not avoid selecting the riskier project and therefore accepted the risk of the firms as presented in the financing proposal. In the presence of excess demand, the lender had different maxima that corresponded to the rates with the lower adverse selection likelihood for credit rationing Stiglitz and Weiss, (1981). Furthermore, rationing conditions reduced access to

financial resources not only for new investment, but also for employment creation and poverty alleviation. Another facet of credit rationing was that financial institutions managers accepted personal responsibilities for non- performing loans advanced to SMEs without government guarantees, hence agency problems existed. Managers had the responsibilities to protect the depositors' interest hence operated under credit rationing conditions.

Start-up SMEs are more likely to be affected by information asymmetry problems. Deakins et al (2008) argued that information asymmetries are more acute in new and technology-based propositions. They argued that at an early stage, information is limited and not always transparent and assets are often knowledge based exclusively associated with the founding entrepreneur. Especially with manufacturing or technology based firms, entrepreneurs were reluctant to provide full information about the opportunity because of concerns that disclosure could dispose their ideas to the competitors. There were also some categories of owners of SMEs who faced additional problems due to lack of security, such as young entrepreneurs or those from deprived areas. In addition, there were asymmetries arising from location as well as sector. For example, owners of SMEs in rural environments faced difficulties with access to bank finance.

Financial institutions approved loans to firms which provided collateral in addition to those firms that had established long term relationships with lenders. Due to the existence of asymmetric information, banks based their lending decisions on the amount of collateral availed. Collateral acted as a screening device and reduced the risk of lending faced by commercial banks. By pledging an asset, a borrower signalled the quality of his project and his intention to repay the amount advanced. In the event of default, collateral

taken by the bank placed it in a privileged position with regard to other creditors Green, (2003).

Small firms were disadvantaged in this regard, due to the fact that they lacked collateral security and also they lacked a proven credit track record. Therefore, start-up firms with new innovative products were constrained to access financing due to the fact that they were unlikely to furnish securities. In addition, due to information asymmetries, financial institutions failed to see the profitability and viability of the proposals.

### **2.2.3 Bank Market Power Theory**

Theoretical models of lending and industrial organisation theory predicted that firm's access to credit depended critically on bank market structure. The traditional market power was that concentrated banking markets are associated with less credit availability and a higher price of credit. However, empirical studies offered mixed results. Some studies established that higher concentration is associated with higher credit availability consistent with information hypothesis that less competitive banks had more incentive to invest in soft information. Other empirical studies, however, found support for the market power hypothesis that credit rationing was higher in less competitive bank markets Valverde, (2005). However, an alternative view that emerged over the past decade argued that the impact of competition on credit may be related to the level of asymmetric information in the market Dell'Ariccia and Marquez, (2005).

Olomi, (2001) revealed that growth was another factor that constrained access to finance based on capital rationing. There was a wide controversy about the growth of SMEs in Kenya; and the survival rate which was established to be significantly low. Therefore due

to doubts about the possibility of growth in SMEs, financial institutions were inclined to tightened requirements and information from SMEs to approve a loan to finance a viable investment. Such information was not furnished adequately leading to potentially viable business ideas falling into the credit rationing trap.

## **2.3 Empirical Review**

According to Kitindi, Magembe and Sethibe (2007), creditors, banks and other lenders use financial information provided by firms to analyze their present performance and predict future performance. Information obtained from the financial statements acted as an indicator of borrower's future prospects and ability to service a loan. Bass and Schrooten (2005) concluded that lack of reliable information led to comparably high interest rates charged even if a long term relationship between borrower and bank existed. In a situation like this, having audited financial statements played a major role. Berger and Udell (2006) argued that, relationship lending was not the only way in which banks considered while extending financing to SMEs. Different transactional technologies that facilitated arms-length lending (such as credit scoring and significantly standardised risk-rating tools and processes) increasingly applied in SME lending.

Bougheas et al., (2005) argued that collateral is an important factor for SMEs in order to access debt finance. Collateral reduced the riskiness of a loan by giving the financial institution a claim on a tangible asset without diminishing its claim on the outstanding debt. Although it was difficult to construct the measures for firm performance in the SME sector, many studies have attempted to do this and found that greater sales and profits are associated with greater access to credit Bigsten et al., (2000).

Previous researchers emphasized that networks can be used as the solutions to overcome the problems of access to limited resources and markets. Curran et al (1993) argued that networks helped to provide advice, information and capital to small firms. Applying this idea in the context of banking, it was also argued that, having associated with a professional, trade or social associations such as Chambers of Commerce, clubs and societies led to having access to bank loans.

De La Torre et al., (2008) did a study on bank involvement with SMEs where the objective of the study was to explore whether and to what extent the main tenets of conventional wisdom – that banks in general are not interested in dealing with SMEs, and that the small niche banks engaged with SMES mainly through relationship lending – held in reality. The methodology used was a survey of commercial banks in 12 countries before and soon after the 2007 financial crisis. A linear regression analysis was used to analyse the data. The results showed that SME profitability, strategy, SME relationship with a corporate, the level of interest rates and the level of competition in other segments were key factors that influenced banks engagement with SMEs.

Beck et al., (2009) found significant differences across banks in developed and developing countries, driven by differences in the economic, institutional, and legal environment, as opposed to differences in lending technologies and organisational structures. In particular banks in developing countries provided a lower share of investment loans and charged higher fees and interest than those in developed countries. Further, the share of SME lending devoted to long investments or lending was statistically and economically significantly lower at 28 percentage points lower among banks in developing countries. At the same time, banks in developing countries charge

0.7 percentage points' higher fees and seven percentage points' higher interest rates than those in developed countries.

Pandula (2001) argued that there was a correlation between firm age and access to credit. Being in the business for many years suggested that the firms were at least competitive on average. It was argued that an older firm had sufficient record of information required by the lenders to evaluate and process an application. On the other hand, the new firms were unlikely to meet the collateral requirements of the banks since they had not accumulated sufficient assets. Combined with the absence of information on their financial records, this made it difficult for lenders to assess the lending proposals submitted by new firms.

The studies conducted in the past have found that the financing constraints are particularly severe in start-up enterprises and relatively young firms (three years old or less). Aryeetey et al., (1994) conducted a survey on one hundred and thirty three firms, of which seventy six had less than ten workers, in various industries in Ghana in the early 1990s. It was revealed that only ten percent of start-up firms in Ghana obtained bank loans but medium size enterprises and older firms were provided with credit three times more often than their smaller counterparts. Levy (1993) conducted a similar survey in Sri Lanka and Tanzania and reported that eighty percent of firms with sixteen or more workers and with six or more years in operation were able to access bank loans, compared to the success rate of around fifty five percent in the case of smaller firms with six to fifteen employees of similar age, and less than ten percent for firms with five or fewer workers, regardless of age.

Firm size is one of the most important variables in literature related to access to credit. This was true for both developed as well as developing countries. Calomiris and Hubbard (1990) noted that when the company was smaller, the restrictions on credit are greater. Previous studies mentioned several reasons for small firms to have less access to credit. Binks and Ennew, (1996) argued that the small firms faced challenges with information such as being unable to provide financial information. When the firm is small, most of the time it is owned and operated by the entrepreneur and there is no such legal requirement to regularly report financial information and many firms do not maintain audited financial accounts.

