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MODERATING EFFECT OF INSTITUTIONAL SIZE ON THE RELATIONSHIP BETWEEN EQUITY FINANCING AND LENDING PROPENSITY OF MICROFINANCE BANKS IN KENYA

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Abstract:
Globally, bank lending remains a critical issue, sparking continuous debate in both policy and academic circles. The lending propensity of financial institutions, including microfinance institutions (MFIs), averages 133.8% of GDP globally, while Sub-Saharan Africa lags at 45.5%. In Kenya, lending as a percentage of GDP has declined from 35.22% in 2015 to 12.2% in 2023, despite policy interventions such as interest rate caps. Given that over 75% of GDP is driven by credit availability, this trend presents a significant economic concern. Existing studies have explored factors influencing lending, with mixed findings regarding equity financing and institutional size. However, most research is based on data from developed economies, while studies in emerging markets, including Kenya, focus primarily on commercial banks rather than microfinance banks (MFBs). Moreover, limited research on Kenyan MFBs examines lending propensity. Consequently, a knowledge gap exists on whether equity financing and institutional size affect the lending behavior of MFBs in Kenya. The primary objective of this study was to examine the influence of institutional size on the lending propensity of MFBs in Kenya. Specific objectives include assessing the impact of equity financing and institutional size on lending propensity, and evaluating whether institutional size moderates the relationship between equity financing and lending propensity. The study is grounded on the Bank Capital Channel Theory and Pecking Order Theory. A correlational research design was employed, using secondary data from 10 purposively sampled MFBs between 2015–2023, yielding 90 observations. Moderated Multiple Regression was used for

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analysis. Findings show equity financing negatively affects lending propensity (β = -0.421), institutional size positively influences it (β = 0.251), and size significantly moderates the relationship (β = 0.108). The study recommends strengthening capital buffers, pursuing mergers, and advocating regulatory reforms.

JEL: G21, G32, L25, O16

Keywords: equity financing, lending propensity, institutional size, microfinance banks, Kenya

1. Introduction

Credit financing is a key driver of economic growth, supporting business expansion, household investment, and infrastructure development. Despite numerous financial sector reforms, Kenya's lending-to-GDP ratio has steadily declined—from 35.22% in 2015 to 12.2% in 2023—far below the global average of 133.8% and Sub-Saharan Africa's 45.5% (World Bank, 2022). This downward trend poses significant concerns, particularly as over 75% of Kenya's GDP relies on access to credit, with vital sectors such as trade, agriculture, and SMEs heavily dependent on lending. To address declining credit access, the government and Central Bank of Kenya have implemented several interventions, including interest rate caps, credit guarantee schemes, risk-based lending, and digital credit platforms. However, lending activity remains weak, suggesting deeper institutional factors may be at play. While previous studies have explored lending determinants, most focus on commercial banks, with limited attention to microfinance banks (MFBs), which play a crucial role in financial inclusion. The impact of equity financing on lending propensity remains unclear, and little is known about how institutional size influences this relationship within MFBs. This study addresses this gap by examining whether institutional size moderates the relationship between equity financing and lending propensity in Kenyan MFBs. Understanding this interaction is critical for designing policies and institutional strategies that enhance credit access and promote sustainable lending in Kenya's microfinance sector. The significance of this study lies in its contribution to closing a critical knowledge gap in the literature concerning the lending behavior of Microfinance Banks (MFBs) in Kenya. Existing research has typically examined the influence of equity financing, institutional size, and lending propensity in isolation or in limited combinations. However, there is a noticeable lack of documented studies that analyze the three variables concurrently particularly within the context of developing economies like Kenya. By investigating the moderating effect of institutional size on the relationship between equity financing and lending propensity, this study offers a novel and integrated perspective that is largely absent in current scholarship. The findings are expected to provide a foundational framework for future academic inquiries on similar themes, both in Kenya and in comparable emerging market settings. In addition, the study provides practical insights for policymakers,

regulators, and financial institutions seeking to improve credit access and resilience in the microfinance sector. By highlighting how institutional size influences lending behavior, the results can inform targeted strategies that align capital structure decisions with credit expansion goals, ultimately supporting Kenya's broader agenda of financial inclusion and economic development.

