

**EFFECTS OF INTEREST RATE CAPPING ON THE BORROWING BEHAVIOUR
OF SMEs IN NAIROBI CBD**

BY

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DECLARATION

I declare that this work has not been previously submitted and approved for the award of a degree by this or any other University. To the best of my knowledge and belief, the thesis contains no material previously published or written by another person except where due reference is made.

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Abbreviations and Acronyms

SMES- Small and Medium Enterprises

MFIs-Microfinance Institutions

GDP-Gross Domestic Product

CBD-Central Business District

CHAPTER ONE: INTRODUCTION

1.1 Background to the study

Small and Medium Enterprises (SMEs) refer to businesses and other organizations that are between small office size and large enterprises, having no more than 500 employees. They are an important segment of the economy contributing 3 percent of GDP growth out of a total of 6.4 percent GDP growth in Kenya as of 2017 (Muriithi, 2017). SMEs are the backbone to many economies around the world. In order for this and other sectors of the economy to thrive, financing plays a major role. Finances enable business enterprises to start up, diversify, expand and meet the working capital requirements.

SMEs get finances from various sources such as personal investments, business incubators, government grants, venture capital and bank loans. Access to credit for SMEs is a fundamental part to the growth of SMEs and economic growth of developing countries such as Kenya. Other factors held constant, a strong relationship exists between the size of a country's SME sector and its economic advancement and growth. Most of the jobs in the developing and developed world come from SMEs showing how important SMEs are to the economy and therefore financial and institutional development helps alleviate SMEs' growth constraints and increase their access to external finance and thus levels the playing field between firms of different sizes. (Akinyemi & Adejumo, 2017)

Lending and borrowing has been recorded as early as the beginning of human civilization (Steiner-Khamsi, 2012). It has simply been a matter of temporarily transferring excess wealth from those who are not using it to those who are in a deficit position but want to utilize these funds where this relationship is built on the trust. Lending has driven commercial, national and industrial growth over the years which would have otherwise been impossible without it.

Individuals and institutions which lend out their resources do so while on an agreement with the borrowing party that the borrower will repay back those funds and at a cost. Cost of credit is the amount of money that individuals part with in the process of acquiring funds from financial institutions. These costs are a mix of different charges such as legal fees, personal insurance, negotiating fees, processing fees and interest rates (Samuel et al, 2014).

An interest rate is the amount of interest due as a percentage of funds lent per period. These rates are dependent factors such as the amount of funds borrowed, the length of time those funds are borrowed, demand and supply in the market, amount of collateral provided and the risk level of the borrower. (Krishnamurthy & Vissing-Jorgensen, 2011) Governments and the Central Banks in some countries such as Kenya, Zambia, United Kingdom and India have had to intervene in order to bring down high interest rates by introducing caps due to various reasons affecting each of these countries.

It is vital to first understand the reasons behind capping of interest rates in order to then look into the effects the capping has brought along. Interest caps are used for various economic and political reasons identified such as market failures in certain industries or an attempt to force more focus of financial resources on a certain sector than the market would be able to accomplish on its own (Miller, 2017). It is possible that interest caps could be effected based on the fact that financial institutions could be charging high interest rates to their customers and making very high profits. The government then has a duty to protect venerable clients from such practices as the clients may not be able to individually protect themselves from such detrimental on goings but the government has the power and ability to step in and make necessary changes and policies.

The capping of interest rates has however come under a lot of criticism. A recent ruling by the High Court in Kenya has declared this capping as unconstitutional because it has a retroactive effect which means that its application affects events that took place even before the law was in effect. Another argument is that the law offended the constitutional rights to property by restricting contractual relationships between banks and their customers, especially pre-existing rights (Odote, 2019). Another issue that has recently been raised is whether the law has taken over the monetary policy role that banks are in charge of. The court has given Parliament 12 months to make amendments to the law so as to clear the uncertainty in the section.

The International Monetary Fund is also pushing for the government to scrap the interest rates control which were capped since it stifled credit access for small and micro enterprises. On the other hand The Treasury says it will introduce legal amendments before Parliament to abolish the rate cap and address the high cost of credit that has seen banks shun small, micro and medium-sized businesses since December 2016. (Akinyemi & Adejumo, 2017)

Around the world however, interest rate caps have been declining over the past years as industrialized countries and developing countries continue easing up their financial policies.(Samuel, 2014)

1.2 Historical background of interest rates in Kenya

This section lays down the history of interest rate regime in Kenya over the years and the developments that have occurred over time. Kenya has had a well-developed and diversified financial system as compared to other Sub-Saharan Africa countries. The financial sector includes building societies, Nairobi Securities Exchange, commercial banks, Micro finance institutions, insurance companies among others. The major ways in which the government intervenes in the financial system include the government owning commercial banks, pension fund, finance companies and an insurance company. This shows that the government has direct and extensive control on setting the maximum lending rates and minimum interest rates on deposits.

The financial sector policy environment was in the 1970s under direct control of the government. It set policies that directed the rates of interest within the country through a 'low pegged interest rate policy'. This policy enabled the government to lower or raise interest rates in order to make the currency weaker or stronger and enable exports and trade to flourish. It was assumed that frequent fluctuations in interest rates would lead to uncertainty in payments and could create confusion in the credit market.

However, in the 1990s, it was fully liberalized and the interest rates were thereafter market-driven. The government committed to enabling a free market economy as written down in the Sessional Paper No.1 of 1986 (GOK, 1986). This commitment was due to negative economic consequences that arose from the different controls that has previously been put in place during independence that were in line with the Sessional Paper No. 10 of 1965.

Recently, in 2016 August, the President of Kenya approved the amendment of the Banking Bill 2015 effected in September 14, 2016 to cap interest rates. This set the lending rates of commercial banks to no more than four percent above the base rate while the minimum interest rates on deposits were set at seventy percent of the same rate. There have however been discussions that this move was unconstitutional since the constitution Article 231 states that the Central Bank should not be under the direct control of any authority or person in the

carrying out of its actions or exercise of its powers. The Central Bank of Kenya has also raised concerns that the capping has led to negative monetary policy outcomes that have led to the decrease in the growth of credit to the private sector.

1.3 Problem statement

Interest rate capping is one of the government intervention methods in the financial market that have been used for many years (Campbell, Jackson, Madrian, & Tufano, 2011). Government control of any form causes changes in the natural market forces which lead to results that are not very predictable. The capping of interest rates was effected by the Kenyan government fundamentally to protect its citizens from being exploited by banks and other financial institutions who before the capping had set high interest rates on loans which made many people default the loans as they could not be able to service them and policy makers were sure that only legislation was going to be able to instil discipline in the banking industry by reducing interest rates to an acceptable level.