In addition, smaller firms had lesser assets to offer as collateral. In order to reduce the anticipated risk and moral hazard associated with lending, the banks used collateral as one of the instruments. Berger and Udell (1995) established that smaller and younger firms faced higher cost of financing and were required to offer collateral. Smaller firms posed high risks to lenders because of high failure rate compared to large firms. Schiffer and Weder (2001) did a study that sampled firms across a number of countries which revealed that there was a negative relationship between the size of a business and the risk posed to a lender. Lopez-Garcia and Aybar-Arias (2000) in contrast through their study came up with a different explanation which stated that smaller firms had limited themselves to financing access from banks by avoiding the need to share control of the business with others.

Industry's sector is stated as a factor that affects access to finance. The lending banks may show preference for industry sectors that are growing Pandula, (2011). Some industries are more likely to depend on external financing than others, depending upon project

scale, and cash flows Pandula,( 2011). Firms in certain sectors will require more credit to invest in equipment, machinery, buildings, labour and raw materials than firms in other industry sectors. For instance, the industries with more capital requirements faced proportionately greater constraints Kumar and Francisco, (2005).

Tagoe, Anuwa-Amarh and Nyarko (2008) carried out a study on the relationship between information management practices for SMEs and their access to bank finance. The researchers administered questionnaire and analyzed the data using non-parametric correlation tests. It was revealed that SMEs that kept records and presented certain types of information improved their access to bank finance. Audited financial statements were very useful in accessing credit from financial institutions. Berry et al (1993) found that lenders in the UK paid much attention to accounting information in order to deal with the loan applications for SMEs. Given the reduced information risk arising from audited financial statements, potential lending institutions offered low interest rates as well. In other words, audited financial statements improved borrower's credibility and therefore reduced risk to lenders.

Previous researchers suggested that bank financing depended upon whether the lending is secured by collateral Storey, (1994) as well as Berger and Udell, (1998). Johnsen and McMahon (2005) also stated that other factors held constant, firms with more intangible assets needed to borrow less, compared to firms with more tangible assets, because of collateral factor. In the early stages of a firm, it was likely that it had lower retained profits hindering it to purchase fixed assets compared to the larger firms which had a longer history. Another reason for small firms having a smaller proportion of fixed assets was the capital constraints faced by them. As a result of the need to raise large amounts

of capital, they found it difficult for them to acquire a large number of fixed assets. Hence a positive association between an acceptable collateral assets and having access to credit can be expected.

Although it was difficult to construct the measures for firm's performance in the SME sector, many studies have attempted to do this and found that greater sales and profits are associated with greater access to credit Topalova, (2004). In addition, firms with increased sales and increased sales turnover ratios would be expected to have less credit constraints Pandula, (2011).

Banks' over cautiousness towards SMEs can be explained by several factors; the volume effect leading to high unit costs, the risks on these counterparties, banks' lack of long-term resources, information asymmetry between entrepreneurs and bankers Lefilleur, (2008). While most of the other obstacles are structural to SSA markets and may therefore be difficult to overcome, risks stemming from information asymmetry and securitization difficulties could be minimized by the development of financial systems that are more adapted to local environments. Several factors, that are specific to the SSA context, are at the root of this information asymmetry between entrepreneurs and bankers.

Beck, Demirguc-Kunt and Pería (2009), through a study established that while the financial assessment is the most important approval criterion across countries, a firm's credit history and owner characteristics were important in developing countries, while loan size is the second important criterion in developed countries. For small business lending, fifty percent of banks in developed countries and forty nine percent of banks in the developing countries indicated that the financial assessment of the business is the

most important criteria. For banks in developing countries, a firm's credit history with the bank was considered the second most important criteria, followed by the firm's owner characteristics and collateral. Although the collateral was not a decisive criterion for lending, in developing country, about eighty seven percent of banks required it for lending.

## **2.4 Conclusion**

This chapter discussed supply-related factors and the demand related factors that affected flow of credit to SMEs. The effect of information asymmetry was cited to be influencing the lending guidelines of banks which mainly leaned towards use of collateral as a measure to avert the lending risks that are accentuated by the information inadequacy. The emphasis on collateral led to crowding of the SMEs which had good projects but lack the collateral to support their loan applications. In this connection, the information gap forced the banks to rely on approving of loan applications, evaluating and recovery procedures that have a high probability of impeding rather than facilitating credit flow to SMEs.

It was also established the organisational structure in which lending decisions took place had been designed to reflect the problem of information asymmetry. The structure imposed responsibility of collecting information about the loan application but at the same time largely denied them the power to make the lending decisions and this generally promoted conflict between loan officers and management as well as encouraging the culture of informality in decision-making.

Most of the factors in the literature reviewed concentrated on demand side challenges affecting SMEs borrowing. There are little researched done on the supply side affecting bank engagement with SMEs. In this regard, this study focused on the factors that banks consider and the relationship with the selected factors and bank lending to SMEs. This then formed the research gap and relevancy for this study.

## **CHAPTER THREE: RESEARCH METHODOLOGY**

### **3.1 Research Design**

Research design refers to the way the study is designed, that is, the method used to carry out a research. The research problem was investigated through the use of a descriptive research design. In this research, quantitative data was collected and analyzed in order to reveal the specific supply side factors that determined lending by commercial banks to SMEs in Kenya. Descriptive research design was chosen because it enabled the researcher to generalize the findings to a larger population. The descriptive research allowed analysis of the relations of variables under study using linear regression in consideration that the sampling units for the study were many. It also allowed greater flexibility in terms of money and time as well as avoiding the hardship of hunting for respondents more than once to produce high response rate. These reasons justified the use of descriptive research design and therefore generalized the findings to all the commercial banks in Kenya.

### **3.2 Population**

Mugenda and Mugenda (1999) defined a target population as a compute set of individuals, cases/objects with some common observable characteristics of a particular nature distinct from other population. A population is a well-defined set of people, services, elements, events, and group of things or households that are being investigated. This definition ensured that the population of interest was homogeneous. The population

for this study was the forty four Commercial in Kenya. The researcher undertook a survey of the population consisting of all licensed commercial banks in Kenya.

### **3.3 Data Collection**

The researcher developed a questionnaire that was used to collect the necessary information. According to Sproul (1998), a self-administered questionnaire was the only way to elicit self-reports on people's opinion, attitudes, beliefs and values. In this study the questionnaire contained the structured as well as open ended questions. These types of questions were accompanied by a Likert scale with possible alternatives that ranged from strongly disagree to strongly agree, from which respondents were required to select the answer that best described their situation that is strongly disagree on one extreme to strongly agree on the other extreme.

The study collected both primary and secondary data. Primary data was collected using semi-structured questionnaires. The independent variables in the questionnaires included the bank strategy towards SMEs, Profitability, relationship with an important corporate customer, competition, the level of interest rates, and the cost of lending to SMEs. The researcher collected data using a Likert Scale ranging from one to five where one was strongly disagree and five was strongly agree. All primary data was collected from each of the forty four commercial banks and the secondary data was obtained from CBK and NSE which provided data on the audited accounts for all commercial banks.

The CBK had already collected information on profitability, sector lending, balance sheet growth and other information from the commercial banks on a monthly basis hence the data was also readily available. The questionnaires were administered using email and

follow up with an interview with the commercial banks. The questionnaires were used because they allowed the respondents to give their responses in a free environment and helped the researcher get information that would not have been given out had interviews been used. The questionnaires were self-administered to the respondents.

