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FINTECH STARTUPS: CAN THE FINTECH BOOM ADDRESS THE MSMES FINANCE GAP IN KENYA

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ABSTRACT

MSMEs are considered the backbone of the Kenyan economy. However, they are considered too risk by financial institutions. With the emergence and growth of Fintech in the country Fintech is becoming more attractive to MSMEs as a source of credit, this is causing panic among the financial institutions. The purpose of this study was to analyze the effect of Fintech boom on mitigating of the Financial Gap among MSMEs in Kenya. The study was anchored on Constraint-Induced Financial Innovation Theory, Diffusion of Innovations Theory, and Traditional Theory of Financial Innovation. A desktop analysis of existing literature on Fintech studies was used and from the analysis it was established that existing financial institutions deny MSMEs financial support as they are considered too risky. However, with the Fintech boom in Kenya the landscape is changing hence significantly narrowing the financial gap for MSMEs. Moreover, the findings indicates that the percentage of underserved MSMEs has reduced as many continued to expand their operation using funding from Fintech. It's also observed that the rise of Fintech start-ups has helped reduce the cost of credit in the local market.

Keywords: Business Incubators, Cost of Credit, Diffusion theory, Financial Inclusion, Fintech startups, MSMEs.

1. Introduction

According to Gatheca (2013), startups are different from large businesses, especially in terms of their size. They are more innovative and flexible which can be described as a result of their flat organizational structure and their small founding teams. Chirchietti (2017) defined a startup as a company that is in the early stage of operation. The Kenyan context of a start-up is an

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innovative business which can grow and can survive for up to 3- 5 years (Karitu, Wangondu & Muathe, 2022, Muathe *et al.*,2022). The term "fintech" was coined by Citigroup during a project in the 1990s aimed at improving collaboration among financial service providers. The popularity of the term increased in 2014 with the rise of technologies enabling easy access to financial services. Fintech refers to financial services enabled by innovative technology and business models related to these services. Fintech startups offer financial services using technology such as data analytics, mobile computing, and the internet. There are five main categories of fintech services: financing, payment, settlement and clearing, investment management, insurance and risk management, and regulatory technology. The growth of fintech startups is aided by economic and technical factors, as well as non-functional aspects of consumer-facing service offerings.

FinTech companies have very popular startups (Harris, 2021). According to Crunchbase (2020), the number of fintech companies increased by 17% in 2020. The term Fintech was first Bettinger (1972) was the first person to define the term fintech as a combination of the banking experience and information technology. Presently, the term fintech has many descriptions, including concatenation of the terms "financial" and "technology" (Hill, 2018). Matveevskii et al. (2019) defined Fintechas a combination of tools and technologies related to computing that readily offer financial services without interruption. Also, FinTech can be defined as the process where technologies such as data analytics, mobile computation, andthe Internet enable, improve, or disrupt financial services. The evolution of fintech has led to its classification into five main services based on financial institution functions: financing, payment and settlement, investment management, insurance and risk management, and regulatory expertise (Haddad & Hornuf, 2019; Lee & Shin, 2018; Thakor, 2020). Fintech startups are new companies that offer financial services using innovative technology, and research has been conducted on the non-functional aspects of their consumer-facing service offerings, as well as the economic and technical factors that have contributed to their growth (Gimpel *et al.*, 2018).

Fintech are transforming at every stage of the financial services value chain, mainly through new value propositions, such as better ways of improving customer satisfaction, especially for low-income earners, and offering flexible services (Gimpel *et al.*, 2018).The benefits include making financial services accessible and affordable, improving financial services customer experience, and building a framework for easier verifying identities digitally, improving customer collaboration through data sharing and due diligence and payment schemes for catalyzing financial services.

