THE EFFECT OF AGENCY BANKING ON FINANCIAL PERFORMANCE OF SMALL AND MEDIUM SIZED ENTERPRISES IN NAIROBI COUNTY

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DECLARATION

I declare that this is my original work and has not been presented in any other institution or forum for any other award prior to this declaration.

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DEDICATION

I dedicate this project to my son and mother for their understanding, support and encouragement for the whole of my academic life. Without their love and support this project would not have been made possible.

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LIST OF ABBREVIATION

CBK	:	Central Bank of Kenya
CGAP	:	Consultative Group to Assist the Poor
FSD	:	Financial Deepening Sector
GOK	:	Government of Kenya
SMEs	:	Small and Medium Sized Enterprises
SPSS	:	Statistical package for Social science

ABSTRACT

Agency banking model has been found to be very successful in propelling the performance of commercial banks in many developing countries that includes Kenya, Colombia, Brazil, Peru and India but the effect on SMEs businesses remain unknown. Bank agents have been found to lack the capacity to handle large transactions of cash and that they are not spending enough on security measures leading to poor performance of agency banking. Studies in Kenya and around the world have focused on determining the effect of agent banking model on financial performance of commercial banks with no attention being paid to effect of agency banking on financial performance of end users who include small and medium sized enterprises. Driven by this knowledge gap, this study sought to determine the effect of use of agency banking services on financial performance of SMEs in Nairobi County. The study used descriptive study design and extracted five years data from year 2009 to 2013 relating to SMEs financial performance as measured by return on assets and amount transacted through agency banking model. The study sample was identified through stratified random sampling technique where SMEs in Nairobi County were classified into their industry and a sample of 120 SMEs using agency banking services selected. Multiple regression analysis was used to show the relationship between dependent and independent variables. The study found that agency banking has led to financial inclusion of small SMEs and has significant positive weak relationship with financial performance of SMEs in Nairobi County. The adoption of agency banking by SMEs and mainly the medium sized enterprises is still low with the transaction costs of transacting through agent bank being high and the perceived risk of transacting through agent banks. The study recommends reduction of transaction costs through agent banks, banks to allow agents to be able to convert cheques into cash, deal with foreign currency exchange among other services and banks to develop strategies to manage the perceived risks of using agency banking which will include end user education and formulation of regulations to ensure highest security measures for the firms.

CHAPTER ONE

INTRODUCTION

1.1 Background of Study

The introduction of agency banking in Kenya was meant to facilitate and enhance access to affordable financial services especially to the poor, low-income households and micro and small enterprises, which largely comprise those segments which are un-served and under-served by the financial sector. This was based on the promise that financial access leads to widespread economic development; and hence the development of the financial sector is seen as essential to the realisation of Vision 2030. In fact, the realization of vision 2030 goals hinges upon widening financial access and use of affordable financial services and products by a majority of the Kenyan population (FSD, 2013). The need to embrace innovative changes in financial sector aimed at enhancing financial access, led to publication of agency banking guidelines published by the CBK in 2010, where effective December 2010, financial institutions were allowed, under strict conditions to operate agencies through third parties (Cracknell, 2012). This was further motivated by agency banking model widespread and success over the past decade in Latin America and Brazil. Latin America is the only region with the strongest development towards agency banking with Brazil being the most developed market where agency banking has significantly lead to developments in the financial system structure (Bloodgood, 2010).

The Kenyan SMEs sector has grown rapidly, and the government estimates that the SMEs sector constituted 89.7 per cent of total employment created in 2012 (GoK, 2013). The financial performance of Kenya's SMEs sector firms, even though mostly not documented, has been hampered by low demand, poor infrastructure, lack of human capital, and lack of appropriate financial products. The amendment of Kenya's finance Act in 2009 to facilitate use of third parties by banks to provide banking services marked the introduction of agency banking in Kenya. Consequently, the CBK issued the agent banking guidelines to regulate agency banking. Since its introduction, agency banking has enabled bank customer to access the banking services within the comfort of their neighbours-hood.

Agency banking has dramatically reduced the cost of delivering financial services to unreached people. The cost reduction creates the opportunity to significantly increase the share of the population with access to formal finance and, in particular, in rural areas where many people in developing countries live (Lyman, Pickens, and Porteous, 2008). Development of agency banking is expected to lead to improved financial performance of SMEs sector business. According to Ivantury (2006), agency banking can benefit the users of the service by lowering transaction cost, longer opening hours, shorter lines than in branches, more accessible for illiterates and the very poor who might feel intimidated in branches, to the agency; increased sales from additional foot-traffic, differentiation from other businesses, reputation from affiliation with well-known financial institutions, additional revenue from commissions and incentives, increased customers base and market share by banks, increased coverage with low-cost solutions in areas with potentially less number and volume of transactions, increased revenue from additional investments, interest and fee income, improved indirect branch productivity by reducing congestion (Ivantury, 2006).

Agency banking, which is a part of branchless banking model, can play a key part in delivering better, safer and more reliable financial services than those usually available to the unreached (Musau, 2013). Lyman et al (2006) indicate that protecting client funds is priority for many financial regulators under agency banking, as loss of funds can have serious consequences for customers, as well as for public confidence in financial systems. Therefore, agency banking needs to be regulated and banks should comply with prudential rules created to ensure systematic stability and depositor protection. Countries with the most prominent branchless banking models have taken varied approaches to handling and protecting client's funds. Hence, although agency banking is a bank based model, it has different regulatory treatment from the branch banking (Collins 2010).

Agency banking establishment in Kenya has not been without challenges with one of the biggest challenge being the establishment and the effectiveness of the agent network. Agents are the touch- points where the subscribers of the service can get money into and out of the system. In instances where a subscriber arrives at an agent with the need to withdraw a large amount it does happen that the agent do not have enough cash to satisfy the cash-out request. This leads to frustration and is one of the reasons why take-up of these systems is slower than what is expected. This problem is often approached in a way where the system keeps track of the actual cash available in the drawer of each agent in order to guide subscribers where they can withdraw big amounts (Musau, 2013).

1.1.1 Agency Banking

Agency banking is a form of branchless banking and refers to contracting of a retail or postal outlet by a financial institution or a mobile network operator to process bank clients' transactions. It is different from a branch teller since it is the owner or an employee of the retail outlet who conducts the transactions, ranging from: deposits, withdrawals, funds transfers, bill payments, account balance inquiry, receiving government benefits or direct deposits from employers. Banking agents may include: pharmacies, supermarkets, convenience stores, lottery outlets and post offices (CGAP, 2006). Agency banking can be seen as a partnership between a bank and a non-banks, organization typically retail commercial outlets, ranging from lottery kiosks, pharmacies, post offices, construction goods stores, and so forth, to provide distribution outlets for financial services (Kumar, Nair, Parsons and Urdapilleta, 2006).

Agency banking model is meant to enhance access to financial services by allowing small businesses to operate as satellite branches. Based on early experiences, agency banking has a large contribution to make towards financial inclusiveness in developing countries (Mwando, 2013). This has led to growth in agency banking as evident in countries such as in Australia where post offices are used as bank agents, France utilizing corner stores, Brazil making use of lottery outlets to provide financial services, Nigeria, South Africa and the Philippines (Siedek, 2008). Policy makers and regulators are demonstrating keen interest in this topic, although in most countries regulation continues to constrain the emergence of agency banking. Where regulation permits, new branchless banking initiatives are being developed by a plethora of market participants (Neil and Leishman, 2010). However, agency banking has yet to demonstrate pro-poor, pro-growth impact for SMEs businesses, households, communities and the National economics (Morawczynski and mark, 2009).

The global view and application of agency banking vary according to the country. India, on average has 10,000 agents Nationwide which translates to approximately 84000 deposit and 31800 withdrawals each day, with an average deposit processed size of USD 301,000 and withdrawals of USD 221,000 each day (CGAP, 2010). Agents in Brazil in 2008 transacted 75% of the financial transactions volume and 70%

of the value of total bill payments (CGAP, 2010). Again in Brazil, rural agents transact more deposits and withdrawals as a percentage of total transactions (38%) than their urban counterparts (8%) (CGAP, 2010). In Colombia from August 2010 to July 2011, collections of utility bill payments through agency banking made up the majority of transactions averaging $1.8 million in July 2011, followed by mandatory payments, such as loan repayment and official government payments, such as tax accounting for over $ 800,000. Although there were reported more withdrawals than deposits, the number of these two transaction types were typically and consistently close. Yet, the number of credit applications, money transfer and opening of savings accounts were negligible (CGAP, 2010).

In Kenya, the banking sector comprises of the Central Bank of Kenya, as the regulatory authority, 45 banking institutions (44 commercial banks and 1 mortgage finance company), 5 Deposit-Taking Microfinance Institutions (DTMs) and 126 Foreign exchange Bureaus. Banks offering agency banking include Equity Bank; Co-operative Bank (Co-op Kwa Jirani); KCB Bank (KCB mtaani); Post Bank (Post bank mashinani); Family Bank (Pesa Pap); Chase Bank (Chase Popote); Consolidated Bank (Conso Maskani); Diamond Trust Bank; Citibank and NIC Bank (Kiragu, 2012). Data from CBK reveals that over 10,000 agencies have been licensed, with Equity claiming 50% market share (CBK 2011). It is against this background that the researcher have conducted studies on how policy, regulation and procedures, cost, liquidity, security and other risk factors attributed to agency banking affect the performance of the banks in Kenya.

Without the support of the regulatory authorities, agent banking would not be facilitated and its growth will be limited. This is because; agency banking retail outlets are forced to extend their limited sources of financing in a bid to meet the regulations so as to fulfil the legal requirements necessary to operate as banking agents. Such requirements usually involve having a specific level of capital investment to assure the regulators of the sustainability of the venture. Inability of the retail outlets to fulfil these requirements prevents the expansion of retail banking to areas of low income earners (Mwando, 2013). Unless the tight regulations are eased, few retail outlets would be able to meet the standards required by the policy makers (Ivatury& Lyman, 2006).

1.1.2 Financial Performance

Financial performance refers as a firm's ability to generate new resources from day to day operations over a given period of time. A firm's finances and operations are integrally connected. The concept of corporate performance is multidimensional in nature. Within corporate performance, the focus has always been on the financial side; hence it is traditionally defined in financial terms (Dess & Robinson, 1984). In addition, investors, shareholders and other stakeholders are interested in to get information about the firms' performance conditions frequently. Financial information that includes return on investments (ROI), return on equity (ROE), growth of sales and return on assets (ROA) are the most extensively explicit and valid information among the other performance dimensions. The financial performance traditional measures based on accounting/financial data that includes effect of actions on one year's profits, ROI, ROE, and ROA which reflect a firm's past performance are commonly used to measure firm's financial performance (Bora, and Bulut, 2008).