### **3.4 Data Analysis**

Before processing the responses, the completed questionnaires were edited for completeness and consistency. The data from the Likert scale was then coded which enabled the responses to be grouped into various categories and analyzed. Descriptive statistics, which are the means, standard deviation and frequency distribution, were used in the analysis. The independent variables under study were measured using the Likert scale ranging from one to five where one meant was strongly disagree and five meant strongly agree. All quantitative data on selected factors and lending to SMES were measured in real values by normalizing and analysed using the SPSS. Tables and other graphical presentations as appropriate were used to present the data collected for ease of understanding and analysis. The researcher used the data with an aim of presenting the research findings in respect of relationship between selected supply side factors considered by commercial banks while lending to SME s in Kenya. Tables were used to summarize responses for further analysis and to facilitate comparison. This generated quantitative reports through tabulations, percentages, and measure of central tendency. Cooper and Schindler (2003) noted that the use of percentages is important for two reasons; first they simplified data by reducing all the numbers to range between zero and

one hundred. Secondly, they translated the data into standard form with a base of one hundred for relative comparisons.

This study aimed at determining the relationship between selected supply side factors and lending to SMEs by commercial banks in Kenya. The selected supply side factors of SME lending by commercial banks were  $\beta$  (independent variables) and dependent variable was Y.

The regression equation is:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \alpha$$

Where

Y was defined as the level of lending to SMEs amongst all the commercial Banks in Kenya. This was obtained from the questionnaire and was measured using a Likert scale of one to five to get level of lending information.

$\beta_0$  was the regression coefficient,

$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5$  and  $\beta_6$  were the slopes of the regression equation,

X1 was the profitability of the SME sector, as obtained from the questionnaire and was measured using a Likert scale of 1 to 5 to get profitability information.

X2 was the relationship with a big corporate client of the SME. This data was obtained using a questionnaire and measured using a Likert scale of one to five with one being strongly agree and five being strongly disagree.

X3 was the strategic focus of the bank on the SME sector. This data was obtained using a questionnaire and measured using a Likert scale of one to five with one being strongly agree and five being strongly disagree.

X4 was the level of competition in the other segments the bank operated in. This data was obtained using a questionnaire and measured using a Likert scale of one to five with one being strongly agree and five being strongly disagree.

X5 was the Interest rates prevailing in the economy; this was analysed using secondary data obtained from the CBK using the average lending rates prevailing for the period between years two thousand and four (2004) and two thousand and thirteen(2013)

X6 was the administrative cost of lending to SMEs, This data was obtained using a questionnaire and measured using a Likert scale of one to five with one being strongly agree and five being strongly disagree.

$\alpha$  was an error term normally distributed about a mean of zero and for purpose of computation, the  $\alpha$  was assumed to be zero. The equation was solved by the use of statistical model where SPSS was applied.

### **Statistical Tests of Significance**

In testing the significance level  $\alpha$  the statistical significance was considered positive if the P-value was less than or equal to 0.05. This value was considered because of the probability of observing such extreme values by chance.

## CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

### 4.1 Introduction

This chapter presents an analysis and findings of the study as set out in the research objectives and research methodology. The study findings present the relationship between selected supply side factors and lending to SMEs by commercial banks in Kenya. The data was gathered both from primary data using a questionnaire as the research instrument and also from secondary sources from the CBK mainly on interest rates. The questionnaire used was designed in line with the objectives of the study. To enhance quality of data obtained, a Likert scale was used where respondents indicated the extent to which they strongly agreed or strongly disagreed with the statement.

#### 4.1.1 Response Rate

The study targeted to census survey forty four banks as respondents. From the study, twenty seven out of forty four surveyed respondents filled in and returned the questionnaire contributing to sixty one percent.

**Table 4.1: Response Rate**

<b>Response</b>	<b>Frequency</b>	<b>Percentage</b>
Responded	27	61
Not responded	17	39
<b>Total</b>	<b>44</b>	<b>100</b>

*Source: Survey Data (2013)*

## **4.2 Descriptive Statistics**

Descriptive statistics, which are the means, standard deviation and frequency distribution, were used in the analysis. The study used ANOVA to establish the significance of the regression model from which f-significance value of p less than 0.05 was established. The model was statistically significant in predicting how profitability, relationship with a big corporate client, strategic focus, level of competition, interest rates and administrative cost of lending affect commercial banks lending to SMEs. This showed that the regression model had a probability of less than 0.05 of giving a wrong prediction. This therefore means that the regression model had a confidence level of above 95% hence a high reliability of the results obtained.

### **4.2.1 SME Segment Profitability**

The study sought to establish the profitability of the SME sector on the one hand and that of corporate, retail and treasury businesses on the other hand in commercial banks and concluded that: first the SME segment is very profitable as indicated by an average mean score of 3.2085 and a mean score of 4.0000. Secondly, the other segments of the bank for example corporate, retail and treasury were profitable as shown by a mean score of 2.9259 but despite this profitability most banks still focused on the SME segment. Thirdly, the study established that even though some banks had reported higher NPLs and losses due to SME lending this was generally low and banks still focused on SME sector lending as shown by a mean score of 3.0741.

#### **4.2.2 Bank Competition**

The study sought to establish the level of competition in the banking industry and found it to be high as shown by a mean score of 3.5185 with competition becoming cut-throat every day as demonstrated by many new banks starting lending to SMEs driven by more and more of the banks customers asking for SME financing from their respective banks. Few banks responded that they found the competition to be low as indicated by a low mean of 2.7778.

#### **4.2.3 Bank Strategy and SME**

The study aimed to establish the importance of SMEs to the banks' strategy and found that most banks considered SMEs to be a core part of their strategy as shown by an average mean score of 3.1574 and a mean score of 3.7778. The study further found that banks felt they had a larger exposure to their corporate business and diversified into SME supported by a mean score of 3.33. Banks also found the SME sector somewhat risky as shown by a mean of 2.5826 but the higher scores on the other two areas indicate that this was not a deterrent to banks participating in this sector.

#### **4.2.4 Interest Rates**

The study sought to establish the relationship between the level of interest rates and lending to SMEs by banks and found that the interest rates in the market were largely unpredictable and when the interest rates were high then there was less lending to the sector just like there was less borrowing demand from the SME customers as shown by a

mean of 3.4074. Fewer SMEs borrowed when interest rates were high as shown by a mean of 4.1739.

From the CBK secondary data on interest rates the study found that the average interest rates were 18.34% in 2002 dropping rather sharply to 13.47% in 2003 and further down to 12.25% in 2004 which is the base line for this study. Between the year 2005 and 2010 the average interest rates remained in a narrow range between 13.32 and 14.87 with the lowest rate in 2007 and the peak in 2008. From 2011 the interest rates shot up to an average of 20.04% then gradually reduced to 18.15% in 2012 and 16.97 in first nine months of 2013. The 91 day Treasury Bill rate and the Central Bank rates over the same period behaved in a similar manner as the average interest rates since banks pegged their lending rates on the other two rates. For example when the average interest rates was at its peak in 2011 at 20.04%, the 91 day Treasury Bill rate was at 18.30% and the CBR was at 18%. Similarly when the average rate was low at 13.32% in 2007, the 91 day Treasury Bill rate was at 6.87% and the CBR was at 8.5%. It is worth noting that the Central Bank Rate was introduced by the Central Bank of Kenya in 2006. The secondary data supports the findings from primary data that interest rates have big swings and that when the interest rates are high then banks shy away from lending to SMEs and similarly SMEs themselves are cautious about borrowing from banks so they delay any investment projects.