This was in order to enable growth in the economy since liquidity problems among companies would be reduced and the cost of capital would be lower. Also, poverty levels would decrease among households and rate of failed businesses would reduce since funds could be easily accessed. This would in turn create more employment opportunities and raise living standards of its citizens. Such a move has also been seen before in countries such as Germany, USA, South Africa, and Zambia (Samuel et al, 2014).

The effect of interest rate capping has had various effects across the economy and several studies have been conducted into its effects on the banking industry and steps the banking industry has taken to counter this move. Banks have had reduced profits since most of the banks heavily rely on interest income to run their operations and beat competition.

Commercial banks now had to resort to other means such as increasing efficiency in order to earn profits and stay afloat. Some measures taken include reducing operational costs such as salaries and wages and opting to offer huge loans to big corporations and the government in order to earn much more and reduce the risk of nonperforming loans which is more often witnessed among risky small businesses and personal loans.

In an ideal business environment, access to funds by SMEs should not be a daunting task due to the benefits that this sector brings to the economy. Viable SMEs should be able to access funding especially loans since they contribute almost half of Kenya's GDP. They employ about 85 percent of the workforce and according to Kenya's vision 2030, small and medium enterprises will be a major driver of social development and youth employment(Muriithi, 2017).

Since the interest rates were capped, banks shunned lending to SMEs and this has reduced their borrowing rate, supported by the Kenya Private Sector Alliance Survey which revealed that respondents from the banking industry reported a downward trend in lending since the capping of the interest rates.

Krishnamurthy and Vissing-Jorgensen (2011) concluded that rate caps were a good government policy for the government to put in place where insufficient credit was being provided to a specific industry which is highly valued in the economy but this measure should be effected only on a short term basis. However, other researchers such as (Porter, Takáts, & Feyzioglu, 2009) advised on the liberalization of the financial function of the economy such as getting rid of interest rate caps in order to improve lending and borrowing, efficiency in investments and efficiency in the financial sector of the economy for all industries to grow without inhibitions.

Due to this conflicting findings it was worth examining further the results that the interest rate capping had over the borrowing behaviour of SMEs. Results show whether the government accomplished its objective in enabling easy access and availability to affordable credit in the country. Having observed the outcomes in different countries, a study in Kenya would agree or disagree with the conclusions of other researchers. This research paper therefore looked into the influence that interest rates capping had on the borrowing behaviour of SMEs.

1.4 Research objectives

1.4.1 General objective

The main objective of this study was to analyse the effect of interest rate capping on the borrowing behaviour of SMEs in Nairobi County-Kenya.

1.4.2 Specific objectives

The specific objectives of the study were:

- i. To determine the volume of borrowing before and after capping of interest rates.
- ii. To identify sources of capital before and after capping of interest rates.
- iii. To determine the cost-benefit analysis of interest rate cap on SMEs

1.4 Significance of the study

The outcomes of this study benefited various stakeholders in the following ways;

For the government, it provided insight into how much its actions directly affected the SMEs on the ground, specifically in Nairobi County and some of the benefits and disadvantages this caused. It provided knowledge on the level of input the government can have in making regulations while putting into consideration all parties affected and different means that can be used to alleviate some challenges that have come about this decision, some of them unintended.

For managers and owners of small businesses, the study helped them understand the policies put in place by the government and therefore make informed decisions going forward for example where to source for funding by being able to measure the pros and cons of different financing options.

Donors and bilateral agencies that play a critical role in the inclusion of the SME sector also gained from this study as they got advice on how best to support SMEs and the cost at which they lend their services in order to be able to effectively boost the sector and offer proper support. This study was also a source of reference for other scholars who may have wanted to research into this field or just build onto their knowledge.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter described the theories that were used in the study as reviewing the related literature is very important because it provided the rationale for undertaking the research project. The interest rate cap was in the recent past introduced at 14% which was much lower than the previous rate which would be as high as 18% on loans based on the factors prevailing in the market such as inflation rate, exchange rates, the risk level of investments, cost of funds, level of non-performing loans, rate of saving relative to borrowing and bank administration and operating costs. The interest rate capping was however associated with a number of things such as the interest rate spread, interest charged on lending and borrowing, government initiatives dealing with the amount of money in circulation among other factors.(Samuel Munzele Maimbo Claudia Alejandra Henriquez Gallegos, 2014). The literature therefore sought to expound further about the factors associated with the interest rates and to show how interest rate capping is involved.

2.2 Theoretical review of literature

This section presented the different theories that back up the study and how they relate with interest rates.

2.2.1 Loanable funds theory

Loanable funds simply mean the sums of money offered and demanded during a given period of time for immediate use at a certain price(Tsiang, 1989). This theory of interest is the theory that maintains the levels of interest rates which is the price at which suppliers of funds demand for foregoing current consumption by loaning out the funds. It is also the price at which those borrowing funds are willing to pay to enjoy current consumption with funds availed to them that ought to be repaid at some point in the future. The market for loanable fund therefore consists of processes and arrangements to enable transactions between those who want to borrow money and those who want and are willing to lend money(Bertocco, 2013).

Demand for loanable funds arises from two basic units of the economy which are business firms, including SMEs and consumers. These two units have a positive rate of time

preference meaning that at any point in time given a choice, a person will always place a higher value on immediately available goods than on the same quantity of future goods(Olson & Bailey, 1981) due to uncertainty of what the future might hold. Consumers are ready to pay interest for earlier availability of funds to purchase durable goods as they view the interest as being the cost for earlier and easier availability of goods. Business firms on the other hand demand loanable funds to serve their need for capital in order to be able to run their operations smoothly without capital constraints(Matete, Ndede, & Ambrose, 2014).

Supply of loanable funds is provided by those who possess surplus funds or those who have funds that they could put into use but opt to curtail current consumption to avail more loanable funds in the market if the interest is sufficiently attractive. Even though people generally prefer current consumption, they also prefer more goods to few goods and so this sacrifice enables them to acquire more goods at a future date.(Matete et al., 2014)

2.2.2 Financial intermediation theory

Financial intermediation is the process performed by commercial banks in which the banks take funds from depositors and lend them out to borrowers. The banking sector flourishes on the financial intermediation abilities of financial institutions which permit them to lend out money at comparatively high rates of interest while they receive deposits at lower interest rates(Diamond, 1984). Through provision of liquidity by financial institutions, these FIs ensure they are able to meet their obligations by charging higher interest rates in order to prevent bank runs where large number of customers withdraw their deposits simultaneously due to worries of the bank's solvency which might lead to the FIs collapsing(Bhattacharya, Boot, Boot, & Thakor, 2010). The financial intermediation process is hindered by information asymmetries since information does not flow smoothly. FIs do not always know about the individuals of businesses they are providing their services to and so they may not be able to track if they spend in such a way that they will be able to repay the loan or that they will not run away without repaying the loan.

