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**Interest Rate Control Law and Accessibility of Credit by MSMEs in  
Kenya: Towards Alternative Approaches**

By

Samuel N. Wamaitha

148607



**Master of Laws**

**July, 2023**

# **Interest Rate Control Law and Accessibility of Credit by MSMEs in Kenya: Towards Alternative Approaches**

By

Samuel N. Wamaitha



**Submitted in Partial Fulfillment of the Requirements for the Degree of Master of Laws at  
Strathmore University**

**Strathmore Law School  
Strathmore University**

**Nairobi, Kenya**

**July, 2023**

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## Abstract

Kenya has been through a complete cycle of imposing and eliminating interest rate caps when it comes to the lending practices of banks. This has born both positive and negative consequences on lenders and borrowers in equal measure. Even so, the recent elimination of interest rate caps has left Micro, Small and Medium Enterprises (MSMEs) affected the most. With a view to establishing a different approach to interest rate control that takes to account the interests of MSMEs, this study investigates the implications associated with capping laws on the interests of MSMEs by way of doctrinal legal research. In its findings, it identifies alternatives and best practices that can be implemented to limit the high costs of borrowing in the even interest rate control becomes an inevitable regulatory mechanism. This is based on the postulation that interest rate control law can be iterated towards enhancing financial inclusion of MSMEs without registering negative effects on their interests as borrowers. The study finds that despite being aimed at financial inclusion of low-income consumers of credit such as MSMEs, interest rate control also bears negative implications such as adverse selection and financial exclusion of this group. Hence, the study finds that the Kenyan legal framework can be iterated pursuant to the pillars of the social contract theory to exercise interest rate control with caution through consumer protection and through monetary policy tools used by the Central Bank to influence liquidity in the banking sector.

Key words: *interest rate control, MSMEs, financial inclusion, cost of borrowing*



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## **List of Abbreviations and Acronyms**

CBKs – Central Bank of Kenya

CBR – Central Bank Rate

CEO – Chief Executive Officer

CGS – Credit Guarantee Scheme

CRR – Cash Reserve Ratio

IMF – International Monetary Fund

MOU – Memorandum of Understanding

MPAC – Monetary Policy Advisory Committee

MPS – Monetary Policy Statement

MSMEs – Micro, Small and Medium Enterprises

OECD – Organization for Economic Co-operation and Development

REPOS – Repurchase Agreements

SACCO – Savings and Credit Cooperative Society

SMEs – Small and Medium Enterprises



## **List of Cases**

*Boniface Oduor v The Hon. Attorney General & Others (2019) eKLR*

*G. Muthoga V. Habib Zurich Finance (K) Limited & another (2016) eKLR*

*Godfrey Paul Okutoyi (suing on his own behalf and on behalf of and representing and for the benefit of all past and present customers of banking institutions in Kenya) v Habil Olaka – Executive Director (Secretary) of the Kenya Bankers Association Being sued on behalf of Kenya Bankers Association) & another [2018] eKLR.*

*Kenya Commercial Finance Company Ltd vs Ngeny & Another [2002] 1KLR.*

*Kenya Hotels Limited Vs Oriental Commercial Bank Ltd (Formerly known as Delphis Bank Limited) (2019) eKLR*

*Momentum Credit Limited v Kabuiya (Civil Appeal E035 of 2022) [2022] KEHC 13705 (KLR) (Commercial and Tax) (7 October 2022) (Judgment)*

*Mwambeja Ranching Company Limited & another V. Kenya National Capital Corporation (2019) eKLR*

*Pius Kimaiyo Langat vs. Co-operative Bank of Kenya Ltd [2017] eKLR.*

*Trustees of Maximum Miracle Centre v Equity Bank (K) Limited (Civil Case E055 of 2021) [2021] KEHC 237 (KLR) (Commercial and Tax) (11 November 2021) (Ruling)*

## **List of Statutes**

Constitution of Kenya, 2010

Central Bank Act

Banking Act

The Finance Act

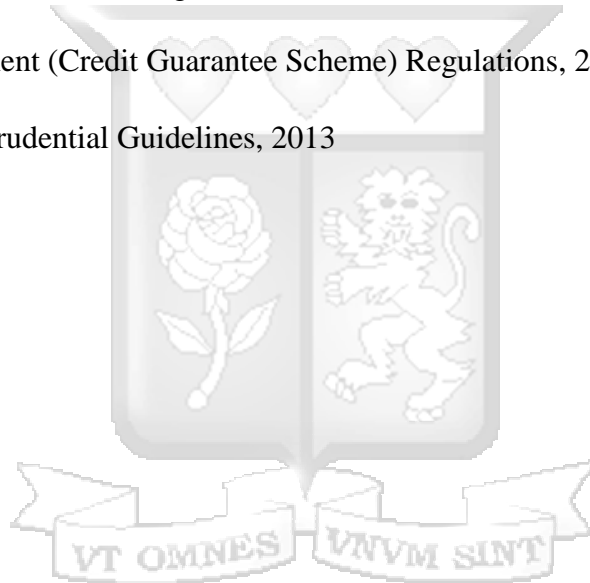
Public Finance Management Act, 2012

Banking (Amendment) Act, 2016.

Banking (Credit Reference Bureau) Regulations, 2020

Public Finance Management (Credit Guarantee Scheme) Regulations, 2020

Central Bank of Kenya Prudential Guidelines, 2013



## Acknowledgements

I want to preface this acknowledgment section by stating some matters of common knowledge. It was not easy. It was not so clear from the onset. It finally took shape with the help of a couple of experienced hands to whom I am forever grateful.

I want to thank the Almighty God for His Grace that surpasses all human understanding in granting me the capacity to undertake this research.

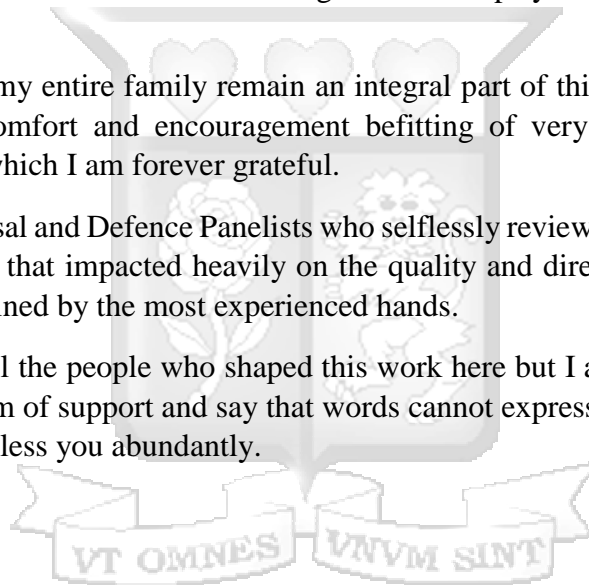
Secondly I want to thank my supervisor, Dr. Gikonyo who provided enriching insights and feedback and without whom it would not have been possible to put this together.

Thirdly, I wish to thank my boss, John Njenga – Associate Director, Legal Services at Equity Bank Kenya Limited for giving me time off and encouragement to keep eyes on the ball and accomplish the task.

My wife, Margaret, and my entire family remain an integral part of this journey having kept my spirits high, provided comfort and encouragement befitting of very able assistants even for believing in me and for which I am forever grateful.

I want to thank my Proposal and Defence Panelists who selflessly reviewed this work and provided knowledge and expertise that impacted heavily on the quality and direction that the task took. I bear benefits of being trained by the most experienced hands.

It is not possible to list all the people who shaped this work here but I am forever grateful to any person who gave any form of support and say that words cannot express my gratitude. Thank you and may our good Lord bless you abundantly.



## Chapter 1: Introduction

### 1.1 Background

Interest rate refers to the cost of debt to a borrower which corresponds to the rate of return to the lender.<sup>1</sup> It is therefore an important phenomenon to the extent that it affects the price or cost of debt which in turn affects accessibility to debt.<sup>2</sup> Interest rate capping depicts a legal tool that is used by regulators of the financial regulators with a view to protecting the interests of the consumers of financial products. The underlying objective behind interest rate control law is to restrain the amount of interest rate that is charged on loans by commercial banks by industry players and increase financial inclusion.<sup>3</sup> In this regard, the regulator seeks to take charge of the pricing of loans away from the management of commercial banks. Even so, a free market economy only exists when the allocation of resources is determined by the rules of supply and demand as opposed to government intervention.<sup>4</sup> However, such government interventions are often only sought under very limited circumstances to manage the affordability of certain goods and services that are of critical and strategic interest.<sup>5</sup>

Kenya has had its fair share of a complete circle when it comes to testing the implications of caps on interest rates imposed on commercial banks in the country. Upon attaining independence in 1963, interest rate capping in Kenya was inspired by the need to encourage investments and spur economic growth and development in the country.<sup>6</sup> However, during the post-independence period until 1994, interest rate control took the form of imposing maximum lending rates on all commercial banks and other lending institutions.<sup>7</sup> With time, the government established that capping of interest rates resulted in negative real interests during periods affected by shocks.<sup>8</sup>

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<sup>1</sup> Alper, E; Clements, BJ; Hobdari NA & Porcel, RM. Do interest rate controls work? Evidence from Kenya. (International Monetary Fund, 2019).

<sup>2</sup> Alper, E; Clements, BJ; Hobdari NA & Porcel, RM. Do interest rate controls work? Evidence from Kenya, 2019.

<sup>3</sup> Titus Kyalo Kiseu, 'The effect of interest rate capping on the amount of credit issued by commercial banks in Kenya.' 2017 Retrieved from: [http://erepository.uonbi.ac.ke/bitstream/handle/11295/102817/Kiseu%2cTitus%20K\\_The%20Effect%20of%20Interest%20Rate%20Capping%20on%20the%20Amount%20of%20Credit%20Issued%20by%20Commercial%20Banks%20in%20Kenya.pdf?sequence=1&isAllowed=y](http://erepository.uonbi.ac.ke/bitstream/handle/11295/102817/Kiseu%2cTitus%20K_The%20Effect%20of%20Interest%20Rate%20Capping%20on%20the%20Amount%20of%20Credit%20Issued%20by%20Commercial%20Banks%20in%20Kenya.pdf?sequence=1&isAllowed=y)

<sup>4</sup> Bremmer, I. 'The end of the free market: Who wins the war between states and corporations?' 2010 *European View* Vol. 9.

<sup>5</sup> Bremmer, I. 'The end of the free market: Who wins the war between states and corporations?' 2010

<sup>6</sup> CBK, 'The impact of interest rate capping on the Kenyan economy: Draft for comments' March 2018 Retrieved from: [https://www.centralbank.go.ke/wp-content/uploads/2018/03/Interest-Rate-Caps\\_-March-2018final.pdf](https://www.centralbank.go.ke/wp-content/uploads/2018/03/Interest-Rate-Caps_-March-2018final.pdf)

<sup>7</sup> CBK, 'The impact of interest rate capping on the Kenyan economy: Draft for comments' 2018, 5.

<sup>8</sup> CBK, 'The impact of interest rate capping on the Kenyan economy: Draft for comments' 2018, 5.

Further, it was established that these interest rate caps were not sufficient to deal with the adverse effects of external shocks to the financial system as they resulted in more financial exclusion.<sup>9</sup>

Hence, in November 2019, the government made an amendment to the Finance Act and repealed Section 33B of the Banking Act effectively removing the caps on interest rates charged on loans.<sup>10</sup> The motive underlying this amendment was to realize financial inclusion by incentivizing commercial banks in Kenya to extend credit facilities to Micro, Small and Medium Enterprises (MSMEs) and other consumers of financial products. The decision was also based on negative results that had been previously registered by the implementation of interest rate capping in September 2016 that resulted in exclusion of MSMEs and the poor by commercial banks.<sup>11</sup> During the subsistence of the cap on interest rates, commercial banks had significantly shunned small scale borrowers – largely MSMEs<sup>12</sup> – while reinforcing their ties with established borrowers.<sup>13</sup> Empirical studies have demonstrated that there is a direct relationship between interest rate ceiling and financial exclusion.<sup>14</sup> That is, the imposition of interest rate ceilings has a negative effect on credit access owing to low performance of banks leading to exclusion of low-income borrowers such as MSMEs.<sup>15</sup>

MSMEs occupy a very strategic place in the national economy considering the extent to which they facilitate trade and investment through creating a business environment that allows domestic import and export businesses to thrive.<sup>16</sup> For this reason, they are described to be the economic backbone of Kenya.<sup>17</sup> As at the year 2022, MSMEs comprised of 98% of registered and

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<sup>9</sup> CBK, 'The impact of interest rate capping on the Kenyan economy: Draft for comments' 2018, 6.

<sup>10</sup> Loice Koskei, 'Interest rate ceilings and financial exclusion in Kenya: Evidence from Banks' Sectoral Credit Distribution.' 2020 *International Journal of Business Economics and Management*, Vol. 7(5). Retrieved from: <https://archive.conscientiabeam.com/index.php/62/article/view/1253>

<sup>11</sup> Loice Koskei, 'Interest rate ceilings and financial exclusion in Kenya: Evidence from Banks' 2020.

<sup>12</sup> Mehnaz Safavian and Bilal Zia, 2018 'The impact of interest rate caps on the financial sector: evidence from commercial banks in Kenya.' *World Bank Group Policy Research Working Paper* 8393. Retrieved from: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3154872](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3154872)

<sup>13</sup> Central Bank of Kenya, (2018), The impact of interest rate capping on Kenyan economy, March 2018.

<sup>14</sup> Loice Koskei, Interest rate ceilings, 2020.

<sup>15</sup> Central Bank of Kenya, 2018 'The impact of interest rate capping on the Kenyan economy,' Retrieved from: [https://www.centralbank.go.ke/wp-content/uploads/2018/03/Summary-of-the-study-on-Interest-rate-Caps\\_February-2018.pdf](https://www.centralbank.go.ke/wp-content/uploads/2018/03/Summary-of-the-study-on-Interest-rate-Caps_February-2018.pdf)

<sup>16</sup> Muturi, PM 'The role of micro and small enterprises (MSEs) in achieving Kenya vision 2030' 2015 *International Journal of Economics, Commerce and Management* Vol. 3(5).

<sup>17</sup> Mulae, E. 'The micro and small medium enterprises development in Kenya' December, 2022 *Tralac* Retrieved from: <https://www.tralac.org/blog/article/15863-the-micro-and-small-medium-enterprises-development-in-kenya.html>

unregistered business entities in Kenya.<sup>18</sup> The MSME sector therefore drives socio-economic transformation in the country's national economy considering the opportunities they create to the labour force and the impact they have in agribusiness, manufacturing, trade and services.<sup>19</sup> However, this potential is greatly affected when they suffer limited access to finances owing to the price of credit that is affected by interest rates charged by banks.

Contrary to the Central Bank of Kenya (CBK) and other World Bank findings, other studies also reported that interest rate capping had a positive effect on the financial performance of banks.<sup>20</sup> Premised on these findings, various scholars recommended that the CBK, as the regulator, should carry on with the enforcement of interest rate capping law as it did not have a negative effect on banks which would translate to MSMEs.<sup>21</sup> On the contrary, regarding loss in interest income, they point to the need for commercial banks to diversify their investment portfolios to maintain good return on their assets to avoid poor performance as a result of interest cap legislation.<sup>22</sup> In the same vein, similar findings have been recorded recently regarding the impact of interest rate capping on the performance of microfinance institutions in Kenya. According to findings of empirical analysis, it was established that interest rate capping in Kenya had a positive effect on deposit and loan performance of microfinance institutions, though only to a smaller extent.<sup>23</sup> It would be anticipated that since such institutions are the main lenders to MSMEs then this strategically important sector would not have suffered during the reign of capping law in Kenya. This is

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<sup>18</sup> Mulae, E. 'The micro and small medium enterprises development in Kenya' 2022.

<sup>19</sup> Mulae, E. 'The micro and small medium enterprises development in Kenya' 2022.

<sup>20</sup> Kyalo Mutemi and Daniel Makori, 2019 'Interest rate capping and financial performance of commercial banks in Kenya.' *International Journal of Current Aspects* Vol. 3(4). Retrieved from: <http://journals.ijcab.org/journals/index.php/ijcab/article/view/51/47> P. 119.

<sup>21</sup> Gichuki Edwin Mugo, Gillian Mwaniki, and Douglas Ogolla, 2019 'Interest rate capping by the Central Bank of Kenya on loans uptake.' *International Academic Journal of Economics and Finance* Vol. 3(5). Retrieved from: [https://www.iajournals.org/articles/iajef\\_v3\\_i5\\_33\\_44.pdf](https://www.iajournals.org/articles/iajef_v3_i5_33_44.pdf) p. 34.

<sup>22</sup> Korir Geoffrey and Oluoch Oluoch, 2019 'Impact of interest rate capping on the financial performance of commercial banks in Kenya,' *International Journal of Recent Research in Social Sciences and Humanities* Vol. 6(1). Retrieved from: <https://www.paperpublications.org/upload/book/IMPACT%20OF%20INTEREST%20RATE%20CAPPING-1309.pdf> P. 37.

<sup>23</sup> Muriuki Wilson Nduma and Oluoch Oluoch, 2021 'Impact of interest rate capping on the financial performance of microfinance institutions in Kenya,' *International Journal of Recent Research in Commerce Economics and Management* Vol. 8(4). Retrieved from: <https://www.paperpublications.org/upload/book/paperpdf-1634208332.pdf> P. 33.

reiterated by findings of a study conducted in 2021 that MSMEs and SMEs still have access to credit even if the CBK imposes interest rate caps.<sup>24</sup>

What has become apparent is the discord between academic and policy literature regarding the impact of interest rate capping on access to credit by SMEs with respect to the performance of commercial banks and financial institutions in Kenya. Further, majority of the perspectives established by various scholars on the impact of capping law on MSMEs are predominantly based on economic analysis and not a legal perspective to which the legal risks and implications are weighed.

A different twist that has made the discourse on interest rate capping more interesting is the recent developments that have been reported following the repealing of the Kenya's capping law. As of May 2021, it was still reported that majority of commercial banks in Kenya are yet to post an increase in the demand for credit following the lifting of the interest rate cap.<sup>25</sup> According to a Survey Conducted by the Central Bank in March 2021, it was established that 82% of credit officers from different lending institutions observed no increase in loan requests after removal of the interest rate caps.<sup>26</sup> With regard to MSMEs, the CBK reported that according to 76% of the respondents, the repeal of the interest rate capping law did not have an effect on the lending of commercial banks to MSMEs.<sup>27</sup>

Even so, the general policy direction seems to be inclined towards restraining the extent to which interest rates can result into financial exclusion. Jurisprudence that has been set by the Court of Appeal in Kenya had in a 2019 decision upheld the application of the *in duplum* rule.<sup>28</sup> This is a common law principle that provides that interest rates must cease to be applied in the event that the accrued interest equates to the principal amount of the loan initially advanced.<sup>29</sup> According to

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<sup>24</sup> Osir Rosalyne Adhiambo, Chesoli Joshua Wafula and Ngacho Christopher, 2021 'Relationship between interest rate cap and access to credit my mucro, small and medium enterprises in Kisumu County, Kenya. *World Journal of Innovative Research* Vol. 10(2). Retrieved from: [https://www.wjir.org/download\\_data/WJIR1002003.pdf](https://www.wjir.org/download_data/WJIR1002003.pdf) P. 54.

