

**FACTORS INFLUENCING ACCESS TO LOANS BY SMALL BUSINESSES FROM
MICROFINANCE INSTITUTIONS IN SOUTH B AREA, NAIROBI COUNTY, KENYA.**

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**A RESEARCH PROJECT REPORT SUBMITTED IN PARTIAL FULFILMENT OF
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DECLARATION

This research study is my original work and has not been presented for a degree or any other examination body in any college or University.

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DEDICATION

This project is dedicated to my husband Charles Gaya for his unwavering love and support and to my children Tasha and Tyron Gaya for being my inspiration in life.

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ABBREVIATIONS AND ACRONYMS

GDP:	Gross Domestic Product
MFI:	Micro Finance Institutions
MSE:	Micro and small enterprises
SME:	Small and Medium Enterprises
APEC:	Asia-Pacific Economic Cooperation
SMME:	Small, Micro and Medium enterprises
WAMU:	West African Monetary Union
WAEMU:	West African Economic and Monetary Union

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ABSTRACT

Small and medium enterprises have been considered as the main engines spurring economic growth and promoting equitable development and in many countries are the driving force of the economies. Financing is necessary to help these small businesses set up and expand their operations, develop new products, and invest in new staff or production facilities .However small businesses find it much harder than larger businesses to obtain financing from banks, capital markets or other suppliers of credit. This is because they may lack collateral, or have not been in the business long enough to have a proven track record, or may not have audited financial statements like larger businesses. They are usually considered a high risk due to these factors by the microfinance institutions that can give those loans and as a result will be charged very high interest to mitigate against this. In many countries small businesses still report having problems when trying to access loans both from banks and microfinance institutions.

The purpose of this study was to find out the factors influencing access to loans from microfinance institutions in Nairobi, Kenya. The key variables of the literature review that were examined in the study were the microfinance characteristics, the business characteristics, the financial characteristics and lastly the entrepreneur's characteristics. According to the literature review some constraints come into place when small business are looking for loans like the credit rationing behavior of microfinance institutions by requiring collateral or by insisting on audited records before giving loans. Some of the studies established that some business sectors reported bigger problems when trying to access loans than other sectors. None of the studies looked at the effect that default penalties had as a factor affecting access to loans by small businesses and also the amount applied and the actual amount given to the small businesses. Studies on the effect of availability of loan providers gave mixed results with some studies showing that with the increase of loan providers the uptake of loans was less while other studies had more loans uptake . Other studies did not have a clear methodology and so the findings may not be generalized. Only one study addressed the age of the business as a variable affecting access to loans by small businesses. The study used a descriptive research design. Simple random sampling rotary method without replacement was used so as to ensure that the same businesses were not interviewed twice. This ensured that there was no bias in the findings and that the results could be generalized to other businesses in the area. Questionnaires were administered randomly to the small businesses in the area covering the four variables that were identified. Chi square statistics was used to find out the relationship between the variables and access to loans. The chi square results indicated that, education and experience of the entrepreneur, default penalties charged and the business sector are the main determinants of access to credit, all other factors identified in the study did not show any association with access to loans by small businesses. The study recommended publicization of microfinance policy to increase awareness and also capacity building by policy makers through training and support programmes for the small businesses. The study also recommended formation of small business associations to help in networking especially when applying for loans.

CHAPTER ONE

INTRODUCTION

1.1 Background of the study

In the 1800s, credit union was developed by Friedrich Wilhelm Raiffeisen and his supporters to assist the rural population to break out of their dependence on moneylenders and to improve their welfare. From 1870, the unions expanded rapidly over a large sector of the Rhine Province and other regions of the German States. The cooperative movement quickly spread to other countries in Europe and North America, and eventually, supported by the cooperative movement in developed countries and donors. In Indonesia, the Indonesian People's Credit Banks (BPR) or The Bank Perkreditan Rakyat (BPR) opened in 1895. The BPR became the largest microfinance system in Indonesia with close to 9,000 units (Osemene and Abdulraheem, 2011)

The origin of microfinance is generally traced to the Grameen Bank, founded in Bangladesh in 1975 by Professor Mohamed Yunus, who characterizes the mission of microfinance organizations as providing the poor—whom he describes as “natural entrepreneurs”—with working capital with which they can realize their entrepreneurial instincts (Pollinger, Outhwaite and Guzman , 2007)

In sub-Saharan Africa, the microfinance landscape evolved from two interlinked factors. Firstly, the formal financial sector excluded the poor as commercial banks, established during the post World War II period, exhibited a colonial legacy of financial service provision to urban areas and large-scale export-led projects. Such banks therefore had ‘[an] intimidating appearance;

unhelpful staff attitudes; inconvenient opening hours; relatively complicated transaction forms; and [were] perceived as designed for the middle class clients' (Mutesasira, Sempangi, Hulme, Rutherford and Wright, 1998) to the extent that the poor saw them as 'institutions of thieves' (Dzingirai, 2002). Zeller (2001) notes that the banks' limited outreach was because of 'fear of default, high costs, and rigid organizational structures inadaptable to high volume, small size loans (de Haan and Lakwo, 2010)

Microfinance in Latin America had a relatively early start, and in fact, the first experiments with micro lending in the region began around the same time as the well-known Grameen Bank in Bangladesh. In the early- to mid-1970s, informal organizations began lending small amounts of money to low-income individuals. In Brazil for example, Project Uno began in 1972; in the Dominican Republic, loans from Banco Ademi were given to *tricicleros* (men who sold goods from their bicycles); and in El Salvador, loans were given to the poor through Fedecredito (Berger *et al*, 2010)

Increasingly, microfinance is also being offered in developed countries to those who want to become micro-entrepreneurs but cannot access credit. The promise of microfinance is that it spurs entrepreneurship and empowers borrowers to help themselves Khavul (2010). According to (Barman, Himendu, Mathu and Kalra, 2009) microfinance is the provision of financial services on small scale for target groups that have been excluded by the banks like the poor or small scale traders.

Financing is necessary to help businesses set up and expand their operations, develop new products, and invest in new staff or production facilities. If they are successful, there comes a time for all developing SMEs when they need new investment to expand or innovate further. That is where they often run into problems, because they find it much harder than larger businesses to obtain financing from banks, capital markets or other suppliers of credit (OECD policy brief, 2006)

Approximately 10,000 MFIs have evolved worldwide over some three decades— in an amalgam of nongovernmental organizations (NGOs), commercial banking entities, credit unions, cooperatives, and finance companies—serving some 40 million clients worldwide (Krauss and Walter, 2009)

The impact of microfinance in the economic growth and development of a state cannot be overemphasized and according to (Osemene and Abdulraheem, 2011) microfinance has a significant role to play in the economy, through reduction of poverty by providing financial services to the active poor. It also helps in generating employment and provides small loans to grow small businesses. The United Nations declared 2005 the International Year of Microcredit, highlighting the current popularity of microenterprises as asset building and economic development tools (Pollinger *et al*, 2007)

A large number of small loans are needed to serve the poor, but lenders prefer dealing with large loans in small numbers to minimize administration costs. They also look for collateral with a

clear title - which many low-income households do not have (Vetrivell and Kumarmangalam, 2010)

Finance in general and credit in particular is especially important for SMEs, since they are unable to finance themselves through retained earnings or equity financing. Despite the fact that financing is a major factor for growth of Small and Medium Enterprises(SMEs) , a number of studies and government enquiries have mentioned that SMEs face problems when accessing to bank finance, due to a market failure in credit markets (Pandula, 2011)

In Nigeria, Small and Medium Enterprises Equity Investment Scheme (SMEIS) was initiated in 2001, giving banks the mandate to set aside 10 percent of their pre-tax profit as contribution for the growth of the Small and Medium Enterprises. This is because the Nigerian formal financial system only serves 35 percent of the economically active population. 65 percent of the population are excluded and consequently serviced through NGO's (Micro Finance Institutions), money lenders, friends, relations and credit unions which are unregulated and problematic. Central Bank of Nigeria after wide consultation with stakeholders produced the microfinance policy in December 2005 to ensure provision of financial services to the lower economic segments traditionally not served by the conventional financial institutions. This is distinguished from other financial products by small size of loans, absence of asset-based collateral and simplicity of operations (Olalekan 2009). The small and micro enterprises (SMEs) play an important role in the Kenyan Economy. According to the Economic Survey (2006), the sector contributed over 50 percent of new jobs created in the year 2005 (Bowen, Morara, and Mureithi, 2009)

1.2 Statement of the problem

Financing is a major factor for growth of SMEs, a number of studies and government enquiries have mentioned that SMEs face problems when accessing to bank finance, due to a market failure in credit markets (Pandula, 2011)

Africa's private sector consists of mostly informal microenterprises, operating alongside large firms. SMEs are weak in Africa because of small local markets, and difficult business conditions like cumbersome official procedures, poor infrastructure unsupportive legal systems or even inadequate financial systems. From the reviewed literature small businesses find it much harder than larger businesses to obtain financing from suppliers of credit. This is because they do not meet most of the conditions set out by the suppliers of credit like; having collateral, having a proven track record supported by financial statements or even having business networks that can be used for reference purposes .Due to this access to loans is constrained in small businesses and when given very high interest are charged.

Information found in literature asserts that some constraints come into place when a small business is looking for loans. Some of the studies established that some business sectors report a bigger problem when trying to access loans than other sectors. None of the studies looked at the effect that default penalties had as a factor affecting access to loans by small businesses and also the amount applied and the actual amount given to the small businesses. Studies on the effect of availability of loan providers gave mixed results with some studies showing that with the increase of loan providers the loans taken were less while other studies had more loans taken . Other studies did not have a clear methodology and only one study addressed the age of the

business as a variable affecting access to loans by small businesses. This creates further areas for research so as to check whether the age of the business, the default penalties and the amount applied for versus the amount given affect access to loans by small businesses.

The question of access to loans by small business is therefore an aspect that is important since the significance of the SME's in the economy of a country cannot be underestimated.

1.3 Purpose of the study

The purpose of this study was to examine those factors that influence access to loans from micro finance institutions by small businesses in South B area Nairobi County, Kenya.

1.4 Objectives of the study

The general objective of this study was to find out the factors influencing access to loans by small businesses in Nairobi, South B. The specific objectives were as follows:

1. To determine the extent to which microfinance characteristics affect access to loans by small businesses from microfinance institutions.
2. To examine the extent to which business characteristics affect access to loans by small businesses from microfinance institutions.
3. To establish the extent to which financial characteristics affect access to loans by small businesses from microfinance institutions.
4. To determine the extent to which entrepreneur characteristics affect access to loans by small businesses from microfinance institution.

1.5 Research Hypothesis

The following hypotheses were tested for the study:

- 1) There is an association between loan application procedure and loan access.
- 2) There is no relationship between government legal framework and loan access.
- 3) Loan repayment options have an effect on access to loans.
- 4) Awareness of different microfinance institutions has an influence on access to loans.
- 5) High default penalties lead to fewer loan access options.
- 6) Younger businesses have difficulty accessing loans.
- 7) Ownership type affects the businesses' ability to access loans.
- 8) Business sector affects the businesses' ability to access loans.
- 9) Businesses with fewer employees have difficulty accessing loans.
- 10) Businesses without audited financial statements will have difficulty accessing loans.
- 11) Businesses without tangible assets will have difficulty accessing loans.
- 12) Businesses with negative sales growth will have difficulty accessing loans.
- 13) Entrepreneurs with less education background find it difficult to access bank finance.
- 14) Entrepreneurs with less or no work experience find it difficult to access loans.
- 15) Entrepreneurs with no affiliations with business associations have limited access to loans.

1.6 Significance of the Study

This study will have its significance to Microfinance institutions as the research study was carried out in their area of jurisdiction. The challenges discussed will enable them to take the necessary measures in access of loans and in policy making.