Fintech has kept its pledge to increase financial services access by offering financially underserved and unserved financial customers. But more and more, the faster/cheaper/better service models offered by fintech startups are affecting the current banking system. Fintech firms

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are now offering financial products that were the conventionally exclusive domain of traditionally licensed credit institutions' payment services and loans, among others (European Banking Authority, 2017). These smaller, more agile companies support a greater variety of providers and products; they promise better transferability of digitized financial products, built on hybrid and cross-industry business models allowing them to reach a wider market compared to traditional financial service providers. Additionally, fintech companies offer more transparency and improved risk management, at least partly enabled by their ability to get instant customer feedback and use it to power real-time adjustments in the services they offer. However, while fintech has a very broad and massive technical and managerial impact, it does not mean that incumbent banks and traditional financial services cannot compete (Mention, 2019).

According to Zarrouk, Ghak and Bakhouch (2021), the success and survival of fintech companies depend on resources, particularly venture capital, but financial barriers, regulations, and legal issues hinder their innovation and growth. The success of fintech companies is also affected by their product/service offering and value proposition. Fintech startups in France are clustered geographically, and larger clusters and the presence of incubators attract newer fintech startups. Fintech startups located in larger clusters have a lower risk of failure but a higher chance of being acquired, while increased competition within a particular fintech segment leads to a higher failure rate. Fintech startups developed in an incubator have significantly lower failure risks.

1.2 Statement of the problem

The financial sector in Kenya is severely skewed against MSMEs (Finance Business – Supply Bank Financing of SMES in Kenya 2015). Many financial institutions consider these enterprises as risky and rarely fund their projects. The Kenyan market has a huge supply of mighty financial institutions, including the government, which constantly needs financial assistance. Consequently, banks deny smaller financial organizations funding, especially due to their risk factor. Whenever financial institutions consider an application for funding, they place their profitability against prevailing conditions (Yao, Haris, & Tariq, 2018). If a borrower cannot match up to these expectations, they are usually left out without funding, a situation many MSMEs know all too well.

The risk factor is also a major concern for MSMEs. Credit risk is based on the borrower's statistical capability to repay a loan in a certain period (Spuchľáková, Valašková and Adamko). Many MSMESs lack the proper financial strength to claim such capability unquestionably (Lakuma, Marty & Muhumuza, 2019). Most of these companies are cash-strapped and have not made significant advancements in their market segment. These circumstances contribute to their advanced risk making them inappropriate for investment. Even though these companies would eventually work or close down, they take too long to break even. If conventional financial institutions cannot fund MSMEs, there is one less fund source to facilitate their projects and production processes. In cases where funding is available, there are punitive and sometimes exploitative terms that negatively affect MSMEs. The most common forms of collateral accepted by most financial institutions are the Title deed and logbook.

Most MSMEs are founded by jobless youths trying to make ends meet. This demographic does not have enough wealth to use as collateral. Most of these companies would borrow to remain in production amid harsh economic times. Collateral conditions, therefore, prevent more MSMEs from being fundedby mainstream financial institutions. These businesses are left to shylocks and other exploitative elements in the financial sector. The rise of more Fintech organizations will go a long way in bridging the finance gap witnessed by most MSMEs.

1.3. Objective of the Study

i. To analyze the effect of FinTech growth on mitigatingthe Financial Gap among MSMEs in Kenya

2.1. Theoretical Framework

2.1.1. Constraint-Induced Financial Innovation Theory

Silber (1977) developed the constrained-induced financial innovation theory which suggested that the key reason for financial services innovation is to improve the profitability and growth of financial institutions. Silber (1977) noted that the management of the organization in question could either improve or hinder growth based on internal and external environments. Later, Silber revised this theory by stating that the main motive for accepting financial innovation in a firm is to enhance its financial position.

Maina and Ndwiga (2018) suggest that firms face external and internal constraints in improving financial performance, which can limit their competence and stability. To overcome these constraints, financial institutions pursue financial innovation. Johnson and Kwak (2012) argue that MSMEs that fail to embrace financial innovation is likely to fail. The Fintech Boom is seen as a solution to address the finance gap for MSMEs by providing innovative financial solutions to overcome these constraints.

