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Research Article

Influence of Collateral Requirements on Performance of SMEs Business in Meru County, Kenya

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Abstract

The purpose of this study is to examine the influence of collateral requirements on the performance of small and medium-sized businesses (SMEs) in Meru County, Kenya. A proportional random stratified design was used to select the 234 SMEs that make up the study's sample. Data was gathered from registered business owners and/or employees using questionnaires. Descriptive statistics, frequency tables, and chi-square tests were used to examine the data. The study established that demand of collateral affected performance of SMEs negatively by a proportion of 74%. Additionally, there was a significant relationship between collateral requirements and the performance of SMEs in Meru County. It is proposed in this study that financial institutions should consider accepting non-tangible collateral. However, this should take place after thorough customers' background checks have been done. The findings are significant for addressing credit and financial concerns, which are critical to the growth and long-term sustainability of the SME sector.

Keywords

Collateral Requirements, Performance of SMEs, Credit Accessibility

1. Introduction

1.1. Background to the Study

In varied degrees, small and medium-sized businesses (SMEs) are credited for transforming the economies of numerous countries worldwide [1]. SMEs make up 95% of all businesses, making them a prominent presence on the global business scene [2]. Furthermore, around 60% of job openings in the private sector are the result of these entrepreneurial endeavors.

Governments, development institutions, and central banks have made significant investments in this sector after realizing the transformative potential of SMEs [1]. SMEs make up 99 percent of all business transactions in Europe, making them the foundation of the continent's economy [3]. Approximately 85% of all new jobs since 2011 have been produced by SMEs. The establishment and success of the Small and Medium Entrepreneurs of Europe (SME Europe), an organization dedicated to influencing EU policy in a way that benefits SMEs, is indicative of the focus on SMEs as engines of the European economy [4].

Small businesses had made up 99.3% of private sector enterprises by January 2015, with 99.9% of them being SMEs [45]. Furthermore, 15.6 million people, or 60% of all private sector workers in Britain, were employed by SMEs. SMEs make up 95% of enterprises in Azerbaijan, Moldova, Armenia, Georgia, Ukraine, and Belarus [5]. In OECD nations, SMEs

make up 95% of businesses and account for approximately 55% of national GDPs [2].

SMEs also contribute significantly to Africa's economic growth. SMEs make over 90% of all enterprises in Sub-Saharan Africa [6]. For instance, in Ghana and South Africa, SMEs account for more than half of national GDPs and make up 91% and 92% of all businesses, respectively. 93% of all industrial businesses in Morocco are of this sort [2]. SMEs are essential to the economic development of African nations [46]. According to a Nigerian study, the lending processes were unfriendly to small and medium-sized enterprises (SMEs) and the credit system was inadequate in identifying creditworthy borrowers, which prevented prospective borrowers from obtaining credit [7].

Since a sizable section of the population in Kenya depends on the SME sector for employment and income, it is seen as a vital contributor to the country's economy. In a number of policy publications, the government has acknowledged the SME sector's ability to reduce poverty and create jobs. Employment in the SME sector grew from 4.2 million in 2000 to 5.5 million in 2003, making up 75.3% of all active workers in that year. Eighty five percent of Kenya's labor force was employed in this sector, which also provided 45% of the nation's GDP [8]. Therefore, the SME sector should be viewed not just as a supplier of goods and services but also as a catalyst for innovation and competition as well as for strengthening the enterprise culture, all of which are essential for the growth and industrialization of the private sector [9].

1.1.1. Performance of SMEs

The Kenyan government has passed a number of legislations to assist SMEs, such as the MSME Act of 2011, since it acknowledges the significance of this industry [10]. SMEs are thought to account for 90% of all enterprises and generate roughly 45% of Kenya's GDP, according to [11]. Furthermore, these companies are essential to achieving the objectives of Vision 2030. Despite this, according to [9], finance issues are one of the reasons why roughly three out of eight enterprises fail to make it through the first few months of operation. This is why public and commercial stakeholders need to pay close attention to SMEs. To design appropriate, proactive, and corrective methods towards increased profitability and sustainability of SMEs, such a critical component of economic growth necessitates extensive empirical study to elicit pertinent restrictions. This study investigates how the performance of SMEs in Meru County is impacted by credit accessibility.