The study will also be of benefit of small businesses since issues raised will help them know what to do in order to gain better access to credit and also know the pitfalls to avoid when trying to get credit from microfinance institutions

The study will have its significance to commercial banks since this will provide an area in which they can tailor products to meet that segment of the market and improve the access by providing competition in the microfinance sector.

The Government of Kenya will also benefit from this study since microfinance is important in providing support to small businesses which help in growing the economy of the country. This makes it key sources of governments' revenues. The findings of this research will help the government in the area of policy in the microfinance sector. Lastly the study will also benefit other researchers working on microfinance and small businesses by adding on to the literature that is available in that field

1.7 Delimitation of the Study

This study was carried out in South B area in Nairobi County. The study confined itself only to small businesses and not other businesses. South B area has a mix of different small businesses and also microfinance institutions and is easily accessible.

1.8 Limitations of the Study

The study was limited by availability of funds which was mitigated against by requesting family members to assist. Another limitation of the study was time constraints and consequently the study only covered small businesses in South B, area and not the whole of Nairobi.

1.9 Basic assumptions of the study

The study assumed that the sample chosen was a good representation of small businesses in the country. The study also assumed that the data collection instrument used had validity and

measured the desired constructs; and also that the respondents answered questions correctly and truthfully.

1.10 Definitions of Significant terms

Access to finance / credit: The ease at which businesses or individuals are able to get credit from microfinance institutions. This will be the degree to which financial services are available to all at a fair price and that there is a ready supply for the credit from different institutions. This will include availability of the providers of the service as well as the application process and the turnaround time for getting the amounts applied for as a whole when trying to get access to credit

Collateral: Security given when an individual or a business is applying for a loan that can be reclaimed in case of default

Entrepreneur: An individual who starts up a business either for profit or to meet a certain need that that they have or to fill in a gap that is in the market

Microfinance :The provision of financial services on a small scale for target groups that have been excluded by the bank by providing credit and other financial services and products in very small amounts to the small businesses to enable them to raise their income levels and improve their standard of living sometimes offered without asset or collateral.

Microfinance institutions (MFIs): A semi formal organization which provides a wide range of financial services including loans, savings, insurance, leasing and transfers provided by other formal, semi-formal and informal institutions. The Microfinance institutions usually provide small loans that are repaid within short periods of time and are essentially used by low income individuals and households who have little or no assets that can be used as collateral

Small businesses: Businesses that are small in terms of revenue made and clientele served .This includes businesses that generate revenues of between 1 to 100 dollars a day and employ

between 2 and 10 employees. The owner of the business will also often make all the decisions regarding all needed financial services.

Small and micro enterprises (SMEs): Small businesses and enterprises SMEs are non subsidiary, independent firms which employ less than a given number of employees. For the purposes of this study a Small and Medium enterprise is an independent firm that has between two to 10 employees with revenues of between 1 to 100 dollars a day

1.11 Organization of the study

This study starts with the Introduction which introduces the background of the study, statement of the problem, shows the objectives and the research questions guiding the study, significance, underlying assumptions, limitations and delimitations of the study.

Chapter two contains a comprehensive literature review starting with a general overview of microfinance and small business both internationally and locally. The literature review is guided by the independent variables namely microfinance characteristics, business characteristics, financial characteristics and lastly entrepreneur characteristics. The literature review also covers the theoretical framework and conceptual framework. Lastly the literature gap is explored and a summary of the literature review is given.

Research Methodology which includes the research design, target population, sample size and sampling procedure, data collection procedure, validity and reliability of research instruments and the data analysis procedure are discussed in chapter three.

Chapter four contains the data analysis, presentation and interpretation of findings arising from data analysis using the techniques described in chapter three. These findings are presented in the form of tables accompanied by explanations underneath.

Chapter five contains summary findings, discussion of findings, conclusion and the research recommendations. A section for suggested areas for further studies arising from the study findings and its contribution to the body of knowledge will be included.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews and analyzes the past literature on the factors affecting access to loans by small businesses from microfinance institutions. The research was organized around the research objectives in a systematic order. From the past literature, the researcher states the general overviews and stand based on the trends and dynamisms in the field of the affecting access to loans by small businesses then a review of related literature. This particularly focused on microfinance characteristics, business characteristics, financial characteristics and entrepreneur characteristics. These were considered as being the pillars of the study. The last section of this chapter presents both theoretical and conceptual frameworks that guide the study.

2.2 General overview of microfinance internationally and locally

The past thirty years or so has seen microfinance take off from small group based lending experiments to several hundred microfinance institutions (MFIs) serving a growing portion of the developing world today. Nevertheless, the challenge to improve broad-based access to financial services—going beyond credit and into other products such as savings, insurance and money transfer services—remains (Mendozaa and Vick, 2008)

From the mid 1980s, the African countries started liberalizing their financial services. The main characteristics of that financial liberalization were the determination by the market of interest rates and the increase in the credit supply to ultimately increase the rate of the economic growth as instructed by McKinnon (1973) and Shaw (1973)

The West African Economic and Monetary Union (WAEMU) was created in 1994 to reinforce the West African Monetary Union (WAMU) created in 1960. The purpose of the WAEMU treaty was to establish a common market enabling free movement of people, goods, services and capital. Another purpose was to lead to a stronger economic convergence after the devaluation of the CFA franc in 1994. The WAEMU comprised of eight countries, namely Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo. Microfinance institutions are the most prolific financial institutions in the world since the experience of Grameen Bank in 1970. This is also true in the WAEMU, where those institutions have been flourishing and meeting poor people's needs. In the WAEMU, the number of microfinance institutions was 272 in 1999 and 2,339,071 people were benefiting from their credit service. In 2004, this number had more than doubled to 643 institutions whereas people that benefited from the credit service were numbered at 3,881,393. This underpins the importance and the growth of microfinance institutions in these countries (Sodokin and Donou-Adonsou, 2010)

Microfinance emerged as an innovation in lending to the rural poor in Asia and as a response to frequent failure of previous interventions in rural financial markets, such as directed and subsidized production credit disbursed by agricultural development banks. While it started as a collection of banking practices built around providing small loans (typically without collateral) and accepting tiny savings deposits today, many microfinance institutions (MFIs) expand their services and strive to offer payment and savings facilities, insurance, housing, and longer-term loans to marginalized clientele in rural and urban settings (Hartarska, Christopher, Parmeter and Nadolynyak, 2010)

Ahmed (2009) found that within the global coverage of microfinance, Bangladesh's achievement stands out prominently. According to the Microcredit Summit Campaign Report, 67.6 million families have been reached by microfinance in 2002 around the world. Out of that 59.6 million clients are in Asia and Bangladesh alone covered 13 million clients (22.6 percent). In recent years MFIs have moved from the margins of the financial system towards the mainstream. It is now more widely accepted that populations traditionally excluded by the formal financial sector can be a profitable market niche for innovative banking services. The 1997 Microcredit Summit held in Washington, DC, launched a global movement to reach 100 million of the world's poorest families with credit for self-employment and other financial and business services by the year 2005. Much remains to be done, however, to integrate microfinance systems, and for orthodox financial institutions, notably commercial banks, to recognize its full potential.

In sub-Saharan Africa, the microfinance landscape evolved from two interlinked factors. Firstly, the formal financial sector excluded the poor as commercial banks, established during the post World War II period, exhibited a colonial legacy of financial service provision to urban areas and large-scale export-led projects. Such banks therefore had 'an intimidating appearance; unhelpful staff attitudes; inconvenient opening hours; relatively complicated transaction forms; and were perceived as designed for the middle class clients' (Mutesasira et al, 1998) to the extent that the poor saw them as 'institutions of thieves' (Dzingirai, 2002). Zeller (2001,) notes that the banks' limited outreach was because of 'fear of default, high costs, and rigid organizational structures inadaptable to high volume, small size loans'. Secondly, follow-up donor attempts with concessionary loans from development financial institutions – and often with commercial banks

– ended up increasingly alienating the bulk of the population. This was because such loans, managed by government officials, targeted either political cronies or specific cash crops such as cotton and coffee in Uganda, or both. Moreover, such donor support was characterized by unsustainable and externally dependent strategies that lacked product diversification. Their focus on credit without savings led to the insolvency of a number of the institutions when external funds were withdrawn under the country's Structural Adjustment Policy (de Haan and Lakwo, 2010)

The microfinance industry started in Kenya about 20 years ago, but it only gained the status of an industry in the past ten years, where it is generally categorized along two lines. First and most common is the formal versus informal. Formal providers are registered by Kenyan law. Informal providers are subject to self-regulation or group-based rules. Second, microfinance in Kenya can be categorized as client- or member-based. In member-based organizations, members provide the resources as well as constituting the main target group for the loans. These are cooperatives. In client-based organizations, the customers are distinct from the owners. Customers are not involved with the management of the organization (Waweru and Spraakman, 2012)

There seems to be a steady growth in the microfinance industry starting from Bangladesh where the movement started to Africa. In Kenya the industry is picking up now while in the Asian countries the microfinance industry started at around the same time as the Grameen Bank. There is still insufficient data to find out how exactly the growth is since there is no universal regulation governing microfinance in different countries. This means that the data used is mostly

done by self reporting by the microfinance institutions and in some countries micro finance is still growing and so the impact can only be measures a few years from now.

2.3 General overview of small businesses internationally and locally

Micro and small enterprises (MSE) in Turkey have contributed significantly to the national economy in terms of both employment and value added. In 2001, MSE produced 34% of the total value added in the manufacturing sector, 84% in the trade sector, and nearly 100% in the services sector (Özar, 2006).

Preliminary results of the General Census of Industry and Business Establishments (GSIS) for the year 2002 show that nonagricultural enterprises that engaged 1–49 persons constituted 99.4% of the total nonagricultural enterprises in Turkey. It is notable that, in less than two decades, between 1985 and 2002, the number of MSE has shown a remarkable increase of 96%.

According to GSIS, for the year 2002, the average enterprise in Turkey engaged 3.7 persons. This figure is greater for the manufacturing sector (8.3 persons engaged) and smaller for the trade sector (2.6 persons engaged) (Özar, Özertan and BurcuIrfanolu, 2008)

SMEs in Indonesia account for more than 90 percent of all firms outside the agricultural sector in the country, and thus are the biggest source of employment, providing livelihood for over 90 percent of the country's workforce, especially women and the young. In the Asia-Pacific region, Indonesia is the biggest economy with respect to total number of SMEs. A 2003 report from the Asia-Pacific Economic Cooperation (APEC) and some official estimated data from a number of member economies show that about 50 percent of total non-farm SMEs in the region were in Indonesia and China. According to official data from the Ministry of Cooperative and Small and

Medium Enterprises, Small Enterprises in 1997 accounted for more than 39.7 million units, or constituted about 99.8 percent of the total number of enterprises in the country in that year, and increased to more than 40 million units in 2004. Generally speaking, this table may indicate that every year new entrepreneurs have been born in the country (Tambunan, 2007)

The Small and Medium Enterprises (SMEs) play a vital role in the industrial development of any country. The importance of the SME sector is well-recognized world over for its significant contribution in gratifying various socioeconomic objectives, such as higher growth of employment, output, promotion of exports and fostering entrepreneurship. The small scale sector in India employs around 26 million people and produces over 7,500 industrial items with the product range varying from very simple items produced with traditional technology to hi-tech products. At present, the Small Scale Industry (SSI) sector accounts for over 90% of industrial units in the country, 40% of value addition in the manufacturing output and approximately 35% of India's exports (Sharma and Wadhawan, 2009)

In China the number of registered SMEs exceeds 40 million, accounting for more than 99 per cent of all enterprises. SMEs have become important as a source of employment and as contributors to the economy and structural reform. Every year they contribute around 59 per cent of gross domestic product (GDP), 50 per cent of tax revenue, 68 per cent of foreign trade volume, and 75 per cent of urban employment. They are also responsible for 65 per cent of the invention patents and 80 per cent of new products in China. Chinese SMEs not only maximize the efficiency of the nation's resource allocation and distribution by mobilizing and utilizing

local human and material resources, but also stimulate the growth of certain sectors

(Cunningham, 2008)

Africa's private sector consists of mostly informal microenterprises, operating alongside large firms. Most companies are small because the private sector is new and because of legal and financial obstacles to capital accumulation. SMEs are weak in Africa because of small local markets, undeveloped regional integration and very difficult business conditions, which include cumbersome official procedures, poor infrastructure, dubious legal systems, inadequate financial systems and unattractive tax regimes (Kauffmann, 2005)

While the importance of SME's is evident by the role that they play in most economies by proving employment and contributing a lot to the Gross Domestic Product of most nations in Africa there still exists obstacles like legal and regulatory framework that is not conducive

2.4 Review of related literature

Previous studies have focused on whether SMEs face difficulties in accessing finance, which can be determined as demand side studies, and issues in bank lending practices, which can be determined as supply side studies. The demand side studies suggest that; whilst overall the majority of SMEs appear not to have difficulties obtaining external finance, there is evidence to indicate that a number of groups and sectors do face distinct challenges in accessing finance.