Information asymmetry leads to two main problems which are moral hazard and adverse selection(Leland & Pyle, 1977). Moral hazard arises when an individual's behaviour changes

after accessing the financial services. For example, an owner of an SME may decide to engage in a riskier investment after being given a loan with high interest rates. Adverse selection on the other hand refers to the fact that people or businesses whose activities are considered to be risky are those who take up loans and it is impossible for FIs to determine exactly how risky their customers' behaviour is. Such factors lead to FIs imposing higher interest rates (Kwakye, 2012) to safeguard themselves against defaulters and also cater for the high transaction costs required to get the data they need about potential clienteles to provide them with services.

2.2.3 Keynesian theory

The Keynesian theory states that the economy can settle at any equilibrium. At any particular moment in the economy when there is a lot of money in circulation, interest rate is one of the methods that can be used to control it (Robertson, 1931). This therefore means that an increase of money in the economy will lead to an increase in interest rates which has an inverse relationship with income as this reduces disposable income available to individuals.

Another view which John Keynes put forward was the liquidity preference (Dalziel, 1996) which explains the determination of interest rates by the supply and demand for money. He stated that interest paid was not a reward for saving rather a reward for refraining from consuming current income, that is, parting with liquidity. Money is the most liquid asset and therefore the more quickly an asset is converted to money the more liquid it is. The demand for money arises three motives (Bibow, 2013): the transaction motive which is money needed for day to day operations by a person or in a business. In case of inflation, transaction costs of banks may increase and the banks may decide to increase their interest rates in order to raise more money for their day to day operations. Precautionary motive is where individuals and firms prefer to have liquidity in case of any unexpected problems or opportunities that they may want to venture into. Keynes argues that money is kept in order to fulfil the store of value and if all actions were known certainly then only money for transaction purposes would be held. These uncertainties explain why banks charge premiums and increase interest rates so as to compensate the risk of defaulters. Speculative motive is the demand for money to invest in opportunities that offer high returns. According to Keynes, if a bank decided to lend to a risky sector in the economy, the interest rates will be high so as to compensate the risk of defaulters. Bond investments are introduced where bonds and interest rates have an inverse relationship such that if interest rates are low the bond prices are high and vice versa (Davidson, 1965)

This theory however does consider other determinants of interest such as government intervention where introduction of interest rate capping is under its scope.

2.2.4 Classical theory of the rate of interest

This theory states that the rate of interest is determined by the equilibrium of demand for investment and the willingness to save. The price of investment is the interest paid since firms borrow money for investment. Therefore, interest rate determines investment which represents demand. Households on the other hand save their money in order to earn interest. Low interest leads to low saving and high interest leads to high saving and so saving is directly related to interest rates. Household's saving thereby fulfils firms' demand for investment. Interest rates are then determined at the point which supply for saving and demand for investments intersect each other. Interest rates move to adjust changes in either savings or investments.

A relationship between this theory and interest rate capping can be derived since one of the reasons behind capping of interest rates was to enable individuals and businesses access credit facilities regardless of their monetary capabilities (Akinyemi & Adejumo, 2017). Capping of interest sets aims to set the equilibrium to a point where the ability to invest is at a point where more individuals can be able to afford and by doing that, meet the demand in the market.

2.3 Review of empirical studies

2.3.1 Reasons for interest rate caps

Samuel et al (2014) state that interest rate capping was introduced as a measure to curb the high cost of credit and high interest rate spreads where individuals and SMEs brought forward complaints on the unaffordability of credit facilities from the banking sector and a very high discrepancy in the average rates offered by banks on deposits and yields received from loans. Cost of credit is the amount of money that individuals part with in the process of acquiring funds from financial institutions. These costs are a mix of different costs such as legal fees, interest rates, personal insurance, negotiating fees and processing fees.

Miller (2013) brings forward another view which is that lawmakers wanted to expand access to credit facilities, lower lending rates and increase the return on savings by capping interest rates. These high lending rates by banks were seen as the source of excess profits for the banking industry which was leading to harm in the economy as investments were curtailed. It was

getting more and more expensive by the day for individuals and businesses to access credit facilities from banks within the country as these factors put borrowing out of reach of many individuals and businesses.

Delis and Kouretas (2011) state that lack of trust in the banking sector can cause interest rate caps to be effected. Lacking trust in the banking sector can manifest itself in various ways such as bank failures that were seen here in Kenya. Some of the banks that were closed include Imperial Bank Limited, Chase Bank and Dubai Bank. After the closure of these banks depositors were unable to access their deposits and were left helpless.

2.3.2 Volume of borrowing before and after interest rates capping

Research has shown that there was a slowdown in credit uptake since the introduction of interest rate caps (Aisen & Franken, 2010) in countries such as Ecuador and Nicaragua in the past. This was due to banks constricting their credit parameters in order to reduce credit risk. This has however led to high risk borrowers such as individuals and SMEs being excluded from accessing these funds. They are considered as high risk due to the unpredictable operating environment, uncertain competitive environment, delayed payments for products offered and services rendered and the high fixed costs associated in obtaining accurate information about those borrowing which also leads to high cost of credit to this group (Smit & Fatoki, 2012). In Nicaragua for example, it was witnessed that credit uptake dropped massively in 2001 from 30% to 2% (Reinhart & Rogoff, 2010) after the cap was introduced.

Also evidenced in Japan loan acceptances dropped with the introduction of the cap (Samuel and Alejandra, 2014). SMEs and individuals have borne the burden of being disadvantaged by the capping of interest rates since banks prefer to lend to the government and investing in government securities as they are less risky. Business men are then unable to meet their working capital needs and funds to invest and expand their operations which ties to lower GDP growth from this segment in the economy that contributes 3% of the total 6.4% GDP growth in Kenya (Muriithi, 2017). SMEs have been pushed to seek financing from MFIs which lend unmaintainable interests on short term loans.

According to (Nuwagaba, 2015) the volume of borrowing declined since interest rate caps were effected. The volume of loan accounts in the country declined by 26.1% within the first year of interest rate capping. Large banks reported a drop in loan accounts by 27.7% while medium

sized banks reported a reduction in loans by 11.1%. This clearly indicated that large banks were at the forefront in the squeezing out of small borrowers who include individuals and SMEs.