<sup>25</sup> Patrick Alushula, 'Interest rate cap removal fails to excite borrowers.' 3 May 2021 *Business Daily* Retrieved from: <https://www.businessdailyafrica.com/bd/markets/market-news/interest-rate-cap-removal-excite-borrowers-3398072>

<sup>26</sup> Central Bank of Kenya, 'Credit officer survey,' 31 March 2021 Retrieved from: [https://www.centralbank.go.ke/uploads/banking\\_sector\\_reports/1506362303\\_Credit%20Survey%20Report%20for%20the%20Quarter%20ended%20March%202021.pdf](https://www.centralbank.go.ke/uploads/banking_sector_reports/1506362303_Credit%20Survey%20Report%20for%20the%20Quarter%20ended%20March%202021.pdf)

<sup>27</sup> CBK, 2021, Credit officer survey, 4.

<sup>28</sup> Mwambeja Ranching Company Limited & another V. Kenya National Capital Corporation (2019) eKLR.

<sup>29</sup> Kenya Hotels Limited Vs Oriental Commercial Bank Ltd (Formerly known as Delphis Bank Limited) (2019) eKLR

the court of appeal, the rule is advanced premised on the position that it is in the interest of the public that borrowers should be protected from lenders who intend to accelerate interest rates to astronomical rates.<sup>30</sup> However, the principle has also been historically applied in the interest of banks to make it possible for them to redeem charged property. As such, the principle comes as a mechanism that was meant to reconcile the interests of both lenders and borrowers with regard to interest rates. As such, it presents itself as an equitable principle of interest rate capping that balances the interests of the main stakeholders when it comes to the issue of the cost of borrowing.

## **1.2 Statement of the Problem**

Despite the full cycle of imposing interest rate caps and eliminating the same in Kenya still, what remains constant is that high cost of credit is directly linked to hindrance to access credit by MSMEs. This cycle has demonstrated that taking the power of pricing of loans from commercial banks has similar effects of financial exclusion of MSMEs. The shift in the structure of lending away from the MSMEs to safer corporate clients was a major pattern reported in 2019. The legal interests in financial consumer protection therefore still point to the need to relook the interest rate control law to establish the economic and practical implications of interest rate control laws. The study, investigates these legal implications incidental to interest capping laws towards defining the parameters within which meaningful regulation can be established to limit high cost of lending skewed against MSMEs in the consumer lending market considering that MSMEs are often highly affected by such banking regulations that affect the cost of borrowing. This is important in improving the country's monetary policy by establishing how interest rate controls can be implemented through flexible legal and policy mechanisms to promote financial inclusion of MSMEs.

## **1.3 Research Questions**

The general question to which this research shall respond to is; can the law on interest rate control be improved for the benefit of MSMEs. This shall be answered based on findings on the following specific research question;

- a) To what extent does the current legal and institutional framework for interest rate control sufficient in protecting the interests of SMEs in access to credit.

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<sup>30</sup> G. Muthoga V. Habib Zurich Finance (K) Limited & another (2016) eKLR.

- b) What are the risks incidental to interest rate capping on the interests of MSMEs as consumers of financial products?
- c) What are the risks incidental to interest rate capping on the interests of MSMEs as consumers of financial products?
- d) Are there any parameters within which Kenya's law on interest rate capping can be improved for the benefit of both MSMEs and lending institutions?

#### **1.4 Research Objectives**

The overriding objective of this research is to establish the extent to which the law on interest rate control can be improved for the benefit of MSMEs. This objective shall be met courtesy of the following specific objectives;

- a) To analyze the current legal and institutional framework for interest rate capping to determine whether it is sufficient in protecting the interests of MSMEs in access to credit.
- b) To identify the risks incidental to interest rate capping on the interests of MSMEs as consumers of financial products.
- c) To establish the parameters within which Kenya's law on interest rate capping can be improved for the benefit of both MSMEs and lending institutions.

#### **1.5 Hypothesis**

Interest rate capping law can be iterated towards enhancing financial inclusion of MSMEs without negatively affecting the rights of lenders.

#### **1.6 Justification for the Study**

With the mixed perspectives between academic literature and policy literature regarding the propriety of interest capping law based on its economic impacts, this study finds it important to revisit the legal interests at stake in the subject. This is based on appreciating the inherent effect that implementation and elimination of interest capping law has on financial inclusion of MSMEs. As such, the findings of this study shall be essential to legislators and policy makers to the extent that it establishes the metrics within which interest capping law should be implemented while striking a balance between the interests of key stakeholders, industry players and vulnerable financial consumers such as MSMEs. The research shall also be essential to MSMEs, academics and students considering its significant contribution to the existing knowledge on the impact of interest rate capping on MSMEs.

## 1.7 Theoretical Framework

### *Social Contract Theory*

The social contract theory emanates from the argument that a society without rules and laws to govern individual's conduct would be a dreadful place to exist in.<sup>31</sup> In such a society, people are likely to act based on their own discretion without responsibility to the society. Under such circumstances, the society is likely to be engulfed in chaos when a catastrophic event strikes. Even in the absence of such calamities, the strife by individuals to acquire more wealth and power in such a society would make existence in such a society intolerable. It is based on this premise that the major proponents of the social contract theory such as Thomas Hobbes propose that the solution to such a society is the establishment of a social contract in which the society comes to a collective agreement that protects everyone's interests in enforcing rules that guarantee the security of the weakest.<sup>32</sup>

The aim of such an agreement – the social contract – is to build a flourishing society where weak individuals can survive. The proponents of the social contract theory advance five principles that justify why laws are required in society; the harm principle, the offence principle, legal paternalism, legal moralism and benefit to others.<sup>33</sup> Hence the role of the law is to prevent harm against others, to prevent behavior that is likely to offend those prone to be victimized, to prevent harm generally through regulations, to avert immoral activities and to prevent conduct that is detrimental to a segment of the society.<sup>34</sup>

The theory as advanced by Jean-Jacques Rousseau contextualizes the role of the law with regards to distribution of wealth in the economy. He builds up on Locke's argument on the theory, where property takes central place. According to Rousseau, inequality became more pronounced in the society with the introduction of private property.<sup>35</sup> According to him, the initial conditions of inequality were manifest when some people had private property while others did not. Hence those who had property found it in their best interest to create a government that would protect their private property from those who do not have. However, the latter group can still get to own

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<sup>31</sup> Jean Hampton, 1980, The social contract theory of Thomas Hobbes, Harvard University.

<sup>32</sup> Edward N. Zalta & Uri Nodelman, Contemporary approaches to the social contract.' 2021 Retrieved from: <https://plato.stanford.edu/entries/contractarianism-contemporary/#ConSocConPubJus>

<sup>33</sup> Jean-Jacques Rosseau, 1950, The social contract: and discourses, Dutton.

<sup>34</sup> Edward N. Zalta & Uri Nodelman, Contemporary approaches to the social contract.

<sup>35</sup> Jasay, AD Social contract, free ride: A study of the public-goods problem. (Liberty Fund, 2008).

property through the combined effort of their labor and raw materials of nature.<sup>36</sup> Hence, according to Rousseau, a social contract which claims to be in the interest of everyone in the society was rather skewed to be one that upholds the interests the few who have become stronger and richer as from their developments of private property. However, this can be iterated towards ensuring fair distribution of wealth in the society.

The social contract theory is essential in this research to the extent that it speaks to the other end of the need for regulation to protect the interests of the consumers of financial products. This is based on the premise that the absence of capping regulations could extend discretion to financial institutions to act without responsibility in a manner that is detrimental to consumers. This is supported by the conventional economic theory. The main argument underlying the theory is the suggestion that in the absence of regulatory intervention from the government, individuals and corporations are likely to establish negative externalities that would impose uncompensated costs on third parties.<sup>37</sup> Hence, the idea that even free markets need rules. The social contract theory shall therefore be an important tool of analysis for this study towards striking a balance regarding how capping law and alternatives to capping law can be structured with metrics that balance the interests of industry participants as well as consumers of credit from commercial banks in Kenya.

## **1.8 Literature Review**

### ***1.8.1 Interest Rate Control as a Tool for Financial Consumer Protection***

Mehnaz Safavian and Siddharth Sharma in their literature on creditor rights make the following observations regarding the role of creditor-friendly laws. According to the authors, creditor-friendly laws are inherently linked with the advancement of more credit to the private sector.<sup>38</sup> According to their analysis, firms are more likely to have access to bank loans in jurisdictions that implement laws with better credit rights as opposed to those that don't. As such, the authors encourage legal protection of creditors and the establishment of efficient court systems to strongly complement the effectiveness of such rights. In the alternative, the authors argue that creditor rights

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<sup>36</sup> Mansell, SF Capitalism, corporations and the social contract: A critique of stakeholder theory. (Cambridge University Press, 2013).

<sup>37</sup> Stephen F. Copp, 'The legal foundations of free markets.' P. 38 Retrieved from: <http://www.iaea.org/sites/default/files/publications/files/upldbook438pdf.pdf>

<sup>38</sup> Mehnaz Safavian and Siddharth Sharma, 2007 'When do creditor rights work?' *The World Bank Policy Research Working Paper* 4296. Retrieved from: [https://books.google.co.ke/books?id=IUUnnw\\_PqmhoC&printsec=frontcover&dq=interest+rate+capping+law&hl=en&sa=X&ved=2ahUKewjh\\_bv29rv3AhWixYUKHUIvCROQ6AF6BAgLEAI#v=onepage&q&f=false](https://books.google.co.ke/books?id=IUUnnw_PqmhoC&printsec=frontcover&dq=interest+rate+capping+law&hl=en&sa=X&ved=2ahUKewjh_bv29rv3AhWixYUKHUIvCROQ6AF6BAgLEAI#v=onepage&q&f=false)

are more enforceable when they are delinked from the judicial system as enforcement is likely to take more time. As such, significant financial market reforms should be based on introducing non-binding regulations that can be enforced through out-of-court enforcement proceedings to reduce judicial discretion in the application of creditor-friendly laws.<sup>39</sup> While their analysis does not touch on interest rate capping, their perspective must have informed the position of various policy literature on the arguments against interest capping laws.

Thomas Miller and Harold Black in 2016 developed literature in proposition of interest rate capping by examining the arguments advanced by advocates for interest rate caps. Harold and Black report that there are four overriding arguments for interest rate caps that summarize the perspectives of various jurists. These include the naivety of consumers of financial services and credit, the need to protect vulnerable social groups from predatory lenders, the need to ensure that financial consumers are protected from themselves, and finally, small dollar lenders have considerable market power that is likely to be subjected to abuse.<sup>40</sup> Regarding the interests of naïve borrowers, the two authors aver that capping law is essential for financial consumer protection because borrowers are often not aware of the costs of their loans especially the annual percentage rates regardless of their level of education. With regard to protecting the most vulnerable groups from predatory practices, the two authors find that interest rate caps are important towards protecting the interests of consumers with modest income and low levels of formal education. However, they also observe that this category of consumers who are considered to be vulnerable are more likely to find alternative financial services that are convenient to their circumstances.<sup>41</sup> With regard to the need for the law to protect consumers from themselves, the authors reiterate the conventional argument that high rate borrowers are not likely to see how high interest rates would harm them. This is attributable to the position that lenders lure them into borrowing at high rates before many of them end up in cycles of debt known as a debt trap.<sup>42</sup> Finally, they also taken note of the argument that interest rate capping is relevant because when the power to price loans is left in the hands of banks and other financial institutions, then they are more likely to impose interest

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<sup>39</sup> Mehnaz Safavian and Siddhart Sharma, When do creditor rights work? P. 21.

<sup>40</sup> Thoma W. Milller and Harold A. Black, 'Examining arguments made by interest rate cap advocates,' in Hester Pierce and Benjamin Klutsey, eds, Reframing financial regulation: Enhancing stability and protecting consumers. 2016 George Mason University. Retrieved from: [https://www.mercatus.org/system/files/peirce\\_reframing\\_ch13.pdf](https://www.mercatus.org/system/files/peirce_reframing_ch13.pdf) P. 352.

<sup>41</sup> Thomas W. Miller, Examining arguments made by interest rate cap advocates, p. 353.

<sup>42</sup> Thomas W. Miller, Examining arguments made by interest rate cap advocates, p. 354.

rates that are higher than those that ought to exist in a competitive market due to the market power they hold.<sup>43</sup>

As such, based on the weaknesses that the authors find in these arguments advanced by the proponents of interest rate capping, they propose a unique approach towards interest rate capping that is characterized by these elements. First, is to apply different interest rates to different loan amounts. Second is to study the impact of capping law before imposing them. And the third feature is to undertake constant revision of interest rate caps. Upon laying criticisms on various arguments supporting interest rate capping, Miller and Black only propose mechanisms that are meant to improve the implementation of capping laws. According to them, these measures are likely to enhance voluntary exchange in the loan markets that are both beneficial for borrowers and lenders. According to them, like any other market that obeys the laws of demand and supply, the letting the loan market to determine its own prices and quantities will be of great benefit to participants

According to the Samuel Munzele Maibo and Claudia A. H. Gallegos, the stability of the financial sector significantly relies on the adequacy of financial consumer protection. The role of the law and regulation in this regard is to insulate vulnerable groups from abuse and predatory lending practices.<sup>44</sup> As such, the authors find this to be a better alternative towards protecting MSMEs and other vulnerable groups without having to resort to an imposition of interest rate caps. Based on this proposition, a regulatory framework that effectively achieves such an outcome ought to provide for transparency on disclosure of interests rates and other loans costs and at the same time guarantee fair and non-abusive practices by industry players.<sup>45</sup> Samuel and Claudia therefore prescribe caveats that should be applicable to jurisdictions that still intend to pursue capping rates as a mechanism for financial consumer protection.

First, they prescribe that the imposition of credit ceiling should be with respect to specific products or limited to an identified categories of financial institutions for instance, microfinance institutions as opposed to the entire financial sector.<sup>46</sup> Second, the regulation should provide a clear definition of the cap by outlining the total cost of credit in order to avoid efforts by industry players to evade

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<sup>43</sup> Thomas W. Miller, Examining arguments made by interest rate cap advocates, p. 358.

<sup>44</sup> Samuel Munzele Maibo and Claudia A. H. Gallegos, 2014 'Interest rate caps around the world: still popular, but a blunt instrument.' *Policy Research Working Paper* 7070. Retrieved from: P. 24.

<sup>45</sup> Samuel and Claudia, 2014 'Interest rate caps' 26.

<sup>46</sup> Samuel and Claudia, 2014 'Interest rate caps' 26.

the cap. Third, they also recommend that the cap should be established at a reasonable level that is high enough to allow lenders to make profit from their interest income and low enough to eradicate excess profit emanating from lack of competition.<sup>47</sup> Above all, they recommend that interest rates should be differentiated based on different financial products, duration, and the amount of credit.

Nathalie Martin in 2014 also developed literature which supports the need for interest rate capping by Congress at the federal level in the interest of consumers. His findings, being based in a developed economy such as the USA, are critical in establishing the eventuality that anticipate a market without capping law. According to Martin, the ignorance by the federal government to set interest rate caps (leaving this role to state most of which are yet to set caps) has brought the country to the point where there an urgent need for federal usury capping.<sup>48</sup> In a market with limited interest rate capping that is only dependent on state law, the Martin reports that Americans have now found themselves servicing loans subject to triple or quadruple-digit interest rates from various lenders including 1000% interest rate on loans that has now become commonplace in majority of states in the USA.<sup>49</sup> According to the author's account of the history of usury laws in the United States, capping on consumer loans has historically been the main protection mechanism that consumers have conventionally benefited from to insulate them against harsh credit practices. As such, any attempts to find a different mechanisms to protect consumers from this plight are yet to succeed. As such, the author argues that interest rate capping can be implemented with caution towards based on lessons from previous attempts to regulate high cost lending.<sup>50</sup> This is following the position that efforts by the court to police consumer laws based on unconscionability and other common law theories have been rendered futile over the years.<sup>51</sup> A greater part of her argument emanates from the perspective that interest rate capping enjoys greater public support and the endorsement of various members from the two divides of the country's political spectrum.

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<sup>47</sup> Samuel and Claudia, 2014 'Interest rate caps' 27.

<sup>48</sup> Nathalie Martin, 2014 'Public opinion and the limits of state law: The case for a federal usury cap.' *Northern Illinois University Law Review* Vol. 34. Retrieved from: [https://heinonline.org.ezproxy.library.strathmore.edu/HOL/PrintRequest?public=true&handle=hein.journals/niulr34&div=14&start\\_page=259&collection=journals&set\\_as\\_cursor=0&men\\_tab=srchresults&print=section&format=PDFsearchable&submit=Print%2FDownload](https://heinonline.org.ezproxy.library.strathmore.edu/HOL/PrintRequest?public=true&handle=hein.journals/niulr34&div=14&start_page=259&collection=journals&set_as_cursor=0&men_tab=srchresults&print=section&format=PDFsearchable&submit=Print%2FDownload) P. 260.

<sup>49</sup> Nathalie Marin, Public opinion and the limits of state law, P. 261.

<sup>50</sup> Nathalie Marin, Public opinion and the limits of state law, P. 302.

<sup>51</sup> Nathalie Marin, Public opinion and the limits of state law, P. 304.

### ***1.8.2 Outcomes on Interest Rate Control***

In policy literature reflected in a study conducted by the Central Bank of Kenya in 2018 on the impact of capping law on the country's economy, the Bank established these negative effects. First, that capping infringed on the autonomy of the central bank with effect to complicating how it conducts monetary policy.<sup>52</sup> According to the Central Bank, monetary policy yields 'perverse outcomes' in an environment engulfed in interest rate capping law.<sup>53</sup> The import of this is the second negative effect that, as a result of imposing caps on the interest rate, commercial banks tend to shun individuals whose credit risk fall above the capped rate leading to decrease in the rate of growth of credit to the private sector. Third, even though the demand for credit in the private sector increased after the introduction of capping law, commercial banks defected into lending to banks and large corporates. Fourth, as a result of the reduction in revenue from interest income, commercial banks resorted to increasing the fees on loans in a bid to offset their losses in interest income. The fifth negative effect that was captured by the CBK in this study was that the industry players in the banking sector registered significant decline in profitability. At the same time rationed out of the credit market by commercial banks causing decline in growth of the national economy. It is this premise that must have informed the revision of the position of the law in 2019 following the expectation that these negative effects might continue to be magnified.