Profitability differs from firm to another depending on firm's specific factors like the amount of investment and managers characteristics as well as the industry factors like level of competition and regulation. Profitability is necessary for firm survival in the long run in a competitive environment, but not a precondition for growth since firm's management may choose not to grow. Long-term profitability derives from the relations between cost and revenue; it is a necessary but not sufficient condition for growth. Revenues may be held up by entry barriers and costs pushed down by management ingenuity. A low-profit firm will lack the finance for expansion, but a high-profit business may conclude the risk and rewards of expansion are inadequate (Bora, and Bulut, 2008).

Dess and Robinson (1984) performed a study that compared subjective measures to objective measures of profitability. They used a three-step approach to test the correlation between objective and subjective measures of return on assets (ROA), sales growth, and overall financial performance. Both objective and subjective measures of the ROA and sales growth were used in addition to two measures of overall financial performance. The measures of overall financial performance were compared to the objective and subjective ROA and sales growth. Dess and Robinson (1984) found that a firm's subjective perceptions of how well it had done over a specific time period were in agreement with the objective measures of change in return on assets and sales. They were also in agreement with the firm's subjective evaluation of overall financial performance. Finally, it was stated that subjective performance measures were probably the most appropriate for examining relative performance within an industry (Dess & Robinson, 1984).

1.1.3 Effect of Agency Banking on Financial Performance

Agency banking is expected to lead to increased financial performance of SMES. This is as a result of increase in financial access to business and consequently leading to increased SMEs firms' financial performance due to reduced transaction cost and liquidity advantage. Lack of financial access limits the size of firms, as well as their growth, profits, activations and their scope of operations. Understanding the implications of financial exclusion on this businesses is of first-order importance for the performance of aggregate economies, especially for developing economies, as capital market imperfections can therefore impair the aggregate accumulation of capital, the rate of return of investments, innovations and accumulation (Alexander, and Hall, 2003).

Agency banking entails use of technology in SMEs banking which ensures that firms are able to access financial products and services more conveniently, reliably and affordably. According to Koivu (2002), an appropriate banking environment is considered a key pillar as well as an enabler of economic growth. In an environment with a continuously emerging wave of information driven economy, the banking industry in Kenya has inevitably found itself unable to resist technological indulgence. The need for convenient ways of accessing financial resources beyond the conventional norms has seen the recurrent expansion and modernization of banking patterns.

Bank agents have thrived and are currently estimated to have 33% penetration. The number of banks opening branches has decreased and is attributed to affordable agent banking and lowers service charges (Musau, 2013). Reaching SMEs in rural areas is often prohibitively expensive for financial institutions since transaction numbers and volumes do not cover the cost of a branch (Kitaka, 2001). In such environments banking agents that bank on existing retail infrastructure and lower set up and running cost can play a vital role in offering many businesses their first time access to a range of financial services. Also low income clients often feel more comfortable banking at their local store than walking into a mobile branch (Adiera, 1995).

One of the primary impediments to providing financial services to businesses through branches and other bank-based delivery channels is the high costs inherent in these traditional banking methods. The amount of money expended by financial service providers to serve a poor customer with a small balance and conducting small transactions is simply too great to make such accounts viable. In addition, when financial service providers do not have branches that are close to the customer, the customer is less likely to use and transact with their service. However, we see the emergence of new delivery models as a way to drastically change the economics of banking the poor. By using retail points as cash merchants (defined here as agent banking), banks, telecom companies, and other providers can offer saving services in a commercially viable way by reducing fixed costs and encouraging customers to use the service more often, thereby providing access to additional revenue sources (Aduda et al, 2013).

As a result of lower transaction costs and a transaction-driven revenue model (rather than a float-driven model), agent banking systems are most cost effective for transactional accounts with low balances and frequent transactions which is the case for firms. For example, an account that sees two deposits and two withdrawals per month will incur more than 70 percent fewer costs if the customer transacts through an agent rather than a branch. Commitment accounts with increasing balances, a large number of small deposits, and only one withdrawal over a pre-set period of time can be profitable through agent banking systems, depending on their average balance and transaction volume (Veniard and Melinda, 2010).

1.1.4 Small and Medium Sized Enterprises in Nairobi County

An SME is defined as an enterprise with between 1 to 50 employees, the World Bank defines an SME as one that fits to either of the following criteria that is to say: (1) A formally registered business (2) with an annual turnover of between Kenya Shillings 8 to 100 million (3) an asset base of at least Kenya Shillings 4 million and (5) employing between 5 to 150 employees (GoK, 2005). It is therefore evident that these definitions vary in terms of number of employees, level of investment, total asset and turnover. This shows that there is no consensus on the issue of definition of SMEs. It may not be appropriate to differentiate the scale of operations of the enterprises given the changes in the value of the domestic currency, heterogeneity of assts and variations in turnovers. For these reasons, the study will adopt the definition of SMEs based on the number of employees ranging between one and twenty.

The Economic Survey, (2009) indicates that developing countries with large informal or micro enterprise sectors, SMEs constitute the middle of the size range, a fact that explains much of their strategic importance. It is estimated that there are 7.5 million SMEs in Kenya, providing employment and income generation opportunities to low income sectors of the economy. The Sector has continued to play an important role in the economy of this country. The sector’s contribution to the Gross Domestic Product (GDP) has increased from 13.8 per cent in 1993 to about 40 per cent in 2008. The Small Enterprise Sector or Informal Sector provided approximately 80% of total employment and contributed over 92% of the new jobs created in 2008. The sector therefore plays a key role in employment creation, income generation and is the bedrock for industrializing the Country in the near future.

The SMEs sector in Nairobi has provided a dynamic and entrepreneurial spirit, which in turn has led to more competition, innovation, higher efficiency and increased investment (Schneider and Klingmair, 2004). The existence of the SMEs in Nairobi makes it possible for agents to engage in entrepreneurship or to obtain scarce goods and services that otherwise would not exist (Barro, 2000). In addition, the SMEs sector in Nairobi helps to absorb labour of new arrivals in the urban areas (Madziakapita, 2003). Without the existence of the SMEs sector, it is likely that a 'social economic crisis' can emerge hence destabilizing the whole society in general. As opposed to the formal sector, the SMEs sector capably creates a large number of jobs at a very low capital cost because it does not incur extra costs such as employment benefits (Misati, 2007).

The role of the SMEs sector in Kenya's economies towards private investment growth, generation of employment and incomes, and poverty reduction cannot be overemphasized. However, the SMEs sector has not been accorded the recognition it deserves in major policy documents such as the Poverty Reduction Strategy Papers, in which policies of attaining increased investment and growth are documented. These existing gaps may be justified on grounds of the difficulties in the measurement and quantification of the SMEs sector activities (Misati, 2007).

1.2 Research Problem

Introduction of agency banking in Kenya was meant to address the low financial access in Kenya among small enterprises (most of which are SMEs firms) and the poor individuals with the promise that financial access promotes growth (Mwando, 2013). As a result, Kenya's financial inclusion landscape has undergone considerable change with the overall conclusion that it has expanded; however 33.7% of households remaining unbanked (FSD, 2013). Agency banking has proved to be a cost saving network as compared to the banking branches and keen to take the agency banking advantages, Kenyan banks have embarked on an aggressive entry into this segment. Agency banking model has been very successful in propelling the performance of commercial banks in many developing countries that includes Kenya, Colombia, Brazil, Peru and India but the effect on SMEs businesses remain unknown. In addition, bank agents have been found to lack the capacity to handle large transactions of cash and that they are not spending enough on security measures leading to poor performance of agency banking (Veniard, & Melinda, 2010). However, what remains unknown is the effect of agency banking on the main users of agency banking services who includes the SMEs.

Various studies have been done in Kenya on agency banking. Musau (2013) studied the utilization of agency banking by commercial banks in Kenya where she found that agency banking had positively affected banks' performance. Aduda et al (2013) also studying agency banking effect on commercial banks in Kenya also found a positive correlation between money flowing through agent banking system on banks profitability. Whereas these studies in Kenya and other countries have confirmed that agency banking model has positive impact on bank performance, no study had been conducted to determine the effect agency banking on the users of the services who mainly include the SMEs.

It is not known whether the development of agency banking model in Kenya has led to increased financial performance of small businesses, majority of which fall under SMEs sector. This study therefore sought to bridge the gap in literature by assessing the contribution of agency banking on financial performance of SMEs sector businesses in Nairobi County. It sought to answer the question; what is the effect of agency banking on financial performance of SMEs sector firms in Nairobi County?

1.3 Objective of the Study

To determine the effect of agency banking on financial performance of small and medium sized enterprises in Nairobi County

1.4 Value of the Study

Banks in Kenya have turned to agency banking in their efforts to increase their competitive advantage over their rivals. Agency banking in Kenya is in the early stages as it has been there since 2010 and with a limited number of outlets offering agency banking. Despite the fact that agency banking is in existence, the service has not yet been exploited fully and this calls for more studies to determine its effects not only commercial banks, but also the users of the services who include mainly business in the SMEs sector.

The study is of importance to the various users who include the commercial banks and other financial institutions; SMEs, the government, policy formulators, general public and researchers. To the banks and other financial institutions study findings can enable them to lobby for appropriate policy formulation and strategies that can fully exploit agency banking opportunities in Kenya with an aim of increasing their profitability and customer satisfaction.

To the SMEs, the study has highlighted the effect of agency banking on their financial performance which will go a long way towards improved financial performance of the businesses. The study has informed the government on the areas that require changes and how to make agency banking more beneficial to the users of the services. To the policy makers and bank regulators, the study has highlighted the areas requiring formulation and changes in regulation to enhance agency banking performance. To the general public, advancement of agency banking as a result of study findings will increase financial inclusion and lead to increased welfare to the general public. To academicians and researchers, the study has added to existing body of knowledge on agency banking and shows the areas for further research.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

The chapter focuses on theoretical and empirical literature. The chapter starts with section 2.2 on theoretical review, section 2.3 on the determinants of SMEs sector financial performance, section 2.4 on empirical review and ends with section 2.5 on chapter summary.

2.2 Theoretical Review

The study was guided by theories developed over the years on the subject of the study, which presents set of arguments that required further research. These theories include the bank-led theory, Porter theory of competitive advantage and agency theory.

