CHALLENGES IN FINANCING SMALL & MEDIUM ENTERPRISES (SMEs) IN KENYA
THE EXPERIENCE OF FINA BANK KENYA LIMITED

BY

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Declaration

This research report is my original work and has not been presented for a degree in any other University.

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This research report has been submitted for examination with approval as the University Supervisor.

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Epilogue

"When a piece of scholarly work can be read without effort, a lot of effort has gone into its writing".

»

Dedication

To my loving dad, the late

Mzee Wasonga Ondigo

Acknowledgement

I am deeply indebted to all those people who, in their own individual way, contributed either directly or indirectly to the successful completion of this project.
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Abbreviations

SMEs - Small and Medium Enterprises

CBS - Central Bureau of Statistics

MFIs - Micro Finance Institutions

DF1D - Department of Direct Foreign Investment

ILO - International Labour Organisation

NGOs - Non-Governmental Organisations

GoK - Government of Kenya

LDCs - Less Developed Countries

MNPD - Ministry of Planning and National Development

NFBIs-Non Bank Financial Institutions

FBL - Fina Bank Limited

EU - European Union

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Abstract

The study was seeking to determine the challenges faced in the process of financing SMEs in Kenya, examine how commercial banks with specific reference to Fina Bank are trying to address these challenges and to examine the banking needs of Small and Medium Enterprise in Kenya. The study was a case study and the unit of study was Fina Bank (K) Limited and therefore, no sample in the study. Primary data was collected using structured questionnaires while the published financial statements for the bank were the main source of secondary data. The questionnaires were divided into three sections; section A addressed the background information on Fina bank; section B addressed SME products offered by the bank while section C addressed the challenges commercial banks face in the process of extending finance to SMEs.

Out of 19 questionnaires distributed only 15 were filled and returned. This represented a response rate of 79% with a non-response rate of 21%. This was a good representation from the respondents which have resulted into conclusive research findings. Detailed information on bank's operation especially on the guarantee schemes, sources of funds and the total sum of SME lending book could not be availed due to bank's confidentiality policy. These were some of the challenges faced while collecting data in the field. An empirical survey should be done to include all of the 45 registered commercial banks in Kenya which might produce representative results. Small business enterprises financing faces various challenges in the process of accessing credit from commercial banks in Kenya.

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

The research revealed that 33% of SME customers preferred business loans with 60% of the applicants goes for loans rangiog between Kshs. 500,000 and Kshs. 1 Million. Most SMEs do not submit mandatory documents required for financing by commercial banks. 100% of SMEs submit balance sheets, 66.7% cash flow

projections while 53.3% submits certificates of registration/incorporation. This indicates a bigger challenge the commercial banks face in financing this sector. Securities provided are also weak as 22% provides chattels mortgage and inventory hypothecation while 4% provide housing as their collateral.

The study recommends that a further research can also be done on the challenges facing Small and Medium Enterprises in getting financing from commercial banks in Kenya and a more detailed research could also be done to look into different financing strategies adopted by commercial banks in serving the SME sector.

CHAPTER ONE

1.0 INTRODUCTION

1.1 Background of the study

Small and Medium Enterprise (SMEs) firms play an increasingly important role in a country's economy; therefore, the well-being of these firms is a necessity for a country's future success. EU commission recommendation (2003), show that Micro, small and medium-sized enterprises are socially and economically important, since they represent 99 % of all enterprises in the EU and provide around 65 million jobs and contribute to entrepreneurship and innovation. Ayyagari, Beck and Kunt (2002) in a comparative study showed a marked increase in the SME sector's contribution to total employment from the low-income countries (17.56%) to the high income (57.24%). The SME share of GDP followed a similar trend increasing from 15.56% of GDP in the low-income countries to 51.45% in the high-income countries.

In Kenya, SMEs employed 5.1 million people in 2003 and accounted for about 18 percent of GDP. By streamlining the problems of governance and finance that hinder SME growth, the rate of employment and SME contribution to GDP in the next five years could be doubled (Ministry of Planning and National Development, 2006). Africa's private sector consists mostly of informal micro- enterprises operating alongside large firms. Between these large and small firms, Small and Medium Enterprise (SMEs) are very scarce and constitute a "missing middle" (African Development Bank and Organization for Economic Co-operation & Development Centre, 2005).

In 1999, there were approximately 1.3 million Small and Medium Enterprises (SMEs), creating employment for 2.3 million people. Of these MSEs only 9,041 fell into the 11-50 employees- this lack of enterprises in this bracket comprises of the "missing middle" of the SME sector in Kenya (Central Bureau of Statistics [CBS], 1999).They are considered too large to be classified as micro enterprises yet too small to be considered large industry. Currently, there is an estimated number of 22,000 SMEs in Kenya (66%) of all formally registered private enterprises compared to 3.5 million micro-enterprises (MNPD, 2006)

Of all the major problems facing SMEs in Africa, Kenya has identified two as the most critical. The first one is lack of a supportive governance framework. SMEs suffer due to lack of a legal framework that protects their interests, harassment from local authorities, unsupportive tax regime (Turnover Tax being introduced by Minister for Finance to be operational on June 1, 2008) and exposure to corruption. The second reason is lack of inadequate access to credit (MNPD, 2006). SMEs have little access to finance, which thus prohibits their emergence and eventual growth. Small and Medium Enterprises have been sourcing their funds from Micro-finance institutions in Kenya. Such micro-finance institutions are; K-Rep, Faulu Kenya, Kenya Women Trust Fund and many more. This has not been easy for SMEs due to the stringent credit terms offered by Micro-financial institutions. Most of small businesses do not have access to finance due to lack of minimum requirements from commercial banks in Kenya. Most commercial banks have been hesitant in lending to the small businesses due to lack of collateral, credit history, financial statements and banking history. Their main sources of capital are retained earnings, borrowings from friends, family capital and informal savings, which are unpredictable, not very secure and have little scope for risk sharing. Access to formal finance is poor because of the high risk of default among SMEs and due to inadequate financial facilities (Kauffmann, 2005). In a recent study Atieno (2001) found that although informal finance provides easier access to credit, it is confined to specific activities and at lower levels of income, thus limiting its use.

Fair access to credit and banking services are a ladder to development and poverty reduction the world over. Access to a bank account gives an individual greater control and security over their money, and a loan from a credit organization can be vital in promoting enterprise development (DFID, 2007). Banks need to address the needs of these SMEs so that they can grow and expand and therefore be a major driver in the growth of the economy. Most commercial banks have been hesitant in lending to the small businesses due to lack of collateral, credit history, financial statements and banking history.

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

1.1.1 Small and Medium Enterprises

The definition of SMEs differ according to the type of the study one is carrying out or the size of the economy being studied, criteria used in a given country or study also differ depending on the purpose of classifying the business into small, medium or large. Ombok (1990) points out that the point under which an enterprise is deemed to be small and the way in which its size is measured has been a debatable subject for a long time. There is no general consensus as to the definition of what a small, medium or large business is. Itoh and Urat (1994) point out that while in countries such as the United States, Britain and Canada, businesses are defined in terms of annual turnover and the number of employees. In Japan such businesses are defined in terms of paid up capital and the number of employees. In Britain, a small business is an industry with annual turnover of 2 million pounds or less with fewer than 2000 paid employees while in Japan a small business is manufacturing firm with 100 million or less Yens paid up capital and 300 or less employees.

In Nigeria there is no single definition of a small business enterprise. In the 1990 budget, Federal Republic of Nigeria defined a small business enterprise (for the purpose of Commercial Bank Loans), as those enterprises with a turnover not exceeding 500,000 Nairas while for Merchant Bank Loans as those enterprises w ith capital investments not exceeding 2 million Nairas (excluding cost of lad) or a maximum of 5 million Nairas, (Ekpenyona 1992). Belandress (1987) defines small medium enterprises as the manufacturing or non-manufacturing service enterprises in which the owner manager is not necessarily actively engaged in production but performs the various tasks involved in the guidance and leadership without the help of a specialised staff. He further defines small businesses which are mainly family based, unregistered by the government or lack collateral as assets that are bankable.

