KIPPRA
The KENYA INSTITUTE for PUBLIC POLICY RESEARCH and ANALYSIS

Policy Brief

No. 7/2023-2024

Thinking Policy Together

Enhancing Utilization of External Business Financing in Kenya's Arid and Semi-Arid Lands

By Catherine Nyaboke and Joseph Munene

Key Highlights

Accessing and utilizing external financial resources remains low for entrepreneurs operating in arid and semi-arid lands (ASALs) of Kenya. This policy brief discusses the factors contributing to low utilization of external business financing in Kenya's ASALs. The key highlights include:

i) Entrepreneurs in ASALs predominantly rely on internal funding to initiate and sustain their day-to-day business operations. The primary obstacle contributing to this is the substantial cost associated with obtaining external financing, and the stringent requirements that must be met. Additionally, religious and cultural norms partly act as barriers to financial access.

ii) Internal financing, primarily personal savings and contributions from family or friends, is the dominant source for startups and financing business day to day operations in ASALs.

iii) Low external financing, including bank loans, play a limited role, due to inadequate access to formal financial institutions.

iv) The education level significantly influences external financing for startups, demonstrating the role of knowledge and skills in decision-making.

Introduction

Access to finance is essential in fostering business growth, and enhancing access to financial markets is crucial in supporting and expanding entrepreneurial activities beyond mere subsistence levels. One of the key drivers of development in ASALs is entrepreneurship, especially through startups and small businesses. The FinAccess Household Survey 2021 revealed that wholesale and retail is the most prevalent sector in ASALs, constituting 41.81 per cent and 44.12 per cent of economic activities in arid and semi-arid regions, respectively. However, there is a significant gap in financial inclusion between ASALs and non-ASALs, as only 64.4 per cent of adults in ASALs have access to formal financial services, compared to 86.8 per cent in non-ASALs.

Sources of Finance for Business in ASALs

The utilization of external financing for business in ASALs remains strikingly low, prompting businesses to primarily rely on internal funding sources (Figure 1). The FinAccess 2021 report sheds light on this financial landscape, underscoring the fact that most entrepreneurs primarily rely on their own funds and the assistance of family and friends and capital contributions from other enterprises to finance startups and support day-to-day business operations.

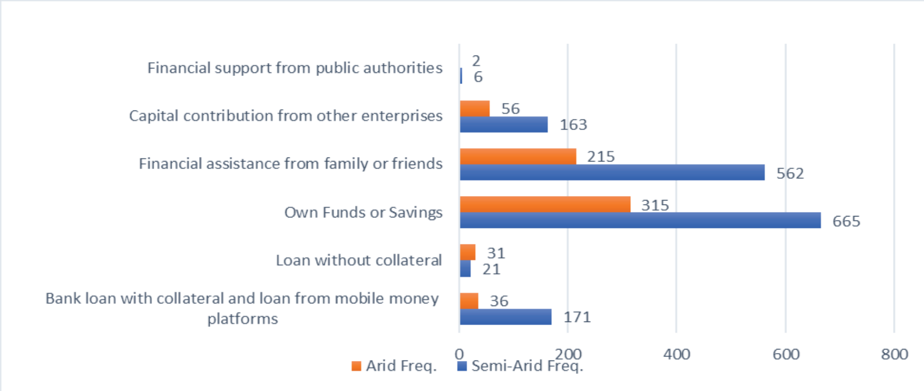
In parallel with these sources, grants and public funding contribute to the financial ecosystem, although they are not the primary choice. A noteworthy observation from the data is that bank financing and government funding are notably under-utilized (Figure 2).

One of the critical areas for policy action involves improving access to external finance. External financing is hindered by factors such as lack of collateral or the unavailability of specialized financial tools, such as patient capital or equity financing. This is compounded by prevailing biases within credit markets that present a challenge to entrepreneurs seeking to thrive in ASALs.

