EFFECT OF EQUITY FINANCING ON THE LENDING PROPENSITY OF MICROFINANCE BANKS IN KENYA

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EFFECT OF EQUITY FINANCING ON THE LENDING PROPENSITY OF MICROFINANCE BANKS IN KENYA

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Abstract

This study investigates the effect of equity financing on the lending propensity of Microfinance Banks (MFBs) in Kenya. Despite policy interventions, Kenya has experienced a marked decline in lending as a percentage of GDP from 35.22% in 2015 to 12.2% in 2023 posing economic risks, given the critical role of credit in driving over 75% of GDP. Existing literature has largely focused on commercial banks in developed economies, with limited evidence on how equity financing influences lending behavior in Kenyan MFBs. Anchored on the Bank Capital Channel Theory and Pecking Order Theory, the study employed a correlational research design using panel data from 10 purposively sampled MFBs over a nine-year period (2015–2023), yielding 90 observations. Secondary data were obtained from audited financial statements, and Moderated Multiple Regression (MMR) analysis was conducted after diagnostic tests confirmed compliance with classical regression assumptions. The findings reveal that equity financing has a significant negative effect on lending propensity ($\beta = -0.421$, $p = 0.0001$), indicating that MFBs with higher equity levels adopt more conservative lending strategies. The study concludes that while equity strengthens capital adequacy, excessive reliance may constrain credit access unless balanced by institutional growth. It recommends that MFBs build robust capital buffers, pursue strategic scaling through mergers or expansion and advocate for regulatory frameworks that balance capital adequacy with lending flexibility. These insights contribute to financial policy discussions and support the development of a more resilient and growth-oriented MFB sector in Kenya.

Keywords: *Equity Financing, Lending Propensity, Microfinance Banks, Kenya, Capital Adequacy, Moderated Multiple Regression, Financial Policy*

1.0 INTRODUCTION

Access to credit financing is widely acknowledged as a cornerstone of economic development, driving entrepreneurship, household investments, and infrastructural expansion. Despite numerous financial sector reforms, Kenya has experienced a sustained decline in domestic credit as a proportion of GDP—from 35.22% in 2015 to 12.2% in 2023 (World Bank, 2022). This is significantly below the global average of 133.8% and Sub-Saharan Africa's average of 45.5%, raising serious macroeconomic concerns. Kenya's key sectors such as trade, agriculture, and small and medium-sized enterprises (SMEs) are heavily reliant on credit, with over 75% of GDP being credit-dependent (Central Bank of Kenya, 2021).Policy responses, including interest rate capping (2016–2019), implementation of credit guarantee schemes, promotion of risk-based lending, and expansion of digital credit platforms, have aimed at enhancing credit access. However, lending remains constrained. Microfinance Banks (MFBs), which play a pivotal role in advancing financial inclusion, have not been spared. This trend necessitates deeper analysis into the determinants of lending behavior among MFBs. In this study, the findings present a significant negative correlation, implying that lending propensity is lowered by increased equity financing, which may be attributed to greater risk aversion by institutions funded through equity.

1.1 Statement of the Problem

The sustained downward trend has major economic implications, as over 75% of Kenya's GDP relies on credit, with key sectors like trade, agriculture, and SMEs heavily dependent on lending. Available information from the Central Bank of Kenya (CBK) indicate that various policy measures have been used to reverse reducing access to credit. Among them are the imposition of interest rate caps (2016–2019) and lifting the caps in 2019 to boost credit flow. In addition, the government has established credit guarantee schemes to fund SMEs, promoted risk-based lending frameworks to align loan pricing with the risk profiles of borrowers, and promoted the adoption of digital lending solutions to enhance financial inclusion and enhance the availability of credit. Notwithstanding these, lending is still subdued, hence the necessity to investigate the determinants of the lending behavior of financial institutions, in this instance, Microfinance Banks (MFBs), that are central to promoting financial inclusion.

1.2 Purpose and Significance of the Study

This study seeks to deepen understanding of the relationship between equity financing and lending propensity, with a specific focus on Microfinance Banks (MFBs) in Kenya. The primary objective is to assess the effect of equity financing on the lending Propensity of MFBs. Its significance is threefold:

i. **Policy and Regulation:** Findings will inform regulators and policymakers on the need to balance capital adequacy requirements with credit expansion objectives, especially in institutions serving vulnerable market segments.
ii. **Institutional Strategy:** MFBs can use the insights to design optimal capital structures and pursue scaling strategies such as mergers or capitalization that support sustainable lending.

iii. **Academic Contribution:** The study fills a critical gap in literature by simultaneously analyzing equity financing and lending behavior, thereby providing a new framework for future research in corporate finance and financial inclusion in emerging economies.