The EU Commission recommendation (2003) on the definition of SME considers SMEs as small enterprises as enterprises which employs fewer than 50 persons and whose annual turnover and /or annual balance sheet total does not exceed EUR 10 million. The United State Committee for Economic Development (1978) outlines in one of their reports that a small business has two or more or the following characteristics:-

- Management independence - usually in small business enterprises, the managers are also the owners.
- Capital supply and ownership - an individual or a small group of individuals who hold the ownership supplies capital.
- Areas of operations in small businesses - areas of operations mainly local, workers and owners are in one home community but the need not be local.
- Size within industry is relative - usually the business is small when compared to the biggest firm in its field.

Kilonzi (1992) concludes that analyzing the problems facing the small business enterprises sector in Kenya is even complicated further by differences and ambiguities in the terminologies used. To him, small business enterprise is a general term, which refers to firms whose size is in some way limited. According to Fina Bank Credit Policy (2007), Small and Medium Enterprises are those businesses with employees not more than 100 people and an annual turnover of between kshs. 2 and 10 million. Therefore, this study will adopt the definition as described by Fina Bank.

1.1.2 Commercial Banks.

Commercial banks are normally reluctant to extend credit to Small and Medium Enterprises (SMEs) due to lack of securities that can be used as collateral in convectional lending process. Commercial banks perceive SMEs as a highly risky and undeserving of any credit even though the SME owners save with these banks. The costs associated with administering and monitoring credit services are quite. The loan value required by people in this sector is low hence proportionally low revenue is generated from the loans (Mudiri, 2003). Over the past few years banks have made a significant push in developing of SME products and provision of credit facilities to SMEs due to the prevailing high levels of profitability and economic growth. This has been witnessed as a result of bottleneck competition within the banking industry (Baydas et al, 1997).

1.2 Statement of the problem

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

Helmsing and Kolstee (1993) clearly indicates that despite SMEs perceived importance in generating employment and production, the SME sector in Kenya has very inadequate access to credit. According to the Poverty Reduction Strategy Paper (1999), a large number of Kenyans derive their livelihood from the SMEs. Therefore, the development of this sector represents an important means of creating employment, promoting growth and reducing poverty in the long-term. However, in spite of the importance of this sector^ experience shows that provision and delivery of credit and other financial services to this sector by commercial banks has been below expectation (Omino, 2005). Most financing, therefore, comes from own savings or informal credit markets controlled by NGOs and community welfare groups. Microfinance institutions have played a great role in the provision of credit and other services but under stringent credit terms which do not favour most SMEs. Despite all these benefits SMEs contributes to the economy of the country, commercial banks have been very reluctant in extending credit to this sector due to various challenges they face in the process. This study intends to determine challenges facing commercial banks in extending credit to SMEs and how they are trying to address these challenges. The study undertakes to answer the following questions: What are the challenges faced in the process of financing SMEs? How do commercial banks try addressing these challenges they face in financing SMEs and their banking needs?

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

1.3 Objectives of the study.

The objectives of the study are mainly:

a. To determine the challenges faced in financing SMEs in Kenya.
b. To examine how commercial banks with specific reference to Fina bank are trying to address these challenges.
c. To examine the banking needs of SMEs.

1.4 Justification of the study

Various studies have been done in the Small and Medium Enterprises (SME) sector locally but none of them has emphasized on the evaluation of challenges faced by commercial banks in financing SMEs. Mwaka (2006) focuses her study on the financial structure and growth of SMEs. The study assess the growth of SMFs but fails to deal with the challenges these businesses face in accessing finances from commercial banks. Rukwaro (2001) looks at the credit rationing aspect of financing on the micro-finance institutions and the influence on the operations of SMEs. This study does not touch on the financing of SMEs by commercial banks. Wanyungu (2000) on the other hand focuses on the financial management practices of SMEs in Nairobi and yet failed to tackle of the issue of challenges faced by commercial banks in providing credit to these firms. Mueni (2006) looks at the linkages between micro finance institutions and commercial banks in Kenya. The study does not address the issues on challenges faced during the process of accessing and lending credit by both SMEs and commercial banks respectively.

Kilonzo (2003) further examines the relationship between financial structure and performance of Micro and Small Enterprises in Nairobi. The study reveals that Micro and Small Enterprises are mainly finagced by internal funds. Dossajee (1992) in his study indicates that a number of variables combined could contribute to success of small businesses. These include hard work, optimism, trade credit, business contacts, capital base of the business capable manpower and ability to organize business operations. The study however fails to identify the challenges commercial banks face in providing credit to SMEs for their expansion of the businesses. Therefore, this gives the need to examine the challenges that may be faced by commercial banks, how to address these challenges and the specific banking needs required by SMEs to expand and manage their operations.

1.5 Importance of the study.

This study will be of great importance to different stakeholders in the society since majority of Kenyan population are focussing on self employment through these Small and Medium Enterprises. The following are some of the importance to be derived from the study.

Small and Medium Enterprises (SMEs)

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

Commercial Banks in Kenya

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

The Government

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

Academicians

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

Tax Authorities

Make recommendations to tax authorities so that they make efficient tax structures which are favourable to the SMEs.

CHAPTER TWO

2.0 LITERATURE REVIEW

2.1 Introduction

This chapter reviews literature guided by the objective of the study which is to examine the successful model of financing adopted by Fina Bank Kenya in financing of Small and Medium Enterprises in Kenya for the last three years. The chapter looks and tries to come up with a common understanding of the suitable models used by commercial banks in financing the SMEs. It also provides an enumeration of challenges encountered by SMEs in seeking finances and financial services from commercial banks. The chapter provides an evaluation on the effectiveness of the products offered and the nature of SME relationship with commercial banks. These considerations therefore, become the basis for the study.

2.2 Small and Medium Enterprises in Kenya

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

As globalisation intensifies and with global competition in labour intensive manufacturing large enterprises have sought and will continue to seek to evade mandated protection to labour by subcontracting to unprotected labour in the informal sector, therefore leading to the growth of the informal sector (Maloney, 1999). The informal sector has been described variously by a number of reports and scholars (ILO Report, 1972; Republic of Kenya, 1988; Ikiara, 1991 and Mc McCormick, 1998). Generally it comprises of semi organised registered and unregistered activities undertaken by self employed persons in the open air markets, market stalls, undeveloped plots or on street pavements within the urban centres with or without licenses from local authorities. The reason why the informal sector flourishes in Kenya is the operations of business without much restriction or regulation, the entrepreneur's flexibility in meeting customer needs and the goods and services provided depended on demand as perceived by entrepreneurs (Mc McCormick, 1998).

The informal sector will continue growing thereby providing income generating opportunities for those willing and able to take advantage (Myers 1977; Tokman. 1978). Shortage of credit has been identified as one of the most serious constraints facing SMEs and hindering their development.

The SMEs Survey (1999) indicates that most of the SMEs had never access to credit facilities with only a small portion (10.4%) of SMEs having received credit. The study observes that 89.6% of SMEs received credit from informal sector. It further notes that out of those who have received credit only a minority accessed the credit from formal financial sector. The sources of credit included NGOs (2.8%); Rotating Savings and Credit associations (ROSCAs) (2.5%); family members and friends (1.5%) and commercial banks (1.5%). The National Baseline Survey (1999) identified the following operational problems, 34% cited access to markets while 18% cited capital as operational problems. Other constraints were inadequate business support service, poor roads, transport, shortage of raw materials, poor security, lack of work site and others. Sessional paper No. 1 of 1986; Economic Management of renewed growth set out to create an enabling environment for SMEs. The 1979 to 1983 Development plan of the government of Kenya put forth a proposal that a credit scheme of Kshs. 50 million be set aside for lending to small enterprises. The Government of Kenya report on the strategy for small enterprises development sets out mechanisms for the removal of constraints to the growth and development of the SME sector.

