

Influence of Collateral Requirements on Performance of Micro and Small Enterprises Business in Isiolo North Sub-County

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How to cite this article: Mwenda, B., & Kambura, S. (2021). Influence of collateral requirements on performance of micro and small enterprises business in Isiolo North Sub-County. Journal of Finance and Accounting, 1(1), 9-17.

Abstract

Entrepreneurs have established restricted access to informal and formal credit as a major constraint to the growth of MSEs in Isiolo County. The County is also characterized by high level of unemployment, particularly among the youths, nomadic life and low educational levels and all these can be attributed to limited access to credit. The high poverty level is indication that the MSE businesses in this County are not doing well. The objective of the study was to determine the influence of collateral requirements on performance of MSE's business in Isilo North Sub-County. The study adopted a descriptive survey research design. The unit of analysis was 120 micro and small enterprises within Isiolo town. The study found that collateral requirements have a statistically significant and negative relationship with performance of MSE's business in Isiolo North Sub-County. The study concluded that collateral demanded by the financial institutions was not affordable, that the lending institutions did not allow non-tangible collateral and that, based on the amount of the collateral offered, the financial institutions gave credit. The study recommends the need for financial institutions to review aspects related to collateral requirements. They should particularly make collateral affordable to clients and also introduce a variety of collaterals that MSE owners can manage. For instance, given that most people in Isiolo keep livestock, financial institutions should consider livestock as one of the collateral to secure loan.

Keywords: *Collateral Requirements, Performance, Micro and Small Enterprises*

1.0 Introduction

Collateral requirements it applies to the conditions of the borrower's financial institutions/lenders for qualifying/being given credit and may include collateral itself, collateral title, willingness to pay, credit worthiness. This might affect whether the owners of the MSE can access credit and enhance their efficiency (Mole & Namusonge, 2016). On the other hand, Micro and Small Enterprises is a firm, trade, service, industry or a business activity whose annual turnover ranges between five hundred and five million shillings and employ 1 to 49 people (Mugo, 2016).

Small enterprises account for nearly 99.3 percent of private sector companies by January 2015, with 99.9 percent of these companies being MSEs, according to the United Kingdom

Department of Innovation and Skills (2015). Moreover, 15.6 million workers are hired by micro and small-sized businesses, about 60 percent of the total private sector work force in Britain. 95 per cent of businesses are MSEs in Azerbaijan, Moldova, Armenia, Georgia, Ukraine and Belarus (EBRD, 2016). The Edinburg Group (2013) reported that 95% of businesses are MSEs in OECD countries and contribute about 55% to national GDPs.

The MSE in Kenya are characterized as businesses in the formal and informal sectors, categorized into agricultural and non-farm categories, employing 1-49 employees. MSEs are expected to contribute approximately 45% of Kenya's GDP and constitute 90% of all enterprises. In addition, these corporations are critical to the achievement of the targets of Vision 2030 (Muriithi, 2017). Syekei and Opijah (2015) argue that Kenya's government recognizes the value of this sector by enacting many MSE support laws, including the 2011 MMSE Act. It is in this context that MSE need coordinated public and private stakeholder attention. In order to create reliable, pragmatic and remedial strategies for greater viability and sustainability of MSEs, such a vital factor in economic growth requires in-depth empirical studies to draw up acceptable constraints. Given their unambiguous and vital contribution to national and global economic growth, micro and small-sized enterprises are constrained by multiple challenges, the primary one being the lack of or insufficient support. Financing is perceived to be a big impediment to MSE success in Europe by the European Commission (2016). CNBC Africa (2014) believes that for South Africa's MSE development, access to credit is crucial.

Isiolo County is emerging as a hub for entrepreneurial opportunities following the county's growth in the recent years. Some of the notable development include Isiolo International airport. The town is also described as the gateway to the Northern Frontier, and with the construction of the Isiolo-Moyale road, the vision 2030 resort city plan, the LAPSETT corridor among others (Mwenda, 2018). If hurdles to funding were eased in Isiolo County, a thriving MSE sector could contribute more to national economic growth (Gichuki, Njeru & Tirimba, 2014).

