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Influence of Interest Rates on Performance of SMEs Business in Meru County

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Abstract

Purpose: This study sought to examine interest rates' influence on the performance of Small and medium sized enterprises in Meru County, Kenya. It sought to understand how cost of borrowing affect operations, and overall growth of SMEs in Meru.

Methodology: It adopted a descriptive research design. Proportionate random stratified design was used to identify a sample of 234 SMEs. Questionnaires were used to collect data, which was analyzed and presented using descriptive statistics like frequency tables and graphs. Chi-square tests were conducted to test for any relationship between independent variables and the performance of SMEs in the county.

Findings: The majority of the respondents (75%) agreed that the interest rates charged on business loans by the financial institutions were too high, hence affecting the performance of SMEs negatively.

Unique Contribution to Theory, Practice and Policy: The study recommends policymakers and stakeholders should prioritize strategies that enhance financial inclusion and provide supportive environments for SMEs to thrive. The findings of the study will assist financial institutions in reviewing their interest policies towards increasing credit uptake while also contributing to the existing corpus of information on lending.

Keywords: *Interest Rates, Performance, SMEs*

JEL Codes: *E43, G21, L25*

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INTRODUCTION

Many nations around the world attribute their economic transformation to small and medium-sized enterprises (SMEs) in varying degrees (World Bank, 2015). According to the Edinburg Group (2013), SMEs account for 95% of all businesses, making them a significant player on the global business scene. Additionally, these entrepreneurial endeavours account for about 60% of private sector job openings.

The World Bank (2015) states that after recognizing the transformative potential of SMEs, governments, development organizations, and central banks have made large investments in this sector. SMEs are the backbone of the European economy, accounting for 99 percent of all business transactions in the continent, according to the European Commission (2016). Since 2011, small businesses have created about 85% of all new jobs. The focus on SMEs as engines of the European economy is demonstrated by the creation and success of the Small and Medium Entrepreneurs of Europe (SME Europe), an organization devoted to influencing EU policy in a way that benefits SMEs (SME Europe, 2016).

According to the UK Department of Innovation and Skills (2015), small businesses accounted for 99.3% of private sector enterprises by January 2015, with 99.9% of them being SMEs. Additionally, SMEs employed 15.6 million people, or 60% of all private sector workers in Britain. In Azerbaijan, Moldova, Armenia, Georgia, Ukraine, and Belarus, SMEs comprise 95% of businesses (EBRD, 2016). SMEs comprise approximately 55% of national GDPs and 95% of businesses in OECD countries, according to the Edinburg Group (2013).

SMEs also play a major role in the economic expansion of Africa. In Sub-Saharan Africa, SMEs account for more than 90% of all businesses (IFC, 2016). For example, SMEs comprise 91% and 92% of all businesses in Ghana and South Africa, respectively, and contribute more than half of their respective countries' GDPs. According to The Edinburg Group (2013), 93% of Morocco's industrial enterprises are of this type. Sousa dos Santos (2015) asserts that SMEs are critical to the economic growth of African countries, citing Angola as an example. A study conducted in Nigeria found that the credit system was insufficient in identifying creditworthy borrowers and that the lending procedures were unfriendly to small and medium-sized businesses (SMEs). As a result, potential borrowers were unable to obtain credit (Obinne & Igwebuike, 2013).

The SME sector is regarded as a crucial contributor to Kenya's economy because a significant portion of the populace relies on it for employment and income. The government has recognized the SME sector's capacity to lower poverty and generate employment in a number of policy publications. Employment in the SME sector increased from 4.2 million in 2000 to 5.5 million in 2003, accounting for 75.3% of all active workers in that year, according to the 2014 Kenya Economic Survey. This industry employed 85% of Kenya's workforce and contributed 45% of the country's GDP (SMEFEST, 2016). Thus, it is important to consider the SME sector not only as a provider of goods and services but also as a driving force behind innovation, competition, and enterprise culture, all of which are critical to the expansion and industrialization of the private sector (KNBS, 2015).