2.0 LITERATURE REVIEW

This section focuses on the study's theoretical foundations and the literature on comparative empirical research

2.1 Theoretical Review

This study is anchored in two foundational theories: the Bank Capital Channel Theory and the Pecking Order Theory.

2.1.1 Bank Capital Channel Theory

The Bank Capital Channel Theory, advanced by Bernanke et al. (1991) and refined by Kishan and Opiela (2000), postulates that the behavior of lending is influenced by external financing constraints and capital structure. Well-capitalized banks can absorb financial shocks and continue to lend, whereas undercapitalized banks may be forced to reduce the credit supply during periods of monetary contraction (Van den Heuvel, 2002).

2.1.2 Pecking Order Theory

Myers and Majluf in 1984 proposed the Pecking Order Theory according to which companies adhere to a hierarchical structure of funding, internal sources of funds which take precedence over debt or equity, e.g., retained earnings. The theory based on models suggests companies would avoid external funding unless unavoidable and would go for debt funding over equity since it is relatively cheaper. The implication of what this hypothesis has on Microfinance Banks (MFB) is that institutions that use equity funding might restrict lending operations due to its high opportunity cost, aversion from risk, and regulation.

2.2Empirical Literature Review

Based on an agency theory point of view, Kar (2012) analyzed the connection between capital and financing structure and the functioning of microfinance institutions (MFIs) using GMM and IV estimation, with panels that encompasses 782 MFIs operating in 92 countries between 2000 and 2007. The findings indicate that higher leverage enhances MFI profit-efficiency. Besides that, the study indicate that capital structure has no perceivable effect on outreach scope and has no significant relationship with women participation as borrowers.

Black et al. (2010) considered US banks' business model in mortgage finance and lending. Using a panel regression method, they found that the only "transition banks" that operate among different business models are most likely to react to monetary contraction by significantly raising their lending rate spreads. They discover proof of a bank lending route that is only used by transition bank, which strongly restrict lending for mortgages in response to monetary recession, which is consistent with their prediction.

Based on an agency theory point of view, Kar (2012) analyzed the connection between capital and financing structure and the functioning of microfinance institutions (MFIs). Through use of instruments, GMM and IV estimation has been undertaken Using a dataset with panels that

encompasses 782 MFIs operating in 92 countries between 2000 and 2007. The assertion from agency theory that higher leverage enhances MFI profit-efficiency is corroborated by the findings. Moreover, it is also discovered through the study that decreasing leverage means declining cost efficiency. Likewise, it is also arguable why leverage has an adverse and extreme effect on outreach depth. Nevertheless, based on the study, capital structure has no perceivable effect on outreach scope and has no significant relationship with women participation as borrowers.

The influence of changing banks' capital financing requirements on bank lending and capital ratios is examined by Bridges et al. (2014). It examined how banking supervisors in the UK altered bank capital funding criteria between 1990 and 2011. There are two main findings. In order to maintain consistent buffer levels above the statutory minimum, banks first gradually rebuild their buffers in response to an increase in the financing demands for equity capital. Subsequent to an increase in equity funding requirements, banks often slowed the growth of their loans for household secured loans, other corporates, and commercial real estate in the given year. Most loan growth recovers in three years or less. These findings could be useful in estimating the possible consequences of raising lending standards for equity capital financing.

Using panel-regression techniques, Berrospide and Edge (2010) investigate the loaning practices of large bank holding corporations (BHCs) and explore the loan market's marginal effects of equity capital financing, building on the findings of Hancock and Wilcox (1993, 1994) as well as Bernanke and Lown (1991). Next, they use a modified version of VAR model developed by Lown and Morgan (2006) to investigate how equity capital ratios affect lending, and they once more discover negligible effects of modifications to the bank equity capital ratios regarding loans. Estimates derived from straightforward empirical relationships between growth in leverage and total assets of commercial banks, which have recently had a significant impact on how forecasters and policymakers perceive the link between loan growth and bank equity capital financing sharply differ from these results. After that, the models are applied to comprehend recent changes in bank lending, with a focus on how TARP-related equity capital injections have influenced these transformations.

