CHALLENGES OF FINANCING SMALL & MEDIUM ENTERPRISES [SMEs] INEQUITY BANK BRANCHES IN KENYA

BY

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A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILLMENT OFTHE REQUIREMENT FOR THE AWARD OF THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION, SCHOOL OF BUSINESS, UNIVERSITY OF NAIROBI

NOVEMBER, 2013

Declaration

I, the undersigned, declare that this my original work and has not been submitted for a degree in this or any other University for examination

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Date…………………………………………………..

This research project has been submitted for examination with my approval as the University supervisor.

Signature

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Date……………………………………………………

Acknowledgements

I am deeply indebted to all those people who, in their own individual way, contributed either directly or indirectly to the successful completion of this project. Special thanks go to my supervisor Mr. Luther Otieno, who patiently and conscientiously guided me through the research, for without caring guidance, this project would not have been possible.

I am also deeply indebted to my loving family members for their unrivalled perseverance, support and love during the whole period of this study. Special thanks goes to my dad the late Mzee John Joshua Okoth, who never lived to taste the fruits of his long self-denial and enduring support throughout my academic life. My loving mother Mary Aoko, brothers, sisters, sisters in – laws and entire John Joshua [J.J] Okoths' family for their equal support, thank you for your tireless efforts of ensuring that my dreams are realized.

Thanks to all my friends without mentioning names, who encouraged me through the period of study. More special thanks to the entire staff of the university of Nairobi ,school of business especially, the Coordinator of Business school, Kisumu campus ,Mr. Alex Jaleha and all lectures who took me through the Master's degree programe, lastly to my former manager at Equity bank for the permission he used to extend to me to attend classes at School of business and former colleagues at Equity Bank L.T.D for the data and relevant information that enabled me complete this report .Naturally ,whereas I received a lot of support and guidance in this researchproject, responsibility and blame for any deficiencies therein solely rests on my shoulders.

Dedication

To my late father **John Joshua Okoth** [J J] who passed on late last year, he had given me the encouragement and motivation through my studies right from primary to University until his sudden painful demise.

To the two most important women in my life: My wife **SusanAyugi**and my mum **Mary AokoOkoth**.

To my children,**Rihana**,**J J**and **Randy.**

And to my other family members, classmates and friends, I say a big thank you for your moral and material support that you accorded me during my studies. All praises goes to our Almighty Father.

Acronyms and Abbreviations

SMEs- Small and Medium Enterprises

CBS- Central Bureau of Statistics

MFIs- Micro Finance Institutions

DFID- Department of Direct Foreign Investments

ILO- International Labor Organization

NGOs- Non- Governmental Organizations

GoK- Government of Kenya

LDCs- Less Developed Countries

MNPD- Ministry of Planning and National Development

NFBIs- Non Bank Financial Institutions

EBL- Equity Bank Limited

EU- European Union

Abstract.

The study was seeking to determine the challenges faced by Equity Bank branches in financing SMEs in Kenya and examine how it's trying to address these challenges. The unit of study was Equity Bank (K) Limited and judgmental sampling was used to select 50 branches to be studied. Primary data was collected using structured questionnaires while the published financial statements for the Bank were the main sources of secondary data. The questionnaires were divided into three sections; section A addressed the background information on Equity Bank; section B addressed SME products offered by the bank while section C addressed the challenges in the process of extending finance to SMEs. Major challenges faced by the Equity bank branches as revealed by the study in the process of lending to small businesses are that: most SMEs do not submit mandatory documents required for financing, 66.7% of SMEs submit cash flow projections while 52.8% submit certificates of registration/incorporation and securities provided are weak as 22% provides chattels mortgage and inventory hypothecation while only 4% provide housing as their collateral. This indicates a bigger challenge the bank branches face in financing this sector. Detailed information on the bank's operation especially on the guarantee schemes, sources of funds and the total sum of SME lending book could not be availed due to the bank's confidentiality policy. These were some of the challenges faced while collecting data in the field. An empirical survey should be done to include all of the 160 branches in Kenya which might produce representative results. The study recommends that a further research could also be done to look into different financing strategies adopted by commercial banks in serving the SME sector.

Table of Contents

List of tables

List of figures

CHAPTER ONE: INTRODUCTION

1.1 Background of the study

Small and Medium Enterprises (SMEs) firms play an increasingly important role in a country's economy; therefore, the well-being of these firms is a necessity for a country's future success. Africa's private sector consists mostly of informal micro-enterprises operating alongside large firms. Between these large and small firms, small and medium enterprises (SMEs) are very scarce and constitute a "missing middle" (Tagoe, Nyarko and Amarh, 2005)).

Of all the major problems facing SMEs in Africa, Kenya has identified two as the most critical. The first one is lack of a supportive governance framework. SMEs suffer due to lack of legal framework that protects interests, harassment from local authorities' unsupportive tax regime and exposure to corruption. The second reason is lack of adequate access to credit. SMEs have little access to finance, which thus prohibit their emergence and eventual growth. This has not been easy for SMEs due to the stringent credit terms offered by financial institutions. Most of small businesses do not have access to finance due to lack of minimum requirements from commercial banks in Kenya, most commercial banks have been hesitant in lending to the small business due to lack of collateral, credit history, financial statement and banking history. Their main sources of capital are retained earnings, borrowings from friends, family capital and informal savings, which are unpredictable, not very secure and have little scope for risk sharing. Access to final finance is poor because of the high risk of default among SMEs and due to inadequate financial facilities (Kauffmann, 2010). In a recent study, Atieno (2009) found that although informal finance provides easier access to credit, it is confined to specific activities and at lower levels of income, thus limiting its use.

Fair access to credit and banking services are a ladder to development and poverty reduction world over. Access to a bank account gives an individual greater control and security over their money, and a loan from a credit organization can be vital in promoting enterprise development (Kauffmann, 2010). Banks need to address the needs of these SMEs so that they can grow and expand and therefore be a major driver in the growth of the economy. Most commercial banks have been hesitant in lending to the small businesses due to lack of collateral, credit history, financial statements and banking history.

Most commercial banks in the recent past have developed different financial products to consumers in business banking, retail banking, and personal banking and SME banking. Banks such as Kenya commercial bank, Barclays bank, Standard chartered bank, CFC bank, Co-operative bank, I & M bank, NIC bank, bank of Africa and Equity bank have tailored their products to suit the surging demand for different financial products. Banks in Kenya by the mere fact that they are commercial in nature and because of the level of risk involved are forced to charge high interest rates, require high value collateral from SMEs, financial statements, bank statements, and insurance for the facilities sought, which eventually increase the transaction cost for the SMEs. This has brought in a daunting challenge for banks in the provision of the credit to the SMEs. On this account, commercial banks need to focus on the provision of products which satisfy the customers' needs in the current changing market at the same time addressing various challenges they are facing in extending the credit facilities to this clientele.

1.1.1 Small and median Enterprise

The definition of SMEs according to the type of the study one is carrying out or the size of the economy being studied, criteria used in given country of study also differ depending on the purpose of classifying the business into small, medium or large. Ikiara, G.K., [1991] points out that the point under which an enterprise is deemed to be small and the way in which its size is measured has been a debatable subject for a long time. There is no general consensus as to the definition of what a small, medium or large business is. Tagoe, Nyarko and Amarh,(2005) point out that while in countries such as the United States, Britain and Canada, businesses are defined in terms of annual turnover and the number of employees. In Japan such businesses are defined in terms of paid up capital and the number of employees. In Britain, a small business is an industry with annual turnover of 2 million pounds or less with fewer than 2000 paid employees.

While in Japan a small business is manufacturing firm with 100 million or Yens paid up capital and 300 or less employees. Mc Menamin, (2009) defines small medium enterprises as the manufacturing or non-manufacturing service enterprises in which the owner manager is not necessarily activity engaged in production but performs the various tasks involved in the guidance and leadership without the help of a specialized staff. He further defines small business which are mainly family based. Unregistered by the government or lack collateral as assets those are bankable.

Kilonzi (2003) concludes that analyzing the problems facing the small business enterprises sector in Kenya is even complicated further by differences and ambiguities in the terminologies used. To him, small business enterprise is a general term which, refer to firms whose size is in some way limited. According to Equity Bank credit policy (2007), Small and Medium Enterprises are those businesses with employees not more than 100 people and an annual turnover of between Kshs. 2 and 10 million. Therefore, this study will adopt the definition as described by Equity Bank.