Performance of SMEs

Syekei and Opijah (2015) state that because the Kenyan government recognizes the importance of SMEs, it has passed several laws to support them, including the MSME Act of 2011. According to Katua (2014), SMEs are estimated to make up 90% of all businesses and contribute about 45% of Kenya's GDP. These businesses are also crucial to accomplishing Vision 2030's goals. Despite this, KNBS (2015) reports that about three out of eight businesses fail within the first few months of operation due to financial difficulties. For this reason, stakeholders in the public and private sectors must closely monitor SMEs. Since SMEs are such an important part of economic growth, designing appropriate, proactive, and corrective methods to increase their profitability and sustainability requires a thorough empirical study to elicit pertinent restrictions. This study examines the relationship between credit accessibility and the performance of SMEs in Meru County.

Interest Rates

One of the biggest obstacles to SMEs borrowing is high interest rates. After conducting a study on SMEs in Ghana's Wa Municipality, Bawuah, Yakubu, and Alhassan (2014) came to the conclusion that high interest rates had a detrimental impact on business performance, particularly by decreasing profit margins and raising the likelihood of default. On the other hand, credit with low and medium interest rates encouraged the expansion of businesses. In a study conducted in Lurambi Sub-County, Kenya, Nyumba et al. (2015) examined the relationship between loan interest rates and SMEs' performance and found a statistically significant positive correlation between the two variables.

Statement of the Problem

Globally, the SME sector is recognized as a crucial pillar of economic expansion. According to the European Commission (2016), SMEs are the foundation of the European economy because they account for more than 85% of all jobs created by the private sector. The goal of Kenya's 1965 strategy, "African Socialism and its Application to Planning in Kenya," was to boost private sector investment and expansion, among other things (Obwocha, 2006). 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 obtaining credit and funding. Three out of eight SMEs fail within the first few months of operation, according to KNBS (2015). 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 mitigating measures. There have been several related studies conducted elsewhere. The majority of them focus on the barriers that SMEs face when trying to obtain credit. These consist of Hvingelby, Jensen (2013), Avevor (2016), Gichuki et al. (2014), Ackah and Vuvor (2004), and Falkena et al. (2001). A study on the variables affecting credit accessibility in the Imenti Central Sub-County was conducted by Omboi and Wangai (2011). However, Kinyua (2014) investigated the factors that affected the performance of Jua Kali SMEs, while Nyumba et al. (2015) examined the impact of interest rates on SMEs' performance in Uasin Gishu County and found that interest rates had negative and statistically significant effect on performance of SMEs. The study was distinctive because it looked into the performance and accessibility of credit for SMEs in Meru County. No research had been conducted on this subject, and none had been conducted in Meru County.

LITERATURE REVIEW

Theoretical Review

Asymmetry Theory

According to Bebczuk (2003), information asymmetry occurs in the credit market when the borrower is sufficiently aware of the risks and rewards of investing in the company for which they are taking out a loan. On the other hand, the lender lacks adequate knowledge about the borrower (Bloem & Gorter, 2001). The lender has issues with moral hazard and adverse selection as a result of this information asymmetry. This clarifies the situation facing MFIs, where they must use excess resources to evaluate and track borrowers but the borrowers are only eligible for modest sums.

Data that is essential for MFIs to monitor and screen applicants and borrowers, respectively, is not readily available when needed, which influences borrowing choices (Brigham & Houston, 2009). It is crucial that lenders use credit evaluation to screen borrowers (King & McGrath, 2002). The contradictions presented in the asymmetric information theory cannot be resolved without the collection and compilation of such data. When evaluating credit, both quantitative and qualitative approaches are crucial, but the latter is subjective, which raises questions about credibility.

Nevertheless, by employing a scale and allocating weights according to a preset threshold, qualitative data can be transformed into quantitative data. This reduces the cost of processing the documents and eliminates potential biases and subjective judgments (Greuning & Bratanovic, 2009). Furthermore, by removing applicants with bad loans and calculating the amount required to cover any gaps that may arise from future loan losses, such a scale helps to improve the pricing of risk potential. One of the main issues that both lenders and SMEs must deal with is information asymmetry. For financial institutions and SMEs, respectively, decisions about funding or borrowing are influenced by incomplete or missing information (Turyahikayo, 2015).

Credit Rationing Theory

According to Basu (2012), Stiglitz and Weiss, the authors of the credit rationing theory, believe that interest rates from credit institutions serve two purposes. These include selecting borrowers (which is frequently disastrous) and affecting their behavior (which necessitates incentives). Although interest rates have an impact on market transactions, they now essentially improve the market. This situation occurs as a result of incomplete information in credit markets. Because it increases their profitability, banks are eager to choose borrowers who have a high chance of repaying their loans. Adverse selection results from this. Interest rates are frequently used by financial institutions as a criterion to find deserving borrowers—those who are prepared to pay the specified rates. Even though they are prepared to pay high interest rates, borrowers still run the risk of defaulting. This suggests that interest rates are directly correlated with default risk, which negatively impacts banks' return on investment.

