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Influence of Credit Risk Education on Access to Credit by Micro Enterprises in the Formal Sector in Kenya

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Abstract

Access to credit from financial institutions for the purpose of financing state-regulated micro-enterprises in Kenya has been largely based on personal judgment, resulting in a lack of available credit from banks and other financial organizations due to the high rate of credit default. This has severely restricted the prospects of entrepreneurs funding their enterprises. In order to address this issue, a study was conducted that investigated the influence of credit risk education on access to credit by micro-enterprises in the formal sector in Kenya. Credit risk education and access to credit were the independent and dependent variables. The study was guided by collective risk theory to hypothesize the interconnection between the variables. To accurately capture the insights of the research, a descriptive survey design was employed, with the target population being 1,215,184 formal sector micro-enterprises in Kenya recorded by the Business Registry. A sample size of 384 respondents was determined using the Cochran formula. A stratified proportionate sample technique was employed comprising eight regions in Kenya. Informed consent from respondents was acquired and confidentiality maintained in data collection. The study gathered and analyzed primary data using semi-structured questionnaires. Descriptive and inferential statistics were used from grouped data obtained from the overall Likert scale. Cronbach's alpha was used to test reliability and factor analysis for validity. Logistic regression was applied to investigate the relationship between the study variables using advanced SPSS version 23. The results indicated that credit risk education had a positive influence on access to credit. However, the low levels of credit risk education, have hindered access to credit for financing the regulated micro-enterprises, thereby affecting the performance of the MSMEs sector. Based on these findings the study recommends that the Government of Kenya develops strategies for active engagement to promote credit risk education to enhance access to credit.

Keywords: *Credit Risk Education, Access to Credit, Micro Enterprises, Formal Sector, Kenya*

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1.0 Introduction

One of the key considerations for investors in establishing a business is the choice of the appropriate source of financing that would help their business grow and expand (Pticar, 2020). They seek to understand the risks involved in every type of financing they adopt, and also determine the credit risk of their business. In Kenya, micro and small enterprises have faced a myriad of challenges when it comes to financing, including determining the appropriate type of credit to use, and how to access the same (Kaaa, 2019; Mbuva & Wachira, 2019).

Scholars have contributed to the debate on addressing an enterprise's access to credit, thereby expanding the literature. One of the outstanding contributors is Lysander Spooner, a theorist, who between 1810 and 1830 pioneered the idea of business access to credit. He focused on the access to credit of micro, small, and medium-sized businesses but did not mention the necessary types or forms of credit, and how they would be selected (Micro finance & micro credit n.d.; Pticar, 2020; Khidirov, 2020). Improving on Spooner model were Friedrich W. Raiffeisen in 1864 and mohammad Yunus and Akhtar H. Khan in 1973.

The credit idea was further expanded to the development of corporate finance and the concept of financial inclusion in consumer finance (Libretexts, 2021; micro finance & micro credit n.d.; Pticar, 2020; Khidirov, 2020). Access to credit gained prominence among individual researchers and research institutions when the concept of financial inclusion was introduced.Policy framework can facilitate the process of managing and use of the forms of access to credit

(Fouejieu et al. 2020). Micro enterprises in some parts of the globe are seeking financial knowledge before choosing the right type of credit access (Van Song, et al. 2022; Snider & Davies, 2018). For instance, in Canada, micro-enterprises have access to credit using the "business growth stage approach".

"Newly organized enterprises face constraints in obtaining credit due to a lack of collateral, management competencies, proper business data, legal requirements, crime, adherence to ethical principles and networking. "

This procedure is superior because it looks at the stages of growth, a mechanism introduced by financial advisors based on factors such as the level of business stability, the number of customers, sales, and the competitors' information. This method is favoured due to its operational effectiveness and efficiency based on continuous assessment of the enterprise through technology and other measures.

In South Africa, external financing comprising of bank loans and informal financing like trade credit are the main types of access to credit for both old and new micro enterprises. Newly organized

enterprises face constraints in obtaining credit due to a lack of collateral, management competencies, proper business data, legal requirements, crime, adherence to ethical principles and networking. These challenges prompt some business enterprises to seek other alternative forms of financing (Fatoki & Smit, 2017). In Kenya, the main type of credit for micro enterprises is commercial bank lending. Reliance on only one source of access to credit posed a threat to many of them. Only about five percent of business enterprises use personal, equity and informal forms of financing. Some enterprises seek mobile credit, but due to limited financial literacy, they have little success from the mobile loans. In fact, mobile credit is negatively related to the financial performance of micro enterprises (Alumasa & Muathe, 2021).