1.1.2 Challenges in financing SMEs

Small business enterprises have traditionally encountered problems when seeking financial from banks to support their fixed capital investment as well as working capital for their operations (Tagoe, Nyarko and Amarh, 2005). Finance providers for small- and medium-sized enterprises (SMEs) range from venture capitalists commercial banks, micro-finance institutions, grants and soft loans from family, friends as well as personal savings. Marwanga et al[2003]. points out that challenges that faces SMEs in many developing countries including Kenya is monumental. The worse worrying among these challenges is funding. Most new small business enterprises are not very attractive prospects for mainstream banks, with their rigid lending regulations. Some of the challenges are as discussed below.

1.1.2.1 Credit Risk management

Stanghellini (2003) observed that consumer credit is any of the many forms of commerce under which an individual obtain goods or services on condition of promise to pay their value, along with a fee (interest), at some specific future date. He further acknowledges that the need to cope up with a vast demand for credits forced the lenders to implement automatic techniques for deciding whom to lend loan or not, risk is exposure to a proposition of which one is uncertain.

Cook and Nixon, (2006). states that a number of major world's commercials banks have developed sophisticated systems to quantify and aggregate credit risk upon which their lending is determined. Credit risk management refer to the systems, procedures and controls which a company has in place to ensure the efficient collection of customer payment and minimize the risk of default,(Mc Menamin, 2009).

1.1.2.2Credit Assessment

Commercial banks and other lending institution have set up standardized risk assessment criteria in screening loan applicants which is great hindrance to many small and medium enterprises. The criteria have been summarized in 5 Cs which have been applied as a rule of thumb for a long time in the lending market. Robert Warlow (2006) explain that while no one "C" is more important than another "C" (all "C" are relatively equal and together help to form an entire picture of the project and client) we present the categories in the way they are generally presented.

Character: This can refer to managerial ability and also personal integrity. While judging the personal integrity of anyone is delicate matter, we try to look for indications which reflect these personality traits. These are items that can inform our decisions as to the credit worthiness of the proposal and the character of the borrower, customer served, skills to do the business, personality and commitment to repay the loan facility.

Capacity: capacity refers to the ability of the borrower to generate enough cash sales to meet the operating needs of the business and to also meet all the debt repayments (current debt payment and projected). Capacity mainly deals with cash, because it is cash which pays back the loan. This gives main focus on the cash flow. Customers, competition, suppliers, market strategy and product or service.

Collateral: Cash generated from the business is the primary source of loan repayment. Regardless of the best efforts and analysis, loans go delinquent and borrowers default. This leads the secondary sources of repayment which the collateral. These are the assets lenders take to secure the loan. Adequate collateral coverage is necessary to protect the banks in case of default. This mainly focuses on liquidity, location of the business and legal consideration.

Condition: All business including SMEs are influenced by the economic environment in which they operate. There are general conditions which can have a positive as well as negative concern. These influences can come from main source including both macro and micro economic changes and legal environment.

Capital: This is also referred to as owners as Owners Equity or Shareholders Equity. This represent what the borrowers can lose personally if the loan goes into default and subsequently declared bankrupt/non-solvent. Lenders want to ensure that when they make loan which goes into default, then the borrower (as the company and personality) is hurt as much greater than the lender. The potential for hurt is a greater motivator to help ensure that the business operates as successfully as possible.

In most occasions the criteria discussed above are not attainable by SMEs thus leaving them out of credit especially from the main banks that can be quite flexible in trying to protect their assets.

1.1.2.3 Information asymmetry

The problem faced by small firms when attempting to raise finance may also arise from information asymmetry. The nature of the information asymmetry problem on the firm’s side is that it cannot prove the quality of its investment projects to the provider of finance. Thus; the information asymmetry problem is partly one relating to difficulties in the spheres of communication and credibility (Fischer, 2008).This is compounded by the fact that new or recent start-up businesses may be unable to provide evidence of a good financial performance track record. Banks in particular rely on past financial performance as an indicator of the future profitability of the projects. This can be resolved by demonstrating creditworthiness and project viability. However, because of poor accounting practices and record keeping, many SMEs are unable to do so (Cook and Nixon, 2006).

1.1.2.4 Firm Characteristics

Other small firm financing problems relate to the characteristics of the firm itself, the attitude and objective of the owner-manager. Such characteristic include their diversity, their higher risk, their inability to provide strong collateral, and stage of development effects. Binks and Ennew (2009) notes that there is no such thing as a typical small firm. This heterogeneity presents lenders with great difficulty in determining the risk associated with the firm's projects.

The stage of development then may be an importance determinant of, and constraint on the type and amount of external finance raised. Small firm financing, then will typically be heavily secured debt, with few incidences of external risk capital contribution (Cruickshank, 2000). The reason for lack of credit for formal enterprise are difficulties in loan administration like screening and monitoring high transaction costs, and the risk of default. Credit markets are characterized by information asymmetry, agency problem and poor contract enforcement mechanisms (Aryeetey, 2005). They are mainly fragmented because different segments serve clients with distinct characteristics. Because of this, lending units are unable to meet the need of the borrower interested in certain types of credit.

The result is a credit gap that capture those who borrowers who cannot get what they want from the informal market, yet they cannot gain access to formal sources. Enterprises that want to expand beyond the limits of self-finance but luck access to bank credit demand finance, which the informal sector is unable to satisfy.

1.1.2.5 Appropriate Information

Edward and Turnbull (2008) found out on unexpected lack of appropriate information collection within the companies. In the smaller retailing companies the lack is particularly marked. However, the nature of the problem was such that improvement was apparently possible. Elijah (2007) points out that lending to small firm is difficult because of the problems of information asymmetry.

A more serious obstacle to change existed in the perceived function of budgets. The dissemination of information was restricted not only with regard to external users, but significantly, also to internal management. In at least some companies this was linked to the perceived function of the budgets. Many companies did not recognize a role for budget in strategic planning. If companies are to use income gearing as an effective tool for obtaining loans then a culture change may be necessary in terms of the perceptions about the function of budgets and the dissemination of information, both internally and externally. There was recognition of the deficiencies in information and the lack of computer literacy. Those interviewees working in companies which did not prepare any form of budget information, provide evidence, the albeit restricted by the small numbers, that improved information preparation does occur in response to external demands.

1.1.3Commercial Banks

Commercial banks are normally reluctance to extend credit to Small and Medium Enterprises (SMEs) due to lack of securities that can be used as collateral in convectional lending process. Commercial banks perceive SMEs as a highly risky and undeserving of any credit even though the SMEs owners save with these banks. The costs associated with administering and monitoring credit services are quite high. The loan value required by people in this sector is low hence proportionally low revenue is generated from the loans (Mudiri, 2003). Over the few years banks have made a significant push in developing of SME products and provision of credit facilities to SMEs due to the prevailing high levels of profitability and economic growth. This been witnessed as a result of bottleneck competition within the banking industry (Baydas, 2007).

1.1.3.1 Equity Bank L.T.D.

Equity Bank Limited (The "Bank") is incorporated, registered under the Kenyan Companies Act Cap 486 and domiciled in Kenya. The address of the Bank's registered office is 9th Floor, Equity Centre, P.O. Box 75104 – 00200 Nairobi. The Bank is licensed under the Kenya Banking Act (Chapter 488), and continues to offer retail banking, microfinance and related services. The Bank has subsidiaries in Kenya, Uganda, South Sudan, Rwanda and Tanzania. Its shares are listed on the Nairobi Securities Exchange and Uganda Securities Exchange.

Equity Bank was founded as Equity Building Society (EBS) in October 1984 and was originally a provider of mortgage financing for the majority of customers who fell into the low income population. The society's logo, a modest house with a brown roof, resonates with its target market and their determination to make small but steady gains toward a better life, seeking security and advancement of their dreams. The vast majority of Africans have historically been excluded from access to financial resources.

Having been declared technically insolvent in 1993, Equity's transformation into a rapidly growing microfinance and then a commercial bank is widely considered to be an inspirational success story. The company's vision is "to be the champion of the socio-economic prosperity of the people of Africa".

Equity Bank retains a passionate commitment to empowering its clients to transform their lives and livelihoods. Through a business model that is anchored on access, convenience and flexibility, the Bank has evolved to become an all-inclusive financial services provider with a growing pan African footprint.

As a Bank, it is guided by the following Core Values which it upholds in all the activities it undertake. These are Professionalism, integrity, creativity& Innovation, teamwork, unity of Purpose, respect & Dignity for Customers and effective Corporate Governance

1.2 Research Problem

In the recent past some commercial banks have introduced the SME banking concept but they have not yet examined the real needs of SMEs, challenges they face in trying to lend these funds and the suitable methods that banks can use to satisfy the financial needs of this sector. However, Equity Bank has positioned itself in the market as a SME bank focusing purely on the SME market for the last three years.