2. Literature Review

This study integrates the Bank Capital Channel Theory and Pecking Order Theory to analyze how equity financing, institutional size, and lending propensity interact in Kenyan microfinance banks (MFBs).

"Bank Capital Channel Theory" argues that size and capitalization are robust determinants that play an essential role in shaping lending behavior in response to a change in monetary policy (Kishan & Opiela, 2000). The theory mentioned argues that monetary policy affects the cost of funds for financial institutions, thus having an impact on their lending behavior (Van den Heuvel, 2002). Banks that are under-capitalized respond more slowly and more emphatically than those that are highly capitalized in response to interest rate shocks. Besides that, bank size creates a difference in the credit channel, and those having both the smallest size and lowest capitalization have the quickest response relative to monetary policy changes. The relationship between those variables of interest would thus be understood through the theory. Therefore, and as per theory, it is hypothesized in the study that both equity capital and the size of the institution play an integral part in lending in MFBs, expense ratio and risk tolerance level being constant. The size of the institution is hypothesized to also have an empowering moderating effect since under a flexible monetary regime, widespread bank lending increasingly subjects economic turning points to increased vulnerability in that relationship is reversed.

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 this hypothesis for Microfinance Banks (MFB) is that institutions that use equity funding might restrict lending operations due to their high opportunity cost, aversion to risk, and regulation. Larger institutions, however, may have access to more diversified funding sources, potentially offsetting these constraints.

Through integrating the two theories, the study tried to have a comprehensive framework describing the effect of institution size on the relationship between lending willingness and equity finance in Kenyan MFBs.

The effect of the global financial crisis (GFC; 2007–10) on FTSE350 UK companies' financial and non-financial performance was examined by Ahmad *et al.* (2023). The moderating effects of company size, non-financial performance of environmental, social,

and governance (ESG), and corporate governance (CG) are estimated in this research, and GFC's relationship with firm financial performance and these factors is analyzed. Data from 2002 to 2018 is employed based on a sample of 351 UK companies. The best approach for estimating the relationship between firm performance and the financial crisis has been shown through demonstration, in which the random effect model is proved to best estimate these relationships. The results show that during the financial crisis, company performance both financially and environmentally was lowered. The relationship between firm's ESG performance and financial crisis is being moderated by firm size. The influence of bank size as a moderating variable on fintech and its impact on the financial performance of registered Financial Services Authority-conforming traditional Indonesian banks was investigated by Hermuningsih *et al.* in 2023. Traditional commercial banks utilizing fintech from 2012 to 2021 make up the research sample. The method employed was purposeful sampling. 200 financial statement data sets from 20 banks were gathered. The results demonstrate that fintech improves financial performance, bank size influences how fintech affects financial performance differently than bank size does, and bank size influences how liquidity affects financial performance differently from both sources. Santosa (2020) examined the influence of firm size on Islamic firm value and financial features. Next, examine the impact of business size moderating the link between financial features as well as corporate governance and firm value. Over a six-year period, secondary data from financial statements were assessed using a panel data technique. Samples for the study included all 331 businesses listed on the Indonesian Stock Market between 2013 and 2018. Using the Islamic index component population, the purposive sampling approach is used to arrange the sample selection. In conclusion, the value of Islamic firms is significantly positively impacted by leverage, profitability, and efficiency, but not by liquidity or the audit committee. Committees for audits and liquidity have favourable impact on the company's worth since moderators of firm scale reinforce all other independent factors. Kirimi *et al.* (2022) examined how Kenyan commercial banks' financial performance and soundness are correlated, and the moderating impact of bank size. Data from 39 commercial banks were gathered from a ten-year span from 2009 through 2018. The data analysis approach that was applied is a panel data regression model. Findings proved that the relationship between the commercial banks' financial solidity and its net interest margin (NIM) and return on assets (ROA) were negatively impacted by bank size through its values of correlation being -0.1699 and -0.218, respectively.

