

**THE IMPACT OF INTEREST RATE CAPPING ON CREDIT
ACCESSIBILITY –A CASE OF SMALL AND MEDIUM ENTERPRISES IN
NAIROBI COUNTY**

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D61/79709/2015

**A RESEARCH PROJECT SUBMITTED IN PARTIAL FULFILMENT OF
THE REQUIREMENTS FOR THE AWARD OF DEGREE IN MASTER OF
BUSINESS ADMINISTRATION IN FINANCE, SCHOOL OF BUSINESS
UNIVERSITY OF NAIROBI.**

NOVEMBER, 2018

DECLARATION

This research project is my original work and has not been presented in any examination body for any award.

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This research project has been submitted for examination with my approval as the University:
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ACKNOWLEDGEMENT

I would like to acknowledge The Almighty God for the far He has enabled me to reach in my academic life.

I would also like to thank my Supervisor and Moderator Doctor Okiro and Doctor Lishenga for sufficiently guiding me through my research. Special appreciation for my husband for the support and encouragement throughout the whole period. I also greatly acknowledge my parents and siblings as well as my larger family for the prayers and all manner of support they accorded to me as I went throughout the whole Masters program. To my friends and colleagues and all those who supported me and were there for me throughout the whole period may God richly bless and reward you.

DEDICATION

The research project is dedicated to my husband, my parents and parents in law as well as my siblings, friends, colleagues and larger family for the care, support and prayers through it all.

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ABSTRACT

This research project was set to study the impact of interest rate capping on credit accessibility-a case study of SMEs in Nairobi County. Interest rate capping refers to the setting of a controlled lending interest rate or margin at which commercial banks can lend out to borrowers. The interest rate cap in the study was introduced in Kenya August 2016 by The Kenya Banking Amendment Act, 2016 but came into effect in September 2016. The main aim was and has always been to protect consumers from exploitation by lenders who charge exorbitant prices. Interest rate capping affects the affordability of credit as well as accessibility to it. Credit accessibility refers to how easy or difficult it is to get credit facilities when one needs them. Interest rate has capping has attracted mixed reactions with regards to its impact in the economy. Since the enactment of the law in September 2016, there has been considerable debate on its effects with some arguing that it is beneficial to borrowers and the economy as a whole and other saying the cap should be revisited, revised or scrapped off. This research therefore sought to look into one of the major impacts and that is credit accessibility to find out if the cap has been beneficial or detrimental. Credit accessibility was measure by comparing the amount requested versus that received before and after capping in September 2016, the time taken for loan processing before and after and the number of loans accepted and rejected before and after interest rate capping. The study concentrated on SMEs in Nairobi County due to their concentration thus a good representation and due to resource limitations, a sample size of 100 SMEs was preferred with a response rate of 89%. The study used the student t-test method to analyse the primary data that was presented using graphs. Secondary data was also obtained from the Central Bank of Kenya researches.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

The Central Bank of Kenya set the Commercial Banks Lending interest rate cap at 4% above the CBK base rate of 9% as from 2016 by approving The Banking Amendment Act of 2016. The law relating to the same was approved on August 2016 and became applicable as from September 2016 despite the debate on the effect on lending by commercial banks. Before then, banks enjoyed a period of interest rates being brought about by the equilibrium of supply and demand at the then existing market conditions. The market was more liberalized then. The capping was instituted in a bid to protect consumers off exploitation by Commercial Banks who were maximizing their profits through charging high interest rates on deposits. The bid was also to increase affordability and accessibility to loan facilities thus steering the economy on an upwards positive trend (Meja,2017)

Credit Accessibility is the capacity of individuals or firms to get financial services such as loans (Demirguc-Kunt,2008). Financial access promotes growth for firms due to availability of credit for growth purposes. This facilitates economic growth, competition and boosts employment. It also increases income for low income earners, (Richardson,2008). Lack of adequate finance on the other hand limits growth and the full potential of individuals or firms. In many countries, only 20-50% of the population have access to financial services and this leaves out many individuals and small firms.

Interest rate capping affects credit accessibility in that it regulates the price at which credit is issued to borrowers. Interest rates are used to control the flow of money in an economy(Ingram,2011). High interest rates help to control or reduce inflation but lowers the growth rate of the economy. On the other hand, low interest rates help in stimulating the economy but may lead to inflation on the flipside. Low interest rates are beneficial to the customer as this means accessibility to affordable financing. On the other hand, high interest rates discourage borrowing and thus the purchase of real assets goes down. Countries such as France, Belgium and United Kingdom as well as Thailand have enacted interest rate capping to protect consumers from predatory and excessive interest rate as well as to create affordable sources of finance for borrowers with low incomes (Maimbo & Gallegos,2014).

In Kenya interest rate capping has also had an impact on credit accessibility. The Monetary Policy Committee (MPC) Survey of March 2017 shows that commercial bank officers perceive that though interest rate capping may increase demand for credit, actual credit granted to borrowers will remain constant due to high credit controls or stringent measures. Banks have introduced stringent measures in a bid to take less risk due to the expectations of high credit risk. Credit risk refers to the risk of not being able to meet one's loan repayment obligations.

1.1.1 Interest Rate Capping

Interest Rate is described as what you pay in order to get or have money (Kimutai, 2003). Those who lend money expect to be compensated for handing over to those who borrow money. Interest rates caps have existed over a long period of time however limited due to the limitations placed on the economy. Governments employ different strategies either rigid or flexible systems based on the nature of clients or type of loan. A flexible cap means interest rates are tagged to a base rate for example the Central Bank base rate as seen in Kenya and Zambia (Miller, 2013). On the other hand, a fixed rate cap means a specific interest rate set by government that should be adopted by all commercial banks and lending institutions operating in an economy. Most African countries from time to time use interest rate ceilings as a consumer protection method shielding them from high interest rates charged by lenders-such being as result of political pressure to ensure low interest rates (Mbenue, 2013). Interest rate capping is actually a most common method of government financial control in developed and developing countries.

Interest Rate Capping in Kenya sort to develop interest rate ceilings and credit controls. Thus maximum lending rates were set for all commercial banks, Non-Bank Financial Institutions (NBFIs) and building societies while as well as the minimum rates of savings for all deposit taking institutions. Thus there was a stable spread between the lending and savings rates. The move to cap interest rates has changed the business environment and thus the institutions affected have to respond appropriately (Mulwa, 2017). Banks in Kenya have for the past 20 years benefitted from high interest rate spreads of 11.4% on the average in comparison to the world average of 6.6% -such a huge disparity from the world average and even countries competing with Kenya such as Namibia, South Africa, and Mauritius. In 2000 the interest rate spread was 14.2% and this reduced to 9.9% in 2014.