To examine the impacts of the equity capital cushions that large U.S. banks need to achieve in order to pass the quantitative part of the Federal Reserve's CCAR stress tests, Berrospide and Edge (2019) use data from regulatory filings that pairs banks and firms. The sample in this study examines volumes of Commercial and Industrial (C&I) loans by firms and banks, debt in total, investment outlays, and hiring of these buffers. They discover that bank C&I lending is considerably reduced by increased capital buffers for stress tests. Utilized growth rate of loans is 2 proportion of points lower and committed loan growth rate is 1 1⁄2 percentage points lower with a capital rise of one percentage point buffer. When looking at loans that firms get from banks that are put through stress tests, the effects on firm lending levels are more pronounced. Borrowing from banks who, on average, have a 1 percent greater stress-test capital buffer also results in a 4 percent lower growth rate for used loans and a 3 percent lower growth rate for committed credit lines for the company. But when we look at the total amount of debt that the firms have, it is discovered that stronger buffers for equity capital under stress tests have no effect. This implies that the companies might look for alternative funding to make up for drop in bank loans that are subject to stress testing.

Empirical evidence on bank lending determinants in Nigeria is provided by Oyebowale (2020). With yearly data from 1961 through 2016, using unit roots analysis for its frugal paradigm

discusses the impact of bank lending increases on increases in the loan-to-deposit ratio, inflation, aggregate money supply, and bank capital. Granger causality tests and
Autoregressive distributed lags (ARDL) bounds testing procedure are employed in this research in order to examine the relationship and direction of causality between variables. While no causal link between bank lending in Nigeria as well as other explanatory factors, the tests of Granger causality demonstrate that increase in broad money grows bank lending.

Long term viability of Kenyan deposit-taking microfinance institutions (DTMs) in relation to capital structure is analyzed by Mwongeli and Ariemba (2018). Target population for the study included Kenya's 13 registered Central Bank of Kenya DTMs. Secondary data from reports released by Central Bank of Kenya provided all of the DTM financial data. Data were analyzed using a multiple regression model. According to the analysis of the ANOVA table, factors independently impacted the dependent variable under the 5% significance level. With a five percent significance level in place, debt and retained earnings had the highest statistical significance and were ranked first and second respectively with coefficients of 1.630 and 1.265. Thus, in order for deposit taking microfinance institutions to survive long term as lenders, they need to exploit available borrowings, invest earnings within the company and have a minimal percentage of preferred share capital. Common share capital should not be employed since it has a negative impact on finances' performance and viability.

Ngumo et al. (2020) researched factors influencing Kenyan microfinance banks' performance. Over five years between 2011 and 2015, seven MFBs' secondary data were analyzed using descriptive research method. Regression analysis and correlation were employed in analyzing data collected. The findings identified a strong positive relationship between Kenyan microfinance banks' operational effectiveness, adequacy in capital, and business size and their performance. However, a small inverse relationship between credit risk, risk to liquidity, and Kenyan microfinance institutions' financial results was discovered by research.

Kiemo et al. (2022) sought to uncover the role played by equity financing in creating financial stability and minimizing credit risk. This was achieved by developing a Financial Soundness Index for measuring financial stability. Through a Panel Vector Auto Regression Model based on annual bank level data for 37 institutions from 2001-2020, bank capital's impact on credit risk and financial stability was tested. Despite the declining pattern that sets in since 2011 and the volatility margins that have prevailed since 2016, long-term trends in the financial stability index prove that banks are still robust. Also, bank capital decreases credit risk and increases financial stability, as per the study. The article finds that equity financing contributes towards ensuring financial stability by minimizing credit risks and goes on to suggest that in a bid to ensure financial stability and enhance bank lending, authorities should continually create and enforce appropriate capital rules.

Kipkoech and Muturi conducted a study in 2014 intended to establish the relationship between various variables and microfinance institutions' performance. The core indicator that was applied in measuring financial success was return on assets. Descriptive research design was employed in the research in which quantitative and qualitative aspects were included. The target for distributing questionnaires from which data was collected comprised managers and staff who were engaged in finance. A sample of 52 respondents was selected from individual microfinance institutions in Nakuru Town, Kenya. Descriptive statistics in analyzing data, dispersion and central tendency metrics, and results in tables were employed in analyzing data. The study also applied regression analysis in interpreting their correlations. Three variables were revealed through the analysis which had the greatest impacts on the performance of microfinance institutions in respect of doing well:

branch network, equity finance, and number of borrowers. 63.7% variance independent variable was explained by components based on multiple regression analysis findings that showed strong explanations of variation in dependent variable.