Alternatively, by using return on equity (ROE) as a measure of financial performance, no moderating effect occurred. Thus, it recommends that for purposes of ensuring the optimum level of financial soundness for improving banks' performance, policy makers and bank managers must consider bank size in creating financial soundness regulations. Wayongah and Mule (2019) in a study used panel data methods in conjunction with both accounting-based (Return on Equity) and market-based (Tobin's Q) performance indicators in an effort to examine the moderating effect of firm size in figuring out what relationship exists between financial leverage and performance of non-

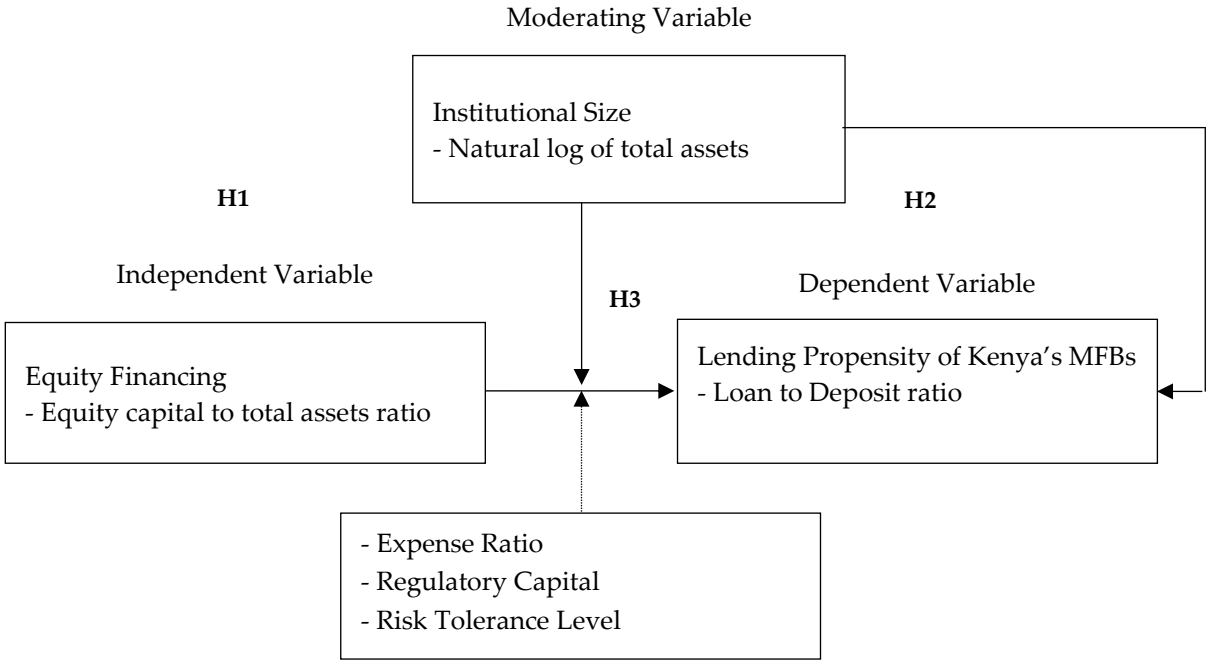
financial companies listed on Nairobi Securities Exchange (NSE). Through a correlational research approach and using 47 non-financial companies listed on NSE during 2012-2018 as a sample population, 28 companies were identified through a purposive selection process and therefore gave 196 firm-years for analysis during the seven years. The study provided findings of firm size being a highly significant and positive indicator of performance by using ROE. The study also revealed that firm size was a negative moderator of financial leverage and firm performance. Therefore, based on these findings, it was concluded that firm size has a significant effect on the interaction between financial leverage and performance. Ishmail *et al.* (2023) examined how company size and credit risk impacted Kenyan microfinance banks' financial performance. The population under investigation was Central Bank of Kenya (CBK) regulated MFBs. Census methodology was employed in conducting research from 2011- 2019 annual reports; thirteen (13) MFBs' secondary data were collected. The research design applied was explanatory. The modelling applied was uneven panel Regression modelling with an F.E. The dependent variable, financial performance, was measured using equity return (ROE). The moderating variable, firm size, was indicated by the total assets of MFBs, while the ratio of loan loss provision over total loan amount, asset quality ratio, net non-performing loan ratio, and loan loss provision over total equity were measured as the ratios of the independent variable credit risk. Findings revealed that risk to credit is a significant and negatively impacting factor on financial performance. The findings also revealed that the relationship between financial success and credit risk was being positively and significantly moderated by business size, confirming larger MFBs' suitability for credit risk.

