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## The Influence of Collateral Availability on Access to Credit by Small and Medium Enterprises (SMEs) in Meru County

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### Abstract

**Purpose:** Small and Medium Enterprises (SMEs) significantly contribute to both social and economic development of people largely through their roles in job and innovation creation, and revenue generation. Majority of SMEs are undercapitalized due to inaccessibility of credit facilities. This adversely influence their capacity to invest in productive ventures and realize their corporate goals. Factors that influence SMEs' access to credit are not well known. Thus, the current study sought to establish the influence of collateral availability on access to credit by SMEs in Meru County.

**Methodology:** The study was guided by the theory of information asymmetry and the pecking order theory. The study was based on the descriptive survey design. The study targeted 204,810 SMEs in Meru County of which 384 SME owners were sampled using stratified sampling. Quantitative data was analyzed using both inferential and descriptive statistics. Qualitative data was analysed thematically.

**Findings:** The study found that majority of SMEs in Meru County are able to access credit from SACCOs but not from MFIs and Banks without necessarily having to provide collateral since guarantors' savings act as security for the loans.

**Recommendations:** The study recommend that SMEs should ensure that they do not have negative listing by CRB to increase their chances of accessing credit. The study also recommend SMEs owners to acquire training on how to prepare and maintain proper financial statements.

**Keywords:** *Small and medium enterprises, under-capitalized, access to credit, collateral*

## INTRODUCTION

Financial inclusion is a key component of any country's all-inclusive social, political, and economic development. In addition, an all-inclusive financial system helps to reduce the proliferation of informal credit sources, which can not only be exploitative but also undermine the stability of the financial system of a country as a whole. Advancing balanced economic growth and financial inclusion is vital to sustainable development as it encompasses the majority of the population in developing countries, such as the poor and the vulnerable (Agyemang-Badu et al., 2018) communities in both urban and rural populations.

Financial inclusion allows for a country's enhanced and more sustainable economic and social development (Were & Wambua, 2013). This also recognizes the participation of disadvantaged groups, such as poorer portions of the population and low-income families, depending on their degree of access to financial resources such as savings and loan plan, credit protection, pensions, among others (Kathuo et al., 2015). In addition, the goal of financial inclusion is the simple availability of financial resources that require maximum investment in business opportunities, schooling, retirement savings, rural citizens and businesses to insure against risks (Rebei, 2014). Furthermore, the gaps in financial exposure between the wealthy and the poor, men and women, and rural and urban areas have substantially deteriorated. Key drivers of those changes included; mobile money growth, government initiatives and funding, and information and communications technology innovations.

The world is witnessing dynamic changes in the international business environment. The role of SMEs playing in today's global economies is a highly interesting matter, as they are primary driving forces for job creation, decrease the unemployment, income generation, and have a grand role in the innovation and technological progress. SMEs and micro-enterprises comprise more than 95% of firms and represent 50% to 66% of non-farm employment and Gross Domestic Product worldwide (Mutiria, 2017). World Bank (2015) reported that approximately 70% of all SMEs in developing markets lack access to finance that makes it difficult to survive or expand.

Small and medium enterprises (SME's) play a critical role in an economy. It has been found out that world over, SMEs fundamentally add to both the social and financial advancement of individuals to a great extent through their parts in work and development creation, and income age (Kelly, Singer and Herrington, 2011). Worldwide, SMEs add to more than half Gross Domestic Product (GDP) in created nations (IEG World Bank/IFC/MIGA, 2013). For example, their contribution towards GDP was 57% and 60% in Germany and China respectively and 55.3% in Japan (IEG World Bank/IFC/MIGA, 2013). Further, according to a study by Abor and Quartey (2010), SMEs contribute an estimate of between 52% and 57% to the GDP of South Africa. Madata (2011) reported that SMEs contribute an estimated 33% to the GDP of Tanzania. According to a report by Deloitte (2016), SMEs in Uganda contribute 20% of GDP. In Kenya, SMEs contribute 45% towards the country's GDP (Argidius Foundation, 2015). Yet SMEs still face key challenges in accessing credit and in particular external financing to meet their corporate goals.

In South America, Botello Peñaloza (2015) asserts different SMEs' determinants related to; collateral availability and availability of information influenced their access to credit. In Bolivia, Peñaloza (2015) reported availability of information and business risks significantly influenced access to credit by SMEs. Padilla-Pérez and Fenton Ontañón (2013) reported availability of information and collateral availability to have had significant influence on credit access by SMEs in Mexico. In Brazil, Da Motta (2016) reported availability of information particularly between lenders and SMEs and capacity to pay significantly influenced access to



credit by the later. Additionally, Pasquini and De Giovanni (2010) assert capacity to pay had a significant influence on credit access by SMEs in Argentina.