Likewise, a number of empirical studies (Berrospide & Edge, 2010, 2019; Black et al., 2010; Bridges et al., 2014; Gambacorta & Mistrulli, 2004; Jeremiah & Irungu, 2024; Kar, 2012; Kim & Katchova, 2020; Kipkoech & Muturi, 2014; Mwongeli & Ariemba, 2018; Ngumo et al., 2020; Oyebowale, 2020; Ricci et al., 2023) exist on the result of equity financing on performance with very few on bank lending based on dynamic panel GMM, instrumental variable technique, autoregressive distributed lag (ARDL), descriptive research design, fixed and random effect techniques, Granger causality tests, multiple regression and panel techniques. Nonetheless, the few on equity financing and lending are inconsistent on their findings. Kiemo et al. (2022), Atiti et al. (2022) established that equity financing supports monetary stability through mitigating lending risks. Yet, Berrospide and Edge (2010) discovered impact of equity financing on lending, although Gambacorta and Mistrulli (2004) suggest that equity financing plays a significant role in the spread of various lending shocks. Oyebowale (2020) found that an increase in bank capital does not inevitably result in more bank loans. In addition, Berrospide and Edge (2019) found that lending is considerably reduced when stress-tested equity capital buffers are increased.

From the forgoing empirical literature, it is evident that financing is among the major factors affecting lending. However, empirical findings are inconsistent with some reporting a positive effect while others reporting a negative effect. Additional empirical research suggests that equity financing has a role in the spread of various kinds of lending shocks. Most of these empirical studies are based on information primarily from developed countries' commercial banks. The very few on MFIs from the emerging economies including Kenya relate specifically to financial factors and financial performance. There is no documented evidence of any study done locally in Kenya relating to equity financing and microfinance banks' lending in Kenya. Thus, this study intended to close the gap by demonstrating the effect of equity financing on lending propensity of Kenya's MFBs.

2.3Conceptual Framework

This research investigates the connection between equity financing, and lending propensity in Kenyan microfinance banks (MFBs). Myers and Majluf's (1984) Pecking Order Theory (POT) contends that businesses prioritize internal funding as opposed to outside funding because of information asymmetry, which influences their risk appetite. MFBs with higher equity reliance may adopt conservative lending practices to mitigate financial risk and ownership dilution. To ensure robust analysis, the study incorporates expense ratio, regulatory capital, and risk tolerance as control variables. They stem from a comprehensive survey of empirical studies that have examined key financial determinants of lending behavior. Ricci et al. (2023) and

Kimani et al. (2021) determined that lending is greatly impacted by the expense ratio capacity through its role in cost efficiency. Complementing that are Sufian and Habibullah (2010) and Gambacorta and Mistrulli (2004) provided that capital adequacy and risk tolerance play a pivotal part in determining credit growth and regulating financial stability. Gjeçi et al. (2023) also reaffirmed that more-capitalized institutions lend more while risk-tolerant institutions watch lending volatility**.** These findings justify the use of these control variables in this study in order to provide comparability and robustness in the measurement of lending propensity among MFBs in Kenya.

a) Expense Ratio

The ratio of expense to assets gauges operating efficiency, with a higher ratio reflecting higher operating expenses as a proportion of asset size. This method allows for comparability across institutions since operating expenses naturally increase with bank size. By taking a ratio instead of using absolute figures, expense control is assessed proportionally, and a normalized gauge of cost efficiency is obtained across various microfinance banks (MFBs).

b) Regulatory Capital

The core capital-to-deposit ratio is a capital adequacy measure that reflects the ability of an MFB to absorb financial shocks and maintain its lending operations. Stating regulatory capital in terms of a ratio facilitates comparison between institutions of different deposit bases and asset structures, enabling a uniform benchmark of financial strength irrespective of MFBs size.

c) Risk Tolerance Level

The ratio of risk-weighted assets to total assets quantifies an MFB's risk appetite by reflecting its credit risk exposure. Given that institutions have different risk profiles, a ratio-based method ensures a uniform evaluation of risk exposure against total assets, enabling comparative assessments of MFBs with diverse asset portfolios