(Deakins, North and Baldock, 2008)

This section will consider the factors identified in general literature that influences access to microfinance loans by small businesses. These factors include the microfinance characteristics,

the business characteristics, the financial characteristics of the business and the entrepreneur's characteristics.

2.5 Microfinance Characteristics

Microfinance characteristics include the application procedures, legal framework, repayment plan and availability of loan providers

2.5.1 Application procedures

Since the 1960s, larger organizations have been utilizing credit scoring to quickly and accurately assess the risk level of their prospects, applicants and existing customers mainly in the consumer lending business (Sabato, 2010).

The nature of problems reported by SMEs in general and manufacturing SMEs in particular were related to issues of the application process for debt finance at the banks. The main reasons for younger firms encountering problems in accessing finance related to lack of credit history (Deakins *et al* 2008)

Chimucheka and Rungani (2011) sought to investigate the impact of inaccessibility of bank finance and lack of financial management knowledge to small, micro and medium enterprises (SMMEs) in the Buffalo City Municipality in South Africa. Findings of this research showed that SMMEs in the Buffalo City Municipality found it difficult to access bank finance. The research results also showed that inaccessibility of bank finance have a greater impact on survival and success of SMEs. Inaccessibility of finance did not have a greater impact on growth

or survival of SMMEs because after SMMEs are established, they can seek other sources of finance other than bank finance.

In economic terms, the loan application process represents an investment at origination with the aim of minimizing credit losses in the future. All else being equal, a greater investment in the credit application process will result in lower subsequent rates of delinquency and default; conversely, a less stringent process would result in greater rates of credit loss in the future.

(Pollinger *et al*, 2007)

As access to loans is one of the major problems facing small scale enterprises in Nigeria. The idea of creating microfinance institutions is to provide an easy accessibility. Small scale enterprises do not have access to loans and these will bring effect on them because they will not be able to satisfy their clients (Suberu, Aremu, and Popoola, 2011)

Major findings by (Chimucheka and Rungani, 2011) in South Africa found that majority of the SME who did not apply for a loan did not know the procedures (53% of the sample) .Another 23% said they lacked knowledge on the sources of finance available at banks. The study however had limitations since it was carried out in one area there is no guarantee that the results could be generalized to other areas of South Africa. There was also no stratification to check whether there were any significant differences in different business sectors. Studies by Suberu et al, (2011) also found that access to loans was a major problem facing small enterprises in Nigeria. The studies however did not find out whether the applications procedures had any impact on the businesses applying for loans. Pollinger *et al*, (2007) approached application procedures from the

aspect of the microfinance organization and found that the application process if well done would lead to fewer losses in the future. Deakins *et al*, (2008) found that manufacturing SME's in particular had problems related to application procedures when applying for a loan. The study also found that the age of the business also impacted on the application procedures while none of the other studies had this as a variable. This creates a gap in the study and the age of the business will be looked at as a variable in the study.

2.5.2 Legal framework

The regulatory frameworks seen in most emerging countries do not facilitate the development of efficient models for the distribution of micro financial services. The regulatory framework governing the popular savings and lending sector in developing countries is highly fragmented and difficult to grasp, which leaves a large number of institutions operating outside of the current legal system. Such a situation hampers the development of networks that could benefit from operating synergies, which are a basic factor for efficient development of the sector (Prior and Argandon, 2009)

Ahmed (2009) argues that MFIs provide financial services and products to the poor, outside the formal banking system. In view of this, it can be argued that the conventional regulatory framework such as that of formal banks and financial institutions is not appropriate and hence not required under the circumstances prevailing in many countries. The regulatory framework in such cases cannot meet the needs of the micro finance institutions.

Olsen (2010) did studies to assess the role that increased competition, state actors, international actors, and macro-political variables play in MFIs' ability to attract borrowers. The population

used included 299 firms working in 18 Latin American and Caribbean countries. Regulation had the effect that it enabled MFIs to increase their outreach. Macro-political factors also play a role. There were found to be fewer borrowers per MFI in countries that are more developed. Likewise, citizens of countries with larger service and industry sectors are less likely to use microfinance services. Those economies with greater service and industry sectors will have fewer borrowers. The objectives of the study were met though one weakness is that the methodology used did not come out clearly in the study. However the findings from the research are similar to the findings that say for example that the industry affects access to microfinance.

Mohammad (2010) explored the challenges and opportunities of microfinance sector in Pakistan. Secondary data was used from different sources e.g. the World Bank to get information from the Microfinance institutions. Major findings from the research is that there were still numerous challenges in the microfinance sector ranging from, political interference and lack of proper government policies , competition among microfinance institutions and limited capacities of the microfinance institutions . In Pakistan microfinance being an emerging sector no proper legislation has been made towards the said sector. At the initial stage some rules and regulation were made but these rules and regulation were not sufficient to cater for the ongoing challenges At the moment regulatory norms are very complicated which cause increase in the cost of operation of the MFI's. The study did not use primary sources of data for its research and so it may not be possible to measure the validity and the reliability of the information given. Legislation however is still a challenge in many countries especially specific to microfinance institutions. Lastly there was also an opportunity for commercial banks to branch into microfinance so as to boost the sector.

Government policies and programs designed to develop small scale enterprises in Nigeria are ineffective and thereby need to be re conceptualized. Apart from provision of tax incentives and financial support, it is recommended that government should try to provide sufficient infrastructural facilities such as, good road network and training institutions (Suberu *et al*, 2011)

Kenyan banks reported that the lack of adequate government support was hindering the further development of the SME sector and that they would need their government to assist in creating an enabling environment, including the provision of financial support. At the time of the survey, the Kenyan government had a draft bill for the support of the SME sector awaiting enactment.

The merits of the credit reference bureau were agreed to by all the banks interviewed although all of them mentioned that it was still new and still needed to accumulate a decent database and was therefore not currently influencing their lending decisions in a significant manner (Calice, Pietro, Chando, Victor, Sekioua and Sofiane, 2012).

Most of the studies done seem to indicate that the regulatory framework is very important for the MFI's to be effective and the lack of one could actually lead to increase in cost of doing the business. One of the studies (Mohammad 2010) used secondary data and so there was no way to measure the validity and reliability of the data used. Olsen (2010) did not have a clear methodology meaning that the results may also not be very reliable or valid. Prior and Argandon (2009) hold that the regulatory frameworks in most developing countries are highly fragmented in nature and cannot support efficient microfinance development.

2.5.3 Repayment plan

Loan repayment rates are the single most watched figure in micro financing. For example, Grameen Bank posts on its Web site monthly statistics on the repayment rates on loans. The focus on repayment rates is understandable, as repayment rates are linked to the sustainability of the micro financing organization (Khavul, 2010)

A primary indicator of success is Grameen's (Bank) famously high (98%) repayment rates. This measure rests on the claim that recipients repay their loans because they know that doing so is the only way to get new loans, and because purchase of productive assets with their loans will increase household income at a rate that will keep repayment unburden some (Cons and paprocki, 2010)

This rapid increase in access to capital has allowed borrowers to take on more debt than they can repay, which, in some cases, is leading them to take out additional loans to repay the earlier ones. In India, for example, the average individual microfinance debt has gone up fivefold, from \$27 in 2004 to \$135 in 2009 (Gokhale, 2009).

Small business in Africa can rarely meet the conditions set by financial institutions, which see SMEs as a risk because of poor guarantees and lack of information about their ability to repay loans (Kauffmann, 2005)

2.5.4 Availability of loan providers

The lack of access to financial services in emerging countries is mainly due to a supply problem: the business models used by the financial institutions operating in these countries are inadequate

and inefficient, as they are unable to profitably serve the low-income segments (Prior and Argandon, 2009)

Arogunda (2010) sought to check whether there has been attitudinal change in the practices of community banks in Nigeria since the change from community banks to microfinance institutions. Major finding from the study revealed that although the financial operations of microfinance banks has improved over the ancient traditional community bank practices and finance observed as a major problem in financing SMEs, microfinance banks were not seen as having sufficiently the kind of funds required to oil the wheel of economic development via SME.

In Sri Lanka the Micro Finance sector comprises mainly of three types of institutions, i.e. the formal sector organizations, semiformal sector organizations and the informal sector organizations. The rapid growth of the Micro Finance sector in Sri Lanka has brought about severe competition among the MFIs, highlighting the critical need to retain old clients and attract new ones by offering higher quality service than those offered by others (Rupasinghe and Aheysekera, 2007)

In Arampur, (Bangladesh) eight different MFIs serve a village of some 1500 households. It is common for households to have upwards of four loans at any given time (Paprocki 2010)

In many countries, including Uganda, Bangladesh, and Bolivia, microfinance has become more competitive in recent years. Competition is generally expected to benefit consumers by offering a

wider choice of appropriate products and providers, better service, and lower prices (CGAP, 2006)

However, in some countries where microfinance is considered competitive, interest rates on microloans have remained stubbornly high. For example, in Bangladesh, interest rates on loans have averaged 15 percent flat for many years, despite competition among hundreds of microfinance institutions. It is widely assumed that competition leads to lower prices because, in a market sector in which private firms make excess profits, new firms will enter and will seek to gain customers by offering lower prices than are offered by other firms in the market (CGAP, 2006)

In Pakistan competition has increased among the microfinance banks and institutions which can provide better services to the clients but these competitions is not so grave in formal sector of microfinance. Now clients have more information about microfinance so they are demanding more facilities which improve the services in this sector as well (Mohammad, 2010)

A study done in the post World War II, in the years 1946-56 however found that small businesses, as a group, obtained at least as much equity funds and nearly as much loan funds from external sources as did large corporations in non-regulated industries, i.e., all industries other than public utilities, communications, and railroads. For both types of funds, the expansion was considerably greater percentagewise for small business. On this basis, it can be said that, in the postwar period, credit became more readily available to small business, for more extended periods, and at a cost that has differed less and less from that of large businesses (Schweiger,

1958)

Olsen (2010) sought to assess the role that increased competition, state actors, international actors, and macro-political variables play in MFIs' ability to attract borrowers. The population used included 299 firms working in 18 Latin American and Caribbean countries. Major findings of the study showed that increased competition decreased the number of borrowers, which would mean that markets were saturated or that the MFIs were not able to attract new customers.

Studies done to assess the availability of loan provider have given mixed results. Some studies like the one done by (Olsen, 2010) found that increased competition led to decreased number of borrowers. This is in contrast to findings by (Cons and Paprocki, 2010) whose studies reveal there was increased loan uptake due to the competition. The CGAP report (2006) observed that increased competition did not have the desired effect of lowering the interest rates charged by microfinance institutions to customers. Studies by (Mohammad, 2010) in Pakistan revealed that competition had led customers to demand for better service and so there was better service. The findings from the different studies are conflicting since availability of loan providers should have an effect of increasing the reach of the number of customers who can be served.