2.2.1 Bank-led Theory

The theory was brought forward by Lyman, Ivatury and Staschen (2006) and is based on the argument that, a licensed financial institution delivers financial services through a retail agent. The theory supports agency banking model by stating that the work of a bank is developing financial products and services, but distributes them through retail agents who handle all or most customer interaction (Lyman, et al, 2006). The bank is the ultimate provider of financial services and is the institution in which customers maintain accounts. Retail agents have face-to-face interaction with customers and perform cash in/ cash-out functions, much as a branch-based teller would take deposits and process withdrawals (Owens, 2006). In some countries, retail agents also handle all account opening procedures and, in some cases, even identify and service loan customers. Virtually any outlet that handles cash and is located near customers could potentially serve as a retail agent. Whatever the establishment, each retail agent is outfitted to communicate electronically with the bank for which it is working. The equipment may be a mobile phone or an electronic point-of-sale (POS) terminal that reads cards.

Bank-led model offers a distinct alternative to conventional branch-based banking in that customer conducts financial transactions at a whole range of retail agents instead of at bank branches or through bank employees (Lyman, et al, 2006). This model promises the potential to substantially increase the financial services outreach by using a different delivery channel (retailers/ mobile phones), a different trade partner (Chain Store) having experience and target market distinct from traditional banks, and may be significantly cheaper than the bank based alternatives. In this model customer account relationship rests with the bank and agency banking leads to increased financial outreach which in turn leads to increased performance of SMEs sector businesses (Tomaskova, 2010). In relevance to the study, it can be concluded that to commercial banks offering agency banking, adoption of the agency banking model is just meant to create their distribution channels as opposed to enhancing financial access and well being of SMEs. This implies that, the financial performance of banks that have adopted agency banking could have improved as a result while that of users of the service remaining unchanged.

2.2.2 Porter Theory of Competitive Advantage

The theory was proposed by porter (1985) and states that and businesses should pursue policies that create high quality goods that sell at high prices in the market. Competitive advantage theory stresses on maximizing economies of scales in goods and services that garner premium prices. Competitive advantage occurs when an organization acquires or develops an attribute or combination of attributes that allows it to outperform its competitors. These attributes can include access to natural resources, such as high grade over or inexpensive powers, or access to highly trained and skilled personnel human resource (Porter, 1990).

In reference to agency banking, adoption of agency banking model by commercial banks and use of the agency banking facilities by SMEs leads to competitive advantage on the firms. Failure to adopt agency banking by the firms implies that some banks will be better off than the others and hence, for the banks to remain relevant, they ought to adopt agency banking model. The banking industry in Kenya has been characterized by stiff competition between the banks with each competing for market leadership. It is advantageous for any bank when it is a market leader because it has significant financial and perpetual benefits which then lead to consistently and focus on quality; it also enhances the use of the full range of banking tools to solidify performance and leads to ownership of core benefits with a balance of national and economic massages. The secret of gaining competitive advantage among the banking service provider is by building themselves as brand and target to retain brand loyalty and enhance brand presence where it is limited and this has been achieved by the use of agents banking in the unbanked locations in Kenya. Branding helps banks to distinguish and differentiate themselves from competitors (Musau, 2013). Use of agency banking facilities by SMEs will give them competitive advantage from reduced transaction costs, convenience in banking and increased performance.

2.2.3 Agency Theory

The theory was proposed by Jensen and Meckling (1986) and view commercial bank as the principle and correspondent bank as the agent whereby problems arise owing to misunderstanding or incongruence of their interest. Agency theory will occur where the bank agency fail to observe the agency regulations as issued by the central bank and hence putting the interest of the bank at risk since it is the one required to ensure that the agents comply with the regulations. Generally, according to agency theory, intermediation places financial institutions (banks and their agents) as intermediating between money and the market or households. Resource (money) allocation based on perfect and complete markets is hindered by frictions such as transaction costs and asymmetric information (Aduda et al, 2013).

Agency theory analyzes the relationships between a business firm's owners and its managers who, under law, are agents for the owners. The key issues in agency theory centre upon whether adequate market mechanisms exist that compel managers to act in ways that maximize the utility of a firm's owners where ownership and control are separated. Under the terms of agency theory, a principal (P) passes on authority to an agent (A) to conduct transactions and make decisions on behalf of the principal in an effort to maximize P's utility preferences. Agency problems emerge because contracts between principals and their agents are neither costless written nor costless enforced. Managers, as agents of a firm's shareholders, may not devote their best efforts toward managing the firm unless those efforts are consonant with maximizing their own welfare. In the commercial banking industry, ownership is becoming increasingly diversified among individual and institutional shareholders, and the dominance of individual stockholders in the industry appears, on the whole, to be decreasing. These trends may exacerbate agency problems in the banking industry if these problems truly (Williamson, 1981).

In relation to agency banking and SMEs, agent banks are retail establishments contracted by the banks and authorized by the central banks to render services for banks by ensuring that all security measures are in place and the SMEs transactions and information is secure. Since agency banking offer services including savings deposits, credit withdrawals, bill payments, new account openings, money transfers, insurance, and government benefits including pension receipts to provide access to SMEs, the agents my obtain the information and use it in a way that puts the interest of commercial banks and SMEs at risk hence creating an agency problem.

2.3 Determinants of Financial Performance

Numerous factors affect the financial performances of small and medium enterprises as identified in literature. These factors include agency banking services, SMEs size and quality of labour being applied by SMEs.

2.3.1 Agency Banking

Agency banking enhances SMEs financial access which eliminates financing challenge that has been found to limit SMEs financial performance. Djankov et al., (2003) found that the main factors that affect SMEs firms' performance is the lack of access to appropriate financial products and services. The lack of financial services and access to credit provided by banks may have a detrimental impact on SMEs performance because of two reasons. First, capital constrained SMEs will scale down their capacity, and operate below the efficient scale of production. Second, high cost of capital or limited outside financing will force SMEs firms to substitute (low-skill) labour for physical capital (Amaral and Quintin, 2006). The use of agency banking by

SMEs will be measured by the amount of money transacted through agency banking model.

2.3.2 Size

Another key factor affecting SMEs sector firms is the size of the SMEs firm. There is a positive correlation between SMEs size and profitability. If economies of scale are relevant, at least among very small firms then their financial performance will be lower (Perry et al, 2007). In such a case, if SMEs firms shy away from growth because of fears of detection, eliminating regulatory burden will make it easier for SMEs to grow, and the average productivity will rise through economies of scale.

SME size also affects the costs incurred by the firm. Argument on costs is prevalent from the reasoning that SMEs may not benefit from key public goods, enforcement of property rights and contracts. This could increase their transaction costs due to inefficient contractual relations, i.e., a part of SMEs resources will be wasted due to inefficient institutional mechanisms in which SMEs are forced to operate. Moreover, they will not be able to benefit from various public support schemes (training of employees and managers, technology diffusion services, etc.) that may improve performance (Galiani and Weinschelbaum, 2007).

2.3.3 Quality of Labour

Another important determinant of SMEs performance is the quality of labour that SMEs sector firms use in their operations. There are a large number of theoretical studies, mainly based on heterogeneous workers and/or firms and matching models that show that more productive workers go to big companies jobs, whereas less productive workers select into the SMEs sector (Galiani and Weinschelbaum, 2007). The most talented managers self-select into the big firms, and that managers in big companies operate with more physical capital than SMEs managers in the model developed by Amaral and Quintin (2006).

2.4 Empirical Review

This section reviews the local and international studies on agency banking and financial performance of small and medium enterprises. The studies have been discussed in relation to the methodology adopted, the findings and the conclusions of the study.

2.4.1 International Literature

Arora and Ferrand (2007) studied "Meeting the challenge of creating an inclusive financial sector in London". The study found that access to finance was critical for sustainable economic growth and social development. Agency banking was found to lead to financial inclusion which empowers low income people and marginalized sectors of society to actively participate in the economy, which leads to increasing employment and decreasing poverty levels. Apart from increasing access to those excluded from financial services and reducing reliance on informal financial sources such as Accumulating Savings and Credit Associations (ASCAs), Rotating Savings and Credit Associations (ROSCAs) and shylocks, agent banking was found to reduce the need for more staff and branches to reach customers. The study further revealed that technology adoption especially, in banking systems shown a great momentum and spread at an unbelievable pace across the world. They concluded that considering the importance of banking system's high presence and affordability, there was great potential of using agent banking for provision of banking services to unbanked community and businesses.

Veniard and Melinda (2010) studied how agent banking changes the economics of small accounts using data provided by service providers in Africa, Latin America and Asia, found that agent banking systems were up to three times cheaper to operate than branches. Reason responsible for that was that agent banking minimizes fixed costs by leveraging existing retail outlets and reducing the need for financial service providers to invest in their own infrastructure. They further stated that although agent banking incurs higher variable costs from commissions to agents and communications, fixed costs per transaction for branches are significantly higher. They further found that when functioning at maximum capacity, a branch cashier incurs more than 78 cents in fixed costs per transaction, compared to just 11 cents for a Point Of Sale enabled agent and 4 cents or less for a mobile-enabled agent or mobile wallet. They conclude that by bringing the channel closer to the client, agent transaction platforms may also benefit from additional revenue associated with transactions acquired by the agent, such as person-to-person transactions and bill payments. Although customers can conduct these transactions in a branch, proximity may increase their willingness to pay for these services and increase the number of transactions conducted through the channel.

2.4.2 Local Evidence

Kirimi (2011) studied the extent of implementation of agency banking among commercial banks in Kenya. The study established that there is difficulty in enforcing appropriate oversight by the agent and customer interaction was inconsistent with overall banking regulatory framework. The findings revealed need for regular training of agents on changes in operational processes and policies in order to eradicate occurrence of error and mistakes that obstruct penetration of agency banking in Kenya thus enhance banks' financial performance. The study further noted that commercial banks were keen to take advantage of the cost-saving and accessibility brought about by the agency banking model.

Mwangi (2011) studied the role of agency banking in the performance of commercial banks in Kenya on the four banks that were offering agency banking services using questionnaires distributed to the banks' branch managers. The study found that infrastructure cost and security influenced the performance of commercial banks attributable to agency banking to a very great extent. The study recommended that agency banking to be given more attention on security measures including risk-based approach and that the banks should find better ways of screening their agents to ensure that the large cash transactions handling is effectively carried out on their behalf; secure operating systems capable of carrying out real time transactions, generating an audit trail, and protecting data confidentiality and integrity.