Contrary to the findings of the Central Bank, in the same year (2019), a study conducted by Gichuki Edwin Mugo, Gillian Mwaniki and Douglas Ogolla on interest rate capping by the CBK on loans uptake established the following findings. According to data analyzed over the period between 2015 and 2017, the study found that uptake in loans increased as a result of the enactment of capping law.<sup>54</sup> However, the increased uptake in credit was only attributable to the issuance of loans to large borrowers. Even so, it was established that the profitability of commercial banks during the period under review had increased. Based on these and other findings, the authors concluded that interest rate capping had a positive effect on the performance of commercial banks.

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<sup>52</sup> Central Bank of Kenya, 2018 'The impact of interest rate capping on the Kenyan economy,' Retrieved from: [https://www.centralbank.go.ke/wp-content/uploads/2018/03/Summary-of-the-study-on-Interest-rate-Caps\\_February-2018.pdf](https://www.centralbank.go.ke/wp-content/uploads/2018/03/Summary-of-the-study-on-Interest-rate-Caps_February-2018.pdf)

<sup>53</sup> CBK, 2018, The impact of interest rate capping, 16, 29 & 31.

<sup>54</sup> Gichuki Edwin Mugo, Gillian Mwaniki, and Douglas Ogolla, 2019 'Interest rate capping by the Central Bank of Kenya on loans uptake.' *International Academic Journal of Economics and Finance* Vol. 3(5) p. 34.

As a result, the authors recommended that the CBK and the government alongside the state department for finance should come up with additional policies that ought to be beneficial in a manner that is inclusive of small borrowers as well. Technically, the study was not recommending the scrapping off of interest rate capping but encouraging an innovative approach that generates policy that is beneficial to small borrowers. In addition to their findings, the authors also argue that the Central Bank of Kenya ought to be conferred with exclusive powers to generate policies that ensure competition and efficiency in the banking sector.<sup>55</sup> Similar findings were also registered by Kyalo Mutemi and Daniel Makori in 2019<sup>56</sup>

### ***1.8.3 The Role of Interest Rate Capping on Financial Inclusion***

**P. K. Ozili** in 2020 reviewed various theories and presented new theories that can be relied on in research, discourse and policy debates involving financial inclusion. First, he defines financial inclusion as the provision of access to financial services to all members of the society with special regard to the poor and those who are likely to be excluded.<sup>57</sup> In a separate instance, he defines financial inclusion as the provision of banking services at a cost that is affordable enough to the disadvantaged low-income social groups.<sup>58</sup> According to Ozili, financial inclusion ought to be studied from a theoretical perspective in order to avoid misinterpretation of what financial inclusion implies. As such, he advances theories that explain concerns such as who benefits from financial inclusion, who should deliver financial services to the people, and who should fund financial inclusion. With regard to the question on who benefits from financial inclusion, he presents the vulnerable group theory of financial inclusion.<sup>59</sup> According to this theory, financial inclusion policies should be targeted at the vulnerable members of the society that suffer the most during crises and hardships.

However, some of the demerits he attributes to this theory is that by targeting the vulnerable groups, policies tend to ignore non-vulnerable groups that also need access to the formal financial sector. In answering the question on who should be responsible for delivering financial inclusion,

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<sup>55</sup> Gichuki Edwin Mugo, Interest rate capping, P. 42.

<sup>56</sup> Kyalo Mutemi and Daniel Makori, 2019 'Interest rate capping and financial performance of commercial banks in Kenya.' *International Journal of Current Aspects* Vol. 3(4).

<sup>57</sup> Peterson. K. Ozili., 2020, Theories of financial inclusion, *Munich Personal RePEc Archive*. Retrieved from: [https://mpra.ub.uni-muenchen.de/101810/1/MPRA\\_paper\\_101810.pdf](https://mpra.ub.uni-muenchen.de/101810/1/MPRA_paper_101810.pdf) P. 3.

<sup>58</sup> Peterson K Ozili, Theories of financial inclusion, 3.

<sup>59</sup> Peterson K Ozili, Theories of financial inclusion, 7.

he presents the public service theory of financial inclusion. According to this theory, financial inclusion is a public responsibility that the government owes to its citizen.<sup>60</sup> As such, financial inclusion should be delivered by the government through public institutions despite caution that tax revenue might not be sufficient to fund financial inclusion. Regarding the question on who should fund financial inclusion, he presents the public money theory of financial inclusion. According to this theory, financial inclusion should be funded using public money.<sup>61</sup> This, he argues, is constrained where the government lacks sufficient funds to finance financial inclusion.

In 2013, Howard Miller conducted a study to establish the nature of the impact that interest rate caps have on financial inclusion. According to Miller, an interest rate cap is good policy when it is being implemented to counter insufficient credit being provided to a sector that is of strategic importance to a country's national economy.<sup>62</sup> Under such circumstances, interest rate caps are only reliable as a short term solution. When implemented for economic reasons, interest rate caps can be used to kick-start a sector of the economy or incubate that sector from market forces for a certain period of time. As such, the interest rate cap should only exist for a limited period, until that sector can commercially sustain itself without government support.<sup>63</sup> With regard to inclusion of MSMEs, he argues that interest rate caps should only be implemented in a fair manner that financial institutions to undertake profitable lending to MSMEs. Similarly, in this quest to strike a balance between the interests of lenders and creditors, he argues that interest rate caps can also be implemented under circumstances where lenders are known to be very profitable.

Hence, capping law can be implemented based on comfort in the idea that the costs of lending at lower rates would be absorbed into the lenders profit margins. Even so, more importantly, he argues that caps on interest rates can promote financial inclusion by protecting vulnerable consumers of financial services from usurious lending practices. Therefore, according to Miller, the state should not use interest rate caps as a long term strategy to lower interest rate as this only addresses a symptom as opposed to dealing with the cause of financial market failures and exclusion. According to him, the sustainable approach to bringing down interest rates requires the

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<sup>60</sup> Peterson K Ozili, Theories of financial inclusion, 10.

<sup>61</sup> Peterson K Ozili, Theories of financial inclusion, 13.

<sup>62</sup> Howard Miller, 2013, Interest rate caps and their impact on financial inclusion, Retrieved from: [https://assets.publishing.service.gov.uk/media/57a08a0de5274a31e00003d0/Interest\\_rate\\_caps\\_and\\_their\\_impact\\_on\\_financial\\_inclusion.pdf](https://assets.publishing.service.gov.uk/media/57a08a0de5274a31e00003d0/Interest_rate_caps_and_their_impact_on_financial_inclusion.pdf) P. 12.

<sup>63</sup> Howard Miller, 2013, Interest rate caps, 12.

government to act on market information and understand the country's market structure in order to introduce deeper market reforms.

#### ***1.8.4 The Gap in Literature***

Despite prescribing how capping can be implemented cautiously with respect to different sectors of the economy, Samuel and Claudia do not offer a serious guide on the metrics of financial consumer protection that are uniquely applicable to MSMEs. Miller and Black upon evaluating arguments for interest rate capping end up suggesting that like any other market of demand and supply, the loan markets should be left to run themselves. However, these findings are ignorant of the weight that the MSMEs sector bears in a developing economy as in Kenya. Hence, based on the strategic importance of the SME sector to Kenya, this study contributes to their literature by evaluating the extent these improvement measures can be implemented as caveats for interest rate capping for the benefit of MSMEs. Similarly, Nathalie Martin's arguments in proposition of interest rate capping are based on the premise that the practice enjoys public opinion and is important to protect the interest of financial consumers who are subjected to high cost consumer lending. Neither of her justifications point towards the justification of capping law that targets the protection of MSMEs based on their strategic importance to the national economy of a developing country. Hence, the contribution that this study shall raise with respect to her findings.

With regard to the findings of the CBK in 2018, the questions that continue to linger are, was it too early to make a conclusion on the effect of capping law based on the manifest negative effects within the short time that the law was brought into play? Was it inherent that the effects would continue to be magnified under the capping law? With regard to the findings by Gichuki Edwin and others recommending the exclusive centralization of the power of interest rate control to the Central Bank of Kenya, it is unclear how this approach would be beneficial to MSMEs without affecting banks which are the non-vulnerable groups whose actions are likely to affect the vulnerable MSMEs.

The literature reviewed reflects an outright conflict between policy and academic literature on the effect of interest rate capping and whether it remains a good tool for managing high cost lending based on its effects on commercial banks and other financial institutions as well as strategic economic sectors such as MSMEs. Academic literature is centered on the link between financial inclusion and policy levels as well as income inequality and the impact on financial inclusion on

the national economy. As such, it is inclined towards supporting interest rate capping as opposed to policy literature. On the other hand policy literature is inclined towards investigating the possibility of imposing alternative regulations to deal with current and imminent market failures resulting in financial exclusion instead of rushing to interest rate capping as a quick-fix solution. Although Howard Miller prescribes the sustainable approach towards resorting to much deeper financial sector reforms, he does not point to specific aspects of the financial sector that need to be alternatively regulated in order to bring down interest rates in a sustainable manner. Therefore, this study's major contribution to knowledge is found in establishing the legal metrics that are specific to striking a balance for the interests of MSMEs (as financial consumers) while taking to account the need for financial consumer protection as well as the interests of market participants such as banks.

### **1.9 Research Methodology**

This research shall be undertaken through doctrinal research methodology. The study shall therefore rely on data from primary and secondary sources. These include statutes, case law, books authored by authoritative jurists, peer reviewed journals, annual reports, data from reputable information systems such as the CBK and other reputable internet sources. The study conduct an analysis of different legal approaches and mechanisms towards interest rate control.

### **1.10 Chapter Outline**

Chapter one includes an introduction to the study that sets the background of the subject before posing the statement of the problem that informs the study. This chapter also outlines the research questions and objectives against which the study's hypothesis shall be tested. It further proceeds to establish the significance of the study before outlining the theoretical framework, reviewing the literature to which the study shall contribute and stating the research methodology through which the study shall be undertaken.

Chapter two shall undertake an analysis of the laws of Kenya establishing the interest rate capping. This shall be with a view to establishing the consequences that the implementation and elimination of interest rate capping laws have had on the legal interests and financial inclusion of MSMEs. To this end, it shall evaluate the legal risks that are at stake with regard to interest capping law based on the country's broader legal framework including constitutional rights, creditor rights and consumer protection interest of vulnerable consumers of financial services. This being with a view

to identify the parameters within the Kenyan legal framework that interest rate capping can be improved for the purposes of ensuring financial inclusion of MSMEs.

Chapter three shall entail a comprehensive review of policy and academic literature to establish the discrepancy manifest in the position of policy makers and academics regarding the impact of interest rate capping on MSMEs as consumers of financial services. This shall be done in light of investigating the legal risks that arise from interest rates capping when it comes to the financial inclusion of MSMEs as consumers of financial products. As such, it shall establish the bottom line effects that are shared based on consensus between policy-makers and academics before establishing the points of divergence in light of the extent to which they affect financial consumer protection from a legal perspective.

Chapter four shall conduct an analysis of the legal risks of interest capping law on MSMEs with respect to its effects on creditor rights. This chapter shall proceed to explore the legal metrics within which interest capping can be done to balance the conflicting interests of creditors and MSMEs. At the same time, the chapter shall borrow lessons from other jurisdictions to explore alternatives regulatory mechanisms to interest rate capping that are essential to financial inclusion of MSMEs. This shall be done in light of identifying alternative regulatory mechanisms, other than interest rate capping that can be applied to reduce the cost of borrowing and promoting financial inclusion of MSMEs.

Chapter five shall conclude the study by conclusively summarizing the findings of the study in light of the research objectives. This part shall also proceed to prescribe policy recommendations with respect of the findings of the analysis in the previous chapter.

## Chapter 2:

### The Kenyan Legal Framework on Interest Rate Capping

#### 2.1 Introduction

This chapter undertakes an analysis of the laws of Kenya establishing the interest rate capping. This shall be realized through a review of the law on interest rate ceilings in Kenya; an examination of the impact of the *in duplum* rule in protecting the interests of MSMEs; a look at collaborative regulation of interest rates between the executive and the legislature. The chapter also investigates the extent to which interest rates are affected by the country's Monetary Policy before reviewing the Micro and Small Enterprises Act, 2012 to examine its role in promoting the development of MSMEs. Based on these, it draws the relevant parameters of the legal framework that are essential in rethinking interest rate capping in Kenya which shall be analyzed further in the next chapter.

#### 2.2 The Law on Interest Rate Ceilings in Kenya

The CBK is entrusted with the mandate of setting and publishing the lowest or minimum rate of interests it charges when advancing loans to banks and other financial institutions.<sup>64</sup> The current legal position in interest rate capping law is informed by the decision of the President of Kenya's successful recommendation to the National Assembly to repeal section 33B of the Banking (Amendment) Act, 2016 that had been in operation since 14<sup>th</sup> September, 2016. Pursuant to this provision, the CBK directed banks to set the maximum interest rate chargeable for credit facilities at not more than four (4) per cent of the base rate set and published by the CBK.<sup>65</sup>

The Amendment Act, therefore, created an offence against directly or indirectly borrowing at an interest rates that was excess of what was prescribed. Otherwise, the same would attract a fine of at least one million shillings or imprisonment of the bank CEO for at least one year upon default.<sup>66</sup> It is important to note that the said provision was repealed through executive action for reasons that are neither published or documented for reference. However, the said provisions have been reviewed before various courts where issues surrounding the legality of the provision have been determined.

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<sup>64</sup> Central Bank of Kenya Act, Section 36(4).

<sup>65</sup> The Banking (Amendment) Act, No. 25 of 2016 (Repealed), Section 33B.

<sup>66</sup> The Banking (Amendment) Act, No. 25 of 2016 (Repealed), Section 33B(3).

For instance, one of the concerns raised about the Act is the position that interest rate capping undermines the right banks and financial institutions to freely deal with their assets in a free market as well as an open and democratic society.<sup>67</sup> However, in *Boniface Oduor v Attorney General* it was held that the interest rate capping provisions neither prevented banks and financial institutions from lending nor did it stop borrowers from accessing credit. This is on the grounds that the provision merely limits the interest rate parameters within which parties can interact with respect to their property.<sup>68</sup> Therefore, even with regard to the freedom to contract, it would suffice to infer from the court's interpretation that interest rate capping does not limit the extent to which the relevant parties exercise their freedom of contract.

Another issue arising from the dilemma of capping interest rates or otherwise was the Constitutionally entrenched right to equality and freedom from discrimination. On the one hand, the imposition of interest rate caps is said to have the effect of discriminating against banks and financial institutions.<sup>69</sup> This is to the extent that similar constraints are not extended to competing financial institutions such as mortgage finance institutions, micro finance banks, insurance companies as well as institutions dealing with Islamic banking.<sup>70</sup> Another limb of discrimination is based on the averment that setting interest rate ceilings undermine the rights of banks and affected financial institutions from freely dealing with their property and assets as any other businesses do in a free and open democratic society as constitutionally protected.<sup>71</sup> This is considering that loan agreements are entered pursuant to the exercise of freedom of parties to contract based on terms that are agreeable to them.

Following the decision in *Boniface Oduor v Attorney General*, one of the justifications that were advanced in favor of repealing the said provision was based on the position that through it, Parliament purported to direct or control the CBK in the exercise of its functions to formulate and implement the country's monetary policy contrary to Article 231(3) of the Constitution of Kenya,

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<sup>67</sup> Constitution of Kenya, 2010, Article 40

<sup>68</sup> *Boniface Oduor v Attorney General & another; Kenya Banker's Association & 2 others (Interested Parties)* [2019] eKLR, para 130.

<sup>69</sup> *Boniface Oduor v Attorney General & another; Kenya Banker's Association & 2 others (Interested Parties)* [2019] eKLR, para 14.

<sup>70</sup> *Boniface Oduor v Attorney General* [2019], para 14.

<sup>71</sup> Constitution of Kenya, 2010, Article 40.

2010.<sup>72</sup> This is following the premise that the function that involves the setting of interest rates is a monetary policy issue that ought to be left to the CBK's Monetary Policy Advisory Committee (MPAC)<sup>73</sup>

However, the prevailing regime under the Banking Act still anticipates the establishment of interest rate ceilings that ought not be violated by the parties. According to section 52(3) of the Banking Act, there is an outright prohibition against the recovery of interest and other charges (from a court of law) beyond the maximum prescribed under the provisions of the Act or the Central Bank of Kenya Act.<sup>74</sup> Even so, the only outright provision under the Banking Act that set the maximum interest that could be recovered by banks and other financial institutions was repealed. Despite this act of repeal, the reading of section 52(3) still infers an anticipation that the Act ought to prescribe a limit with regard to interest rates and charges that can be recovered by financial institutions from debtors. A further look into the framework reveals an implied provision of a maximum limit with respect to interest rates and charges that can be recovered by banks and financial institutions in form of the *in duplum* rule that is discussed in the following section.

### **2.3 Interest Rate Capping Through the *in duplum* Rule**

With regard to protecting the interests of other stakeholders, the Banking Act makes a provision with respect to prohibiting financial institutions against increasing their rates of banking or any other charges without the approval of the relevant Cabinet Secretary.<sup>75</sup> However, this provision is ambiguous to the extent that it only alludes to the 'rate of banking or any other charges' without specifically referring to interest rate on credit or interest rate on deposits. As such, it might not be so reliable as a mechanism of protecting MSMEs against arbitrary variation of interest rates by financial institutions.

Hence, another legal mechanism through which the prevailing legal framework that protects the interests of MSMEs and other vulnerable consumers of credit from banks is the *in duplum* rule established under section 44A of the Banking Act. This refers to a limit established under the Banking Act that limits the interests that banks and related financial institutions can recover from

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<sup>72</sup> *Boniface Oduor v Attorney General & another; Kenya Banker's Association & 2 others (Interested Parties)* [2019] eKLR.

<sup>73</sup> Central Bank of Kenya Act, Section 4D.

<sup>74</sup> Banking Act, section 52(3).

<sup>75</sup> Banking Act, Section 44.

defaulting creditors. According to the provision, with regard to non-performing loans, banks can only recover the principal amount owing, expenses incurred in debt recovery as well as the contractual interest (not exceeding the principal owing) when the loan becomes non-performing.<sup>76</sup>

First, the interpretation of the question on whether section 44 applies to interest rates has been the subjected of contention in various court cases that depict different interpretations. On the one hand, the trial court in *Pius Kimaiyo Langat v Co-operative Bank of Kenya Ltd* found that section 44 of the Banking Act only applies to bank charges.<sup>77</sup> According to the courts construction of this provision, bank charges relate to the price and costs incidental to the offering of banking services. Hence, the outright position that interest rate adjustments were not regulated under the said section. This is based on the premise that the equivalent of section 33B that was found in Act No. 9 of 1996 was repealed in order to liberalize interest rates and leave the same to the whims of market forces. This position was neither upheld nor overturned by the Court of Appeal when the same matter was placed before them. Rather the Court of Appeal invoked its jurisdiction to prevent the enforcement of unconscionable contracts to protect the interest of the Appellant. Hence, regarding the interpretation that section 44 only applied to charges relating to the price and cost of baking services is yet to be controverted.