2.3 Financial needs of Small and Medium Enterprises (SMEs)

The importance of Small and Medium Enterprises (SMEs) in the alleviation of poverty in Kenya has been recognised in the Ministry of Finance budget speeches (1999/2000, 2000/2001, 2001/2002, 2002/2003, 2003/2004). These businesses are largely undertaken by self-employed persons; own account workers or working employers of a small number of workers (Economic Survey, 2003). The SMEs employ nearly 2.3 million people or 29% of the country's total employment (CBS 1999). The SMEs have faced various challenges when seeking funds for investments. These SMEs cannot easily access funds from commercial banks due to their undeveloped businesses that have very short bank history making banks unwilling to lend them funds.

Owners ®f these businesses may not have a banking history with commercial banks that can form the basis of their lending. This possibly explains why banks in the late 1990s to early 2000 relocated their operations from rural areas to urban centres rendering potential customers in these areas to have no access to credits (Coetzee et al, 2002). SMEs need funds for new investments inform of business expansion. Rukwaro (2000) observes that most SMEs obtain funds from own sources, including savings, friends, family members, citing the fact that very few creditors are willing to lend for start up businesses. SMEs also need credit for operational activities and growth of business. Studies have also found that the most funds received from credit institutions are used as working capital (Gatune, 2002).

2.4 Access to Credit by Small and Medium Enterprises

In the recent past, presence of SMEs in all the major and secondary cities in the less developed countries (LDCs) is no longer an issue of dispute among stakeholders. In a World Bank study on lending to SME projects, three major objectives were more frequently cited; creating employment and income opportunities through creation and expansion of SMEs to increase the activity and income of vulnerable group especially women and the poor so as to decrease rural family dependency on drought through diversification of their income generating activities (Webster, Riopelle and Child Zero, 1996). World Bank Report (2001) states that, 80% of the world's 4.5 billion people living in low and lower middle income economies do not have access to formal sector financial services. About 360 million account for the unmet demand for the commercial savings and credit service from financial institutions.

2.5 Merits of Small and Medium Enterprises

Gaedeke et al (1985) cites that there are a variety of areas in which the small business owners enjoys distinct advantages that are the direct result of being small. SMEs also provide various advantages to the entire economy,

a) Personalized customer service.

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

b) Superior knowledge of their customers and markets.

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

c) Close ties to the community.

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

d) Personalized approach with employees.

The personalized approach of many small businesses is the fertile ground to attracting employees who want to be thought of and treated as individuals. Employees value the personal relationship with the manager brought about by direct face-to-face communication.

e) Flexibility of management.

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

2.6 Challenges in accessing credit facilities from commercial banks.

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

2.6.1 Credit Risk Management

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

Risk is exposure to a proposition of which one is uncertain (Holton, 2004). The Basle committee (1999) states that a number of major world's commercial banks have developed sophisticated systems to quantify and aggregate credit risk upon which their lending is determined.

Credit risk management refers to the systems, procedures and controls which a company has in place to ensure the efficient collection of customer payments and minimise the risk of default, (McMenamin, 1999).

2.6.2 Credit Assessment

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

- ***Character: -*** This can refer to managerial ability and also personal integrity. While judging the personal integrity of anyone is a delicate matter, we try to look for indications which reflect these personality traits. These are items which can inform our decisions as to the credit worthiness of the proposal and the character of the borrower. These include; reference of the borrower, suppliers to the borrower, customers served, skills to do the business, personality and commitment to repay the loan facility.
- ***Capacity:-*** Capacity refers to the ability of the borrower to generate enough cash sales to meet the operating needs of the business and to also meet all the

debt repayments (current debt payments and projected). Capacity mainly deals with cash, because it is cash which pays back the loan. This gives main focus on the cash flow, customers, competition, suppliers, market strategy and product or service.

- ***Collateral:*** - Cash generated from the business is the primary source of loan repayment. Regardless of the best efforts and analysis, loans go delinquent and borrowers default. This leads to the secondary sources of repayment which is the collateral. These are the assets lenders take to secure the loan. Adequate collateral coverage is necessary to protect the banks in case of default. This mainly focuses on liquidity, location of the business and legal consideration.
- ***Conditions: -*** All businesses including SMEs are influenced by the economic environment in which they operate. These are the general conditions which can have positive as well as negative impacts on borrowers and their ability to repay loans and remain viable business concerns. These influences can come from main sources including both macro and micro economic changes and legal environment.
- ***Capital: -*** This is also referred to as Owners Equity or Shareholders Equity. This represents what the borrowers can lose personally if the loan goes into default and subsequently declared bankrupt/non-solvent. Lenders want to ensure that when they make loans which goes into default, then the borrower (as the company and personally) is hurt as much or greater than the lender. The potential for hurt is a greater motivator to help ensure that the business operates as successfully as possible.

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

2.6.3 Information Asymmetry.

The problems faced by small firms when attempting to raise finance may also arise from information asymmetry. The nature of the information asymmetry problem on the firm's side is that it cannot proye the quality of its investment projects to the provider of finance. Small firm managers often suffer from a lack of financial sophistication, as they are often product or service specialists, not specialists in the area of finance. Thus, the information asymmetry problem is partly one relating to difficulties in the spheres of communication and credibility (Fischer, 1995).

This is compounded by the fact that new or recent start-up businesses may be unable to provide evidence of a good financial performance track record. Banks in particular rely on past financial performance as an indicator of the future profitability of projects. This can be resolved by demonstrating creditworthiness and project viability. However, because of poor accounting practices and record keeping, many SMEs are unable to do so (Cook and Nixon, 2000).

2.6.4 Firm Characteristics

Other small firm financing problems relate to the characteristics of the firm itself, the attitude and objectives of the owner-manager. Such characteristics include (heir diversity, their higher risk, their inability to provide strong collateral, and stage of development effects. Binks and Ennew (1996) notes that there is no such thing as a typical small firm. This heterogeneity presents lenders with great difficulty in determining the risk associated with the firm's projects. Owing to the lack of business experience of many small owner-managers in the early years of the business, business risk may be more significant than for larger firms. Small and medium firms generally have smaller financial reserves to draw on in times of crisis and are also relatively highly geared compared to larger firms. Thus, such firms are characterized not only by higher business risk but also higher financial distress risk. Banks tend to respond to this risk by adopting a capital-gearing rather than an income-gearing approach to lending. Thus, rather than focusing their attention on evaluating the income streams flowing from an investment project, they may focus more on the value of collateral available in the event of financial distress. This creates a problem for small firms in that they often do not have significant fixed assets to secure on in their early years of establishment.

The stage of development, then, may be an important determinant of, and constraint on, the type and amount of external finance raised. Small firm financing, then, will typically be heavily secured debt, with few incidences of external risk capital contribution (Cruickshank, 2000). The reasons for lack of credit for formal enterprise are difficulties in loan administration like screening and monitoring, high transaction costs, and the risk of default. Credit markets are characterized by information asymmetry, agency problems and poor contract enforcement mechanisms (Aryeetey, 1996a). They are mainly fragmented because different segments serve clients with distinct characteristics. Because of this, lending units are unable to meet the needs of borrowers interested in certain types of credit.