There are several advocacies for interest rate capping which include supporting a specific industry experiencing an economic or market crisis or where there is need for greater financial resources (Maimbo & Gallegos, 2014).The interest rate caps can be helpful to an industry or sector by providing short-term credit for stabilization (Miller 2013).Interest rate ceilings are justified by the argument that financial institutions are making exorbitant profits by charging clients high lending interest rates, (Dewatripont & Tirole 1994).By introducing an interest rate cap, the government of a country is aiming at lowering lending rate and credit facilities are deemed to be more accessible and less costly thus creating a larger pool of willing investors and hence consumer surplus. Banks are faced with a problem of unidentifiable credit-worthiness caused by this large pool of borrowers. Lenders therefore have to increase lending even to clients with doubtful credit-worthiness, thus increasing the volume of Non-Performing Loans (NPLs).To curb this, banks have to invest in better processing systems to be able to identify good clients and as a result the overhead costs are increased shifting the supply curve to the left which has negative effects on the quantity of credit (Miller, 2013)The major disadvantage of interest rate capping is that financial institutions shy away from providing credit to those at the lower end of the market-low volume borrowers like individuals and SMEs that have no alternative access to credit (Agolla,2016).Market conditions also become distorted. Banks react by creating high limits on borrowing and high levels of collateral needed to obtain loans while others are strategically discriminated (Miller, 2013).

1.1.2 Credit Accessibility

Credit Accessibility refers to as situation where individuals or firms are able to get financial services such as loans, (Demirguc-Kunt2008).Financial access promotes growth for firms due to availability of credit for growth purposes. This facilitates economic growth, competition and boosts employment. The availability of external sources of finance to an institution spurs growth positively by raising productivity and enhancing expansion. It also increases income for low income earners, (Richardson, 2008). Lack of adequate finance on the other hand limits growth and the full potential of individuals or firms. Access to financial access in most countries is limited to 20-50% of the population thus leaving out many individuals and small firms. This can be explained by high cost of borrowing from high interest rates, inadequacy of credit facilities, lack of awareness among others. The cost of credit is normally determined by interest rate charged by the lenders.

In Kenya credit accessibility has always been dictated through the interaction of the demand and supply curve for funds that are loanable,(Ndung'u,2014).Thus this has for a long time been determined by the equilibrium of supply and demand thus a more liberalized market economy. Financial institutions have packaged different types of credit facilities to meet the different needs of borrowers including SMEs. SMEs in Kenya also rely on loan facilities for financing but due to market liberalization in Kenya, interest rates have been on the high with spreads of even up to 11.4% and this makes credit costly. The government therefore from time to time caps interest rate to control the cost of borrowing so as to increase access to credit facilities by small scale borrowers. Availability of affordable credit steers up growth and entrepreneurship thus the reason why governments introduce such measures like interest rate capping to protect low income borrowers.

1.1.3 Interest Rate Capping and Credit Accessibility

Countries that have instituted interest rate caps have the main reason has been to protect consumers from lenders and commercial banks who charge exorbitant interest rates and thus making loans more affordable. Spain, Portugal, Belgium, Nigeria, Ivory Coast, Mali and Zambia among others have regulated interest rates with the objective centered around consumer protection, decreasing risk taking behavior and reducing over indebtedness. The reason was also to reduce the high costs of credit.

Worldwide studies have revealed that interest rate caps have had major negative unintended effects on the respective economies. In Japan, due to lower interest caps, credit supply contracted, number of loan applications that were accepted reduced and illegal lending increased. In countries belonging to the West African Economic Monetary Union (WAEMU), according to Kablan (2012), there has been a withdrawal of microfinance institutions from poor areas as the institutions increased their loan sizes to improve returns and efficiency due to low interest rate ceiling.

1.1.4 Interest Rate Capping and Credit Accessibility in Kenya

In Kenya the interest rate cap was introduced to make credit more accessible to all both high and low income earners. However, private sector growth after interest rate capping in Kenya has been constrained rather than enhanced. Banks have become very cautious in lending to the private sector due to historical accumulation of bad debts previously before interest rate capping.

There has also been crowding out effect due to the public sector borrowing that has increased significantly. Treasury Bill offers have increased to 24 billion in 2017 up from 16 billion in 2016. With the interest rate cap at 14%, banks prefer lending to the public sector where the risk is low than to the private sector that has high credit risk.

SMEs in Kenya as well who are part of the private sector may not have benefitted from the interest rate cap as expected. This may be due to high bottlenecks introduced by lenders. The same can also be explained by crowding out effect where banks prefer to lend to the government who borrow in large quantities compared to the SMEs. This study will look at how SMEs have been affected by the interest rate capping since September 2016 and the alternatives which may be sought to assist them have more access to credit.

1.2 Problem Statement

One of the major challenges that SMEs face is lack of adequate financing. Some are said not to even celebrate their second birthdays mainly to liquidity problems and mismanagement. Due to the high contribution of SMEs to the economy through productivity and creation of employment, the government of Kenya needs to create a more enabling environment for these SMEs to thrive. Some of the strategies include financing and reducing bottlenecks on registration. Small borne & Welter (2001) identify that the government has a major responsibility in influencing the nature and development of SMEs by providing an enabling external environment where businesses can develop and also through direct intervention and support. Howard and Nathan (2013) also identify that there is need for more financial inclusion for small firms.

Interest rate capping are a way of creating an enabling environment for all especially the small income earners. This is normally taken up by governments. However economists argue that the intended effect of making credit accessible may not be achieved by such a measure. It actually distorts the equilibrium in the market economies affected. In actual sense as studied in some economies interest rate capping leads to credit rationing by lenders of credit. Banks have no motivation to lend out due to low and more controlled returns brought about by interest rate capping. According to a study carried out by Siddiqui (2011), for a period between 2000 and 2008, a free market economy where interest rates are liberalized, there is seen the best and more efficient banking structure. Others on the contrary argue for capping of interest rates as credit

becomes more affordable for many. However in Kenya no actual study has focused on effect of interest rate capping on SMEs.

There has been some research on various effects brought about by interest rate as a cost for credit and the effects on its changes. Copper (2012) found out that SMEs in Nairobi depend on financing from MFIs for growth. According to Mwindi (2002) higher levels of interest rates were charged to SMEs in order to meet their operational costs considering their high risk levels. Zachary (2013) investigated the effects of levels of interest rates on SMEs in Nairobi County at a time where interest rates were determined by the equilibrium point of demand and supply in the more liberal Kenyan financial market. Odhiambo (2013) conducted a study on ‘The effects of changes of interest rates on demand for credit and loan repayments by small and medium enterprises in Kenya’. He found out that interest rates have no effect on credit demand by SMEs.

These studies have focused on interest rate changes on borrowing and on personal loans issued out by commercial banks. However there has been no research on the direct impact of interest rate capping on credit accessibility by SMEs since its inception in September 2016. The CBK also acknowledges that there is need to review the actual impact caused by interest rate capping as the intended results may not have actually been achieved. SMEs who are a major sector in the economy have more or less not been considered in a major way and thus a research gap exists in this area with regards to interest rate capping. The study will therefore focus on the impact of the capping of interest rates on credit accessibility after inception on September 2016.

1.3 Research Objective

To analyze the impact of interest rate capping on credit accessibility the case of SMEs in Kenya-Nairobi County.

1.4 Value of the Study

Meja (2017) conducted a research on “the effects of interest rate capping on personal loans issued out by commercial banks in Kenya” and found out that interest rates and levels of personal loans are related. In this case, interest rates are regularized thus making credit more affordable. Individuals are thus encouraged to take up more loan facilities. Zachary (2013) investigated the effect of levels of interest rates on SMEs in Kenya and found out that interest rates have a positive and direct effect on the level of demand by SMEs for credit facilities.