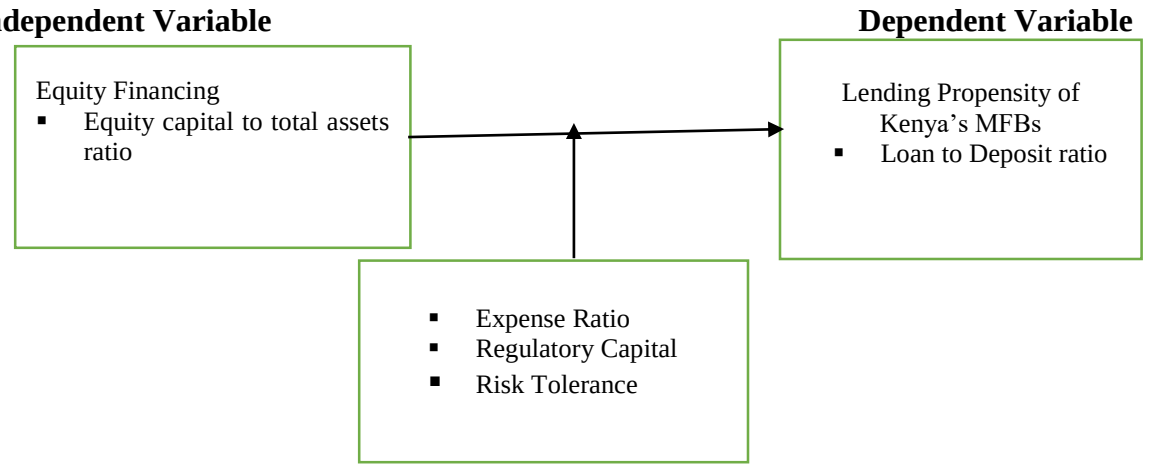

Figure 1: Equity Financing and MFIs' Lending Relationship.
Source: (Santosa, 2020)

3.0METHODOLOGY

The study adopted correlational research design utilizing, panel data regression models to examine relationships between variables over the 2015–2023 period. This approach allows for an in-depth assessment of how equity financing and institutional size influence lending propensity. This design demonstrated how one or more variables affect another or variables and makes an effort to explain the reasons behind these changes (Kerlinger & Lee, 2000).

When studying the extent to which variations in a given variable are reflected by variations in the other, researchers use the correlational study design (Creswell & Garrett, 2008). It is preferred when valuable information on the phenomenon of interest is available (Cooper & Schindler, 2003). In most cases, it uses quantitative data. Quantitative data were applied to conduct studies in this research. Molavi and Jamalzade (2015) analyzed the relationship between capital adequacy and

financial ratios all over Iran's banking network. This is why this research design is adopted because the study examines the relationship among the study variables using quantitative data.

$$LN\_DEP_{it}=\alpha+\beta_1 MEQF_{it}+\beta_2 EXPNS\_TAST_{it}+\beta_3 CCAP\_DEP_{it}+\beta_4 RWT\_TASTit+_{\varepsilon it}$$

Where;

- **LN_DEP** = Lending propensity; capturing the extent to which MFBs extend credit relative to their deposits
- **MEQF** = Equity financing; measures equity financing, reflecting the proportion of total assets financed by shareholders' equity
- **EXPNS_TAST** = Operating expenses to total assets; represents operating expenses to total assets, serving as a measure of cost efficiency in MFB operations
- **CCAP_DEP** = Core capital to total deposits; denotes core capital to total deposits, an indicator of capital adequacy and financial stability that affects an MFB's ability to sustain lending activities
- **RWT_TAST** = Risk-weighted assets to total assets; measures risk-weighted assets to total assets, assessing the level of risk exposure in an MFB's loan portfolio.
- **α** = Intercept; represents the baseline lending propensity of microfinance banks (MFBs) when all independent variables are held at zero
- **ε_{it}** = Error term; captures the unobserved factors affecting lending propensity
- $\beta_1 - \beta_4$ are the parameters for the explanatory variables; represent the estimated coefficients of the independent and control variables in the regression model.

4.0RESULTS AND DISCUSSION

4.1Equity Financing and Lending Propensity

Table 1: Findings on the relationship between equity financing and lending propensity of MFBs in Kenya

Variable	Coefficient	Standard Error	t-Statistic	p-Value
Constant (C)	0.674	0.070	9.692	0.000
MEQF	-0.421	0.100	-4.199	0.000
EXPNS_TAST	0.682	0.237	2.882	0.005
CCAP_DEP	0.493	0.068	7.253	0.000
RWT_TAST	0.102	0.059	1.729	0.088

Metric	Weighted Statistics	Unweighted Statistics
R-squared	0.816	0.793
Adjusted R-squared	0.785	—
Standard Error of Reg.	0.294	—
Root Mean Squared Error	0.270	—
Mean Dependent Variable	1.520	1.089
S.D. Dependent Variable	0.893	—
Sum of Squared Residuals	6.559	6.822
F-statistic	25.939	—
Prob(F-statistic)	0.000	—
Durbin-Watson Statistic	1.283	1.102

Note. MEQF = Equity Financing Ratio; EXPNS_TAST = Operating Expenses to Total Assets; CCAP_DEP = Core Capital to Deposits Ratio; RWT_TAST = Risk-Weighted Assets to Total Assets.