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

2.6.5 Appropriate Information

Edwards and Turnbull (1994) found out on unexpected lack of appropriate information collection within companies. In the smallest retailing companies the lack is particularly marked. However, the nature of the problem was such tiiat improvement was apparently possible. Three deficiencies capable of immediate change were identified. First, companies probably failed to produce budgets with sufficient frequency. Second, the planning horizon was generally very restricted, and third, companies failed to use sensitivity analysis. Elijah (2007) points out that lending to Small firms is difficult because of the problems of information asymmetry.

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

2.6.6 Bank Lending Culture

Binks, Ennew and Reed (1990), also identified a gap in the financing of SMEs w hich they argued might be closed if banks were willing to lend on the basis of future cash flows. This, they argued, would require a change of culture within the bank.

The results from Cowling and Westhead (1996, pp. 52-68) study suggests that firms with few employees generally borrowed from local branches while a significantly higher proportion of larger firms dealt with regional offices. Contrary to popular myth, firms whose bank loans were obtained from a local branch generally received the best all round lending conditions. However, this additional assistance and service did not come free. This group of firms had loans with slightly higher interest margins.

In addition, it showed that bank lending decisions by local branches and regional offices were, in part, influenced by the size of the firm requesting a loan. However, when these size effects were stripped out and controlled, they found the need for collateral by banks had a considerable influence on their lending decisions (Cowling and Westhead, 1996). Most notably, firms dealing with regional offices generally needed to provide collateral. Further, firms dealing with local branches had a tendency to provide more collateral than was requested.

Large foreign banks with a limited knowledge of local markets may, for instance, prefer to grant credit on a transaction-by-transaction basis, using standardized decision rules when assessing creditworthiness. This may especially be the case if the foreign head office is chartered in a country with a significantly different culture and language (Berger, Klapper and Udell, 2001). Foreign banks may also focus more on serving multinational corporations from their home country (Sabi, 1988). In contrast, smaller domestic banks, with more knowledge of the local business sector, will base their credit decisions on idiosyncratic and "soft" information and will build up client relationships (Berger and Udell, 1995, 2002). They may also have a greater commitment to local prosperity (Collender and Shaffer, 2003).

Some of studies confirm the hypothesis that banks lend less to informational opaque SMEs. In the U.S., large banks tend to supply less credit to small firms (Berger and Udell, 1995; Berger and Udell, 2002; Goldberg and White 1999). They find that large, foreign-owned banks have more difficulties in lending to small firms, although this result only holds for foreign banks that are headquartered in a geographically distant nation

Keeton (1996) finds for the U.S. that banks that form part of an out-of-state holding bank are less likely to grant credit to local businesses.

2.7 Relationship between Banks and SMEs

Financial service organizations operate in a high contact business where the nature of buyer-seller interactions and the establishment of long-term relationships based on confidence and trust have real implications for successful retention of customers and recruitment of prospects (Ennew and Etal, 1997). A survey of senior financial services marketers' revealed that after pricing policy they perceived the interface with customers as the second highest potential for improving company performance (Easingwood and Arnott, 1999). Relationship banking is defined by Moriarty et al. (1983) as "a recognition that the bank can increase its earnings by maximising the profitability of the total customer relationship over time, rather than seeking to extract the most profit from any individual product or transaction" (p. 4). Such an emphasis is in keeping with the dominant trend in business - the shift from a transaction orientation to one of long-term interactive relationships - and would be expected to exist in the banking-enterprise arena. Small firms and banks, however, despite their importance to each other in economic and social development, experience relationship difficulties.

The relationship between banks and small businesses is invariably a long term one and the extent to which a bank can meet its customers' needs effectively is heavily dependent on the willingness of the customer to provide appropriate information (Binks and Ennew, 1996). This need is particularly in evidence in the context of lending decisions. Furthermore, building effective and successful relationships can contribute significantly to customer satisfaction, loyalty and retention and thus to improved performance (Reichheld and Sasser, 1993; Rust and Zahorik, 1993).

Competitive, regulatory and product-market changes require banks not only to recruit new business, but also to retain existing customers through relationship development.

In the personal banking sector, the huge investment made to attract and retain personal accounts, through product incentives and high levels of media spend is notable. In commercial or business banking, the relatively recent introduction of "small business banking" specialist units and services packages now offered by commercial banks in Kenya is in the same vein.

Given their distinctly different characteristics and experiences, it should not be surprising that small firms and banks find it difficult to develop good working relationships. Following Mintzberg's classic categorisation of organisation structures, the bank is a "machine bureaucracy", wherein rules and regulations tend to supersede managerial discretion. Decisions are routinized; unanticipated problems upset systems and managers (Butler and Durkin 1998). In contrast to this, the typical entrepreneurial small firm is organic and informal - the "simple structure". The owner-manager makes his or her own decisions, usually quickly, and often intuitively. Nutt (1989), reporting on cultural influences in bank loan decisions, states that "findings suggest that the personal decision style of bank executives has less impact on their decision making than the culture in which they operate". In almost every aspect of organisational structure and behaviour, the typical bank and the typical entrepreneurial small firm are at opposite ends of a continuum.

A further understanding of the problem between bank officials and entrepreneurs can be found in terms of empathy. There is a profound difference in the realities of daily working lives of both actors. The branch bank manager - and it is at this level that the vast majority of small firms owner-managers contact the bank - has been socialized in process, procedure and standardization of work. This leads the bank manager to tend to analyze, prioritize and impose a particular kind of order on the small firm, who's internal and external environments are radically different from those of the bank. This is the opposite of the entrepreneur's view and understanding of the world and of what makes a successful manager, i.e. taking risks, informally planning, following hunches (Butler and Durkin 1998).

In Butler and Durkin (1995) it was ascertained that small firm owner-managers and bank managers had self-perceptions and perceptions of each other that were often "critically mismatched". For instance, where the bank felt itself (indeed, prided itself) on being procedural, systematic, and prudent, the small firm perceived those factors as obstructive, procrastinating and tcarfuI of natural commercial risk. On the other hand, where the small finn perceived itself to be risk-taking, entrepreneurial and innovative, the bank perceived it to be foolhardy, immature and lacking in an understanding of commercial consequence.

These perceptions underpinned the parties' expectations of each other, which both entrepreneur and bank managers consistently described as "unrealistic". The gaps between the parties' expectations of each other come to light when they move into the early stages of relationship development. For instance, the banks' expectations of their new small firms' clients include track records, forecasts and some form of collateral. The typical small business, in applying for funding, also seeks support, empathy and advice from the bank. The gaps between these mutual expectations are at the source of many of the relationship difficulties. Without each party having a deeper understanding of the others' fundamental characteristics, objectives and constraints, mutual expectations are likely to be unrealistic, and their relationship consequently problematic.

Paulin, Jean, Ferguson, Salazar and Seruya (1998) in their study of commercial banking illustrated the conceptual and managerial importance of relational norms in a business-to-business service environment. Showed, the higher the client-company's assessment of the strength of the bank-client relationship, as measured by relational norms, the higher the client-company rated the external effectiveness and the lower was the likelihood it would switch to another bank. Convincing client-companies to want to rather than have to remain in a long-term relationship did not seem to be a priority in commercial banking. In fact, bank personnel did not appear to be in touch with the needs and perceptions of client-companies. This was a reflection of a preoccupation with internal rather than external effectiveness. However, in a global economy, attracting and keeping valued segments of knowledgeable and mobile client-companies will require an understanding of the prerequisites of external effectiveness. Among other things, effective service management in commercial banking would involve improvements in the manner in which account managers are selected, trained, supported and rewarded (Paulin et al. 1998).

As many of these small firms have the potential to grow much larger and inevitably become much more profitable for banks, then it would be in the best interests of banks to attract and retain this profitable customer segment and facilitate their growth in the longer term (Butler and Durkin, 1998). This, however, would not appear to be the case, given past and current criticism of the small business/bank relationship.