This credit type is an overdraft that ranges from 100-70,000 shillings with a repayment of period of 1-30 days and an average interest rate of 1.083% that increases daily in case of default. Another overdraft is not allowed by the lender until the outstanding ability from the previous overdraft is settled. The fund is intended to support those with an insufficient cash balance at the time of purchase in order to complete the transaction (Alumasa & Muathe, 2020).Micro enterprises are constrained by daily repayment which affect their operations unlike bank loans. These sources of credit increase a firm's debt burden resulting to closure of some enterprises. To remedy the situation, the government has drafted a policy to enable micro-enterprises to participate in Government Procurement process that will allow owners to get funds to invest in their financially distressed firms (Alumasa & Muathe, 2020; Central Bank of Kenya [CBK], 2021; Financial Sector Deepening [FSD], 2015; Muturi & Njeru, 2019).Gaining full knowledge on the variety of loans offered by the lenders and their selection is an important factor to SMEs since selection of credit determines the success or failure of the enterprise due to the associated risks.

Lenders usually offer various types of loan products. The decision to choose a suitable type of loan rests on if borrower is financially literate or seek financial advice from either the lender providing the product or an independent financial consultant. Seeking monetary advice directly from the creditors in borrowing arrangements could indicate a conflict of interest since the lenders are privy to inside information about the borrower, and therefore protect their investment from losses owing to default by focusing on the enterprise' credit risk management strategies of the borrowing organization as a basis for lending. Such strategy does not fully protect the interest of the borrowers.

Evidence is insufficient on how borrowers' credit risks are fully managed by lenders for their benefit. The Debtor is not fully protected as the lender prays that the borrower should default to lose the collateral, which exceeds the value of the loan (Shahid, et al. 2019). In Kenya more than 50% of the over 65% of SMEs who borrowed from financial firms faced credit default difficulties and some resulted in closure of operations. Seeking financial advisory services to understand the types of loans offered by lenders and the appropriate ways for credit selection by micro-enterprises and other SMEs might have

been ignored in Kenya. Interestingly, this consideration could be the solution to the many credit risk challenges being experienced by micro-enterprises resulting to 70% closure rate in the first three years of operations (Douglas et al., 2017; Packalen & Dyer, 2021).

There is no literature on the influence of financial advisory services on access to credit by micro-enterprises in the formal sector in Kenya. Kaaa et al. (2019) has examined the benefits of financial access on enterprise advancement and its application to loans offered to women-owned SMEs in the hinterland of Kenya. Moreover, while examining collateral, management competencies, proper business data, legal, crime, following ethical principles and networking, Mutinda, (2019) evaluated the significance of factors that affect financial access in Kenya. There exist therefore, a contextual and conceptual knowledge gap on SME credit access in Kenya which this study seeks to address. This study seeks to determine the influence of financial advisory services on access to credit by micro-enterprises in the government-regulated sector in Kenya.

Purpose of the Study

The purpose of this study was to investigate the influence of credit risk education on access to credit by micro enterprises in the formal sector in Kenya.

Hypothesis

$H0_1$: Credit risk education does not influence access to credit by micro enterprises in the formal sector in Kenya.

Theoretical Review

This study is underpinned by risk theory, also known as collective theory, propounded by Filip Lundberg in 1946. He advanced the theory and published it as an extended version of his doctoral thesis in 1903. Risk theory was developed to provide risk education in actuary science. Lundberg's preposition set the stage for teaching risk mathematics concerned with stochastic models for the flow of payments in an insurance business (Englund & Martin-Löf, 2001; Cramér, 1969). The development of the preposition provided a new paradigm of knowledge for understanding the enterprise risk, and finding solutions.

This can be viewed from the research works of numerous researchers including Blanco-Mesa et al. (2019) who studied the determinants of business enterprise risk identification; and Etges, et al. (2018) who analyzed various scenarios involving healthcare inventory risk management.The theory is employed to explain the connection between credit risk education and access to credit of micro-enterprises. There are various risks involved and adequate education is needed by business owners and managers to understand the firm survival. Credit risk education will enable entrepreneurs of micro businesses to perform the necessary analysis of the various forms of risks associated with financing an organization before deciding the on the type of credit to obtain from the available and different kinds of credit access available for their enterprises **(**Dvorský, et al., 2018**).**

Some risks such as business, environmental and country risks are critical to the organization. Business risk comprises a sub-form of risks because of asymmetric

information in the financial markets. Among them are financial and compliance risks. Financial risks are categorized into credit risk, market risk, operation risk, liquidity risk, and legal risk (Dankiewicz, et. al. 2020; Verma, 2022). Credit risk is a type of financial risk that arises from borrowers' default to repay loans as scheduled. This risk includes credit spread risk, default risk, industry risk, institutional risk, and downgrade risk. The consequences of credit risk to the borrower involves legal action and seizure of personal property provided as collateral during the borrowing arrangement.