2.6 Business Characteristics

Business characteristics will include the age of the business, ownership type, the industry or sector or product /service, number of employees and the location

2.6.1 Age of the business

A firm's age is an important factor in the study of SMEs' financing decisions, especially regarding variations and/or adjustments of debt. Being in the business for many years suggests that the firms are at least competitive on average. It can be argued that being an older firm means there is lower informational opacity. The reason is information required by the lenders to evaluate and process applications is readily available because these businesses have an established reputation or track record. The studies conducted in the past have found that the financing constraints are particularly severe in startup enterprises and relatively young firms (three years old or less) (Pandula, 2010)

Young firms exhibited a greater propensity to try to access finance and were twice as likely to try to access bank finance. However, young firms were also significantly more likely to encounter problems in accessing finance, notably with regard to accessing bank finance. The most recent FSB biennial survey indicates that the youngest businesses (1–3 years) are less likely to use bank overdraft and retained profits and more likely to use own savings, family, personal credit card and (less than three years old) were least likely to have their applications approved (Deakins *et al*, 2008)

Thus, SMEs are at a particularly severe disadvantage when trying to obtain financing relative to larger and more established firm. As SMEs begin to grow, but have yet to establish the track record or size and collateral that would give them access to bank financing, they tend to turn to other types of risk capital offered by venture capitalists, who favour larger projects at later stages of the business cycle (OECD, 2006)

The smaller size of SMEs implies a high operational risk associated with their activities, and consequently greater probability of bankruptcy. In addition, many SMEs have considerable difficulty in providing collateral security on debt. Therefore, problems of information asymmetry are particularly relevant in the context of the relationships between the owners of SMEs and creditors. In addition, the majority of SMEs do not fulfill the requirements to be listed on the stock market, and so creditors have greater difficulty in obtaining accurate information about these firms (Serrasqueiro and Nunes, 2011)

Greater SME age can contribute to a reduction of problems of information asymmetry implicit in the relationships with creditors. As these firms consolidate their business, with a past characterized by good performance giving them credibility, they are more able to obtain credit on favorable terms (Diamond, 1989).

Deakins *et al* (2008) found that younger SMEs and owners with limited security will find it difficult to raise finance for propositions that contain higher risk or do not meet banks' financial modeling requirements. The report by OECD (2006) also reinforced this position that younger firms will have more problems when trying to access loans. Pandula (2010) also reports similar findings that firms less than 3 years old will experience more problems than other firms when trying to access loans.

2.6.2 Ownership type

SME owners that are established as either sole proprietorships or partnerships prefer to exhaust internal sources of finance before going for debt or equity because of the collateral incentives of

financing institutions that have bearings on personal assets of the SMEs. Ownership structures in the firms can influence the ability to have access to finance (Gebru, 2009)

Entrepreneurs choose ownership structures in large part to ensure adequate financing and because of the selection effect whereby finance goes to firms with conducive ownership structure. Ownership structures in the firms can influence the ability to have access to finance (Pandula, 2010)

Ayodeji and Balcioglu (2010) carried out a study in Kwara State in Nigeria sought to access financing of industrial development through the SMEs in Kwara State in regards to the type of ownership of the SME and the significance it had on financing. Major findings from the study were that the ownership type played a big role in the financing used.

A study carried out to investigate the role of family control in corporate financing decisions during the period 1998–2008 had the following findings. Family controlled firms preferred to use debt capital than use equity due to control issues. The family controlled firms were also more likely to use long term as opposed to short term debt indicating that are viewed by credit markets as non risk seeking firms (Crocchia, Doukas and Gonenc, 2011)

Gebru (2009) opined that businesses both sole proprietorship or partnerships will prefer to use internal sources since they may be forced to use collateral so as to access external funding. All the studies reviewed revealed that the ownership type played a big role in the financing of the small businesses. This in contrast to Studies by (Crocchia *et al*, 2011) who reported that family

owned businesses prefer debt finance so as not to dilute the ownership structure of the businesses.

2.6.3 Industry Sector

The lending banks may prefer lending to industry sectors that are growing. Firms in certain sectors will also 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 may face proportionately greater constraints (Pandula, 2010)

The demand side analysis found that the preponderance of manufacturing SMEs reporting Problems accessing bank finance was quite remarkable. The demand side studies suggest that; whilst overall the majority of SMEs appear not to have difficulties obtaining external finance, there is evidence to indicate that a number of groups and sectors do face distinct challenges in accessing finance. Manufacturing firms were found to exhibit twice the proportion of problems per bank application (30.3%) when compared to all other sectors SMEs in competitive sectors may find it difficult to raise finance, especially if they are operating in ways that do not fit the banks' own internal guides on benchmarking for the sector (Deakins *et al*, 2008)

Ayodeji and Balcioglu (2010) found that some SMEs in some sub-sectors were able to generate more financing than others. This was largely due to some structural defects in the nation's economic scene meaning that the industry that the business is in will have a direct effect on the access to loans.

2.6.4 Number of employees

Small, medium, and large businesses utilize debt financing for a range of reasons from securing working capital to making longer-term investments. For micro businesses—small entities with less than five employees—this is no less true (Pollinger *et al*, 2007)

SMEs tend by their very nature to show a far more volatile pattern of growth and earnings, with greater fluctuations, than larger companies. Their survival rate is lower than for larger companies. One analyst found that manufacturing firms with fewer than 20 employees were five times more likely to fail in a given year than larger firms (OECD, 2006)

2.6.5 Location

There is some evidence to suggest that some SMEs in rural environments may face additional difficulties. Rural locations can be difficult environments for SMEs, having limited local markets and limited networks and resources. Large areas of Scotland, the Highlands and Islands and the South of Scotland, qualify as rural under Scottish Government definitions¹. The SMEs in such localities seeking to grow and raise finance may find it difficult to raise bank finance, especially if reliant on local and regional markets (Deakins *et al*, 2008)

2.7 Financial Characteristics

Financial characteristics have been categorized into three types namely, having audited financial statements, tangible assets/ collateral and, and business performance.

2.7.1 Financial statements

When the firm is small, most of the time it is owned and operated by the entrepreneur himself and there is no such legal requirement to regularly report financial information and many firms

do not maintain audited financial accounts. Audited financial statements are very useful in accessing credit from financial institutions. Often, banks require audited financial statements before granting credit. However, most of the SMEs in the South Asia have difficulty in getting credit from the formal financial institutions because they lack proper financial records. Most of the businesses in these countries often keep multiple sets of books and do not have audited financial statements based on reliable accounting standards. On the other hand, these firms end up getting loans at higher interest rates because banks considered them as high risk borrowers. Combined with the absence of information on their financial records, this makes difficult to lenders to assess lending proposals submitted by new firms (Pandula, 2010)

Banks usually cannot lend to SMEs as much as would be warranted if firms do not report reliably their full financial activity on their financial statements. Furthermore, informality implies that the firm has unrecorded, contingent senior liabilities to the government and its own employees. Faced with the risk that tax and/or labor authorities could cause such liabilities to materialize, banks would lend less to SMEs or charge a higher risk premium (Soledad, Sergio and Schmukler, 2008)

Tagoe, Nyarko, and Anuwa-Amarh (2005) carried out studies that showed that good information management and the ability to use information to present a well-crafted business case for financing reduced risk perception and increased the chance of SMEs getting adequate funds. Therefore, SME's should seek to improve their information management practices and investor relations skills to improve their access to credit.

2.7.2 Tangible Assets / Collateral

Innovative firms have characteristics which make it particularly difficult for them to finance themselves using debt capital; the high operational and financial risks, the lack of a track record, their inability to offer guarantees, and the significant degree of moral hazard, all mean that, once we have accepted that capital markets are not perfect, innovative firms require different forms of finance to fund their innovation in the different stages of their life-cycles. In other words, the lack of track records, and the fact that specific information about the project to be financed is hard to provide, limits the availability of debt capital, or renders it prohibitively expensive. The findings in the literature and economic policy publications report that innovative firms are fundamental to economic growth, but suffer from major barriers to access to external financing due to the imperfections of the capital markets and their own intrinsic characteristics (Venturelli and Gualandri, 2009)

Smaller firms have fewer assets to offer as collateral. In order to reduce the anticipated risk and moral hazard associated with lending, the banks use collateral as one of the instrument. The collateral is an assurance to the bank in case of default and it also ensures the borrowers commitment to the loan repayments. On the other hand, the new firms are not likely to meet the collateral requirements of the banks since they have not accumulated sufficient assets (Pandula 2010). Some demand-side research with young entrepreneurs has confirmed that market failure probably exists due to the limited security and personal assets of younger SME owners (Deakins *et al*, 2008)

The degree to which the firms' assets are tangible and generic should result in the firm having a greater liquidation value. This will reduce the magnitude of financial loss incurred by financiers should the company default. By pledging the firms' assets as collateral or arranging so that a fixed charge is directly placed to particular tangible assets of the firm, also reduces adverse selection and moral hazard costs. This will result in firms with assets that have greater liquidation value having relatively easier access to finance, and lower costs of financing, leading to these firms having a higher level of debt or outside financing in their capital structure (Cassar and Holmes, 2003)

2.7.3 Business performance

Although it is 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 (Pandula, 2010)

2.8 Entrepreneur Characteristics

The literature presents conflicting evidence about whether personal characteristics are an issue when entrepreneurs seek bank finance – though it does seem that there is a perception amongst specific groups of entrepreneurs that they experience difficulty in raising finance (Irwin and Scott 2006). Entrepreneur characteristics will include the education background, entrepreneurs experience and networking.

2.8.1 Education background

Education has always been considered important for entrepreneurs determining the type of business to be started or even the networks that will be formed. Bosworth (2009) found a strong correlation between education and forward thinking in business. There was also a strong link

between education and the use of internet which is associated with embracing technology so as to benefit the business. In terms of access to loans 25 per cent of those with undergraduate or postgraduate degrees applied for grants compared to just 16 per cent of other business owner's applicants with degrees were also marginally more successful with 72 per cent.

Other studies also show evidence supporting a positive and significant relationship between the level of general education and entrepreneurial performance, whether performance is measured as growth, profits or earning power of the entrepreneur (Dickson, Solomon, Weaver, 2008)

The evidence linking general education to selection into entrepreneurship could however not be classified as either positive or negative. It would appear that there is sufficient evidence to suggest that the level of educational attainment by entrepreneurs is significantly and positively associated with entrepreneurial performance. The review also notes the ambiguous findings regarding the links between general education and selection into entrepreneurship

The research appears to suggest that personal characteristics do make some difference to the ability of entrepreneurs to raise finance. Not surprisingly, graduates have the least difficulty in raising finance. Education appears to make little difference to sources of finance, except that those educated (only) to A levels seem more likely to use friends and family and to remortgage their home (Irwin, 2006)

Ayodeji and Balcioglu (2010) also indicated that the entrepreneur's capacity (educational) development level has significant effect on the financing of Small and Medium Enterprises in Kwara State of Nigeria.

2.8.2 Entrepreneur's experience

The accrual of experience in that business sector during the learning phase will provide both the requisite business knowledge as well as the skills to do the work. With these attributes, an individual is well placed to identify a business opportunity and to turn that opportunity into reality (Bosworth, 2009)

2.8.3 Networking

The statistical data confirmed that higher education qualifications were associated with higher levels of networking and use of business advice services (Bosworth, 2009) where a business owner lacks skills; these can often be overcome with strong support networks. The presence of other entrepreneurs in networks of social relationships can also reduce the ambiguity associated with entrepreneurial activity. Not all business owners have access to networks that are rich in human capital or entrepreneurial ability. This was reflected in the statistics, which showed that business owners with higher education qualifications were the most likely to have used a variety of business advice and networking organizations.