The study will be useful to government and regulatory bodies as it will provide insight on one of the more affected sectors of the economy which is Small and Medium Enterprises a case study of Nairobi County. Even as the debate for and against the interest rate capping in Kenya continues, the study will help provide more insight on the actual impact of the cap with regards to SMEs in Nairobi County. This is also intended to serve as an eye opener for policy makers involved in such decision making to consider major players in the economy during policy making. The study will also expand the field of knowledge in the area of interest rate capping and practice to identify when interest rate capping is possible or its value both in the short run and long run with regards to financing of SMEs.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter brings into perspective theories that exist and that guided the study and existing research on SMEs in Kenya and their main source of capital being borrowing from credit facilities. An in-depth study is done on how the SMEs have been impacted by the interest rate capping in Kenya since September 2016 through event studies before and after the declaration.

2.2 Theoretical Review

The section provides the relevant theories to the study seeking to explain existing knowledge. Different sets of theories will be explored as no single theory can account for the capping of interest rates to support some of the assumptions adopted. The theories that were analyzed include: classical theory of interest rates and rational expectations theory.

2.2.1 The Classical Theory of Interest Rates

This theory was advanced by Marshall and Fisher in the 1930s and later propagated by Pigou, Tausig and Knight. Classical theory helps explain how demand and supply forces determine the rate of interest. Demand refers to the need for investment while supply refers to the making available of credit through savings. The rate of interest is the amount paid for saving as per the theory. The rate of interest influences the willingness to save and the demand for investments thus bringing an equilibrium in the market. The theory therefore proposes that when savings are more than investments then interest rates will fall and when investments exceed savings, interest rates will rise. Gorder (2009) argues that an increase in interest rate is an incentive to save. Caplan (2000) also pointed out that the equilibrium interest rate is where demand for investments equals the supply in form of savings. The demand for capital goods increases with a decrease in the rate of interest. Conversely, the supply of capital increases by the amount saved by an individual and the saving is basically the transfer of the present requirement to the future requirement.

The rate of saving would increase with the increase in the interest rates that is an incentive to save. The rate of interest can be explained with the help of demand of investment and supply of savings. It would be the point of equilibrium where demand and supply intersects each other or

get equal. The rate of interest can be changed by changing the demand and supply of savings and investment. Thus in a free market economy, the price that is interest rate on loans is determined by the interaction of the supply curve for deposits and demand curve for loan facilities while at during interest rate capping the price is fixed and thus inelastic. This is also supported by the Free Market theory advanced by Milton Friedman in the year 1962..Rochan and Vernego(2001) argued that if the classical theory holds true, banks with excess levels of credit or savings should offer credit at low interest rates since savings are more than investments while those with low amounts of credit should give out loans at a higher cost and thus high interest rates will discourage borrowing thus establishing an equilibrium position in the market.

2.2.2 The Liquidity Preference Theory

Liquidity Preference is the need or demand for money. This was developed by John Maynard Keynes in 1936 in his book ‘The General Theory of Employment, interest and Money after his criticisms on the Classical Theory of interest rates. He defined interest as the opportunity cost of letting go of one’s liquidity. In this theory, liquidity is let go so as to hold bonds and other forms of savings. If one hoards money, there is no interest gain but if he saves then he will receive interest for parting with liquidity. According to Keynes people hold money for 3 main different reasons-the transaction motive, the precautionary motive and the speculative motive. In the transaction motive, people hold money for daily transactions, the precautionary motive is for meeting unexpected social problems, while the speculative motive is for speculation purposes.

The supply of money and the liquidity preference curve interact and at their meeting point is the interest rate which is quantity demanded equaling money supplied. Thus using the liquidity preference theory, the price of credit or loan facilities is determined at the interest rate or opportunity cost that holders of money are willing to accept in order to let go of their liquidity and thus influence the supply of credit for use by borrowers.

2.2.3 The Rent Seeking Theory

Gordon Tullock advanced the idea of Rent Seeking in 1967 in connection with monopolies. He explained that rent-seeking is the idea that individuals or firms seek to gain benefits for themselves using the political stage. Rent seeking is also defined as efforts to increase the share

of one's existing wealth without actually contributing to the creation of new wealth. Thus it supports the motive for interest rate capping which is to reduce exploitation of customers done by commercial banks who charge exorbitant interest rates. Banks are then viewed as those who engage in rent seeking practices at the expense of consumers by charging high interest rates initially before interest rate capping. Rent seeking behavior proves to be costly and it leads to poor allocation of resources, reduced actual wealth creation, income inequality increases and there is a potential economic decline. Organizations who engage in rent seeking value rent-seeking rather than productivity.

Through interest rate capping, there is an effort to curtail the rent seeking behavior with the intention of protecting consumers and make credit accessible and affordable to all. Joseph Stiglitz an American economist actually argues that rent seeking has contributed highly to income inequality in the United States. Those countries who institute interest rate cap support this theory is actually in place and there needs to be a turnaround to protect the exploited in society.

2.3 Empirical Studies

Evidence shows that interest rate capping most of the times leads to credit rationing. Zachary (2013) found an inverse relationship between the demand for credit by Small and Medium enterprises and the available rate of interest. Thus a higher interest rate reduces demand for credit while a lower interest rate attracts higher demand for credit. A high interest rate makes credit costly thus reducing demand while a low interest rate makes credit affordable to all thus increasing the demand for credit. Thus if followed an interest rate cap set on the low would increase credit uptake while absence of interest rate cap leads to fluctuation in interest rates that would eventually make credit expensive.

Maimbo & Gallegos, (2014) found that the interest rate cap brought in positive outcomes in their study in Arkansas and this is what is the intention of interest rate capping is. Due to the reduced cost of credit, uptake of loan facilities increased. There was also evidence of a reduction in the number and amount of non-performing loans. Since credit became more affordable, this was an incentive to borrow and thus there was increased financing for firms which were able to expand, employ more and survive for longer periods than before thus spurring up economic growth. Thus

high costs of credit on the flipside, reduce the urge to borrow as this affects profitability negatively.

Peterson & Falls(1981)in their research found out that when the cap was low, loans were not readily available in Arkansas and Oregon. As a result, many small companies closed down due to inadequate finance, lenders stopped giving out loans for small consumption and loan providers like pawnbrokers who are unregulated sprang up to provide lending services. The study also found that commercial banks and credit unions to rationed credit due to the cap on interest rates by including Japan which has had one of the longest history of controlling interest rates in the larger economies.

Porteous & Collins (2010) found that an interest rate cap below the rate prevailing in the market resulted to a reduction in the amount of supply of credit to borrowers, thus few loans regardless of the borrower needs were accepted by the banks and increased the level of unregulated lending. This was also backed by Ellison &Forster (2006) findings. All these indicate that the interest rate cap may instead of solving the problems it was first meant to, has aggravated them even more.

Ellison &Forster (2006) found that the different types of credit facilities given by banks to low income households were affected by interest rate capping. In Germany, low income earners and the risky borrowers were left out by increasing the minimum amount of personal loan amount to two and half times more than other unregulated countries hence creating a bottleneck to borrow for small-scale borrowers. They observed that banking systems with less control on interest rate were attractive than those that had more controls. All these indicated that despite efforts by the government to ensure more accessibility to credit the reverse actually happened. Regulators and policy makers need to be really careful when setting caps on fees as low rates could easily reduce the flow of credit to the high risk borrowers who need it the most (Stegman, 2007).