Murray and Walbridge (2000) emphasize the fact that "'the major banks have never really liked small business customers" and assert that banks are quite often ambivalent towards such clients. The fact that predicting how well a start-up business will perform, or if in fact it will survive, is difficult, and is offered as one of the main reasons why banks are skeptical of their small business clientele.

The relationships formed between buyers and sellers need to be built on mutual trust and commitment if they are to be developed and maintained in the long term. By their very nature financial services tend not to be one-off purchases but ones which are required on recurring basis with he result that there is a clear need for financial services suppliers to establish initial relationships with their prospects while at the same time maintain and develop long-term relationships with existing customers. Furthermore financial services are based on customer trust and confidence not only in the organization supplying these services but also particularly in the customer contact employees themselves (Christopher, Payne and Ballantyne, 1991).

CHAPTER THREE

3.0 RESEARCH METHODOLOGY

3.1 Research Design

The research design used for this study was a case study. It is a case study design where the unit of study was Fina Bank Kenya Limited. Case studies are most appropriate when detailed analysis for a single unit of study is desired. Case studies provide very focused and valuable insights that may otherwise be vaguely known or understood.

Churchill et al (2002) observes that cases will be most valuable depending, of course, on the problem in question. They further observe that the frequently used example of cases to develop insights is benchmarking since it involves identifying one or more organisations that excel at carrying out some function and using their practices as a source of ideas for improvements. This justifies the use of case study in this research in order to establish various challenges faced in the process of financing Small and Medium Enterprises in Kenya with specific reference to Fina Bank Kenya Limited.

3.2 Sample

The study was a case study and therefore, no sampling was done as the study focused on Fina Bank Kenya Limited.

3.3 Data Collection Methods

The study used primary data collected from Fina Bank staff from credit administration, credit risk, special assets departments, SME relationship managers and the head of SME banking using a structured questionnaire (see appendix 1). At the same time the study also used secondary mainly the published financial statements sourced from the bank's website, bank's credit policy and various guarantee agreements. The detailed questionnaires were constructed using open-ended, closed - ended and likert scale type of questions. The questions contained in the questionnaire were in different sections to simplify the work of the respondents as well as for classification purposes. The sections are as: Section A: Background information of the bank where variables such as age of the bank in the market, bank size in terms of size, branch networks, total assets, lending book size were outlined; Section B: SME products offered by the bank such as the loan types offered, asset finance, business loan, trade finance; Section C: this focused on the challenges faced in the process of financing the SMEs such as credit requirements, security needed, financial statements, certificates of registration, banking history.

The questionnaire method was appropriate as the respective bank officials were able to give related information depending on their area of operations and skills. Secondly, questionnaires were convenient to the bank officers to fill them at their own time. Direct face to face interview was also used in limited occasions for various clarifications on related information that the questionnaires could not address directly.

3.4 Data Analysis

Descriptive statistics were used to determine the various challenges commercial banks in Kenya face in the process of financing SMEs, the banking needs of SMEs and how commercial banks are trying to address these challenges. At the same time a five point likert scale was used to determine the importance of different financial ratios used in the credit analysis process, financial statements required and the recovery methods used by the bank. Mugenda (1999) indicates that likert scale reduces the level of subjectivity employed and enables the use of quantitative analysis.

CHAPTER FOUR

4.0 DATA ANALYSIS, PRESENTATION AND RESEARCH FINDINGS

4.1 Introduction

The chapter presents the analysis of the data collected and interpreted on the challenges commercial banks face in the process of financing Small and Medium Enterprises. The objectives of the study were to determine various challenges commercial banks face in the process of financing Small and Medium Enterprises, their various banking needs and how commercial banks try to address these challenges.

The data was collected from Fina Bank Kenya Ltd. The questionnaires were self administered and data were collected from the heads of Credit, Group Risk, Special Assets, SME banking, SME credit analysts, Credit Administration team, and the SME Relationship Managers/Officers. The bank's financial statements were also of vital information. It provided data on the bank's total assets and liabilities in the previous financial year.

Table 4.1 Overview of data collected

	Officers Given Questionnaires	Administered Questionnaires (t)	Response rate (r)
1	Head of Credit	1	1
2	Head Group Risk	1	1
3	Head Special Assets	1	1
4	Head SME Banking	1	1
5	SME Credit Analysts	3	2
6	Credit Administration Team	3	2
7	SME Relationship Managers	4	4
8	SME Relationship Officers	5	3
	Total	19	15

Key: t = No. of officers given questionnaires r = Response rate (78.9%)

Source: Research Data

Out of the 19 questionnaires that were circulated, 15 were dully filled and returned by the respective bank officers. This represents a response rate of 78.9% which is considered significant enough to provide a basis for valid and reliable conclusions with regard to the challenges the commercial banks face in the process of financing Small and Medium Enterprise.

4.2 The Background of Fina Bank Kenya Ltd

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

Size	
Assets	Kshs. 8.6 billion
Employees	130
Branch Network	8
Regional Presence	Kenya, Uganda & Rwanda

Source: Research Data

Fina Bank was incorporated as a commercial bank in 1996 having previously operated as a non-banking financial institution since 1986. The research has revealed that it is a private liability company and has assets worth Kshs. 8.6 billion, 130 employees. 8 branches countrywide and has subsidiaries in Uganda and Rwanda. The bank is currently expanding their operations by increasing their branch network in the three countries.

4.3 SME Products offered by the bank.

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

	Preference of the Products				
Product	Low	Medium	High	No. of Responses (r)	Perce (%)
Business Loan	-	-	30	30	33.3
Asset Finance	-	-	10	10	11.1
Letters of Credit	-	10	5	15	16.7
Bid Bond	5	5	5	15	16.7
Bank Guarantees	5	5	-	10	11.1
Temporary Overdrafts	-	-	10	10	11.1
No. of Responses	**10**	**20**	**60**	**90**	
Percentage (%)	11.1	22.2.	66.7		

r=No. of Products x No. of Respondents (6x15 = 90)

Source: Research Data

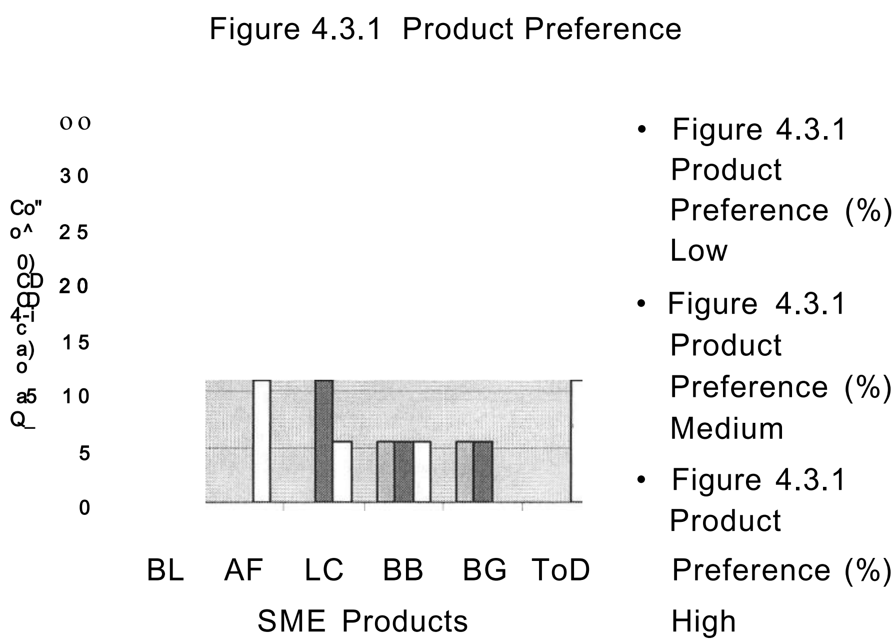
The SME products offered by the bank are; Business Loans, Asset Finance, letters of Credit, Bid Bonds, Bank Guarantees and Temporary Overdrafts. High, Medium and Low preferences accounted for 66.7%, 22.2% and 11.1 % of the responses gathered from the respective bank officials who responded.