1.1.2. Collateral Requirements

Lending organizations require collateral before granting business owners loans. Title deeds, automobile logbooks, homes equipment, and other valuable items owned by the borrower or their guarantor may be examples of this. Most business owners are unable to obtain loans since they are unable to raise the required collateral. In a study on the factors influencing the success of SMEs in the Jua Kali sector, [12] found that one of the factors was the strict collateral requirements set by lenders in Nakuru Town, Kenya. The same conclusion was reached by [13] in a related study conducted in Iraq.

1.1.3. Statement of the Problem

Globally, the SME sector is recognized as a crucial pillar of economic expansion. Small and Medium-sized Enterprises are the foundation of the European economy because they account for more than 85% of all jobs created by the private sector [3]. The importance of this industry in developing countries such as Sub-Saharan Africa cannot be overstated, especially given its capacity to alleviate the unemployment crisis, boost national GDPs, and reduce poverty [14]. The goal of Kenya's 1965 plan, "African Socialism and its Application to Planning in Kenya," was to boost private sector investment and expansion, among other things [15]. Unfortunately, despite the fact that many laws have been passed to encourage the expansion of SMEs, these business endeavors continue to function far below their potential, primarily due to difficulties in obtaining financing and funding. Three out of eight SMEs fail within the first few months of existence, according to [9]. This sector won't meet the expectations of entrepreneurs, society, and governments unless different stakeholders comprehend the problems relating to the relationship between credit accessibility and SMEs' performance and implement corrective and mitigation actions. There have been several related investigations conducted elsewhere. The majority of them focus on the barriers that SMEs face while trying to obtain loans. These include [16-18], and [19]. A study on the variables affecting credit accessibility in the Imenti Central Sub-County was conducted by [20]. However, [12] investigated the elements that affected the performance of Jua Kali SMEs, whereas [21] examined the impact of lending rates on SMEs' performance. The study was distinctive since it looked into the performance and accessibility of financing for SMEs in Meru County. No research had been conducted on this subject, and none had been conducted in Meru County.

1.2. Objective of the Study

To determine collateral requirements' influence on performance of SMEs business in Meru County.

1.3. Hypothesis of the Study

Ho: There is no significant relationship between collateral requirements and performance of SME business in Meru County.

H_1: There is significant relationship between collateral requirements and performance of SME business in Meru County.

2. Literature Review

2.1. Theoretical Review

2.1.1. Demand Theory

The demand theory essentially examines the connection between pertinent prices and the cost of goods and services [22]. This theory examines how customers make purchasing decisions and how price influences the quantity of a product they wish to purchase. This theory was developed by the French economist Leon Walras, who lived from 1834 to 1910. Economists developed the law of demand based on this theory. According to this law, a product's demand falls as its price rises and vice versa, provided that all other factors remain the same [23]. In the context of credit availability, demand is determined by price, or the cost of acquiring and using the funds. When borrowers request loans from lenders, they are subject to conditions including the need for collateral and variable interest rates over the loan repayment period. Therefore, when the terms of the loan are favorable to the borrower, a larger portion of the credit capacity will be demanded.

2.1.2. Credit Rationing Theory

The founders of the credit rationing hypothesis, Stiglitz and Weiss, hold that lending institutions' interest rates have two functions [24]. These are influencing borrowers' behavior, which calls for incentives, and choosing them, which is usually disastrous. To understand the function of credit demand in the context of SMEs, one needs to understand the borrower's choice of participation, whether or not to borrow, and where to borrow from. Numerous factors influence this decision, chief among them being the borrower's financial stability and prospects. Accordingly, credit rationing is thought to take place inside the constraints of the credit demand schedule [25]. In regions where financing is scarce, there appears to be a similar level of suggested demand. Furthermore, when the credit market fails, the cost of acquiring credit increases relative to its inherent value. Because of this, entrepreneurs are forced to fund working capital in a number of ways. Official credit institutions are forced to compete with non-traditional credit sources as a result.