The above studies indicate that the implementation of interest rate capping has actually had more detrimental effects to the low income earners as they were excluded as they were deemed risky for defaulting and income from interest may not be sufficient to cover the risks involved. The above experience generally supports the idea by critics of interest rate control that it is basically a

political and populist move which is not supported by positive results from research. The idea of reintroducing interest rate control by the Kenyan government since liberalization of markets in 1992 may eventually not have brought in the benefits they were ideally expected to bring to the economy according to research from other economies. The Central bank of Kenya is actually suggesting that the interest rate capping law is revisited and revised and we evaluate other alternative ways of determining or regulating the interest rate through more market oriented intervention methods.

2.4 Determinants of Credit Issued by Commercial Banks to SMEs

The following factors determine the ability of a bank to create credit affect how much funds are available to be extended to the borrower.

2.4.1 Interest Rate on Loans

Loan interest rates are a major determinant of credit issued out by commercial banks and other financial institutions. From the 1990s upto August 2016, interest rates were determined by benchmarks set by the Monetary Policy Committee (MPC) of the Central Bank of Kenya. Thus banks were allowed to set any rate surrounding the benchmark thus making the rates a more liberal affair. However after the interest rate cap of September 2016, banks were only allowed 4 points above the CBK base rate of 9%(CBK,2018). Laeven (2003) found that market based and liberal interest rates actually make financial institutions more ready to offer credit to borrowers.

Capping of interest rate below the prevailing market rate decreases the interest rate spread like in the Kenyan scenario. Reduction of interest rate by the capping law definitely reduces the interest income among the banks. Chodechai (2004) advised that financial institutions should be cautious when determining the interest rate. Low interest rate affects the bank returns which are supposed to be sufficient to cater for the cost of deposits and general expenses and losses in the loan portfolio resulting from defaulting customers.

2.4.2 Supply of Funds and Size of the Bank

Funds must be available for them to be allocated efficiently. The deposits from customers is the major source of funds inflow. Banks create credit through deposit taking. High amount of

deposits mean there is more to lend while a low amount of deposits means less amount of money to loan out. Chernykh & Theodossiou (2011) identified that the big banks were more diversified, had large source of funds and more accessible by large borrowers as well as resource capability to develop advanced system to manage and assess credit risk. There thus exists a positive relationship between credit availability and size of the bank.

High deposits impact the rate of growth in the credit supplied to the private sector positively (Imran & Nishatm, 2013). Olokoyo (2011) also found out that the volume of deposits in banks has a major impact on the lending volume by a bank. Large banks have the financial capability to give out larger chunk of credit in an economy as compared to their counterparts. Their asset base, availability of funds, investment in human capital and ability to invest in high levels of technology to manage and reduce credit risks gives them an upper edge and they are able to bank on economies of scale. There is expected a positive relationship between this variable and the bank's level of credit.

2.4.3 Level of Non-Performing Loans

A high number of non-performing loans affects negatively the loans being granted. Non performing loans are usually loans not repaid according to the agreed schedule between the lender and borrower. They usually arise due to the high cost of credit because of high interest rates or a larger amount of credit issues out to a borrower or borrowers more than their ability to pay. Due diligence and lack of complete information about the borrower may largely contribute to non performing loans.

Non-performing loans are therefore key in determining the interest rate charged on loans by the banks. An increase in the volume of the non-performing debt leads to a reduction in the volume of the credit granted and the strength of the banking sector is compromised (Guo & Stepanyan, 2011). It is expected that there exists a negative relationship between credit availability and amount of non-performing loans. A high level of non performing loans at any given time discourages banks from lending while a low amount of non-performing loans is a positive indicator that borrowers are willing and able to pay their loans as per schedule thus large amount of credit can be issued to them.

2.4.4 Inflation Rate

Inflation is the continuous increase in the price of goods and services without a corresponding rise in the value of the same goods and services. High inflation rates reduce the real value of loan granted and although there may be growth in the quantity of loans given, the value may be reduced by the inflation.

During inflationary times banks charge high interest rates which will definitely reduce the demand for loans as they become costly. Sharma & Gounder (2012) argued that although the value of loans issued may increase among banks it may be due to inflation and not increase in real value of the loans. The relationship expected here between inflation and credit availability is negative. Thus during periods of inflation, credit becomes costly and not easily available while during periods of low inflation, credit is much cheaper thus borrowers are encouraged to take up more loan facilities.

2.4.5 Legal Reserve Requirement

The central bank of a government may require all financial institutions under their mandate to retain or save a certain amount of money with them. A higher legal reserve requirement reduces the amount of funds that can be loaned out hence decreasing the amount of credit available in the market. On the other hand, lower legal reserves are favorable to the commercial banks.

Olokoyo (2011) in his research work indicated that one of the major determinants of banks' lending behaviors in Nigeria is the legal reserve requirement. A high requirement reduces amount available for lending out while a low reserve requirement increases the credit available for lending. It is expected that there exists a negative relationship between credit availability and legal reserve requirements.

2.5 Conclusion

The theoretical and empirical studies above reveal that there exists a gap in the study of effects of interest rate capping on the credit accessibility by SMEs in Kenya. This has not been clearly brought out by any of the researches above. This study therefore endeavored to contribute and fill in the gap by examining the effects of interest rate capping on SMEs in Nairobi County.

2.6 Conceptual Framework

This is a pictorial representation of the variables that were be studied in this research project:

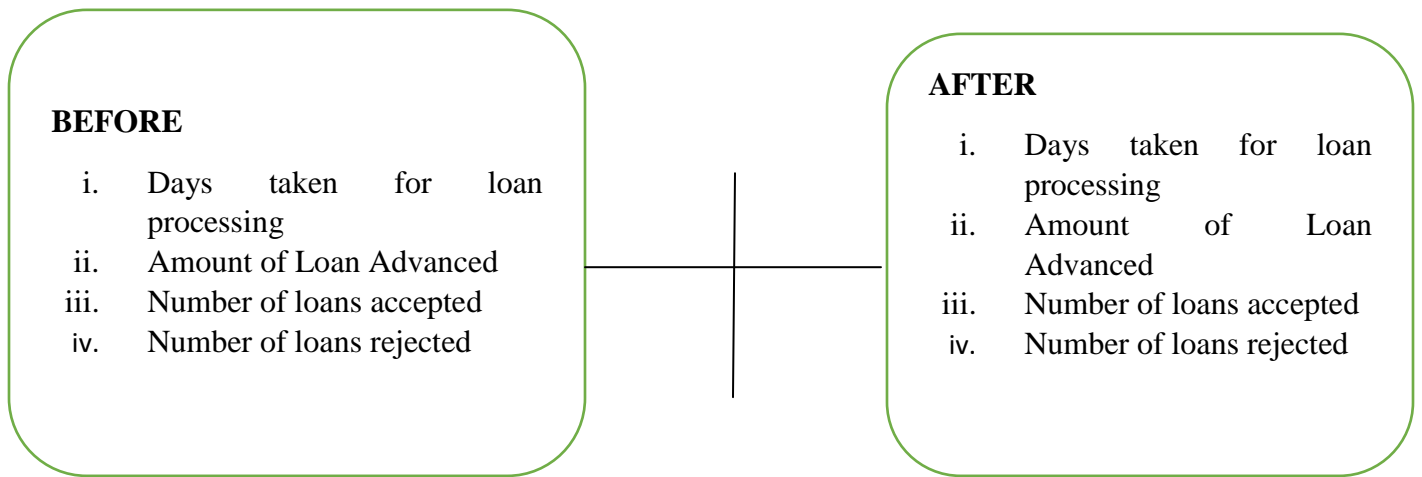


Figure 2.1: Conceptual Framework

Variables:

Interest Rate Capping-The rates before and after capping were analysed. The time Span taken for loan processing-How long do SMEs take for their loan requests to be processed (before and after capping).Amount of Loan in comparison to loan demand for SMEs before and after capping. The number of successful and unsuccessful loan applications prior to and after interest rate capping.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

The chapter will identify the steps that were followed in the research, the design approach that was used in literature review and data collection and analysis for the study. The target population that was studied is also explained. The sections contained herein are the research design, target population, sample and sampling procedure, methods of data collection, validity and reliability of data and methods of data analysis.

3.2 Research Design

The research design is the glue that holds a research project together according to Trochin (2005). Coopers and Schindler (2008) define research design as a plan for investigation in order to answer research questions. Descriptive research design was used in this study. Descriptive research refers to collection of data used to analyse or describe people, items or situations. The data collected was both qualitative and quantitative due to the different nature of variables involved hence the suitability of using descriptive design.

Causal Research design was also used that explains the relationship between the variables of the study-effect of interest rate capping on accessibility to credit facilities, time taken to process loans and the amount of credit forwarded to clients. The study used questionnaires to collect the desired information from firm managers, employees, accountants and other relevant stakeholders in SMEs management and financing. The time frame was the two years before interest rate capping and the two years after interest rate capping-from September 2016.

3.3 Target Population

Coopers and Schindler (2008) define the target population as all the element under the field of study that are relevant to the researcher. The target population was Small and Medium Enterprises in Nairobi County. There are over 42,880 registered and formal SMEs in the Nairobi County.

The respondents were generally managers, directors or owners of these firms since they are directly involved in decision making in these firms.

3.4 Sample and Sampling Procedure

Due to the large number of SMEs in Nairobi County-a sample size of 100 respondents was preferred from the top 100 SMEs in Nairobi county that can be accessed from the PPOA Website(ppoa.go.ke). Stratified sampling method was used whereby the population is divided into different strata each strata containing elements with similar characteristics. The strata into which the population were divided are Manufacturing SMEs, Trading SMEs and Service SMEs.

3.5 Methods of Data Collection

This study relied on both Primary and Secondary data. The primary data was collected through a semi-structured questionnaire so as to obtain both quantitative and qualitative data for the research. Both closed and open types of questions were used to obtain qualitative and quantitative data to obtain information. Open questions were used to obtain qualitative data while closed questions were used to get quantitative data. Secondary data was obtained from the available publications by the Central Bank of Kenya, the Kenya National Bureau of Statistics as well as other relevant publications.

3.6 Validity and Reliability

A validity test to ensure that only the correct variables are studied was conducted. Validity means the ‘accuracy and meaningfulness of inferences’ based on results from the research. In this study construct validity was used to assess the validity of the data obtained. Construct validity is a measure of the degree to which data obtained using an instrument represents in a manner that is accurate the theoretical concept.

Reliability is the stability and consistency with which the instrument used for data collection measures the concept. Reliability depends on the random error. Increase in random error reduces reliability in the research. Two common tests are test-retest and split-half technique. In this research due to resource constraints, the split-half technique was preferred as it requires only one testing session. In this technique, the research instrument is designed in such a manner as to have two parts then results from one part are compared with scores from the other part (Mugenda & Mugenda, 2003).

3.7 Methods of Data Analysis

3.7.1 Data Analysis

Data analysis was conducted by use of Student T-Test method which incorporates measures of central tendency such as mean, mode, percentages and frequency distributions to gain an understanding of the data. The data was compared before and after interest capping on September 2016 using the Split-Half Techniques. The split-half technique is a method used to check instruments used to measure where half of the data is computed and is then correlated against the other half of data. The data was represented using visual data representations such as scatter diagrams, pie charts, bar and line graphs to analyse and represent the data.

Both descriptive and statistical approaches were utilised to analyse the data. Data was also be analysed using t-test statistic using the Statistical Package for Social Sciences (SPSS version 17). Qualitative data was analysed on a comparison basis.

3.7.2 Empirical Model

An event study was conducted and the variables indicated in the conceptual framework were studied. The study looked at the effect on the variables in the table below before and after interest rate capping in September 2016 as per the table below:

Variables before interest rate capping	Variables after interest rate capping
Days taken for loan processing	Days taken for loan processing
Amount of Loan Advanced	Amount of Loan Advanced
Number of loans accepted	Number of loans accepted
Number of loans rejected	Number of loans rejected

Figure 3.1: Empirical Model

The time taken for loan processing before and after interest rate capping were studied as indicates how efficiency has changed after interest rate capping.

The amount of loans advanced to SMEs vis a vis the borrowed amount for the same firms were also studied to identify the effect by interest rate capping.

The number of loans requested by SMEs that have been accepted or rejected before and after interest rate capping were also analysed.

3.8 Chapter Summary

This chapter looked at the research design for the project, the target population, sample and sampling procedure, methods of data collection, validity and reliability of collected data and the methods of data analysis.

CHAPTER FOUR: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter deals with the analysis of data that was collected and presents findings of the study as per the research methodology. The results are shown using a sample T-test that is used to analyse two different samples. The main aim of this study was to analyse the impact of interest rate capping on credit accessibility by SMEs in Nairobi County.

4.2 Descriptive Statistics of the Population

This studied the data for credit accessibility for SMEs in Nairobi County and how they have been affected by interest rate capping. It compared two periods that is 2 years before interest rate capping and two years after interest rate capping in September 2016. The means, median, maximum, minimum statistics for the two periods are as below:

4.2.1 Amount of Loan

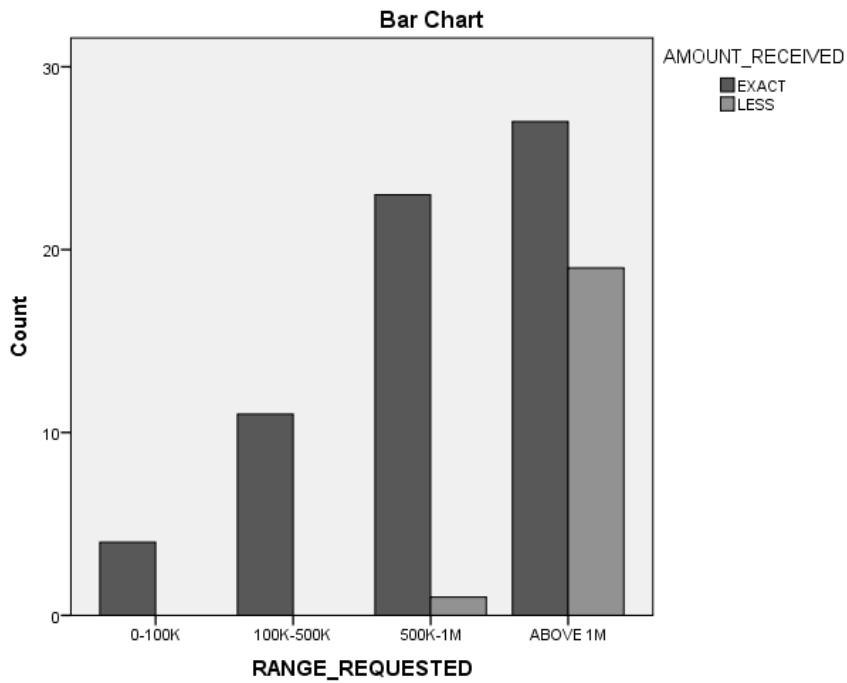
4.2.1.1 Amount of Loan Requested versus that Received before Interest Rate Capping