1.1 Problem Statement

Globally, MSE business is regarded as a critical economic development pillar. In Kenya, it is estimated that over 80% of employment opportunities are provided by the MSE sector (KNBS, 2019). According to sessional paper no. 10 of 2012, Isiolo County has been identified as a gateway for development of Northern parts of Kenya. Consequently, the county is emerging as a hub for entrepreneurial opportunities and has attracted businesses of all kinds (Muriithi, 2017). Nonetheless, businesses in Isiolo County still face serious challenges that impede their performance.

Entrepreneurs have established restricted access to informal and formal credit as a major constraint to the growth of MSEs in Isiolo County (Karanja, Mwangi & Nyakarimi, 2016). The County is also characterized by high level of unemployment, particularly among the youths, nomadic life and low educational levels (Were, 2017), and all these can be attributed to limited access to credit. A report by USAID (2018) revealed that the poverty rate in Isiolo County was 72.6%. The high poverty level is indication that the MSE businesses in this County are not doing well. If they were performing well, then the poverty rate and unemployment levels ought to be declining. The decline in credit accessibility among businesses has been linked to several factors such as lack of collateral (Kangala, 2016). The

goal of this analysis was to evaluate the impact of collateral requirements on MSE business success in Isiolo North Sub County.

1.2 Objective of the Study

The objective of the study was to determine the influence of collateral requirements on performance of MSE's business in Isilo North Sub-County.

2.0 Literature Review

2.1 Theoretical Framework

The study was supported by the Loanable Funds Theory introduced by Robertson (1940) and assumes that the availability of loanable funds and the demand for credit dictate interest rates. An effort to expand the classical theory of interest is the loanable funds theory. It accepts that resources in the saving and spending periods will play a troubling role and thus cause disparities in the amount of revenue. Thus, as distinct from that of classical economics, it is a monetary approach to the theory of interest. In reality, both the monetary and non-monetary aspects of the problem are synthesized by the loanable funds theory (Wensheng, Wung & Shu, 2002).

The interest rate is the price that is equal to the demand for and supply of loanable funds, according to the loanable funds theorem. At the degree of balance, where demand meets the supply of creditworthy fund savers and where customers are as satisfied as possible. Interest rate fluctuations result from changes to either the market for the credit or the availability of loans or liquidity funds available for lending. Ngugi (2001) argued that the price which equates the demand for loanable funds with the supply of loanable funds is interest.

In any point in the money market, the sums of money given and demanded are loanable assets. At that time, people's savings to the money supply (usually by the development of banks' loans) will affect the supply of cash or funds available for lending. In the other hand, investment demand plus the capital hoarding criteria will determine the demand side of the loanable assets (Turnovsky, 1985). According to this principle, the principle of loanable funds means that bank savers and creditors should be well paid at equilibrium.

The theory is relevant to the current study since it explains the role of interest rates in evaluating credit supply and demand. The theoretic argument emphasizes the importance of interest rate in influencing credit accessibility to individuals and businesses. One of the main concepts in this study is credit accessibility by MSE. The theory therefore makes a prediction that interest rate influences access to credit by MSEs, which is then expected to enhance their performance. The study findings confirm the loanable funds theory prediction that interest rate influences access to credit by MSEs, which is then expected to enhance their performance.

2.2 Empirical Review

Collateral requirements are defined as the necessity for the borrower to apply / be given credit by the financial institution lenders which may include, collateral itself, collateral identity, willingness to pay, credit worthiness. This might impact whether the owners of the MSE can access credit and increase their efficiency (Mole & Namusonge, 2016). Ondabu (2019) suggested that a low risk of default is seen for secured loans, resulting in lower interest being paid. Many micro and small-sized businesses do not have productive assets that they can use to finance their loans, so their financing is limited.