Table 4.3.2 Percentage presentation of the preferences of the products

Product/Preference	Low %	Medium %	High %
BL	-	-	33.3
AF	-	-	11.1
LC	-	11.1	5.6
BB	5.55	5.55	5.6
BG	5.55	5.55	-
ToD	-	-	11.1
Percentage (%)	**11.1**	**22.2**	**66.7**

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

Figure 4.3.1 Products Preference



Source: Research Data

The research reveals that 33.3%, 11.1%, 11.1%, 5.6% and 5.6% of SME customers highly prefer Business Loans, Asset Finance, Temporary Overdrafts, Letters of credit and Bid Bonds of the products offered by the bank. While at medium preference

Letters of Credit, Bid Bonds and Bank Guarantees accounts for 11.1%, 5.55% and 5.55% respectively. SME clients at low level give the same preference of 5.55% to Bid Bonds and bank Guarantees.

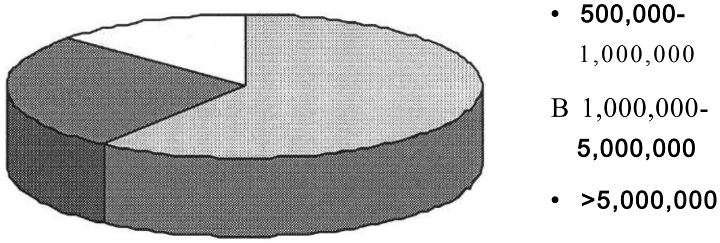
Table 4.3.3 Loan Amount Frequently Sought for by SME

Range - Loan Amount (Kshs)	No. Respondents	Percentages (%)
500,000- 1,000,000	9	60.0
>1,000,000- 5,000,000	4	26.7
>5,000,000	2	13.3
Total	15	100

Source: Research Data

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

Figure 4.3.2 Loan amount (Kshs.) Frequently
Appied for No. of Respondents



Source: Research Data

Most (60%) of the SME customers apply for loans ranging between Kshs. 500,000.00 and 1,000,000.00, about 26.7% of SME customers apply for loans ranging between Kshs. lm and 5m while 13.3% apply for loans above 5 million as evidenced by the response given by the bank officers. The total SME lending book as at August 31. 2008 was Kshs. 780 million. This illustrates how Fina bank has embarked on lending this sector despite numerous challenges commercial banks face in the financing process.

4.4 Challenges faced by Commercial banks in financing SMEs

4.4.1 Key requirements for lending to SMEs by commercial banks

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

Table 4.4.1 Documents required for lending to SMEs by commercial banks.

Documents	No. of Respondents	Percentage (%)
Certificate of Registration	8	53.3
PIN Number	7	46.7
Tax Compliance Certificate	6	40
Cash Flow Projections	10	66.7
Balance Sheet	15	100
Income Statement	15	100
Annual Returns	5	33.3
Bank Statement	6	40
Management Accounts	15	100
Memo & Articles of Association	10	66.7

Source: Research Data

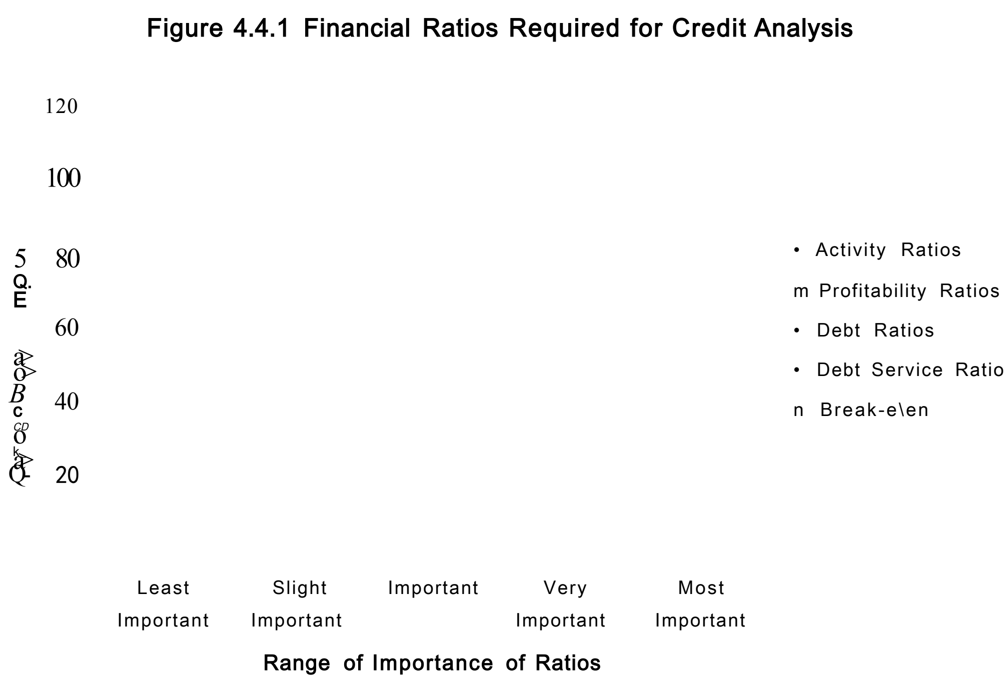
Considering the various documents required for lending to the SMEs, 100% of SME clients submits balance sheet, income statements and management accounts, 66.7% of them submits cash flow projections for their businesses, memorandum and articles of association. 53.3% of the SMEs provide certificate of registration/incorporation. 46.7% provides PIN numbers, 40% provide both tax compliance certificates and bank statements while 33.3% submits their annual returns. This clearly indicates that most of the SMEs do not comply with commercial banks lending requirements. These pose great challenge to commercial banks in financing Small and Medium Enterprises. The banking history of these firms is a big challenge to banks as only 40% of them do

Table 4.4.2 Financial Ratios Importance in the Credit Analysis

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

Source: Research data

Figure 4.4.1 Financial Ratios Required at the Credit Analysis



Source: Research Data

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

4.4.2 Securities required for lending to SMEs

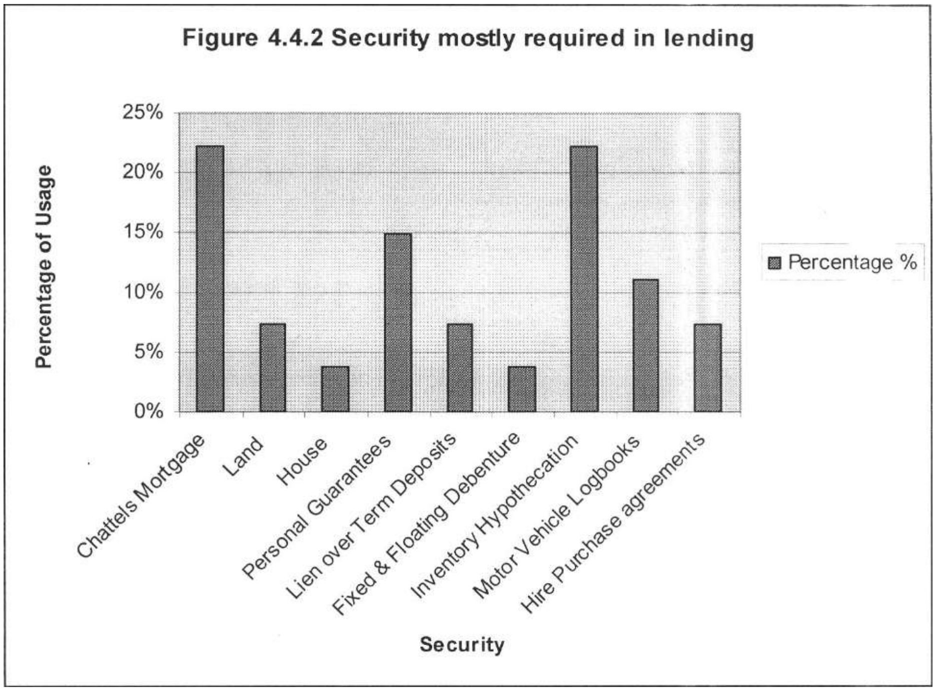
In many occasions security is not required for loans amounting up to Kshs. lm lent to SMEs. However securities are required for in most cases where these businesses cannot prove their credit worthiness. Most commercial banks require securities for the facilities which most of SMEs do not provide. This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