#### **4.2.5 Cost of Administration and Business Models to Serve SMEs**

The study sought to find out how costly it was to lend to SMEs and the variously business models that that banks were using to serve this sector. First, it was revealed that

the banks did not find the cost of serving SMEs any higher than that of serving any other customer for example retail or corporate. This was largely seen in light of the business models employed by the banks where credit application, analysis, monitoring and control were largely automated thus creating efficiencies for the banks. Secondly the research found that credit approval decisions were centralized at the banks' head offices while business is sourced from their branches across the country in most instances as shown by a mean score of 4.1111. Banks had put in place a dedicated team located at their head office to manage SMEs (mainly credit approval) but business was sourced from branches as part of the banks sales and service model as shown by a mean score of 4.1111 and 3.9630 respectively. Further the existence of the Credit Reference Bureau (CRB) significantly improved the lending decisions by banks to SMEs as shown by a mean score of 4.4444.

#### **4.2.6 Relationship with a Corporate Customer**

The study revealed that banks largely had a very good relationship with their corporate customers but did not target only those SMEs that supplied to their key corporate for lending purposes as shown by a mean score of 2.9259. Most banks stated that they served any SME who met their internal requirements whether or not they are connected as a supplier to their large corporate customer as shown by a mean score of 4.4074.

#### **4.2.4 Additional Suggestions from respondents**

Respondents were asked to cite any comments or suggestions concerning the relationship between selected supply side factors and lending to SMEs by commercial banks in Kenya. According to the respondents obtained, it was notable that the SME

segment drives a large part of the economy. They recommended more financial and non financial support to SMEs, a sector that is critical to the growth and development of the economy and to the achievement of Vision 2030. They also pointed out that SMEs are the backbone of the Kenyan economy offering a ready market to the micro enterprises and in turn the SMEs support to a major extent the corporate businesses. SMEs constitute at least 35% of the credit portfolio for all commercial banks in Kenya.

### **4.3 Regression Analysis of the Findings**

The researcher conducted a multiple linear regression analysis to determine the relationship between selected supply side factors and lending to SMEs by commercial banks in Kenya and the six independent factors namely; profitability, relationship with a big corporate client, strategic focus, level of competition, interest rates and administrative cost of lending

The regression equation was

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \varepsilon$$

Whereby Y = Level of lending to SMEs

X<sub>1</sub> = Profitability

X<sub>2</sub> = Relationship with a big corporate client

X<sub>3</sub> = Strategic focus

X<sub>4</sub> = Level of competition

$X_5$  = Interest rates

$X_6$  = Administrative cost of lending

**Table 4.2 Model Summary**

<b>Model</b>	<b>R</b>	<b>R Square</b>	<b>Adjusted R Square</b>	<b>Standard Error of the Estimate</b>
1	0.843	0.742	0.724	0.4216

a) Predictors: (Constant), Profitability, relationship with a big corporate client, strategic focus, level of competition, interest rates and administrative cost of lending

b) Dependent variable: Level of lending to SMEs

Coefficient of determination explained the extent to which changes in the dependent variable (level of lending to SMEs) are explained by the change in the independent variables ( $X_1, X_2, X_3, X_4, X_5$  and  $X_6$ ), or the percentage of variation in the dependent variable that is explained by the independent variable. The study used the R square being the coefficient of determination and explained how the level of bank lending to SMEs varied with profitability, the relationship with a big corporate client, bank strategic focus, level of competition, interest rates and administrative cost of lending. The six independent variables that were studied explained 74.2% of the factors affecting level of lending to SMEs as represented by R Square (Coefficient of determination). This therefore means that other factors not studied in this research contribute 25.8% of the

factors affecting level of lending to SMEs. The study further conducted an analysis of variance to check on the strength of the model. The findings were as shown below:

**Table 4.3: ANOVA**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	11.72	9	1.302	44.231	.000(a)
	Residual	3.432	18	0.066		
	<b>Total</b>	<b>15.152</b>	<b>27</b>			

a) Predictors: (Constant), profitability, relationship with a big corporate client, strategic focus, level of competition, interest rates and administrative cost of lending

b) Dependent Variable: Level of lending to SMEs

The study used ANOVA to establish the significance of the regression model from which f-significance value of p less than 0.05 was established. The model was statistically significant in predicting how profitability, relationship with a big corporate client, strategic focus, level of competition, interest rates and administrative cost of lending affect commercial banks lending to SMEs. This showed that the regression model had a probability of less than 0.05 of giving a wrong prediction. This therefore means that the regression model had a confidence level of above 95% hence a high reliability of the results obtained.

**Table 4.4 Coefficients Results**

	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	0.116	.186		0.623	.535
Profitability	0.577	.068	.559	8.478	.000
Relationship with a big corporate client	0.157	.043	.257	3.676	.036
Strategic focus	0.082	.042	.301	2.252	.020
Level of competition	0.021	.002	.245	6.906	.001
Interest rates	0.501	.071	.523	8.411	.007
Administrative cost of lending	0.103	.023	.217	3.579	.021

a) Predictors: (Constant), profitability, relationship with a big corporate client, strategic focus, level of competition, interest rates and administrative cost of lending

b) Dependent Variable: level of lending to SMEs

The established regression equation was

$$Y = 0.116 + 0.577X_1 + 0.157X_2 + 0.082X_3 + 0.021X_4 + 0.501X_5 + 0.103X_6 + \varepsilon$$

The regression equation above established that holding all factors (profitability, relationship with a big corporate client, strategic focus, level of competition, interest rates and administrative cost of lending) constant (at zero), the level of lending to SMEs will

be 0.116. The findings presented also show that taking all other independent variables at zero, a unit increase in profitability led to a 0.577 increase in the scores of level of lending to SMEs. A unit increase in relationship with a big corporate client led to a 0.157 increase in level of lending to SMEs. A unit increase in strategic focus led to a 0.082 increase in the scores of the level of lending to SMEs; a unit increase in level of competition led to a 0.021 increase in the scores of the level of lending to SMEs. Further a unit increase in interest rates led to a 0.501 increase in the scores of the level of lending to SMEs. It was further established that a unit increase in administrative cost of lending led to a 0.103 increase in the scores of the level of lending to SMEs.

This infers that profitability influenced the banks level of lending to SMEs most followed by interest rates, relationship with a big corporate client, administrative cost of lending, strategic focus and then level of competition. The study also established a significant relationship between the level of lending to SMEs and the independent variables; profitability ( $p=0.00<0.05$ ), relationship with a big corporate client ( $p=0.036<0.05$ ), strategic focus ( $p=0.20<0.05$ ), level of competition ( $p=0.001<0.05$ ), interest rates ( $p=0.007<0.05$ ) and administrative cost of lending ( $p=0.021<0.05$ ) as shown by the p values. The researcher dropped the regression model because  $p>0.5$  and  $t<1.96$ . Therefore the restated model is as follows:

$$Y = 0.116 + 0.577X_1 + 0.157X_2 + 0.082X_3 + 0.021X_4 + 0.501X_5 + 0.103X_6 + \epsilon$$

#### **4.4 Non-Parametric Correlation**

A spearman correlation was used since the variables were assumed not to be normally distributed. The values of the variables were converted in ranks and then correlated. The

study correlated profitability, relationship with a big corporate client, strategic focus, level of competition, interest rates and administrative cost of lending under the assumption that these variables are normal and interval.