Kamau (2012) studied the relationship between agency banking and financial performance of the banks in Kenya. Through review of secondary data, the study found that agency banking had 9,748 active agents in 2011 from 8,809 in 2010 facilitating a total volume of 8.7 million transactions valued at KSh 43.6 billion. Using regression analysis, the study found negative weak correlation between number of agents, deposit and withdrawals transactions undertaken through agents and financial performance of banks as measured by return on equity.

Kithuka (2012) sought to establish the factors influencing growth of agency banking in Kenya. The study sampled 100 Equity Bank agencies in Kwale County. The study revealed that convenience of the money transfer technology plus its accessibility, cost, support and security influenced the use of agency banking. Waithanji (2012) sought to establish effect of agent banking as a financial deepening initiative in Kenya. Descriptive statistics were used for the analysis. The findings revealed lack of connection between agent banking and financial deepening. Waithanji noted that the relationship could not be conclusively determined due to the low number of banks that have implemented it and impact may become clearer once all banks adopt agency banking.

Aduda et al., (2013) studying the relationship between agency banking and financial performance of commercial banks in Kenya found that out of a total of 43 banks, 8 had rolled out the agency banking service with Equity Bank, Co-Operative Bank and Kenya Commercial Bank showing significance performance index. However other banks that had rolled up the service (Family Bank, NIC Bank, Diamond Trust bank, ECO bank and Post bank) did not show much significance performance index. The findings further showed that yearly performance improved significantly from 2008 to 2011. They concluded that agency banking was continuously improving leading to significance increased financial performance in those banks that have rolled up the service due to its convenience and efficiency in operation.

Mwando (2013) examined at the contribution of agency banking on financial performance of commercial banks in Kenya using descriptive survey and found that the move by the central bank regulate agency banking had a high positive influence on the financial performance of commercial banks in Kenya. The study concluded that low transaction cost through agency banking had a positive impact on the financial performance of commercial banks in Kenya with many of the baking institution recording high amount of deposits and thus creation enough pool of for willing investors to borrow. Further, the study concluded that financial services accessibility by customers through banking agencies had a positive impact on financial performance of commercial banks in Kenya with many of the banking institutions indicating that agency banking had made it easier for them to reach out to many potential clients without investing so much in opening branches hence it's a cost effective measure.

2.5 Summary of Literature Review

Agency banking is not new in the world and it has been applied successfully in Brazil and Asia. With the enactment of agency banking regulation in 2010, banks in Kenya have been keen to take advantage of the cost-saving and accessibility brought about by the agency banking model. As a result, many studies have been conducted to evaluate the effect of agency banking on to the performance of these banks in Kenya with all of them finding a positive relationship between banks financial performance and agency banking. Kumar et al., (2006) states that agency banking allows banks to serve more clients at lower cost, increases reach into areas where a full branch would not be cost-justified, and allows clients to access their accounts more frequently and manage their loan funds more easily thus leading to increased revenue.

The emergence of new delivery models has drastically changed the economics of banking the SMEs sector and the poor. By using retail points as agent banking other providers can offer saving services in a commercially viable way by reducing fixed costs and encouraging entrepreneurs to use the service more often, thereby providing access to additional revenue sources. Mas (2008) established that agency banking leads to cost minimization by reducing maintenance cost of banks fixed assets such as buildings and cost of service delivery. While there are numerous studies carried out on the effect of agency banking on banks performance, there is no study done to show the effect of agency banking on SMEs sector firms' financial performance; the target of this study. This is in addition to considering the importance of SMEs sector in Kenya's economy in employment creation and economic growth; most significantly in urban areas.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

The chapter has focused on the research design and methodology that was employed by the study. The chapter is divided into section 3.2, Population in section 3.3, sampling design in section 3.4, data collection, section 3.5 and data analysis in section 3.6.

3.2 Research Design

The study employed a descriptive research design. A descriptive study is used to describe or define, often by creating a profile of a group of problems, people or events, through the collection of data and tabulation of the frequencies on research variables or their interaction (Cooper and Schindler, 2003). Descriptive research design was chosen because it enabled the researcher to generalize the findings to a large population. The descriptive research approach was also appropriate due to the fact it allowed analysis and determination of relationship between dependent and independent variables.

3.3 Target Population

The study target population was all the SMEs in Nairobi County. The target population is the specific population about which information is desired. According to Kothari (2005), a population is a well defined set of people, services, elements, event, and group of things or households that are being investigated. Total of 4,560 SMEs were registered in Nairobi County by the ministry of industrialization in 2011. These include 2,500 in the manufacturing sector, 1,500 in the general trading and 560 of them in the service industry (Government of Kenya, 2012).

3.4 Sampling Frame and Techniques

Sampling is the process of selecting a number of individuals for a study in such a way that the individuals represent the larger group from which they were selected (Creswell, 1994). Stratified random sampling was used in identifying the respondents. The researcher classified the SMEs into Manufacturing, trading and service strata, after which purposive sampling was used to select respondents who were using agency banking. The SMEs owners or senior personnel were the respondents since they could provide the reliable information. Total of 120 SMEs using agency banking from all sectors in Nairobi County were studied.

3.5 Data Collection

The study collected data using questionnaires which had both open and closed ended questions. The close ended questions were considered appropriate since they conserved time and they are easy to fill as well as easy to analyse as they are in an immediate usable form. Open ended questions were used as they encourage the respondent to give in-depth response without feeling held back. The use of questionnaires was justified because of cost effective and gave adequate time to the respondent to fill in and return to the researcher (Mugenda & Mugenda, 2003). The questionnaire had two sections, section one on background data and section two on use of agency banking. SME financial performance was obtained from the secondary data sources which included the annual financial statements. Five years financial performance data was collected from year 2009 to 2013.

3.5.1 Data Validity and Reliability

The accuracy of data collected largely depended on the data collection instruments in terms of validity and reliability (Mugenda and Mugenda 2003). Validity is the degree to which results obtained from the analysis of data actually represents the phenomenon understanding. Reliability on the other hand refers to a measure of the degree to which research instruments yield consistent results (Mugenda and Mugenda 2003). In this study, data reliability was ensured by pre-testing the questionnaire with a selected sample. After analysis a Cronbach alpha of 0.5 % and above was acceptable. The pre-testing assisted to enhancement of clarity of the questionnaire.

3.6 Data Analysis

Data collected was analysed using descriptive statistics. The descriptive statistical tools such as frequencies, percentages, mean and standard deviation helped the researcher to describe the data. In addition inferential statistics also used to determine the accuracy of the models developed. Multiple Regression analysis was used to determine the relationship between agency banking and SMEs firms' financial performance. SPSS version 21 was used to analyze the data which was then presented into tables, charts, graphs and figures.

3.6.1 Analytical Model

Regression analysis model was used to show the relationship between agency banking and financial performance of SMEs sector firms. The model took the form of;

$$\mathbf{Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon}$$

Whereby,

Y= SME financial performance as measured by Return on Capital

X_1= Agency banking use as measured by total cash withdrawals and deposits done through bank agents

X_2= Size of SME as measured by number of employees

X_3= Quality of labour used by SMEs as measured by employees education and years of experience

β1, β2 and β3 are coefficients of determination

ε is the error term which will be assumed to be zero in this study

3.6.2 Test of Significance

The study used ANOVA and z tests to determine the level of significant of the variables on the dependent variable at 95% level of significance. Coefficient of correlation (R) was used to determine the magnitude of the relationship between the dependent and independent variables. Coefficient of determination (R^2) was also used to show the percentage for which each independent variable and all independent variables combined were explaining the change in the dependent variable.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the analysis of data collected from the administered questionnaires. The results and findings of the study were based on the research objectives. The chapter links the various variables included in the model and aims at establishing the relationship between agency banking and financial performance of SMEs in Kenya.

4.2 Descriptive Statistics

Data collected using questionnaires was analyzed using descriptive statistics. 120 questionnaires in total were administered but the researcher managed to obtain 105 completed questionnaires representing 88% response rate. A response rate of 50% is considered adequate, 60% good and above 70% rated very good (Mugenda & Mugenda, 2003).

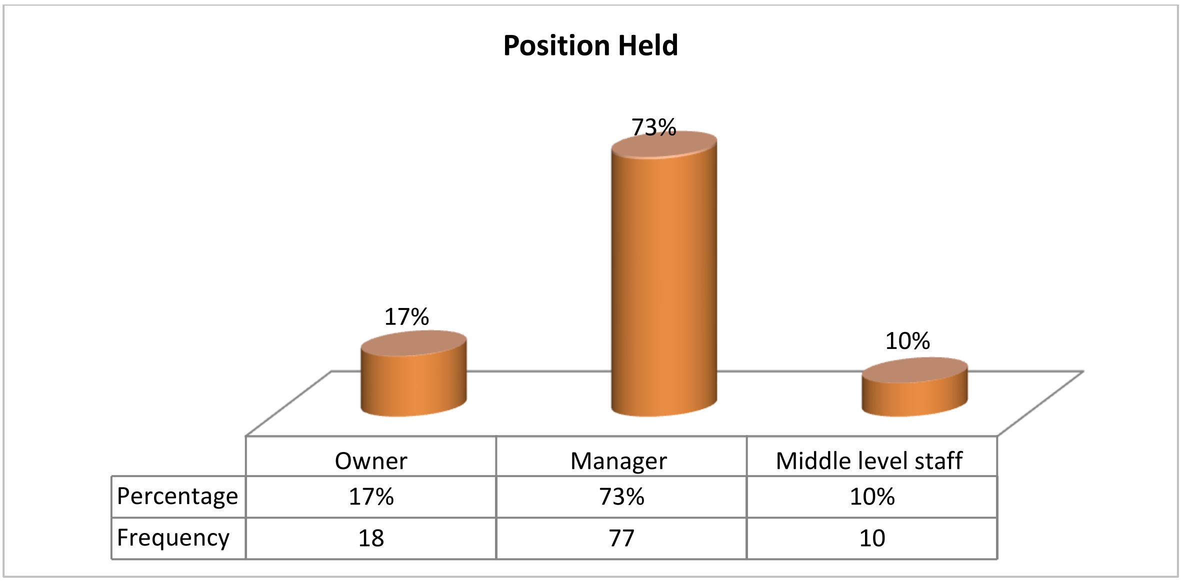
4.2.1 Reliability Analysis

Reliability refers to a measure of the degree to which research instruments yield consistent results. In this study, data reliability was done by use of Cronbach alpha where yield of 0.5 % and above was accepted. Agency banking, size of SMEs and quality of SMEs labour were found to have Cronbach alpha of 0.8315, 0.9742 and 0.6209 respectively.