2.3.3 Sources of capital before and after capping of interest rates.

(Ngwenya & Ndlovu, 2003) indicate that in Zimbabwe after the interest rates were capped MFIs stepped in to bank those high risk borrowers that were left out by mainstream banks. SMEs were therefore able to access funding for capital and expanding operations from MFIs. The MFIs backed their reason to provide finances to such groups which include SMEs and individuals based on the reasoning that these groups lacked financial resources rather than the skills to run viable projects.

(Abdulsaleh & Worthington, 2013) indicate that SMEs in South Africa initially had various sources of funding available to them such as personal savings, friends and family, venture capitalists, MFIs, SACCOs, government grants and commercial banks. According to (Naceur & Kandil, 2009) South Africa then introduced interest rate caps to curb the high interest rates that banks were charging on lending. This led to negative consequences which were witnessed all over the country which was that there was less transparency in the banking sector. Banks found a way to increase their income on lending by introducing many extra commissions and fees which beat the purpose of lowering the cost of lending as loans became more expensive overall. It however led to innovation such as the Grameen Bank (Whittaker, 2007) which introduced microcredit, pioneered by Bangladeshi Professor Muhammad Yunus, where poor people and SMEs were granted small loans which is being duplicated by many MFIs around the world.

Mungiru & Njeru (2017) state that after SME loan applications were denied by commercial banks SMEs resorted to informal sources of finance in order to enable their operations. SMEs reported that they turned to sources such as shylocks in order to secure finances. Others resorted to using credit from suppliers while others sought funds from their family and friends.

Ndung'u (2018) reports that due to the great improvement of technology mobile money services are available and being used by SMEs. These services are available in 61 percent of the world's developing nations with approximately two hundred and fifty-five live mobile money services in Sub Sahara Africa which indicate the acceptance and usage of these services.

In Kenya particularly, usage of these services increased after introduction of interest rate caps due to the ease of accessing finances as compared to mainstream commercial banks.

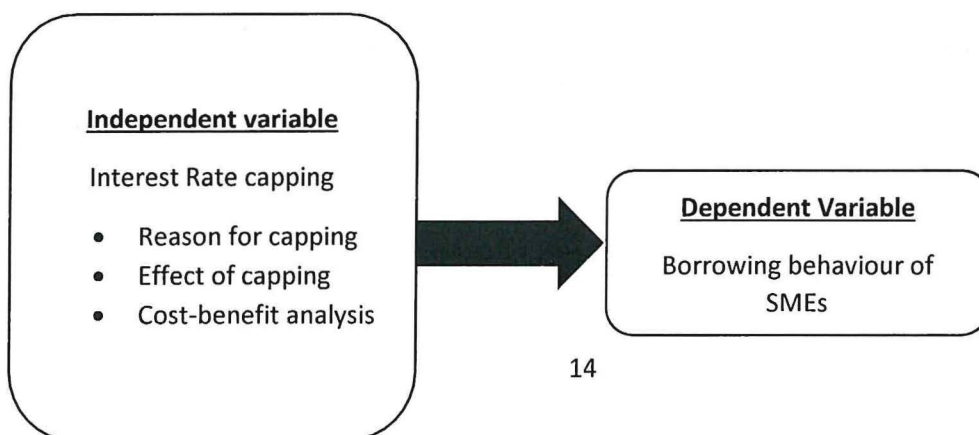
2.3.4 Cost-benefit analysis of interest rate caps on SMEs

According to (Zinman, 2010) SMEs were unable to meet their work in capital requirements leading to losses in terms of revenue and also customers brought about by lack of credit from banks. Firms that have greater access to finances and capital are able to take advantage of opportunities that arise easily and faster thereby growing and gaining higher profits (Musamali & Tarus, 2013). Generally, SMEs operate on tight budgets and often get financing from personal savings, loans from family and friends and credit from banks. They are most times unable to access huge amounts of money needed to purchase machinery and equipment as well as raw materials needed for the day to day running of the businesses and due to low goodwill and little fixed investments they are unable to secure loans at reasonable interest rates.

Fell and Morgenstern (2010) brought forward an argument that interest rate caps indirectly led to businesses lowering their operational costs. Due to constraints in accessing funding from commercial banks after the introduction of interest rate caps, businesses sought other ways to maximize the resources they currently had and the little they could acquire from other sources like friends and creditors. They therefore streamlined their activities to remove and wastages and therefore have more money to reinvest or expand their operations.

2.4 Conceptual framework

The conceptual framework defines the concepts relevant to the study and their interrelationship which is portrayed diagrammatically. The independent variable in the study is the interest rate capping while the dependent variable is the borrowing behaviour of SMEs



2.5 Research Gap

Several studies have been conducted on the impact that interest rate capping has had on the economy. However, no study was conducted on the effects that the interest rate capping directly had on the borrowing behaviour of SMEs in terms of loans applied for and granted to SMEs before and after the capping of interest rates and this is the gap that my study focused on in order to shed more light on the issue.

2.5 Summary of literature review

It is evident from the literature review that the issue of interest rates, their capping and the levels of credit issued by commercial banks locally and internationally has been discussed severally. The variables affecting the study and their interrelationship has also been addressed.

Generally speaking, interest rate capping has not had positive outcomes although it is a tool that has been widely used around the globe to ensure affordable credit in the economy. Application of this control has been backed up by claims that some major economies like the United Kingdom have applied them although it is evident that there are other factors that make such economies operate effectively. Some of those factors include information symmetry on potential lenders and borrowers in the market and competition among banks. This section then shown the research gap that is present in the current body of researches done within the country and even beyond its borders.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

The chapter discussed and outlined the research methodology that was used to meet the research objectives in Nairobi County. A research is an outline of how objectives of the study are met and how problems under investigation are solved by use of study materials and other sources in order to arrive at a new conclusion(Ary, Jacobs, Irvine, & Walker, 2018). The chapter therefore provides information on the study population, method of data analysis, data reliability and validity, data collection instruments and procedures used.

3.2 Research Design

Research design is the plan that provides the structure that brings together all elements of the study so that the results obtained are free from bias, credible and generalizable(Dannels, 2018). In order to achieve the proposed research objectives which is to identify the effects of interest rate capping on the borrowing behaviour of SMEs the design selected for this study was quantitative research using the descriptive design.

The quantitative research was used in this case in order to test the hypothesis that capping of interest rates has an effect on the borrowing behaviour of SMEs. It was used to draw conclusions after conducting research from a large number of respondents and the results can be projected onto the entire population. The descriptive design was used in order to establish the association between the variables(Rahi, 2017). It does not restrict the researcher to fact findings and it also describes data and attributes about the population studied. The research topic was based on the borrowing behaviour of SMEs which cannot be quantified using figures and so the best way to present such characteristics is through describing it.