2.1.2. Diffusion of Innovations Theory

The diffusion of innovations theory helps in understanding the effects of the tipping point when trends spread exponentially in a society (Rogers, 1995, Muathe, 2010, Muathe & Muraguri-Makau, 2020). The process of diffusion is created when communication mechanisms used for

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innovation are shared through different members and channels in society. Generally, the process has several stages including following the S curve which has several innovators and adopters. Later, the innovation is adopted by the earliest majority and later all adopt it.

Fintech follows a similar pattern as outlined by Rogers (1995) for the adoption of new technology by consumers. Consumers first seek information and are influenced by their environment before deciding to use fintech products. They confirm their decision through interactions with their surroundings. The structure of fintech is shaped by communication and significance, as well as sanctions and legitimacy. These structures are relevant not only for the relationships between fintech providers and consumers but also between government regulators, venture capital investors, and industry associations (Iman, 2019).

2.1.3. Traditional Theory of Financial Innovation

The study is anchored on the traditional theory of financial innovation propounded by Drucker in 1947. The theory posits that financial innovation help reduces agent costs facilitate risk sharing, complete the market, and ultimately improve allocative efficiency and economic growth. The theory has three main assumptions about MSMEs' growth. Firstly, MSMEs that spend and devote resources to financial innovation would be able to translate growth opportunities into Gross Domestic Product (GDP) per capita growth. Secondly, MSMEs that rely more on external finance experience more volatile growth, and thirdly, Research and Development (R&D) are critical to the continuous growth of enterprises. For research, innovation, development, and growth, entrepreneurs according to the theory must undertake three useful tasks namely: Limitation of useful changes in business architecture, adapt to changes brought about by the new business structure, and assume responsibility for consequences of uncertainty related to the new structure. The relevance of the theory to the study stems from its emphasis on the importance of financial innovation as a factor that triggers the MSME's financial gap.

2.2. Empirical Review

Access to funds from mainstream institutions is skewed against MSMEs and other small enterprises. The evaluation will analyze how the fintech boom has helped bridge the inequality in access to finance. Evaluating the IMF report on financial inclusivity provides various indices to use when analyzing whether the fintech boom has helped bridge the access gap or not (Tok & Heng, 2022). The IMF report alone will help give the study insights into what to look for and where and how best to interpret the findings to achieve desired results. This review analyzes the different aspects of the fintech boom and how it contributes to the growth and expansion of small businesses

2.2.1. Fintech Boom in Kenya

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Kenya is currently experiencing a major fintech boom. Kenya is slowly curving its place as a global hub for fintech innovations (Chitavi, 2021). Compared to neighbouring countries, Kenya has invested heavily in laying down the internet infrastructure that has allowed the boom. As more people have access to the internet, they are taking up the numerous financial products being offered by Fintech in the country. Before the internet boom, Kenya had few fintech companies. As the access to the internet continued to expand, more people were able to take up fintech products which included loans to fund business projects. The digital environment has continued to improve and fintech companies have developed mobile applications to increase access to products. The environment has also continued to evolve to cater to the evolving cyber security risks that threaten the sector. Kenya has witnessed greater acceptability and adoption of fintech products to finance small and medium businesses.

2.2.2. Financial Inclusion

The growth of fintech companies has helped build greater financial inclusion in the country. The challenge of financial inclusivity is a broad problem which takes numerous shapes and forms (Aicha, 2023). Fintech companies have helped provide affordable sources of credit which have helped Micro, Small and Medium Enterprises (MSMEs) in the country. Fintech companies came in handy to bridge the funding gap that affected the MSME sector. Despite the challenges that emerge from having many fintech companies offering credit, the boom has helped reach a marginalized sector. Many MSMEs are discouraged from seeking funding from mainstream facilities such as banks because they are expensive and often rigid. The rise of Fintech institutions came in handy to support this marginalized group hence promoting greater financial inclusion. Greater financial inclusion has been a major boost for the sector since it has allowed small, financially unstable businesses to gain access to affordable funding. Fintech products are often flexible and tailored to cater to the different needs of small businesses.

