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A Critical Review on Micro-financing of Small Businesses in Kenya

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The Small business sector has continued to play an important role in the Kenyan Economy. The sector's contribution to the Gross Domestic Product (GDP) increased from 13.8% in 1993 to over 18% in 1999. The Economic survey of 2012 estimated that the contribution to the GDP of this sector currently stands at over 25%. It is the objective of every small business to grow into large enterprises. This paper seeks to identify the impact of Micro financing on Small Business Enterprises in Kenya. Specifically, this study proposes to establish the impact of Microfinance institutions (MFI's) on Kenyan Small and Medium Enterprises, to establish the products offered by MFI's to Kenyan small and medium enterprises and to establish why some customers are dropping off MFI's. The provision of financial services, especially credit plays an important role in the development of the economy. From the relevant studies done in this area and the accompanying literature review, Micro finance organizations provide financial services to their clients (small scale entrepreneurs), such as savings and credit services to finance their new business startups in order to engage in productive economic activities and thus contribute to the development in low income population. Thus, their growth has been attributed to the availability of micro credit opportunities in the country. It can thus be concluded that micro finance services have a major effect on the growth of Small businesses in Kenya. This concurs with Koech (2011) that the factors affecting growth Small businesses were capital markets, cost, capital access, collateral requirements, information access, capital management and cost of registration. Thus, micro finance services have made it possible for the poor to start small and medium enterprises in Kenya.

Keywords: Microfinance, Entrepreneurship, & sustainable development.

INTRODUCTION

Microfinance entails the provision of financial products and services to small and micro businesses (Asiama, 2007). The concept of microfinance though not new, is gaining ground as a preferred mode of financing of small and micro businesses which are excluded from the mainstream financial intermediation systems. Microfinance institutions provide credit services and other financial services to millions of populations across the globe. According to Harris (2002), microfinance lending, savings and financial services, provide the poor with an effective way to move out of poverty, build income, create wealth and asset their mortgage risks. Microfinance includes the provision of a broad range of financial services to the lower income class in the society. Microfinance entails the provision of retail financial services, including savings, credit, cash transfer, financial management, insurance and other financial services to the poor.

Microfinance involves the provision of financial services to clients in lower income segments of the society, including, small scale traders, vendors in the streets, farmers and other small scale business people e.g. artisans and producers (Ledgerwood, 1999). According to a publication Microfinance vital to economic growth (2005), microfinance is a facility or special instrument vehicle that helps the poor people with focus to acquire small credit facilities for business startups, acquire loans for school fees, acquire houses or receive medical attention. Ledgerwood (1999), noted that there are different providers of microfinance services. He identified institutions such as NGO's, cooperatives, credit unions,

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government banks, commercial banks and non bank financial institutions.

Existing statistics from the United Nations Development Program (UNDP), show that there are over one billion poor people or 'economically active people' in the world who have no access to financial services, especially in developing countries like Kenya. This has led to this critical group languishing in poverty and being excluded from the financial intermediation process and with it the opportunities for growth (Otero *et al.,* 1994). Early research treated small enterprises as peculiar and peripheral survival mechanisms whose developmental impact was marginal (Ongile and McCormick, 1996). This outlook was, however, irrevocably altered by the International Labor Organization report (ILO, 1972) that demonstrated the significant employment and wealth creation potential of the burgeoning small and often informal sector. Universally, microfinance has been acclaimed as an important tool for poverty eradication, especially in the developing economies (Armandariz and Morduch, 2005, Johnson and Rogaly, 1997, Gibbons and Meehan, 2002). In a 2005 publication, the United Nations noted that, microfinance has changed the lives of thousands of people and revitalized communities since the inception of trade (United Nations, 2005).

In Kenya, there exist several microfinance institutions and firms that are providing financial services of savings and credit to micro and small businesses. Some of the institutions that are active on the ground include; Faulu Kenya, K-rep Bank, Rafiki Deposit taking microfinance, Kenya Women Finance Trust and a host of other small and medium sized microfinance institutions. However, as at 31st December 2011, there were fifteen micro finance institutions and 6 licensed deposit taking micro finance institutions licensed by the Central Bank of Kenya (CBK, 2012). Entrepreneurship world over has emerged as an opportunity for employment, a way of helping the poor to indulge in the field of employment, and a way of improving both their socioeconomic status. Small businesses are viewed as a driving force of economic and social growth in the African perspective (Pelham 2000). Small businesses are a means through which accelerated growth and rapid industrialization have been achieved, Koech (2011). Small businesses have been recognized as being great contributors to the Kenyan economy offering both employment and a platform for innovative ideas. They form a larger percentage of businesses that operate in Kenya as compared to their counterpart, the large companies. As part of business enterprises, they need finance to start up, expand, diversify and for working capital of the business firms. Without finance, no one business enterprise can achieve its objectives (Mckernan& Chen, 2005). Both in the developing and developed world small firms have been found to have less access to external finance and to be more constrained in their operation and growth (Galindo & Schiantarelli, 2003).