In Asia, Harvie, Oum and Narjoko (2010) reported that various SMEs' determinants including; collateral availability and capacity to pay had a significant influence on their access to credit. In Vietnam, Le (2012) revealed accessibility of data and insurance accessibility essentially impacted admittance to credit by SMEs. Further, Jiang, Li and Lin (2014) detailed ability to pay as far as income and business benefit introduced a considerable effect on admittance to credit by SMEs in China. In Malaysia, Haron, Said, Jayaraman and Ismail (2013) security accessibility, for example, land and structures fundamentally impacted admittance to credit by SMEs. Additionally, Nikaido, Pais and Sarma (2015) assert collateral availability in terms of land had an insignificant influence on credit access by SMEs in India.

In Africa, the financial gap for formal SMEs was projected to be US\$1.2 trillion, while the financial gap for the informal was US\$1.4 trillion. IFC and McKinsey brought up that nearly 45% to 55% of the MSMEs in emerging markets do not approach the needed finance, which should support them and help them to grow and expand (IFC, 2013). Therefore, enhancing access to finance SMEs may improve their capability to thrive, in addition to reducing unemployment (Niskanen & Niskanen, 2010). In Africa, Beck and Cull (2014) established that various SMEs' determinants such as; collateral availability, capacity to pay and availability of information between them and lenders significantly influenced their access to credit. In Ghana, Ackah and Vuvor (2011) reported availability of information and capacity to pay as key SMEs' determinants that significantly influenced their access to credit. In Nigeria, Egbuta and Gilbert (2018) observed SMEs' determinants related to business risks and capacity to pay had a significant influence on their access to credit. Further, Mandiefe Piabuo, Menjo Baye and Chupezi Tieguhong (2015) reported collateral availability, capacity to pay and business risks as the predominant SMEs' determinants that significantly influenced their access to credit in Cameroon.

The SME sector in Kenya has limited access to finance due to the following determinants: The sector is perceived as a high risky; inability of the SME operators to fulfil the collateral requirements; lack of a guarantee scheme to back up banks financing SMEs; high cost of screening and administering small loans spread over big areas and inability of borrowers to prepare and present business plans that meet bank's requirements (MSME BILL, 2009). Despite these challenges, some banks in Kenya have taken a chance on SMEs and are offering them loan facilities. This has largely improved on the stature of SMEs and thus contributing towards the vision 2030 specifically the economic pillar. In the recent past SMES have benefited from both banks and micro financiers for funding their businesses. However, just as the future of SMEs seems to be brighter another challenge of credit repayment on the part of the SMEs is cropping up. Although loans offered by these banks and micro financiers have loosened their loan application requirements and conditions that SMEs can now access financing. There seems to be an increasing trend of loan defaults that has now created an issue of SMES credit repayments abilities which in turn is making financiers jittery to continue financing them.

An estimated number of between 52% and 64% of SMEs in developing countries like Kenya have limited or no access to credit (The International Finance Corporation, IFC, 2013). This leaves majority of SMEs undercapitalized adversely influencing their capacity to invest in productive ventures and realize their corporate goals (IFC, 2013; Mandiefe, Menjo & Tieguhong, 2015). Further, this state of affairs also significantly contributes to the shortage of SMEs' cash flows. In particular, this liquidity challenges created by limited access to external

financing largely contributes to SMEs eventual collapse during their infancy years with most not hitting the five year mark (Franco & Haase, 2010; Fatoki, 2014). Despite the fact that there exist supply side imperatives, for example, high loan fees and enormous security necessities that add to SMEs' restricted admittance to outside credit, request side requirements which are these organizations' qualities similarly contribute. For instance, Ndungu (2016) established that a number of lending institutions, interest charged on loans, collateral security and literacy levels are the most significant determinants that affect access to credit among SMEs in Murang'a.

Another study by Thuku (2017) established that small SME's experience a challenge accessing loans from banks as compared to big firms, location of a firm also affects access to finance, banks prefer lending to women than men, access to finance is not influenced by networking, and that audited financial statements and collateral are needed before a loan is approved. Similarly, a study by Mole and Namusonge (2016) established that among the determinants that lending procedures, collateral requirement, credit bureau referencing policies and training offered by finance Institutions significantly influence access to credit facility by SME from financial institutions. Another study by Osano and Languitane (2016) established that there is a relationship between the structure of the financial sector, awareness of funding and collateral requirements and access to finance by SMEs. It is apparent that there are various determinants that may influence access to credit by SME's. However, the level of significance of this influence is not well understood. The current research study therefore sought to fill the gap in literature by investigating how the requirement of collateral influence SMEs' access to credit in Meru County.