3.3 Target population

Research population is a large body of objects, items or individuals that are the main focus of a scientific enquiry where the population have common characteristics or traits(Drake, Rancilio, & Stafford, 2017). The population for this study is all SMEs that operate within Nairobi CBD and information required involving the borrowing of these SMEs can only be addressed by business managers and top administrators in these SMEs and so these individuals form the target population from which a sample was chosen.

Based on data provided by the Public Procurement Oversight Authority(PPOA) there are 832 SMEs licensed by the Ministry of Industry, Trade and Cooperatives(Authority, 2016). NCBD was chosen by the researcher because it is a lucrative business town and also due to its convenience. The categories of SMEs are service providers, manufacturing enterprises and merchandisers. The target population was stratified below:

Table 1: Target Population

Nature of SMEs	Population
Service providers	263
Merchandising enterprises	460
Manufacturing enterprises	109
Total	832

3.4 Sampling

A sample is a subgroup of the elements of the population selected to participate in the study(Krejcie & Morgan, 1970). The researcher is able to study a smaller part of the population and obtain data that is a representative of the whole population. This is because total coverage of the population is difficult to achieve due to time and resource constraints.

The sampling unit in this research is the Central Business District (CBD) in Nairobi.

3.4.1 Sampling procedure

Stratified random sampling was used in this research to select a 10 percent sample size from each strata thereby ensuring all elements are given an equal chance of being selected to

obtain the highest accuracy(Zinn & McDonald, 2018). The sample size was therefore distributed as; eleven small scale manufacturers, twenty-six service providers, nine wholesalers and large scale retailers and thirty-two small retailers.

Table 2: Sampling design

Nature of SME	Population	Multiplier	Sample
Service providers	263	0.1	26
Merchandising enterprises	460	0.1	46
Manufacturing enterprises	109	0.1	11
Total	832		83

3.5 Data Collection Techniques

Primary data and secondary data were collected by the researcher. Primary data was collected through the use of questionnaires. The questionnaire was open and closed ended and was administered through drop and pick later method. Secondary data on the other hand was collected from past records and official documents.

3.6 Data analysis and presentation

Data analysis is the process through which data is assessed through analytical and logical reasoning in order to determine the variables(Dannels, 2018). It involves gathering data from different sources, reviewing this data and analysing it in order to form a deduction. Completed questionnaires were checked for completeness and consistency. Data analysis was done using descriptive and statistical approaches. Data was then presented in charts and graphs using Microsoft Excel and tables to enable clear visual comparison.

3.7 Empirical model

An event study was conducted and the variables were studied. The study compared the effects on the variables in the table below showing before and after capping of interest rates.

Table 3: Effects of capping on the variables

Before interest rate capping	After interest rate capping
Amount of loan advanced	Amount of loan advanced
Number of loans accepted	Number of loans accepted
Number of loans rejected	Number of loans rejected

3.8 Ethical considerations

Participants in this study cooperated out of their own volition and their refusal to be participate or to answer all the questions was respected. Information gathered was treated as confidential and was only used for research purposes. Formal approval was also obtained and granted by Strathmore University Business School to carry out the research.

CHAPTER 4: DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter deals with the analysis of data that was collected and compiled of the findings of the study. The end-goal of this study was to analyse the effect of interest capping on the borrowing behaviour of SMEs in Nairobi CBD. The study targeted 83 respondents however 75 questionnaires were returned duly filled giving a response rate of 89%.

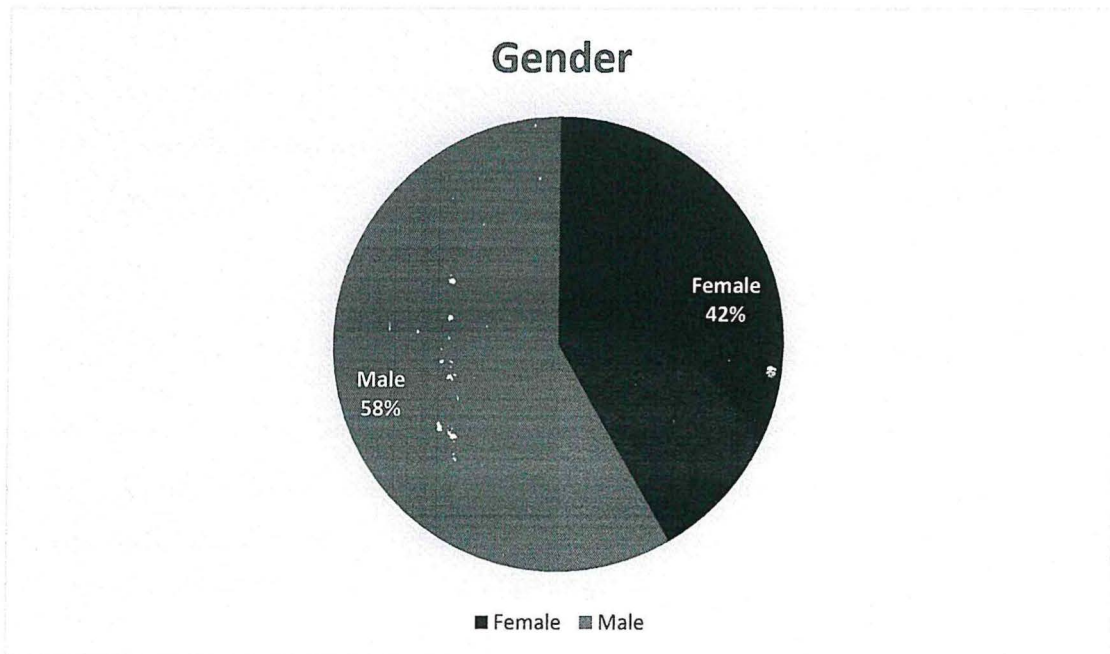
4.2 Demographic information

The section looks into the respondents' demographic data and specifically into the age of respondents, their gender distribution and how long their business has been operating.

4.2.1 Gender

This was looked into in order to ensure there was both genders involved in the study. The results were analysed below showing a majority of male respondents at 58.4% and female respondents at 41.6%.

Figure 1: Gender categories



4.2.2 Age bracket

The age of the respondents gives an insight of how different age groups respond to various circumstances and issues such as the capping of interest rates. To make sure that opinions from different age groups were considered, respondents were requested to select their age group. Majority of the respondents were between 36-40 years followed by the 31-35 age group. The lowest age group was the above 40 years one. The respondents were fairly distributed in terms of age.