Existing Interventions and Policies Promoting External Financing

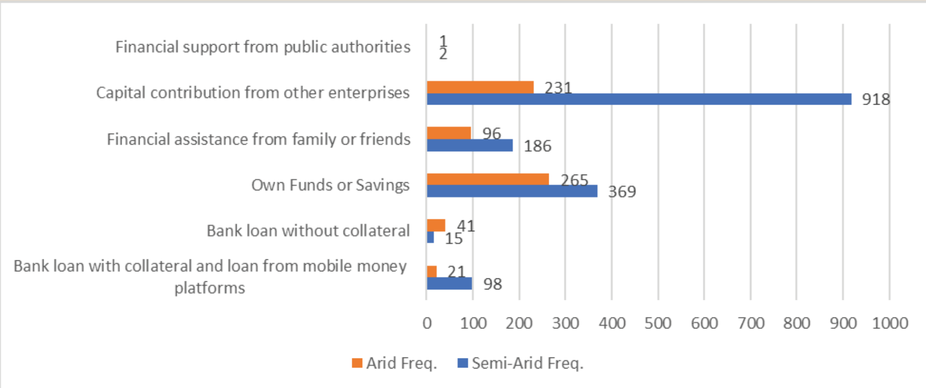
The Kenya Vision 2030 recognizes the need to expand access to finance for micro, small, and medium-sized enterprises (MSMEs) and outlines strategies

Figure 1. Sources of start-up finance in ASALs



Source: Finaccess 2021

Figure 2: Sources of finance for business day to day operation in ASALs



Data Source: FinAccess 2021

for achieving this, especially in ASALs. The Financial Inclusion (Hustler) Fund initiative stands out for its innovative approach, offering conditional loans that effectively mitigate the challenges related to market and cultural barriers. This support significantly contributes to startups and expansion of businesses in ASALs.

Moreover, public financial support has contributed to business start-up by a significant group of entrepreneurs. Women and youth are the categories of entrepreneurs most targeted by public financial support. The government has promoted tailor-made programmes, including the Women Enterprise Fund, Youth Enterprise Development Fund, and Uwezo Fund, aimed at empowering women and youth entrepreneurs who often grapple with unique cultural and skills-related challenges. These initiatives provide financial resources and essential training, simplifying access to external financing and unlocking the full entrepreneurial potential of under-represented groups.

Barriers to Accessing External Financing

The barriers that make access to finance difficult for entrepreneurs in ASALs fall in four main areas: market barriers, cultural barriers, skills barriers, and institutional barriers.

Market Barriers: The credit market suffers from information asymmetries, where lenders often require collateral assets that many entrepreneurs in ASALs do not have, particularly women and youth. Banks also tend to favour individuals with more personal wealth, leading to unequal access.

Cultural Barriers: Cultural biases may exist against ethnic minority or female entrepreneurs, although evidence is limited. Entrepreneurs from Islamic religious background also face cultural barriers, as Islamic beliefs prohibit the payment or acceptance of interest (usury), which can limit their engagement with conventional interest-based financial systems. On the demand side, language barriers and mistrust can hinder interactions with banks.

Skills Barriers: Countless loan applications are declined due to incomplete or incorrect information, predominantly affecting ASAL entrepreneurs who may lack the experience in developing business plans or managing enterprises. Skills deficits also encompass a limited grasp of critical financial concepts needed to navigate entrepreneurial risks and opportunities.

Institutional Barriers: Operational aspects of financial institutions can introduce hurdles for marginalized and under-represented groups. Some microcredit systems fail to allow beneficiaries to establish a credit history, preventing access to favourable interest rates from lending institutions. Furthermore, a lack of legislation concerning new finance sources tailored to disadvantaged entrepreneurs perpetuates these challenges.

Role of Financial Education

Financial literacy plays a vital role in shaping financial behaviours, with individuals possessing greater financial knowledge exhibiting better financial practices such as savings and accessing credit. For entrepreneurs from ASALs, mastering financial literacy is especially crucial, as it impacts their financing decisions and access to credit markets, ultimately influencing their livelihoods and that of their families.

To address this, tailored financial education programmes are essential, given the variance in entrepreneurs' initial financial knowledge. In addition, policy makers should emphasize accrediting and qualifying financial education providers to guarantee training quality. Encouraging banks and financial institutions in ASALs to use simple language in their communications can enhance accessibility and understanding for clients.

Emerging Finance Products

Innovative financial products have emerged to bridge the gap between lenders, investors, and entrepreneurs, offering avenues that are more accessible for business owners while also helping to mitigate discrimination effects.

Crowdfunding addresses various barriers to accessing finance, whether they are market-related, culturally rooted, or institutional in nature. It operates on the principle that business funding can be sourced from a multitude of individuals who invest smaller amounts, often facilitated through online platforms. A significant advantage for both entrepreneurs and investors is the reduction in intermediation costs, making crowdfunding a cost-effective alternative to traditional loans and loan guarantees.

Peer-to-peer lending holds promise for inclusive entrepreneurship for two key reasons. Firstly, it extends financial opportunities to entrepreneurs who may not be considered creditworthy by conventional banks, although due consideration must be given to the risk of over-indebtedness. Secondly, it fosters the transfer of resources among members of the same communities, promoting local economic support and collaboration.