Belonging to a professional body helps gain a competitive advantage in a business. Being a member of an industry association implies that one is serious about the business they do. This could also help in networking and obtaining of business information (Bowen *et al* 2009)

Ayodeji and Balcioglu (2010) also showed that the membership of business/trade organizations significantly affected the financing of the SMEs in Kwara State in Nigeria. Most of the SMEs in Kwara State did not belong to any organization and the SMEs that belonged to one or more had not made tangible contributions in the organization.

2.9 Theoretical Framework

This theoretical framework will examine the Agency theory, Growth cycle theory Entrepreneurship theory and the Theoretical model of equilibrium.

2.9.1 Agency Theory

Jenson and Meckling (1976) explain the principal-agent relationship between equity holders and debt holders. In a principal-agent framework, the business is the agent and the finance provider is the principal. This theory asserts that principals have higher agency costs because equity-controlled firms have a tendency to invest sub optimally to expropriate wealth from debt holders that in turn results in incremental risk for the principal. That is, business owners invest on high risk projects that the cost of debt should have been higher to share on the marginal return on investment.

2.9.2 Growth Cycle Theory

Berger and Udell (1998) initiated the Growth Cycle Theory of small business financing. This theory illustrates the dynamic financial needs, as the small business becomes more experienced and enhanced informational transparency. In this theory ,the firm gets better access to venture capital as a source of equity and midterm-loans as a source of debt yet, as the firm gets older and information-wise transparent it tends to have better access to public equity and long-term financing. Gregory, Rutherford, Oswald and Gardiner (2005) found that only firm size, as measured by total employees, could significantly determine the decision of whether to use insider financing instead of going for public equity or long-term financing

2.9.3 Entrepreneurship theory

Entrepreneurship theory (Shane, 2003) stated that entrepreneur's ability to discover and exploit opportunity for entrepreneurial activity differs between individuals and depends on individual's attitude towards risk taking. For instance, a risk-averse individual is less likely to exploit entrepreneurial opportunity (Shane, 2003). As such, a person may not search for or discover entrepreneurial opportunity if he/she has a negative attitude towards risk-taking. In the same vein, an individual may have an innovation business or service idea, and great likelihood to access micro-finance but may not utilize the opportunity if he/she fears risk.

2.9.4 The theoretical model of equilibrium

The theoretical model of equilibrium with credit rationing follows from the pioneering work of (Stiglitz and Weiss, 1981). The model is based on imperfect credit markets characterized by information asymmetry, which makes it too costly for banks to obtain accurate information on the borrowers and to monitor the actions of the borrowers. The model assumes the existence of many banks that seek to maximize their profits through their choice of interest and collateral (thereby reducing the probability of default on their loans) and many potential borrowers who seek to maximize their profits through the choice of projects. The probability of success of the projects is unknown to the bank but known to the firms due to information asymmetry.

2.10 Conceptual framework

This conceptual framework shows the relationship between the independent variables, extraneous variables and moderating variables influence on access to loans by small businesses from microfinance institutions

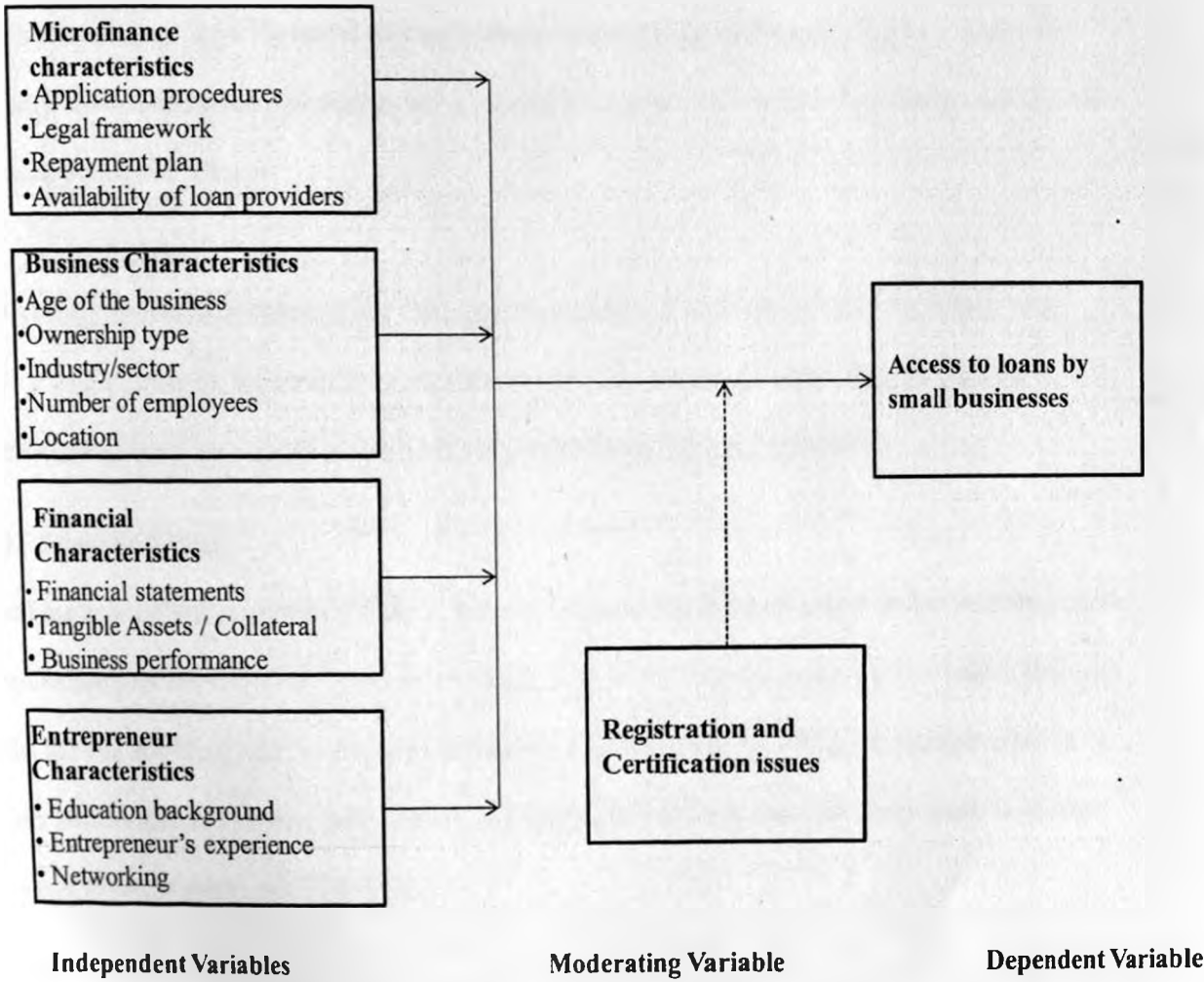


Figure 1: Conceptual framework

Microfinance characteristics affect access to loans by small businesses since this will affect how accessible the institutions are. The characteristics of the business will also affect access to loans for example how long the business has been in operation is important when trying to access loans.

Any business must have financial characteristics that will help when applying for a loan like keeping audited financial statements or by having collateral. This help in building a strong case when applying for a loan.

The entrepreneur characteristics are also important and will include factors like networking which will expose the business to more opportunities for access to loans. Regulations and certification issues significantly affect the access to loans by small businesses.

2.11 Literature Gap

Deakins *et al* (2008) found that SME's in the manufacturing industry experienced problems with application procedures when trying to access a loan. There was no clarity as to whether this only affected one sector or other sectors. This study will address this by checking whether SME's in other sectors also experience problems in the application procedures. Only one study looked at the age of the business and its impact.

Chimucheka and Rungani (2011) in South Africa found that majority of the SME who did not apply for a loan did not know the procedures or lacked knowledge on the sources of finance available at banks. There was also no stratification to check whether there were any significant differences in different business sectors. There was no link shown on the business sector and the

knowledge of the application procedures and the sources of finance. Other studies while acknowledging that access to loans was a major problem facing small enterprises (Suberu *et al*, 2011) applications procedures were not checked to find out if they had any effect.

Most studies done seem to indicate that the regulatory framework is very important for the MFI's to be effective. One of the studies (Mohammad, 2010) used secondary data and so there was no way to measure the validity and reliability of the data used. Olsen (2010) did not have a clear methodology meaning that the results may also not be very reliable or valid. Both studies seem to have a methodology gap and the results of the study may need to be verified through similar studies but with different methodology.

Studies done to access the availability of loan provider have given mixed results. Some studies like the one done by (Olsen, 2010) found that increased competition led to decreased number of borrowers. This is in contrast to findings by (Paprocki, 2010) whose studies reveal there was increased loan uptake due to the competition. The CGAP report (2006) observed that increased competition did not have the desired effect of lowering the interest rates charged by microfinance institutions to customers. Mohammad (2010) revealed that in Pakistan competition had led customers to demand for better service and so there was better service. The findings from the different studies are conflicting since availability of loan providers should have an effect of increasing the reach of the number of customers who can be served. These mixed results make it difficult to generalize the findings to different areas so the studies can only be used for the specific areas in which they were done.

There was insufficient data on the effect that the number of employees a business had on its ability to access loans with only two studies using this as a variable. OECD (2006) and Pollinger *et al* (2007). There was also insufficient data on the effect that the location of the business has on its ability to access loans. Deakins *et al*, (2008) explored this looking at the small business that are located in rural areas vis a vis those in the urban areas.

Lastly, none of the studies looked at the effect that default penalties had as a factor affecting access to loans by small businesses and also the amount applied and the actual amount given to the small businesses

2.12 Summary of literature review

Based on the literature review in this study, it can be argued that varied factors affect access to loans by small businesses. That access to loans by small business is essential for the survival and expansion of the businesses cannot be over emphasized. The literature cited the need for small businesses to change the way in which they work and keep records to access funds easily.

Some of the constraints that come into place when small business were looking for loans was the credit rationing behavior of microfinance institutions by requiring collateral or by requiring businesses to have audited records before they can give the loans.

The results of this study also show that microfinance institutions need to realize that some of the stringent conditions put in before businesses can access loans may lock out business which may be highly profitable. Commercial banks were also encouraged to branch out into microfinance as

an additional service to increase the access to small businesses and also to create competition within the sector.

Studies on the effect of availability of loan providers gave mixed results with some studies showing that with the increase of loan providers the loans taken were less while other studies had more loans taken . This gives room for further research in the area so as to check the results that will be obtained. Other studies did not have a clear methodology and so the findings may not be generalized and only one study addressed the age of the business as a variable while the other studies did not.

The researcher also established that there is limited empirical research known to have been undertaken to study the factors that affect access to loans by small businesses from microfinance institutions in South B area, Nairobi County. Therefore to fill in the above gap, the researcher will collect sufficient data on factors that affecting access to loans by small businesses: These factors are: microfinance characteristics, business characteristics, financial characteristics and entrepreneur characteristics

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents a description of the selected research design. The researcher described the general research design used and defined the target population and sampling technique applied. This was followed by a description of the methods used to collect data from the respondents. The researcher also described the methods used to analyze the data collected. The last section provides a summary of the main elements in the chapter on the methodology

3.2 Research Design

A descriptive research design was used for this study. Kothari (1990) says that descriptive research studies are those studies concerned with describing the characteristics of a particular individual, or of a group. The major purpose of descriptive design is description of the state of affairs as it exists. In a descriptive design the researcher must be able to define what he wants to measure and must find adequate methods for measuring it along with a clear definition of population to be studied. This being a study that had the characteristics that have been described i.e. concerned with describing characteristics of a group with clear definitions of the population and the measures that will be used, the descriptive research design was the most fitting and was therefore be utilized.