Table 4: Age bracket

Age bracket	Frequency	Percentage
20-25 years	8	10.6
26-30 years	15	20
31-35 years	21	28
36-40 years	25	33.4
40 and above years	6	8
Total	75	100

4.2.3 Period of time which SME has been in operation

The period of time the SME has been in operation enables the respondents to give responses that can be relied upon based on how long they have been in the sector and their experience before and after the capping of the interest rates if they were in operation. From the analysis below, majority of the SMEs, 30.6%, had been in business for 8-10 years. 25.4% had been in operation for more than 10 years and 20% for 1-3 years. The group with the lowest period of time in existence was 9.4% which was less than one year in operation and 14.6% which was between 4-7 years in operation. This analysis implies that the SMEs had been in business for a considerable amount of time and so were in a position to provide credible information.

Table 5: Period which SME has been in operation

Period	Frequency	Percentage
Less than one year	7	9.4
1-3 years	15	20
4-7 years	11	14.6
8-10 years	23	30.6
Above 10 years	19	25.4
Total	75	100

4.3 Effects of interest rate capping

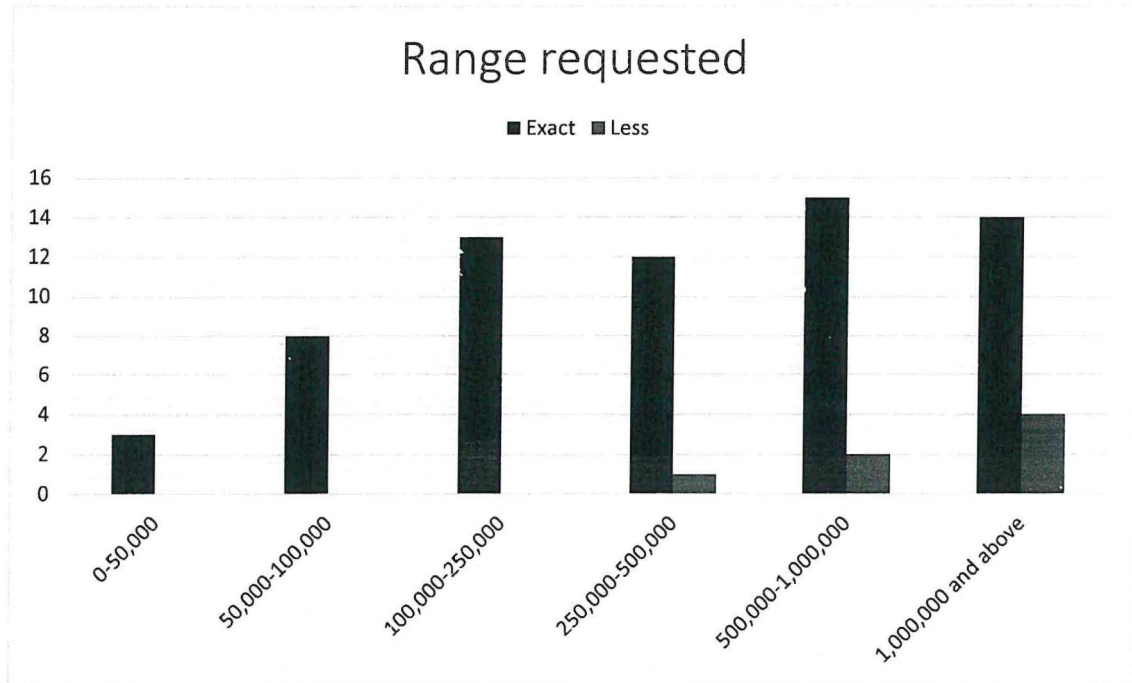
4.3.1 Amount of loan requested versus received before capping of interest rates.

The study revealed that SME owners who borrowed funds from banks before the interest rates were capped were 72 out of 78 business owners. 65 of them received the exact amount they requested for while the other received reduced amounts due to reasons such as high levels of security required as well as risk levels specific to the firm.

Table 6: Loans requested and received before capping

Range requested	Amount received		
	Exact	Less	Total
0-50,000	3	0	3
50,000-100,000	8	0	8
100,000-250,000	13	0	13
250,000-500,000	12	1	13
500,000-1,000,000	15	2	17
1,000,000 and above	14	4	18
Total	65	7	72

Figure 2: Graph showing range of loans requested and received before capping



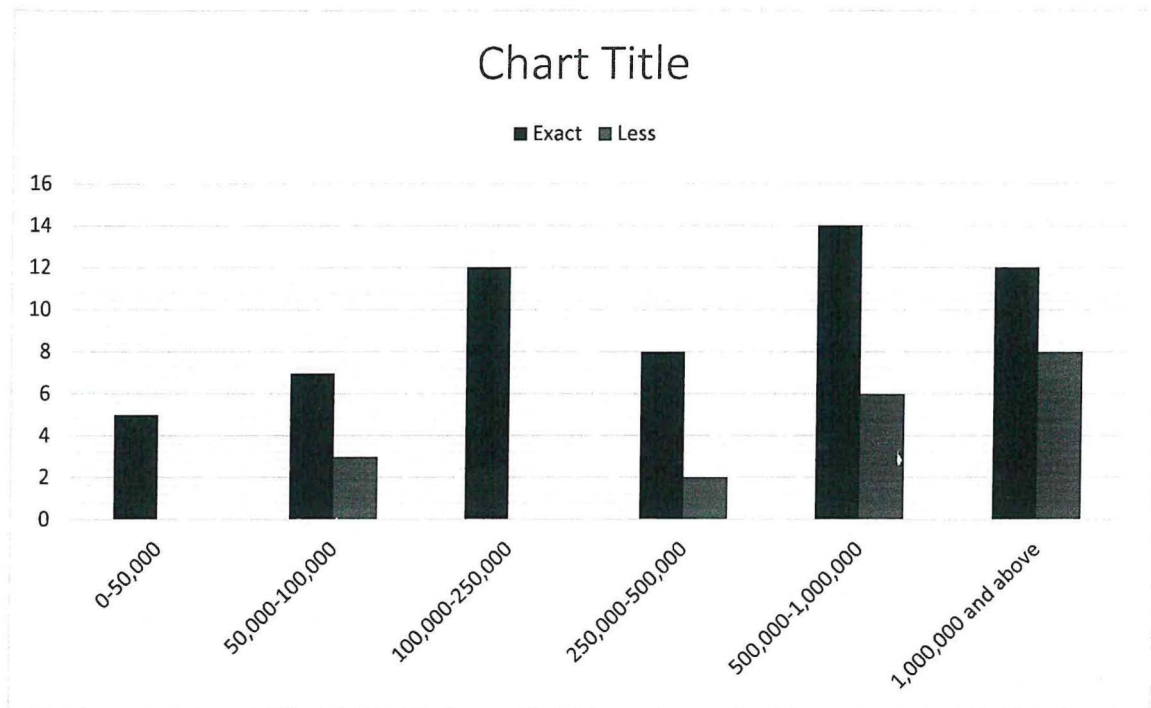
4.3.2 Amount of loan requested versus received after capping of interest rates.