2.1.3. Asymmetry Theory

When a borrower is adequately informed about the risks and benefits of investing in the business for which they are taking out a loan, information asymmetry takes place in the credit market [26]. However, the lender does not know enough about the borrower [27]. This information asymmetry causes the lender to face problems with adverse selection and moral hazard. This makes clear the predicament MFIs are in, where they have to expend extra efforts to assess and monitor borrowers who are only qualified for little amounts. Borrowing decisions are influenced by the lack of easily available

data that MFIs need to monitor and assess applicants and borrowers, respectively [28]. Lenders must screen applicants using credit evaluation [47]. This eliminates any biases and subjective judgments and lowers the cost of processing the papers [29]. It may be possible to enhance the rating systems by ensuring that they assess the level of risk related to loan advances.

2.2. Empirical Literature Review

Banks have throughout history demanded collateral before funding borrowers. Towards SMEs, banks are averse to risk, instead of capitalizing on the potential of small businesses to generate profits. It is for this reason that banks are cautious when lending to SMEs. Moreover, the fact that small businesses lack asset registers and conventional collateral disadvantages them when it comes to credit access [30]. Collateral is a key hindrance to SMEs when accessing loans. This site conducted a survey in which 92% of firms that had attempted to get loans had their applications rejected. Others did not even apply, believing that they did not meet the collateral demands of lenders. Borrowers in this study were aware of the importance and need for credit for their businesses, but they identified collateral as a key obstacle to credit accessibility and the thriving of their businesses. The respondents in the survey had set up their enterprises using personal savings or money borrowed from relatives, as the latter did not ask for collateral before loaning to SMEs [31]. Granting of credit remains a problem as many SMEs are not able to fulfil lending conditions [32], based on a study in Maputo, Mozambique, further asserts that most SMEs are denied funding by the lenders due to high risk and lack of collateral. SMEs faced difficulties in accessing credit because of the difficulty of most of them to meet the requirements for loan granting. Lenient lending conditions can largely induce increased uptake of credit. [14] further established that requirement of specific types of collateral, such as guarantors, logbooks, title deeds, and existing bank accounts, greatly limited credit accessibility.

In a study carried out in Nakuru Town, Kenya, to investigate the factors that influenced the performance of SMEs in the Jua Kali sector, [12] found that these businesses were hampered by stringent collateral demands of lending institutions. This study further established that most SMEs did not have sufficient assets vis-à-vis the amounts they wanted to borrow. Others could not afford any collateral for the loans they sought. This did not augur well with these businesses because all lenders pegged the amount a business could borrow on the value of collateral that was provided. This study employed stratified random simple sampling design and proportionate sampling to arrive at the sample. A similar study carried out in Iraq by [13] arrived at comparable findings.

A study on problems that SMEs in Denmark face in the process of funding in the European Union by [16] established
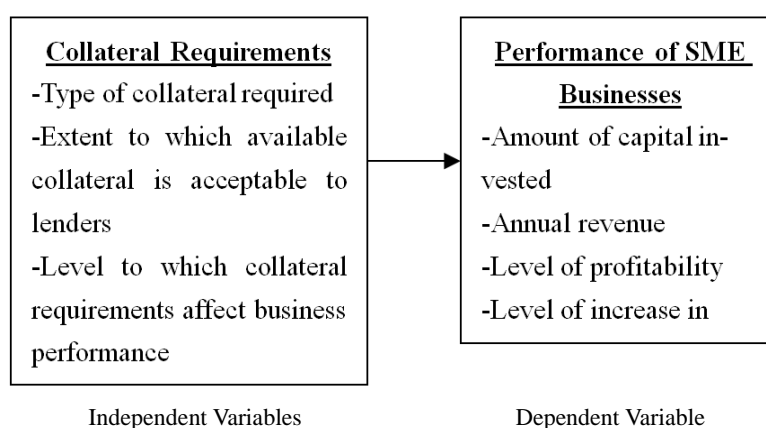
that these business ventures struggle while accessing finances despite the national and European political intentions for SMEs to create jobs and growth. Evaluations of Danish SMEs' performance show that access to finance is still a challenge to SMEs.