According to Basu (2012), there is a problem known as Moral Hazard because businesses are more inclined to undertake projects with greater returns but a higher chance of failure when interest rates are high. Since they have no control over the actions of borrowers, financial institutions turn to offering favorable terms and conditions to low-risk borrowers in the hopes of making money. Interest rates eventually level off, and consumers start asking for more credit than banks are able to provide. The amounts that borrowers can access, as well as the kind and value of collateral that banks require, all have an impact on their behavior. Certain borrowers are locked out and the banks miss out on a profit-making opportunity when they raise interest rates due to overdemand for their loan products.

One must comprehend how the borrower chooses to participate, whether or not to borrow, and where to borrow from in order to comprehend the role of credit demand in the context of SMEs. This decision is influenced by a number of factors, most notably the borrower's financial strength and opportunities. Therefore, it is assumed that credit rationing occurs within the parameters of the credit demand schedule (Matthews and Thompson, 2005). There seems to be a comparable level of expressed demand in areas with a low credit supply. Furthermore, obtaining credit becomes more expensive in comparison to its inherent utility when the credit market fails. This forces business owners to finance working capital through a variety of activities. Because of this, official credit institutions must compete with other credit sources.

Demand Theory

In essence, the demand theory analyzes the relationship between relevant prices and the cost of goods and services (Grant and Vidler, 2002). This theory looks at how consumers choose what to buy and how price affects how much of a product they want to buy. The French economist Leon Walras, who lived from 1834 to 1910, created this theory. From this theory, economists went on to develop the law of demand. This law states that, when all other factors are held constant, the demand for a product decreases as its price increases and vice versa (McEachern, 2013). Price—the cost of obtaining and utilizing the funds—determines demand in the context of credit availability. Borrowers who apply for loans from lenders are bound by terms and conditions such as the requirement for collateral and fluctuating interest rates while repaying the loan. As a result, more of the credit facility will be requested when the terms of credit are advantageous to the borrower. Loans have the power to improve living standards by helping people and families escape poverty when used properly. In contrast to when they lack economic power, credit also increases people's purchasing power and aids in budgeting (Arnold, 2010). According to this study, increasing credit accessibility will lead to more borrowing, which will enhance SMEs' performance.

Interest Rates

Stutely (2003) opines that credit should be availed efficiently. Risks of financial credit have been shown to affect taking up of financial credit. In a study which was carried out by Avevor (2016) in Ghana on challenges faced by SMEs when accessing funds from financial institutions, it was established that while accessing funds from formal financial institutions SMEs are normally considered as a risky industry thereby being offered credit facilities at higher interest rates compared to larger and well established corporations. The study established that 50% of the credit facilities advanced were required to be paid back within three months of approval. The difficulties of getting access to finance increased SMEs' transaction costs.

According to a study by Oteng, Peprah, and Osei (2015) on challenges Faced by SMEs in accessing credit in Tamale, Ghana, 17.5% of the respondents indicated that fear of risk as a factor which affects performance of SMEs. Nyumba, *et. al*. (2015) also carried out a study in Lurambi Sub-County, Kenya, on the relationship between loan interest rate and performance of SMEs and concluded that there was a statistically significant positive link between the two

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constructs. Bawuah, Yakubu and Alhassan (2014), also arrived at similar conclusions when they carried out a study in Wa Municipality, Ghana, on how interest rates affected business performance. They concluded that when the cost of borrowing is high, chances of default by borrowers increase and profit margins decrease. They also established that low and medium interest credit promoted business growth.

Moreover, aaccording to a study by Zachary and Aduda (2013) on effects of interest rates on demand for credit by small and medium enterprises, 86.9% of demand for credit by SMEs in Nairobi County could be explained by interest rates. The study also revealed that the respondents considered interest rate charged as an important factor before they applied for any loan. The respondents indicated that they were not satisfied because of high interest rates and long durations taken to process the credit facility. The study recommends that a proper credit access strategy should be established and it must be acceptable, accessible, ethically sound, relevant, appropriate, innovative, efficient, sustainable and replicable, and have a positive perceived impact.