The study revealed that before interest rate capping, those who borrowed funds were 85 out of the 89 respondents as per the table below. 65 of them received the exact amount they had requested loans for from Commercial Banks while only 20 had their amounts reduced due to issues such as high levels of security required and scrutiny levels by the banks as well as risk levels attributable to the firms.

RANGE AMOUNT OF LOAN REQUESTED AND COUNT -
before capping Crosstabulation

Count

		Amount_Received		Total
		EXACT	LESS	
ED	RANGE_REQUEST 0-100K	4	0	4
	100K-500K	11	0	11
	500K-1M	23	1	24
	ABOVE 1M	27	19	46
Total		65	20	85



4.2.1.2 Amount of Loan Requested versus that Received after Interest Rate Capping

From the data below, after interest rate capping, there was a slight increase in the total number of borrowers especially with regards to the larger amounts. This can be attributed to the reduced and controlled cost of borrowing thus encouraging firms to request for a higher amount of loans.

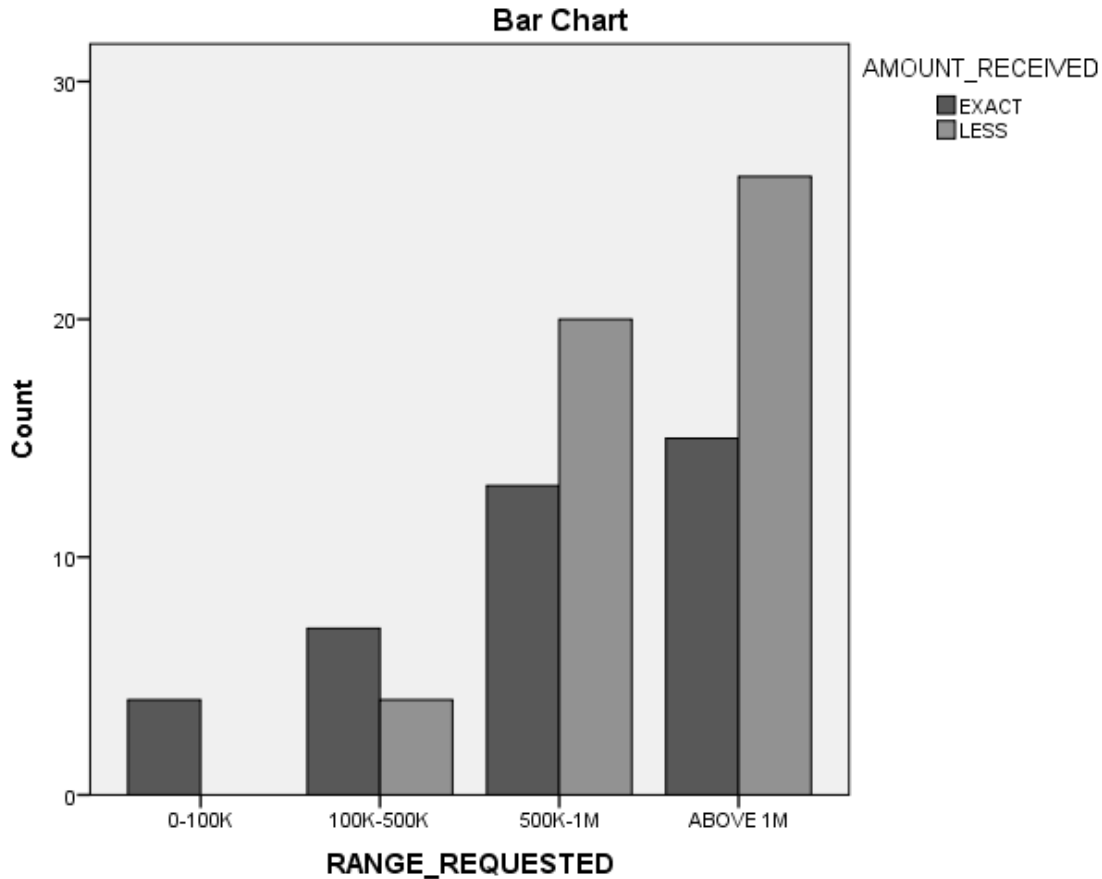
Case Processing Summary

	Cases					
	Valid		Missing		Total	
	N	Percent	N	Percent	N	Percent
Range_Requested * Amount_Received	89	100,0%	0	0,0%	89	100,0%

RANGE AMOUNT OF LOAN REQUESTED AND COUNT - after Capping Crosstabulation

Count

		Amount_Received		Total
		EXACT	LESS	
RANGE_REQUESTED	0-100K	4	0	4
	100K-500K	7	4	11
	500K-1M	13	20	33
	ABOVE 1M	15	26	41
Total		39	50	89