Recognizing the critical role small businesses play in the Kenya economy, the Government through Kenya Vision 2030 envisages the strengthening of the sector to become the key industries of tomorrow by improving their productivity and innovation (Ministry of Planning, National Development & Vision 2030 [MPNDV2030], 2007). However, it is generally recognized that small businesses face unique challenges, which affect their growth and profitability and hence, diminish their ability to contribute effectively to sustainable development (International Finance Corporation, 2000). In Kenya, the small business sector has both the potential and the historic task of bringing millions of people from the survivalist level including the informal economy to the mainstream economy. According to the last comprehensive survey conducted in 1999, the sector was estimated to employ over 50 per cent of the working population (accounting for 2.3 million people). As much as the majority of the MSEs in Kenya operate informally, there are over 35,000 formal MSEs that employ over 40 per cent of the working population (Kenya Economic Report, 2013)

Access to finance helps all firms to grow and prosper. However, lack of access to credit is a major impediment inhibiting the growth of small businesses (GOK, 2005). There is no structured institutional mechanism in Kenya to facilitate the flow of financial resources from the formal sector through micro finance institutions to such enterprises. Generally, small businesses operate on tight budgets, often financed through owner's own contribution, loans from friends and relatives and some bank credit. They are often unable to procure adequate financial resources for the purchase of machinery, equipment and raw materials as well as for meeting day-to-day expenses. This is because, on account of their low goodwill and little fixed investment, they find it difficult to borrow at reasonable interest rates. As a result, they have to depend largely on internal resources (GOK, 2005). The definitions assigned to small businesses vary across countries and institutions. Most definitions are based on quantitative factors such as the number of workers, assets, and sales, sometimes differentiated by industrial sector. A small business is a business that employs a small number of workers and does not have a high volume of sales. Such enterprises are generally privately owned and operated sole proprietorships, corporations or partnerships. In the United States the Small Business Administration establishes small business size standards on an industry-by-industry basis, but generally specifies a small business as having fewer than 500 employees for manufacturing businesses and less than $7.5 million in annual receipts for most non manufacturing businesses. The European Union generally defines a small business as one that has fewer than 50 employees. However, in Australia, a small business is defined by the Fair Work Act 2009 as one with fewer than 15 employees.

In Kenya, the definition that would classify and categorize enterprises, while taking into account capital, employment and output is theoretically the most appropriate. However unavailability of capital and output figures frequently requires that small business is defined based on employment alone. Dondo in 1990 in his study of the "Changing role of key institutions actors in implementing credit programs for small scale enterprise development in Kenya" with K-rep; defined small enterprise as an enterprise with fewer than 50 employees. In many emerging markets the small business sector is one of the principal driving forces of economic and job creation. Small businesses constitute over 95 per cent of all enterprises and account for two thirds to one half of total non-farm employment and gross domestic product (GDP) worldwide (Obwocha, H. 2006). Small businesses play pivotal roles in creating dynamic, market oriented economic growth, employing the growing workforce in developing countries, alleviating poverty and promoting democratization (UNDP, 1999). However, inadequate access to financing continues to be one of the major significant impediments to the creation, survival and growth of the small business sector in Africa. Further, owing to their high risk profile, small businesses largely remain an unattractive investment for mainstream investors (UNEP, 2007)

In the definition of microfinance, most critics condemn it as offering micro credit or micro finance, however, unknown to most, microfinance encompasses much more than micro credit. Indeed, micro credit is just one of the major components of microfinance. Due to broad definitions of microfinance, very few studies have sought to identify the impact of microfinance of small businesses in developing countries. However, some literature exists, e.g. Obli (2011), who sought to identify the impact of microfinance on SME's in Ghana, Luyirika (2010) who sought to identify the role of microfinance in socioeconomic development of women in Uganda, and Mustafa (2012) who sought to identify the performance and interventions of microfinance institutions in Sudan. While these studies have provided evidence of the impact of microfinance institutions all over the world, there is a dearth of literature on the Kenyan Local sector. According to Idowu (2010), a major impediment to rapid development of the small and micro enterprises sector is an absence of both debt and equity financing. Accessing finance has been identified as a key element for small and micro enterprises to thrive in their drive to build productive capacity, to compete, to create jobs and to contribute to poverty alleviation (Idowu, 2010). Without finance, small and micro enterprises cannot acquire or absorb new technologies nor can they expand to compete in global markets or even strike business linkages with larger firms. Though not entirely new in the Kenyan environment the study of Microfinance has taken many dimensions, the impact of microfinance institutions on the growth of small businesses is a rarely researched topic. This paper therefore seeks to establish the impact of Microfinance institutions on small businesses in Kenya, thus seeking to provide literature and filling a research void existing in the Kenyan market on the impact of MFI's on small businesses in Kenya.