Muguchu (2013) asserts that the entrepreneur is sometimes faced with the option of continuing to operate the business to generate money to pay the loan or to wind up the business, sell assets and use the proceeds to settle the debt. Numerous businesspeople fear this possibility thus keeping off credit. In Kenya, banks have innate structural weaknesses, another deterrent to borrowers. This is because banks engage in short term lending owing to lack of stable funding sources. Borrowers cannot, therefore, access long term loans and even if they do, interest rates are quite high. In the final analysis, SMEs cannot access (affordable) credit and this hampers performance. In another study on the challenges faced SMEs in obtaining credit in Ghana by Ackah and Vuvor (2011), it was revealed that those who are able to access credit also faced high interest rates and short repayment periods making it very difficult to embark on any developmental or expansion projects.

Conceptual Framework

Independent Variable

Interest Rates
-Level to which interest rates are favorable to borrowers
-Level of awareness of types of interest rates for different credit products.
-Extent to which interest rates influence business performance

→

DependentVariable

Performance of SME Businesses
-Amount of capital invested
-Annual revenue
-Level of profitability
-Level of increase in output

Figure 1: Conceptual Framework

METHODOLOGY

A survey descriptive study design was used in this investigation. Data from a cross-section of SME business owners and/or managers at a particular point in time was gathered and analyzed by the researcher for this study. Nine Meru County sub-counties participated in the study. Questionnaires were used to gather data, and SPSS version 22—the Statistical Package for Social Sciences—was used to analyze the results. The data was analyzed using descriptive analysis and frequencies. Tables and charts were used to present the results. In addition, inferential statistics were used to determine whether the performance of small and medium-sized businesses and the four independent variables were related in any way.

RESULTS

In this section, the researcher wanted to establish the influence of loan interest rates on the performance of SMEs. The respondents were asked to state the extent to which they agreed with the statement that interest rates offered on business loans by the financial institutions was too high. The results are presented in Figure 2.