Rahman, Belas, Kliestik, and Tyll (2017) investigated the determinants of collateral for micro and small enterprises in the Visegrad countries: the Czech Republic, Slovakia, Hungary, and Poland. A binary logistic regression model with different criteria was used to investigate the impact of independent variables on the frequency of collateral. The findings indicate that vulnerable investors need to guarantee collateral and that minimizing asymmetric details will minimize the risk of collateral for micro and small-sized businesses. However, their study focused on MSEs in other countries and not Kenya.

Virglerova, Dobesh, Kramolish, and Kotaskova (2017) investigated how MSE owners in the Czech Republic view the position of the state, and whether these views vary depending on educational attainment. Managers and owners of micro and small-sized companies are asked to address questions about the business climate as part of this initiative. Initial market conditions, government financial support for the business, and change in long-term business conditions were chosen as the three variables that would affect the business climate. It was discovered that the lower a businessperson's education, the more satisfied they were with the position of the state in the Czech Republic's business climate. More trained businesspeople are more aware of the administrative hurdles that must be overcome when starting a company. The majority of MSEs are dissatisfied with the government's financial assistance.

A study conducted by Karanja, Wachira and Lyria (2015) on the effect of security conditions on SACCO's credit accessibility in Meru County showed that to protect the loans being procured, all formal banks need collateral from borrowers. Most of the collateral required by lending institutions is in the form of immovable assets such as houses or title deeds for land. Given that majority of MSE lack immovable assets; they are unable to access credit from lending institutions such as banks. This is even worse for women owners of MSEs who have limited ownership of properties due to stereotyping in the society. Thus, majority of entrepreneurs cannot access credit due to lack of collaterals. The site reported that 92% of MSEs in their survey were denied credit due to lack of collaterals. This is notwithstanding the fact that majority of the entrepreneurs in the study acknowledged the importance of external funding such as use of credit in growth of business. The survey respondents suggested that most of them began their companies with their own savings or through the financing of relatives who did not need protection in most cases.

Nikaido (2015) conducted a study on what hinders and enhances access to formal credit for small businesses in India. The study used a descriptive survey and the findings revealed that access to structured credit is favorably correlated with company size, owners' education level, being listed under an organization and being engaged in diversified activities. The possession of property that can be used as collateral, though, is adversely correlated with the possibility of formal credit being earned. This may be because of an outdated method of land administration that results in high land acquisition costs as collateral.

In their report on the review of variables affecting women entrepreneurs' access to financial facilities in Kenya, Karanja et al. (2016) showed that lending procedures were showed to be restrictive and do not address the needs of woman entrepreneurs. The equity criteria introduced by the FIs do not attract female entrepreneurial creditors to obtain credit services. The impact of inflexibility on the lending amount of FIs affects women borrowers' demand for credit services, and it was also observed that several respondents (above 50 percent) accepted that different aspects of the intent of the loan were not attractive and did not attract woman entrepreneurs.

Rithaa, Munene and Kariuki (2019) explored the impact of banks' accessibility to credit on the growth of micro and small-sized businesses in Meru County. Loan collateral criteria and efficiency of MSEs was the basic subject of the analysis. Stratified and basic methods of random sampling have been implemented. The findings found that collateral requirements had an inverse impact on the output of MSE. The study nonetheless did not focus on MSEs in Isiolo County.

An investigation on the effect of collateral protection on the output of MSEs in Turbo Sub County, Kenya was conducted by Sakwa, Rambo and Osogo (2019). Descriptive and correlational designs of analysis were also included. The study concluded from the regression findings that collateral coverage had a favorable and substantial effect on access to credit and thus on the output of MSE. Companies with credit protection have convenient access to loans similar to those with zero. However, the analysis did not concentrate on MSE results in Isiolo County.

Gichuki, Njeru and Tiramba (2017) researched problems facing MSE businesses in Kenya. In choosing 241 MSEs out of a population of 656 MSEs residing on the market, a stratified sampling technique was used. Using descriptive figures, information gathered was analyzed. The study identified several primary barriers that prohibit MSEs from obtaining credit facilities, including high repayment rates, stringent collateral standards and individuals' inability. The study however failed to focus on performance of MSEs in Isiolo County.