3.3 Target population

This study targeted all small businesses having between 2 and 10 employees with revenue of between 1 and 100 dollars daily in South B area, Nairobi County, Kenya. Population of small businesses as given by the Nairobi City Council office was 313 registered small businesses. The

table below showed the distribution of the target population. Managers of 3 microfinance institutions were also be interviewed.

Table 3.1: Target population; Source Nairobi City Council Office

Target Group	Population	Percentage
Small Trader/ Shop/ Kiosk	180	58
Workshop/ repair	80	26
Eating house/ snack bar	20	6
Professional services	20	6
Transport	13	4
Total	313	100

3.4 Sample Size and Sampling Procedure

The research used a descriptive research design and employed simple random sampling rotary method without replacement. This ensured that all the small businesses in the sample population had an equal chance of being picked to minimize bias. Gay (1981) recommends a sample size of ten percent or more of the accessible population for descriptive studies.

A sample of 30 % was picked from the whole population as illustrated in the table below as this was more than the 10 % recommended (Gay1981). The first two categories (small trader /shop /kiosk and workshop or repair) were picked through systematic sampling where after the first business is picked every 5th business of the sample was interviewed. Since the rest of the

population was small, simple random sampling rotary method without replacement was used.

This means that a total of 96 small businesses were to be interviewed as part of the study.

Table 3.2: Sample Frame

Target Group	Population	Sample	Percentage
Small/Trader/Shop/ Kiosk	180	54	30
Workshop/ repair	80	24	30
Eating house/ snack bar	20	6	30
Professional services	20	6	30
Transport	13	4	30
Total	313	96	30

3.5 Methods of Data Collection

The researcher used questionnaires for collecting the data. The selection of this data was guided by the nature of data to be collected, the time available as well as the objectives of the study.

This was a set of few questions asked in a logical sequence but put in writing form. They required brief and direct answers. Questionnaires were used since the study was concerned with variables that could not be directly observed such as views, opinions perceptions and feelings of the respondents.

3.6 Data Collection Procedure

The questionnaire was administered randomly to the target population. This meant that all the businesses that meet the criteria i.e. had between 2 to 10 employees with revenues of between 1 to 100 dollars a day had an equal chance of being picked. The research used the help of 4 field assistants who assisted in the administering of the questionnaires to the target population. This

was done through face to face administering of the questionnaire. Questionnaires were also to be administered to a sample of microfinance institutions targeting the managers to collect data on what factors lead to loan applications to be rejected by them.

3.7 Validity of research instruments

Validity is the accuracy and meaningfulness of inferences, which are based on the research results (Mugenda and Mugenda 1999). To test for validity, the instrument was given to the supervisor who assessed that the questions asked address the key issues.

3.8 Reliability of research instruments

A measure is reliable to the degree that it supplies consistent results. Reliability is concerned with estimates of the degree to which a measurement is free of random or unstable error. (Cooper and Schindler 2003)The reliability of the instrument was tested through split half technique. In this technique the instrument is designed that there are two parts. Scores from the one part are then correlated with the scores from the second part. The split half method was used to calculate the correlation using the r- function of spearman brown prophesy formulae.

$$\begin{aligned} \text{Reliability of scores} &= \frac{2 \times \text{reliability for } \frac{1}{2} \text{ tests}}{1 + \text{reliability for } \frac{1}{2} \text{ tests}} \\ &= \frac{2r}{r+1} \end{aligned}$$

The Spearman-Brown coefficient result of reliability analysis was 0.9347 which meets the reliability criteria indicating that the questionnaire passes the reliability test.

3.9 Data Analysis Procedure

This involved the use of both descriptive qualitative and descriptive quantitative methods to analyze the data. Descriptive statistics analysis was used for closed ended questions while

content analysis was used to analyze the views of the respondents that could not be quantified, especially for open-ended questions where the respondents gave their own view and opinions.

Chi square (χ^2) statistics was used to determine the relationship between the four independent variables and access to loans. This is similar to studies done by (Pandula 2010) and (Ayodeji and Balcioglu 2010) who having similar variables used this method of analysis. The study also used simple descriptive statistical tools like mean, average, percentage, and standard deviation.

3.10 Operational definition of variables

The researcher carried out research on the independent variables on the factors affecting access to loans by small businesses in Nairobi South B area.

Table 3.2: Operationalization of Variables

Objectives	Variable	Indicators	Measure	Measurement Scale	Type of Analysis	Tools of Analysis
Determine extent to which microfinance characteristics influence access to loans by small businesses	Independent Variable Microfinance characteristics Dependent Variable Access to loans	1)Application procedures 2)Legal framework 3)Repayment plan 4)Availability of loan providers	1) Ease 2) Ease 3) Time 4) Number	Ratio	Descriptive	Mean
Determine extent to which business characteristics influence access to loans by small businesses	Independent Variable Business Characteristics Dependent Variable Access to loans	1) Age of the business 2) Ownership type 3) Industry sector / product/service 4) Number of employees 5) Location	1) Number 2) Rating 3) Rating 4) Number 5) Rating	Nominal Ratio	Descriptive	Mode/ mean

Variables	Variable	Indicators	Measure	Measurement Scale	Type of Analysis	Tools of Analysis
Determine extent to which financial characteristics influence access to loans by small businesses	Independent Variable	1) Financial statements 2) Tangible Assets / Collateral 3) Business performance.	1) Number 2) Number 3) Number	Ratio	Descriptive	Mean
	Financial Characteristics			Ordinal		
Determine extent to which entrepreneur characteristics influence access to loans by small businesses	Independent Variable	1) Education background 2) Entrepreneur's experience 3) Networking	1) Level 2) Years 3) Membership	Nominal	Descriptive	Mode/ mean
	Entrepreneur Characteristics			Ratio		
	Dependent Variable					
	Access to loans					

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION AND INTERPRETATIONS

4.1 Introduction

This chapter presents analysis of the data found on the factors influencing access to loans by small businesses in South B area Nairobi, Kenya. This chapter focused on data analysis, interpretation and presentation. The researcher made use of frequency tables and percentages to present data.

4.2 Response Rate

The data targeted a sample of 95 respondents from which 94 filled in and returned the questionnaires making a response rate of 98%. This response rate was good and representative and conforms to Mugenda and Mugenda (1999) stipulation that a response rate of 50% is adequate for analysis and reporting; a rate of 60% is good and a response rate of 70% and over is excellent. It was however not possible to get data from the microfinance institutions. Two of the microfinance institutions interviewed were not allowed to disclose any information and the third microfinance institution interviewed said that the policy of the organization does not allow research. All the data presented is therefore from the point of view of business owners only.

Only two of the respondents had gotten a loan from a microfinance institution the rest got the loans from banks.

4.3 General characteristics of the Respondents

The respondents were asked to indicate their age bracket .The findings are shown in Table 4.1 below.

Table 4.1: Age bracket of the respondents in years

Age Bracket	Midpoint (x)	Frequency(f)	fx	Percentage
20 - 30	25	67	1675	71.3
31 -40	34.5	21	724.5	22.3
41 - 50	44.5	6	267	6.4
Total		94	2666.5	100

The study found that majority of the respondents were between 20-30 years as shown by 71.3%, 22.3% were aged between 31 – 40 years, 6.4% of the respondents were between 41 – 50 years. From the above findings the average age of the respondents was seen to be 28.4. This shows that a majority of the businesses in the area had been started by young people

4.3.1 Gender of the respondents

The respondents were asked to indicate their gender .The findings are shown in Table 4.2 below.

Table 4.2: Gender of the respondents

Gender	Frequency	Percentage
Female	33	35.1
male	61	64.9
Total	94	100.0

From the findings, the study established that the majority of respondents were male as shown by 64.9%, while females were 35.1%.

4.3.2 Number of employees in the business

The respondents were asked to indicate the number of employees in the business. The findings are shown in Table 4.3 below

Table 4.3: Number of employees

Number of employees	Frequency	Percentage
1	55	58.5
1 - 3	35	37.2
4 - 6	4	4.3
Total	94	100.0

From the findings majority of the respondents were the sole employee as shown by 58.5%, 37.2 % had between 1 and 3 employees and 4.3 % of the businesses had between 4 and 6 employees.

4.3.3 Business existence

The respondents were asked to indicate the number of years that the business has been in existence. The findings are shown in Table 4.4 below

Table 4.4: Business existence

Business existence	Frequency	Percentage
1 - 3 years	52	55.3
4 -5 years	26	27.7
6 -10 years	12	12.8
More than 10 years	4	4.3
Total	94	100.0

From the findings the study established that majority of the businesses had been in existence between 1 and 3 years as shown by 55.3%. 27.7% of the businesses had been in existence between 4 and 5 years while 12.8% had been in existence between 6 and 10 years and lastly 4.3% of the businesses had been in existence for more than 10 years. This indicates that most of the businesses were still young implying that either most of the businesses were new or that there

is a high failure rate of businesses in the area. This is because majority of the businesses had been in existence between 1 and 3 years while a smaller number had been in existence between 4 and 5 years. The smallest number of businesses had been in existence for over 10 years.

4.3.4 Ownership type

The respondents were asked to indicate whether the businesses were sole proprietorship or partnerships and the responses are shown in Table 4.5 below

Table 4.5: Ownership type

Ownership type	Frequency	Percentage
Sole proprietorship	75	79.8
Partnership	19	20.2
Total	94	100.0

From the findings it was evident that 78.8% of the businesses were sole proprietorships while 20.2% were partnerships. Individuals may have a preference for sole proprietorship due to the degree of control that this provides in terms of business decisions.

4.3.5 Business Sector

The respondents were asked to indicate the sector that their business was in. The responses are shown in Table 4.6.

Table 4.6: Business Sector

Business Sector	Frequency	Percentage
Small trader	47	50.5
Workshop or Repair	27	28.4
Eating house or snack bar	6	6.3
Professional services	8	8.4
Transport	6	6.3
	94	100

It was established from the findings that 50.5% of the businesses were small traders, 28.4% workshop or repair, 6.3% were eating houses or snack bars, 8.4 %were professional services and 6.3 % were transport services. This shows that the spread of the businesses in the area are mainly small traders while the rest are spread across the other businesses.

4.4 Factors influencing access to loans results

The study was to find out the factors influencing the access to loans by small businesses from microfinance institutions. In this regard the study looked at the four variables i.e. microfinance characteristics, business characteristics, financial and entrepreneur characteristics and if there was a relationship between these and access to loans. The chi square statistics was used to find out if there was any significant difference between businesses that had taken a loan and those that had not based on the different variables.

4.5 Microfinance Characteristics and access to loans

The following were looked at under the microfinance characteristics; application procedures government legal framework, repayment plan, availability of loan providers and the penalties for loan defaulters.

4.5.1 Application Procedures and access to loans

The hypothesis that was tested for this was; there is an association between loan application procedure and loan access. The results are on the table below. The Pearson Chi- Square statistic 0.682 with a significance value of 0.40894 is below the alpha level. The hypothesis is therefore rejected. There is therefore not enough evidence at 5%significanace level to infer that application procedure and loan access are related

Table 4.7: Application procedures

Loan application procedure	With Loan	Without Loan	X ²	p value
Good	17	4		
Bad	11	1		
Total	28	5	0.682	0.40894

4.5.2 Government legal framework and access to loans

The hypothesis that was tested for this was; government legal frameworks have an effect on access to loans. The results are on the table below. The Pearson Chi- Square statistic 2.227 with a significance value of 0.13563 is below the alpha level 0.5. The hypothesis is therefore not supported.