Descriptive statistic before the capping and after the capping

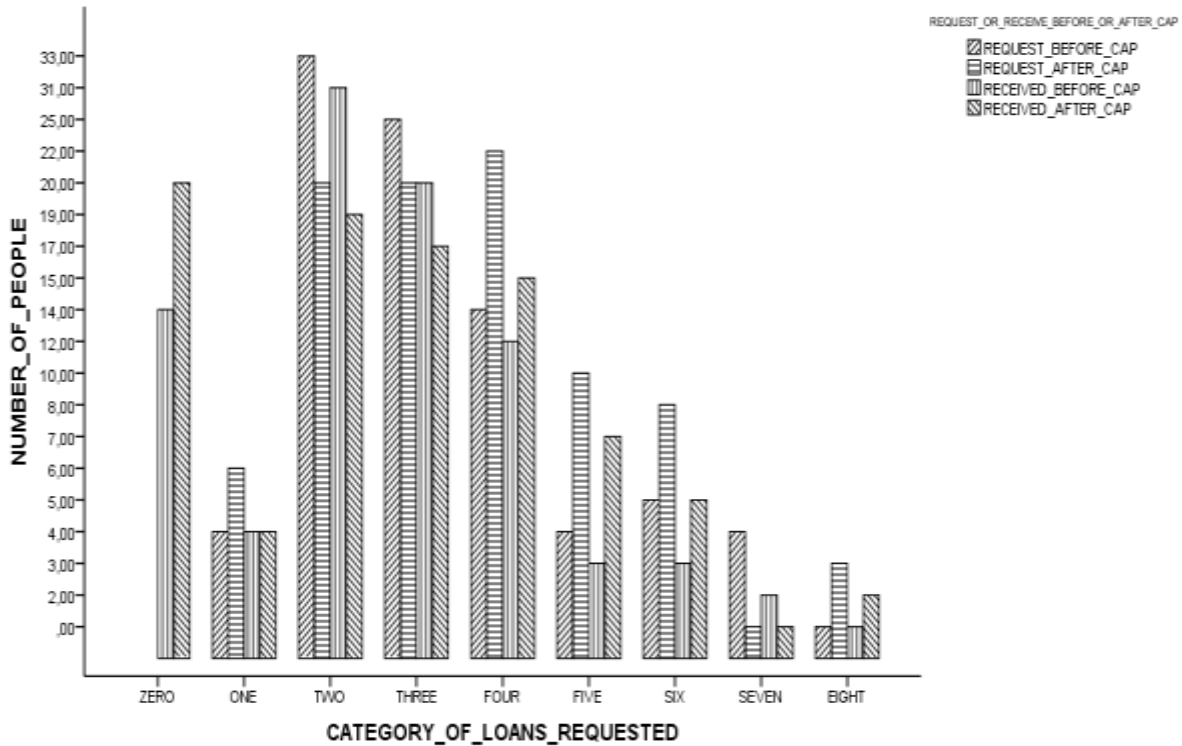
4.2.2 Time Taken To Process The Loans

The time taken for loan processing for the SMEs under study was found out to have increased and most respondents attributed it to the lengthy scrutiny and security measures by lending institutions. Banks are faced with a large number of borrowers who were encouraged by the controlled lower cost of credit that followed the law of demand-the lower the cost, the lower the demand and the higher the cost of an item, the lower the demand.

Higher bottlenecks were experienced by the SMEs in study thus lengthening the time taken to receive their loan requests as per the table and graphs below:

4.2.2.1 Number of Loan Requests

As per the table and graphs below, the number of loan requests is seen to have increased. This is attributed to the reduces cost of borrowing brought about by the interest rate capping.



4.2.2.2 Number of Loan Requests Received

The percentage of the loans requested versus that received is however seen to have reduced after interest rate capping as per the table above. Respondents indicate that this was due to the higher number of bottlenecks introduced by banks to control lending to small scale borrowers thus their presence to large scale borrowers. The number of loans requested after the interest rate capping is also seen to have increased with the respondents indicating that the interest rate became more affordable thus encouraging them to go for more loan facilities. However they indicated that they were under much scrutiny by the bank and more bottlenecks were introduced due to their high risk nature.

4.3 Secondary Data from CBK

CBK data indicates that there has been a negative effect on lending to SMEs due to the mitigation structures instituted by commercial banks. High security measures were instituted so as to control credit risk. 62% of the commercial banks have actually indicated the same in the first quarter of 2018 and 55% in the last quarter of 2017 thus an increase in those banks that have more bottlenecks. The second quarter of 2018 revealed a 57% who still feel interest rate capping has a negative impact on lending to SMEs (CBK, 2018). This means then that even banks realize that due to the controlled interest rates they have to introduce more measures to control the risk of default by the many small scale borrowers.

4.4 Summary and Interpretation of the Findings

As per the above analysis, it can be seen that there was an impact on credit accessibility due to interest rate capping on SMEs in Nairobi County. The amount of loan requested by the SMEs increased considerably due to credit becoming more affordable. On the other hand, the number of those who registered to have received their loan amounts as requested reduced after capping and most attributed this to the large number of bottlenecks instituted to discourage them from borrowing. The time taken for SMEs to receive their loan requests is seen to have gone up after the capping of interest rates in September 2016. This was perceived by the respondents to be strategy to discourage them from borrowing. On the other hand the number of loans requested increased after interest rate capping as SMEs were encouraged to go for more credit due to the increased affordability. However there was a considerable increase in the number of loan requests that were rejected.

The above results indicate that there is a general negative effect on credit accessibility by SMEs due to interest rate capping as more stringent measures have been introduced to control or reduce lending to small scale borrower. Those at the advantage are large corporations and the government that are less risky and due to economies of scale banks are able to glean more profit from such. The SMEs therefore end up not accessing as much credit as they would need for their expansion and growth. This is seen by the reduction in the number of those who received their loans as requested and an increase in the time taken to process the loans and increase as well on the number of rejected loan applications.

CHAPTER 5: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter explains the summary and conclusions of the study. It also explains the recommendations for the purpose of policy and practice as well as pointing out the limitations of the study and indicating suggestions for further study.

5.2 Summary

This study endeavored to establish the impact of interest rate capping on Credit Accessibility in the case of SMEs in Nairobi County. Several stakeholders had raised concerns over the negative effects brought about by interest rate capping contrary to expectation that credit would be more affordable thus higher financing for businesses and start-ups. Interest rate capping means a control on the interest rate charged by lending institutions such as commercial banks, micro-finance institutions and other non-bank financial institutions. Interest forms the major income of financial institutions and thus by capping it then this means the profit is curtailed compared to the previous periods before September 2016 when lending interest rates were liberalized. Financial institutions therefore have to devise ways and thus strategies to survive and make profit. The bid to cap interest rates was not welcome to many especially commercial banks who resorted to strategies that would lock out many households, individuals or firms with high default risk and this was general because of their size which was deemed to affect their payment capabilities. Hence many 'small scale' borrowers would or are being left out while lending shifts to the 'large scale' and thus less risky borrowers like the government and corporations. Small scale borrowers include households and small firms and in this category are Small and Medium Enterprises (SMEs).

The data in this study was collected for a total period of 4 years or 48 months. The four years were split into two-two years before interest rate capping that is September 2014 to September 2016 and two years after interest rate capping-September 2016 to September 2018. This was to allow for comparison of Credit Accessibility before and after interest rate capping for SMEs. Credit Accessibility was analyzed using the following parameters: Amount Received versus amount borrowed before and after interest rate capping, Time taken for loans to be processed

before and after interest rate capping, Number of loans accepted versus Requested before and after interest rate capping and Number of loans Rejected versus Requested after interest rate capping. Data was obtained first hand and second hand from the primary source which was a sample of SMEs in Nairobi County. Both descriptive and statistical analysis was conducted on the data obtained from the two periods to make statistical conclusions of the impact of interest rate capping on credit accessibility by SMEs in Nairobi County.

Descriptive statistical analysis showed that the mean, maximum and minimum amounts of loans advanced to SMEs have reduced, the time taken for them to access loans have increased, the number of loan requests received may have increased due to high credit uptake but when compared to those rejected before and after there seems to be an increase as lending institutions have shifted towards large scale borrowers.

5.3 Conclusions

The results of this study indicate that there is a relationship between interest rate capping and credit accessibility. While credit becomes more affordable, it may not be easily accessible due to crowding out effect by lending more to large corporations and the government who have lesser default risk than small firms (SMEs) and households. The results indicated that there has been a negative impact on credit accessibility by SMEs contrary to the previous expectation that credit would be more accessible. SMEs therefore have to rely on other means of financing from unregulated borrowing or lending.