Locally, Wayongah and Mule (2019) established that firm size moderates the association with regard to the relationship between leverage and NSE-listed non-financial companies' performance. Gjeçi *et al.* (2023) illustrate that, for big, well-funded banks, there is a stronger association between non-performing loans and loan expansion. Kirimi *et al.* (2022) established that the relationship between commercial banks' soundness and ROA and NIM was negatively moderated by bank size. Kiai (2021) had a moderating effect on whether Kenyan licensed MFIs' performance and their characteristics are related. Ishmail *et al.* (2023) showed that size significantly moderated positively the relationship between credit risk and MFB performance. Kivaya *et al.* (2020) also proved that size moderates the relationship between Kenyan microfinance institutions' success and corporate governance.

In view of the above, it is evident that much research has examined the moderating role of institutional scale; some have established a connection between leverage and listed non-financial enterprises' performance that is moderated by firm size. Some researchers discovered that when start-up microenterprise finance interacts with MFI size, the favorable effect it has on MFI performance declines. However, some claim that only large banks have a good correlation between bank liquidity as well as impact of bank capital on lending growth. Other have linked non-performing loans and loan growth to large and well capitalizes banks. Others have found that size moderates the relationship

between Kenya's regulated MFIs' financial performance and their institutional features. However, these studies are flawed with a number of statistical and methodical challenges, including the use of simple interaction terms, in analyzing the moderation effect of leading to false conclusions. Moreover, most of these studies relate to commercial banking institutions as well as listed non-financial entities. The very few studies regarding MFIs relate to institutional size and performance. There is no documented evidence of any study relating to the role of institutional size on equity financing and lending, focusing on MFBs in Kenya. Thus, this research study intends to bridge the literature gap by looking at how institutional size influences the link between equity and lending propensity of Kenya's MFBs. This study investigated the connection between equity financing, institutional size, and lending propensity in Kenyan microfinance banks (MFBs), with institutional size acting as a moderating variable. 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. Institutional size is expected to moderate this relationship, as larger MFBs have better risk absorption capacity, diversified funding sources, and higher operational resilience, enabling them to sustain lending even under capital constraints. The Bank Capital Channel Theory (Bernanke *et al.*, 1991; Kishan & Opiela, 2000) supports this perspective, arguing that well-capitalized banks withstand financial shocks better, while undercapitalized ones restrict lending under monetary tightening (Van den Heuvel, 2002). To ensure robust analysis, the study incorporates expense ratio, regulatory capital, and risk tolerance as control variables, aligning with previous empirical studies.

Figure 1: Equity Financing, Institutional Size and MFIs' Lending Propensity Relationship



Source: Santosa, 2020.

3. Methodology

The study adopted a 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.

$$LN\_DEP_{it} = \alpha + \beta_1 MEQF_{it} + \beta_2 MSZ_{it} + \beta_3 (MEQF_{it} \times MSZ_{it}) + \beta_4 EXPNS\_TAST_{it} + \beta_5 CCAP\_DEP_{it} + \beta_6 RWT\_TAST_{it} + \varepsilon_{it}$$

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 extent to which total assets are funded through equity contributions
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
MSZ = Institutional size; included as the natural logarithm of total assets, ensuring comparability across MFBs
MEQF × MSZ = Interaction term (effect of institutional size on the equity financing and lending propensity relationship).
$\beta_1 - \beta_6$ are the parameters for the explanatory variables; they represent the estimated coefficients of the independent and control variables in the regression model.