1.1 Significance of the Review

This paper is significant in the following ways:

i. As noted, Microfinance institutions are very important players in the poverty reduction strategies of countries around the world. However, in the local setting this paper will be very important to several key stakeholders in the microfinance value chain.
ii. The discussions in this paper, is going to enable micro finance institutions to better understand their role in the growth of Small businesses in Kenya in order to implement better and effective loaning programs.
iii. Potential investors in the micro finance sector as well as entrepreneurs willing to start Small businesses shall find this discussion relevant to them. The discussion finding sheds some light on the future of micro finance institutions and Small businesses, thus enabling potential investors to make sound decisions.
iv. To the government, the discussions of this paper are of importance as it would assist in setting up specific management policies that enhance effectiveness and sustainability of Small businesses in Kenya.
v. Millions of Kenyans have no access to financial products and services in their localities. Financial intermediation is an important catalyst of wealth creation and there the lack of access to financial services reduces the chances of wealth creation. This paper will provide information to the general public on the services and products offered by the Microfinance institutions across Kenya. In addition, this paper will inform the general public about the availability of micro finance products and how the products compare to other products offered in other countries.
vi. This paper is also of significance to scholars in understanding the level of Small business development in Kenya, which play a significant role in providing ancillary services to multi-national corporations.
vii. Finally, this paper contributes to the future development of this area of research, particularly in a developing country like Kenya

2.0 A review of Previous Studies on Micro Financing Small Businesses

2.1 Introduction

Although the word finance is in the term microfinance and the core elements of microfinance are those of the finance discipline, microfinance has yet to break into the mainstream or entrepreneurial finance literature. Throughout the world, poor people are excluded from formal financial systems. Exclusion ranges from partial exclusion in developed countries with full or nearly full exclusion in lesser developed countries (LDCs) (Mutua, *et al.,* 1996). Microfinance has existed, although mostly in the shadows and unseen by casual observers, since the rise of formal financial systems, and indeed probably predates them. It has only been within the last four decades, however, that serious global efforts have been made to formalize financial service provision for the poor. This process began in earnest around the early to mid-1980s and has since gathered an impressive momentum. Today there are thousands of MFIs providing financial services to an estimated 100 -200 million of the world's poor (Christen *et al.,* 1995). What began as a grass-roots movement motivated largely by a development paradigm is evolving into a global industry informed increasingly by a commercial/finance paradigm.

Absent access to formal financial services, the poor have developed a wide variety of informal, community-based financial arrangements to meet their financial needs. In addition, over the last two decades, an increasing number of formal sector organizations (non-government, government, and private) have been created for the purpose of meeting those same needs. Microfinance is the term that has come to refer generally to such informal and formal arrangements offering financial services to the poor (Mutua, *et al.,* 1996).

Microfinance institutions are institutions that provide credit services and other financial service to the poor in the form of small loans or savings (Harris, 1994). According to Diagne and Zeller (2001), lack or inhibited access to credit or loans by the poor has had negative effects on most of the Small and Medium business around the world. Indeed, access to credit has been identified as a critical stimulant to the growth and development of SME's. In most development partners and aid organizations, it is though that access to loans helps the poor to uplift their living standards in a number ways. This includes; overcoming liquidity challenges, making investments, increasing incomes, provision and access to employment (Hiedhues, 1995).

In modern business environments, every firm seeks to grow and make profits. Penrose (1995), defines a firm an organization with administrative structures and is legally incorporated which may expand in time through the accumulation of physical resources, tangible or intangible resources. Growth in firms can be measure as the relative expansion in size or other quantifiable aspects of the business.