4.2.2 Position Held in the Firm

Respondents were required to indicate their positions in the organization. The position held by the respondents determines the reliability of information provided. 73% (77) of the respondents were SME managers, 17% (18) were SMEs owners and 10% (10) middle level staffs. The findings reveal that by the virtue of the positions of the respondents they had the authority to comment on the aspects under study because they are directly involved with management of the SMEs. The findings are shown in Figure 4.1.

Figure 4.1: Position Held

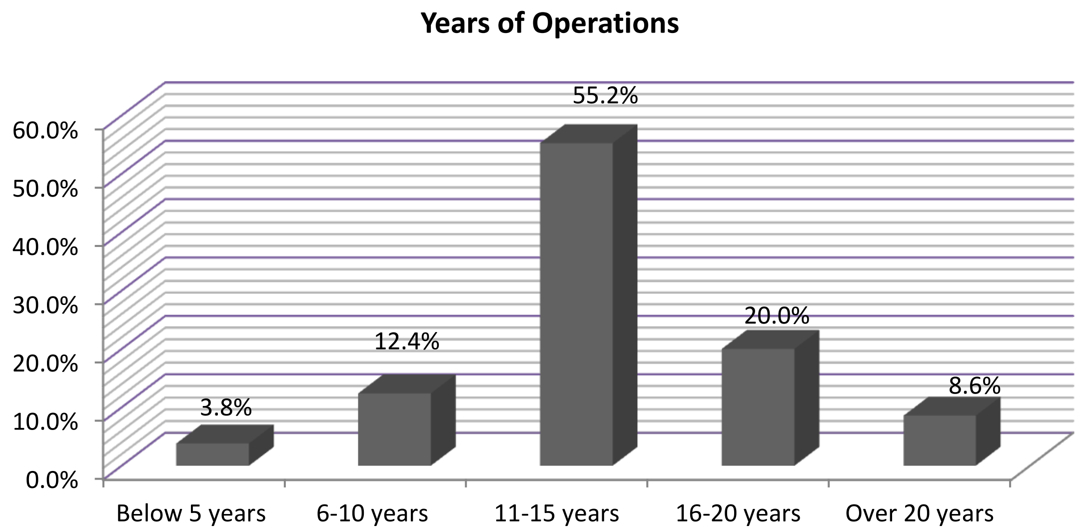


Source: Research Findings

4.2.3 Period of Business Operation

The period a firm has been in operation affects the adoption of agency banking services as well as profitability. Firms which have been in operation for long also have stable and higher financial performance than young firms (Amaral & Quintin, 2006). 55.2% of the indicated that their businesses had been in operation for a period of between 11-15 years, 20% a period of between 16-20 years, 12.4% between 6-10 years, 8.6% over 20 years and 3.8% below 5 years. This reveals that a significant number of SMEs had been in business for a period more than five years and hence could provide reliable and required information. The findings are as shown in figure 4.2 below.

Figure 4.2: Period of business operation



Source: Research Findings

4.2.4 SMEs Number of Employees

Number of employees is a measure of the size of a firm depending on the sector. Size of SME affects firms' profitability and level of use of agency banking. The findings are presented in table 4.1 below. The table shows that 42.9% (45) of the SMEs had 16-50 employees, 21.9% (23) 51-100, 16.2% (17) over 100 employees, 14.3% (15) had 6-10 employees, 4.8% (5) had below 5 employees.

Table 4.1: Number of Employees

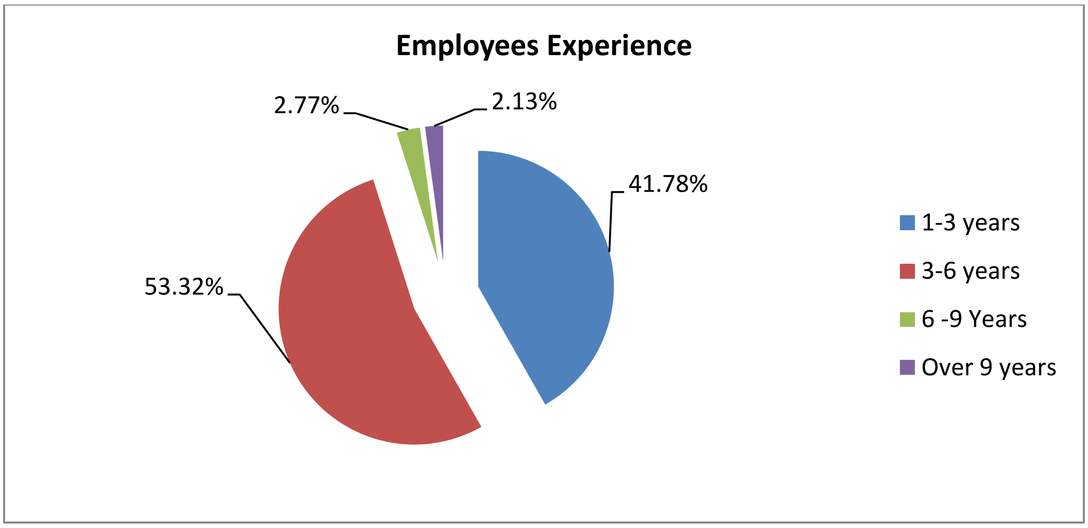
Number of Employees	Frequency	Percentage
Below 5 Employees	5	4.8%
6-15 Employees	15	14.3%
16-50 Employees	45	42.9%
51-100 Employees	23	21.9%
Over 100 Employees	17	16.2%
Total	105	100%

Source: Research Findings

4.2.5 Employees' Experience

This measured the employees' skills to ensure highest productivity. As shown in figure 4.3 and table 4.2 below, out of the total SMEs employees, majority of them, 53.32% (2500) had experience of 3-6 years, 41.78% (1959) had experience of 1-3 years, 2.77% (130) had experience of 6-9 years, 2.13% (100) had over 9 years.

Figure 4.3: Employees Years of Experience



Source: Research Findings

As shown in table 4.2 below, majority of SMEs employees (95%) have experience of less than 6 years. This could be explained by inability of SMEs to pay and attract very experienced staffs.

Table 4.2: Employees Years of Experience

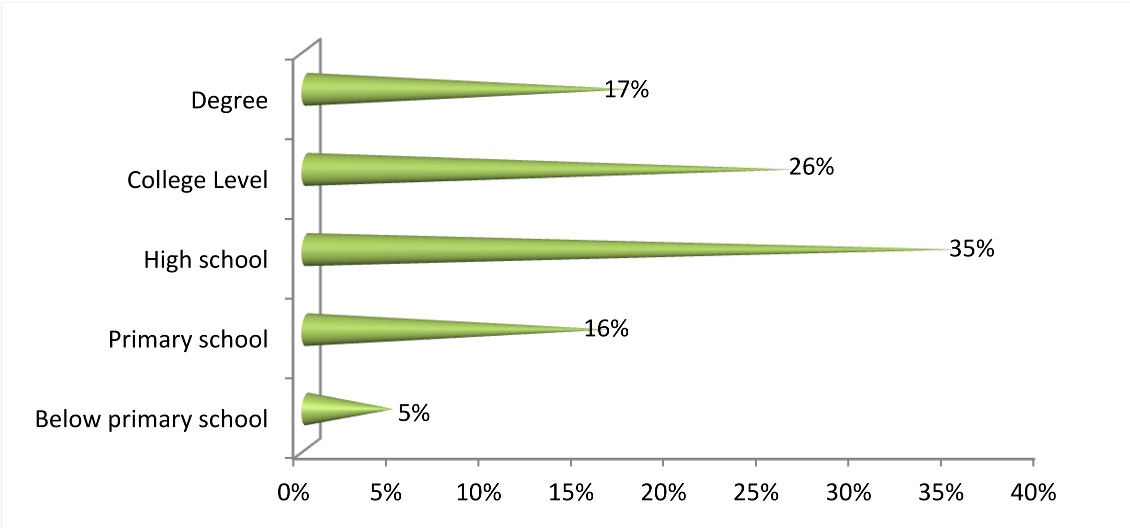
Employees Experience	Frequency	Percentage
1-3 years	1959	41.78%
3-6 years	2500	53.32%
6 -9 Years	130	2.77%
Over 9 years	100	2.13%
Total	4689	100.00%

Source: Research Findings

4.2.6 Employees Education Level

As shown in figure 4.4 below, 35% of SMEs employees had high school education, 26% college education, 17% degree education, 16% primary education and 5% below primary education. This was explained by the fact that majority of SMEs activities did not require very educated employees. Most educated employees were observed to be in the supervisory and management levels. In addition, Galiani and Weinschelbaum (2007) found that more productive workers go to big firm jobs, whereas less productive workers select into the SMEs sector.

Figure 4.4: Employees Education Level

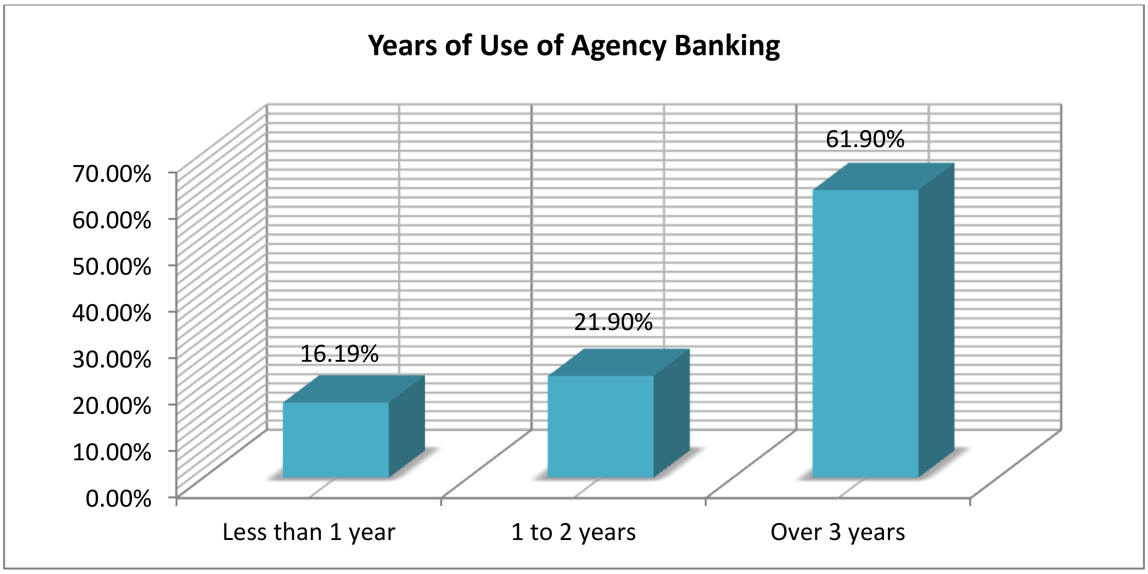


Source: Research Findings

4.2.7 Years SMEs have been using Agency Banking

As shown in figure 4.5 below, 61.9% of the studied SMEs had been using agency banking for over 3 years, 21.9% years 1 to 2 while 16.19% had been using agency banking for less than one year. The duration in which SMEs had been using agency banking affects the effect of the same on profitability.