4. Results and Discussion

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

Variable	Coefficient	Standard Error	t-Statistic	p-Value
Constant (C)	0.632	0.071	8.875	0.0000
MEQF	-0.322	0.085	-3.794	0.0003
MSZ	0.279	0.041	6.724	0.0000
MSZ*MEQF	0.108	0.038	2.869	0.0054
EXPNS_TAST	0.605	0.247	2.451	0.0166
CCAP_DEP	0.472	0.068	6.907	0.0000
RWT_TAST	0.200	0.061	3.290	0.0015

Model Summary

Metric	Weighted Statistics	Unweighted Statistics
R-squared	0.857	0.831
Adjusted R-squared	0.828	—
Standard Error of Reg.	0.269	—
Root Mean Squared Error	0.244	—
Mean Dependent Variable	1.740	1.089
S.D. Dependent Variable	1.311	—
Sum of Squared Residuals	5.355	5.570
F-statistic	29.590	—
Prob(F-statistic)	0.000	—
Durbin-Watson Statistic	1.508	1.272

Note: MEQF = Equity Financing Ratio; MSZ = Institutional Size; MSZ*MEQF = Interaction between Institutional Size and Equity Financing; EXPNS_TAST = Operating Expenses to Total Assets; CCAP_DEP = Core Capital to Deposits Ratio; RWT_TAST = Risk-Weighted Assets to Total Assets
Source: Compiled from field data, 2025.

The study's objective was to examine the moderating effect of institutional size on equity financing and lending propensity among Microfinance Banks (MFBs) in Kenya. Findings present strong indications of a robust relationship showing that larger MFBs are suited to counteract the constraining influence of equity financing on lending activities. Table 1 shows that the interaction term of institutional size and equity financing (MSZ*MEQF) is 0.108, with a p-value of 0.0054. This suggests that a unit increase in the logarithm of the size of an institution and a unit increase in equity financing raise lending tendency by 10.8%, which is indicative that large institutions counterbalance the risk-avoiding lending tendency that is normally triggered by equity financing. Moreover, adding an interaction term into the Moderated Multiple Regression (MMR) model increased R^2 from 0.78 to 0.82, an improvement by 4-percentage points in explanatory capability.

This improvement underscores the significant role played by institutional size in tempering the equity financing–lending propensity relation, in line with the argument that larger MFBs have the ability to cushion financial shocks and optimize their lending potential. The statistical significance of the interaction term ($p < 0.05$) also reaffirms that institutional size exerts a large and positive moderating effect on this relation.

$$Y = 0.632 - 0.322\beta_1 MEQF_{it} + 0.279\beta_2 MSZ_{it} + 0.108\beta_3 (MEQF_{it} \times MSZ_{it}) + 0.605\beta_4 EXPNS\_TAST_{it} + 0.472\beta_5 CCAP\_DEP_{it} + 0.200\beta_6 RWT\_TAST_{it} + \varepsilon_{it}$$

The findings obtained align closely with the Bank Capital Channel Theory (Bernanke *et al.*, 1991; Kishan & Opiela, 2000), which asserts that banks with high levels of capital are more resilient to financial constraints and more capable of sustaining credit supply amidst economic fluctuations. The larger microfinance banks, being in a position to manage regulatory capital requirements more easily, experience a smaller negative impact of equity finance on lending activities.

In addition, Pecking Order Theory (Myers & Majluf, 1984) provides an explanation for why smaller MFBs cannot overcome the financing constraints of equity. According to theory, companies prefer internal to external financing because of information asymmetry and flotation costs of raising new equity. However, the bigger institutions are endowed with greater market credibility, better structure of finances, and multiple capital sources with which to address such issues with ease and adopt a more aggressive lending strategy. This confirms the study's finding that institution size acts as a shield against the constraint of equity financing on their lending propensity.

The evidence in this research is consistent with Gjeçi *et al.* (2023), whose study revealed that well-capitalized banks experienced stronger loan growth due to their ability to utilize equity capital more effectively. Similarly, Kimani *et al.* (2021) demonstrated that institutional size enhances credit growth in Kenyan financial institutions, which further strengthens the argument that larger firms possess financial flexibility that enables them to cope better with funding constraints.

5. Conclusion

Based on the findings of this study, the institution size is a moderator between equity financing and lending propensity, whereby larger MFBs are able to offset the constraints of equity financing and maintain a healthy lending capacity.

6. Recommendations

The research recommends scaling institutional size, and as such, policy interventions need to focus on steps that foster institutional growth, such as mergers, acquisitions, and strategic partnerships, to enhance MFBs' financial sustainability and lending capacity.

Conflict of Interest Statement

The authors declare that they have no conflicts of interest.

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