Helmsing and Kolstee (2006) clearly indicates that despite SMEs perceived important in generating employment and production, the SMEs in Kenya has vary inadequate access to credit. According to Rukwaro, (2007), a large number of Kenyans derive their livelihood from the SMEs. Therefore the development of this sector represents an important means of creating employment, promoting growth and reducing poverty in the long-term. However, in spite of the importance of this sector, experience shows that provision and delivery of credit and other financial services to this sector by commercial banks has been below expectation (Mwaka,2006) most financing, therefore, comes from own savings or informal credit markets controlled by NGOs and community welfare groups.

Microfinance institutions have played a great role in the provision of credit and other services but under stringent credit terms which do not favor most SMEs. Despite all these benefits, SMEs contribute to the economy of the country, commercial banks have been very reluctant in extending credit to this sector due to various challenges they face in the process. This study intends to determine challenges facing commercial banks in extending credit to SMEs and how they are trying to address these challenges. The study undertakes to answer the following questions: What are the challenges faced in the process of financing SMEs? How do commercial banks try addressing these challenges they face in financing SMEs and their banking needs?

The study aims to examine the banking needs of Small and medium Enterprises (SMEs), challenges faced by commercial banks in financing SMEs and how commercial banks with specific reference to Equity bank are trying to address these challenges.

1.3 Research Objectives

The objectives of the study are mainly:

a. To determine the challenges faced by Equity Bank branches in financing SMEs in Kenya and examine how Equity bank branches in Kenya are trying to address these challenges.

1.4 Justification of the study

Various studies have been done in the Small and Medium Enterprises (SMEs) sector locally but none of them has emphasized on the evaluation of challenges faced by commercial banks in financing SMEs. Mwaka (2006) focuses her study on the financial structure and growth of SMEs. The study access the growth of SMEs but fail to deal with the challenges these business faces in accessing finances from commercial banks. Rukwaro (2001) looks at the credit rationing aspect of financing on the micro-finance institutions and the influence on the operations of SMEs. This study does not touch on the financing of SMEs by commercial banks. Wanyungu (2000) on the other hand focuses on the financial management practices of SMEs in Nairobi and yet failed to tackle of the issue of challenges faced by commercial banks in providing credit to these firms.

Mueni (2006) looks at the linkages between micro-finance institutions and commercial banks in Kenya. The study does not address the issues on challenges faced during the process of accessing and lending credit by both SMEs and commercial banks respectively.

Kilonzo (2003) further examines the relationship between financial structure and performance of Micro and Small Enterprises in Nairobi. The study reveals that Micro and Small Enterprises are mainly financed by internal funds. Dossajee (2005) in his study indicates that a number of variables combined could contribute to success of small businesses. These include hard work, optimism, trade credit, business contacts, and capital base of the business, capable manpower and ability to organize business operation. The study however fails to identify the challenges commercial banks face in providing credit to SMEs for their expansion of the businesses. Therefore this gives the need to examine the challenges that may be faced by commercial banks, How to address these challenges and the specific banking needs required by SMEs to expand and manage their operations.

This study will be of great importance to different stakeholders in the society since majority of Kenya population are focusing on self-employment through these small and medium enterprises. The following are some of the importance to be derived from the study.

Small and medium enterprises (SMEs)

It will benefit the small and medium business owners by giving them the information on the source of funds available to them and the relevant requirement by commercial banks to extend the credit to them.

Commercial bank in Kenya.

The research will give challenge to the commercial banks in Kenya to modify and restructure their lending policies to be in line with the dynamic structure of the economy as well as the changing consumer demands in order to effectively address the challenges they face in the process of financing these small and medium enterprises.

The government.

It will also help the government in identifying the area of support to banks by coming up with policy incentives so as to serve SMS better, to encourage their growth which in turn will stimulate economic development and hence creating employment opportunities.

Academicians.

To academics who want to understand better the nature and success of relationships between banks and SME clients bringing the gap between the two and their respective credit policy.

Tax authority

Make recommendation to tax authorities so that they make efficient tax structures which are favorable to the SMEs.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter reviews literature guided by the objectives of the study which is to examine the successful model for financing adopted by Equity Bank Kenya in financing of small and medium enterprises in Kenya for the last three years. The chapter looks and tries to come up with common understanding of the suitable models used by commercial banks. The chapter provides an elevation on the effectiveness of the products offered and the nature of SME relationship with commercial banks. These considerations therefore, become the basis for the study.

2.2 Small and Medium Enterprises in Kenya

The rapid growth of SME sector can be attributed to the adjustment programs that have result in widespread retrenchment both in public sector and private sector. Many retrenched workers have sought alternative employment in the informal sector. In addition, the recent growth in Kenya economy has really improved the growth of SME sector in Kenya.

The reason why the informal sector flourishes in Kenya is operations of business without much restriction or regulation, the entrepreneur's flexibility in meeting customer needs and the goods and services provided depended on demand perceived by entrepreneurs (Berger, A. N. 2005).The informal sector will continue growing thereby providing income generation opportunities for those willing and able to take advantage (Mullei, A. &Bokea, C. 2009). Shortage of credit has been identified as one of the most serious constraints facing SMEs and hindering their development.

Development plan of the government of Kenya put proposal that credit scheme of Ksh. 50 billion be set aside for lending to small business development sets out mechanisms for the removal of constraints to the growth and development of the SME sector.

2.3 Financial needs of small and medium enterprises (SMEs)

The importance of small and Medium enterprises (SMEs) in the alleviation of the poverty in Kenya has been recognized in the Ministry of Finance budget speeches (2009/2010, 2010/2011, 2011/2012, 2012/2013). These businesses are largely undertaken by self-employment persons; owned account workers employ nearly 4.3 million people or 36% of the country's total employment. The SMEs have faced various challenges when seeking funds for investments, these SMEs cannot easily access funds from commercial banks due to their underdeveloped businesses that have very short bank history making banks unwilling to lend them funds. Owners of these businesses may not have banking history with commercial banks that can form the basis of their lending. This possibly explain why the banks in the late 1990s to 2000 relocated their operation from rural areas to urban centers rendering potential customers in these areas to have no access to credit (Coetzee et al, 2006). SMEs need funds for new investments inform of business expansion. Rukwaro (2007) observe that most SMEs also need credit for operational activities and growth of business. Studies have also found that the most funds received from the credit institution are used as working capital (Gatune, 2002).

2.4 Merits of small and medium enterprises

Mwaka (2006) cites that there are a variety of areas in which the small business owners enjoys distinct advantages that are direct result of being small. SMEs also provide various advantages to the entire economy.

a) **Personal customer's services**.

Small and medium enterprises provides environment in which management is close to their customers. This gives businesses opportunities to serve their customers who have specific needs. They also respond to client's suggestions and complaints, this is seen as the avenue of improvement of their services to the clients.

b) **Superior knowledge of their customer and markets**.

Being small in size, the business owners know their customers better. They know their specific needs and serve them better. The SME owners know their market well including their competitors in the business. Markets are ever dynamic in nature and keep on changing in response to customer's needs and demands. These also give them the opportunity to apply different strategies to different customers.

c) **Close ties to the community**

Small businesses are started with the community. They tend to serve the community with their services hence closure ties to the community. They know clearly the needs of the community and usually the residents prefer to work with the local businesses.

d) **Flexibility of management**

Small firms have fewer procedures and less internal paperwork. The small business owners are relatively free to enter and leave business, to grow or contract and to succeed or changing market or declare bankruptcy. This inherent flexibility to meet changing market, production and overall business to adapt quickly to the ever changing environment of which it is part.

2.5 Relationship between banks and SMEs

Financial service organization operate in a high contact business where the nature of the buyer-seller interactions and the establishment of the longtime relationship based confidence and trust have real implication for successful retention of customers and the recruitment of prospects (Ennew and Etal, 2007). A survey of senior financial services marketers' revealed that after pricing policy they perceived the interface with customer as the second highest potential for improving company performance ((Tagoe, Nyarko and Amarh, 2005). Relationship banking is defined by Edward and Turnbull (2008) as "a recognition that the bank can increase its earnings by maximizing the profitability of the total customer relationship overtime rather than seeking to extract the most profit from any individual product or transaction". Such an emphasis is in keeping with the dominant trend in business- the shift from transaction orientation to one of long-term interactive relationships and would be expected to exist in the banking enterprise arena. Small firms and banks, however despite their importance to each other in economic and social development, experience relationship difficulties.