### **Pecking Order Theory (POT)**

It argues that firms prefer to internally finance investment project in order to avoid undervaluation arising from the information asymmetries. Firms exhaust internal finances and debt financing options before resulting to equity financing. POT is relevant to the SME sector in Kenya because of the relatively greater information asymmetries and the resultant high cost of external equity for SMEs (Ibbotson, Sindelar & Ritter, 2001). Furthermore, firm owners' desire to retain control of the firm and maintain managerial independence, is a common phenomenon in this sector (Jordan, Lowe & Taylor, 1998).

### **MATERIALS AND METHODS**

A descriptive survey design was adopted in this study. The research was carried out in Meru County, Kenya. The target population consisted of 204,810 SMEs owners in Meru County. This study used stratified random sampling procedure to sample the respondents. The stratum in this case was the 9 sub-counties/towns in Meru County. The study used the Creative Research Systems (2012) sample size calculator to determine sample size. The study used a confidence level of 95% and confidence interval of 5. Computation from the calculator indicate that the study sampled 384 respondents who were SMEs owners (Creative Research Systems, 2012). Primary data was collected using a questionnaire constructed by the researcher. Preceding the real information assortment measure, a pilot study was carried out in Maara Sub-county in Tharaka Nithi County. In this study a reliability coefficient of 0.8 was obtained suggesting that the instruments were reliable. As per Rodríguez-Rey et al. (2016), content legitimacy of an instrument is improved through master judgment. In that capacity, help was looked for from managers and different specialists from Meru University on information assortment instrument plan to help improve content legitimacy of the instruments. The examination of quantitative information was utilized both elucidating and inferential. Qualitative data was analyzed using thematic data analysis where data was grouped together in terms of themes and presented in form of narratives.

The study administered a total of 384 questionnaires among different SME holders. A total of 297 questionnaires were filled and returned. This constituted a return rate of 77.3 %. According to Morton et al. (2012), a return rate approximating to 60% for most studies is considered good, while a 50% return rate is suitable for analysis. A 70-85% return rate is very good, while a return rate above 85% is regarded as excellent. Since this study obtained a return rate of 77.3 % it can be asserted that the return rate for the current study was very good.

## RESULTS AND DISCUSSION

The study gathered data on the category of businesses conducted in Meru County. The results indicated that residents in Meru County engage in diverse types of SME businesses. They ranged from general shops, bookshops, transport (“*Matatu* and *boda boda*), second hand clothes sales, saloon, grocery, spare parts sales (motor vehicle and motor cycle), money transfer businesses among others. The diversity of enterprises implies that the study was able to gather data that could help answer the current study research questions in a more detailed manner.

From the results, majority of the respondents (201, 67.7 %) indicated that their businesses had been in operation for between two to five years while 50 (16.8 %) had been operation for less than two years and 46 (15.5 %) had been in operation for between six to ten years. Given that over 73 % respondents indicated that their businesses had been in operation for over two years. The data gathered might have been appropriate in answering the study questions in relation to the influence of SMEs’ determinants on their access to credit in Meru County. The finding that only 15.5 % of the respondents had been in business for over five years could be supportive of the assertion by Kasimov (2017) that across all industries, start-up failure rates seem to be 70 % during years two through five.

The results also indicated that 268 (90.2 %) of the respondents agreed that they had ever borrowed money. This constituted the majority of the respondents implying that they were better placed on answering questions on access to credit. This implies that most of the respondents had access to credit. This contradicts Bell (2015) assertion that in emerging markets, access to finance is a key constraint to SME growth and that it is the second most cited obstacle facing SMEs to grow their businesses in emerging markets and developing countries. Nonetheless, the respondents who had never accessed to credit were also important in answering questions on impediments to access credit.

The results indicated that majority of the respondents (149, 55.6 %) indicated that they had borrowed money from the SACCOs while 45 (16.8 %) of them had borrowed from banks and 41 (15.3 %) had borrowed from microfinance institutions. The high number of SMEs getting financial credit from SACCOs could explain why access to credit by SMEs in Kenya is high since Kiunga (2022) argues that SACCOs have over the years played a very significant role in the growth and development of small enterprises. The remaining 17 (6.3 %) of the respondents had borrowed from groups (Chama) and 16 (6.0 %) of them had borrowed from mobile money application (M-shwari). It is apparent from this results that access to credit by SMEs from banks is still low in comparison to other institutions such as SACCOs. This could explain why Bell (2015) argues that SMEs access to credit in developing countries is a constraining factor for the growth of this sector. They are also facing stiff competition from microfinance institutions. The implication of this finding is that SMEs are still highly dependent on savings to borrow and fund their enterprises.