Small and micro businesses now have less access to financial credit due to the strict lending requirements that banking institutions have created. Lending institutions require collateral or asset tangibility, particularly when working with the small and micro-enterprise sector, whose information availability is limited and thus higher information asymmetry, according to a study by [33] on factors influencing SMEs' access to finance in Westland Division, Kenya. Financial institutions saw assets as the property of owners or managers rather than as business assets, the study also found that these enterprises' lack of assets was linked to their lack of borrowing. Credit takers who had multiple assets in certain cases preferred to stay in their current financial situation rather than risk their few assets because they were afraid of the burden that would come with a bank loan. In the long run, this makes financial loans less accessible.

In a study targeting Nairobi retailers, [34] established that lenders always demanded collateral from borrowers as a way of assessing whether the latter was creditworthy, thus minimizing the risk of default and maximizing the potential of loan repayment. This study also established that collateral was a limiting factor for SMEs when borrowing loans. Moreover, the prevailing policy environment locked out many SME owners who could not raise the required collateral. Finally, this study established that collateral substitutes can be viable alternatives, but their effectiveness is dependent on how well the lender can access information on the ability of the borrower to repay low-cost loans.

2.3. Conceptual Framework

Figure 1. *Conceptual Framework.*

3. Materials and Methods

3.1. Research Design

This investigation was conducted using a survey descriptive study approach. [35] state that the best way to think of a research design is as the glue that binds the many but related parts of a study together. This study's objective was to collect and analyze data from a sample of SME owners and/or managers at a specific moment in time. Descriptive studies explain certain and predetermined aspects of a phenomenon without trying to influence outcomes [36, 48, 38]. In order to identify any gaps and offer practical solutions for raising the productivity of SME enterprises in Meru County, this study examined their performance and loan availability.

3.2. Target Population, Sampling Design and Sample Size

The study was based in Meru County, where 599 SMEs that had been operating for at least three years were registered by the Meru County Government [37]. Only small business owners were involved in the study, and data was collected from the SME's management in cases where the owner was unavailable during the researcher's visit. The sampling design outlines how the researcher selects a sample from the population [38]. The study comprised 599 SME businesses that were registered with the Meru County administration and had been in operation for at least three years. The study covered nine sub-counties within Meru County.

To determine the sample size, Krejcie and Morgan's 1970 table for calculating sample size for a given population was used [39]. According to the table, for a population of 599

SMEs, a sample size of 234 was appropriate. To create the sample, the researcher employed a proportionate random stratified sampling design. Additionally, purposive random sampling was used to ensure that the various types of SMEs were adequately represented in each stratum or sub-county. This was essential as certain types of businesses tend to dominate specific markets, and random sampling alone may not fully capture the diversity of the entire market.

3.3. Research Instruments

The technique of gathering data involved the use of questionnaires. The survey had both open-ended and closed-ended questions. The questions had explicit instructions to guarantee that respondents would not encounter any difficulties in responding to them. As shown by [40], the method was better because it was free of bias, allowed ample time for meaningful responses, made it simple to get in touch with respondents, and yielded more reliable and trustworthy results.