**Table 4.5 Correlations**

			Profitabil ity	Relations hip with a big corporate client	Strateg ic focus	Level of competiti on	Intere st rates
Spear man's rho	Profitabilit y	Correlation	1.000	.617	.547	.667	.301
		Coefficient	.	.000	.000	.000	.000
		Sig. (2- tailed) N	27	27	27	27	27
	Relationshi p with a big corporate client	Correlation	.617	1.000	.437	.235	.376
		Coefficient	.000	.	.000	.001	.000
		Sig. (2- tailed) N	27	27	27	27	27
	Strategic focus	Correlation	.547	.437	1.000	.441	.407
		Coefficient	.000	.000	.	.002	.000
		Sig. (2- tailed) N	27	27	27	27	27

		tailed) N					
	Level of competitio n	Correlation Coefficient Sig. (2- tailed) N	.667 .000 27	.235 .000 27	.441 .000 27	1.000 .000 27	.667 .000 27
	Interest rates	Correlation Coefficient Sig. (2- tailed) N	1.011 .000 27	.213 .000 27	.517 .000 27	.601 .000 27	1.037 .000 27
	Administra tive cost of lending	Correlation Coefficient Sig. (2- tailed) N	0.407 .000 27	.499 .000 27	.601 .000 27	.648 .000 27	0.322 .000 27

The results suggested that the relationship between profitability and relationship with a big corporate client ( $\rho = 0.617$ ,  $p = 0.000$ ) is statistically significant. Profitability and strategic focus had a  $\rho$  of 0.547 and a  $p$  value of 0.000 therefore denoting statistical significance. Similarly, the profitability and level of competition posted a  $\rho$  of 0.667 with a  $p$  value of 0.000 therefore providing a statistical significance. Profitability and

interest rates had a rho of 1.011,  $p=0.000$  further pointing to a statistical significance. On the same note, the profitability and administrative cost of lending correlated at  $\rho=0.407$  and  $p=0.001$  and hence this was statistically significant.

## **CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS**

### **5.1 Summary of the Findings**

The objective of this study was to determine the relationship between selected supply-side factors and lending to SMEs by commercial banks in Kenya. The study found the following: Firstly, that commercial banks viewed the SME sector in Kenya to be very profitable and made it a core part of their strategy. Secondly, the other segments of the bank were profitable as well but despite this profitability most banks still focused on the SME segment. Thirdly, many banks had diversified into the SME segment making the sector to very competitive both in SME and the other segments where the banks served. Fourthly, the study established that even though some banks had reported higher NPLs losses due to SME lending this was generally low and banks still focused on SME sector lending as shown by a mean score of 3.0741. Fifthly, the level of competition was high and rising with time to become cut-throat. Sixthly, the interest rates in the market were largely unpredictable and when the interest rates were high then there was less lending to the sector. Seventhly, the banks did not find the cost of serving SMEs any higher than that of serving any of the other customers. Related to this the research found that credit approval decisions are centralized at the banks' head offices while business is sourced from their branches across the country. Lastly, the study found that banks largely have a very good relationship with their corporate customers but did not target only those SMEs that supply to their key corporate for lending purposes.

The study further found that CRB listing significantly improved decision making in approving a SMEs credit application to a great extent. Further, the study found that to a

very large extent banks have computerised systems that supported appraisal for SME credit applications and in accepting or rejecting these applications based on the risk appetite level, credit scoring, monitoring and control, provisioning and collections efforts required. To a large extent, banks had a robust credit policy in place that scientifically discriminated between acceptable and unacceptable SME credit applications while to a moderate extent banks internal processes were geared to serving the SME sector.

## **5.2 Conclusion**

From the analysis in chapter four and the summary above, the study concluded that holding all factors equal to zero (profitability, relationship with a big corporate client, strategic focus, level of competition, interest rates and administrative cost of lending), the level of lending to SMEs was 0.116. The findings presented also show that taking all other independent variables at zero, a unit increase in profitability led to a 0.577 increase in the scores of level of lending to SMEs. A unit increase in relationship with a big corporate client led to a 0.157 increase in level of lending to SMEs. A unit increase in strategic focus led to a 0.082 increase in the scores of the level of lending to SMEs; a unit increase in level of competition led to a 0.021 increase in the scores of the level of lending to SMEs. Further a unit increase in interest rates led to a 0.501 increase in the scores of the level of lending to SMEs. It was further established that a unit increase in administrative cost of lending led to a 0.103 increase in the scores of the level of lending to SMEs.

This infers that profitability influenced the banks level of lending to SMEs most followed by interest rates, relationship with a big corporate client, administrative cost of lending,

strategic focus and then level of competition. The study also established a significant relationship between the level of lending to SMEs and the independent variables; profitability ( $p=0.00<0.05$ ), relationship with a big corporate client ( $p=0.036<0.05$ ), strategic focus ( $p=0.20<0.05$ ), level of competition ( $p=0.001<0.05$ ), interest rates ( $p=0.007<0.05$ ) and administrative cost of lending ( $p=0.021<0.05$ ) as shown by the p values.

### **5.3 Policy Recommendations**

The study has recommended that the government should put in place legislation to govern the SME sector including standard definition of SME. Further the study recommends that the CBK should shift focus to allow cash flow based lending as opposed to fixed asset or collateral based lending which will ensure that more banks increase the percentage of lending to SMEs. There is necessity for collaboration by the key stakeholders of the economy to reduce those factors militating against banks' lending to SMEs, and put in place a strategy by which the perceived "riskiness" associated with the sector can be eliminated. One way is for government to create an SME bank that will focus on SME lending both directly and through other banks. This will ensure that all strategic areas get funding without credit rationing by banks. Government should collate and analyse information on SMEs so that informed decisions are made on the full understanding of the problems of the SME sector. Lastly, bank support to the SMEs through Small and Medium Industries Equity Investment Scheme (SMIEIS) should be properly coordinated to reduce costs and possible chance of default. The measures suggested in this study are

of importance to policy planners, not only in Kenya, but in other developing countries at the same level of SME and economic development.

Reforming the legal and regulatory environment will contribute to increased banks' involvement with SMEs. A first area of intervention should be the legal framework for creditor rights and for secured lending. Efficiency of the courts and issues surrounding the definition of collateral has been listed as important constraints to the development of the SME lending market. Targeted interventions on the relevant legislation might contribute to speed up enforcement procedures and improve the efficiency of the judiciary. For SMEs, what constitutes acceptable collateral is also an important issue. Reforming the legal framework for secured lending and reviewing the regulatory treatment of collateral would facilitate SMEs to pledge a wider share of their assets as a guarantee for their borrowings. The Kenya government needs explore the possibility of introducing a simplified company registration process, which takes into consideration the peculiarities of SMEs compared to larger companies.

The study also recommends that while the government has done a lot to support SMEs such government programs are perceived as generally insufficient in supporting the growth of the market. This might be due to the lack of consistency. Kenya government should therefore consider introducing a dedicated and organic SME policy to boost this segment. A first start should be the adoption of a uniform definition of SME. Most of the banks in the study use loan size and turnover as criteria to define SMEs. The adoption of such criteria and their formalization into relevant legislation might ease the attainment of policy objectives in this area. A second area of intervention should include the optimization of current financing support mechanisms, including national and regional

development finance institutions, by focusing on developing new instruments. In this respect, an assessment of their mandate and their development effectiveness would help fine tune a policy review in this area.

Finally, a better understanding of the SME segment and the implementation of measures aimed at addressing some of their intrinsic weaknesses should be a further policy priority. Given the crucial importance attributed by banks to SME-specific constraints, priority should be given for example to the collection of statistics and data on their characteristics in order to better further understand the demand-side perspective, which is equally important in the development of the SME lending market. Measures in this domain should include the scaling up of capacity building programs and the introduction of incentives for SMEs to formalize. There should be empowerment of SMEs to access not just financial support but entrepreneurial education that gives an effective and enduring strategy for solving the capital problems of SMEs.