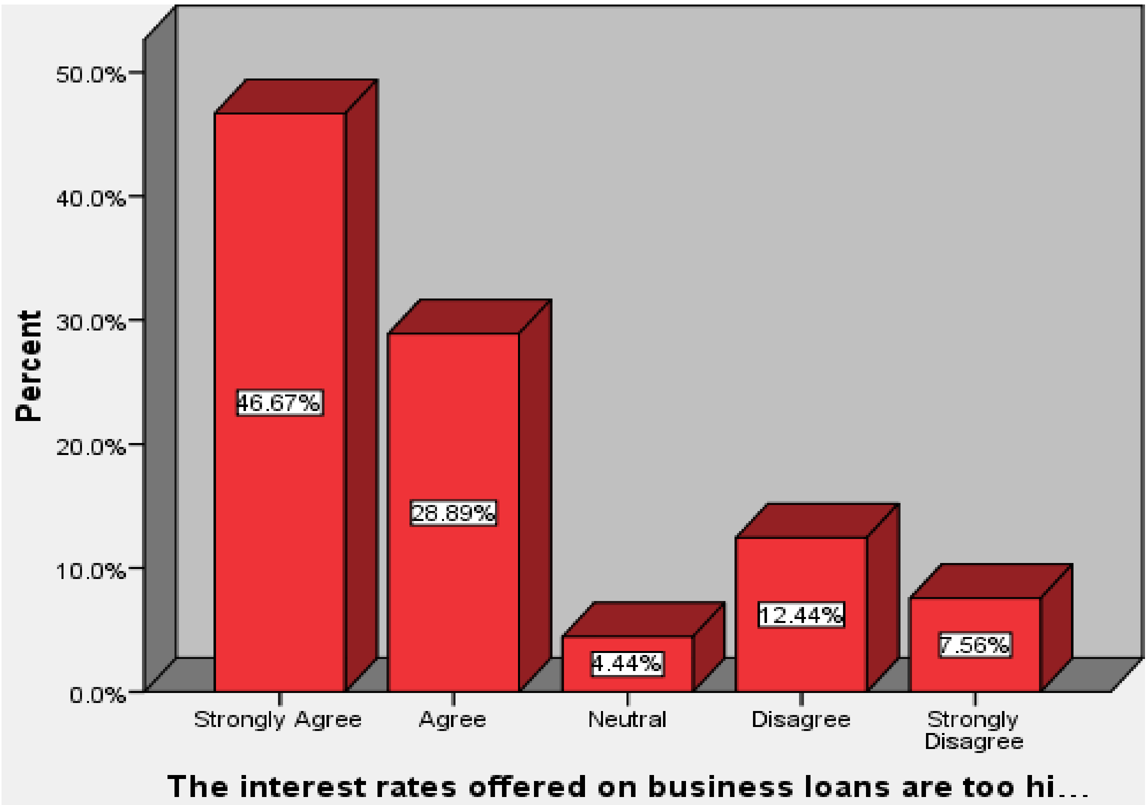

Figure 2: Interest Rates Offered on Business Loan is Too High

Source: (Survey Data, 2017)

It was established that majority of the respondents at 75% agreed that the interest rates charged on business loans by the financial institutions was too high hence not affordable. Out of the sampled respondents only 20% of them disagreed that the interest rates charged by the financial institutions was too high.

According to a study by Nyumba et al (2015) on loan interest rates and performance of SMEs in Kenya, it was revealed that there existed a statistically significant negative interest on the performance of SMEs in Lurambi subcounty. Similarly, a study by Makundi (2015) on factors influencing repayment capacity of SMEs in Morogoro Tanzania established that 90% of the respondents agreed that high interest rates influenced repayment capacity.

Different Interest Rates are Available for Various Business Loans

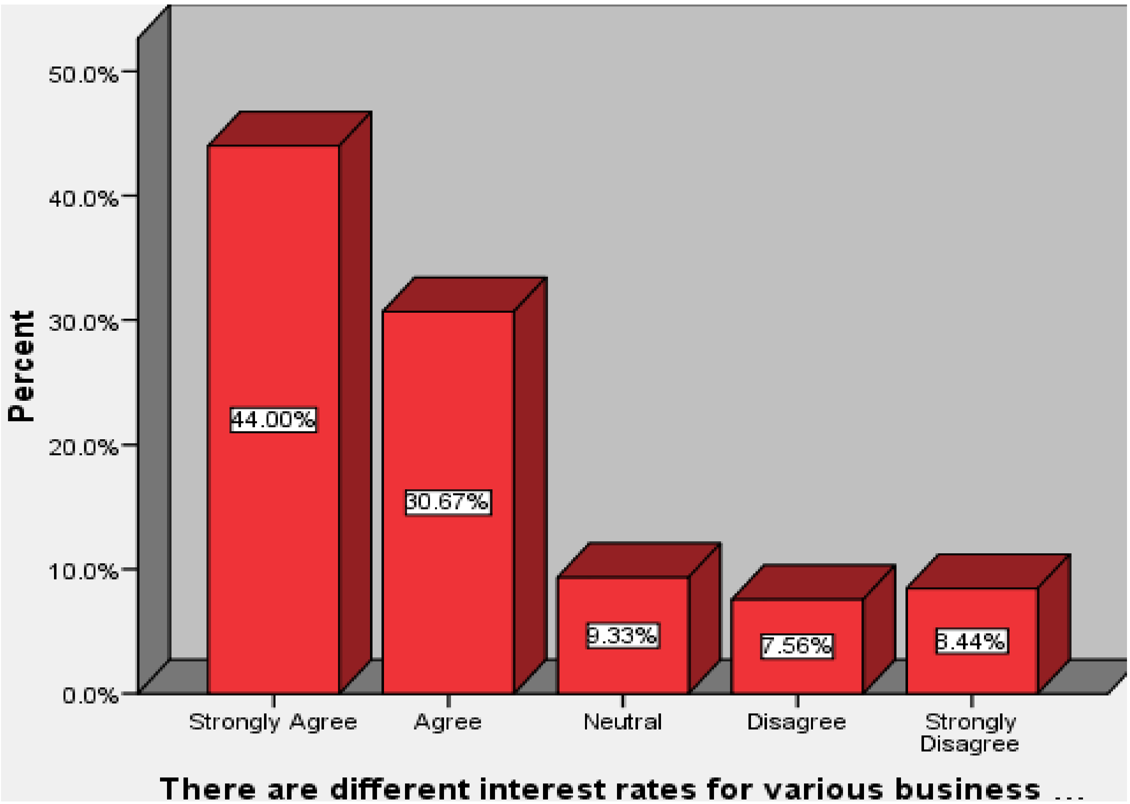

Figure 3: Different Interest Rates are Available for Various Business Loans

Source: (Survey Data, 2017)

It was established that 44% of the respondents strongly agreed that there existed different interest rates for various business loans. Thirty one percent agreed whereas sixteen percent of the respondents disagreed that there were different interest rates for various business loans.