From the data that was analysed, the researcher realised that there was a slight increase in the number of loans requested after interest rates were capped as this meant that credit was going to be cheaper since the interest rates were capped at a lower rate therefore lowering the cost of borrowing.

Table 7: Loans requested and received after capping

Range requested	Amount received		
	Exact	Less	Total
0-50,000	5	0	5
50,000-100,000	7	3	10
100,000-250,000	12	0	12
250,000-500,000	8	2	10
500,000-1,000,000	14	6	20
1,000,000 and above	12	8	20
Total	58	19	77

Figure 3: Graph showing range of loans requested and received after capping



4.3.3 Number of loan requests received

The number of loans requested versus those received is seen to have reduced after the interest rates were capped. SME owners indicated that this reduction was brought about by the increased bottlenecks introduced by commercial banks to control lending to small scale borrowers and in turn lend to large scale borrowers such as governments and institutions in order to increase their profit margins.

However, the number of Loan requests to commercial banks increased after the capping of the interest rates. This is due to interest rates becoming more affordable which encouraged many business owners to apply for loans. Due to tougher measures by banks, for example more collateral needed, more individuals were denied these services due to their high risk nature.

4.4 Secondary data from Central Bank of Kenya

In Kenya, regulation of deflation and inflation is a role assigned by the government to the CBK. This therefore tasks the CBK with controlling interest rates within the country. Data from the CBK indicates that the capping of interest rates led to negative effects being felt in the SME sector with many SMEs being locked out from accessing credit. This was due to measures

effected by commercial banks to control credit risk(Maigua & Mouni, 2018). 55% of commercial banks in 2017 and 62% in 2018 indicated that high security measures were instituted thus creating more bottlenecks(CBK,2018). Commercial banks therefore realized that due to controlled interest rates in the country, they had to introduce more measures in order to control the risk of default by small scale borrowers.

4.5 Cost-benefit analysis of interest rate capping on SMEs

Table 8: Interest rates are considered before taking loans

	Frequency	Percent	Cumulative percentage
Strongly agree	64	85.3	85.3
Agree	9	12	97.3
Neutral	1	1.3	98.6
Disagree	1	1.3	100
Strongly disagree	0	0	100
TOTAL	75	100	100

A big percentage of the respondents,97.3%, agreed that interest rates were definitely a consideration before taking loans as this determined the cost of borrowing and the ease of paying back the loans. High interest rates discouraged uptake of loans while lower interest rates promoted the uptake of loans.

Table 9: Interest rate capping affected decision regarding uptake of loans

	Frequency	Percent	Cumulative percentage
Strongly agree	53	70.6	70.6
Agree	11	14.6	85.2
Neutral	7	9.3	94.5
Disagree	3	4	98.5
Strongly disagree	1	1.5	100
TOTAL	75	100	100

After the interest rates were capped, many SME owners decided to take up loans since the interest rates were lower and they could therefore manage to service these loans. Some of the respondents who were not using credit as a source of finance reconsidered this decision after the capping and applied for credit from commercial banks. Banks however did not grant these loans easily and many SMEs were locked out with their requests denied.

Table 10: Interest rate capping affected access to credit

	Frequency	Percent	Cumulative percentage
Strongly agree	67	89.3	89.3
Agree	5	6.6	95.9
Neutral	3	4	100
Disagree	0	0	100
Strongly disagree	0	0	100
TOTAL	75	100	100

Once the interest rates were capped the SME sector immediately felt the effects of this action since most of the SMEs were then unable to access credit from commercial banks and most were unable to comfortably continue with their operations. This was however not the intended repercussion since the capping of interest rates was meant to avail more credit especially to SMEs.

Table 11: Money supply in the economy has had an effect on the business

	Frequency	Percent	Cumulative percentage
Strongly agree	31	41.3	41.3
Agree	25	33.3	74.6
Neutral	10	13.3	87.9
Disagree	7	9.3	97.2
Strongly disagree	2	2.8	100
TOTAL	75	100	100

Due to the restrictions of commercial banks to small scale borrowers, money in circulation was less and so SMEs were unable to finance their operations such as their working capital requirements and they also recorded lower profit margins since customers were fewer due to

less disposable funds to enable them pay for goods and services. Some of the SMEs went out of business due to these factors and the SME sector has definitely been experiencing lower growth and sustainability rates since the interest rates were capped.

Table 12: Interest rate capping has had a positive impact on your business activities

	Frequency	Percent	Cumulative percentage
Strongly agree	7	9.4	9.4
Agree	12	16	25.4
Neutral	11	14.6	40
Disagree	18	24	64
Strongly disagree	27	36	100
TOTAL	75	100	100

Most respondents reported that the capping of interest rates did not have a positive impact on the business activities as it had been anticipated. SME owners had expected to have greater access to funding as it was cheaper after the capping of the interest rates but unfortunately this was not the case. Lack of credit access was a major setback to many SMEs that rely on credit to operate and this was felt across the sector as businesses became more difficult to operate and keep afloat.

Table 13: Interest rate capping has had a negative impact on your business activities

	Frequency	Percent	Cumulative percentage
Strongly agree	32	42.6	42.6
Agree	20	26.6	69.2
Neutral	11	14.6	83.8
Disagree	8	10.6	94.4
Strongly disagree	4	5.5	100
TOTAL	75	100	100

Majority of the respondents stated that the capping of interest rates brought about negative effects felt in the sector since it became increasingly difficult to secure credit meant to enable efficient running of business. Business owners were unable to acquire stock for sale, expand their businesses or meet business expenses with ease thus leading to some SMEs closing down or scaling down in their operations.

Table 14: Interest rate capping should be reversed for the good of the SME sector in Nairobi

	Frequency	Percent	Cumulative percentage
Strongly agree	60	80	80
Agree	10	13.3	93.3
Neutral	4	5.3	98.6
Disagree	1	1.4	100
Strongly disagree	0	0	100
TOTAL	75	100	100

A majority of the respondents indicated that they would prefer if the capping of interest rates was lifted as this would definitely enable them access more credit advances from banks once the banks ease the bottlenecks in place that lock out SMEs from accessing credit easily. Businesses would then thrive as money in circulation would be more enabling trade to take place efficiently.