This paper also seeks to evaluate the impact of increased access to funding on the growth and expansion of the MSME sector. In a review done by Mayabi (2013), a sample of small businesses within the Nairobi CBD was studied to evaluate the impact of access to credit. The study showed that a majority of the businesses in the sample reported tremendous growth because of their uptake of the targeted study fintech products. The businesses that took credit products from the fintech companies reported better success. The credit was beneficial in promoting production and sustaining the business through its operations. If this credit was unavailable, a sizable number of the businesses would have collapsed or experienced stunted growth which is typical of most Kenyan MSMEs. Many of the businesses in the sample grew and expanded their scale of operation because of the strategic accessibility of credit from selected fintech companies.

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2.2.3. Policy Reforms

Going into the future, Kenya is ripe for a variety of policy reforms that would help increase access to credit for MSMEs. Bridging the funding gap is among the most important interventions to promote the growth of the MSME sector (Clarke et al., 2018). The country should explore ways of boosting access to credit to ensure sustainable economic growth which is characterized by the growth and expansion of its enterprises. Private finance is one of the policies issues the government should consider to boost competition in the funding sector for the benefit of small-scale traders. The policy reforms should also look into ways of creating an enabling environment for startups by relaxing establishment regulations and fees. As a result, more Kenyans will invest and the challenge of unemployment might become a thing of the past.

2.2.1. Growth and Expansion

The study will also adopt an extensive literature review methodology to analyze the impact of the fintech boom on the growth and expansion of the MSME sector. Dai (2020) is an example of a peer-reviewed report that will demonstrate the extent to which the fintech boom has catalyzed the growth and expansion of this sector. The report analyzes records before the boom which showed that most startups struggled to stay afloat because of a lack of funds. Mainstream financial institutions saw MSMEs as risky and hence avoided funding them at the expense of financially mighty borrowers. This article will demonstrate how this tide turned in favour of MSMEs.

The study will focus on identifying how the catalyst conditions that led to the collective growth of the MSME sector applied to individual firms. The collective growth was realized through individual growth and expansion. The literature review will demonstrate that the fintech boom availed many startups and small businesses with capital to grow and expand. This capital was not present before since the cost of credit from mainstream institutions was high, beyond the reach of the smaller MSMEs. The study will be focused on identifying a direct link between the increasing number of startups growing and breaking even and the fintech boom(Dai, 2020).

2.2.2. Impact on Cost of Credit

The evaluation will also seek to analyze the impact of the fintech boom on the cost of credit. When more fintech companies emerged, the competition for credit products intensified resulting in an average reduction in the cost of credit (Cornelli et al., 2021). This reduction in the cost of credit came in the form of more competitive interest rates and reduced value of collateral needed. This study will analyze how this reduction helped spur the growth and expansion of MSMEs. It will investigate to establish how the reducing cost of credit led to the growth of individual businesses in the sector.

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The evaluation will also analyze the ripple effect of cost competition on the performance of mainstream banks and other financial institutions. The cost competition has had a tremendous impact on the stability and profitability of banks and other lenders (Safiulla & Paramati, 2022). As the new tariffs introduced by the fintech boom dominate the market, banks are forced to review their terms to compromise in exchange for a share of the boom. In the process, banks lowered their prices to remain competitive and profitable. This study will evaluate if these variations affected the banking sector and if indeed it gates the emerging fintech and edge over their more established competitors.

3. Research Methodology

This study adopted a desktop review methodology. The study involved evaluating peer-reviewed articles and financial reports that would help confirm the hypothesis (Mugenda & Mugenda, 2003). The literature review focused on current literature, no more than 5 years old relating to the rise of fintech startups in the country. The focus was targeted at demonstrating the impact they had on the greater financial services sector in the country. The selected literature expressly demonstrated how they contributed to closing the funding gap for MSMEs. Without a literature review, the research process would have been clueless with a large volume of case studies to observe or experiments to run.