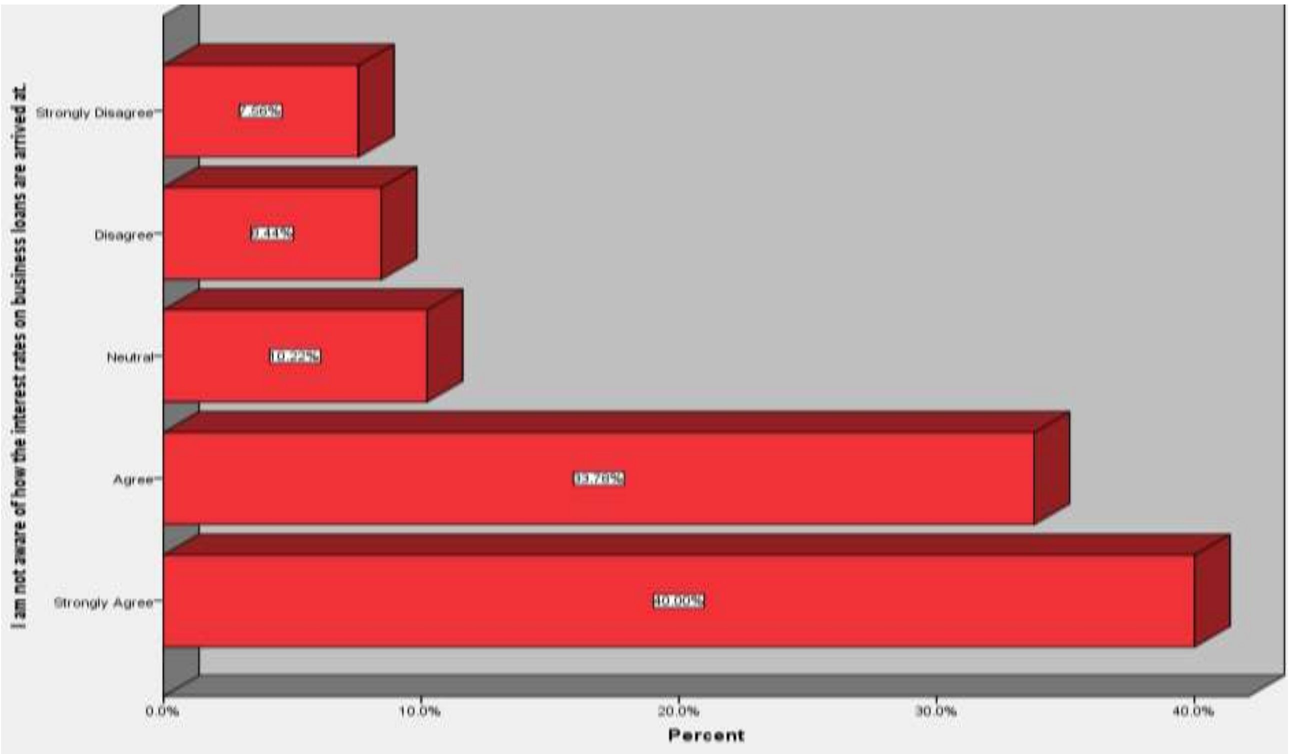

Figure 4: Respondents Knowledge on how Interest Rate is arrived at

Source: (Survey Data, 2017)

According to this study, it was established that majority of the respondents at 74% agreed that they were not aware of how the interest rates on business loans were arrived at. Only sixteen percent of the respondents disagreed that they were not aware of interest on business loans was arrived at. According to Mole and Namusonge (2016) the amount of interest rate payable on loans depends on interest rate charged which is driven by the base lending rate of interest set by the Central Bank of Kenya. According to a study done in Ghana by Kwaning, Nyantakyi and Kyereh (2015) it was established that majority of SMEs at 65% did not understand the terms and conditions and also were oblivious of the interpretation of the percentage charged on the loans.