3.4. Data Collection Procedures

Data was collected utilizing the drop and pick method following an appointment with the respondents. This strategy was useful in delivering the surveys to the chosen group because it ensured that respondents were reached irrespective of external constraints [41]. In order to ensure that respondents finished the surveys at their convenience and within the designated time constraints, the questionnaires were chosen after three days.
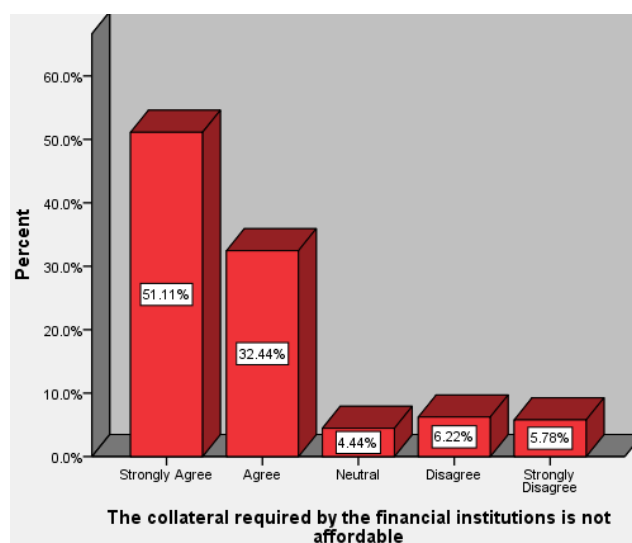
3.5. Data Processing and Analysis

Frequencies and descriptive analysis were used to examine the data. The results were displayed using tables and charts. Additional inferential statistics were performed to see if the four independent variables and the performance of small and medium-sized firms were correlated. In order to investigate the relationship between the independent and dependent variables, the study used the chi-squared test at 0.005. According to [42], this method is employed to measure the correlation between independent and dependent variables. The data was analyzed using version 22 of the Statistical Package for Social Sciences (SPSS), which is the most recent version. The study conducted three diagnostic tests on the data. Multicollinearity was used to analyze the connection between the variables. Multicollinearity occurs when there is a significant correlation between these variables and r is less than 0.9 [43]. This test was carried out using the Variance Inflation Factor (VIF). Heteroscedasticity was used to determine whether the variance of the outcome variable increased proportionately to the size of the predictor variable. The Normality Test was used to determine if the variables had a normal distribution.

4. Results

In this section, the researcher wanted to find out if collateral requirements as an independent variable influenced performance of SMEs in Meru County as a dependent variable.

4.1. Collateral Requirements by the Financial Institutions Is Not Affordable

Majority of the respondents at 51% strongly agreed that the collateral required by the financial institutions was not affordable to them. Thirty two percent agreed that the collateral requirement was not affordable. In general, 83% of all the respondents could not afford the collateral required by the financial institutions. However, twelve percent of the respondents disagreed that the collateral requirements by the financial institutions was not affordable. A study [44] on collateral requirements for financing of small and medium enterprises in Kakamega Municipality established that personal and private assets/documents were necessary collateral for one to access formal financing.
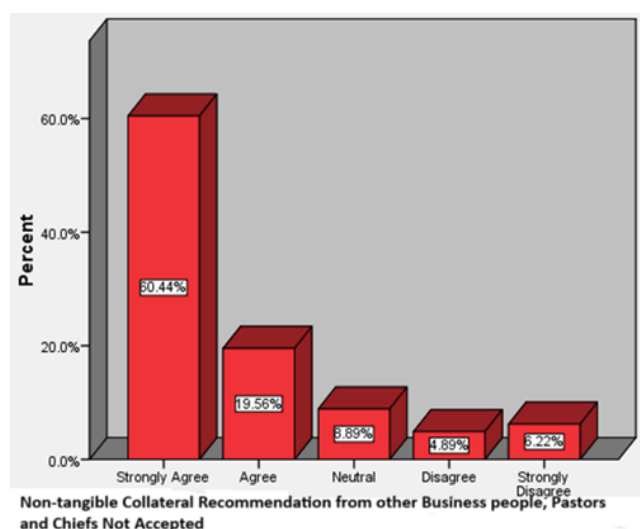

Source: (Survey data, 2017)

Figure 2. Collateral required in not affordable.