In addition, growth can be measured in terms of increase in efficiency or changes that improve the company (Penrose, 1995). Small business firms have thus become the focus of attention to the economic development, economic growth and job creation in the world. Their importance in the economies has been recognized by many players such as the World Bank, UN agency UNCDF, the governments, non-governmental organizations and private entities (Kenya, Government of the Republic, 2005). They are an integral element of the informal sector in most developing countries.

While small businesses may not generate as much money as large corporations, they are a critical component of and major contributor to the strength of local economies. According Pelham (2000), Small businesses can contribute to pro-poor economic growth by means of: Employment creation and income generation, Rural-Urban migration and remittances to the rural economy, Income diversification, Increasing youths, women's and people living with disabilities, economic activity and incomes, Small enterprises as a seedbed for modernization, and Linkages with other businesses which either provide supplies or purchase from the enterprise to make other products or services

2.2 Small Business Sector in Kenya

Governments throughout the world are nowadays turning their attention to small scale enterprises. This is because attempts to promote economic progress by establishing large industries have usually failed to improve the lives of the majority of the populations concerned (White Paper on International Development, 2000). The Kenyan small enterprise sector is a mixture of self employment outlets and dynamic enterprises involved in an array of activities that concentrate in urban areas but are also evident in rural Kenya. There are about 900,000 establishments employing 2 million Kenyans and generating about 14 per cent of the country's GDP (Memba, *et al.,* 2012). Through the small enterprise sector, unskilled rural migrants acquire skills needed for survival in the more challenging urban environment. The sector also attracts skilled persons retrenched from formal sector jobs, but is viewed as a second-best option for those unable to find and keep jobs in the modern sector.

The current constitutional framework and the new Micro and Small Enterprise Act 2012 (MSE Act 2012) provide a new window of opportunity through which the evolution of small businesses can be realized through the devolution framework. However, the impact of devolution on small business development depends on the architecture of the regulatory and institutional framework inclined to support enterprises in an economy (Ong'olo and Odhiambo 2013). However, Lack of access to credit is a major constraint inhibiting the growth of the small business sector. Formal financial institutions perceive small businesses as high risk and commercially unviable (Memba, *et al.,* 2012).

2.3 Origins of micro financing

The concept of micro-financing arose out of the need to provide to the low-income earners who were left out by formal financial institutions. The practice of micro-credit dates back to as early as 1700 and can be traced to the Irish Loan Fund System, which provided small loans to the rural poor with no collateral (Ogindo 2006). The rise of the microfinance industry represents a remarkable accomplishment taken within historical context. It has overturned established ideas of the poor as consumers of financial services, shattered stereotypes of the poor as not bankable, spawned a variety of lending methodologies demonstrating that it is possible to provide cost-effective financial services to the poor, and mobilized millions of dollars of social investment for the poor (Mutua, *et al.,* 1996). It must be emphasized too, that the animating motivation behind the microfinance movement was poverty alleviation. Not only that, but microfinance offered the potential to alleviate poverty while paying for itself and perhaps even turning a profit doing well by doing good. This potential, perhaps more than anything, accounts for the emergence of microfinance onto the global stage.

Micro financing of groups, businesses, traces its origins to 1976, when Dr. Mohammed Yunus started a small microfinance scheme as an experiment in the rural areas of Bangladesh. The experiment evolved from its initial success into the Grameen Bank, the world's first microfinance institution, which popularized group lending, in which loans were issued to individual members of small, homogeneous groups, who collectively guarantee loans issued to their members. All members were barred from further access to credit in the case of default by one group member, providing strong incentives for the group to ensure the repayment by each individual borrower. This microfinance model eventually spread around the world, especially in third world countries (Yunus, M. 1976). According to Harris (2002), the microfinance industry has greatly grown in the last two decades. In the Asian, African and Latin America continents, non-governmental organizations and other development agencies have established thousands of microfinance institutions to provide microloans using the group lending model and individual lending systems. However, this is not to mean that microfinance has grown without challenges. Indeed, in the 1990's, several microfinance startups by NGO's failed due to lack of volume or failure to achieve commercial viability in terms of numbers (Harris, 2002). None the less, Microfinance has grown partly due to the efforts of international development organizations to eradicate poverty and the presence of a commercially viable population. According to the World Bank (2010), in developing countries, poor people of the female gender have proved to be excellent borrowers who provide a ready market for effective and responsive loan products at commercial rates.