The relationship between small banks and businesses is invariably along term one and the extent to which a bank can meet its customers' needs effectively is heavily depend on the willingness of the customer to provide appropriate information (Binks and Ennew, 2009). This need is particularly in evidence in the context of lending decisions. Furthermore, building effective and successful relationship can contribute significantly to customer satisfaction, loyalty and retention and thus to improve performance(RobertWarlow. (2006)

Competitive, regulatory and product-market changes require banks not just recruit new business, but also to retain existing customers through relationship development. In the personal banking sector, the huge investment made to attract and retain personal accounts, through products incentives and high level of media spend is notable. In commercial or business banking, the relatively recent introduction of “small business banking” specialist units services units and services packages now offered by commercial banks in Kenya is in same vein.

Given their distinctly different characteristics and experience it should not be surprising that small firms and banks find it difficult to develop good working relationships. Following Mintzberg’s classic categories of organization structures, the bank is “machine bureaucracy” wherein rules and regulation tend to supersede managerial discretion. Decisions are routinely; unanticipated problems upset systems and manager. In contrast to this, the typical entrepreneurial small firm is organic and informal- the “simple structure”. The owner manager makes his or her own decision usually quickly, and often intuitively.Baydas(2007) reporting on culture influences in bank loan decisions, states that “findings suggest that the personal decision styles of bank executives has less impact on the decision making than the culture in which they operate”. In almost every aspect of organizational structure and behavior, the typical bank and the typical entrepreneurial small firm are at opposite ends of continuum.

A further understanding of the problem between bank official and entrepreneurs can be found in terms of empathy. There is a profound difference in the realities of daily working lives of both actors. The branch manager-and it is at this level that the vast majority of small firms owner-managers contact the bank- has been socialized in process, procedures and standardization of work. This leads the bank manger to tend to analyze, prioritize and impose a particular kind of order from those of the bank. This is the opposite of the entrepreneur's view and understanding of the world and of what makes a successful manager, i.e. taking risks, informally planning, following hunches (Butler and Durkin 2008).

In Butler and Durkin (2008) it was ascertained that small firm owner-managers and bank managers had self-perceptions and perceptions of each other that were often "critically mismatched". For instance, where the banks felt itself (indeed, prided itself) on the being procedural, systematic, and prudent, the small firm perceived those factors as obstructive, procrastinating and fearful of natural commercial risk. On the other hand, where the small firm perceived itself to be risk-taking, entrepreneurial and innovative, the bank perceived it to be fool hardy, immature and lacking in an understanding of commercial consequence.

These perceptions underpinned the parties' expectation of each other, which both entrepreneur and bank manager consistently describe as "unrealistic". The gaps between the parties' expectations of each other come to light when they move into the early stages of relationship development for instance the banks expectation of collateral. The typical small business, in applying for funding, also seeks support, empathy and advice from the bank. The gap between these mutual expectations is at these sources of many of many of the relationship difficulties. Without each party having a deeper understanding of the others fundamental characteristics, objectives and constraints mutual expectation are likely to be unrealistic, and their relationship consequently problematic.

Pauline, Jean, Ferguson, Salazar and Saruya (2008) in their study of commercial banking illustrate the conceptual and managerial importance of relational norms in a business to business service environment. Showed, the higher the client company's assessment of the strength of the bank and client relationship, as measured by relational norms, the higher the client-company rated the external effectiveness and the lower was likelihood it would switch to another bank. Convincing client-company to want to rather than have to remain in along-term relationship did not seem to be a priority in commercial banking. In fact, bank persona did not appear to be in touch with need and perception of the client companies. This was reflection of a preoccupation with internal rather than external effectiveness. However, in a global economy, attracting and keeping valued segment of knowledge and mobile client companies will require an understanding of the prerequisites of the external effectiveness. Among other things, effective service management in commercial banking would involve improvement in the manner in which account managers are selected, trained supported and rewarded (Pauline et al. 2008)

As many of these small firms have the potential to grow much and inevitable become much more profitable for banks then it would be in the best interest of banks to attract and retain this profitable customers segment and facilitate their growth in the long term(Butler and Durkin, 2008) this however, would not appear to be the case, given past and current criticism of the small business/ bank relationship.

Murray and Walbridge (2002) emphasize the fact that ‘the major banks have never really liked small business customers and assets that banks are quite often ambivalent towards such clients.

Thefact that predicting how well a start-up business will perform, or ifin fact it will survive, is difficult, and is offered as one of the main reasons why banksare skeptical of their small business clientele.

The relationships formed between buyers and sellers need to be built on mutual trust and commitment if they are to be developed and maintained inthe long term, by their very nature financial services tend not to be one-off purchases but ones which are required on recurring basis, this is a clear need for financial services suppliers to establish initial relationships with their prospects while at the same time maintain and develop long term relationships with existing customers. Furthermore financial services are based on customer trust and confidences not only in the organization supplying these services but also particularly in the customer contact employees themselves(Christopher, PayneBallantyne, 2005).

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introductions

This chapter presents the research methodology. Section 3.2 discusses research design. Section 3.3 discusses the sample of the study, Section 3.4 discusses the data collection methods and section 3.5 describes data analysis and presentation.

3.2 Research Design

The research design for this study is a cross sectional surveydesign. Data collection will involve the use of questionnaire. The use of survey design is appropriate in this study because it is a useful method in describing characteristics of a large population [Kothari ,2010] and it also allows the researcher to measure the study variables by asking questions to the respondents and the examining relationships between variables. It's a cross sectional study as data willonly be collected once.

3.3 Population of the study

The population of study will be all Equity Bank branches facing challenges in financing SMEs in Kenya. Currently Equity Bank has 160 branches spread all over the country.

3.4Sample design

Ideally it will be preferable to use simple random sampling technique to design samplewhere each of the branches on the population will have an equal chance of being selected for the study. However, due to such constraints as cost involved and given time frame amongother reasons, the researcher intends to use judgmental sampling where the researcher will use his experience of working with some of these branches to be able to judge on a representative sample size of 50 branches on whom to interview which seems adequate enough to get information required for study objective.

3.5 Data Collection Method

This study will use primary data, to be collected by the way of structured and semi structured questionnaires with both open ended and closed ended questions collected from Equity bank staff from credit administration, credit risk, special assets departments, SME relationship managers and SME relationship officers using structured questionnaire.

The questionnaire method is appropriate as the respective bank officials are able to give related information depending on their area of operations and skills. Secondly; questionnaires are convenient to the bank officers to fill them at their own time. Direct face to face interview is also used in limited occasions for various clarifications on related information that the questionnaires cannot address directly. The questionnaires will be administered by multiple-approaches that include drops and picks later based and use of e-mail to contact the respondent.

3.6 Data Analysis and Presentation

The data will be presented through summary statistics (percentages, mean standard deviation) to measure the interrelationship between variables. Graphs will be used to display the information to improve the presentation of the results for ease of interpretation.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the analysis of the data collected and interpreted on the challenges Equity bank branches in Kenya faces in the process of financing Small and Medium Enterprises. The objectives of the study was to determine the challenges faced by Equity Bank branches in financing SMEs in Kenya and examine how the bank is trying to address these challenges.

The data was collected from Equity Bank Kenya Ltd branches. The questionnaires were self-administered and data were collected from the Credit Managers, Credit Administration team, Credit Officers and the SME Relationship Officers. The bank's financial statements were also of vital information. It provided data on the bank's total assets and liabilities in the previous financial year.

Table 4.1 Overview of data collected

	Officers Given Questionnaires	Administered Questionnaires (t)	Response rate(r)
1	Credit Managers	10	8
2	Credit Administration Team	20	15
3	Credit Officers	10	5
4	SME Relationship Officers	10	8
	Total	50	36

Key: t = No. of officers given questionnaires r= Response rate (72 %)

Source: Research Data

Out of the 50 questionnaires that were circulated, 36 were dully filled and returned by the respective bank officers. This represents a response rate of 72 % which is considered significant enough to provide a basis for valid and reliable conclusions with regard to the challenges Equity bankbranchesfaces in the process of financing Small and Medium Enterprise.

4.2 Background of Equity Bank [K] Ltd

Table 4.2 Size of the bank in terms of assets, Employees, Branch Network & Regional Presence

Size	
Assets	Kshs. 260 billion
Employees	6,700
Branch Network	160
Regional Presence	Kenya,Tanzania,Uganda,South Sudan& Rwanda

Source: Research Data

Equity bank was incorporated as a commercial bank in 1984 having previously operated as a building society. The research has revealed that it is a public liability company and has assets worth Kshs. 260 billion, 6,700 employees, 160 branches countrywide and has subsidiaries in Uganda, Tanzania, South Sudan and Rwanda. The bank is currently expanding their operations by increasing their branch network in the fourmentioned countries.