Figure 4.5: Years of using agency banking

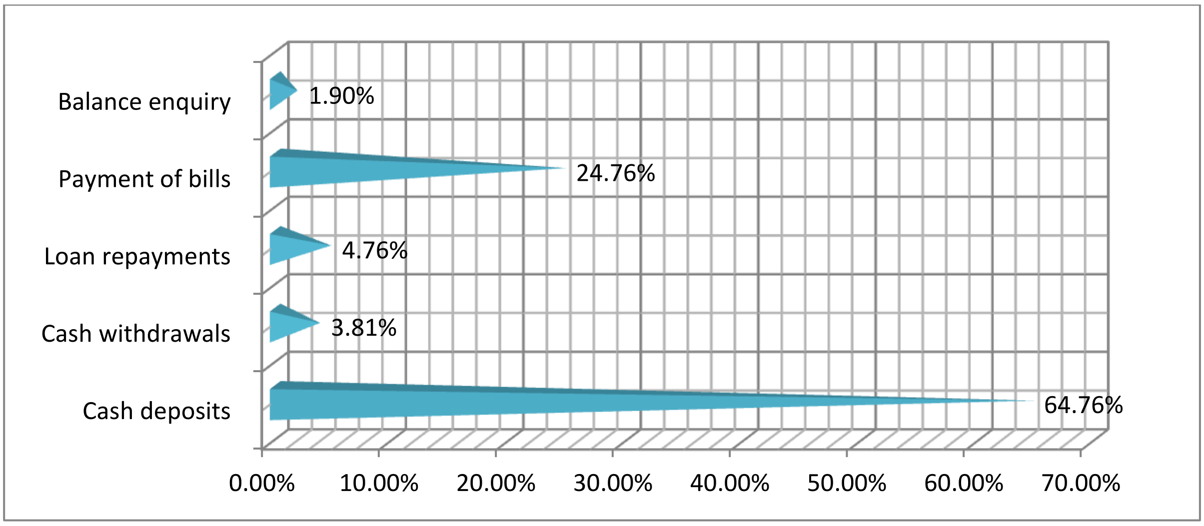


Source: Research Findings

4.2.8 SMEs Use of Agency Banking

Cash deposits was seen as the major use of agency banking by 64.76% (68) of SMEs, 24% (24) using agency banking or bill payments, loan repayment 4.76% (5), 3.81% (4) and 1.9% (2) for balance enquiry. The details are shown in figure 4.6.

Figure 4.6: Uses of Agency Banking



Source: Research Findings

4.2.9 Challenges Limiting SMEs Financial Performance

The question sought to determine the key challenges limiting performance of SMEs. As shown in table 4.3 below, the main challenge identified as limiting performance of SMEs is inadequate financing as highlighted by 35.29% of the respondents followed by poor perception (27.15%), competition from big firms (25.34%) and inability to access export markets (12.22%).

Table 4.3: Challenges Limiting SMEs Financial Performance

Challenge hindering performance	Frequency	Percentage
Competition from big firms	56	25.34%
Inadequate financing due to lack of collateral and high interest rates	78	35.29%
Poor perception of SMEs product and capacity	60	27.15%
Inability to access the export market	27	12.22%
Total	**221**	**100.00%**

Source: Research Findings

4.2.10 Challenges Limiting Use of Agency Banking

The main challenges affecting the SMEs use of agency banking services are shown in table 4.4 below. The main challenges of using agency banking include high costs of transactions, security issues and poor perception of agency banking model by end users.

Table 4.4: Challenges Limiting Use of Agency Banking

Challenge	Frequency	Percentage
Lack of assurance on security of the transactions conducted via agency banking	62	37%
Higher costs of transacting through agency banking	78	46%
Perception issue where suppliers do not trust payments via agency banking	29	17%
Total	**169**	**100%**

Source: Research Findings

4.3 Regression Analysis

This part sought to achieve the main objective of the study by obtaining the mathematical relationship between independent and dependent variable which include agency banking services, size of SMEs and quality of labour being used by the firms. The effect of each of the independent variables on dependent variable was also obtained.

4.3.1 Regression between Financial Performance and Agency banking

As shown in table 4.5 below, agency banking has a weak positive relationship with financial performance as shown by R of 0.3128. However, the relationship is not very strong since agency banking can only account for 9.78% of changes in financial performance as shown by R square. The findings are consistent to that by Mwangi (2011) agency banking positively affected financial performance of commercial banks.

Table 4.5: Model Summary, Financial Performance and Agency banking

R	R Square	Adjusted R Square	Std. Error of the Estimate
0.3128	0.0978	0.0891	0.0710

Source: Research Findings

The ANOVA results in table 4.6 below shows that the positive relationship between agency banking and financial performance is significant since the p value is 0.0012 which is less than the 5% significance level.

Table 4.6: Model ANOVA, Financial Performance and Agency banking

	Sum of Squares	df	Mean Square	F	Sig.
Regression	0.0563	1	0.0563	11.1690	0.0012
Residual	0.5188	103	0.0050		
Total	0.5751	104			

Source: Research Findings

The coefficients of the model developed showing the relationship between financial performance and agency banking is shown in table 4.7 below. As it can be seen from the table, the coefficients are significant since p value of 0 and 0.0012 are less than 5% significance level.

Table 4.7: Model Coefficients, Financial Performance and Agency banking

	Unstandardized Coefficients	Std. Error	t	Sig.
Constant	0.3068	0.0331	1.2722	0.0000
Agency Banking	0.0539	0.0032	0.3420	0.0012

Source: Research Findings

4.3.2 Regression between Financial Performance and SME Size

As shown in table 4.8 below, SMEs size has a weak positive effect on financial performance as shown by R of 0.1112 and R square of 0.0124. Perry et al (2007) also found a positive correlation between SMEs size and profitability due to economies of scale with small firms having lower financial performance.

Table 4.8: Model Summary, Financial Performance and SME Size

R	R Square	Adjusted R Square	Std. Error of the Estimate
0.1112	0.0124	0.0128	0.0074

Source: Research Findings

Table 4.9 below shows the ANOVA of the model between financial performance and size of SMEs. The model is significant at 95% confidence level since the p value is 0.0258.

Table 4.9: Model ANOVA, Financial Performance and SME Size

	Sum of Squares	df	Mean Square	F	Sig.
Regression	0.0071	1	0.0071	1.2900	0.0258
Residual	0.5679	103	0.0055		
Total	0.5751	104			

Source: Research Findings

The model coefficients are shown in table 4.10 below.

Table 4.10: Model Coefficients, Financial Performance and SME Size

	Unstandardized Coefficients	Std. Error	t	Sig.
Constant	0.2058	0.0096	21.4433	0.0000
Size of SME	0.0011	0.0001	-0.1136	0.0026

Source: Research Findings

4.3.3 Regression between Financial Performance and Quality of labour used by SMEs

As shown in table 4.11 below, SMEs quality of labour has a positive and strong relationship with financial performance as shown by R of 0.7402 and R square of 0.5479.

Table 4.11: Model Summary, Financial Performance and Quality of Labour

R	R Square	Adjusted R Square	Std. Error
0.7402	0.5479	0.5101	0.0740

Source: Research Findings

The positive relationship between financial performance and quality of labour was found to be significant at 95% confidence level with a p value of 0.0153. The results are shown in table 4.12 below.

Table 4.12: Model ANOVA, Financial Performance and Quality of labour used by SMEs

	Sum of Squares	df	Mean Square	F	Sig.
Regression	0.0113	1	0.0113	2.0652	0.0153
Residual	0.5638	103	0.0055		
Total	0.5751	104			

Source: Research Findings

The model coefficients obtained are presented in table 4.13 below.

Table 4.13: Model Coefficients Financial Performance and Quality of labour used by SMEs

	Coefficients	Std. Error	t	Sig.
Constant	0.2097	0.0105	19.9110	0.0000
Quality of Labour	0.0101	0.0008	0.0144	0.0154

Source: Research Findings

4.3.4 Analytical Model

This sought to determine the objective of the study which was to determine the effect of agency banking on financial performance of small and medium sized enterprises in Nairobi County. Size of SMEs and quality of labour were included in the model as control variables. The data was analyzed by multiple regression method. The results obtained show a strong and positive relationship between dependent variables and independent variables with an R of 0.9459 and R square of 0.9351. Hence, the model developed could explain 89% of changes in financial performance as measured by return on assets. The results are shown in table 4.14 below.

Table 4.14: Overall Model Coefficient

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	0.9459	0.8948	0.9351	0.0708

Source: Research Findings

The model was observed to significant with a p value of 0.0048 which is less than 5% significant level. The ANOVA results are shown in table 4.15 below.

Table 4.15: Overall Model ANOVA

	Sum of Squares	df	Mean Square	F	Sig.
Regression	0.0688	3	0.0229	4.5763	0.0048
Residual	0.5062	101	0.0050		
Total	0.5750	104			

Source: Research Findings

The model coefficients developed are shown in table 4.16 below. All the variables were found to be significant at 5% significant level. The model developed is $Y = 0.3223 + 0.1229X_1 + 0.01X_2 + 0.0762X_3$ where Y is financial performance as measured by return on assets, X_1 is agency banking, X_2 is size of SMEs and X_3 is the quality of labour. The positive effect of agency banking is in line with that of Amaral and Quintin (2006) who found that capital constrained SMEs will scale down their capacity, and operate below the efficient scale of production. Secondly, high cost of capital or limited outside financing will force SMEs firms to substitute (low-skill) labour for physical capital.