In Nyeri Tengah District, Kiai, Kiragu, and Githinji (2019) investigated the effect of the need for collateral on the financial output of small and micro agribusinesses. The theory of financial intermediation is the basis of this research. The study's target group consisted of 950 agricultural MSEs that had been accepted. Inferential statistics were gathered to determine the relationship between the need for collateral and the financial performance of MSEs in the agribusiness sector in Nyeri's central district. Independence, linearity, and normality were all assumed in the regression. The findings were viewed at a 5% level of significance. The results of the regression analysis with two variants indicate that the need for collateral has a negative and statistically insignificant effect on the financial results of MMSEs in the agricultural sector. The study's findings show that MSE's financial output is influenced by their need for collateral from commercial banks. The study however was carried out in Nyeri, whereas the current study was conducted in Kenya.

3.0 Research Methodology

The study adopted a descriptive survey research design. The unit of analysis was 120 micro and small enterprises within Isiolo town. The unit of observation was owners or managers of the businesses. Because of the small size of target population, the study did not conduct sampling but adopted a census sample design. Data was collected through structured questionnaires. Data was analyzed using descriptive statistics in order to ascertain the extent of practice of the variables. Pearson's correlation and regression analyses were used to establish whether there exists any relationship between collateral requirements and performance of MSE enterprise businesses.

4.0 Results and Discussion

4.1 Descriptive Statistics

The study's goal was to determine the influence of collateral requirements on the performance of MSEs in Isiolo North Sub-County. The participants were asked to state whether they agree or disagree with assertions on collateral requirements.

Table 1: Descriptive Statistics on Collateral Requirements

Statements	1	2	3	4	5	M
The collateral required by the financial institutions is affordable hence it's easy to acquire credit	31(32%)	33(34%)	1(1%)	20(20.6%)	12(12.4%)	2.5
The financial institutions accepts non tangible collaterals like recommendation from other business men, pastors and chiefs	29(29.9%)	32(33%)	1(1%)	23(23.7%)	12(12.4%)	2.6
There are various types of collaterals accepted hence it's easy to access credit	3(3.1%)	6(6.2%)	2(2.1%)	42(43.3%)	44(45.4%)	4.2
There is requirement of a guarantor as collateral and this makes it difficult to access credit	1(1%)	6(6.2%)	1(1%)	38(39.2%)	51(52.6%)	4.4
The financial institutions offer credit depending on the value of the collateral offered.	3(3.1%)	10(10.3%)	0(0%)	42(43.3%)	42(43.3%)	4.1

The outcomes in Table 1 revealed that most of the participants disagreed with the following claims on collateral requirements: the collateral required by the financial institutions is affordable hence it's easy to acquire credit (66%, m=2.5), and the financial institutions accept non tangible collaterals like recommendation from other business men, pastors and chiefs (62.9%, m=2.6). Further, the respondents agreed with the statements that there are various types of collaterals accepted hence it's easy to access credit (88.7%, m=4.2), there is requirement of a guarantor as collateral and this makes it difficult to access credit (91.8%, m=4.4), and based on the value of the assets given, financial institutions grant credit (86.6%, m=4.1).

This implies that collateral requirements are essential in determining credit accessibility in the MSE sector. The findings support Gichuki et al. (2017) assertions some key challenges hinder small businesses from accessing credit facilities including strict collateral requirements and unwillingness of people to act as guarantors. The findings also mirror those of Karanja, Wachira and Lyria (2015) that majority of entrepreneurs cannot access credit due to lack of collaterals. Karanja et al. (2016) have observed that the financial institutions'

collateral conditions did not encourage women entrepreneurial borrowers to pursue credit services.

The participants were requested to rate their satisfaction with collateral requirements and the performance of their business. The findings are shown in Figure 1.