Table 4.4.3 Security required for lending to SMEs

Security	No. of Responses	Percentage %
Chattels Mortgage	30	22%
Land	10	7%
House	5	4%
Personal Guarantees	20	15%
Lien Over Term Deposits	10	7%
Fixed & Floating Debenture	5	4%
Inventory Hypothecation	30	22%
Motor Vehicle Logbooks	15	11%
Hire Purchase Agreements	10	7%
	135	**100**

Source: Research Data

Figure 4.4.2 Security mostly required in the lending process



Source: Research Data

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

4.5 Sources of funds for financing SMEs and various costs involved.

4.5.1 Sources of funds

The research reveals that Fina bank sources its funds for SME financing from development partners such as FMO, shareholders and mobilised funds from depositors. The bank also has loan guarantee schemes from USAID agency amounting to USD 2,500,000. This gives them a reprieve in loan defaults. This also illustrates how vulnerable the sector is faced with uphill task of providing sufficient securities to secure loan facilities from commercial banks.

4.5.2 Various costs involved in the financing process of SMEs

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

Table 4.5.1 Loan range and the corresponding interest rate charged

Amount Range (Kshs.)	Interest Rate
^500,000	19.75% - 21% - Depending on security
> 500,000- lm	19.75%
> lm	17%

Source: Research Data

Interest rates ranging between 19.75% - 21% are charged on the loan facility ranging between Kshs. 500,000 and below depending on the security provided by the SME customers. For the loans greater than Kshs. 500,000 but up to 1 m are lent at 19.75% while for loan more than lm are given at a reduced rate of 17%.

Apart from the high interest rates charged on the loan amounts given, the research also reveals some incidental costs incurred by these businesses. SME clients incur additional charges including processing fees, key man insurance, business search fee, legal fees for security perfection and the valuation fees for either security or an asset they want to acquire. All these eats into their pockets making the loans from commercial banks expensive compared to the amount of returns they get from their business operations. The turn around time for the loan application is between 10-20 days from the day of application to disbursement of the same. This still increases the cost of doing business to these businesses.

4.5.3 Non-performing portfolio and the default rate among SMEs

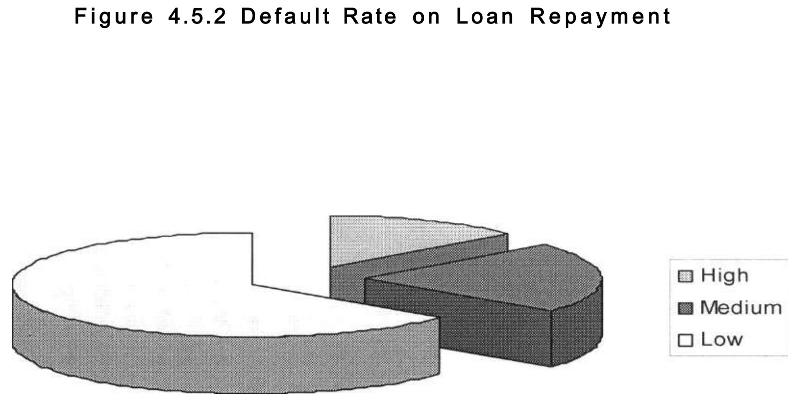
Table 4.5.2 Default rate on loan repayment

Default Rate	No. of Responses (R)	Percentage %
High	6	13.4
Medium	10	22.2
Low	29	64.4
Total	**45**	**100**

R= no. of loan range x no. of respondents (3x15)

Source: Research Data

Figure 4.5.2 Default rate on loan repayments



Source: Research Data

The default rate is low at 64.4%, 22.2% of the respondents says that the default rate is medium while a paltry number of 13.4% indicate that the default rate is high. This clearly reveals that this sector does contribute little in the non-performing loan portfolio within commercial banks.

Table 4.5.3 Non-performing loans in the SME portfolio

Loan Amount (Kshs.)	**No. Response (R)**	**Percentage %**
< 20m	18	24
> 20m-30m	45	60
> 30m - 50m	5	6.7
> 50m- 100m	5	6.7
> 100m	2	2.6
Total	75	**100**

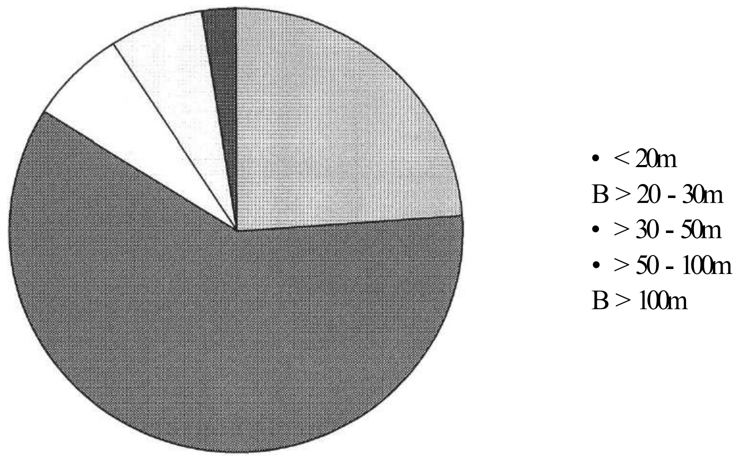
R= no. of loan range x no. of respondents (5x15)

Source: Research Data

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

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

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



Source: Research Data

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

4.5.4 Recovery process from loan defaulters

Table 4.5.4 Loan recovery methods used

Method	No. or responses (R)	Percentage %
Direct Debit	10	66.7
Legal Action	1	6.6
Repossession	4	26.7
Total	**15**	**100**

Source: Research Data

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

At the extreme for the customers who are unable to repay their loans, the bank does restructuring of the loan facility which is at the convenience of the client, they also realise the amounts from the collateral provided by the customers by selling these security items and the bank also make claims from the personal guarantees to recover the loans. The research further reveals that most of the SME customers do not have enough information on the financing requirements by commercial banks. This is a big challenge to most commercial banks offering this kind of facility to the SME sector.

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CHAPTER FIVE

5.0 CONCLUSIONS AND RECOMMENDATIONS

5.1 Conclusions

The objective of the study was to determine the challenges the commercial banks face in the process of financing SME customers in Kenya, examine how commercial banks are trying to address these challenges and to examine the banking needs of SMEs. The findings of the study summarised in chapter four indicate that commercial banks face various challenges in financing SME. The products offered by these commercial banks might not be preferred by the SMEs as most of them might not focus on their core business operations.

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

33.3% of responses show that most SMEs prefer business loans, 16.7% prefer letters of credit and bid bonds while 11.1% prefer asset finance, bank guarantees and temporary overdrafts. This clearly reveals that commercial banks should tailor products which address SME needs rather than coming up with products which the) do not like. Commercial banks should focus a lot on extending business loans to SMEs to finance their working capital needs. This will enable them to expand their businesses and have enough working capital to help them have enough stocks for their operations. Temporary overdrafts are mainly used in financing weekly or monthly working capital needs. This might increase their finance costs in the long run for the business operations.