In various instances before the courts, banks and other financial institutions have resorted to arguments that section 44 of the Banking Act does not apply to interest rates and that it is only applicable to other bank rates and charges.<sup>78</sup> This being premised on the idea that interest rates ought to be governed by the common law principle of freedom of contract where parties ought to be bound to the terms of valid agreements entered freely between themselves.<sup>79</sup> However, this position has been shot down by courts arguing that even though it is not within their jurisdiction to rewrite contracts, the courts have a duty to protect or refuse to enforce contractual provisions that are unconscionable,<sup>80</sup> oppressive and extremely unfair.<sup>81</sup> The courts in this regard have resorted to protecting debtors from the enforcement of interest rates that are found to be unduly

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<sup>76</sup> Banking Act, Section 44A (1), (2)(a), (b) & (c).

<sup>77</sup> *Pius Kimaiyo Langat v Co-operative Bank of Kenya Limited* [2017] eKLR.

<sup>78</sup> *Pius Kimaiyo Langat vs. Co-operative Bank of Kenya Ltd* [2017] eKLR.

<sup>79</sup> *Trustees of Maximum Miracle Centre v Equity Bank (K) Limited (Civil Case E055 of 2021)* [2021] KEHC 237 (KLR) (Commercial and Tax) (11 November 2021) (Ruling).

<sup>80</sup> *Kenya Commercial Finance Company Ltd vs Ngeny & Another* [2002] 1KLR.

<sup>81</sup> *Momentum Credit Limited v Kabuiya (Civil Appeal E035 of 2022)* [2022] KEHC 13705 (KLR) (Commercial and Tax) (7 October 2022) (Judgment).

harsh and commercially unreasonable given the circumstances of the case and as long as they can prove the same.<sup>82</sup>

It is important, however, to note that the protection conferred by the Act through this rule applies with respect to interest that is to be recovered from non-performing loans. First, the limitation on the interest is with respect to the principal amount owing. Second, the rule is only applicable to non-performing loans. According to the CBK's Prudential guidelines, a non-performing loan refers to a loan account whose principal or interest has been due and remained unpaid for at least a period of ninety (90) days; or where interest payments for 90 days have been refinanced; where the interest pertaining to the same have been rolled over to a new loan.<sup>83</sup>

To this end, it would suffice to infer that the *in duplum* rule is not effective as a tool for protecting SME consumers of credit from overexploitation by creditor banks through the imposition of predatory interest rates. It is apparent that as a matter of legislation, interest rates have often been legislated separately as was the case under section 33B of the Banking (Amendment) Act, 2016. Further, the courts are yet to adopt a clearer position as to whether Section 44 prohibiting increase in bank rates without the approval of the relevant Cabinet Secretary is applicable to interest rates. This is important because the Act at the same time also anticipates in its provisions that contraventions of the law laid out in the Banking Act shall not invalidate any contractual obligations between individuals and financial institutions. Hence, the freedom of contract of the parties – to the extent that it involves contractual provisions empowering banks to vary interest rates – ought to be upheld by the courts notwithstanding a violation of any provisions of the Act.

#### **2.4 The Collaborative Regulation of Interest Rates by the Executive and the Legislature**

The Central Bank of Kenya is established in Kenya's constitutional dispensation as an institution entrusted with formulating the country's monetary policy in addition to other functions prescribed by the relevant Act of Parliament.<sup>84</sup> What is more is that the Constitution anticipates that the CBK shall execute this mandate without being subjected to any direction or control from any person or

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<sup>82</sup> *Godfrey Paul Okutoyi (suing on his own behalf and on behalf of and representing and for the benefit of all past and present customers of banking institutions in Kenya) v Habil Olaka – Executive Director (Secretary) of the Kenya Bankers Association Being sued on behalf of Kenya Bankers Association) & another* [2018] eKLR.

<sup>83</sup> Guideline on Risk Classification of Assets, Provisioning and Limitation on Interest Recoverable on Non-Performing Loans (CBK/PG/04), Para 1.4.8.

<sup>84</sup> Constitution of Kenya, 2010, Article 231(1) & (2).

authority.<sup>85</sup> To this extent, it would suffice to infer that CBK retains the ultimate constitutional authority to formulate monetary policy. However, the courts have interpreted this provision to imply that despite having the sole mandate, there is a need to subject this function to collaborative involvement of the other two organs of government; that is the Legislature and the Executive.<sup>86</sup> This is also following agreement with the position that interest rates have far reaching implications and therefore fall within the country's monetary policy. Considering these far reaching implications, the setting of the interest rates should therefore not be exercised arbitrarily as the same can be enriched through the collaborative and consultative involvement of stakeholders and the National Assembly that is a direct representation of the people.<sup>87</sup>

Based on the foregoing, the Central Bank Act provides for a mechanism of close cooperation between the CBK and the Executive in the development of a monetary policy statement. According to this mechanism, it is anticipated that the CBK would submit a monetary statement to the Cabinet Secretary in charge specifying policies, reasons for their adaptation and a review of the progress in implementing the monetary policy in the preceding period of 12 months.<sup>88</sup> The Cabinet Secretary is also required to submit the same to the relevant committee of the national Assembly for discussion.<sup>89</sup> As such, it is important to note that the same is not tabled before the house for discussion neither does the Act stipulate the nature of the National Assembly's power to approve the proposed policy or otherwise.

Further, the CBK Act anticipates that there shall be regular consultations between the CBK and the Executive regarding the country's monetary policy.<sup>90</sup> The nature of the consultation anticipated by Act depicts the important role of the executive to the extent that it anticipates exceptional circumstances when the Cabinet Secretary – after consultation with the CBK – may direct the CBK to adopt a monetary policy that the Cabinet Secretary would specify after resolution by the Cabinet.<sup>91</sup> Under such circumstances, the CBK is expected to implement such a policy within the

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<sup>85</sup> Constitution of Kenya, 2010, Article 231(1) & (3).

<sup>86</sup> *Boniface Oduor v Attorney General & another; Kenya Banker's Association & 2 others (Interested Parties)* [2019] eKLR, para. 204.

<sup>87</sup> *Boniface Oduor v Attorney General*, para 205.

<sup>88</sup> Central Bank Act, section 4B(1)(a), (b) & (c).

<sup>89</sup> Central Bank Act, section 4B(2).

<sup>90</sup> Central Bank Act, section 4C.

<sup>91</sup> Central Bank Act, section 4C(2).

next period of six months notwithstanding any provisions of the Act regarding its specific functions when it comes to developing and implementing the country's monetary policy.

A critical observation in this regard revolves around the central question of whether interest rates charged on loan facilities fall within the scope of the country's monetary policy or should be left to legislation. It is already apparent that the function of developing and implementing the country's monetary policy is already very consultative and collaborative between the CBK, the Legislature and the Executive; despite the overriding powers that the executive enjoys to veto the CBK's monetary policy and replace the same with its own under section 4C of the CBK Act.

This is also subject to taking note of the limited role that the National Assembly plays as it does not have so much power as the executive does with respect to the country's monetary policy. On the other hand, legislation seems to be a very rigid mechanism through which interest rates ought to be regulated. This is considering the procedural constraints incidental to the legislative process and to repeal laws in the event they are not favorable to the country's national economy. This is unlike the monetary policy that is implemented for a period of 12 months and subject to periodic review with consultative and collaborative engagement of the Executive and the Legislature.

At this point, it would suffice to infer that it is more effective to regulate interest rates through monetary policy as opposed to legislation. This is given the flexibility attributable to monetary policy that makes it possible to vary terms of interest rate capping depending on the varying market forces unlike the rigidity of legislation. Besides the flexibility of the country's monetary policy, the same is formulated by the Monetary Policy Advisory Committee (MPAC) established under the CBK Act.<sup>92</sup> The MPAC comprises of the CBK Governor and Deputy Governor, in addition to two members appointed by the governor from among the CBK staff, as well as four members appointed by the Cabinet Secretary – being considered to be such individuals with knowledge, experience and expertise in banking, fiscal and monetary policy.<sup>93</sup> However, a critical examination of the composition of the MPAC reveals the absence of key national values and principles of governance as anticipated under the Constitution.<sup>94</sup> These include democracy and participation of the people.<sup>95</sup> It is important to note that the prevailing constitutional dispensation is anchored on

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<sup>92</sup> Central Bank Act, section 4D(1).

<sup>93</sup> Central Bank Act, section 4D(2).

<sup>94</sup> Constitution of Kenya, 2010, Article 10(1).

<sup>95</sup> Constitution of Kenya, 2010, Article 10(1)(a).

democratization of institutions as a mechanism of strengthening the functioning of state institutions. Hence, considering the far reaching implications of the country's monetary policy on the national economy and the interest of various groups, it is apparent that the core organ responsible for formulating the country's monetary policy does not comprise of representation from key sectors in the economy that are likely to be affected by the monetary policy formulated by the Committee. For instance, having noted that this is an ideal mechanism for regulation of interest rates, it would be essential that if this function is taken up by the MPAC, then the committee ought to be comprised on individuals representing key interest groups such as Banks and MSMEs to contribute on the manner in which variations on interest rates, or the implementation of caps or otherwise are likely to affect their interests. Further, if the government decides to use this mechanism to implement caps on interest rates, there is no clear mechanism through which the affected banking sector and MSMEs are likely to voice their concerns for consideration at the highest levels of governance.

## **2.5 Regulation Interest Rates through Kenya's Monetary Policy Statement**

A review of the prevailing Monetary Policy Statement (MPS) in Kenya is essential towards determining the place of Banks and MSMEs. A quick review of the current MPS reveals that interest rate capping does not form part of the monetary policy instruments that the CBK uses to realize its monetary policy objectives. Rather, it outlines other related instruments that affect the interest rates such as the Central Bank Rate (CBR), Repurchase Agreement (Repos) rates, and Cash Reserve Ratio.<sup>96</sup> First, the CBR refers to the lowest interest rate that the CBK charges when it advances loans to banks and microfinance institutions.<sup>97</sup> Therefore, it influences the rate at which banks and financial institutions lend. It can therefore be used as a tool for controlling the rate at which banks lend. For instance, as an alternative to interest rate capping, a reduction in the CBR influences a reduction in the rate of interest charged by banks and other financial institutions.

On the other hand, Repos refer to collateralized loans that involve the sale and purchase of securities between the CBK and commercial banks at different rates and within stipulated maturity periods.<sup>98</sup> With longer maturity periods, banks are able to retain more liquidity and have more money available for lending at relatively lower interest rates as opposed to the contrary. Finally,

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<sup>96</sup> Monetary Policy Statement – June 2022, p. iii & iv.

<sup>97</sup> Central Bank Act, Section 36(4).

<sup>98</sup> Monetary Policy Statement – June 2022, p. iii.

the Cash Reserves Ratio (CRR) represents the proportion of a commercial banks total deposits that has to be deposited with the CBK.<sup>99</sup> Hence, this determines the liquidity of banks and availability of funds for banks to lend which further translates to the rate at which banks lend.

Pursuant to the 2022/23 MPS, the CBK laid out its policy on interest rates as follows. First, the CBK elected to retain the CBR at 7.00 per cent until May 2022 when the MPC decided to increase the interest rate from the previous 7.00 per cent to 7.50 per cent<sup>100</sup> The justification behind the increase in the CBR rate was the MPC's observation that the increase in global commodity prices would result coupled with supply chain disruptions elevated risks to the inflation outlook in the country.<sup>101</sup> Even though the MPC promised to maintain sanity in the interbank market by monitoring the implications of this policy measure, it is apparent that such an increase in the CBR rate is often accompanied in the increase on interest rates charged on credit.<sup>102</sup>

It follows that such an increase in the cost of credit is likely to exclude MSMEs from accessing credit. Further, for banks this becomes a disincentive to lending low-income consumers of credit as well as MSMEs.<sup>103</sup> This is manifest in the increase in the average lending rate ascribed to by commercial banks. Even though the Policy statement reports that the average lending rate by commercial banks remained relatively stable, it would still be important to note that since the increase in the CBR rate in May 2022, the highest average commercial bank rate of 12.27 per cent was recorded in June 2022 as compared to 12.02 in June 2021.<sup>104</sup> This being the highest figure that has been recorded in that period. This is confirmation that variation of the CBR has a direct impact on lending rates and the same has heavy implications on access to credit and financial inclusion of MSMEs.

This review of the country's monetary policy reveals the position that in the absence of caps on interest rates exposes lending rates to instability occasioned by other monetary policy measures such as the CBR, REPOs and CRRs. Hence the finding that capping can be of great utility in protecting specific and vulnerable sectors in the market economy from such kinds of adjustments in the monetary policy occasioned by market forces. As such, even though capping may not be

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<sup>99</sup> Monetary Policy Statement – June 2022, p. iii.

<sup>100</sup> Monetary Policy Statement – June 2022, p. 5.

<sup>101</sup> Monetary Policy Statement – June 2022, p. 5.

<sup>102</sup> Sinclair, PJN Inflation expectations, Routledge 2009.

<sup>103</sup> Sinclair, PJN Inflation expectations, Routledge 2009.

<sup>104</sup> Monetary Policy Statement – June 2022, p. 5.

used as an absolute tool, it may be implemented through mechanisms that are less rigid such as the country's Monetary Policy Statement which can be structured and varied with effect to imposing caps applicable to vulnerable sectors at times when various detrimental measures are being implemented by the CBK.

## **2.6 The Promotion of the Development of MSMEs in Kenya.**

The Kenyan legal regime appreciates the unique nature of MSMEs to the extent that they are separately recognized, regulated and promoted through the Micro and Small Enterprises Act, 2012. This is considering that MSMEs form a greater portion of businesses in Kenya. The Act establishes the Micro and Small Enterprises Authority which is at the center of promoting the interests of MSMEs.<sup>105</sup> Among the functions of the Authority include monitoring the implementation of government policies that affect MSMEs and advising the government on the appropriate course of action to be taken.<sup>106</sup> The Authority is also mandated to coordinate and facilitate the integration of various public and private sector activities and programs relating to MSMEs.<sup>107</sup>

Following the establishment of the Micro and Small Enterprises Authority,<sup>108</sup> the enactment provides for various measures through which the Authority can steer and influence the development of MSMEs in Kenya. For instance, the Act provides that the Authority shall be in charge of advising and facilitating the relevant state departments and agencies to develop infrastructure and facilities necessary for the development of micro and small enterprises.<sup>109</sup> This also extends to partnering with relevant state departments and agencies as well as public and private training institutions to develop capacity building programs and provide business development services.<sup>110</sup>

These two key functions provided under the Micro and Small Enterprises Act depict a trend through which the Small and Micro Enterprises Authority is expected to coordinate with relevant state agencies and departments in order to promote the development of micro and small enterprises. Even so, with regard to promoting the development of MSMEs, the coordination between the Authority and other state agencies is geared towards development of infrastructure and capacity

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<sup>105</sup> Micro and Small Enterprises Act, 2012, Section 29(1).

<sup>106</sup> Micro and Small Enterprises Act, 2012, Section 31(b).

<sup>107</sup> Micro and Small Enterprises Act, 2012, Section 31(b).

<sup>108</sup> Micro and Small Enterprises Act, 2012, Section 29(1).

<sup>109</sup> Micro and Small Enterprises Act, 2012, Section 47.

<sup>110</sup> Micro and Small Enterprises Act, 2012, Section 48(a) & (c).

building as demonstrated in the previous paragraph. However, the scope of promoting the development of MSMEs can be extended to coordinating with the relevant state agency (that is the Central Bank of Kenya) to formulate a monetary policy that promotes the development of MSMEs. This is considering the position that regardless of the nature of infrastructure that is developed and capacity building that is done, the development of MSMEs is dependent on protecting them from certain market forces that could be detrimental to them. The absence of such a coordinating mechanism makes it impossible for the Authority to effectively realize its objectives on promoting development of MSMEs if it is not involved in promoting the development of monetary policies that are strategically aligned to its objectives.

It is important to note that this development will be essential in complementing the advisory function of the Authority with regard to advising the government on the impact of its policies (including monetary policy) and coordinating and facilitating programs and activities between the public (the CBK) and the private sector (commercial banks). As such, the Authority represents an additional institutional and regulatory mechanism in the Kenyan legal framework that would be essential in advising the CBK on whether to implement interest rate caps as a monetary policy tool or otherwise. Such coordination would be essential with a view to ensuring that regulatory and legislative action towards or against interest rate capping is undertaken with due regard to the impact that the same would have on the development MSMEs in the country.

### ***2.6.1. Impact of Interest Rate Capping on SMEs/MSMEs in Kenya***

It was anticipated that the law on interest rate caps that took effect on 14th September 2016 in Kenya would deal with issues pertaining to cost of credit. Hence, it was interpreted that the government was motivated by both economic and political reasons. Various studies have made different findings on the impact of interest rate capping on MSMEs. A 2018 study confirmed that interest rate capping positively affects the performance of commercial banks. However, this is only with respect to large borrowers. However, small borrowers were found to be the most affected by the capping of interest rates. This was the inevitable effect of banks having to tighten their credit standards as part of mitigation measures in reaction to the capping of interest rates.<sup>111</sup> Hence, credit uptake was more concentrated on high-income borrowers as opposed to low-income borrowers

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<sup>111</sup> Mugo, GE; Mwaniku, G & Ogolla, D 'Interest rate capping by the Central Bank of Kenya on loans uptake' 2019 *International Academic Journal of Economics and Finance* Vol. 3(5), p. 41.

such as MSMEs. Another 2018 study confirmed that commercial banks responded to interest rate capping by elevating their risk mitigation measures and adjusting their portfolios away from MSMEs.<sup>112</sup> This was with effect to rationing out small and unsecured borrowers,<sup>113</sup> hence the corresponding decline in lending to MSMEs.<sup>114</sup>

The former interest rate capping regime, despite its general application, was targeted at alleviating the cost of credit in specific industries and economic areas.<sup>115</sup> This is based on the understanding that interest rate capping is effective when implemented to respond to failures in certain industries and segments in the markets.<sup>116</sup> The targeted section of the credit market was SME who as a counterintuitive result of the capping law were rationed out of the credit market. As a result, it was reported that this lowered growth in country by 0.4 percentage point in 2017, a year after implementation of the interest rate capping law.<sup>117</sup> This was further confirmed in a 2020 study estimating that controls on the interest rates reduced economic growth by .25 percentage points on an annual basis.<sup>118</sup> Hence the suggestion that these adverse effects could be largely avoided by embracing interest rate controls that facilitate lending to high-risk borrowers and resort to alternative policies that address the concerns incidental to the high cost of credit.<sup>119</sup> The following chapter discusses interventions that are inclined towards rethinking interest rate controls for the benefit of SMEs and MSMEs in Kenya.