As noted by Mugenda and Mugenda (2003) one of the most observable advantages of using a literature review methodology is that one benefits from greater familiarity with the topic. A literature review is based on benefiting from the experiments and observations others made before. Their insights trying to solve a past problem can be borrowed to make inferences on modern problems. For instance, many journal articles on this topic touched on broader areas of concern such as the financial aspects of the changes effected by the rise of fintech. A literature review saves on research costs since experiments and observations necessary to understand the research problem have been summarized by others who had done them earlier. Peer-reviewed articles are also credible sources of information in scientific research. Despite these benefits, literature reviews have their fair share of drawbacks. For instance, literature review as a methodology for research is time-consuming. Having to read through volumes of research reports takes time and the review might not be relevant to the research problem at hand(Mugenda & Mugenda, 2003).

Being time-consuming may translate into increased costs which may affect the study budget. The methodology is also prone to bias since the selection of study to incorporate is solely at the researcher and discretion. As a result, the findings may not be independent and verifiable at all times. It is important to incorporate an additional methodology to establish a control line for comparison.

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4. Findings and Discussion

One of the most striking discoveries from the literature review is that the finance difference has significantly decreased since the introduction of Fintech companies in the country. The analysis has demonstrated that these firms are serving a recently underserved portion of the market with the required financial services necessary for growth and expansion. Many MSMEs have secured financial support from Fintech corporations reducing the overreliance on mainstream financial institutions such as banks and cooperative societies (Dai, 2020). The study has confirmed that the proportion of underserved MSMEs has decreased as many continued to grow their operation using funding from newer, less established companies. The statistical inference from this observation is that the funding gap has been reduced and that more borrowers have access to funding now than before the startups emerged.

The assessment has also shown that the growth of fintech start-ups has aided in regulating credit costs in the country. When they had not made considerable headway into the sector, major financial institutions had high-interest rates coupled with punitive credit terms that were unfavourable for MSMEs (Cornelli et al., 2021). When the startups began to overshadow the lower-level borrower segment, they triggered a market change. Many conventional organizations are revising their rates downwards to fight off the competition fintech companies are introducing (Safiulla & Paramati, 2022). The costs of credit have gradually reduced by a considerable margin as demonstrated in the literature review. These dynamics have encouraged greater growth and expansion of MSMEs since credit is relatively more affordable.

The evaluation has also shown that the percentage growth of the MSME segment has gradually risen over the examination period. Though reviewed articles were drawn from research conducted in the last five years, they have shown a progressively rising curve. Many MSMEs are growing and expanding compared to those that were closing down due to harsh economic times.

5. Conclusion

This study has established that the Fintech boom has contributed to the growth and expansion of MSMEs. It is noted from the extensive literature review that the rise in fintech companies has helped boost access to credit for many MSMEs in the country. The boom has helped create access to credit that is also affordable for the MSMEs. In addition, the Fintech boom has helped reduce the cost of credit to the advantage of MSMEs. The increase in the number of credit providers has also helped reduce interest rates and make credit more affordable. This discussion has also shown that the FinTech boom is helping to grow and expand the MSME sector. The increased access to credit is helping many MSMEs grow and switch from accessing credit from traditional financial institutions, hence narrowing the financial gap in Kenya.

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5.1 Policy Implication

The FinTech boom triggered major policy implications. For instance, reduced overreliance on mainstream financial institutions is affecting the revenue base as customers switch to more innovative and efficient FinTech. The FinTech boom is triggering a major policy change around lending and borrowing. The general policy by financial institutions on collateral and loan securities should be revised to accommodate the new realities on the growth of the FinTech. FinTech does not require collateral other than original documentation, this innovation has helped open up the credit market space and thus bridging the gap in access to financial services by MSMEs in the country. The innovation on credit provision is helped MSMEs grow and expand and their enterprise. The collateral policy for mainstream lenders should also be changed into a more relaxed and innovative version to attract more MSMEs access credit.

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