## **5.5 Suggestions for Further Research**

The study has explored the relationship between selected supply side factors and lending to small and medium enterprises by commercial banks in Kenya. The SMEs industry in Kenya however is comprised of various other SMEs stakeholders located in other areas in Kenya which differ in their way of management and have different settings all together. This warrants the need for another study which would ensure generalization of the study findings for all the SMEs stakeholders in Kenya and hence pave way for new policies. The study therefore recommends another study be done with an aim to investigate the relationship between selected supply side factors and lending to small and medium

enterprises by SMEs supporters in Kenya for example Saccos, Micro Finance Organisations among others.

The research established that the studied factors accounted for 74.2 percent of the factors affecting lending to SMEs in Kenya. This implies that there are other factors that were not studied that contribute to 25.8 percent. Another research should be done on the other factors affecting lending to SMES in Kenya not studied by this research.

There is a research gap especially because banks do not keep segmented accounts hence making it difficult to establish the level of profitability that can be attributed to SME as a segment. Another detailed research is needed to establish profitability and relate this to level of lending to SMEs.

## **5.5 Limitations of the Study**

This section takes into account on some of the limitation of the study. Out of the forty four banks that were initially targeted as the population of the study twenty seven responded to the questionnaire with the rest not responding. This therefore limited the full outcome of the research as had been earlier anticipated by the researcher.

The other limitation was on the unavailability of profitability or income by segments from the commercial banks since most banks do not split their income by segment. This meant that they had to estimate the contribution from SMEs to the overall profitability of the banks. This limitation extends to the CBK who likewise do not keep segment performance by the industry therefore hampering the accuracy of the research in regards to SME performance.

A portion of the data used was secondary collected from CBK generated for other purposes. The measures used may keep on varying from one year to another subject to the prevailing conditions. For example the interests' rates which directly affect the level of profits for a bank was sharply affected by the highinflation rates in the year 2011.

Finally, despite assurances that the study was purely for academic purposes and that all data would be aggregated to avoid linking it to any specific bank, many banks were still unwilling to give information due to internal policies or for fear of giving away competitive information thus hampering the quality of the results of the study.

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## APPENDICES

### Appendix I: QUESTIONNAIRE

This questionnaire is strictly for academic purposes and the information collected is confidential. The findings of the research will be aggregated to make conclusions on the overall Banking Industry in Kenya thus individual information will not be analysed.

SMEs are a strategic focus area for the Government of Kenya in its effort to address employment, economic growth, and provision of various products and services to the country. It is estimated that SMEs provide over 70% of all jobs in the country. This survey is very important to us as a way to gain academic knowledge as part of the MBA project and in the industry to improve understating of lending to SMEs by commercial banks and the factors that banks consider when lending to SMEs.

The following questions seek your understanding of the relationship between selected factors and your bank lending to SMEs.

Please answer all the questions to the best of your ability.

#### **Basic information**

1. What is the name of your Commercial Bank? .....
2. In which area do you work? .....
3. How long have your worked in the Banking industry? .....

Below are questions / statements describing selected factors that commercial banks consider important when lending to SMEs. For each of the statements kindly respond by ticking the box corresponding to your choice whether you agree or disagree with the statements made as per the scale given.

Indicate your level of agreement with each of the following statements where

**1=Strongly Disagree 2=Disagree 3=Neutral 4=Agree 5=Strongly Agree**

Statements	1	2	3	4	5
The level of competition among corporate and retail customers is generally stiff and this has to a large extent forced my bank to focus on SMEs to diversify our income lines.					
To a large extent we find that there is not much competition in the corporate and retail segment we operate in and therefore we have not found it necessary to focus on SME lending.					
Many new players have joined banking making the sector to a large extent competitive consequently; we have considered SMEs a must growth area for us.					

<p>More and more of our customers are asking for SME lending and we focused on this area to meet their needs.</p>					
<p>We view the SME sector in Kenya to a large extent to be profitable and we made it a core to our strategy</p>					
<p>We have noted that most of the banks that have focused on SMEs experienced some losses caused by Non-performing SME loans making us to a large extent cautious on SMEs.</p>					
<p>We find that our other businesses, for example, Corporate, Retail, Treasury, among others to a large extent are profitable and we do not need to take the additional risk of lending to SMEs.</p>					
<p>To a large extent the level of monitoring and follow up needed by SMEs is high while the loan sizes are small making the sector too costly administratively. We find that it is better to lend to larger Corporate customers as these give us more income and at lower cost.</p>					

Statements	1	2	3	4	5
Our Bank strategy considers the SME sector a core strategic thrust area that is key to the achievement of our strategic objectives.					
To a large extent our lending exposure to Corporate banking is high and strategically we have decided to focus more on other areas of the business especially SMEs.					
To a large degree we find the SME sector more risky compared to other segments and hence do not focus much in this area.					
We largely have a very good relationship with our Corporate customers and based on that we target only those SMEs that supply to our key Corporates for lending purposes.					
Generally any SME can walk in and apply for a facility without having a relationship with a larger Corporate customer so long as they meet our credit requirements, for example, age of the business, audited accounts, serviceability, collateral, nature of the business they are in, and					

management.					
To a large extent, we have put in place a dedicated team located at our Head Office to manage SMEs but business can be sourced from branches.					
Generally speaking, our SME sales and service model is well distributed across the country to serve the customers better.					

<b>Statements</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
To a very large extent we have computerised systems that support in appraising SME credit applications and in accepting or rejecting the risk including origination, credit scoring, monitoring and control, Provisioning and collections.					
To a large extent, our credit process is manual and is done by credit analysts.					
To a large extent, our internal processes are geared to serving the SME sector					

<p>To a large extent, we have a robust credit policy in place that scientifically discriminates between acceptable and unacceptable SME credit applications.</p>					
<p>To a large extent, our credit process is centralised at the head office with a few select credit officers approving all applications so that quality is maintained.</p>					
<p>Largely, our credit process is done at the branch level so that we can respond to the customer very quickly depending on the need of the customer.</p>					
<p>To a large extent, we find that the Credit Reference Bureau listing significantly improves decision making in approving a SMEs credit application.</p>					
<p>To a large extent, we find that the interest rate regime is unpredictable with huge swings making SMEs a risky business as their default rates tend to increase with higher interest rates. During periods of high interest rates we slow down lending to SMEs.</p>					

Statements	1	2	3	4	5
To a large extent, SMEs have a way of passing on the extra interest cost to their retail customers cushioning themselves against adverse movements in interest rates. We maintain the same risk appetite to SMEs across interest rate movements.					
To a large extent we find that when interest rates increase, fewer SMEs borrow from us.					

Do you have any comments or suggestions? Please feel free to write them below.