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<sup>112</sup> Safavian, M & Zia, B 'The impact of interest rate caps on the financial sector: Evidence from commercial banks in Kenya' 2018 *Policy Research Working Paper* No. 8393, p.9

<sup>113</sup> n, M & Zia, B 'The impact of interest rate caps on the financial sector: Evidence from commercial banks in Kenya' 2018. P.3

<sup>114</sup> n, M & Zia, B 'The impact of interest rate caps on the financial sector: Evidence from commercial banks in Kenya' 2018, p.12

<sup>115</sup> Wangalwa, HH; Kahuthia, J & Ndegwa J 'Strategic responses to interest rate capping by Central Bank of Kenya and its effects on financial performance of commercial banks in Kenya' 2018 *Journal of Management* Vol. 5(3), p.640.

<sup>116</sup> Wangalwa, HH; Kahuthia, J & Ndegwa J 'Strategic responses to interest rate capping by Central Bank of Kenya and its effects on financial performance of commercial banks in Kenya' 2018, p. 640.

<sup>117</sup> Wangalwa, HH; Kahuthia, J & Ndegwa J 'Strategic responses to interest rate capping by Central Bank of Kenya and its effects on financial performance of commercial banks in Kenya' 2018, p. 643.

<sup>118</sup> Alper, E; Clements, B; Hobdari, N & Porcel, RM 'Do interest rate controls work? Evidence from Kenya' 2020 *Review of Development Economics* Vol 24(3), p. 910.

<sup>119</sup> Alper, E; Clements, B; Hobdari, N & Porcel, RM 'Do interest rate controls work? Evidence from Kenya' 2020, p. 920.

## 2.7 Conclusion

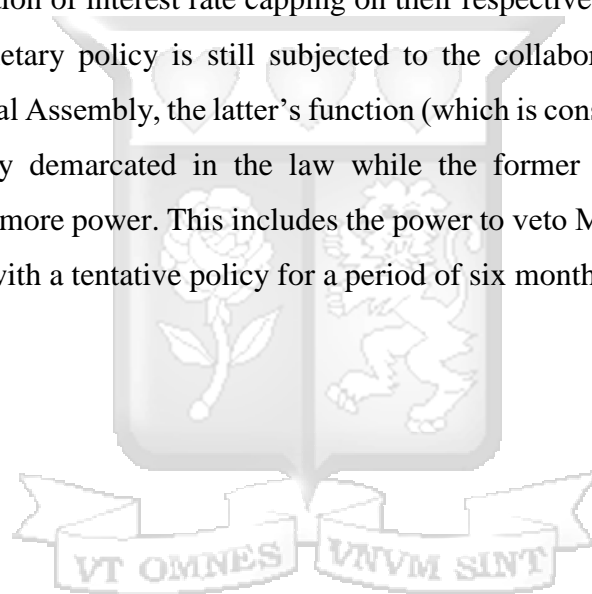
It is apparent that the key parameters of the prevailing legal framework that are essential to rethinking the regulation of interest rate capping in Kenya include regulatory coordination between the Micro and Small Enterprises Authority and the Central Bank in formulating monetary policies; conditional interest rate capping by exclusion of MSMEs and other businesses in strategic sectors from the implications of monetary policy measures that are likely to affect interest rates; clarity on the role of the National Assembly with regard to the Statement of Monetary Policy once the same has been presented before a house committee; and expansion of the scope of the *in duplum* rule away from its limited application to non-performing loans as seen above.

Based on the foregoing review of the Kenyan legal framework, the absence of an interest rate cap ceiling, does not automatically translate to uncontrollable, unpredictable and exploitative loans. However, there are various equivocal aspects of the legal framework that can be improved to effectively regulate interest rates when taking into account the interests of banks and financial institutions as well as SME debtors. Section 52(3) of the Banking Act anticipates that by way of legislation, the legal framework in Kenya ought to provide for the maximum interest and charges that a bank or a financial institution can recover from a debtor. The express provision for this ceiling that was reflected under section 33B that would later be repealed. However, the Banking Act maintains residuary provisions that purport to regulate interest rates by imposition implicit caps. These include section 44 which has been subjected to diverse construction within the judiciary; section 44A that creates the *in duplum* rule whose application is limited to non-performing loans and is not keen on establishing interest rate caps on loans before they can be classified as non-performing loans.

Despite an unclear firm position from the courts, the prevailing case law presents a united front regarding the position that the courts have adopted to refuse to enforce contracts whose interest rates are found to have been implemented through unconscionable terms. Even so, this is still in conflict with section 52(1) of the Banking Act that is alive and not yet invalidated by case law or legislation to the extent that it anticipates that breach of the provisions of the Act should not empower the courts to invalidate contractual obligations entered into between the banks and debtors. The following chapter shall, therefore, analyze these aspects of the Kenyan legal

framework as metrics that can be improved to establish a legal framework on interest rate capping that balances off the interests of MSMEs and that of banks and financial institutions.

Even though the function of formulating monetary policy is key to interest rate capping, (considering the country's diversion away from legislation after the repeal of section 33B of the Banking Act), this part has pointed out the absence of democratization of this function considering the composition of the MPAC. This is considering that it is not comprised of individuals who represent the interest of diverse groups in the national economy that are likely to be affected by the monetary policy. For instance, in this regard, when it comes to setting interest rate ceilings, the Committee is not comprised of any representatives from the banking sector or MSMEs who are able to voice the implication of interest rate capping on their respective sectors. Even though one may argue that the monetary policy is still subjected to the collaborative engagement of the Executive and the National Assembly, the latter's function (which is considered a more democratic institution) is not clearly demarcated in the law while the former (which is relatively less democratized) is granted more power. This includes the power to veto MPAC's formulated policy and to replace the same with a tentative policy for a period of six months.



## **Chapter 3:**

### **The Effects of Law on Interest Rate Control on the Interests of MSMEs in the Credit Markets**

#### **3.1 Introduction**

This chapter undertakes a comprehensive review of academic and policy literature on the effects of interest rate capping on the interests of MSMEs in relation to banks and microfinance institutions. The chapter briefly highlights the nature of interest rate and interest rate capping before reviewing the legal implications of interest rate caps on the welfare of the financial consumer and its effects on the credit markets. The chapter further proceeds to review literature that suggests a cautioned approach towards interest rate capping before demonstrating the emerging findings on the need to strike a balance between the competing interests affected by interest rate caps. The chapter finally concludes by highlighting the gap implications that arise from the reviewed literature in light of what the subsequent chapters shall cover.

#### **3.2 The Nature of Interest Rates and Interest Rate Capping**

Interest rates imposed on loans are meant to cover various components of the costs of lending that a lender has to meet in order to maintain their business as a going concern. In this regard, the interest rate comprises of four elements. They include the cost of funds, overhead costs, provision for non-performing loans and profit.<sup>120</sup> Cost of funds in this regard includes that interest that lenders such as banks have to pay depositors while overheads cover outreach costs, processing fees and general overheads. The provision for non-performing loans on the other hand leaves allowance for lenders to absorb the cost of bad debts that they may have to write off. And the final component entails the profit that the banks have an obligation to make in the interest of their shareholders.<sup>121</sup> These components of the interest rate are therefore important as they are important indicators of the cost of lending and are essential in assessing the reaction of lenders with regard to these costs when regulators implement caps. It is anticipated that an understanding of the impact of caps on these cost implications may make it possible to understand or predict the impact of interest rate caps on access to credit especially for SMEs and MSMEs.

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<sup>120</sup> Howard Miller, 'Interest rate caps and their impact on financial inclusion' 2013 EPS Peaks p.1

<sup>121</sup> Chiu, IH The law of corporate governance in banks (Edward Elgar Publishing, 2015).

That notwithstanding, Maimbo M defines interest rate capping is a form of financial control by government or regulators in the financial sector either as a tool for liberalizing a country's financial policies or as a tool for consumer protection.<sup>122</sup> Interest rate capping could also be motivated by the need to support a specific sector of the economy experiencing market failure as a result of information asymmetries.<sup>123</sup> With regard to consumer protection, interest rate capping is essential to protect consumers from exploitation in jurisdictions where financial institutions possess relatively higher market power.<sup>124</sup> This is essential in instances where financial institutions are making excessive profits by imposing very high interest rates. A justification known as the usury argument which is comprehensively highlighted in the following part.

### **3.3 The Legal Implications on the Welfare of the Financial Consumer: The Case for Capping**

Following the effects of the global financial crisis in 2008-2009 various governments re-opened discussions on interest rate control as a tool for consumer protection.<sup>125</sup> This is considering that different financial regimes preceding the crisis were structured towards promoting the liberalization of financial markets and this also meant the liberalization of interest rates and the prescription of less control.<sup>126</sup> As a reaction to the effects of the financial crisis, different regulators introduced interest rate caps on lenders based on the need to broaden financial inclusion and with a view to protecting the welfare of the consumers of financial products from predatory lending practices. A move that is supported in academic literature by what is known as the usury argument. In a 2021 IMF Working Paper, Dyna Heng and two other authors acknowledge that the intended objective of interest rate caps is to broaden financial inclusion.<sup>127</sup>

#### **3.3.1 The Usury Argument**

The usury argument is at the core of protecting consumers of financial services against the risk of exploitation and predatory lending. It refers to the justification for interest rate capping that is

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<sup>122</sup> Maimbo, SM & Gallegos, CAH 'Interest rate caps around the world: Still popular, but a blunt instrument' 2014 World Bank Group Policy Research Working Paper 7070.

<sup>123</sup> Howard Miller, 'Interest rate caps and their impact on financial inclusion' 2013 EPS Peaks P. 2.

<sup>124</sup> Maimbo, SM & Gallegos, CAH 'Interest rate caps around the world' 2014.

<sup>125</sup> Reinhart, C; Kirkegaard, JF; & Sbrancia, NB 'Financial repression redux' 2011 *Finance and Development* Retrieved from: [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1864806](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1864806)

<sup>126</sup> Liou, KT 'The financial crises and the challenge of government regulation' 2013 *Public Performance & Management* Vol. 37(2).

<sup>127</sup> Heng, D & Heng, B. 'Impact of interest rate cap on financial inclusion in Cambodia.' 2021 IMF Working Paper

ascribed to by various academic scholars in their academic literature. The argument stems from a consumer protection perspective where the government resorts to protect vulnerable consumers of financial services from predatory lenders.<sup>128</sup> What contributes to this state of affairs includes the following market conditions. First, there is an assumption that the demand for credit at higher interest rates is price inelastic.<sup>129</sup> This implies that an increase in the interest rate or the cost of lending might not necessarily reduce the demand for credit and vice-versa. Second, financial institutions are also in a position to easily exploit the information asymmetry that exists between them and potential borrowers in a manner that negatively affects the interests of their clients.

An argument is advanced that when interest rate caps are used to keep the prices of loans below a market equilibrium, then demand for loans increases in a manner that goes beyond what financial institutions are willing to supply.<sup>130</sup> Principles of economics that anticipate supply to be equivalent to demand anticipate that prices are likely to rise in the event demand exceeds supply.<sup>131</sup> If this economic principle is anything to go by, then it is anticipated that an increasing demand for credit is likely to drive and increase in the pricing of loans.<sup>132</sup> Hence, an excess demand for loanable funds inherently imply that the price for such loans is expected to increase to untenable and exploitative levels that amount to usury.<sup>133</sup> It is upon this basis that credit rationing becomes necessary through various mechanisms that include the capping of interest rates. These state of affairs arising from the usury argument, therefore, justifies interventions from the governments to impose interest rate ceilings with a view to protecting the interest of both key stakes holders as well as the interests of the national economy.

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<sup>128</sup> Morris, RA 'Consumer debt and usury: A new rationale for usury' 1988 *Pepperdine Law Review* Vol. 15(2).

<sup>129</sup> Karlan, DS & Zinman, 'Elasticities of demand for consumer credit' 2005 Centre Discussion Paper, No. 926. Retrieved from: <https://www.econstor.eu/bitstream/10419/39348/1/507839250.pdf>

<sup>130</sup> Yosif, N 'Limiting interest rates without limiting access to credit' 2021 *The Regulatory Review* 22 November, 2021 Retrieved from: <https://www.theregview.org/2021/11/22/yosif-limiting-interest-rates-limiting-access-credit/>

<sup>131</sup> Newbery, DM & Stiglitz, JE *The theory of commodity price stabilization: A study in the economics of risk* (Clarendon Press, 1981).

<sup>132</sup> Stiglitz, JE & Weiss, A 'Credit rationing in markets with imperfect information' 1981 *The American Economic Review* Vol. 71(3). p. 393.

<sup>133</sup> Ardic, OP; Ibrahim, JA & Mylenko, N. 'Consumer protection laws and regulations in deposit and loan services: a cross country analysis with a new data set' 2011 *World Bank Group Policy Research Working Paper* No. 5536 Retrieved from: <https://www.cgap.org/sites/default/files/CGAP-Consumer-Protection-Laws-and-Regulations-in-Deposit-and-Loan-Services-Jan-2011.pdf>

### 3.3.2 The Impact on SMEs and Other Borrowers

When advancing loans, the point of focus that becomes the main concern for banks is the interest rate they receive on the loan as well as the risk associated with the loan. In this regard, academic scholars such as Joseph Stiglitz and Andrew Weiss argue that the nature of the interest rate charged on a loan may have a direct effect on the risk of the pool of loans a financial institution offers.<sup>134</sup> The risk in this regard either emanates from the manner in which the creditors identify their borrowers or from the subsequent action that is taken by the borrowers.<sup>135</sup> Therefore, the authors establish justification for capping interest rates based on the averment that interest rate liberalization and subsequent increase in interest rates discourage safer investors or induce borrowers to invest in riskier projects.<sup>136</sup>

This in the long term has the effect of possibly decreasing the returns that are to accrue to the lender.<sup>137</sup> On this premise, it would suffice to infer that monetary policies that encourage capping on interest rates if structured appropriately could have the effect of shifting the supply of funds to safer low-risk investors.<sup>138</sup> This is considering the presumption that such rates would also encourage investors to take-up less risky investments and avoid the moral hazard that is associated with higher interest rates. According to the authors, this argument is limited to credit markets with imperfect information.<sup>139</sup>

Pursuant to an academic study conducted in 2021, it was also established that the implementation of interest rate cap results in the exclusion of high-risk borrowers from the market.<sup>140</sup> According to the authors, the policy implications from the findings of the study were that setting interest rate ceilings negatively influences outreach by microfinance institutions as they have to eliminate

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<sup>134</sup> Stiglitz, JE & Weiss, A 'Credit rationing in markets with imperfect information' p. 393.

<sup>135</sup> Steburnovvs V& Faul, L. Ownership and asymmetric information problems in the corporate loan market: Evidence from Heteroskedastic regression (Create Space independent Publishing Platform, 2015).

<sup>136</sup> Stiglitz, JE & Weiss, A 'Credit rationing in markets with imperfect information' p. 408.

<sup>137</sup> Basel Committee on Banking Supervision 'Interest rate risk in the banking book' 2015 Consultative Document Retrieved from: <https://www.bis.org/bcbs/publ/d319.pdf>

<sup>138</sup> Alpher, CE; Clements B, Hobdari, N & Porcel, RF. 'Do interest rate controls work? Evidence from Kenya' 2019 *IMF Working Paper* Retrieved from:

<https://books.google.co.ke/books?id=IKgZEAAAQBAJ&printsec=frontcover&dq=interest+rate+capping+shifting+supply+to+low+risk+investors&hl=en&sa=X&ved=2ahUKEwiws9L3ttf7AhVrVKQEHRMGAokQ6AF6BAgLEAI>

<sup>139</sup> Campion, A; Ekka RK & Wenner, M 'Interest rates and implications for microfinance in Latin America and the Caribbean, 2012 *IDB* .

<sup>140</sup> Aiba, D et al. 'Impact of interest rate cap policies on the lending behaviours of microfinance institutions: Evidence from millions of observations in the Credit Registry Database' 2021 JICA Ogata Research Institute Working Paper p. 35.

costly loans to maintain the stability of their operations.<sup>141</sup> Such a shift in supply resulting in exclusion of households and MSMEs creates the increasing demand for informal finance. It is also argued that such a proliferation of informal financing is also detrimental to the extent that regulators are forced to incur more administrative costs to monitor and regulate such informal lending practices.<sup>142</sup>

Even so, what stands out from the study is that the implementation of interest rate cap with regard to supply shifts available funds to sound and low risk borrowers who pose less systemic risks to the financial system.<sup>143</sup> Even though the low outreach implies some level of exclusion, it is important to note that such exclusion affects risky borrowers who would otherwise probably negatively affect the profits of the lender or pose systemic risks to the financial system. With regard to the demand side, borrowing practices are, therefore, affected to the extent that borrowers who no longer have the need to borrow are screened-out by the lenders. Based on this, it would suffice to infer that interest rate capping limits financial inclusion to high quality borrowers while at the same time eliminating low-quality borrowers.

What is also important to understand on the demand side is the position that has been established that demand for credit is price inelastic.<sup>144</sup> This implies that the demand for credit remains constant even amidst changes in prices. This realization that the low-income borrowers are not sensitive to high interest rates is what has informed the need for governments to implement caps on interest rates.<sup>145</sup> Otherwise, if demand for credit was price elastic, then usurious lending would not be sustainable for various financial institutions.<sup>146</sup> Although borrowers do not negatively react to increase in interest rates or in the price of borrowing, it is important to establish how they react or how their borrowing trends are affected by the implementation of caps. This is yet to be comprehensively addressed in policy literature. However, when it comes to academic literature,

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<sup>141</sup> Pozo, J 'Interest rate caps in an economy with formal and informal credit markets' 2022 *Graduate Institute of International and development Studies* Working Paper No. 22.

<sup>142</sup> Heng, D; Chea, S & Heng, B 'Impacts of interest rate cap on financial inclusion in Cambodia' 2021 *IMF* Retrieved from: <https://www.elibrary.imf.org/view/journals/001/2021/107/article-A001-en.xml>

<sup>143</sup> Mehanz, S. & Zia, B 'The impact of interest rate caps on the financial sector: Evidence from commercial banks in Kenya' 2018 *World Bank Group Policy Research* Working Paper.

<sup>144</sup> Stiltz, JE & Weiss, A 'Credit rationing in markets with imperfect information' p. 393.

<sup>145</sup> Defusco, AA & Paciorek, A. 'The interest rate elasticity of mortgage demand: Evidence from bunching at the conforming loan limit.' 2014 *Finance and Economics Discussion Series* Retrieved from; <https://www.federalreserve.gov/pubs/feds/2014/201411/201411pap.pdf>

<sup>146</sup> Seidman, DJ 'The impact of interest rates on price and supply' 1987 *The Canadian Journal of Economics* Vol. 20(3).