Microcredit is yet another valuable tool aimed at overcoming market and cultural barriers to financing. Conventional banks typically require collateral and often focus on businesses that may not align with the needs of marginalized groups, such as women or young entrepreneurs. When complemented with financial education and business guidance, microcredit can also address skills-related barriers in accessing finance. Its primary advantage is its tailored approach, specifically designed for entrepreneurs who face challenges in the traditional credit market. Moreover, microcredit helps establish a credit history for clients, thus enhancing their access to conventional sources of financial support.

Mobile money loans have emerged as a significant channel in promoting external financing for businesses. These loans, facilitated through mobile money apps, offer a convenient and accessible means for businesses to access capital from external sources. They allow for quick and streamlined application processes, often requiring minimal paperwork, making it easier for businesses to secure financing. Mobile money loans also cater to a broad spectrum of businesses, including startups and SMEs, providing a more inclusive financing environment. Their rapid approval and disbursement of funds can be particularly advantageous when businesses need to seize time-sensitive opportunities. Moreover, the digital nature of these loans enables businesses to establish a credit history, which can be crucial for attracting larger external investors or lenders in the future. As mobile money loans continue to gain traction, they are reshaping the landscape of external financing, making it more accessible and efficient for businesses of all sizes.

Islamic financing plays a significant role due to the religious and cultural aspects prevalent in ASAL communities. Islamic finance is based on the principles of Sharia, which prohibit the charging or payment of interest, and promote ethical and socially responsible financial practices. In ASALs, where religious and cultural norms often align with Islamic principles, the use of Islamic finance is a notable and favourable option for entrepreneurs and businesses. Islamic financing instruments such as Mudarabah (profit-and-loss sharing), Musharakah (partnership), and Ijara (leasing) offer alternative avenues for entrepreneurs to access capital without resorting to traditional interest-based loans. These instruments align with Islamic principles, making them acceptable to many individuals and businesses in ASALs. Moreover, Islamic microfinance institutions and cooperatives have been established in some ASALs, providing financial services tailored to the unique needs and values of these communities. These institutions aim to promote financial inclusion while adhering to Islamic ethical standards.

Policy Recommendations

Interventions for boosting external financing utilization in ASALs include:

i) Formalization of informal financing: Acknowledging the significance of informal financing, public sector actors could put in place policies that could facilitate the formalization and strengthening of community-based lending associations, peer-to-peer lending platforms, and mechanisms for accessing informal loans to provide additional avenues for external financing.

ii) Strengthen informal financial networks: Recognizing the significant role of informal financing sources in both arid and semi-arid regions, efforts could be made to strengthen these networks. Community-based lending groups, chamas, and support from friends and family can provide reliable financing options for local entrepreneurs.

iii) Tailored financial products: Financial institutions operating in ASALs could develop and offer tailored financial products. These may include flexible repayment terms, lower collateral requirements, and competitive interest rates.

Such products will better suit the specific needs of entrepreneurs in these regions.

iv) Encourage entrepreneurial education: Financial institutions in collaboration with community-based organizations and non-governmental agencies could actively promote financial literacy programmes in ASALs. These programmes could focus on educating entrepreneurs about credit market dynamics, including loan application processes, interest rates, and the time value of money. A financially literate population is better equipped to access and manage external financing.

v) Given the cultural and religious diversity in Kenya's ASALs, promoting Islamic finance options is essential. Islamic finance adheres to Sharia principles, which prohibit the payment or acceptance of interest. Encouraging the development of Islamic banking institutions and products can open financing opportunities for entrepreneurs who adhere to these principles.

References

1. FinAccess Household Survey, 2021: https://finaccess.knbs.or.ke/reports-and-datasets.

Acknowledgements

This policy brief was prepared by Catherine Nyaboke and Joseph Munene (Young Professionals) based on a discussion paper titled "Impact of Financial Inclusion on Access to Finance for Startup and Business Operations in Arid and Semi-Arid Lands of Kenya"

About KIPPRA Policy Briefs

KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

KIPPRA acknowledges generous support from the Government of Kenya and development partners who have continued to support the Institute's activities over the years.

For More Information Contact:

Kenya Institute for Public Policy Research and Analysis
Bishops Road, Bishops Garden Towers
P.O. Box 56445-00200, Nairobi
Tel: 2719933/4, Cell: 0736712724, 0724256078
Email:admin@kippra.or.ke
Website: http://www.kippra.or.ke
@KIPPRAKenya