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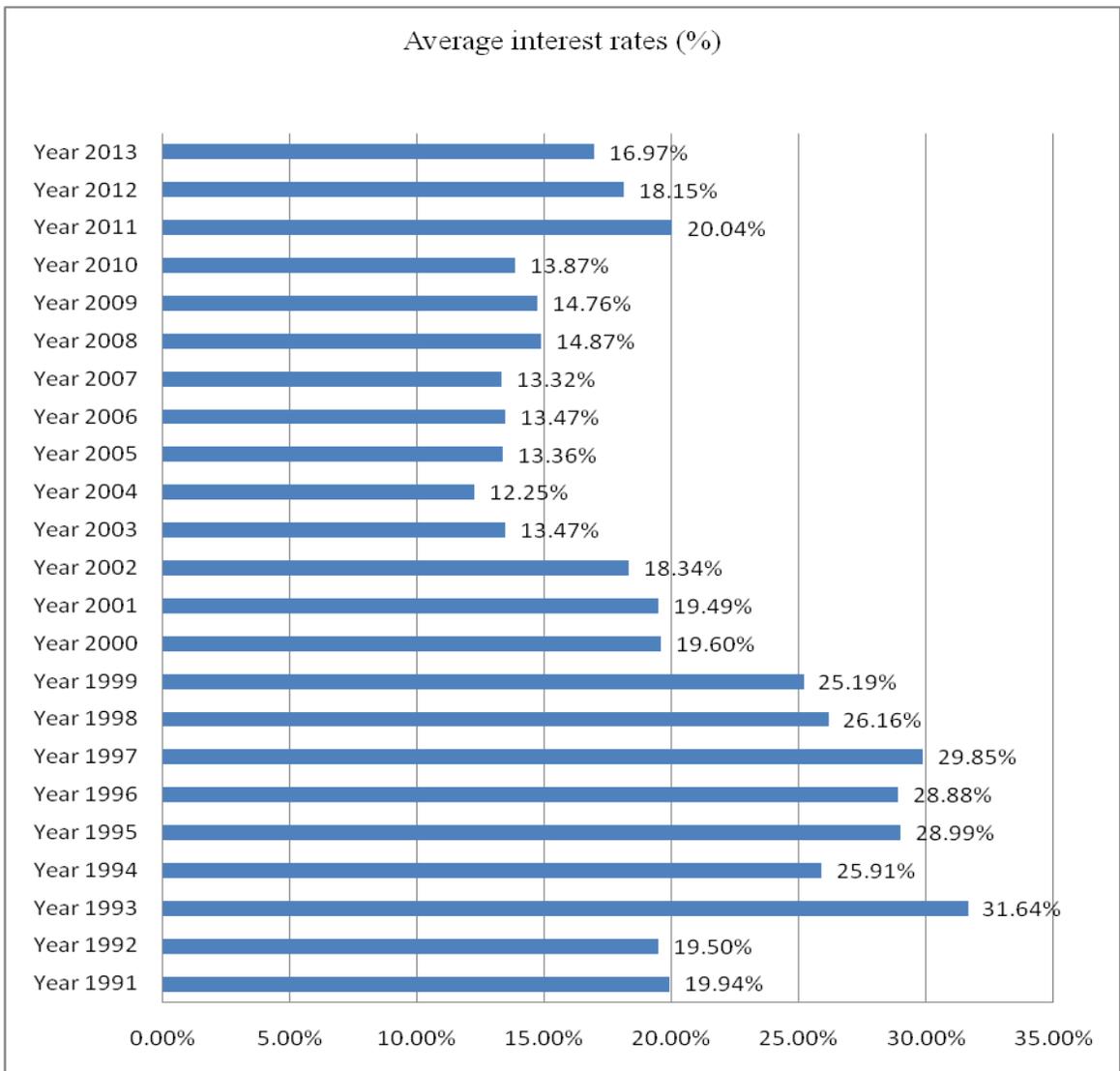
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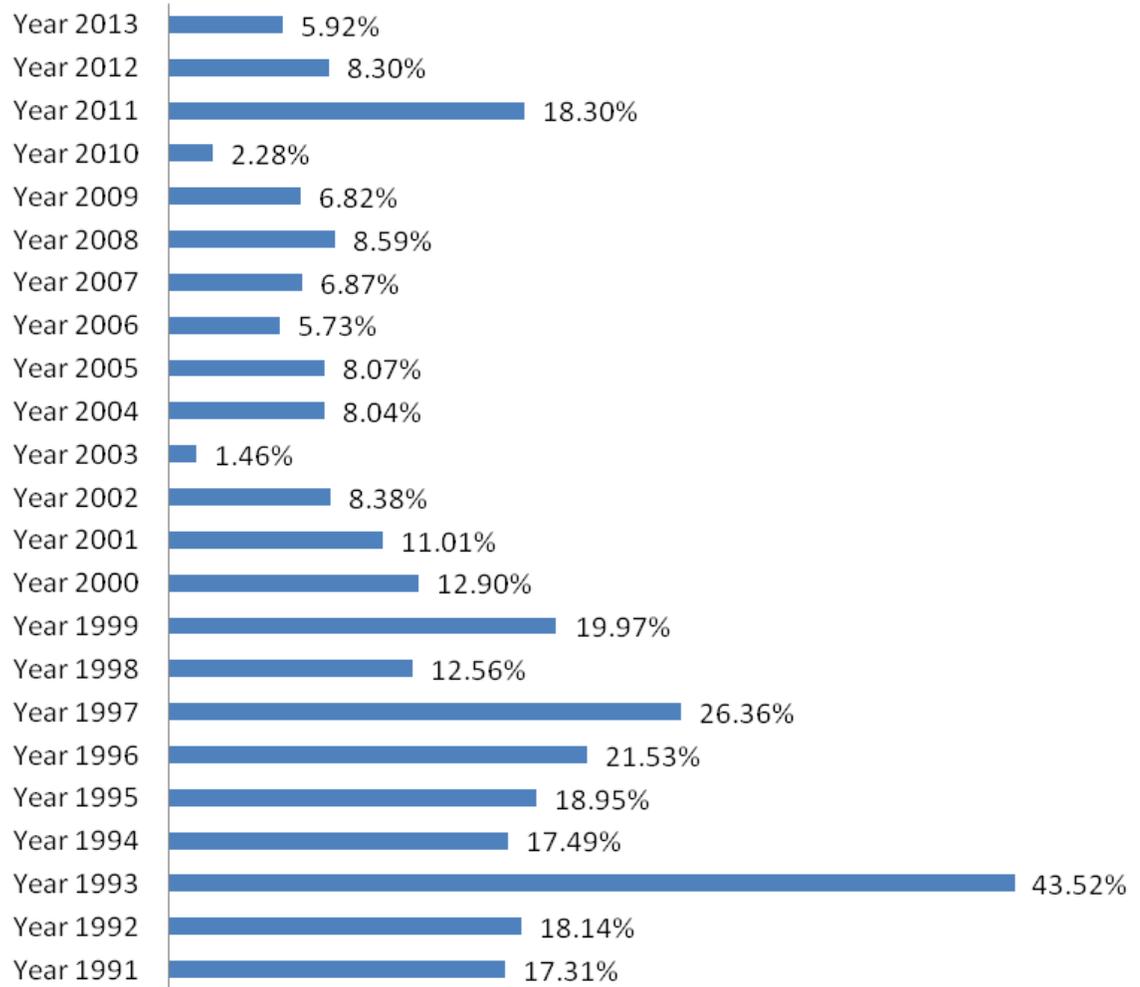
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Thank you for participating in this very important survey!