Joseph Stiglitz and Andrew Weiss examine the nature of the behaviour of borrowers when interest rates change. In this regard, they report that when the lender raises the interest rate, the return on projects which succeed decreases.<sup>147</sup> This implies that higher interest rates force borrowers to undertake riskier businesses that are less likely to succeed but with the potential of higher gains when they succeed.

Based on the foregoing positions, it would suffice to argue that interest rate capping is justified to the extent that it has positive implications on MSMEs and consumer of financial services generally. First, interest rate capping broadens financial inclusion for low risk SME investments and only excludes MSMEs that are meritoriously not eligible to access to funds. Further, the price inelastic nature of interest rates make liberalization of interest rates impossible as it leaves consumers of loan products to usurious practices by the lenders.

### **3.4 The Legal Implications on Credit Markets: The Case against Capping**

It is argued that when it comes to interest rate control, there is a trade-off between competition and stability in the financial system.<sup>148</sup> The overriding goal of interest rate liberalization is to allow banks to set their own interest rates and increase competition between them.<sup>149</sup> However, it is also argued that such intense competition is likely to result in bank failures and even potential bank runs in the event there is no deposit insurance.<sup>150</sup> A study conducted by Leaven in 2003 within the United States established that such financial liberalization measures as elimination of interest rate capping exposed small enterprises to more access to finance.<sup>151</sup> In the same vein, a study conducted by Elison and Forster in 2006 registered observations that individuals and businesses moved more to jurisdictions that had less restricting lending practices.<sup>152</sup>

The trend in recent decades have seen a decline in the caps imposed on interest rates in industrialized countries. On one hand, the move to reduce the caps on interest rate caps is seen as

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<sup>147</sup> Stiglitz, JE & Weiss, A 'Credit rationing in markets with imperfect information' p. 393.

<sup>148</sup> Cuesta, JI & Sepulveda, A 'Price regulation in credit markets: A trade-off between consumer protection and credit access' 2019 Retrieved from: [https://economics.yale.edu/sites/default/files/jmp\\_jicuesta.pdf](https://economics.yale.edu/sites/default/files/jmp_jicuesta.pdf)

<sup>149</sup> Adams, W; Einav, L & Levin, J. 'Liquidity constraints and imperfect information in Subprime Lending' 2009 *American Economic Review* Vol. 99(1).

<sup>150</sup> Alessie, R; Hochguertel, S & Weber, G. 'Consumer credit: Evidence from Italian micro data' 2005 *Journal of the European Economic Association* Vol. 3(1).

<sup>151</sup> Cuesta, JI & Sepulveda, A 'Price regulation in credit markets

<sup>152</sup> Bodenhonr, H 'Usury ceilings and bank lending behaviour: Evidence from nineteenth century New York 2012 *Journal of Political Economy* Vol. 120(1).

a move towards liberalizing financial policies.<sup>153</sup> It is argued that the move away from interest rate capping is meant to make financial markets more accessible. This is considering that lowering interest rates limit access to credit to those with high collateral and those who need it most; and at the same time decreases financial product diversity and the resulting competition within the financial sector. Such limited access to credit forces low-income borrowers to resort to alternatives such as unlicensed money lenders at less concessional terms including relatively higher interest rates.<sup>154</sup>

### ***3.4.1 Averting the Risk of Adverse Selection***

With regard to the interests of banks and microfinance institutions, the lenders are also more inclined to impose higher interest rates to compensate for non-performing loans owing to the risk that they suffer out of their inability to distinguish safe and risky borrowers.<sup>155</sup> On the one hand, since the financial institutions are not able to distinguish between high risk and low-risk borrowers, they tend to impose interest rates that are attractive to high risk borrowers. This inherent increase in the probability of default on credit as a result of the increase in interest rate and attraction of high-risk borrowers is known as adverse selection.<sup>156</sup> On the other hand, the high risk borrowers who obtain debt in the midst of adverse selection are more likely to make riskier investments in order to meet their borrowing costs.<sup>157</sup>

Such investment in riskier investments also increases their probability of default. It is based on these premises that bank and microfinance institutions are more inclined to mitigate the risk of adverse selection by imposing high lending rates. What is also apparent in the first place is that if the state through its policies is able to reduce the risk of adverse selection, then there will be less incentive for financial institutions to impose higher interest rates to cover the said risk. Therefore, imposing caps on interest rate takes away their liberty to be able to price their loan products according to the risks they have assessed to mitigate adverse selection.

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<sup>153</sup> Cuesta, JI & Sepulveda, A 'Price regulation in credit markets

<sup>154</sup> Bodenhonr, H 'Usury ceilings and bank lending behaviour

<sup>155</sup> Cuesta, JI & Sepulveda, A 'Price regulation in credit markets

<sup>156</sup> Bodenhonr, H 'Usury ceilings and bank lending behaviour

<sup>157</sup> Howard Miller, 'Interest rate caps and their impact on financial inclusion'

### 3.4.2 Financial Exclusion

There are works that report that the need to ensure financial inclusion of low-income and high risk Consumers is impossible amidst capping policies.<sup>158</sup> This is premised on the argument that implementing a cap will only prompt detrimental action from financial institutions. While it is anticipated that the lenders will push to increase access to credit while bringing down their lending rates, the implementation of a ceiling is said to magnify the problem of adverse selection for financial institutions. In this regard, it is argued that capping creates a consumer surplus that entails a larger pool of willing borrowers whose creditworthiness cannot be identified.<sup>159</sup> The options available to financial institutions in this regard involve extending the reach of their lending which involves lending to riskier borrowers and therefore increasing their non-performing loans costs.<sup>160</sup> Alternatively, to deal with the adverse selection the lenders would need to improve their processing systems to identify good clients at the expense of increased overhead costs. Further, the lenders may as well increase their investment in outreach to potential borrowers with better potential to repay at the expense of increased overheads.<sup>161</sup> Based on this line of argument, all the alternative for action available to lenders lead to increase in cost of borrowing which is transferred to borrowers.

It therefore suggests that implementing caps can only result in increased access to finance only if the lenders are able to absorb the increasing costs of lending while at the same time maintaining their profits.<sup>162</sup> Even so, it is argued that this can only be achieved if the lenders can focus on advancing credit to the many borrowers that they can readily support at the prescribed interest rate while denying credit to other borrowers whose creditworthiness cannot be ascertained.<sup>163</sup> Such appears to be a credit rationing move that inherently locks out MSMEs from accessing credit considering that they are the ones that are more likely to pose the risk of adverse selection on banks and therefore would be the first victims of such rationing. That notwithstanding, in anticipation of

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<sup>158</sup> Castellanos, S 'Interest rate caps: Back to the future n LatAm? 2012 *BBVA*

<sup>159</sup> Howard Miller, 'Interest rate caps and their impact on financial inclusion' 2013 *EPS Peaks*

<sup>160</sup> Helms, B & Xavier, R 'Interest rate ceilings and microfinance: The story so far 2004 *CGAP* Occasional paper no. 9.

<sup>161</sup> Howard Miller, 'Interest rate caps and their impact on financial inclusion' 2013 *EPS Peaks*

<sup>162</sup> Howard Miller, 'Interest rate caps and their impact on financial inclusion'

<sup>163</sup> Karlan, D & Zinman, J 'Credit elasticities in less-developed economies: Implications for microfinance 2006

such reaction from lenders, governments have identified an approach towards implementing caps by resorting to limiting the total price of a loans.<sup>164</sup>

The 2014 World Bank Policy Research Working Paper reported that capping generally has more negative effects on the National Economy.<sup>165</sup> Some of the impacts of interest rate capping have been noted to include moves by financial institutions to evade such capping by levying credit life insurance with effect to increasing the total cost of credit.<sup>166</sup> It is also argued that interest rate caps force microfinance institutions to withdraw their services from poor low-income borrowing owing to the low interest rate ceiling. In other parts of the world, interest capping has also led financial institutions to impose clandestine fees and commissions in a manner that reduces transparency to the detriment of consumers. Specifically when it comes to MSMEs, caps are reported to drive financial institutions into withdrawing from poor or financially disadvantaged segments of the market.<sup>167</sup> Such effects negatively affect MSMEs as they force them into other informal forms of borrowing at even more expensive interest rates from emerging lending institutions some of which embrace illegal practices.

Another approach to looking at the impact of implementing caps involves investigating the nature of the impact on both the supply side and the demand side of the credit cycle. From the supply side, it is argued that interest rate caps are likely to prevent lenders from offering their loan products to borrowers on the lower end of the market with effect to discriminating them.<sup>168</sup> This is based on the argument that capping forces lenders to prioritize the cost of credit as opposed access to credit. It is argued that in the absence of capping, lenders are more likely to expand their investment to new markets with effect to increasing their outreach, hence, financial inclusion within the financial sector. However, it is further argued that capping forces lenders to cut their outreach and limit themselves to their current markets with effects to undermining financial inclusion by limiting the supply of loan products.

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<sup>164</sup> Howard Miller, 'Interest rate caps and their impact on financial inclusion'.

<sup>165</sup> Maimbo, SM & Gallegos, CAH 'Interest rate caps around the world: Still popular, but a blunt instrument' 2014 World Bank Group Policy Research Working Paper 7070.

<sup>166</sup> Galindo, A; Fabio, S & Weiss, A 'Does financial liberalization improve allocation of investment? Micro-evidence from developing countries 2007 *Journal of Development Economics* Vol. 83(2).

<sup>167</sup> Maimbo, SM & Gallegos, CAH 'Interest rate caps around the world P. 28.

<sup>168</sup> Deaing, S; Panicos D & James, G 'Creditor protection and banking system development in India' 2019 *Economics Letters* Vol. 108(1).

### 3.5 Interest Rate Capping with Caution

What arises from review of the legal impact of interest rate capping is literature that suggests an approach towards imposing interest rate caps with caution with a view to ensuring that the policy is effective for the targeted market. For instance, according to the Maimbo SM, there are various ways in which government action can promote reduction in the interest rates of loans through measures that bear the following characteristics.<sup>169</sup> First, the nature of these measures tend to enhance competition and product innovation, improve financial consumer protection, increase financial literacy, improve access to finance and promote microcredit products.<sup>170</sup> This implies the imposition of all other measures apart from imposing caps. further, the author notes that if at all interest rate capping is to be considered a viable policy for reducing interest rates, then capping ought to be done subject to various caveats.

For instance, capping of interest rates is effective if the same is focused on specific products such as consumer loans. Alternatively, according to Maimbo SM, capping should only be done with respect to specific providers, for instance, microfinance institutions.<sup>171</sup> This is considering the view that capping, while taking to account the interests of low-income lenders, should be undertaken with respect to such institutions that predominantly lend to such vulnerable consumers of credit. Another caveat includes the argument that interest rates should be set at a reasonable level. This implies that the cap should be high enough to allow lenders to make profits while at the same time it should be low enough to get rid of excess profit arising from lack of competition. However, the difference between the two limits should be sufficient to create variations in rates based on competition.

In the same vein, a policy research working paper identifies some of the alternatives to include fostering competition within the financial sector.<sup>172</sup> This is based on the identification of the need to force financial institutions to compete on the price of loans they offer by reducing their interest rates. However, the proposed alternative does not outline how such competition can be achieved considering the collusive behaviour in any markets that often affect competition. This would in

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<sup>169</sup> Maimbo, SM & Gallegos, CAH 'Interest rate caps around the world: Still popular, but a blunt instrument' 2014 World Bank Group Policy Research Working Paper 7070.

<sup>170</sup> Maimbo, SM & Gallegos, CAH 'Interest rate caps around the world.

<sup>171</sup> Maimbo, SM & Gallegos, CAH 'Interest rate caps around the world P. 26.

<sup>172</sup> Ferrari, A; Masetti, O & Ren J. 'Interest rate caps: The theory and the practice' 2018 World Bank Group Policy Research Working Paper

turn incur regulators more administrative costs to monitor banks which a view to averting anti-trust practices. The authors propose that this can be effectively realized when it is combined with policies imposing disclosure obligations on lenders. Such disclosure obligations force lending institutions to disclose their interest rates as well as any hidden costs and fees in a manner that drives competition that is based on interest rates. The underlying question is whether in principle this can make the price of loans elastic to demand.

With regard to the information asymmetry from which the problem of high interest rates emanate, the authors propose that regulators should promote the credit bureaus to access more detailed financial records of potential borrowers.<sup>173</sup> There is also a proposition to promote financial consumer literacy to empower borrowers to identify exploitative loan conditions more easily in a bid to protect them from predatory lending.<sup>174</sup> In other instances, Zatzsche and Dewi argue that the unwanted consequences of interest rate caps have the effect of elevating the importance of the informal credit sector. In this regard, the authors suggest the need to promote competition between regulated banks, microfinance institutions and mobile money lenders; based on a monetary policy that promote competition on merit.

### ***3.5.1 The Trade-off between Consumer Protection Concerns and Market Concerns***

The foregoing review of existing policy and academic literature reveals that the effects of interest rate caps are ambiguous and depend on various factors. Jose Ignacio Cuesta and Alberto Sepulveda recently in 2021 have contributed to literature on the subject and noted that there is limited evidence on the effects of interest rate caps on market outcomes and welfare. The authors find that the negative effects and the positive effects cancel off each other depending on the extent to which the scale tilts in the trade-off between consumer protection from lenders market power and exclusion from access to financial resources. This is consistent with their observations from prevailing literature that in the quest to broaden financial inclusion, so far what is observable is that without the caps, the welfare of the financial consumer is inevitably at stake. In the same vein, the implementation of caps has also been attributed to contributing to financial exclusion.

The analysis by the authors culminate in the finding that interest rate caps have both market effects and welfare effects. According to analysis conducted by the authors, it was established that interest

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<sup>173</sup> Ferrari, A; Masetti, O & Ren J. 'Interest rate caps: The theory and the practice' p. 37

<sup>174</sup> Ferrari, A; Masetti, O & Ren J. 'Interest rate caps: The theory and the practice' P. 38

rate caps in highly concentrated markets register provide consumer protection.<sup>175</sup> However, welfare effects of interest rate caps still remain negative in both concentrated markets and markets under monopolies. With regard to consumer protection, the study finds that the most persisting adverse effect of interest rate capping is the negative effects it has on credit access. By making these observations in this recent study, the two authors seem to have identified the ultimate scale upon which the effect of interest rate cap on MSMEs can be measured. On the basis of these findings, it is apparent that risk-based regulatory measures are not effective towards eliminating the negative effects of interest rate caps. Rather, the essential regulatory approach whether towards capping or otherwise ought to be anchored on striking a balance between financial consumer protection and financial inclusion; depending on the economic realities and needs of the subject market. For instance, when it comes to credit access, there is no harm if the interest rate capping policy is structure in such a way that results in financial exclusion of unmerited or high-risk borrowers who in effect pose systemic risks to the financial system and threaten to undermine the lender's returns.

This position opens the path towards settling the disagreement in literature on the effects of interest rate capping. It is important to note that the authors do not provide a position on whether market outcomes override welfare outcomes and whether the fear of market outcomes may override the need to protect consumer welfare in the event a capping policy is intended for those ends. That notwithstanding, what stands out from the literature reviewed in this part is that the argument for interest rate capping is driven by the need to protect consumer welfare and the argument against interest capping is driven the need to avert market effects or the market outcomes of the imposition of interest rate caps. Depending on the legal regime at stake, the discussion on whether consumer protection concerns override market protection concerns is an analysis that would be the subject of this study in the subsequent chapters. Besides the nature of the regime, the nature of the market – whether concentrated or a monopoly – also plays a critical role in determining the needs of the market to determine on which side of the scale the balance will tilt.

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<sup>175</sup> Cuesta, JI & Sepulveda, A. 'Price regulation in credit markets: A trade- off between consumer protection and credit access' 2021 Stanford Institute for Economic Policy Research Working Paper No. 21-047. P.1

### ***3.5.2 The Gap of Implication***

Even though it is advanced as a criticism, the fact that interest rate caps force lenders to restrict their services to the most qualified borrowers is a complement rather than a critique of interest rate caps.<sup>176</sup> This argument is only a critique to the extent that there is an assumption that there are more less qualified borrowers than there are qualified borrowers. It is important to note that the aim of financial inclusion should not be to grant access to funds to those who are less qualified. In this regard, it would then suffice to infer that interest rate capping is more likely to reduce the problem of adverse selection that banks experience when identifying borrowers. Further, the argument that the prices of loans are inelastic to demand beats the argument that interest rate liberalization is meant to promote healthy competition among lenders. This is considering the position that banks and microfinance institutions are not likely to reduce their interest rates as a result of increase in demand for credit.

Considering the reaction of lenders on interest rate caps such as the increase in non-interest costs, it is apparent that such increased costs are set to restore the deficit that is created by the caps. If this is the case, then it is expected that by imposing these costs, the lenders ought to have been in a position they would have been if the interest rate caps were not imposed. However, in addition to these additional costs, other effects are reported such as reduced outreach by lenders and decline in the number of microfinance borrowers. However, it is anticipated that if additional costs ought to offset the deficit created by the interest rate cap, then these other incidental effects ought not to be there. On the other hand, in the absence of interest rate caps, higher interest rates imposed by lenders are likely to attract high-risk borrowers who are more likely to compromise the returns due to the lenders and pose systemic risks on the financial system resulting from adverse selection and moral hazards. Therefore, the risk resulting from financial inclusion achieved in the absence of interest rate caps is greater than the risk of financial exclusion experienced in the presence of interest rate caps. In fact, the prospective broadening of financial inclusion targeted by capping policies is more promising.

It therefore follows that the present literature developed on the effects of interest rate capping bear a gap in implication of the unintended consequences of interest rate caps. If addition of non-interest

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<sup>176</sup> Zuluaga, D 'Financial inclusion without finance? The misguided quest to limit choice in consumer credit 2019 *CATO Institution* retrieved from: <https://www.cato.org/blog/financial-inclusion-without-finance-misguided-quest-limit-choice-consumer-credit>

costs is not sufficient to restore lenders to a position they were in before the cap, it, it implies that there are other latent factors that influence other effects of the cap (other than the increase in non-interest costs). This is considering that the existing literature does not point out flaws in the prevailing monetary policies establishing interest rate capping regimes with a view to averting these unintended effects of capping. This calls for specific and critical subjective evaluation of specific capping policies and their effects in order to establish the weaknesses in the monetary policies that prevent capping from achieving the intended aim of broadening the financial inclusion.

### **3.6 Conclusion**

This chapter establishes that there is a gap in implication of how interest rate capping affects MSMEs with regard to financial inclusion and as consumers of financial services. On the one hand, policy literature perceives the eradication of interest rate capping as a form of liberal financial policy. On the other hand, academic literature flaws interest rate capping for the various consumer protection concerns it raises. Academic literature also establishes that capped interest rates encourage businesses to undertake projects that are less risky and more likely to succeed, and the reverse is true.