According to the theory, the investor needs proper guidance from the financial advisor on risk knowledge before financing an investment using debt (Fiorillo**,** 2018*;* Caraiman & Mates, 2020; Ali & Oudat, 2020).Non-performing loans poses significant difficulty in the global financial markets, and therefore, several researches have been carried out to establish mechanisms for educating lenders and borrowers on how to handle default risk. Among the studies are Bennouna and Tkiouat (2019) in Morocco who used logit regression and multivariate analysis to analyze data on the credit-scoring model developed to provide credit risk education for analyzing individual credit as well as the firm in question.

Further, the risk management instrument provides credit risk education for understanding borrowers' debt behavior, demographic profile, and attitude toward debt. The credit risk knowledge can also enable SMEs and other investors to access the risk of the various frameworks relating to credit. The study used 1500 individual loan customers as respondents for data collection and analysis prediction model.
In the Czech Republic, Ključnikov and Belás (2019) adopted Chi-square test to establish how SMEs entrepreneurs' low knowledge of credit risk education affects their access to credit, and the conditions under which loans are obtained from lending institutions.

The investigators tested four hypotheses; namely, credit risk education can be important doing a financial crisis; MSME owners' and managers' low knowledge of credit risk affects their loan conditions; entrepreneurs obtain bank loans under transparent conditions due to their perfect knowledge of financial organizations' lending approaches; and entrepreneurs' limited knowledge of credit risk criteria affects their access to credit, and understanding of borrowing costs, and influences default. In their study, arithmetic mean and the Pearson-square statistics were employed to analyze the raw data gathered from 1141 SMEs entrepreneurs'

In Latin America, Wenner et al., (2017) sought to evaluate how monetary organizations with rural agriculture portfolios provide awareness to MSMEs entrepreneurs, and how thy adopt methods of credit risk education to control, manage, reduce and shift default risk and measure the performance of financial firms. Forty-two banks participated in the survey. Data collected was analyzed to determine frequency and percentages. The results were presented and interpreted using tables and charts. The findings reported no differences in the transfer of credit risk between regulated and nonregulated monetary institutions. The regulated

mobilized capital from customers' deposits and, therefore, the risk of default is transferred to the borrowers. Borrowers can also transfer credit by use of a third party like insurance companies. Risk is also shifted using financial instruments and assets that include derivatives, swaps, and collateral.

2.0 Materials and Methods

The study adopted the positivism philosophy and a correlation research design. The estimated number of micro-enterprises in the formal sector is 1,215,184 which represents the target population of this study. The population is drawn from the eight former administrative regions in Kenya. Cochran's (1977) formulated equation was employed for the computation of the representative sample of 384 regulated micro-enterprises. The sample size proportion was used to portion the sample size according to the eight regions. Primary data was collected using questionnaires. The respondents were owners and managers of formal sector micro-businesses.

Reliability Statistics

As shown in table 1, the study used Cronbach's Alpha to check for the reliability of the scale adopted to measure the study variables as suggested by Bolarinwa (2017). The Cronbach's Alpha was adopted for measuring the internal consistency of the variable owing to its firmness in increasing the standard of the study.

Table 1
Summary of Reliability Statistics Test

Variable	Cronbach's Alpha	N of Items	Remarks
Credit Risk Education	0.734	6	Scale Reliable

The findings in table 1 reveal that the measuring scales were dependable and satisfactory as they exceeded the minimum Cronbach's alpha value of 0.7 (Nawi, et al., 2020). The credit risk education variable had a coefficient's alpha of 0.734, with 6 indicators for its measurement.

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Piloting data collection instruments

A questionnaire was employed to gather the data. The tool was tested for its accuracy through a pilot study. Table 2 illustrates the results of the pilot survey

Table 2
Explanatory Factor Analysis for Credit Risk Education

Variables	**Factor Loadings Range**	**No. of Items**
Credit Risk Education	0.591 – 0.762	6

Extraction Method: Principal Component Analysis.

The six constructs used to measure credit risk education had factor loadings that were between 0.40 and 0.762. This means that the six constructs were effective in measuring credit risk education because they exceeded the minimum threshold of 0.40 accepted by this study.

3.0 Results and Discussion

The study respondents comprised owners or managers of registered micro enterprises across the country. They provided the needed information regarding their enterprises using semi-structured questionnaires. A total of 384 questionnaires were administered to the respondents. Out of the 384 questionnaires, 270 were retrieved with answers, representing a 70.3% response rate. Holtom, et al. (2022) notes that a response rate of between 50-68% is adequate for statistical analysis.