In Kenya, the micro-finance movement gained momentum in the late 1980s as a result of the exclusion of a large proportion of the population from the formal financial institution mainly banks. Micro-finance emerged with the aim of filling the gap left by banks in providing credit to individuals, micro, small and medium enterprises which were on the rise during this period (Ogindo 2006). Thus, in the early 1990s with the opening up of political space and ensuing economic disturbances, the need for credit by individuals, micro, small and medium enterprises increased and this led to the recognition of micro-finance institutions in Kenya. Among the pioneer MFIs in Kenya are Equity Building Society (currently Equity Bank), Family Building Society (currently Family Bank), Faulu Kenya and K-Rep, (Mwangi 2011). Robinson, (1998) defines microfinance as a development tool that grants or provides financial services and products such as very small loans, savings, micro leasing, micro insurance and money transfer to assist the very or exceptionally poor in expanding or establishing their businesses. The term microfinance can also be defined as the provision of financial services to low income clients including the self employed.

A study by Oyo, J. S. (2005), found that the majority of business startups, had limited capital, lacked relevant skills and used outdated technologies that constrained their growth.

Prasad, Green and Murinde (2005) found that financing policy, capital structure and firm ownership are all strongly linked. Carpenter and Petersen (2002) argue that firms whose financial needs exceed their internal resources may be constrained to pursue potential opportunities for growth. The insufficient liquidity is therefore one of the factors which is frequently cited as a cause of micro and small business failure in developing economies. It is from this perspective, the micro credits are considered to be an appropriate solution because the amount of money needed to start a micro or small business is generally quite minimal. Access to financial services by smallholders is normally seen as one of the constraints limiting their benefits from credit facilities. However, in most cases the access problem, especially among formal financial institutions, is one created by the institutions mainly through their lending policies. This is displayed in the form of prescribed minimum loan amounts, complicated application procedures and restrictions on credit for specific purposes (Sacerdoti, E. 2005). For small-scale enterprises, reliable access to short term and small amounts of credit is more valuable, and emphasizing it may be more appropriate in credit programs aimed at such enterprises.

Financing small businesses in Kenya are one of the greatest challenges aspiring and practicing entrepreneurs face. Many brilliant business ideas never see the light of the day because the entrepreneur behind the idea lacks sufficient funds to take the idea to market. While the entrepreneur wallows in frustration, they would be buyers are denied the opportunity to access better and probably cheaper goods and services. Often the hardest part of starting a business is raising the money to get going (Oguijiuba, Ohuche, and Adenuga, 2004). Despite efforts by financial institutions and public sector bodies to close funding gaps, small businesses continue to experience difficulty in obtaining capital. These funding gaps relate to firm size, risk, knowledge and flexibility. In addition, small business borrowing requirements are small and more collateral may be required than small businesses can pledge. Further, the financial institutions may lack expertise in understanding small businesses and also flexibility in terms and conditions of financing that are required by small businesses (PECC, 2003).

3.0 DISCUSSION

Overall, the study takes a multi-methods approach and is based on a literature review, a short observation survey on the effects of financing small businesses by micro finance institutions in Kenya. A number of studies have been conducted on micro finance services. Mutuku (2010) studied on the impact of micro finance institutions on MSMEs in Kenya and found out that they had a great impact on employment creation and poverty alleviation. Nilsson (2010) conducted a study to investigate the impact of micro finance institutions (MFIs) on the development of small and medium size businesses (SMEs) in Cameroon. The study findings indicated that; microfinance is an important asset to developing countries since it is able to cater for the financing needs of the very poor in the society and particularly in the new venture start-up.

Memba *et al.,* (2012) conducted a study to establish the impact of venture capital on growth of SMEs in Kenya. The study established that SMEs made significant growth after accessing the finances. Mbugua (2010) studying on the impact of micro finance services on the financial performance of SMEs in Kenya found that micro finance services enhance financial performances of SMEs. Morduch (1999) and standard financial systems note that microfinance is not a panacea, but it is a main tool that fosters development in developing countries. MFI provides small scale financial services to poor people who are otherwise “excluded from the formal banking sector, thus enhancing entrepreneurship which generally includes new venture startups.

4.0 CONCLUSION

Micro finance organizations provide financial services to their clients (small scale entrepreneurs), such as savings and credit services to finance their new business startups. They provide access to capital on a smaller scale and enable poor people to engage in productive economic activities and thus contribute to the development in low income population. Hence, the growth of small scale businesses in Kenya has been attributed to the availability of micro credit opportunities in the country. It can thus be concluded that there is a major effect of the micro finance services on the growth of Small businesses in Kenya. This concurs with Koech (2011) that the factors affecting growth where capital market, cost, capital access, collateral requirements, information access, capital management and cost of registration. Thus, micro finance services have made it possible for the poor to start small and medium enterprises in Kenya.

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