Table 4.16: Overall Model Coefficients

	Unstandardized Coefficients	Std. Error	Standardized Coefficients	t	Sig.
Constant	0.3223	0.0354		0.0969	0.0000
Agency Banking	0.1229	0.0000	0.3300	0.1114	0.0024
Size of SME	0.0100	0.0001	0.0149	0.5807	0.0117
Quality of Labour	0.0762	0.0008	0.0101	0.0070	0.0099

Source: Research Findings

4.4 Interpretation of the Findings

The study sought to evaluate the effect of agency banking on financial performance of small and medium sized enterprises in Nairobi County. Agency banking was found to have weak but positive relationship with financial performance as with coefficient of correlation of 0.3128. The coefficient of determination of 0.0978 implied that agency banking could only account for 9.78% of changes in financial performance. The positive relationship between agency banking and financial performance was significant since the p value was 0.0012 which is less than the 5% significance level. These findings were consistent with those of Mwangi (2011) who found that agency banking positively affected financial performance of commercial banks. The positive effect of agency banking on commercial banks tends to replicate to SMEs but with lesser effect.

Size of the SMEs was found to have weak but positive effect on financial performance with coefficient of correlation of 0.1112 and coefficient of determination of 0.0124. The relationship was significant at 95% confidence level with a p value is 0.0258. The findings agree with those of Perry et al (2007) who also found a positive correlation between SMEs size and profitability due to economies of scale with small firms having lower financial performance.

SMEs quality of labour was also found to have positive and strong relationship with financial performance with a coefficient of correlation of 0.7402 and coefficient of determination of 0.5479. The positive relationship between financial performance and quality of labour was found to be significant at 95% confidence level with a p value of 0.0153.

The study found a strong positive relationship between dependent and independent variables with a coefficient of correlation of 0.9459 and coefficient of determination of 0.89. Hence, the model developed could explain 89% of changes in financial performance as measured by return on assets. The model was found to be significant with a p value of 0.0048 which is less than 5% significant level. All the model coefficients were found to be significant at 5% significant level. The model developed was $Y = 0.3223 + 0.1229X_1 + 0.01X_2 + 0.0762X_3$ where Y is financial performance as measured by return on assets, X_1 is agency banking, X_2 is size of SMEs and X_3 is the quality of labour. These findings were similar to those of Amaral and Quintin (2006) who found that capital constrained SMEs scaled down their capacity, and operated below the efficient scale of production. Further, high cost of capital or limited outside financing forced SMEs to substitute (low-skill) labour for physical capital.

To determine the reliability of variables used, Cronbach alpha was used where yield of 0.5 % and above was accepted. Agency banking, size of SMEs and quality of SMEs labour were found to have Cronbach alpha of 0.8315, 0.9742 and 0.6209 respectively. 73% of the respondents were SME managers, 17% were SMEs owners and 10% middle level staffs. The findings reveal that by the virtue of the positions of the respondents they had the authority to comment on the aspects under study because they are directly involved with management of the SMEs. 55.2% of the SMES had their businesses operating for a period of between 11-15 years, 20% a period of between 16-20 years, 12.4% between 6-10 years, 8.6% over 20 years and 3.8% below 5 years.

Out of the total SMEs employees, majority of them, 53.32% had experience of 3-6 years, 41.78% had experience of 1-3 years, 2.77% (130) had experience of 6-9 years, 2.13% (100) had over 9 years. Also majority of SMEs employees (95%) had experience of less than 6 years. This could be explained by inability of SMEs to pay and attract very experienced staffs. Further, 35% of SMEs employees had high school education, 26% college education, 17% degree education, 16% primary education and 5% below primary education. This was explained by the fact that majority of SMEs activities did not require very educated employees. Most educated employees were observed to be in the supervisory and management levels. In addition, Galiani and Weinschelbaum (2007) found that more productive workers go to big firm jobs, whereas less productive workers select into the SMEs sector.

All the studied SMEs were using agency banking with 61.9% of the studied SMEs having used agency banking for over 3 years, 21.9% years 1 to 2 while 16.19% had been using agency banking for less than one year. The duration in which SMEs had been using agency banking affects the effect of the same on profitability. Cash deposits were seen as the major use of agency banking by 64.76% of SMEs, 24% using agency banking or bill payments, loan repayment 4.76%, 3.81% and 1.9% for balance enquiry. The main challenges identified as limiting performance of SMEs were inadequate financing as highlighted by 35.29% of the respondents followed by poor perception (27.15%), competition from big firms (25.34%) and inability to access export markets (12.22%). The main challenges that affected SMEs use of agency banking included high costs of transactions, security issues and poor perception of agency banking model by end users.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter gives a summary of the findings outlined in chapter four, the conclusion and recommendations of the study on the analysis of the utilization of agency banking on performance of small and medium sized enterprises in Nairobi County, Kenya.

5.2 Summary

This research sought to evaluate the effect of agency banking on financial performance of small and medium sized enterprises in Nairobi County. A descriptive research design was adopted in collection and analysis of data as to achieve the research objective where 120 SMEs in Nairobi County were studied. To ensure reliability of information provided, 73% of the respondents were SME managers, 17% SMEs owners and 10% (10) middle level management staff. The study used size of SMEs and quality of labour in the study as control variables. The data was analyzed by multiple regression method.

The study found that agency banking had weak but positive relationship with financial performance as with coefficient of correlation of 0.3128. The coefficient of determination of 0.0978 implied that agency banking could only account for 9.78% of changes in financial performance. The positive relationship between agency banking and financial performance was significant since the p value was 0.0012 which is less than the 5% significance level. These findings were consistent with those of Mwangi (2011) who found that agency banking positively affected financial performance of commercial banks. Size of the SMEs was found to have weak but positive effect on financial performance with coefficient of correlation of 0.1112 and coefficient of determination of 0.0124. The relationship was significant at 95% confidence level with a p value is 0.0258. The findings agree with those of Perry et al (2007) who also found a positive correlation between SMEs size and profitability due to economies of scale with small firms having lower financial performance.

SMEs quality of labour was also found to have positive and strong relationship with financial performance with a coefficient of correlation of 0.7402 and coefficient of determination of 0.5479. The positive relationship between financial performance and quality of labour was found to be significant at 95% confidence level with a p value of 0.0153. The study found a strong positive relationship between dependent and independent variables with a coefficient of correlation of 0.9459 and coefficient of determination of 0.89. Hence, the model developed could explain 89% of changes in financial performance as measured by return on assets. The model was found to be significant with a p value of 0.0048 which is less than 5% significant level. The model developed was $Y = 0.3223 + 0.1229X_1 + 0.01X_2 + 0.0762X_3$ where Y is financial performance as measured by return on assets, X_1 is agency banking, X_2 is size of SMEs and X_3 is the quality of labour. These findings were similar to those of Amaral and Quintin (2006) who found that capital constrained SMEs scaled down their capacity, and operated below the efficient scale of production. Further, high cost of capital or limited outside financing forced SMEs to substitute (low-skill) labour for physical capital.

Cash deposits was found to be the major use of agency banking by 64.76% of SMEs, 24% using agency banking or bill payments, loan repayment 4.76%, 3.81% and 1.9% for balance enquiry. This indicated low adoption of agency banking services by SMEs with reasons for the same quoted as high costs of transactions via agent banks, security issues and poor perception of agency banking model by end users. However, agency banking model was found to enhance financial inclusion for small SMEs who previously indicated challenges to accessing financial services. 61.9% of the studied SMEs had been using agency banking for over 3 years, 21.9% years 1 to 2 while 16.19% had been using agency banking for less than one year. Studied SMEs were found to have less experienced and qualified employees. 95% of SMEs employees were found to have experience of less than 6 years with 57% of the employees having high school education and less. This was explained by the fact that most SMEs studied (using agency banking) were small and hence unable to pay and attract very experienced staffs. The main challenges facing SMEs were found to be inadequate financing as highlighted by 35.29% of the respondents followed by poor perception (27.15%), competition from big firms (25.34%) and inability to access export markets (12.22%).

5.3 Conclusion

From the study findings, the study concludes that agency banking lead to financial inclusion of small SMEs and has significant positive weak relationship with financial performance of SMEs in Nairobi County. This is as a result of increase in financial access to business and consequently leading to increased SMEs firms' financial performance due to reduced transaction cost and liquidity advantage. Lack of financial access limits the size of firms, as well as their growth, profits, activations and their scope of operations. Also, as a result of lower transaction costs and a transaction-driven revenue model (rather than a float-driven model), agent banking systems are most cost effective for transactional accounts with low balances and frequent transactions which is the case for firms.

The study also concludes that adoption of agency banking by SMEs and mainly the medium sized enterprises is still low with the transaction costs of transacting through agent bank being high and the perceived risk of transacting through agent banks. This is because use of agency banking entails use of technology in SMEs banking which ensures that firms are able to access financial products and services more conveniently, reliably and affordably. Reaching SMEs in rural areas is often prohibitively expensive for financial institutions since transaction numbers and volumes do not cover the cost of a branch The amount of money expended by financial service providers to serve a poor customer with a small balance and conducting small transactions is simply too great to make such accounts viable. In addition, when financial service providers do not have branches that are close to the customer, the customer is less likely to use and transact with their service.

The further concludes that the main uses of agency banks include cash deposit and payment of bills with no SMEs indicating withdrawals of cash via the model. Also, size of SMEs and quality of labour employed has positive and weak relationship with financial performance of SMEs in Nairobi County. However, when agency banking is combined with size of SMEs and quality of labour, a strong positive relationship with financial performance was established.

5.4 Policy Recommendations

There is low adoption of agency banking by SMEs. However, Agency banking has enabled cost saving and accessibility of financial services by SMEs and mostly small firms. SMEs are able to access the basic banking services which include cash deposit or receiving of payments and payment of bills. However, despite these achievements of agency banking, cost of transactions and security are the most critical factors limiting adoption of agency banking. There exists a positive relationship between adoption of agency banking and SMEs financial performance.

First, the study recommends that commercial banks should develop strategies to manage the perceived risks of using agency banking which will include end user education and formulation of regulations to ensure highest security measures for the firms. The support staff working under agency banking model should also be trained and measures to deal with client confidential information enhanced.

The government through Central Bank of Kenya should also formulate regulations aimed at managing risks of agency banking so as to facilitate adoption of agency banking services by SMEs and hence promote their financial performance for economic growth. In addition, the banks should continuously adopt new technology to ensure that their systems remain secure and hence increased agency perception by end users.

The costs of agent banking services are high where even cash deposits are charged transaction costs. The Central Bank of Kenya should develop policies to regularize the charges of agency banking model. The costs should be set being lower than the banking hall charges. The transaction costs should be lower since the fixed costs in agency banking model are minimal.