4.5 Summary and interpretation of the findings

The response rate of 89% was sufficient to draw conclusions for this study. Majority of the respondents have been in business for a considerable number of years which shows they have sufficient knowledge to respond to the questions. The gender of the respondents was 58.4% for males and 41.6% for females which shows that both genders were considered in the study and could give responses adequately from different perspectives.

According to the analysis above it is evident that there was an impact on borrowing behaviour of SMEs in Nairobi CBD after the capping of interest rates. Amount of loans requested was

higher due to credit becoming more affordable however the number of SMEs that then received these loans and in the amounts they requested dropped significantly.

Large corporations and the government are the ones at an advantage due to economies of scale enabling commercial banks earn more profits from them and thus locking out small scale borrowers such SMEs and so crippling the SME sector and therefore cannot contribute as much to the GDP of the country.

The government should definitely look further into this issue in order to enable the SME sector to thrive

CHAPTER 5: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1: Introduction

This chapter gives a summary of the study, conclusion from the study and recommendations for the purpose of practice, policy and further studies in regards to effects of interest rate capping on the borrowing behaviour of SMEs specifically in Nairobi CBD.

5.2: Summary

This study aimed at looking into the effects of interest rate capping on the borrowing behaviour of SMEs in Nairobi CBD. Concerns had been raised by several stakeholders due to the negative effects felt once the capping of interest rates was effected contrary to the expectations that credit would be cheaper and easier to access.

Capping of interest rates means a control put in place on interest rates charged by lending institutions such as microfinance institutions, commercial banks and other non-bank financial institutions. Capping of interest rates then reduces the profits earned by these institutions since interest is a major source of income for financial institutions. This therefore forces these financial institutions to come up with ways to make profit and survive. These strategies are detrimental to the success of the SME sector as evidenced by the loans requested versus those granted.

This data was obtained first hand from SMEs in Nairobi CBD regarding the period before the interest rates were capped and after. Statistical and descriptive analysis was conducted on the data collected in order to make statistical conclusions on the impact that interest rate capping had on the borrowing behaviour of SMEs in Nairobi CBD.

5.3 Conclusion

It is evident from this study that there is a relationship between interest rate capping and the borrowing behaviour of SMEs. In as much as credit is more affordable, it is not easily accessible due to the crowding out effect brought about by commercial banks lending to large corporations and the government with lower default risk than households and SMEs. SMEs are then forced to look for other sources of financing such as venture capitalists, angel investors, personal savings, shylocks, friends and family.

The results of this study therefore indicate that if the interest rate capping remains in place, SMEs may continue having difficulties in accessing credit easily and so they may be forced to close down eventually since financing is a major factor that cannot be overlooked in the operations of a business. The contribution of SMEs to the country's GDP will be significantly lower and the sector may collapse in the long-run if these conditions prevail. The study has therefore proven that the interest rate capping has negatively affected the borrowing behaviour of SMEs in Nairobi CBD.

5.4 Recommendations of the study

This study recommends that the government and major stakeholders review the law on interest rate capping in order to encourage the growth of the SME sector by enabling easier access to funding. SMEs will no longer shy off from borrowing due to fear of being denied credit and will also avoid unregulated financiers such as shylocks.

The government can alternatively enable SMEs access financing by stating the standard minimal requirements for borrowing so as to enable banks grant more credit. Banks can also minimize their operational costs therefore increasing their profit margin and not heavily depend on interest charges as the source of income. In future, all major sectors in the economy need to be carefully put into consideration when making such major economic decisions.

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APPENDICES

Appendix 1: Research Questionnaire

This questionnaire will be used to assess the effect of interest rate capping on the borrowing behaviour of SMEs in Nairobi County. Your company has been selected to participate as a respondent. Information given will be used for academic purposes only and will not be revealed for any other purposes. Mark where appropriate.

PART A: INTRODUCTION

1. Name of the business:
2. How long has your business been in existence?
3. What nature of business are you engaged in?

Service provider	
Merchandising enterprise	
Manufacturing enterprise	

4. What are your sources of financing?

Funding from Personal Savings.	
Debt Financing.	
Friends & Family	
Angel Investors	
Venture Capitalists	

5. Has interest rate capping affected your business, either directly or indirectly?

Yes	
No	

6. What is your gender?

Male	
Female	

7. What is your age bracket in years?

20-25? __ 26-30? __ 31-35? __ 36-40? __ Above 40 years? __

PART B: VOLUME OF BORROWING BEFORE AND AFTER CAPPING OF INTEREST RATES.

1. What is the range of loan amounts taken before capping of interest rates?

0-50,000	
50,000-100,000	
100,000-250,000	
250,000-500,000	
500,000-1,000,000	
1,000,000 and above	

2. Did you find it harder or easier to access loans from commercial banks after capping of interest rates?

Yes	
No	

3. Did the capping of interest rates cause any change to the loan amounts taken?

Yes	
No	

4. Loan amounts subsequently taken:

0-50,000	
50,000-100,000	
100,000-250,000	
250,000-500,000	
500,000-1,000,000	
1,000,000 and above	

PART C: SOURCES OF CAPITAL BEFORE AND AFTER CAPPING OF INTEREST RATES.

1. What sources of capital do you use for your business?

Funding from Personal Savings.	
Debt Financing.	
Friends & Family	
Angel Investors	
Venture Capitalists	

2. Since interest rates were capped, has there been any need to change your source of capital?

Yes	
No	

3. What is the source of capital after interest rate capping was effected?

Funding from Personal Savings.	
Debt Financing.	
Friends & Family	
Angel Investors	
Venture Capitalists	

PART D: COST-BENEFIT ANALYSIS OF INTEREST RATE CAP ON SMES.

No	Statement	Strongly Agree	Agree	Neutral	Disagree	Strongly Disagree
1.	Interest rates are considered before taking loans					
2.	Interest rate capping affected your decisions regarding uptake of loans					
3.	Interest rate capping affected your access to credit?					
4.	Money supply in the economy has an effect on businesses such as yours					
5.	Interest rate capping has had a positive impact on your business activities					
6.	Capping of interest rates has had a negative impact on your business activities					
7.	Interest rate capping should be reversed for the good of SMEs in Nairobi					

Appendix 2: List of Respondents

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

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

66. Njos General Supplies
67. Victorock Kenya Limited
68. Gewan Ventures
69. Laibelos Enterprises
70. Eltam Limited
71. Shaly Enterprises
72. PM Verity Enterprises
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EFFECTS OF INTEREST RATE CAPPING ON THE BORROWING BEHAVIOUR
OF SMEs IN NAIROBI CBD

BY

SYLVIA WAMBUI NJOROGE

091787

A Project Report Submitted to the Strathmore University Business School in Partial
Fulfillment for the Degree of Bachelor of Commerce in Strathmore University

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