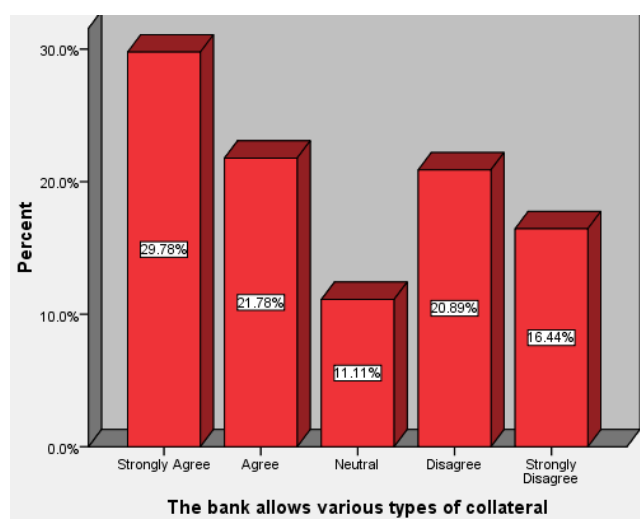### 4.2. Non-tangible Collateral Recommendation from Pastors and Chiefs Not Accepted

In order to access credit from financial institutions, respondents went to an extent of getting recommendation from other business people, chiefs and pastors. Eighty percent of the respondents agreed that the recommendation from them was not accepted by the financial institutions. Only 11% of the respondents indicated that type of recommendation was accepted by the financial institutions.

Source: (Survey data, 2017)

Figure 3. *Non-tangible collateral not accepted.*

4.3. The Bank Allowed Various Types of Collateral
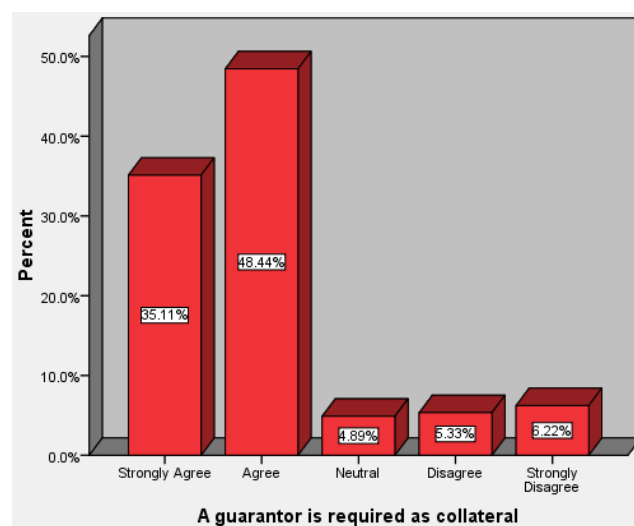

Source: (Survey data, 2017)

Figure 4. *The bank allows various types of collateral.*

It was established that more than half of the respondents agreed that banks allowed various types of collateral while accessing credit. Forty seven percent disagreed that banks allowed various types of collateral. A study by [44] revealed that 92% of the sampled population cited personal assets or documents and business assets of the small and medium enterprises were accepted as collateral.

4.4. A Guarantor Is Required as Collateral

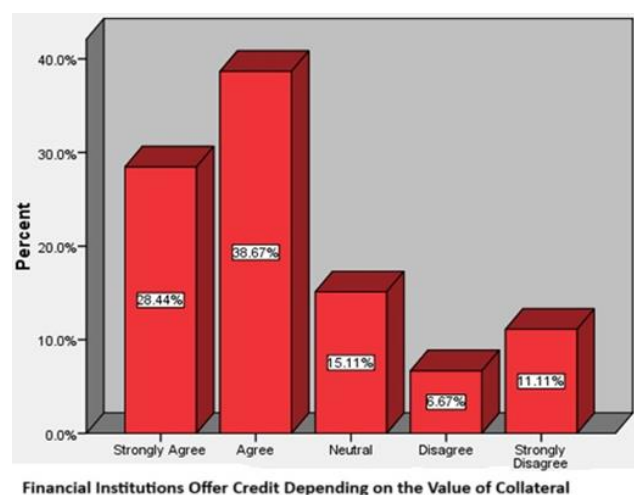The study revealed that 84% of all the respondents sampled agreed that a guarantor was required in case they required loans from financial institutions. Only twelve percent of the respondents disagreed that a guarantor was required. According to [44] two guarantors were required for operators of SMEs in Kakamega County. It was also a requirement that the two guarantors operated an account with the financial institution.