The research further reveals that 60% of the SME customers applying for the loan facility go for loans amounting to between Kshs. 500,000 and 1,000,000, 26.7% seek loans of between Kshs. lm and 5m while those applying for loans more than Kshs.

5m are only about 13.3% . This indicates that commercial banks should focus much of their SME products into business loans which add more value to the SME clients. Commercial banks should increase their SME loan allocations to business loan portfolio; focus on the import business by issuing more letters of credit to clients importing goods from abroad. This is a new area of business whose portfolio amount should be increased to meet the growing demand for this product. New product development by commercial banks for the SMEs is a challenge that most commercial banks face. The specific banking needs for SMEs is revealed by this result.

100% of SME customers submit management accounts, income statements and balance sheet statement, 66.7% submit cash flow projections and memorandum & articles of association, 53.3% submit certificate of registration/incorporation, 46.7% PIN numbers, 40% tax compliance certificates & bank statements while only 33.3% submit annul returns. This reveals that a good percentage of SME clients do not submit the required documents for financing by commercial banks in Kenya. This is a challenge that most of commercial banks face in their lending process. In addition this also indicates that most of the SMEs do not have sufficient information as pertains the minimum requirements by commercial banks for their financing. Meeting all these requirements is an uphill task to SMEs which needs to be addressed.

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

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

At the same time commercial banks charge various incidental costs which prove to be expensive to most of SMEs. This is an impediment to most of SMEs in accessing financing from commercial banks. Variable interest rates depending on the amount of loan applied for as well as the availability of security for the same. An interest rate ranging between 19.75% and 21% is charged on the loan amount of up to Kshs. 500,000 depending on the available security. Amounts between Kshs. 500,000 and 1 m are lent at an interest rate of 19.75% while amounts above lm are charged at 17% on variable basis. SMEs also pay for processing fee, key man insurance, search fee, valuation fee and legal fees for security perfection. All these add into the cost of financing these businesses.

The default rate of loan repayments is very low as indicated by 64.4% of respondents and the non-performing loan within SME portfolio range from 20m and 30m. This indicates the stringent methods put in place and various collection methods employed. Debt recovery methods used are direct debit, legal action to hardcore defaulters and repossession of the assets bought through the loan facility. To the extreme end the research has revealed that loan restructuring, asset realisation and claims from personal guarantors are also employed to recover loans from defaulters. Asset realisation is a challenge as most SMEs provide inventory hypothecation and chattels mortgage which have very low value as their security for financing.

The research has also revealed that Fina bank also has external sources of funds and loan guarantee schemes to aide them in financing. They get their financing from FMO, a Netherlands' financial institution, deposits mobilized from customers and loan guarantee schemes a mounting to USD 2,500,000

5.2 Limitations of the study

The research findings of this study should be interpreted in light of the following limitations;

This was a case study and the research findings may not be representative of the commercial banking sector in Kenya as it only focused on Fina Bank (K) Limited.

Due to financial resources and time constraints, a survey research could not be carried out which would have obtained a more representative results to this study.

Little literature in the Small and Medium Enterprise sector was an impediment to this study.

5.3 Suggestions for further studies

From the research findings of this study, there is need for further research. A number of areas could be looked into.

An empirical survey should be done to include all of the 45 registered commercial banks in Kenya which might produce representative results.

A further research can also be done on the challenges facing Small and Medium Enterprises in getting financing from commercial banks in Kenya.

A more detailed research could also be done to look into different financing strategies adopted by commercial banks in serving this sector.

A research could also be done to look into specific commercial banking products that add more value to SME sector and addresses specific needs of the sector.

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Epitaph

"If education is to be a road map, be sure it describes the right highway. There is no worse situation than years barred in books, the two (you and the books) are finally required to see what remedy there is on a particular dispute, only to discover that their was no resemblance of mission, goals and objectives between education and the way its designed on one hand and you and the purpose of seeking education on the other ".

APPENDIX I - QUESTIONNAIRE

Section A: Background of Fina Bank Kenya Limited

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

Section B: SME products offered by the bank

4. When did the bank start offering SME banking products & services to customers?
5. What are the major banking products and services offered by the bank to the SMEs **(name as many as possible)?**

6. Which among the SME products named above are commonly sought? **(rank them in order from the 1st to the last)?**

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

Section C: Challenges the Bank faces in the process of financing SMEs

9. To what extent are the following challenges faced by Commercial Banks in lending to the SMEs'? **(1- least faced; 5 - mostly faced)**

	1	2	3	4	5
a) Lack of security	0	()	()	()	()
b) Lack of Audited financial	()	()	O	()	()
c) Registration Certificates	()	()	()	()	()
d) Banking History	()	()	()	()	()

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

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

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

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

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

Certificate of registration/incorporation

PIN number

Tax compliance certificates

Memorandum & Articles of Association

Cash flow projections

Income statements

Balance sheet

Annual returns

Management accounts

Bank statements for at lest 2 years

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

	2	3	4	5
Activity ratios				
Profitability ratios				
Debt ratios				
Debt service ratios				
Break even as a % of sales				

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

	1	2	3	4	5
Balance sheet	()	()	()	()	()
Income statement/Income &Expenditure	()	()	()	()	()
Cash flow statement	()	()	()	0	()
Changes in Owner's Equity	()	()	()	()	()

17. Do you always require security for the loan applied for by SMEs?

- Yes
- No

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

- Chattels mortgage ( )
- Land ( )
- House ( )
- Personal guarantees ( )
- Lien over term deposits ( )
- Fixed & floating debenture ( )
- Inventory hypothecation ( )
- Motor vehicle log books ( )
- Hire purchase agreements ( )
- **Any** other **(please specify)**

19. Is your lending **cash flow** based? Yes______________No

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

-

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

- **Kshs**
- **Kshs**
- **Kshs**
- **Kshs_**

22. Do you have loan guarantee schemes for your SME customers?

Yes______________No

23. If yes, what are the amount guaranteed and the source?

Amount **(Kshs)_______________Source**

24. Is the Interest Rates charged to the customers' variable? Yes_______NO

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

- 500,000 and below
- >500,000 - 1 m_

- More than 1 m
- More than 1 Om
- Any other (Specify)

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

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

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

29. What is the size of the non-performing loan from the SME customers?
    - 20m and below
    - 20m-30m
    - 30m - 50m
    - 50m-100m
    - 100m and above

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

31. Do the customers appreciate the collection efforts made by the bank?

Yes______________________NO

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

(1-frequently used; 5-least used)

	1	2	3	4	5
Direct debit	()	()	()	()	()
Legal action	()	()	()	()	0
Repossession	()	0	()	()	()
Any other specify	()	0	0	()	()

33. Do most of the SMEs have enough information on the financing requirements by commercial banks?

Yes NO

APPENDIX II: INTRODUCTORY LETTER

University of Nairobi,

School of Business

P.O. Box 30197-00100

Nairobi

May 20, 2008

To Whom It May Concern:

Dear Sir/Madam,

Ref: Request for Data - Challenges faced in financing SMEs in Kenya: The Experiences of Fina Bank Kenya Ltd.

I am a post graduate student at the University of Nairobi, School of Business undertaking research in Small and Medium Enterprises financing with specific reference to the ***Challenges faced in financing SMEs in Kenya: The Experiences*** *of* ***Fina Bank Kenya Ltd.***

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

Yours faithfully,

Wasonga Jack Kasole.

D33/7414/2006

MBA Student

Supervisor

Herick Ondigo

Lecturer,

Department of Accounting & Finance.