Banks should also allow agents to be more financially inclusive than just offering the cash transfer services, agents should be able to convert cheques into cash, deal with foreign currency exchange among other services. The selection criteria of agents should be restructured so as to favour heavy cash operations in order to meet the demand of handling large cash transactions by SMEs.

5.5 Limitations of the study

The researcher encountered quite a number of challenges related to the research and most particularly during the process of data collection. Some respondents were biased while giving information due to reasons such as privacy and busy schedules at their places of work.

Due to inadequate resources, the researcher conducted this research under constraints of finances and therefore collected data from SMEs located in Nairobi County. SMEs in Nairobi County were sampled and assumed to be representative of all SMEs in Kenya. Due to resources constraints, the researcher could not have been able to travel to other parts of the country to collect data.

The research was constrained by time factor and therefore longitudinal methods of study could not be used. The researcher could also not have able to confirm the data provided and where there were inconsistencies, the same clarified with the respondents.

Further, the sample size used was small and hence could not have been representative and enable generalizations since 100 SMEs cannot be representative of all SMEs in Nairobi County. Small sample size has low statistical power and reduced chance of detecting a true effect.

5.6 Recommendations for Further Research

Arising from this study, the following directions for future research in finance are as follows: First, this study focused on SMEs located in Nairobi and therefore, generalizations cannot adequately extend to other SMEs outside Nairobi. Future research should therefore focus on all SME in Kenya.

The study recommends another study to be done in other areas of Kenya to establish whether the findings can be generalized. SMEs from other Counties or countries can be studied to determine the consistency of the results on SMEs in different localities. This will ensure that more accurate results are obtained

The agency sector in Kenya is also very wide and comprises of other agencies including mobile money agents which differ in their way of management and have different settings and regulations all together, hence a further study should be carried out to investigate the factors which influence other agencies and their effect on financial performance of SMEs.

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APPENDICES

APPENDIX I: QUESTIONNAIRE

This questionnaire is to collect data for purely academic purposes and all information will be treated with highest confidentiality. Do not indicate your name or firms name anywhere on this questionnaire. Please ensure accuracy of information as much as possible. The questionnaire is to be filled by ONLY those whose firms use agency banking. The study seeks to determine the effect of agency banking on financial performance of SMEs sector firms in Kenya: A case of Nairobi County.

PART A: BACKGROUND DATA

1. What is your position in the firm?

   Owner [ ]

   Manager [ ]

   Middle level staff [ ]

2. How long has your firm been operating?

   Below 5 years [ ]

   6-10 years [ ]

   11-15 years [ ]

   16-20 years [ ]

   Over 20 years [ ]

3. How many employees do you have? Please specify

   Number of employees [ ]

4. For the stated employees in 3 above, please indicate as below;

   a. Their experience

      1-3 years [ ]

      3-6 years [ ]

      6-9 [ ]

      Over 9 years [ ]

   b. Education Level

      Below primary school [ ]

      Primary school [ ]

      High school [ ]

      College Level [ ]

      Under graduate [ ]

PART B: USE OF AGENCY BANKING

5. How long has your firm been using agency banking to carry out financial transactions?

Less than 1 year [ ]

1 to 2 years [ ]

Over 3 years [ ]

6. What services do your firm access through agency banking?

   Cash deposits [ ]

   Cash withdrawals [ ]

   Loan repayments [ ]

   Payment of bills [ ]

   Balance enquiry [ ]

7. How much in Kenya Shillings have you transacted through agency banking since you started using the service, both cash deposit and cash payment?

Cash Deposit	KES [ ]
Cash Payment	KES [ ]

PART C: FIRM FINANCIAL PERFORMANCE

8. What are the key factors hindering your firms financial performance

   i………………………………………………………………………………………

   ii………………………………………………………………………………………

   iii……………..………………………………………………………………………

   iv………………………………………………………………………………………

9. What are the key challenges you experience while using agency banking?

   i………………………………………………………………………………………

   ii………………………………………………………………………………………

   iii……………..………………………………………………………………………

Thank you for your responses

APPENDIX II: RESEARCH DATA

Average Cash transacted via agency banking	Number of employees	Quality of labour as measured by total yrs of education &experience	ROA
2510569	71	45	0.0189177
2275734	70	23	0.0190174
1179760	70	42	0.0190151
1168059	69	13	0.16
1166817	69	13	0.200077
1163568	68	42	0.2019453
1161624	75	3	0.2029262
1160864	75	4	0.2052798
1160364	73	55	0.2066406
1158907	73	21	0.2121645
1158764	74	6	0.2122473
1152108	72	4	0.2118262
1147376	77	2	0.1736016
1143852	77	4	0.1743671
1126977	100	4	0.1753021
1123248	100	2	0.1765858
1119771	101	4	0.1770998
1119628	106	2	0.1770858
1106896	106	5	0.1775994
1104117	104	2	0.1778803
1102848	104	18	0.1780732
1102572	171	25	0.17903
1092728	169	23	0.1800938
1088572	169	2	0.1805153
1088463	170	2	0.1812284
1087452	168	18	0.181279
1087137	167	5	0.1820262
1084872	167	7	0.1836346
1080492	166	5	0.1848953
1076536	172	35	0.1852444
1070852	172	4	0.185335
1060344	111	13	0.187149
1055198	108	5	0.1876124
1054584	110	12	0.1879432
1046496	108	12	0.1886745
1046301	89	12	0.1950612
1044196	89	13	0.1971677
1044152	93	12	0.1977141
1042083	93	13	0.1997981
1041356	92	14	0.2004617
1033529	92	13	0.2008051

1025702	91	14	0.2011074
1021716	91	14	0.201699
1017875	90	14	0.201972
1016062	97	13	0.2032275
1008121	95	14	0.2036888
1006461	97	14	0.2461718
1003672	75	14	0.2461263
1002916	98	13	0.2464628
1001648	97	15	0.2470828
991564	42	16	0.2473026
978739	96	3	0.2473848
977315	52	21	0.2479293
976926	51	12	0.2483933
969745	57	12	0.2486255
966621	81	1	0.2479236
961981	82	12	0.2477853
961168	83	5	0.2471837
957831.06	84	7	0.2476439
950284	85	1	0.2493335
940693	11	8	0.2529206
939603	12	5	0.253648
935834	17	7	0.2534188
931369	10	4	0.2538611
926781	107	6	0.2540487
924789	54	3	0.2545246
921501	124	6	0.2544015
920773	25	34	0.2574055
920688	14	3	0.2588755
917391.06	9	5	0.2606077
916019	15	3	0.2614937
912622.5	13	6	0.2622655
909004	78	4	0.2626673
908853	80	6	0.2629271
908070.86	79	7	0.2633834
904496	3	8	0.2644369
901703.84	157	9	0.2646321
900853	157	8	0.2659275
900669	156	9	0.2664403
900467	155	8	0.2672871
894742	156	9	0.2678576
892917	161	7	0.2735814
891059	161	5	0.2752176
889259	159	6	0.2759902
888304	159	4	0.2768925
884917	160	3	0.2778983
881021	158	6	0.2796173
878997	163	8	0.2797414
878778.08	163	9	0.2806355

877643	162	0	0.0188474
869991.06	165	6	0.16
868981	70	4	0.0188379
868191.06	69	6	0.17
867724	68	8	0.0188903
863005	238	8	0.21
862805	37	6	0.0188632
862293	998	5	0.23
861331	997	5	0.0188336
855606	49	4	0.15
853077	75	4	0.0188127
851182.86	98	5	0.0189101
847824	97	6	0.13
846943	42	7	0.0188973
846613	96	7	0.0189239
845225	100	7	0.26

Source: Sampled Firms Financial Records

APPENDIX III: SAMPLED FIRMS

Geomatic Services Ltd.

Abu Engineering Ltd

Acme Container Ltd

Adhesive Solutions Africa Ltd

Africa Kaluworks (Aluware) Division

African Cotton Industries Ltd

Africa Oil Kenya B.V

Agni Enterprises Ltd

Ali Glaziers Ltd

Alpha Dairy Products Ltd

Alpha Fine Foods Ltd

Apex Steel Ltd

AquaSanTec

Aquva Agencies Ltd -Nairobi

Arrow Rubber Stamp Company Ltd.

Artech Agencies (KSM) Ltd

Ashut Quality Products

ASL Ltd – HFD

Athi River Mining Ltd

Atlas Copco Eastern Africa Ltd

Beta HealthCare

Bilco Engineering

biodeal laboratories ltd

blowplast

Blowplast Limited

Blue Ring Products Ltd

Blue Triangle Cement

Bobmil Industries Limited

Bogani Industries Ltd

Bosky Industries Ltd

C. Dormans Ltd

Chemplus Holdings LTD

Chevron Kenya Ltd

Climacento Green Tech Ltd

Collis F B

Commrecial Motor Spares Ltd

Cosmos Limited

Creative Fabric World Co Ltd

Creative Innovations Ltd.

Crown-Berger (K) Ltd.

Cuma Refrigeration EA Limited

Doshi Group of Companies

Eco Consult LTD

Ecolab East Africa (K) Ltd

Ecotech Ltd

Energy Pak (K) Ltd

Energy Regulatory Commission

Equatorial Tea Ltd

Eveready East Africa Limited

Excel Chemical Ltd.

Fairdeal Upvc, Aluminium and Glass Ltd

Famiar Generating Systems Ltd

Farmers Choice Ltd

Flexoworld Ltd

Foam Mattress Ltd.

Forbes Media Electronic Advertising Solutions

furmart furnishers

Gahir Engineering Works Ltd

goldrock international enterprises

Goods Chemistry Practise & Allied Cert. Corp L.T.D

Guan Candle Making Machine Co.,Ltd.

Heluk International Limited

Hills Converters [K] Ltd

Kiesta Industrial Technical Services Ltd

Kim-Fay E.A Limited

KingSource Plastic Machinery Co.,Ltd.

Lake Turkana Wind Power Limited

Magadi Soda

Makiga Engineering Service Limited

Manufacturers & Suppliers (K) Ltd - Head Office

Manzil Glass & Hardware Ltd

Mather & Platt Kenya Ltd

Maweni Limestone Ltd

Mellech Engineering & Construction Ltd.

AMCO Waterless Cookware

Abha Light Homeopathy & Natural Medicine

Agape Electronics

Antarc Office and Home Furniture Solution Store

Aplus Tours & Travel Services

Arctic Computer Shop

Aren Software Ltd

Arkland Palace Hotel

Auto Xpress

Autosolv Automotive Solutions Ltd

Avenue Electronics Ltd

Bermuda Hotel

Bestell Computers