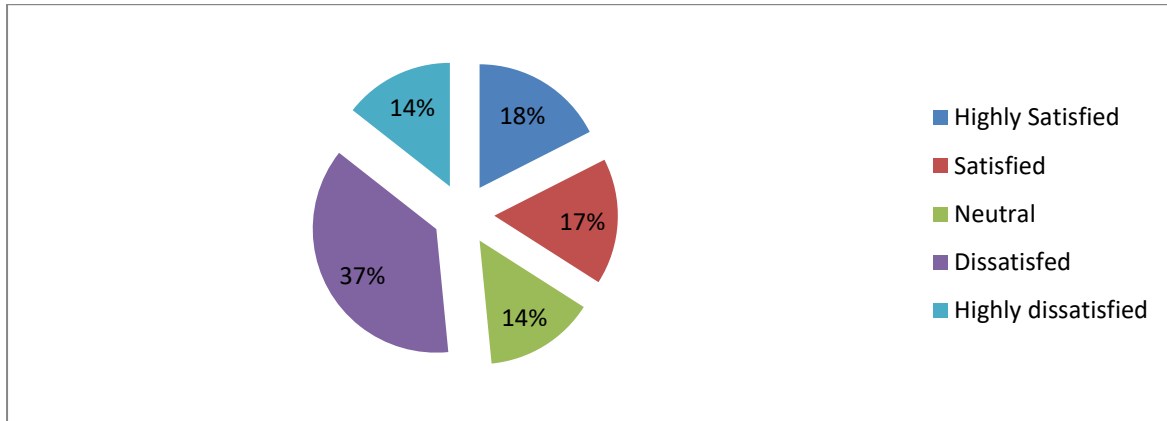


Figure 1: Satisfaction with Collateral Requirements

The outcome in Figure 1 reveals that 37% of the participants were dissatisfied with the collateral requirements, 18% were highly satisfied and 17% were satisfied. The findings confirm that most MSE owners may not afford the collateral required by the financial institutions in order to access credit.

4.2 Hypothesis Testing using Correlation Analysis Results

This section provides findings on the correlation between the independent variables (collateral requirements and dependent variable (performance of MSEs)).

Table 1: Correlation Matrix; Collateral Requirement and MSE Performance

		Performance of police officers
Performance of MSE	Pearson Correlation	1
	Sig. (2-tailed)	.000
Collateral requirements	Pearson Correlation	-.776**
	Sig. (2-tailed)	.000

The findings further reveal that collateral requirements, ($r = -.766^{**}$, $p=.000$), had a strong negative and noteworthy association with the performance of MSEs (Y). The third null hypothesis (H_{01}) predicted that there was no noteworthy connection between collateral requirements and performance of MSE. The computed P -value was 0.000 at 95% confidence level implying that collateral requirements had an indirect and noteworthy connection ($r = -.766$) with performance of MSE. The null hypothesis was therefore rejected and settled that there was a noteworthy connection between collateral requirements and performance of MSE. This means that a decline in the efficiency of MSEs is correlated with an improvement in collateral requirements. The results agreed with those of Rithaa, Munene and Kariuki (2019) that the efficiency of MSEs was adversely affected by collateral requirements.

5.0 Conclusion

The study concluded that collateral requirements have a statistically significant and negative relationship with performance of MSE's business in Isiolo North Sub-County. Moreover, when combined with other variables, collateral requirements had a significant predictive ability to influence performance of MSE's business. In particular, the analysis showed that the collateral demanded by the financial institutions was not affordable, that the lending institutions did not allow non-tangible collateral and that, based on the amount of the collateral offered, the financial institutions gave credit. These aspects hinder MSEs owners from accessing credit and therefore are not able to boost their business performance.

6.0 Recommendations

From the findings, collateral requirements had a statistically significant and negative relationship with output of MSE's business in Isiolo North Sub-County. The study recommends the need for financial institutions to review aspects related to collateral requirements. They should particularly make collateral affordable to clients and also introduce a variety of collaterals that MSE owners can manage. For instance, given that most people in Isiolo keep livestock, financial institutions should consider livestock as one of the collateral to secure loan.

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