Most of the arguments suggesting that implementation of caps results in more financial exclusion are founded on the reaction by lenders to circumvent caps or limit their costs. Action of which at times may not be justified and that could be checked. Interest rate capping only results in financial exclusion only to the extent that it excludes high-risk borrowers which is promising for the stability of the lender as well as the financial system. This effect is contrasted by the position that interest rate caps broaden financial inclusion to the extent that more funds are available to more low risk borrowers in the event their demand meets the available supply of funds availed by banks.

Despite the information asymmetry in the financial markets, challenges facing lenders as a result of capping such as adverse selection depict issues that can be improved by improving the lenders' screening policies. These are challenges that persist even in the face of interest rate liberalization. Hence, instead of eliminating the interest rate cap, it would be more prudent to promote the development of regulatory policies that encourage the amelioration of lenders. Hence, it would suffice to infer that monetary policies implementing caps on interest rates that are ideally structured

taking all social, economic, and political realities to account ought to have the effect of broadening financial inclusion. This includes increase in access to affordable credit by MSMEs.

Therefore, any other outcomes resulting from the imposition of interest rate caps are to be considered as the unintended outcomes that emanate from the inefficiencies associated with the development and implementation of the monetary policy. The unintended effects of interest rate capping with counteractive effects can be mitigated by striking a balance between the effects that such a policy may have on consumer protection or credit access, depending on the needs of the market. The subsequent chapter critically analyses the Kenyan legal framework within which the monetary policy for interest rate cap is established to later account for its impact on credit access by MSMEs.



## **Chapter 4:**

### **Analysis of Alternative Approaches to Interest Rate Control and the Interests of MSMEs**

#### **4.1 Introduction**

This chapter analyzes the alternative approaches to interest rate control in light of the interests of MSMEs with respect to creditor rights and interests. The chapter shall proceed to explore the legal metrics within which interest rate control can be implemented to balance the conflicting interests of creditors and MSMEs. Hence, with regard to rethinking the legal and regulatory regime on interest rate capping law, this part thematically discusses issues dealing with information asymmetry, the protection of the financial system from high risk borrowers, widening scope of regulation to increase competition in the financial markets and so on. This chapter, therefore, discusses how the thinking behind controlling interest rates can be restructured by considering influencing the demand and supply of credit in the financial market, enhancing consumer protection and promoting competition.

#### **4.2 Influencing Demand and Supply of Credit in the Financial Market**

In the previous chapters, this study has established the following. In the second chapter, it was established that demand for credit at higher interest rates is price inelastic. Hence the view that leaving interest rates to the whims of market forces is detrimental as the price of credit does not bear a normal reaction to the rules of demand and supply in the free market. As such, failure to regulate interest rates is likely to expose vulnerable businesses such as MSMEs to usurious practices. A view that is perceived as the usury argument for justification of interest rate capping.

In the third chapter, the study established that there are certain monetary policy tools at the disposal of the CBK that makes it possible to indirectly influence interest rates by influencing the liquidity of banks hence the availability of capital for supply into the financial markets. These monetary policy tools include the CBR, the CRR and Repos. Hence the view that premised on the usury argument as coupled with these policy tools; and despite the view that credit price does not respect the rules of supply and demand, it is possible to influence supply and demand for credit through the Monetary Policy in a quest to protecting the interests of vulnerable players in the financial markets such as MSMEs.

It is important to note that the laws of demand and supply continue to apply in the financial markets under ordinary circumstances.<sup>177</sup> As such, with regard to the law of demand, a higher price will decrease the demand on credit.<sup>178</sup> On the other hand, when it comes to the law of supply, an increase in interest rates will encourage more banks to increase the financial capital they supply to the financial markets as an incentive to reap from the increased rate of return.<sup>179</sup> However, from the principles of economics, an equilibrium interest rate arises between the law of supply and demand at the point where the quantity of demand is equivalent to the quantity supplied.<sup>180</sup>

At this point, any interest rate above the equilibrium level will result in an increase in supply that is met with reduced demand. This would force other creditors to lower their interest rates below the equilibrium level in order to attract more businesses into borrowing. It is important to note that at the point where the interest rates are below the equilibrium, the financial market is characterized by high demand for credit as a result of shortage of funds to meet the same. As the cycle continues, this increased demand for credit and shortage of funds would force creditors to once again adjust their interest rates towards the level of the equilibrium.

Based on these rules of supply and demand coupled with various monetary policy tools, it is possible for the CBK to influence interest rates charged with respect to various sectors depending on the state of average interest rates in the market. The utility of influencing interest rates through its monetary policy tools is that the monetary policy is flexible and can be adjusted at various instances depending on the variations in the market.

In chapter two, it was established that in order to influence the quantity of funds available for banks to lend, the CBK may influence the liquidity of banks by varying the Central Bank Rate (CBR), the Cash Reserve Ratio (CRR) and the terms of the maturity periods of its Repurchase Agreements (REPOs). Hence, if the CBK intends to increase the amount of funds available for banks to lend to SMEs and MSMEs at favorable and not usurious interest rates, the CBK could lower the CBR, lower the CRR and extend the tenor of REPOs.

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<sup>177</sup> Rittenberg, L & Tregarthen, T Principles of economics (Flat World Knowledge LLC, 2011).

<sup>178</sup> Rittenberg, L & Tregarthen, T Principles of economics (Flat World Knowledge LLC, 2011).

<sup>179</sup> Amonoo, E; Acquah, PK & Asmah EE 'The impact of interest rates on demand for credit and loan repayment by the poor and SMEs in Ghana' 2003 *International Labor Organization* Retrieved from:

[https://www.ilo.org/wcmsp5/groups/public/---ed\\_emp/documents/publication/wcms\\_125603.pdf](https://www.ilo.org/wcmsp5/groups/public/---ed_emp/documents/publication/wcms_125603.pdf)

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The effect of reducing the CRR is that the banks will have access to more liquidity as it reduces their obligations to maintain cash reserves with the central bank.<sup>181</sup> A similar effect is achieved with respect to reducing the CBR as this is an indicator to banks to reduce their interest rates on loans.<sup>182</sup> The result of altering these monetary policy tools towards increasing the liquidity of banks is that more funds will be available for banks to supply in the credit market. The CBK when varying these monetary tools is also at liberty to direct banks on the usage of the additional liquidity made available to them. This includes directing that the said funds made available should be used to finance SMEs and MSMEs that are eligible for the same. A practice that was witnessed with the CBK Emergency Measures taken in response to the effects of the Covid-19 pandemic.<sup>183</sup>

Based on the rules of supply, this increase in the availability of funds would force a reduction in demand for credit among SMEs and MSMEs and this would subsequently force banks to reduce interest rates below the equilibrium interest rate. The reduction in interest rates would further trigger an increase in demand for credit and strain the supply of funds by the banks. With time, the strain in supply is expected to force the banks to increase their interest rates towards or above the equilibrium.<sup>184</sup> As the rates approach the equilibrium CBK may further make adjustments in its monetary policy tools accordingly to prevent an increase in interest rates beyond the market equilibrium.

Therefore, the current CBK Monetary Policy Statement represents a suitable mechanism to influence demand and supply of credit with the interests of SMEs/MSMEs. The instrument can be used as a reaction by the CBK to monitoring the credit market especially with regards to loan interest rates and availability of credit for SMEs/MSMEs. This tool is better than legislation considering that the Monetary Policy Statement by the CBK is often varied from time to time. Hence, it is less rigid and more flexible compared to an Act of Parliament or a Regulations.

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<sup>181</sup> Ngata, DM & Njeru, A. 'Effect of Basel liquidity rules on the interbank money market lending rates in Kenya: A survey of commercial banks in Kenya' 2015 *International Journal of Scientific and Research Publications* Vol. 5(11).

<sup>182</sup> Mwega, FM. 'Bank rate and the transmission mechanisms of monetary policy in Kenya' 2014 *CBK* Retrieved from:  
[https://www.centralbank.go.ke/images/docs/Research/Bank\\_Rate\\_and\\_Transmission\\_Mechanisms\\_of\\_Monetary\\_Policy\\_in\\_Kenya.pdf](https://www.centralbank.go.ke/images/docs/Research/Bank_Rate_and_Transmission_Mechanisms_of_Monetary_Policy_in_Kenya.pdf)

<sup>183</sup> CBK, Additional Emergency Measures to Mitigate the Adverse Effects on the Banking Sector from the Coronavirus Pandemic.

<sup>184</sup> Bencic, M & Slovenska, NB 'The equilibrium interest rate – theoretical concepts and applications' 2009 *Interest Rate* Vol. 17(3).

Moreover, the implementation of this approach will require the CBK to invest more in its infrastructure and dedicate more finances to efficiently monitor the impact of interest rates on access to credit by MSMEs.

#### ***4.2.1 Interest Rate Control over Interest Rate Ceiling***

Hence, through proper monitoring of the financial markets, it is possible for the regulator to influence the interest rates that banks would charge on credit. As such, the role of the law in protecting vulnerable players in the market is to create an obligation upon the regulator to establish and maintain a monitoring mechanism through which it adjusts its monetary policies accordingly to take care of the interests of vulnerable players such as SMEs/MSMEs in the credit market. This would not be a foreign concept in Kenya as it played out during the COVID-19 pandemic when the CBK was forced to announce the implementation of emergency measures to mitigate the adverse effects of the pandemic on the banking sector.

For these reasons, on March 24, 2020, the CBK directed that it will revise the CBR down to 7.25% as a way of signaling commercial banks to lower their lending rates.<sup>185</sup> The CBK also revised the CRR down to 4.25% with a view to provide additional liquidity to banks and increase access to credit funds which translates to increase in the supply of credit.<sup>186</sup> This would according to the laws of supply and demand discussed above result in the reduction of the rate of lending below the market equilibrium. Further, the CBK also extended the maximum tenor of REPOs from 28 to 91 days increasing the duration within which banks have access to long term liquidity.<sup>187</sup>

Even though these directions were implemented as emergency measures during the pandemic, their application reveals one of the unique ways through which the CBK can take measures to protect vulnerable market players. However, for more certainty, it would be essential to legislate on a statutory provision that creates an obligation on the CBK to regulate the financial markets with a view to promoting access to credit for vulnerable market players such as SMEs/MSMEs. Such an amendment in law can be made with respect to the Micro and Small Enterprises Act, 2012.

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<sup>185</sup> CBK, Additional Emergency Measures to Mitigate the Adverse Effects on the Banking Sector from the Coronavirus Pandemic, Para. 1.

<sup>186</sup> CBK, Additional Emergency Measures to Mitigate the Adverse Effects on the Banking Sector from the Coronavirus Pandemic, Para. 2.

<sup>187</sup> CBK, Additional Emergency Measures to Mitigate the Adverse Effects on the Banking Sector from the Coronavirus Pandemic, Para. 3.

Further, in a quest to promoting and protecting the development of MSMEs, another approach towards achieving this involves empowering the Micro and Small Enterprises Authority to cooperate with the CBK in recommending the variation of the relevant monetary policy tools. This could be done through assisting in monitoring the credit market and access to credit by SMEs/MSMEs under circumstances when these players are subjected to harsh market conditions that warrant protection considering that they fall within the country's most strategic sector.

In addition, when implementing such measures, the CBK should ensure that the measures are strictly applied to specific market players and direct that additional liquidity created by the variation of its monetary policies ought to be directed towards increasing access of affordable credit to MSMEs. In this regard, SMEs/MSMEs are able to access affordable credit without forcing the CBK to impose interest rate ceilings. This also represents a unique approach to interest rate control that is reactive to market forces and directed at protecting vulnerable market players. As such, it does not affect the business of banks with regard to other market players and it is only invoked when circumstances in the financial markets warrant the same. Hence, a suitable middle ground approach.

### **4.3 Control of Interest Rates through Consumer Protection**

The previous chapters have demonstrated various mechanisms through which the legal framework in Kenya has attempted to directly and indirectly control interest rates. In chapter three, following a construction of the Banking Act, it was established that the Act anticipates that there shall be a prescribed ceiling beyond which banks should not impose interest rates.<sup>188</sup> Further it was also established that the provision for the *in duplum* rule under section 44 of the Banking Act and the CBK Prudential Guidelines still manifests various weaknesses that render the same not effective towards protecting the interests of vulnerable market players such as MSMEs. This is considering that the application of the rule is only limited to non-performing loans. Therefore, it does not purport to control interest rates in initial stages of contract formation between borrowers and lenders.

It was further established in chapter two that one of the elements that determine mark at which interest rates are set is the provision for non-performing loans. It was established that in addition

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<sup>188</sup> Banking Act, Section 52(3).

to other costs of lending, the provision for non-performing loans is factored in on interest rates because of the anticipation by lenders that they risk incurring the costs of bad debt. It was further elaborated, with regard to adverse selection, that one of the detrimental effects of interest rate capping is that lenders are inclined to lend to high-income borrowers and avoid high-risk low income borrowers.

To this end, there is a developing view that one of the factors that determine interest rates set by banks in the absence of ceilings, is the nature of the risk that the borrower poses to the transaction. That is the risk of ending up with bad debt. Even so, it is important to acknowledge that potential high-risk borrowers such as SMEs/MSMEs should not be the overriding mechanism through which banks set high interest rates at the expense of other vulnerable borrowers who are not necessarily high risk.

In the previous chapters, it was also established that there is nothing wrong with the financial exclusion of such high risk borrowers considering that they pose risks to the financial system. Hence, it is important to identify that even among low-income vulnerable borrowers such as SMEs/MSMEs, there are both high-risk and low-risk borrowers. It is also important that the low-risk borrowers not to suffer by incurring high interest rates at the expense of high-risk low income borrowers. The role of the law in this regard is to establish consumer protection mechanisms that protect low-income low-risk consumers of credit from low-income high-risk consumers in the financial markets.

A critical element that informs the borrower's risk that forces banks to factor in provision for bad debt in the calculation of their interest rates is based on information asymmetry that exists between the bank and the prospective borrower.<sup>189</sup> Empirical studies have demonstrated that the information asymmetry that exists between banks and borrowers is responsible for increase in the cost of debt capital.<sup>190</sup> These studies establish that lenders issue loans with higher interest rates as well as shorter maturity periods to informationally opaque borrowers. In a separate study, it was

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<sup>189</sup> Miller, H. 'Interest rate caps and their impact on financial inclusion' 2013 *EPS Speaks* Retrieved from: [https://assets.publishing.service.gov.uk/media/57a08a0de5274a31e00003d0/Interest\\_rate\\_caps\\_and\\_their\\_impact\\_on\\_financial\\_inclusion.pdf](https://assets.publishing.service.gov.uk/media/57a08a0de5274a31e00003d0/Interest_rate_caps_and_their_impact_on_financial_inclusion.pdf)

<sup>190</sup> Moerman, RW 'The impact of information asymmetry on debt pricing and maturity' 2006 *The Wharton School* Retrieved from: [https://care-mendoza.nd.edu/assets/152354/the\\_impact\\_of\\_information\\_asymmetry\\_on\\_debt\\_pricing\\_and\\_maturity.pdf](https://care-mendoza.nd.edu/assets/152354/the_impact_of_information_asymmetry_on_debt_pricing_and_maturity.pdf) p. 37.

established that the use of alternative information sources to reduce information asymmetry lowers the probability that the borrower would incur high interest rates.<sup>191</sup>

For instance, the study determined that information from sophisticated accounting methods such as accrual accounting is essential in reducing the information asymmetries between borrowers and lenders. This further translates to the reduced cost of credit.<sup>192</sup> This view has also been accepted with respect to other types of loans such as syndicate loans where it is established that asymmetric information incentivizes participants to demand higher interest rates<sup>193</sup> This translates to the position that efforts by the borrower to reduce information asymmetry could lower the nature of the risk that lenders are perceived to take and influence them to demand for relatively lower interest rates.

The above premises feed on to the long-held view that it is possible to control interest rates through consumer protection. This is based on the argument that consumers who are able to reduce the information asymmetry between themselves that the lenders should be entitled to reduced interest rates. This should be the case when high-standard information provided by them is sufficient to reduce the error in the lender's assessment of the risk of bad debt which is factored in on interest rates. Therefore, the control of interest rates through consumer protection can be realized through the creation of various 'information-based' obligations that are to accrue to the borrowers, lenders and regulators. That notwithstanding, the overriding objective of law and regulation should be to ensure that lending is exercised with due regard to the borrower's ability to repay. This ability can be established through high-standard information that is sufficient to reduce the information asymmetry and ensure that the same can be effectively enforced by the regulator.

First, with regard to the legal obligation of the lender, it is important for the law to create an obligation upon the lender banks to justify the basis upon which the interest rate they impose on a loan is preferred. This is to ensure that interest rates are not imposed arbitrarily and without due regard to the ability of the borrower to repay. As such, there is an obligation of the lender to

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<sup>191</sup> Cassar, G & Cavalluzzo, KS. 'Alternative information sources and information asymmetry reduction: Evidence from small business debt' 2015 *Wharton Faculty Research* Retrieved from: [https://repository.upenn.edu/cgi/viewcontent.cgi?article=1117&context=accounting\\_papers#:~:text=In%20theory%2C%20borrowers%20can%20reduce,financing%20and%20lowering%20interest%20rates.](https://repository.upenn.edu/cgi/viewcontent.cgi?article=1117&context=accounting_papers#:~:text=In%20theory%2C%20borrowers%20can%20reduce,financing%20and%20lowering%20interest%20rates.)

<sup>192</sup> Cassar, G & Cavalluzzo, KS. 'Alternative information sources and information asymmetry reduction: Evidence from small business debt' 2015, p. 34.

<sup>193</sup> Ivashina, V. 'Asymmetric information effects on loan spreads' 2009 *Journal of Financial Economics* Vol. 92(2), 301.

subjectively ascertain the risk posed by the borrower. As a result, the lender is bound to set an interest rate that is commensurate to the risk posed by the borrower. This would automatically result in financial exclusion – but of high-risk borrowers – who pose a threat to the stability of the financial system. In the previous chapters, it has been established that the Kenyan legal framework provides an obligation for banks or financial institutions to disclose all the charges and terms relating to a loan before the same is granted.<sup>194</sup> However, this does not include a higher obligation on the banks and financial institutions to not only disclose, but also justify the manner in which they have arrived at the charges imposed on the loans, which is the additional view that this argument adopts. This is also incidental to the suggestion that the law and regulations should prescribe a single formula that ought to be used by all lenders to determine their lending rates.

As such, it is possible to argue that banks and financial institutions are likely to incur more costs in conducting such assessments and reporting on the same with respect to all borrowers. However, this is where the obligations of the consumer as well as the relevant regulators come in. In order to make it possible for lenders to conduct accurate assessments, it is also important for the law and regulations to require mandatory disclosure of information from lenders that is key for the assessment of risk. On the other hand, it would also be paramount for the relevant regulators to require and maintain up to date data over information systems that can be shared with borrowers to assist with risk assessments.