The study sought to establish the influence of collateral availability on access to credit by SMEs in Meru County. The results are summarized in table 1 (SD = strongly disagree, D = Disagree, U = Undecided, A = Agree and SA = Strongly Agree).

**Table 1: The influence of collateral availability on access to credit by SMEs**

Statement	SD		D		U		A		SA	
	F	%	F	%	F	%	F	%	F	%
All financial institutions requires SMEs to provide security before they can access credit	112	37.7	16	5.4	94	31.6	39	13.1	36	12.1
Some of security required by financial institutions include vehicle logbooks and land title deeds	51	17.2	81	27.3	58	19.5	51	17.2	56	18.9
Financial institutions require SMEs to provide security in order to limit cases of loan default	47	15.8	93	31.3	71	23.9	57	19.2	29	9.8
The collateral required by financial institutions is often beyond the reach of most SMEs	45	15.2	18	6.1	43	14.5	103	34.7	88	29.6
Access to credit requires guarantors	18	6.1	53	17.8	35	11.8	78	26.3	113	38.0

The results in table 1 indicated that 112 (37.7 %) of the respondents strongly disagreed and 16 (5.4 %) of them disagreed while 39 (13.1 %) of the respondents agreed and 36 (12.1 %) of them strongly agreed with the statement that all financial institutions requires SMEs to provide security before they can access credit. This implies that even though some SMEs are required to provide security prior to accessing to credit, over 42 % of SMEs are not required to provide security before accessing credit. This could be related to Garvin et al. (2021) study finding that uncollateralised borrowing declines for ex ante riskier borrowers while collateralised borrowing increases for borrowers ex ante holding more high quality collateral. Thus, security is not a significant prerequisite for accessing credit. It should, however, be noted that 94 (31.6 %) of the respondents were undecided on whether or not all financial institutions requires SMEs to provide security before they can access credit. This could imply that a significant number of SME holders have not exploited all the available credit providers at their disposal to ascertain whether they require security prior to extending their credit facilities to them.

Moreover, given that majority of the respondents got their loans from SACCOs which often peg their credit on savings which is usually used as collateral might not be clear to the SME owners. Thus, the assertion that majority of the respondents indicated that they are not required to provide collateral need to be taken with caution. This is because looking at 16.8 % of the SME owners who indicated that they got their loans from banks and 15.3 who got loans from MFIs and comparing this to 25.2 % (12.1 who strongly agreed and 13.1 who agreed) that they are required to provide collateral is indicative that SME owners who borrow from banks and MFIs are required to provide collateral. This assertion supports Fanta (2016) and Chowdhury and Alam (2017) argument that lack of collateral security impedes SMEs from accessing credit for growing their enterprises.

The findings in table 1 also showed that 81 (27.3 %) of the respondents disagreed and 51 (17.2 %) strongly disagreed while 56 (18.9 %) of the respondents strongly agreed and 51 (17.2 %) of them agreed with the assertion that some of security required by financial institutions include vehicle logbooks and land title deeds. Given that over 44 % of the respondents disagreed with the assertion, it can be argued that vehicle logbooks and land title deeds are not part of the security required off SME entrepreneurs in order to access credit. This differs from Bagaka and Memba (2015) study finding which indicated that vehicle logbooks and land title deeds are the main collateral requested by financial providers as security for credit. It might also imply that some of the financial service providers do not need security to extent their credit facilities to the SME holders as established above. This could also imply that SME holders do not seek credit facilities from financial providers who require security in form of logbooks and land title deeds. This assertion is supported by the finding that majority of SMEs access credit from SACCOs rather than banks and MFIs which often require collateral in form of logbooks and land title deeds. This assertion augments Onchiri et al. (2015) findings that banks and MFIs often require collateral in terms of logbooks or land title deeds in order to extent their credit facilities to SMEs especially start-ups.