Source: (Survey data, 2017)

Figure 5. *A guarantor is required as collateral.*

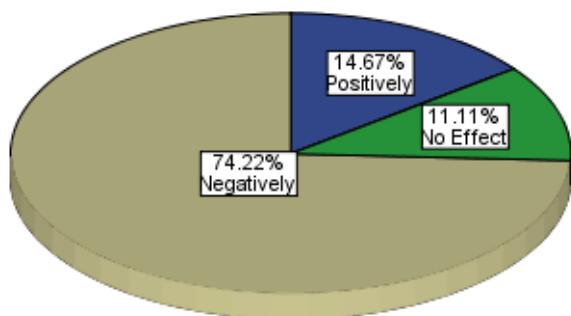## 4.5. Credit Advanced Depends on the Value of Collateral

Source: (Survey data, 2017)

Figure 6. *Credit value depends on the value of collateral.*

When respondents were asked whether financial institutions offered credit depending on the value of collateral, 67% of them agreed whereas 18% disagreed. Citing [49, 50] emphasize that the time period for which credit is advanced is affected

among other factors by collateral value. According to [51] a lender will not advance a loan to a borrower if the loan exceeds the market value of the collateral. The supply of loans will tend to increase with rise in the market value of the collateral.

4.6. How Demand of Collateral Affected Performance of SMEs

Source: (Survey data, 2017)

Figure 7. How demand for collateral affected performance of SMEs.

The study established that demand of collateral affected performance of SMEs negatively by a proportion of 74%. Fifteen percent of the respondents indicated that demand for collateral affected performance of SMEs positively. A study by [52] on factors affecting the performance of small and micro enterprises in Limuru Town Market established that most small and medium enterprises prefer to use personal savings and contributions from relatives because financial institutions impose strict collateral requirements.

4.7. Test of Hypothesis

Test of hypothesis was done in order to establish if there was any relationship between collateral requirements and performance of SMEs. The results are as shown in Table 1. Hypothesis was stated as:

Ho: There is no significant relationship between collateral requirements and performance of SME business in Meru County.

H_A: There is significant relationship between collateral requirements and performance of SME business in Meru County.

Table 1. Chi-square test for collateral requirements and performance of SMEs.

	Value	Df	Asymp. Sig. (2-sided)
Pearson Chi-Square	55.855	12	.000
Likelihood Ratio	56.893	12	.000
Linear-by-Linear Association	540	1	.462
N of Valid Cases	225		

Source: (Survey data, 2017)

From Table 1 the p-value is equal to 0.000. The level of significance was set at 5%. It is clear that the p-value is less than 5% and therefore the null hypothesis was rejected. It can therefore be concluded that at 5% level of significance there was evidence to suggest that there existed significant relationship between collateral requirements and performance of SMEs in Meru County.

5. Discussion

According to the findings, most SMEs experience challenges in assembling the required collateral to access credit. While banks allowed various types of collateral, it was embarrassing for business owners to seek for recommendation from other business people, chiefs and pastors. These findings are in tandem with those of [44] on collateral requirements for financing of small and medium enterprises in Kakamega

Municipality. It is evident that collateral requirements by financial institutions, while necessary, are not friendly enough to business owners hence hampering access to credit.

6. Conclusions

The study demonstrated how collateral requirements impact the performance of Meru County's small and medium-sized businesses. While majority of the enterprise owners were aware of collateral requirements, the latter were still too stringent. Consequently, it is important for financial institutions to review the collateral demands to ensure as may SMEs as possible can apply for loans. Results of inferential statistic revealed a relationship between collateral demands and performance of small and medium business in the county.

Abbreviations

SMEs	Small and Medium Enterprises
GDP	Gross Domestic Product
MSME	Micro, Small and Medium Enterprises
OECD	Organization for Economic Cooperation and Development

Author Contributions

Muriungi Silas Kaimenyi is the sole author. The author read and approved the final manuscript.

Funding

Data Availability Statement

The data is available from the corresponding author upon reasonable request.

Conflicts of Interest

The authors declare no conflicts of interest.

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Biography

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