For instance, it would be essential for the Medium and Small Enterprises Act to create an information system that captures critical financial information of MSMEs that are willing to offer the same as a mechanism that would benefit the latter in reducing information asymmetries when seeking credit, which also translates to lower interest rates. Hence, this represents an indirect mechanism of controlling interest rates through consumer protection by setting truth-in-lending standards.<sup>195</sup> Further, it also targets the right set of vulnerable consumers to protect and exclude those who otherwise pose risks to the financial markets and generally the financial system.

#### **4.4 Control of Interest Rates through Promotion of Competition**

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<sup>194</sup> Banking Act, Section 31A.

<sup>195</sup> Helms, B & Reille, X 'Interest rate ceilings and microfinance: The story so far' September, 2004 *CGAP Occasional Paper No.9*, p.12.

In the previous chapter, it has been established that MSMEs form a significant part of the Kenyan economy to the extent that their development is proactively promoted and protected through a dedicated statutory instrument known as the Micro and Small Enterprises Act 2012. In a bid to realize the objective of promoting the development of this sector, the government has resorted to creation of an Authority that is dedicated to regulating players in the sector and collaborating with other state agencies to promote and protect the interests of MSMEs.

Further, in the previous chapters, one of the inevitable outcomes that has been identified – that is consistent when interest rates are capped and when they are not capped – is the risk that demand for credit is shifted into the informal and unregulated lenders. These kind of lenders inherently expose the borrowers to more risks and even high debt prices with apparent unfair and illegal practices. Hence, it is apparent that there is also an unregulated and risky lending sector of the economy that continues to expose vulnerable consumers of debt such as MSMEs to more detrimental risks. However, it is also important to note that this informal sector is not competitive enough to influence the extent to which banks set interest rates and is therefore ineffective as it is.

There is a view that the absence of competition results in excess profits for banks and other regulated financial institutions.<sup>196</sup> The enjoyment of such profits confers significant market power to banks to an extent that allows them to continue to reap high profits despite setting high interest rates. Based on this premise, it is argued that it is possible to control the interest rates set by banks by increasing competition in the financial sector. It is anticipated that an increase in competition within the financial sector would force banks to survive in the financial markets based on competitive loan prices by adjusting their interest rates to competitive levels.

This is given the view that competition forces market players to improve their efficiency and reduce the costs attributable to lending.<sup>197</sup> It has also been empirically established that there is a direct causal link between strong competition and reduced interest rates in loan market products.<sup>198</sup> Even so, it is important to note that competition may take some time before it gets to the point where it can be effective in forcing efficiency and having an impact on price. Increase in

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<sup>196</sup> Ferrari, A; Masetti, O & Ren J 'Interest rate caps: The theory and the practice' 2018 *Policy Research Working Paper* No. 8398, p. 36.

<sup>197</sup> Vickers, J 'Central banks and competition authorities: institutional comparisons and new concerns' 2010 *Monetary and Economic Development (Bank for International Settlements)* No. 331.

<sup>198</sup> Leuvensteijn, M; Sorensen, CK, Bikker, JA & Rixtel, A 'Impact of bank competition on the interest rate pass-through in the Euro area' 2008 *Documentos de Trabajo* No. 0828.

competition has been reported to result in reduced interest rates in countries in different parts of the world such as Cambodia, Bosnia, Bolivia and Nicaragua.<sup>199</sup>

From this premise, it is important to note that one of the most obvious ways in increasing competition is by increasing the number of players in the financial market who provide access to credit. Another perspective when it comes to increasing competition in the financial market might also involve limiting the number of exits of players from the financial markets as this creates monopolized markets. It therefore follows that creating concentrated markets makes would force lenders to set interest rates at competitive levels that allow them to stay in the markets. A situation that might not be achieved in monopolized markets.

Therefore, when it comes to reducing market exits, it is argued that one of the roles of the law and regulation in the financial sector is the need to improve the legal framework to equip it with tools that allow for orderly resolution and exit of weak banks. In addition, the role of the law is to provide for tools that are sufficient to rescue banks that are ‘too big to fail’ (that is systemic banks) from easily exiting the financial markets.<sup>200</sup> The role of the law in this regard is important in ensuring that key players remain within the financial system to reinforce competition on the one hand. On the other hand, the objective of the law should be to make it difficult for struggling players to exit the system by rescuing banks that are struggling with liquidity through the CBK that is considered to be the lender of last resort. However, it is important to note that this intervention that involves limiting exits from the financial markets ought to be exercised with caution to ensure that it does not create a moral hazard among banks and financial institutions. Hence, the creation of regulatory mechanisms that make it easier to bail out weak banks must be implemented with various constraints that subject such banks to serious scrutiny before they are saved from untimely exits from the financial markets.

Following the effects of the 2008-09 financial crisis, the OECD encouraged the modification of competition rules and policies as a mechanism for stabilizing the financial sector.<sup>201</sup> This was premised on the understanding that competition policies and competition agencies play an

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<sup>199</sup> Ferrari, A; Masetti, O & Ren J ‘Interest rate caps: The theory and the practice’ 2018 *Policy Research Working Paper* No. 8398, p. 37.

<sup>200</sup> OECD, ‘Enhancing the role of competition in regulation of banks’ 1998 *Policy Roundtables* Retrieved from: <https://www.oecd.org/daf/competition/sectors/1920512.pdf>

<sup>201</sup> OECD ‘Competition and financial markets: Key findings’ 2009 Retrieved from: <https://www.oecd.org/daf/competition/43067294.pdf>

important role in taming anticompetitive behaviors as well as limiting anticompetitive mergers that result in unnecessary concentration of markets. It therefore called for the empowerment of competition authorities to closely monitor bank mergers through dedicated competition rules that are specific to the financial sector. This is based on the need to ensure that players in the financial markets do not reduce competition by acquiring other financial institutions in a manner that gives them more market power and control over interest rates.

Therefore, interest rate control through promotion of competition can be achieved through enactment of merger and acquisition regulations that are dedicated and specific to the banking sector. It is apparent that in Kenya, there are no competition rules that are dedicated and applicable to the financial sector. However, these would play an essential role in controlling entries and exits in the financial markets. In the prevailing framework in Kenya, it is apparent that the CBK and the Competition Authority of Kenya entered into a Memorandum of Understanding in 2014 allowing for collaboration between the two institutions with a view to improving the functioning of the financial markets in Kenya.<sup>202</sup> However, the MOU is not available for review by the public. Hence it is important to provide for this mechanism of regulatory coordination in statutory instruments that create outright roles and obligations with respect to these Authorities to collaborate in the regulation of bank mergers in the financial markets.

The dedication of competition rules and regulations to the banking sector will limit exits from the banking sector and ensure that the loan markets remain competitive. This is important for SMEs/MSMEs because low interest rates are more likely to be achieved in credit markets that are more competitive. This is considering that the regulations will reduce the number of banks that exit the sector through liquidation or by mergers and acquisitions. Further, the dedicated regulations will be implemented with rules that limit anticompetitive practices between banks and other lenders in the credit market. As a result, this would limit anti-competitive practices that otherwise result in high interest rates imposed by banks and other lenders.

Another obvious mechanism through which banks may increase competition within the financial sector is by incentivizing more players to join the lending market and subsequently increase

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<sup>202</sup> CBK, 'Signing ceremony of an MOU between Competition Authority of Kenta and Central Bank of Kenya, 2014. Retrieved from: <https://www.centralbank.go.ke/images/docs/speeches/2014/SigningCeremonyMOU-CBKandCAK.pdf>

competition. This can be achieved by broadening the scope of regulation to cover more businesses that undertake lending while granting them access to the payment systems. This can be achieved by ensuring that the law does not prevent market entry of lending businesses. The law should at the same time create a reasonable operating ground for different financial institutions to conduct business.<sup>203</sup> For instance, even though regulatory liquidity requirements were implemented through Basel III Convention to restore stability in the financial sector after the 2008-09 financial crisis, it is important to note that these requirements have forced various market players out of the market. This has been through such mergers or acquisitions that end in lenders acquiring more market power and predisposing them to setting high interest rates.

Therefore, it is important to amend the current banking rules and regulations to eliminate liquidity requirements that prevent lending businesses from being subjected to regulation by the CBK. Other interventions include granting other financial institutions such as SACCOs access to the national payment system have also been discussed in different academic works as a point at which the government may allow the emerging SACCOs to compete on a level playing field with other lenders.<sup>204</sup> This in turn is also expected to reduce competition that is posed by the informal lending sector; make the credit market more competitive which translates to competitive interests rates; which in turn makes credit more accessible to SMEs/MSMEs at affordable rates.

#### **4.5 Conclusion**

The chapter has identified three approaches towards rethinking the control of interest rates within Kenya's legal framework while taking to account the interest of MSMEs and without compromising the businesses of lenders. This is considering the problem that is associated with interest rate capping laws being counterproductive in a manner that is detrimental to both banks and consumers of credit. Based on these three approaches, this part has established that it is possible to maintain control over interest rates through various approaches towards the law. First, this part has established that it is possible to influence lending interest rates in a manner that is protective of the welfare of vulnerable borrowers through varying various tools of monetary policy

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<sup>203</sup> Helms, B & Reille, X 'Interest rate ceilings and microfinance: The story so far' September, 2004 *CGAP Occasional Paper No.9* p. 12.

<sup>204</sup> Safavian, M & Zia 'The impact of interest rate caps on the financial sector: Evidence from commercial banks in Kenya' 2018 *World Bank Group Policy Research Working Paper 8393* Retrieved from: <https://documents1.worldbank.org/curated/en/681501522684167817/pdf/WPS8393.pdf>

from time to time to influence reasonable interest rates that are during times when such borrowers are heavily affected by detrimental market forces.

Second, it has also established that it is possible to control interest rates through consumer protection. This involves the entrenching the requirements for information standards that force banks to lend based on borrowers' ability to pay. This approach creates obligations on borrowers to disclose critical financial information to allow for accurate risk assessments and required regulators to maintain information systems that ought to assist lenders in ascertaining risks. This is expected to have the effect of preventing low-risk borrowers from suffering high interest rates at the expense of high-risk borrowers.



## Chapter 5:

### Findings, Conclusion and Recommendations

#### 5.0 Introduction

This chapter entails a conclusive summary of the findings of the study. As such, it concludes the study and demonstrates whether or not the study has proved or disproved the hypothesis. It also reviews the extent to which the objectives of the research have been met and the extent to which the findings of the study have answered the research questions. The chapter therefore proceeds to summarily highlight the findings of the study in form of a summary of conclusions. It finally proceeds to suggest various legal, policy and administrative recommendations in light of the findings of the study.

#### 5.1 Findings of the Research

In the initial chapter, this study established that Kenya has been on a complete circle of capping interest rates and banning caps on interest rates. Both approaches to interest rate control have not been successful in achieving financial inclusion for SMEs/MSMEs and other low-income high-risk lenders. Hence, the need to rethink approaches towards interest control with a view to promoting access to affordable credit for this group of vulnerable consumers. In light of the research questions identified earlier in the study, this research has examined the legal implications of interest rate capping; critiqued Kenya's legal framework on interest rate control; and analyzed different approaches essential to rethinking interest rate control with the view to promoting financial inclusion of SMEs/MSMEs.

With regard to the question on the legal risks incidental to interest rate capping, this study established that interest rate capping has a negative effect on the welfare of MSMEs. That even though it is anticipated that capping would increase financial inclusion, the accrual outcomes of setting rate ceilings is the reaction by lenders of adverse selection. This implies that lenders are inclined to limit the supply of credit to high-income borrowers as they inherently pose a lower risk and due to the scale, the banks are more likely to generate more revenue by lending to them. Therefore, it establishes the premise upon which the need to rethink approaches towards interest rate thinking is founded. This is considering the outright unintended outcomes of interest rate capping that is identified in both policy and academic literature.

Regarding the question on the essential parameters within which Kenya's legal framework on capping interest rates can be improved, the study established the following. That the key parameters that affect interest rate control in Kenya revolve around regulatory coordination between various regulators such as the CBK, the Micro and Small Enterprises Authority among others as one is at the center of controlling interest rates while the other is tasked with promoting the development and protection of MSMEs in Kenya.

Regarding interest rate ceiling in the Kenyan legal framework, this study established that despite the repeal of section 33B that set an outright interest rate ceiling, the current legal regime as established under the Banking Act and the Central Bank Act anticipate that the CBK should have some level of control over interest rates. This is manifest under the provision for the *in duplum rule* with respect to non-performing loans as well as restrictions on variation of rates by banks without consent of the relevant Cabinet Secretary. However, this part establishes that the country's monetary policy plays a central role in establishing the premise and basis upon which interest rate control can be achieved with respect to protecting vulnerable market players exposed to market forces that are detrimental to them.

Further, regarding the question on whether there are alternative mechanisms towards rethinking interest rate control that reduces the cost of credit while increasing access to credit, this study established the following. That there are three approaches through which the prevailing legal framework in Kenya can approach interest rate control while avoiding the negative legal implications associated with it.

The first approach involves the use of monetary policy tools such as the CBR, CRR and REPOs coupled with the rules of supply and demand to influence liquidity of lenders and availability of funds to finance credit demand by MSMEs at the times when they are confronted by strong market forces that are detrimental to their welfare. This approach is effective considering the nature of flexibility associated with it. However, it calls for legislative intervention involving regulatory coordination between the Micro and Small Enterprises Authority as well as the CBK. Another approach identified in this regard is the use of consumer protection to control interest rates. This involves the establishment of information standards between lenders and borrowers and controlled by regulators in order to implement truth-in-lending principles that ensure that banks can efficiently assess risk and only lend depending on borrowers' ability to pay.

Finally, it also points out the approach towards interest control through stimulation of competition. In this regard, the study establishes the need for incorporation of competition rules with regard to bank mergers to limit exits that confer other lenders with more market power. This is reiterated by identifying the need to broadening the scope of regulation and accommodating more lenders into the financial markets to offer more competition and alternatives to mechanisms that already exist. This is based on the established views that such increase in competition has the inherent effect of forcing lenders to improve their efficiency and set competitive interest rates.

## **5.2 Importance of the Findings**

The findings of the study essentially show that conventional approaches to interest rate control are no longer aligned to the best interest of SMEs/MSMEs. Even so, Kenya's legal framework already lays a foundation upon which new approaches towards interest rate control can be implemented with the interests of SMEs/MSMEs in mind. The new approaches identified are also not novel as they can be implemented within various legal instruments that already exist in the prevailing legal framework. The findings of the study therefore point to the idea that rethinking interest rate control to a greater extent involves higher levels of regulatory coordination between relevant authorities such as the Competition Authority of Kenya, the Micro and Small Enterprises Authority, and the CBK among others. Therefore, financial inclusion of SMEs/MSMEs through affordable credit cannot be achieved merely through a one-stop layer of regulation and decision-making. Rather, the rethinking of the regime calls for the involvement of different layers of regulation.

## **5.3 Recommendations for Statutory Changes**

Based on the findings summarized above, the study makes the following recommendations;

1. There is a need to set interest rate ceilings through the country's statement of monetary policy as opposed to legislation which is not flexible due to constraints associated with bureaucratic legislative processes. This is important given that it ensures that rate ceilings can be varied to align with the country's economic policy depending on the needs and realities of the national economy and targeting specific sectors in the economy that require protection from harsh market forces. For instance, this could include setting rate ceilings with regard to credit advanced to SMEs.
2. There is an emerging need for regulators to enforce high information standards with respect to setting up national information systems with credit information attributable to individuals and

businesses that is accessible to lenders. This is achievable by empowering the CBK to prescribe a single formula for calculation of interest rates coupled with an obligation on lenders to not only disclose but also justify the interest rates they have set based on the formula. This is expected to reduce the information asymmetry between lenders and borrowers to an extent that would avert the risk of adverse selection.

3. The Micro and Small Enterprises Act, 2012 should be amended to include an obligation on the Micro and Small Enterprises Authority to coordinate with the CBK and advise the CBK from time to time to revise its monetary policies affecting liquidity of banks in order to influence increases in the supply of credit to MSMEs upon justification of the existence of forces in the financial markets that are detrimental to the interests of MSMEs. However, it is questionable whether this role would be effectively undertaken to promote the interests of MSMEs considering that the Authority established under the Act is linked to the government and might not therefore always act or react with promptness to meet the demands of MSMEs when they are subjected to unfavorable market forces.
4. The Banking Act should be amended to include truth-lending provisions that create a mandatory obligation on banks and financial institutions to not only disclose all charges and terms under which loans are issued but also to justify how such charges as interest rate have been arrived at based on a predetermined standard formula prescribed by the regulator. Even though there is a risk that banks would incur additional costs, this could be mitigated through creation of equal obligation on borrowers to provide standard financial information that allows for risk assessment. This implies that such consumer legal protection should only extend to borrowers who are compliant as well.

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## Appendices

### Appendix A: Plagiarism Report



#### Document Information

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Submitted by	
Submitter email	Samuel.Wamaitha@strathmore.edu
Similarity	9%
Analysis address	akitavi.strath@analysis.orkund.com

#### Sources included in the report

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## Appendix B: Ethical Clearance Confirmation



20<sup>th</sup> April 2023

Mr Wamaitha Samuel Njuguna,  
samuel.wamaitha@strathmore.edu

Dear Mr Wamaitha,

**RE: Rethinking the Law on Interest Rate Capping Vis-A-Vis Small and Medium Enterprises in Kenya**

This is to inform you that SU-ISERC has reviewed and **approved** your above **SU-masters** research proposal. Your application reference number is **SU-ISERC1704/23**. The approval period is from **20<sup>th</sup> April 2023 to 19<sup>th</sup> April 2024**.

This approval is subject to compliance with the following requirements:

- i. Only approved documents including (informed consents, study instruments, and MTA) will be used
- ii. All changes including (amendments, deviations, and violations) are submitted for review and approval by SU-ISERC.
- iii. Death and life-threatening problems and serious adverse events or unexpected adverse events whether related or unrelated to the study must be reported to SU-ISERC within 48 hours of notification
- iv. Any changes, anticipated or otherwise, that may increase the risks or affect the safety or welfare of study participants and others or affect the integrity of the research must be reported to SU-ISERC within 48 hours
- v. Clearance for the export of biological specimens must be obtained from relevant institutions.
- vi. Submission of a request for renewal of approval at least 60 days prior to the expiry of the approval period. Attach a comprehensive progress report to support the renewal.
- vii. Submission of an executive summary report within 90 days of completion of the study to SU-ISERC.

Before commencing your study, you will be expected to obtain a research license from National Commission for Science, Technology, and Innovation (NACOSTI) <https://research-portal.nacosti.go.ke/> and obtain other clearances needed.

Yours sincerely,

for: **Dr Ben Ngoye,**  
**Secretary; SU-ISERC**

**Cc: Mr Ambrose Rachier,**  
**Chairperson; SU-ISERC**