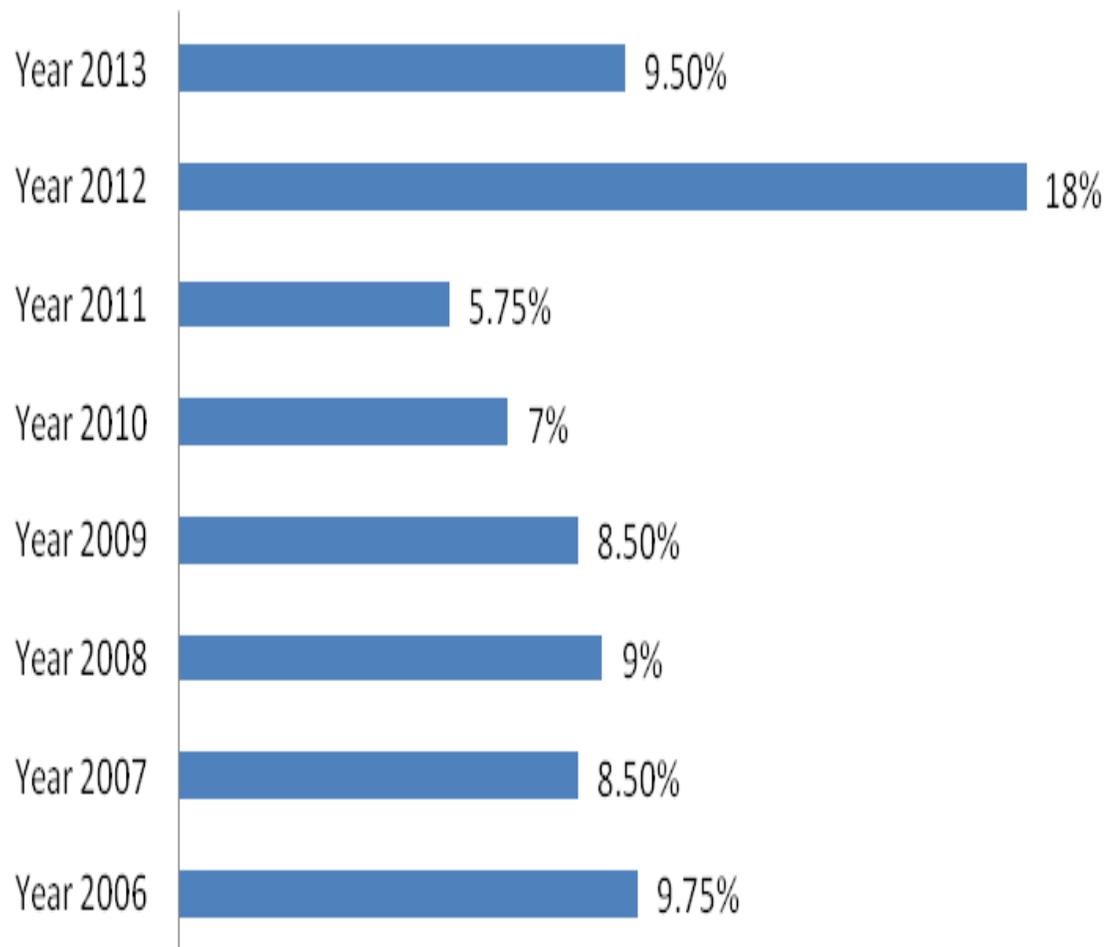
## Appendix II: CBK Average Interest Rates



### 91- Day Tbill



## CBK Rates



### **Appendix III: List of All Licensed Commercial Banks in Kenya**

1. ABC Bank
2. Bank of Africa
3. Bank of Baroda
4. Bank of India
5. Barclays Bank
6. CFC Stanbic Bank
7. Chase Bank
8. Citi Bank
9. Commercial Bank of Africa
10. Consolidated Bank
11. Cooperative Bank of Kenya
12. Credit Bank
13. Development Bank of Kenya
14. Diamond Trust Bank
15. Dubai Bank

16. Eco Bank
17. Equatorial Commercial Bank
18. Equity Bank
19. Family Bank
20. Fidelity Commercial Bank
21. Fina Bank
22. First Community Bank
23. Giro Commercial Bank
24. Guardian Bank
25. Gulf African Bank
26. Habib Bank
27. Habib Bank AG Zurich
28. Housing Finance
29. I&M Bank
30. Imperial Bank of Kenya
31. Jamii Bora Bank
32. Kenya Commercial Bank

33. K-Rep Bank
34. Kenya Post Office Savings Bank
35. Middle East Bank
36. National Bank of Kenya
37. NIC Bank
38. Oriental Commercial Bank
39. Paramount Universal Bank
40. Prime Bank
41. Standard Chartered Bank
42. Trans National Bank
43. United Bank of Africa
44. Victoria Commercial Bank

## AppendixIV: Findings of the Survey

Statement	Mean	Std. Deviation
We view the SME sector in Kenya to a large extent to be profitable and we made it a core to our strategy.	4.0000	.96077
We have noted that most of the banks that have focused on SMEs experienced some losses caused by Non-performing SME loans making us to a large extent cautious on SMEs.	3.0741	1.29870
We find that our other businesses, for example, Corporate, Retail, Treasury, among others to a large extent are profitable and we do not need to take the additional risk of lending to SMEs.	2.9259	1.61545
To a large extent the level of monitoring and follow up needed by SMEs is high while the loan sizes are small making the sector too costly administratively. We find that it is better to lend to larger Corporate customers as these give us more income and at lower cost.	2.8341	1.66239
The level of competition among corporate and retail customers is generally stiff and this has to a large extent forced my bank to focus on SMEs to diversify our income lines.	3.5185	1.25178
To a large extent we find that there is not much competition in the corporate and retail segment we operate in and therefore we have not found it necessary to focus on SME lending.	2.7778	1.64862
Many new players have joined banking making the sector to a large extent	3.6667	1.41421

competitive consequently; we have considered SMEs a must growth area for us.		
More and more of our customers are asking for SME lending and we focused on this area to meet their needs.	3.9630	1.09128
Our Bank strategy considers the SME sector a core strategic thrust area that is key to the achievement of our strategic objectives.	3.7778	1.28103
To a large extent our lending exposure to Corporate banking is high and strategically we have decided to focus more on other areas of the business especially SMEs.	3.3333	.87706
To a large degree we find the SME sector more risky compared to other segments and hence do not focus much in this area.	2.5926	1.33760
To a large extent, we find that the interest rate regime is unpredictable with huge swings making SMEs a risky business as their default rates tend to increase with higher interest rates. During periods of high interest rates we slow down lending to SMEs.	3.4074	.93064
To a large extent, SMEs have a way of passing on the extra interest cost to their retail customers cushioning themselves against adverse movements in interest rates. We maintain the same risk appetite to SMEs across interest rate movements.	3.6250	1.08342
To a large extent we find that when interest rates increase, fewer SMEs borrow from us.	4.1739	.38755
To a very large extent we have computerised systems that support in appraising SME credit applications and in accepting or rejecting the risk	3.7037	.91209

including origination, credit scoring, monitoring and control, Provisioning and collections.		
To a large extent, our credit process is manual and is done by credit analysts.	3.2963	1.06752
To a large extent, our internal processes are geared to serving the SME sector.	3.4444	.93370
To a large extent, we have a robust credit policy in place that scientifically discriminates between acceptable and unacceptable SME credit applications.	3.6667	1.03775
To a large extent, our credit process is centralised at the head office with a few select credit officers approving all applications so that quality is maintained.	4.0370	1.09128
Largely, our credit process is done at the branch level so that we can respond to the customer very quickly depending on the need of the customer.	3.3704	1.18153
To a large extent, we find that the Credit Reference Bureau listing significantly improves decision making in approving a SMEs credit application.	4.4444	.50637
To a large extent, we have put in place a dedicated team located at our Head Office to manage SMEs but business can be sourced from branches.	4.1111	1.15470
Generally speaking, our SME sales and service model is well distributed across the country to serve the customers better.	3.9630	.75862
Generally any SME can walk in and apply for a facility without having a relationship with a larger Corporate customer so long as they meet our credit requirements, for example, age of the business, audited accounts, serviceability, collateral, nature of the business they are in and management.	4.4074	.74726
We largely have a very good relationship with our Corporate customers and	2.9259	1.51723

based on that we target only those SMEs that supply to our key Corporates for lending purposes.		
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