It was also established in table 1 that 93 (31.3 %) of the respondents disagreed and 47 (15.8 %) strongly disagreed while 57 (19.2 %) of the respondents agreed and 29 (9.8 %) strongly agreed with the statement that financial institutions require SMEs to provide security in order to limit cases of loan default. Given that over 47 % of the respondents disagreed with the assertion it can be argued that security requirement is not geared towards limiting default among SME holders who seek credit. This view might be popular among the respondents because most of them indicated that financial service providers do not require security prior to offering them credit. This might also be attributed possibly to low penetration of credit among the respondents and may be due to low financial service literacy among the respondents. However, this argument should be taken with caution since majority of the respondents seemed to depend on SACCOs for access to credit. Moreover, looking at the percentages 9.8 % who strongly agreed and 19.2 % of them who agreed, seems to be almost similar to those who have ever accessed credit facility from banks and MFIs implying that require security prior to extending their credit facilities to SMEs. Thus, it could be argued that whereas banks and MFIs require security, SACCOs do not demand security since loans are based on ones savings which could be argued to be security on its own. Thus, this argument supports Avortri (2013) finding that security requirementt is one of the most significant variable which impede access to credit of the SME sector.

The study also established in table 1 indicated that 103 (34.7 %) of the respondents agreed and 88 (29.6 %) of them strongly agreed while 45 (15.2 %) of the respondents strongly disagreed and 18 (6.1 %) of them disagreed with the statement that the collateral required by financial institutions is often beyond the reach of most SMEs. This finding augments the argument that most of the financial service provider do not require security prior to extending credit to the SME entrepreneurs. The finding further differs from Bagaka and Memba (2015) study which indicated that collateral requirement is often out of reach for most SMEs and hence they are not able to access credit.

The results in table 1 showed that 113 (38 %) of the respondents strongly agreed and 78 (26.3 %) of them agreed while 57 (17.8 %) of them disagreed and 18 (6.1 %) of the respondents strongly disagreed with the assertion that access to credit requires guarantors. Given that majority (64.3 %) of the assertion that access to credit imply that most of financial service providers require SME entrepreneurs to provide guarantors in order for them to access credit.



It can therefore be asserted the main security required by majority of financial service providers to extent credit facilities to SME holders is guarantors. The finding supports Korir (2015) study which established that guarantors are the main security for loans extended to SMEs.

### Regression Analysis

A regression analysis was carried out to establish the contribution of collateral availability on access to credit. The model summary is shown in table 2.

**Table 2: Collateral availability and access to credit (model summary)**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.299 <sup>a</sup>	.089	.086	.593

*a. Predictors: (Constant), Collateral availability*

From the R computed (0.299), there was a positive correlation between the independent variables (collateral availability) and access to credit by SMEs. From the r square computed (0.089) the model: Access to credit = constant + Collateral availability + error, explains 8.9 % of the data. This implies that collateral availability only contributes 8.9 % towards the access to credit by SMEs. Therefore, apart from collateral availability, there are other determinants which enhance credit access by SMEs. The results are in congruent with Osano and Languitone (2016) who indicated that there is a relationship between collateral requirements and access to finance by SMEs. In order ascertain whether the model was significant, ANOVA was computed. The results are shown in table 3.

**Table 3: Collateral availability and access to credit (ANOVA)**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	10.144	1	10.144	28.873	.000 <sup>b</sup>
	Residual	103.641	295	.351		
	<b>Total</b>	<b>113.785</b>	<b>296</b>			

*a. Dependent Variable: Access to credit*

*b. Predictors: (Constant), Collateral availability*

The results showed that the model was significant (p-value = .000). The F- test for the model was significant since it had a p-value less than 0.05. In order to ascertain the contribution of collateral availability on access to credit, the coefficient was computed. The results are summarized in table 4.

**Table 4: Collateral availability and access to credit (Coefficients)**

Model		Unstandardized coefficients		Standardized coefficients		Sig.
		B	Std. Error	Beta	t	
1	(Constant)	.789	.216		3.648	.000
	Collateral availability	.369	.069	.299	5.373	.000

*a. Dependent variable: Ever denied credit by financial institution*

The results indicated that the influence of overall collateral availability ( $\beta = 0.369$ ,  $p = 0.000$ ) on access to credit was significant and its coefficient was positive indicating that an SME is likely to be granted credit when it has the collateral. Thus based on this finding, the null hypothesis that “ $H_{01}$  Collateral availability does not exert significant influence on access to credit by SMEs in Meru County” was rejected.

## CONCLUSION

It was established that security is a significant prerequisite but not majorly in accessing credit. It was also found that vehicle logbooks and land title deeds are not part of the security required off SME entrepreneurs in order to access credit. It was further ascertained that security requirement is geared towards limiting default among SME holders who seek credit. It was established that most of financial service providers require SME entrepreneurs to provide guarantors in order for them to access credit. Regression analysis indicated that collateral availability positively and significantly influence access to credit. It was concluded that majority of SMEs in Meru County are able to access credit from SACCOs but not from MFIs and Banks without necessarily having to provide collateral since guarantors' savings act as security for the loans.

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