4.3 SME Products offered by the bank

Table 4.3.1 SME products offered by the bank and their order of preference by customers

	Preference of the products				
Product	Low	Medium	High	No. of Responses (r)	Percentage (%)
Business Loan	-	-	70	70	32.4
Asset Finance	-	-	24	24	11.1
Letters of Credit	-	25	10	35	16.2
Bid Bond	13	13	11	37	17.1
Bank Guarantees	13	13	-	26	12.0
Temporary Overdrafts	-	-	24	24	11.1
No. of Responses	**26**	**51**	**139**	**216**	
Percentage (%)	12.0	23.6	64.35		

r =No. of Products x No. of Respondents (6 x 36 = 216)

Source: Research Data

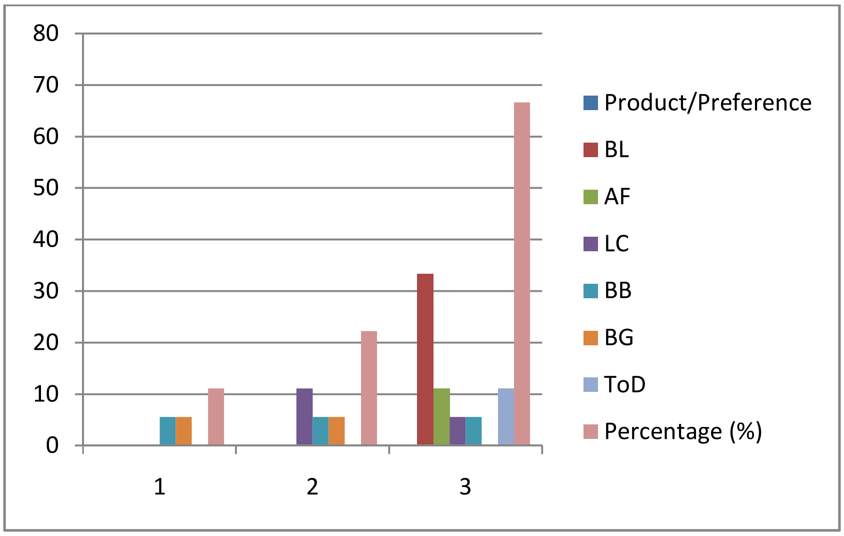
The SME products offered by the bank are; Business Loans, Asset Finance, letters of credit, Bid Bonds, Bank Guarantees and Temporary Overdrafts. High, Medium and Low preferences accounted for 64.35%, 23.6% and 12.0 % of the responses gathered from the respective bank officials who responded.

Table 4.3.2 Percentage presentation of the products

Product/Preference	Low %	Medium %	High %
BL	-	-	32.4
AF	-	-	11.1
LC	-	11.57	4.62
BB	6.01	6.01	5.09
BG	6.01	6.01	-
ToD	-	-	11.1
Percentage (%)	12.02	23.59	64.31

Key: BL-Business Loan; AF-Asset Finance; LC-Letters of Credit; BB-Bid Bond; BG-Bank Guarantee; ToD-Temporary Overdraft

Figure 4.3.1 Products Preference



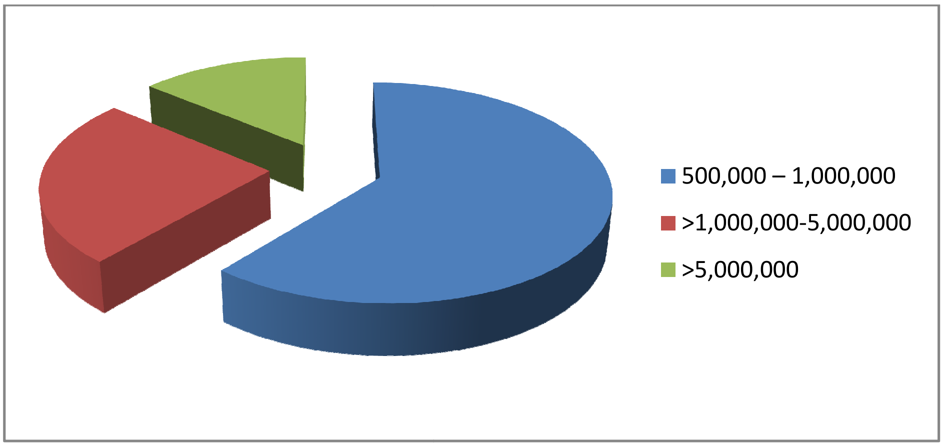
The research reveals that 32.4%, 11.1%, 11.1%, 5.09% and 4.62 % of SME customers highly prefer Business Loans, Asset Finance, Temporary Overdrafts, Bid Bonds and Letters of credit of the products offered by the bank, while at medium preference Letters of Credit, Bid Bonds and Bank Guarantees accounts for 11.57%, 6.01% and 6.01% respectively. SME clients at low level give the same preference of 6.01% to Bid Bond and bank Guarantees.

Table 4.3.3 Loan Amount Frequently sought for by SME

Range –Loan Amount (Kshs)	No. Respondents	Percentages (%)
500,000 – 1,000,000	22	61.11
>1,000,000-5,000,000	9	25.00
>5,000,000	5	13.88
Total	**36**	**100**

Source: Research Data

Figure 4.3.2 Loan Amount (Kshs) frequently applied for SME customers



Most (61.11%) of the SME customers apply for loans ranging between Kshs. 500,000.00 and 1million, about 25 % of SME customers apply for loans ranging between Kshs. 1million and 5million while 13.88 % apply for loans above 5million as evidenced by the response given by the bank officers. The total SME lending book as at September 30, 2013 was Kshs. 70 billion. This illustrates how Equity bank has embarked on lending this sector despite numerous challenges commercial banks face in the financing process.

4.4 Challenges faced by Equity bank in Financing SMEs

4.4.1 Key requirements for lending to SMEs by Equity bank.

The research reveals that Equity banks require various conditions before lending to SMEs. They require that the business must be registered and in operation for at least 12 months, financial statement including current management accounts for 6 months, the business must have a banking history for its operations by providing banks statements for at least 1year, certificate of incorporation/registration, both Memorandum and Articles of Association in case of limited liability company, tax compliance certificate and annual returns.

Table 4.4.1 Documents required for lending to SMEs by Equity bank.

Documents	No. of Respondents	Percentage (%)
Certificate of registration	19	52.8
PIN Number	17	47.2
Tax Compliance Certificate	15	41.7
Cash Flow Projections	24	66.7
Balance Sheet	36	100
Income Statement	36	100
Annual Returns	12	33.3
Bank Statement	15	41.7
Management Accounts	36	100
Memo & Articles of Association	24	66.7

Source: Research Data

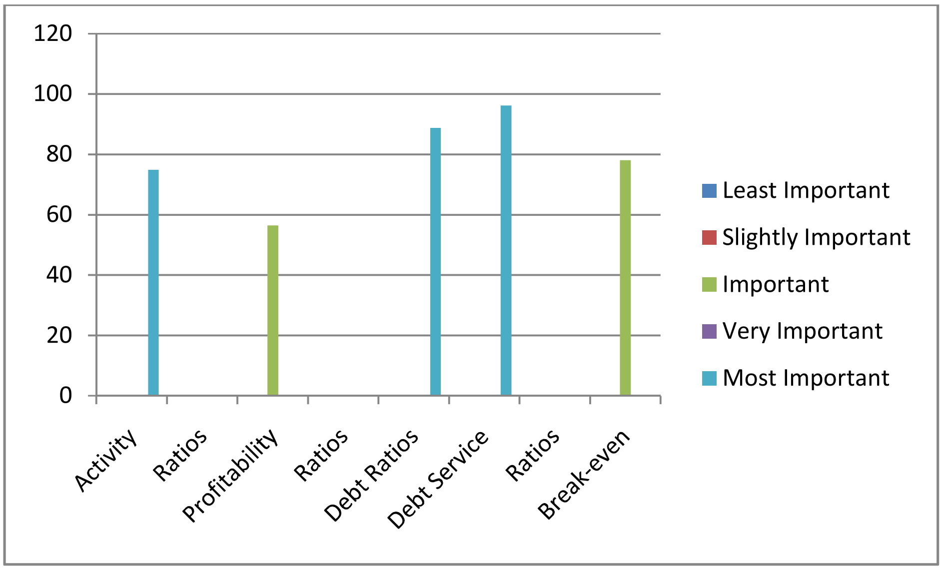
Considering the various documents required for lending to the SMEs, 100% of SME clients submits balance sheet, income statements and management accounts, 66.7% of them submits cash flow projections for their businesses, memorandum and Article of Association. 52.8% of the SMEs provide Certificate of Registration/incorporation, 46.2% provides PIN numbers, 41.7 % provide both tax compliance Certificates and bank statements while 33.3% submits their annual returns. This clearly indicates that most of the SMEs do not comply with Equity bank lending requirements. These pose great challenge to Equity banks branches in financing Small and Medium Enterprises. The banking history of these firms is a big challenge to banks as only 40% of them do .