Table 3

Descriptive Results for Credit Risk Education

	Obs.	mean	Standard Deviation
I am fully aware of all risks in financial services.	270	1.71	0.82
I have received credit risk education in my business financing.	270	1.69	1.08
I closely monitor the risks of my business.	270	1.95	1.02
My business has faced credit risk challenges.	270	1.69	0.84
I would be interested in credit risk education if it would improve your business financing.	270	2.11	1.02
I am aware that credit risk education can help to improve	270	1.98	1.16
Overall mean		2.85	

Table 3 shows the measuring constructs of the collective opinion of the credit risk education variable. The overall score obtained through was 2.85, which indicated that the credit risk education of micro-enterprise owners and managers was very low as reported by most of the respondents. This lack of knowledge can be attributed to the failure of most formal sector micro-businesses during their early years of establishment. It is therefore essential to provide micro enterprises with credit risk education.

Correlation Analysis

The study used Pearson correlation analysis to test the existing connection between credit risk education and access to credit by regulated micro-enterprises in Kenya; as shown in Table 4 below.

Table 4

Correlation Matrix

		Credit Risk Education	Access to Credit
Credit Risk Education	Pearson Correlation	1	
	Sig. (2-tailed)		
	N	270	
Access to Credit	Pearson Correlation	0.241**	1
	Sig. (2-tailed)	0	
	N	270	270

**Correlation is significant at the 0.05 level (2-tailed)

The Pearson correlation coefficient calculated and tested indicated that the interconnection between credit risk education and access to credit was found to be positively and statistically significant (r =0.241, p=0.000). This suggests that if credit risk education activities are promoted and practiced, there will be increase in access to credit. The findings were corroborated by Kordy (2018) who declared that bankruptcy rate for individuals who participated in credit risk education was significantly lower than bankruptcy rate for individuals who did not participate in credit risk education.

Logistic Regression Analysis

After confirming that data met the necessary assumptions, regression analysis was performed.

Table 5

Logistic Regression Estimation Results

Logistic Regression — Number of Observation = 270

LR chi² (4) = 63.820

Prob >chi² = 0.00

2Log likelihood = -22.4213 — Pseudo R^2= 0.6729

Variables	Odd Ratios	P>|z|	Marginal effects (dy/dx)
Credit Risk Education	4.7283	0.0002**	0.4037
Constant	0.2215	0.0000**	1.352

Source: Survey data (2022) **significant at 0.05 level of significance

Table 6 revealed the approximated results for the binary logistic regression with the odds ratios, p-values, and the marginal effects of the credit risk education variable. The Pseudo R2 (0.6729) implied that the model accounts for 67.29% of variations in access to credit, while the remaining 32.71% are accounted for by other factors

beyond the scope of the model. The general significance of the model in predicting the relationship between the independent variables and access to credit is also confirmed by its goodness of fit as given by the p-value < 0.05. The results further indicate that the variable is significant in prognosticating access to credit and the most influential variable in improving access to credit is credit risk education (4.7283, $p<0.05$). This, therefore, means that holding all other factors affecting access to credit constant, an improvement in credit risk education measurement will result in greater improvement in access to credit of regulated micro-enterprises.

4.0 Conclusion

From the findings, the study concluded that credit risk education is an integral part of financial advisory services, and is essential for improving access to credit for micro-enterprises regulated by the government. Results indicated that owners and managers of SME businesses are not well-informed about the risks associated with financial services, neither can they do proper monitoring of risks that could affect their operations due to a lack of education from financial organizations. Therefore, it is imperative to provide frequent credit risk education in order to ensure that micro-enterprises have access to the credit they require for growth and development. Credit risk education should be more than just an integral part of financial advisory services, but rather a catalyst for the development of micro-enterprises in the formal sector of Kenya.

5.0 Recommendations

The results indicated a positive significant influence of credit risk education on access to credit of micro-enterprises in the formal sector of Kenya. This infers the importance of credit risk education. Therefore, the study recommends increased access to credit risk education for government-controlled micro-enterprises, through offering online or in-person courses and seminars that focus on understanding credit risk as well as providing mentorship opportunities by experienced entrepreneurs.

The government should also encourage micro-enterprises to be proactive in seeking financial services, much as it should provide incentives to micro-entrepreneurs to pursue higher education. Further, the Kenya Business Support Organization should advocate for regulatory changes to promote access to fair and reasonable services by micro-enterprises. The study also recommended that financial institutions raise awareness through targeted campaigns and outreaches to sensitize micro-enterprises on the importance of credit risk understanding and management. The government should partner with financial institutions to ensure that micro-enterprises become aware of services they can access and their associated risks.

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