Table 4.8: Government legal framework

Government legal framework	With Loan	Without Loan	X ²	p value
Yes	14	1		
No	14	5		
	29	6	2.227	0.13563

4.5.3 Repayment plan and access to loans

The hypothesis that was to be tested for this was; loan repayment options have an effect on access to loans. The results are on the table below. The Pearson Chi- Square statistic 0.503 with a significance value of 0.47825 is below the alpha level 0.5. The hypothesis is therefore not supported

Table 4.9: Repayment plan

Adequate repayment plan	With Loan	Without Loan	X ²	p value
Yes	16	2		
No	12	3		
	28	6	0.503	0.47825

4.5.4 Availability institutions and access to loans

The hypothesis that was tested for this was; Awareness of the different microfinance institutions has an influence on the access to loans. The results are on the table below. The Pearson Chi- Square statistic 0.131 with a significance value of 0.71741 is below the alpha level (0.05). This indicates that there is no significant relationship between awareness of the microfinance institutions and access to loans. The hypothesis is therefore rejected

Table 4.10: Availability of mfi institutions

Awareness of mfi institutions	With Loan	Without Loan	X ²	p value
Yes	25	4		
No	4	1		
Total	29	5	0.131	0.71741

4.5.5 Penalties for defaulters and access to loans

The hypothesis that was tested for this was; high default penalties lead to fewer loan access options. The results are on the table below. The Pearson Chi- Square statistic 0.005 with a significance value of 0.94262 is above the alpha level 0.5. The hypothesis is therefore accepted

Table 4.11: Penalties for defaulters

Penalties for defaulters	With Loan	Without Loan	X ²	p value
Too high	22	4		
Moderate	6	1		
	29	6	0.005	0.94262

4.6 Business Characteristics and access to loans

Under business characteristics the researcher looked at the age of the business, ownership type, the industry or sector the business is in, number of employees in the business and whether this had an influence in access to loans by the businesses.

4.6.1 Age of the business and access to loans

The hypothesis that tested for this was: Younger businesses have difficulty assessing loans. The results are shown in the table below. The Pearson Chi-Square statistic 1.847 with a significance value of 0.605 is below the alpha level (0.05). This indicates that there is no relationship between age of the business and having a loan. There is not enough evidence at the 5% significance level to infer that the business length existence and having a loan are related. The hypothesis is therefore rejected.

Table 4.12: Age of the business

Age of the business	With Loan	Without Loan	X ²	p value
1 to 3 years	12	4		
4 to 5 years	10	1		
6 to 10 years	4	1		
More than 10 years	3	0		
Total Number	29	6	1.847	0.605

4.6.2 Ownership type and access to loans

The hypothesis that was tested for this was: Ownership type affects the businesses' ability to access loans. The results are shown in the table below. The Pearson Chi-Square statistic 1.81 with a significance value of 0.178 is below the alpha level (0.05). This indicates that there is no relationship between ownership type and having a loan. There is not enough evidence at the 5% significance level to infer that the ownership type affects getting a loan. The hypothesis is therefore rejected

Table 4.13: Ownership type

Ownership Type	With Loan	Without Loan	X ²	p value
Sole proprietorship	22	6		
Partnership	7	0		
Total Number	29	6	1.81	0.178

4.6.3 Business sector and access to loans

The hypothesis that was tested for this was: Business sector affects the businesses ability to access loans. The results are shown in the table below. The Pearson Chi-Square statistic 1.649

with a significance value of 0.80 is above the alpha level (0.05). This indicates that there is a significant relationship between business sector and having a loan. The hypothesis is therefore supported that the business sector has an influence on the access to loans.

Table 4.14: Business Type

Business Sector	With Loan	Without Loan	X ²	p value
Small trader	14	3		
Workshop/Repair	8	2		
Eating house / snack bar	1	0		
Professional services	4	0		
Transport	2	1		
	29	6	1.649	0.8

4.6.4 Number of the employees

The hypothesis that was tested for this was: Businesses with fewer employees have difficulty assessing loans. The results are shown in the table below. The Pearson Chi-Square statistic 6.839 with a significance value of 0.033 is below the alpha level (0.05). This indicates that there is no relationship between number of employees and having a loan. The hypothesis is therefore rejected

Table 4.15: Number of employees

Number of employees	With Loan	Without Loan	X ²	p value
1(owner sole employee)	12	6		
1 to 3	15	0		
4 to 6	2	0		
7 and above	0	0		
Total Number	29	6	6.839	0.033

4.7 Financial Characteristics

Financial characteristics have been categorized into three types namely, having audited financial statements, collateral and business performance and their influence on access to loans. The results are below:

4.7.1 Audited Statements and access to loans:

The hypothesis that was tested for this was: Business without audited financial statements will have difficulty accessing loans. The results are shown in the table below. The Pearson Chi-Square statistic 5.504 with a significance value of 0.018974 is below the alpha level (0.05). This indicates that there is no significant relationship between audited statements and accessing a loan

Table 4.16: Audited statements

Audited Statements	With Loan	Without Loan	X ²	p value
Yes	26	3		
No	3	3		
Total	29	6	5.504	0.018974

4.7.2 Tangible assets and access to loans

The hypothesis that was tested for this was: Business without tangible assets will have difficulty accessing loans. The results are shown in the table below. The Pearson Chi-Square statistic 2.146 with a significance value of 0.14298 is below the alpha level (0.05). This indicates that there is no significant relationship between tangible assets and access to a loan. The hypothesis is therefore rejected.

Table 4.17: Tangible assets

Tangible Assets	With Loan	Without Loan	X ²	p value
Yes	26	3		
No	3	2		
Total	29	6	2.146	0.14298

4.7.3 Sales growth and access to loans

The hypothesis that was tested for this was: Business with negative sales growth will have difficulty accessing loans. The results are shown in the table below. The Pearson Chi-Square statistic 0.196 with a significance value of 0.65774 is below the alpha level (0.05). This indicates that there is no significant relationship between sales growth and accessing a loan. The hypothesis is therefore rejected.

Table 4.18: Sales growth

Sales Growth	With Loan	Without Loan	X ²	p value
Positive	26	3		
Negative	3	3		
Total	29	6	0.196	0.65774

4.8 Entrepreneur Characteristics

Entrepreneur characteristics have profound consequences for running a business. The study wanted to find out if the entrepreneur's education background, experience and networking had an effect on access to loans.

4.8.1 Education background access to loans

The hypothesis that was tested was: Entrepreneurs with less education background find it difficult to access bank finance. The results are on the table below. The Pearson Chi-Square statistic 0.794 with a significance value of 0.851 is above the alpha level (0.05). This indicates that there is a significant relationship between education level of the entrepreneur and accessing a loan. The hypothesis is therefore supported.

Table 4.19: Education Level

Education Level	With Loan	Without Loan	X ²	p value
Did not complete secondary	3	1		
Secondary	3	1		
Vocational training and some university	20	3		
Graduate or postgraduate degree	3	1		
Total	29	6	0.794	0.851

4.8.2 Entrepreneur's experience and access to loans

The hypothesis that was tested was entrepreneurs with less or no work experience find it difficult to access loans. The results are on the table below. The Pearson Chi-Square statistic (x) with a significance value of 0.827 is above the alpha level (0.05). This indicates that there is a significant relationship between years of experience and access to loans. The hypothesis is therefore supported

Table 4.20: Entrepreneur's experience

Years of experience	With Loan	Without Loan	X ²	p value
No experience	1	0		
10 years or less	23	6		
11 - 20 years	1	0		
21 years or more	4	0		
Total	29	6	1.498	0.827

4.8.3 Member of a business association and access to loans

The hypothesis that was tested was Entrepreneurs with no affiliations with business associations have limited access to loans. The results are on the table below. The Pearson Chi- Square statistic 1.889 with a significance value of 0.169 is below the alpha level (0.05). This indicates that there is no significant relationship between being a member of a business association and access to loans. The hypothesis is therefore rejected

Table 4.21: Networking

Member of business association	With Loan	Without Loan	X ²	p value
Yes	7	0		
No	22	6		
Total	29	6	1.889	0.169

CHAPTER FIVE

SUMMARY OF FINDINGS, DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

The chapter presents a summary of the data findings on the factors influencing the access to loans by small businesses in Nairobi. Based on the findings in chapter four, the study gives recommendations on what small businesses can do to access loans. The suggestion for further research is also discussed. From the analysis and data collected, the following discussions, conclusions and recommendations were made. The recommendations are based on the objectives of the study.

5.2 Summary of Findings

The purpose of the study was to establish the factors influencing the access to loans by small businesses in Nairobi South B area. The variables on study were microfinance characteristics, business characteristics, financial characteristics and entrepreneur characteristics.

The chi square results indicated that, education and experience of the entrepreneur, default penalties charged and the business sector are the main determinants of access to credit. Also, somewhat unexpectedly, all other factors identified in the study did not show any association with access to loans by small businesses.

Under microfinance characteristics the only variable that had an effect on loan access was default penalties. For all the other variables under microfinance characteristics, there was not enough evidence to show any relationship with these variables and access to loans.

For business characteristics the only variable that had a relationship with access to loans was the business sector. For all the other variables under business characteristics, there was not enough evidence to show any relationship with these variables and access to loans.

Under financial characteristics none of the responses showed any relationship between the financial indicators i.e. financial statements, tangible assets or collateral and business performance. Under entrepreneur characteristics there was a relation between the education level of the entrepreneur and experience on access to loans. There was however no relationship between the entrepreneur's networks and access to loans

5.3 Discussions of Key Findings

i) Microfinance characteristics

Repayment plan was the only indicator that had a relation with access to loans. This may imply that the business may perceive that the repayment plan is not adequate for their business especially since businesses do not have constant cash flow month on month. The loan providers will on the other hand require a fixed amount each month regardless of whether the business has that amount or not. Due to this, potential borrowers are discouraged from applying for credit when they perceive that they are not likely to get the loans given the eligibility requirements imposed by the lenders. This agrees with a study by (Kauffman, 2005) who asserts that the ability to repay loans for SMEs is a big problem due to poor guarantees when applying for loans.

The majority of businesses were not aware of government policies that have been put in place to improve the microfinance sector so as to improve access to loans. There was no relationship between government policies and access to loans. This agrees with studies by (Ahmed, 2009) who argued that the conventional regulatory framework was not appropriate and hence not required under the circumstances prevailing in many countries. The regulatory framework in such cases could not meet the needs of the micro finance institutions

ii) Business Characteristics

(Gebru 2009) asserts that business owners that are established as either sole proprietorships or partnerships prefer to exhaust internal sources of finance before going for debt or equity because of the collateral incentives of financing institutions that have bearings on personal assets of the . This agrees with the results obtained where the ownership type did not have a relationship with access to a loan. Another important factor to be considered is that most of the businesses were sole proprietorships. Gebru (2009) also opined that small businesses will prefer to use internal sources of funds instead of applying for loans.

The study also found no relationship between the age of the business and access to loans. The findings disagree with the studies conducted by (Pandula, 2010) who found that the financing constraints are particularly severe in startup enterprises and relatively young firms (three years old or less) .The findings also disagree with findings by (FSB, 2006) who found that businesses less than three years old were least likely to have their application approved. This is in contrast to the results obtained where there was no relationship between the age of the business and loan access. This can however be explained since most of the businesses in this study had been in

operation between 1 to 3 years and are mostly sole proprietorship businesses and so may prefer equity financing or other internal sources of funds. The number of employees also did not have any implication on whether the business would be able to access the loan or not.