Table 4.4.2 Financial Rations Importance in the Credit Analysis

	Least Important	Slightly Important	Important	Very Important	Most Important
Activity Ratios	0	0	0	0	74.9
Profitability Ratios	0	0	56.4	0	0
Debt Ratios	0	0	0	0	88.7
Debt Service Ratios	0	0	0	0	96.2
Break-even	0	0	78.1	0	0

Source: Research Data

Figure 4.4.1 Financial Ratios Required at the Credit Analysis



From the above analysis debt service ratio is ranked most important at 96.2% followed by debt ratios at 88.7% and activity ratios at 74.9%. Both profitability rations and break-even as a percentage of sales are ranked important. The ratio analyses are very important as they gives a clear business performance and used as the gauge of financial lending to the SMEs.

4.4.2 Security required for lending to SMEs.

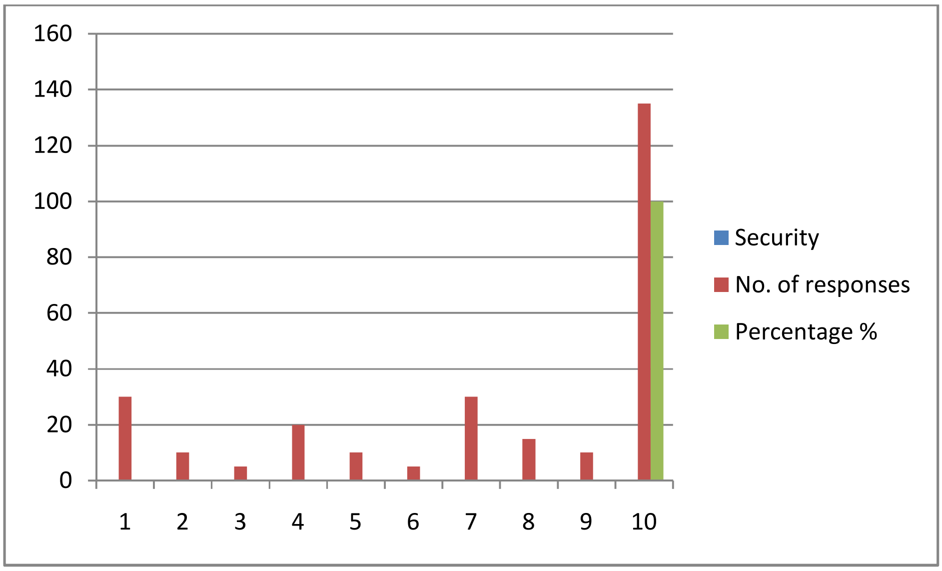
In many occasions security is not required for loans amounting up to Kshs. 1million lent to SMEs. However, securities are required for in most cases where these businesses cannot prove their credit worthiness. Most commercial banks require securities for the facilities which most of SMEs do not provide. This proves a challenge to most commercials bank in the process of financing them.

Table 4.4.3 security required for lending to SMEs

Security	No. of responses	Percentage %
Chattels mortgage	72	22%
Land	23	7%
House	13	4%
Personal guarantees	49	15%
Lien of term deposits	23	7%
Fixed and floating debentures	13	4%
Inventory hypothecation	72	22%
Motor vehicle logbooks	36	11%
Hire purchase agreement	23	7%
	324	100

Source: Research Data

Figure 4.4.2. Security mostly required in the lending process.



Source; Resource Data

From the analysis above ,most of SME customers use chattels mortgage and inventory hypothecation as securities at 22%,15% use personal guarantees,11% use motor vehicle logbooks,7% use land ,lien over term deposits and hire purchase agreements while 4% of customers use houses debentures as securities . This indicates that these businesses have no valuable property to offer as securities when applying for the loan facility acquired .This gives uphill challenges to considering lending to the SME clients because of invaluable security. The research also reveals that SME lending is cash flow based and does not focus immovable securities.

4.5 Sources of funds for financing SMEs and various costs involved

4.5.1 Sources of funds

The research reveals that Equity bank sources its funds for SME financing from development partners, shareholders and mobilized funds from depositors .This gives them a reprieve in loan defaults .This also illustrates how vulnerable the sector is faced with uphill task of providing sufficient securities to secure loan facilities.

4.5.2 Various cost involved in the financing process of SMEs

The research further reveals that SME clients are charged variable interest rates

Table 4.5.1 loan range and corresponding interest rate charged

Amount range (Kshs.)	Interest rate
≤500,000	20% Flat rate
≥500,000-1Million	20 % Reducing balance
≥1Million	18% reducing balance
≥10 Million	Negotiable up to 16% reducing balance.

Source: research data

Interest rate up to 20% flat rate are charged on the facility ranging between Kshs.500,000 and below depending on the security provided by the SME customers. For the loans greater than Kshs. 500, 000but up to 1Million are lent at 20 % reducing balance while for loan more than 1million and less than 10 million are given at reduced rates of the loan the 18% reducing balance and above 10 million interest rates are negotiable up to 16%.

Apart from the high interest rates charged on the loan amounts given , the research also reveals some incidental costs incurred by these businesses .SME clients incur additional charges including processing fees ,insurance cover ,business search fee ,legal fees for security perfection and the valuation fees for either security or an asset they want to acquire .All these eats into their pockets making the loans from commercial banks expensive compared to the amount of returns they get from their business operations. The turnaround time for the loan application is between 10-15 days from the day of application to disbursement of the same. This still increases the costs of doing business to these businesses.

4.5.3 Non-performing portfolio and the default rate among SMEs

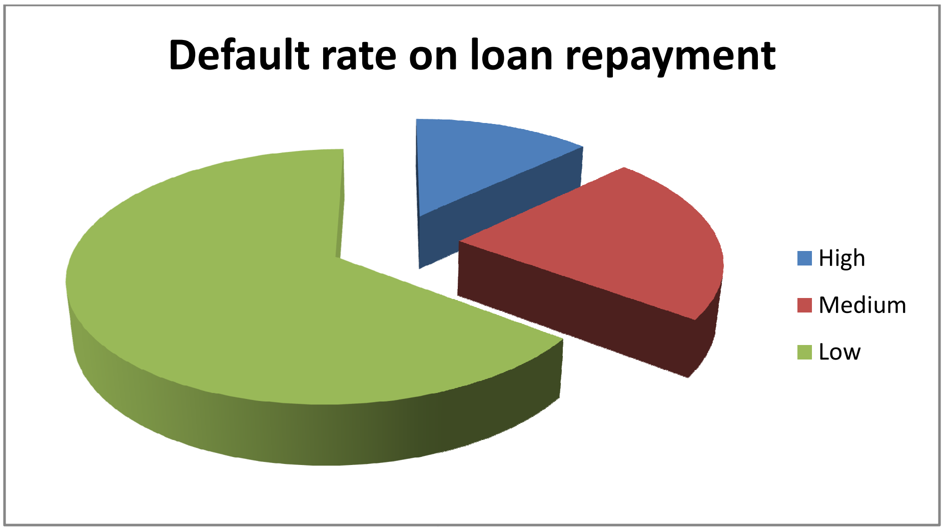
Table 4.5.2 Default rate on loan repayment

Default Rate	No. of Responses (R)	Percentage %
High	14	13.0
Medium	24	22.2
Low	70	64.8
Total	**108**	**100**

R = No. of loan range x no. of respondents (3x36)

Source: Research Data

|Figure 4.5.2 Default rate on loan repayments



The default rate is low at 64.8%, 22.2% of the respondents says that the default rate is medium while a paltry number of 13.0 % indicate that the default rate is high. This clearly reveals that this sector does contribute little in the non-performing loan portfolio within Equity bank.