Source: Field data, (2025)

The study's objective was to examine the effect of equity financing on the lending propensity of Microfinance Banks in Kenya. The study found a significant negative relationship between equity financing and lending propensity of Microfinance Banks in Kenya. The empirical estimates provide evidence showing that Microfinance Banks with a greater proportion of equity finance reliance are likely to be engaged in risk-averse lending behavior, probably driven by higher risk aversion. As is seen from Table 1, the coefficient on equity financing (MEQF) is -0.421 with a t-value of -4.199 and a p-value of 0.0001, reflecting a statistically significant negative relationship. This signifies that a unit increase in equity financing corresponds with a drop in lending tendency by an estimated 42.12%. In addition, the intercept of the model is 0.674 with a t-value of 9.692 and also statistically significant ($p < 0.05$), reflecting the base lending propensity level when all predictors are assumed at a level of 0. These observations suggest that MFBs putting more

emphasis on equity financing are likely to avail more conservative credit expansion policies with a focus on financial stability rather than risky lending. The null hypothesis is, therefore, rejected in favor of the alternative hypothesis, hence establishing a significant and adverse relationship between equity financing and willingness to lend.

$$Y=0.674 \; -0.421\beta_1 MEQF_{it} \; + \; 0.682\beta_2 EXPNS\_TAST_{it} \; + \; 0.493\beta_3 CCAP\_DEP_{it} \; + \; 0.102\beta_4 RWT\_TAST_{it} + \varepsilon_{it}$$

The above results are consistent with the theoretical foundations of Bank Capital Channel Theory (Bernanke et al., 1991; Kishan & Opiela, 2000), which states that increased capital requirements constrain lending because financial institutions would rather hold capital buffers than expand credit issuance. For MFBs, this means that institutions with more robust equity positions can focus on preserving capital as opposed to loan expansion in order to reduce financial vulnerability. MFBs that have higher equity financing are able to pursue conservative lending policies, prioritizing financial stability over loan growth, explaining the negative correlation observed. In further affirmation of these findings, Pecking Order Theory (Myers & Majluf, 1984) contends that firms prefer internal financing, or retained earnings, to external debt and share issue. This is because there are cost considerations and dilution of control in external financing. As MFBs rely more on equity financing, they would curtail lending to avoid the cost of external finance or to maintain financial flexibility.

The findings are supported by Kim and Katchova (2020), who established that Basel III capital regulations curtailed U.S. banks' loan supplies because of high capital demands. Likewise, it is reported by Berrospide and Edge (2010) that even with the significance of equity capital for stability, it only had a narrow impact on lending, supporting the view that well-capitalized banks are likely to engage in conservative lending. These findings collectively suggest that MFBs in Kenya, as in other markets, may show caution in the utilization of equity capital for risky lending. Nonetheless, the evidence is contrary to that by Ngumo et al. (2020), which indicated a favorable relationship between equity finance and performance of Kenyan MFBs.

5.0CONCLUSION

Based on the findings of this study, there is a strong negative relationship between equity financing and MFB lending Propensity. This would mean that MFBs, which are more dependent on equity financing, become risk-averse, and restrict their lending behavior

6.0RECOMMENDATIONS

This research recommends that Microfinance Banks (MFBs) diversify their financing sources by combining equity with deposit funding and other external capital to moderate excess dependence on equity capital, which can restrict lending capacity. Additionally, Policy interventions in MFBs should promote investment in debt recovery and loan tracking systems to improve repayment rates and strengthen their lending potential. Regulators are encouraged to enforce minimum capital requirements to ensure MFBs remain well-capitalized and resilient to financial shocks, enabling them to sustain credit supply even during economic downturns. Finally, adopting robust risk management frameworks that balance risk tolerance with sustainable credit growth will help MFBs optimize lending while managing risks effectively.

Conflict of Interest Statement
The authors hereby affirm that there are no conflicts of interest associated with the publication of this article.

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