Business sector has a positive relationship with access to loans. This could be as a result of various reasons like; some sectors may have easier access especially low risk sectors while others might be considered high risk like service sector. Some industries are also more likely to depend on external financing than others, depending upon project scale, and cash flows. Firms in certain sectors will require more credit to invest in equipment, machinery, buildings, labour and raw materials than firms in other industry sectors. This agrees with studies done by (Deakins *et al* 2008) who also found that SME's in the manufacturing industry experienced problems with application procedures when trying to access a loan. This also agrees with findings by (Ayodeji and Balcioglu 2010) who also found that the ownership type played a big role in the financing used

iii) Financial Characteristics

Surprisingly findings from the research show that none of the financial characteristics have an effect on access to loans. Having assets does not always reflect its availability for its use as collateral. An example would be the personal assets of the proprietor or partner which not shown in the balance sheet of the business and so cannot be used as collateral. This could be a reason why the results do not indicate an association between having collateral and access to loans. This is in contrast to findings by (Cassar and Holmes, 2003) and (Tagoe, Nyarko, and Anuwa-Amarh 2005) who found that firms with assets that had greater liquidation value having

relatively easier access to finance and (Pandula, 2010) who also found that greater sales and profits were associated with greater access to credit

Lastly there was also no relation between having audited statements and access to loans which is similar to results obtained by (Pandula, 2010) .Financial information does not seem to play a role in the loan granting decision

iv) Entrepreneur Characteristics

Entrepreneur characteristics have always played a big role when it comes to loan access in many ways. From this study the educational level significantly affected the financing of small businesses in Nairobi. This is consistent with results obtained by (Ayodeji and Balcioglu 2010). It was possible that the level of education was a major factor in coming to a lending decision, either because bankers valued a higher education or because a higher education means that entrepreneurs were more articulate and more likely therefore to persuade the banks that they have a viable proposition. This agrees with studies by (Bosworth 2009) and (Dickson, Solomon, Weaver, 2008) who all found a strong correlation between education and forward thinking in business and with access to loans. Ayodeji and Balcioglu (2010) also indicated that the entrepreneur's capacity (educational) development level has significant effect on the financing of Small and Medium Enterprises in Kwara State of Nigeria

The entrepreneurs experience also significantly affected access to loans. This could be as a result of previous experience that the entrepreneurs have gone through having them learn from previous mistakes on the application process. The owners would have the ability to understand

complicated loan application procedures, present positive financial information and build closer relationships with their bankers due to the length of the time they have been in business as well as their education level.

There was however no relationship observed between belonging to a business network and having access to a loan. This could be as a result of there not being established small business networks that are recognized and can as a result provide leverage when it comes to loans applications. This is in contrast to findings by (Bowen *et al* 2009) who found that being a member of an industry association implies that one is serious about the business they do and therefore helped in loan access. This could also help in networking and obtaining of business information. Ayodeji and Balcioglu (2010) also showed that the membership of business/trade organizations significantly affected the financing of the SMEs in Kwara State in Nigeria

5.4 Conclusion of the Study

From the findings the study concludes that

- i) Default penalties charged for loans have an effect on access to loans. It is therefore important for these to be reviewed so as to encourage more small business to access loans

- ii) Since different business sectors have different financing needs it is important to have vetting for loans differentiated by sectors. This will make it easier for some sectors to access loans since this has been shown from the study to have an effect on the access to loans.

iii) An investigation of loan evaluation process needs to be done since from the findings none of the financial characteristics seem to have an effect on access to loans. This would be important so that the evaluation process of credit proposals is very clear to the business owners.

iv) Lastly since the education and experience of the entrepreneur play a key role in access to bank finance loan providers must devote sufficient time to attempting to determine these characteristics of the borrowers. Institutions could implement more personalized relations to their Small business clients and improve their methods of checking customers.

5.5 Recommendations

1) Microfinance policy should be publicized so that more of the businesses become aware of what microfinance institutions have to offer them and how they can obtain financial services to grow their small businesses.

2) Regulatory and other statutory bodies should monitor the interest rate on loans and advances to make it accessible to businesses. Where there are no policies in place they should be enacted so as to encourage the growth of both microfinance and small businesses.

3) Policy-makers should consider additional capacity building especially through training and focused support programmes with business owners on the ways to approach microfinance institutions, informational requirements and work closely with the MFIs to provide additional advice and support to the businesses.

4) There is the need to promote the formation of SME associations/organizations in addition to encouraging the active participation of the SMEs. The government/donor agencies should subsidize these associations and their programs (i.e. advisory services) so that they can charge

lower fees on the SMEs. This will help in networking and will be important when it comes to loan applications

5.6 Areas for Further Research

- 1) Microfinance accessibility a comparative study between rural and urban areas.
- 2) Difference between microfinance institutions and banks in regards to loan access
- 3) Should banks venture into microfinance loan provision?
- 4) Do business characteristics affect access to loans?

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APPENDICES

APPENDIX I: LETTER OF TRANSMITTAL

University of Nairobi,
College of Education and External
Studies, Faculty of External studies,
Kikuyu
P. O. Box 92 - Kikuyu, Kenya

To whom it may concern

RE: Collection of data

I am a post graduate student at the University of Nairobi, school of continuing education.

In order to fulfill the degree requirements I am undertaking a project on factors influencing the access to loans by small businesses from microfinance institutions. You have been selected to form part of the study. This is to kindly request you to assist me collect the data by filling out the accompanying questionnaire.

The information you will provide will be used exclusively for academic purposes and will be will be treated with utmost confidence

Your cooperation will be highly appreciated

Thank you in advance.

Yours faithfully,

Elizabeth Akoth Migayi

L50/64060/2010



APPENDIX II: RESEARCH QUESTIONNAIRE

Factors affecting access to loans by small businesses in Nairobi

SECTION A: General information (Tick where appropriate)

1) Your age bracket in years

Below 20

20 - 30

31 - 40

41 - 50

51 and above

2) Gender

Female

Male

3) Number of employees in the business

1

1 to 3

4 to 6

7 and above

4) How long has the business been in existence?

1 to 3 years

4 to 5 years

5 to 10 years

More than 10 years

5) What is the ownership type of the business?

Sole proprietorship

Partnership

6) What sector is the business in?

Small Trader/ Shop/ Kiosk

Workshop/ repair

Eating house/ snack bar

Professional services

Transport

SECTION B: Microfinance Characteristics (Tick where appropriate)

1) Have you tried to get a loan from any institution in the last 12 months?

Yes

No

If no please specify the reasons why.....

2) Where did you apply for the loan?

Bank Microfinance institution Sacco other institution

If other please specify.....

3) How many microfinance institutions are you aware of that give loans to small businesses?

1- 3 4 -6 More than 7

4) How long did it take for your loan to be processed?

Up to 1 month

2-3 months

4-5 months

6-11 months

12 months plus

5) Were you required to give any collateral for the loan applied for?

Yes No

6) Did you experience any difficulty in raising the finance needed to start business?

Yes No

7) Was the loan application approved?

Yes No

If no what reason was given?.....

Collateral Lack of records Age of the business Other

If other please specify the reason.....

8) Did you get the whole amount you applied for?

Yes No

If no what reason was given?.....

9) How long did it take to receive the decision on whether the application was successful or not?

Up to 1 month

2-3 months

4-5 months

6-11 months

12 months plus

10) Do you feel that the government has put in place a legal framework that supports availability of loans to small business?

Yes No

11) Do you feel that the repayment options that you were given were adequate?

Yes No

If no please give reasons.....

12) How do you feel about the penalties for those who default on payment of loans by microfinance institutions?

Too high Moderate Too low

13) How was the application procedure for your loan?

Good Bad

SECTION C: Financial Characteristics (Tick where appropriate

1) Do you keep audited financial statements for your organization?

Yes No

2) Do you have tangible assets that can be used as collateral for loan application?

Yes No

3) Does your firm have positive or negative sales growth?

Positive Negative

SECTION D: Entrepreneur Characteristics (Tick where appropriate)

1) What is your education level?

Did not complete secondary

Secondary

Vocational training and some university

Graduate or postgraduate degree

2) How many years of experience do you have in doing business?

No experience

10 years or less

11 to 20 years

21 years or more

3) Are you a member of any business association?

Yes No

If yes please specify which one.....

Additional Comments and suggestions.

.....

.....

.....

.....

Thank you for your participation

**APPENDIX III: MICROFINANCE MANAGERS RESEARCH
QUESTIONNAIRE**

Factors affecting access to loans by small businesses in Nairobi from microfinance institutions

SECTION A (Tick where appropriate)

1) Does the age of the business affect the approval of a loan application?

Yes

No

2) Does the number of employees a business have affect approval of a loan application?

Yes

No

3) What is the optimum length of business existence having most successful loan applications?

1 to 3 years

4 to 5 years

5 to 10 years

More than 10 years

4) Does the ownership type of the business affect approval of a loan application?

Yes

No

If yes please give reasons why.....

5) What sector is most successful in loan applications?

Small Trader/ Shop/ Kiosk

Workshop/ repair

Eating house/ snack bar

Professional services

Transport

6) How long does it take for a loan application to be processed in your institution?

Up to 1 month

2-3 months

4-5 months

6-11 months

12 months plus

7) Do you require collateral for the loans applied for from small businesses?

Yes No

8) What reasons are there for loans application not being approved?

Lack of Collateral Lack of records Age of the business Other

If other please specify the reason.....

9) How long does it take to give the decision on whether the application was successful or not?

Up to 1 month

2-3 months

4-5 months

6-11 months

12 months plus

10) Do you feel that the government has put in place a legal framework that supports availability of loans to small business?

Yes No

11) Do you feel that the repayment options that you give for repayment of loans by small businesses are adequate?

Yes No

If no please give reasons.....

12) How do you feel about the penalties for those who default on payment of loans by your institution?

High Low

13) What percentage of small businesses got the whole amount applied for in the last 12 months?

.....

14) What are the conditions required to get a loan by small business from your institution?

Financial statements Yes No

Tangible assets Yes No

Positive sales growth? Yes No

Others please specify.....

15) Does the education level of the applicant affect access to loans?

Yes No

16) Does the business experience of the applicant affect access to loans?

Yes No

17) Does membership to any business association affect access to loans by small businesses?

Yes No

Additional Comments and suggestions.

.....
.....
.....

Thank you for your participation

APPENDIX IV: SPLIT HALF QUESTIONS

1) Does the length of the business been in existence affect access to loans

Yes No

2) Does the ownership type of the business affect access to loans?

Yes No

3) Does the sector of the business affect access to loans?

Yes No

If yes please specify the sector.....

4) Have you tried to get a loan from any institution in the last 12 months?

Yes No

If no please specify the reasons why.....

5) Where did you apply for the loan?

Bank Microfinance institution Sacco other institution

If other please specify.....

6) How many microfinance institutions are you aware of that give loans to small businesses?

1-3 4-6 More than 7

7) How long did it take for your loan to be processed?

Up to 1 month

2-3 months

4-5 months

6-11 months

12 months plus

8) When applying for a loan are you required to give any collateral?

Yes

No

9) Have you experienced any difficulty trying to get a loan from a micro finance institution?

Yes

No

10) Have you had successful loan applications from a micro finance institution?

Yes

No

If no what reason was given?.....

Collateral Lack of records Age of the business Other

If other please specify the reason.....

11) When applying for a loan were you given the whole amount you applied for?

Yes

No

If no what reason was given?.....

12) How long did it take to be told that the loan application had been approved or rejected?

Up to 1 month

2-3 months

4-5 months

6-11 months

12 months plus

13) Do you feel that the government supports institutions that give loans to small business?

Yes

No

14) Do you feel that the repayment options you are given are adequate for repaying the loans?

Yes

No

If no please give reasons.....

15) How do you feel about the penalties for those who default on payment of loans by microfinance institutions?

Too high

Too low

16) Was the loan application procedure for your loan user friendly?

Yes

No

17) Does your business have any of the following?

Audited financial statements Yes No

Tangible assets that can be used as collateral Yes No

Positive sales growth Yes No

18) What is your education level?

Did not complete secondary

Secondary

92

Vocational training and some university

Graduate or postgraduate degree

19) How many years of experience do you have in doing business?

No experience

10 years or less

11 to 20 years

21 years or more

20) Are you a member of any business association?

Yes No

If yes please specify which one.....

Additional Comments and suggestions.

.....

.....

.....

Thank you for your participation