Table 4.5.3 Non-performing loans in the SME portfolio

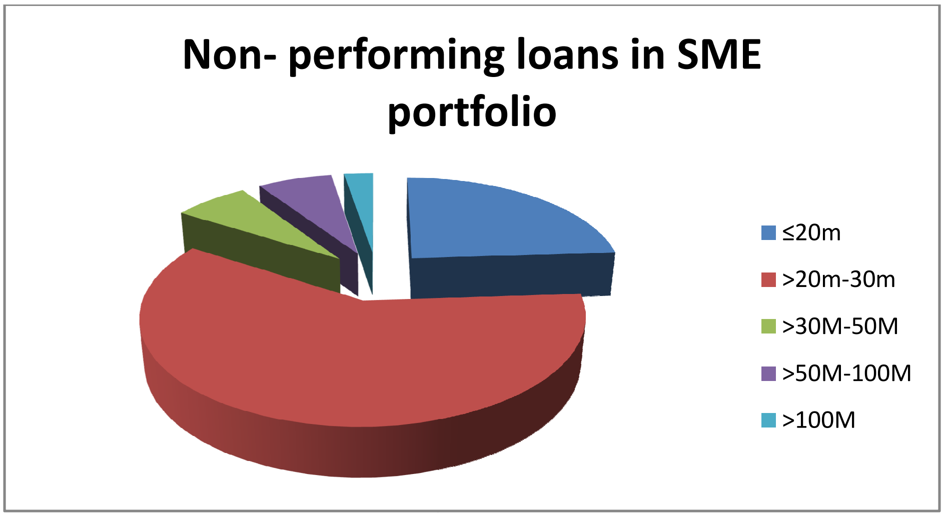
Loan Amount (Kshs)	No. Response(R)	Percent %
≤20m	43	24
>20m-30m	108	60
>30M-50M	12	6.7
>50M-100M	12	6.7
>100M	5	2.6
Total	180	100

R= no. of loan range x no. of respondents (5x36)

Source: Research Data

60% of the non-performing loan is between 20million and 30million, 24% is within 20million and below, 6.7% represents loans above 30million but up to 100million while those above 100million only accounts for 2.6% of the total non-performing loan portfolio for the SME sector at Equity bank.

Figure 4.5.3 Non-performing loan portfolio (SME) at Equity Bank



The results from the above analysis reveal that the non-performing loan portfolio is between 20million and 30million while those above 1million is minimal. This indicate the strict vetting procedures and a more robust collection efforts the bank has put in place to reduce any cases of non-performing loan from SME clients.

4.5.4 Recovery process from loan defaulters

Table 4.5.4 Loan recovery methods used

Method	No. or responses (R)	Percentage %
Direct Debit	24	66.7
Legal Action	2	6.6
Repossession	10	26.7
Total	**36**	**100**

Source: Research Data

The bank applies direct debit (66.7%) method most of the time in recovering loan from the defaulters. 26.7% of the recovery is done through repossession of assets acquired through SME loans while 6.6% of loan are recovered through prosecuting loan defaulters. Research further reveals that most SME customers appreciate collection effort and methods used by the bank in recovering any loan in arrears.

Various communication mechanisms are used before any action is taken against the defaulters. At the extreme for the customers who are unable to repay their loans, the bank does restructuring of the loan facility which is at the convenience of the client, they also realize the amounts from the collateral provided by the customers by selling these security items and the bank also make claims from the personal guarantees to recover the loans.

In summary the research further reveals that most of the SME customers do not have enough information on the financing requirements by Equity banks. This is a big challenge to most commercial banks offering this kind of facility to the SME sector and from the above analysis, considering the various documents required for lending to the SMEs, 100% of SME clients submits balance sheet, income statements and management accounts, 66.7% of them submits cash flow projections for their businesses, memorandum and Article of Association. 52.8% of the SMEs provide Certificate of Registration/incorporation, 46.2% provides PIN numbers, 41.7 % provide both tax compliance Certificates and bank statements while 33.3% submits their annual returns and most SME customers use chattels mortgage and inventory hypothecation as securities at 22%,15% use personal guarantees,11% use motor vehicle logbooks,7% use land ,lien over term deposits and hire purchase agreements while 4% of customers use houses debentures as securities . The research also reveals that SME lending is cash flow based and does not focus immovable securities which clearly indicates that most of the SMEs do not comply with Equity bank lending requirements and these businesses have no valuable property to offer as securities when applying for the loan facility acquired .These pose great challenge in financing Small and Medium Enterprises and the banking history of these firms is a big challenge to banks as only 40% of them do the required documentation .

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

Major challenges faced by the Equity bank branches as revealed by the study in the process of lending to small businesses are mainly: lack of banking/credit history to allow them access the funds easily from commercial banks, they have no valuable collateral to act as security to their financing, non-registration of business; lack of financial statements required for financing and lack of keeping proper books of account. All these issues are challenges impending on financing the small businesses by commercial banks. Hence they resort to informal sources of financing which proves to be expensive and not cash flow projected.

The research revealed that 32.4% of SME customers preferred business loans with 61.11% of the applicants goes for loans ranging between Kshs. 500,000 and Kshs. 1 million. Most SMEs do not submit mandatory documents required for financing by commercial banks. 100% of SMEs submit balance sheets, 66.7% cash flow projections while 52.8% submit certificates of registration/incorporation. This indicates a bigger challenge the commercial banks face in financing this sector. Securities provided are weak as 22% provides chattels mortgage and inventory hypothecation while 4% provide housing as their collateral.

The study recommends that a further research could also be done to look into different financing strategies adopted by commercial banks in serving the SME sector.

5.2 Conclusion

The objectives of the study was to determine the challenges faced by Equity Bank branches in financing SMEs in Kenya and examine how Equity bank branches in Kenya are trying to address these challenges. The finding of the study summarized in this chapter indicates that Equity bank faces various challenges in financing SME.

Major challenges faced by the banks as revealed by the study in the process of lending to small businesses are mainly; lack of banking/credit history to allow them access the funds easily from commercial banks, they have no valuable collateral to act as security for their financing, non-registration of businesses; lack of financial statements required for financing and lack of keeping proper books of accounts and products offered by its branches might not be preferred by the SMEs as most of them might not focus on their co- business operations.

All these issues are challenges impending on financing the small business by Equity bank branches. Hence their resort to informal sources of financing which prove to be expensive and not cash floor projected.

5.3 Recommendations.

The research reveals that 61.11% of the SME customers applying for loan facility go for loans amounting to between Kshs. 500,000 and Kshs.1million, 25 % seek loans of between Kshs.1million and 5million while those applying for loans more than Kshs 5million are only about 13.88 %. This indicates that Equity bank should focus much of their SME products into business loans which add more values to the SME clients. The bank should increase their SME loan allocation to business loan portfolio; focus on the import business by issuing more letters of credit to clients importing. This is a new area of business whose portfolio amount should be increased to the growing demand for the product and specific banking needs for SMEs as revealed by this result should be formulated as part of the long term banks policy.

32.4% of responses show that most SMEs preferred business loans, 16.2% preferred letters of credit and bid bonds while 12 % preferred bank guarantees and 11.1 % preferred asset finance and temporary overdraft. This clearly reveals that Equity bank should tailor products which address SME needs rather than coming up with products which they do not like. The banks should focus a lot on extending business loans to SME to finance their working capital needs. This will enable them to expand their business and have enough working capital to help them have enough stock for their operations. Temporary over drafts are mainly used in financing weekly or monthly working capital needs. This might increase their finance cost in the long run for the business operation

100% of customer submit management accounts, income statement and balance sheet statement 66.7% submit cash flow projections and memorandum & articles association, 52.8% submit certificate of registration/incorporation, 47.2% PIN numbers, 41.7% tax compliance certificates & bank statement while only 33.3% submit annual returns. This reveals that a good percentage of SME clients do not submit the required documents for financing by Equity bank branches. In addition this also indicates that most of the SMEs do not have sufficient information as per pertains the minimum requirement by commercial banks for their financing. Meeting all this requirement is an uphill task to SMEs which needs to be addressed. Such information can be enshrined in the bank marketing strategy /information awareness especially during banks' financial literacy activities/ days.

Research result indicates that financial ratios play a great a role in the SME financing process. 96.2% of the respondents indicate that debt services ratio is highly used, 88.7% highly leverage/ debt ration while 74.9% highly used activity ratios. Break - even sales as a percentage of sales profitability ratios are moderately use as confirmed by 78.1% and 56.4% respondents respectively. Equity bank use this financial rations as a gauge of financing SMEs. Most of the SME clients are highly indebted from other sources of funding and therefore do not meet these requirements.

It was noted that 22% of the respondents indicated that SMEs avail chattels mortgage and inventory hypothecation as a form of security when applying for loan facility, 15% provide personal guarantees, 11% provides motor vehicle log books, 7% provides land, lien over term deposits and hire purchase agreement. A Paltry 4% of the respondents indicated that SMEs use house and debenture as a form security. Chattels mortgage and inventory hypothecation are less valuable securities with high risk of devaluation in case of asset realization. Security perfection is a challenge which faces most of the Equity bank branches as very few SMEs have valuable securities for financing. These firms do not have enough assets to presents as securities to acquire loan facilities to boost their business operation.