The results of this study therefore show that if the law on interest rate capping remains in place, SMEs may continue not being able to access credit easily and since this is needed for financing, some may end up closing shop due to inadequate financing. SMEs will alternatively keep relying on unregulated financing to access credit easily and since they play a significant role in the economy of Kenya, their contribution to growth should not be overlooked as the failure and collapse of this sector of the economy affects employment and people's income and eventually the GDP of Kenya wherein they contribute close to 50%. Thus this study found out that interest rate capping has negatively affected credit accessibility with regards to SMEs in Nairobi County thus having a detrimental effect.

5.4 Recommendations of the Study

This study recommends that the law on interest rate capping be reviewed to allow for more flexibility so as to encourage the banks to lend out to the areas of the economy that they deem risky such as the SMEs. This is because SMEs will continue shying off from borrowing from the commercial banks who institute stringent measures and security requirements for them to access credit facilities and this makes them resort to borrowing from unregulated financiers such as shylock schemes. Alternatively the government can facilitate lending to SMEs by commercial banks by providing standard minimal requirements for borrowing. This study also recommends that while it may take time or while the law on interest rate capping remains in force, commercial banks should introduce strategies to reduce their operational costs and thus increase how much in terms of profit that they glean through charging interest rates. However in future periods, all major sectors of the economy especially SMEs should be carefully considered when making such major economic decisions.

5.5 Limitations of the Study

The major limitation of the study was the time frame or period at which the study was conducted. It considered 2 years before the interest rate capping and 2 years after interest rate capping. A longer period if put in consideration may yield much solid results and may actually give a better overview of the long term effect of the law on interest rate capping on credit accessibility. One question that would be answered is would the results be different in the long run than in the short run.

5.6 Areas for Further Research

The study was conducted on the impact of interest rates on credit accessibility by SMEs in Nairobi County. This study recommends the same research to be carried out to more counties in Kenya to get a better view and even out there in the countries where interest rate capping has been introduced to help determine its advantaged and disadvantages to the general economy. Further research can also be carried out on the impact of interest rate capping on credit accessibility by other sectors of the economy such as the public sector and large corporations.

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APPENDICES

Appendix 1: Questionnaire

Instructions: This study is focused on interest rate capping-setting of the maximum lending rate by financial institutions at 14% by the government in September 2016.

Kindly read the questions carefully. It is advised that you fill on each section as provided. Tick where appropriate.

PART A: Demographic Information

1. Which of the following best describes the nature of your firm:

Manufacturing

Trading

Services

2. What is your position of responsibility in the company?

Top level manager /Director

Middle level manager

Normal employee

3. How long has your organisation been in operation?

1-5 years

5-10 years

10-20 years

Over 20 years

4. What has been the estimated annual turnover of your organisation?

Up to Shs.100,000	Shs.100,000 – 500,000	Sh.500,000– 1,000,000	Over Shs.1 Mil
<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

PART B: Interest Rate Caping and Time taken to Process Loans

5. Does your firm obtain additional capital through debt?

Yes

No

6. How long does it normally (previously before September 2016) take to receive your loan requests and acceptances?

3 days to 1 Week

1 Week to 2 Weeks

2 Weeks to 1 Month

Over 1 month

7. How long does it now (after September 2016-interest rate capping) take to receive your loan requests and acceptances?

3 days to 1 Week

1 Week to 2 Weeks

2 Weeks to 1 Month

Over 1 month

8. How do you think interest rate capping has influenced the time for loan processing?

PART C: Amount of Loan Received versus the requested Amount

9. Kindly give an estimate of the amount of loan requested for the past 2 years:

Up to Shs.100,000 Shs.100,000 – 500,000 Sh.500,000– 1,000,000 Over Shs.1 Mil

10a). Kindly give an estimate of the amount of loan received for the past 2 years:

Up to Shs.100,000 Shs.100,000 – 500,000 Sh.500,000– 1,000,000 Over Shs.1 Mil

b) Given your answers in Q9 and Q10 above, would you say that there has been a change in the amount previously received before interest ate capping and afterwards?

Yes

No

c) If your answer to 10b is yes, how do you think interest rate capping has influenced the amount of loan received. Kindly explain.

PART D; Number of loans accepted and rejected before interest rate capping

11.What is the estimated number of loans your firm requested for the 2 years before September 2016 i.e between 2014 and 2016?

11b.How many of these loans did your firm receive for the 2 years before September 2016 i.e between 2014 and 2016?

12a).What is the estimated number of loans your firm requested for the 2 years after September 2016 i.e September 2016 to date?

12b).How many of these loans has your firm received for the 2 years after September 2016?

13.How has the interest rate capping affected the number of loans received? Please explain.

Thank you for your participation.

Appendix 2: List of Respondents

1. Black Rock Limited
2. Damamu Enterprises
3. Venus Caterers
4. Essah General Supplies
5. Cardiocope Medical Supplies Limited
6. Bentam Enterprises
7. Flex Office Systems Limited
8. Perception Concepts Limited
9. Dataline Enterprises
10. Top Notch Management Services Limited
11. JB Links International
12. Arrow Displays Limited
13. Lodestar Enterprises Limited
14. Ruler Enterprises Limited
15. Verizon Systems NV Limited
16. Graan Enterprises
17. Nuanjeliq Designs
18. Tciti Limited
19. Piety Commercial Solutions
20. Kobby Exporters Limited
21. Piccalily Internationasl Limited
22. Huckster Events
23. Halisi East Africa Heritage Limited
24. Blue Sky Energy Limited
25. Value Drops Ventures
26. Poly Ventures Limited
27. Dorado Travel Plus Limited
28. Teem Solutions Limited
29. Greatwak Technologies
30. Palm Shine Cleaning Services

31. Boulevard Contracts Limited
32. Crescit Logistics
33. Supremacy International
34. Lanton Cleaning Services
35. Dayam Enterprise
36. Jomuwaka Enterprises
37. Printing-Plus
38. Sky Investments Limited
39. Frilike Enterprises
40. Nashua Enterprise Limited
41. Kupa Constructions Limited
42. Dawood Solutions Limited
43. Crust General Supplies
44. Contrast Solutions Limited
45. Citiprime Venture Limited
46. Cintau Agency
47. Labyrinth Limited
48. Cintaru Agency
49. Moglas Enterprises
50. Mjiprint Stationery
51. Jilali Enterprises
52. Space-Bar Systems
53. Spaceven Ventures
54. Jeny Enterprises
55. Gracestep Company Limited
56. Eddan Systems
57. Dyncastle Investment Limited
58. Tessemin Enterprises
59. Mawals Enterprises
60. Hassdiq Investment Limited
61. Brackett Universal Kenya Limited

62. Kenthia Logistics
63. Radar International Services
64. Nuruz Company Limited
65. Eunifess Investments
66. Njos General Supplies
67. Victorock Kenya Limited
68. Gewan Ventures
69. Laibelos Enterprises
70. Eltam Limited
71. Shaly Enterprises
72. PM Verity Enterprises
73. Orion Commodities
74. Asili Group Limited
75. Damak Media Limited
76. Overflow Solutions Limited
77. Trademate Kenya
78. Trendy Fashions Limited
79. Recentia Limited
80. Salvat Holdings Limited
81. Devima Office Supplies
82. Dataline Enterprises
83. Lyca Venture Limited
84. Namwa Investments
85. Jemali Enterprises
86. Superclean Shine Enterprise Limited
87. Alphatech Digital Solutions
88. Xcel Enterprise Limited
89. Kabz Ventures