At the same time Equity bank charges various incidental costs which prove to be expensive to most of the SMEs. This is an impediment to most of SMEs in accessing financing from bank. Variable interested rates depending on the amount of up to Kshs. 500,000 depending on available security. Amount between Kshs. 500,000 and 1million are lent at an interest rate of 20% flat rate while amounts above 1million are changed 20 % reducing balance on variable basis. SMEs also pay processing fee, insurance cover, search fee, valuation fee and legal fees for security perfection. All these add into the cost of financing these businesses. Since SME clients form a key component of banks loan portfolio and a key sector in the national economy it would be imperative for the bank as a policy to reduce such processing cost to reduce burden on SME sector.

5.4. Limitation of the study

The research findings of this study should be interpreted in light of the following limitations; The research design for this study was a cross sectional survey and the use of survey design was appropriate because it is a useful method in describing characteristics of a large population [Kothari ,2010] and it also allows the researcher to measure the study variables by asking questions to the respondents and the examining relationships between variables though the research findings may not be representative of all Equity bank branches sector in Kenya as it only focused on 36 branches due to financial resources and time constraints, a simple random sampling technique could not be carried out which would have obtained a more representatives result to this study unlike judgmental sampling which is subject to a number of shortcomings.

Various studies have been done in the Small and Medium Enterprises (SMEs) sector locally but none of them has emphasized on the evaluation of challenges faced by commercial banks in financing SMEs. Mwaka (2006) focuses her study on the financial structure and growth of SMEs, Rukwaro (2001) looks at the credit rationing aspect of financing on the micro-finance institutions and the influence on the operations of SMEs and Wanyungu (2000) on the other hand focuses on the financial management practices of SMEs in Nairobi. These studies failed to tackle the issue of challenges faced by commercial banks in providing credit to these firms. Little literature in the small and medium enterprises sector was an impediment to this study especially on challenges faced by financial institutions in lending to this sector

5.5 Suggestions for further studies

From the research findings of this study, there is need for further research. A number of areas could be looked into. An empirical survey should be done to include all of the 160 branches of Equity bank in Kenya which might produce representative results.

A further research can also be done on the challenges facing small and Medium Enterprises in getting financing from other commercial banks in Kenya not necessarily Equity bank [K] L.T.D. as a study unit.. A more detailed research could also be done to look into different financing strategies adopted by commercial banks in serving this sector. A research could also be done to look into specific commercial banking products that add more value to SME sector and addresses specific needs of the sector.

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Appendices

INTRODUCTORY LETTER

University of Nairobi

School of Business

P.O Box 30197 – 00100

Nairobi

August 28th, 2013

To Whom It May Concern

Dear Sir/Madam,

Ref: Request for Data – Challenges of financing Small and Medium enterprises [SMEs] in Equity Bank Branches in Kenya.

I am a post graduate student at University of Nairobi, School of Business undertaking research in Challenges of financing small and medium enterprises [SMEs] in Equity Bank Branches in Kenya.

Your kind assistance in providing requested information will be highly appreciated.

Yours faithfully,

Okoth Michael Okoth

D61/63205/2010

MBA [Finance] Student

Supervisor

Luther Otieno

Lecturer

Department of Accounting and Finance.

Appendix: Questionnaire

Section A: background of Equity Bank Kenya limited

1. When was the bank started?...
2. What is the ownership structure of the bank...
3. What is the size of the bank in terms of:
   - Assets (Kshs)…………………………….
   - Employees ……………………………..
   - Branch network…………………………
   - Regional presence ……………………..

Section B: SME products offered by the bank.

4. When did the bank start offering SME banking product & services to the customer?………………………………..
5. What are the major banking products and services offered by the bank to the SMEs.
   - ………………………………………………………………
   - ………………………………………………………………
   - ………………………………………………………………
6. Which among the SME products named above are commonly sought?(Rank them in order from the 1st to the last)
   - ………………………………………………………………
   - ………………………………………………………………
   - ………………………………………………………………

7. What is the loan amount frequently applied for by SME clients (tick only one)?
    - 500,000-1m…………………
    - More than 1m…………….
    - 2m and above……………..
8. What is the size of SME lending of book to date? (Kshs)

Section C: Challenges the bank face in the process of financing SMEs.

9. To what extend are the following challenges faced by commercial banks in lending the SMEs? (1- list faced: 5- monthly faced)

		1	2	3	4	5
a	Lack of security					
b	Lack of audited financial					
c	Registration certificate					
d	Banking history					

10. What are the key items looked for before lending is done to SMEs (name as many as possible)
    - ………………………………………………………………………..
    - ……………………………………………………………………….
    - ……………………………………………………………………….
    - ……………………………………………………………………….

11. What are the key factors/characteristic looked at the credit appraisal stage?

- ………………………………………………………………………..
- …………………………………………………………………………..
- ………………………………………………………………………….
- ………………………………………………………………………….

12. What are the financial statements required for the customer credit analysis process?

- …………………………………………………………………………
- …………………………………………………………………………
- …………………………………………………………………………

13. A part from financial statements required by the bank of lending, what are the other legal documents required by the bank?

- ………………………………………………………………………..
- ………………………………………………………………………..
- ………………………………………………………………………..
- ………………………………………………………………………..

14. Do SMEs submit the following documents while applying for the loan facility from the commercial banks?

Certificate of registration/incorporation ( )

PIN number ( )

Tax compliance certificate ( )

Memorandum & Articles of association ( )

Cash flow projection ( )

Income statements ( )

Balance sheet ( )

Annual returns ( )

Managements accounts ( )

Bank statements for at least two years ( )

15. How important are the following rations in the balance sheet statement to credit analysis process? (1-least important: 5- most important)

		1	2	3	4	5
Activity ratios		( )	( )	( )	( )	( )
Profitability ratios	( )	( )	( )	( )	( )	
Debt rations		( )	( )	( )	( )	( )
Debt services rations		( )	( )	( )	( )	( )
Break even as a % of sales		( )	( )	( )	( )	( )

16. Among the following financial statements, kindly rank them in order of their superiority (1-least important: 5- most important)

	1	2	3	4	5
Balance sheet	( )	( )	()	()	()
Income statements/income and expenditure	( )	( )	( )	( )	( )
Cash flow statements	( )	( )	( )	( )	( )
Changes in owners' equity	( )	( )	( )	( )	( )

17. Do you always require security for the loan applied for the SMEs? Yes /No …

18. If yes, what type of security is more often asked for by the bank?

Chattels mortgage	( )
Land	( )
House	( )
Personal guarantees	( )
Lien over term deposit	( )
Fixed and floating debenture	( )
Inventory hypothecations	( )
Motor vehicle log books	( )
Hire purchase agreements	( )

Any other (please specify ……………….)

19. Is your lending cash flow based? Yes………………………

No…………………………..

20 What are your sources of funds for financing SMEs?...

21 Kindly enumerate the amount of money which has been leant by each source..

Kshs ……………………………..

Kshs ……………………………..

Kshs ……………………………..

Kshs ……………………………..

22. Do you have loan guarantee schemes for your SME customers? Yes/No…

23. If yes what are the amount guaranteed and the source? Amount (kshs)………source……

24. Is the interest rates charged to the customer's variable? Yes/No…………………..

25. If yes, kindly state interest rates (%) pegged on the following range of amounts of loans.

- 500,000 and below ………………………………..
- 500,000 to 1M…………………………………………………
- More than 1M…………………………….
- More than 10M…………………………..
- Any other (specify)……………………..

26. State any other costs incurred by the clients in the process of obtaining the financing:

- ---
  -
- ---
  -
- ---
  -

27. What is the Turn-Around –Time for the loan application?

---

28. What is the rate of default in the loan repayment by the SME clients **(tick one only)**

- High-----------------------------Medium-----------------------Low-----------------------------

29. What is the size of the non-performing loan from the SME customers?

- 20m and below -----------------------------
- 20m – 30m----------------------------------
- 30m – 50m ----------------------------------
- 50m – 100m ----------------------------------
- 100m and above -----------------------------

30. How is the recovery done from SME loan defaulters?

---

31. Do the customers appreciate the collection efforts made by the bank?Yes/No

32. If yes, kindly rank the following methods used in recovery process;

(1-frequency used; 5-least used)

	1	2	3	4	5
Direct Debit	()	()	()	()	()
Legal action	()	()	()	()	()
Repossession	()	()	()	()	()
Any other (specify)	()	()	()	()	()

33. Do most of the SMEs have enough information on the financing requirements by commercial banks? Yes/No