Interest Rate Discouraged SME Owners to Access Credit

The researcher also wanted to establish whether interest rates charged by financial institutions discouraged SME owners to access credit. The respondents were required to state the extent to which they agreed with the statement that interest rates levied on loans by financial institutions discouraged SME owners from accessing credit. Results are as shown in Figure 5.

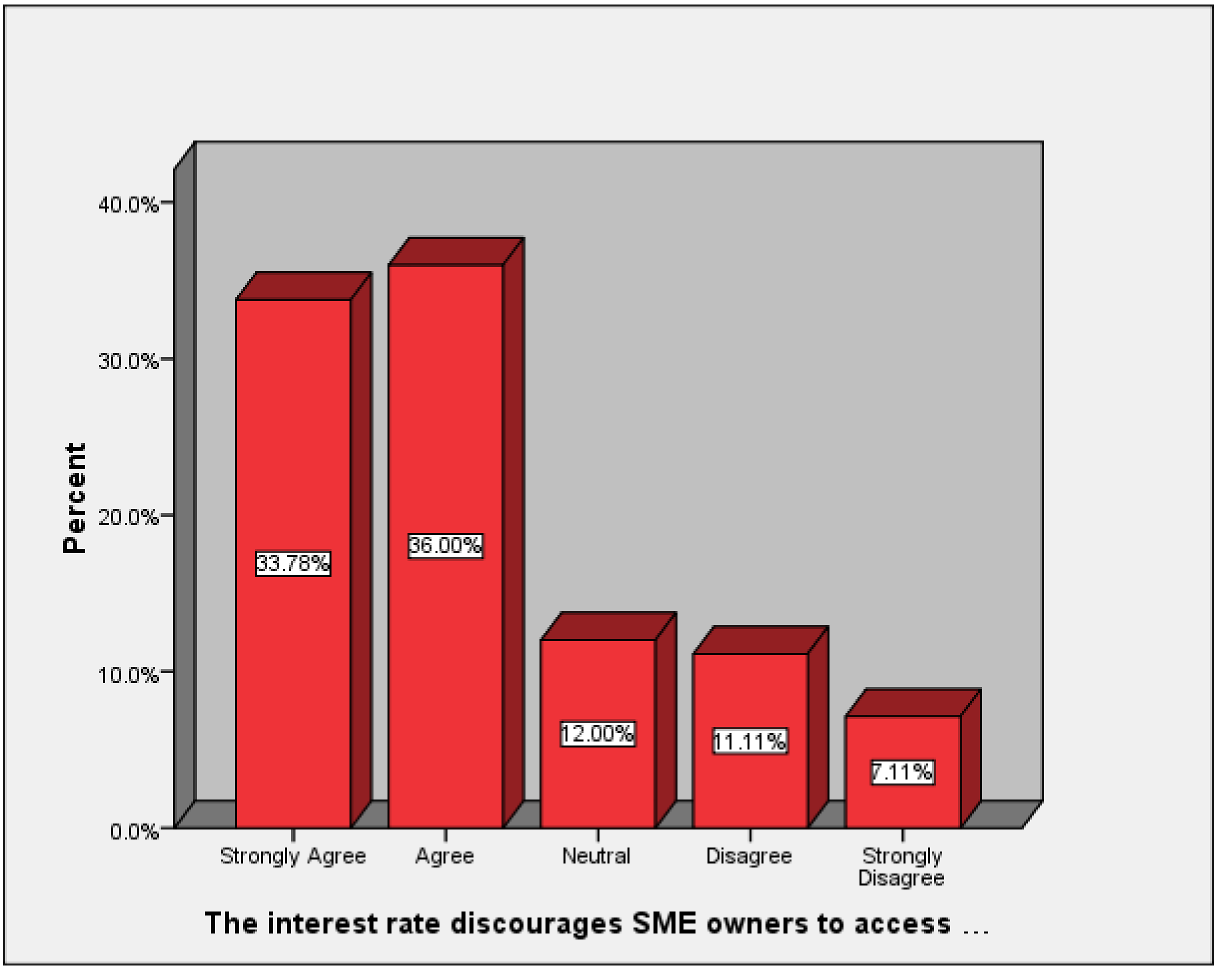

Figure 5: Interest Rates Discourage Owners from Accessing Credit

Source: (Survey Data, 2017)

It was established that 70% of the respondents agreed that interest rate charged by financial institutions discouraged owners of SMEs from accessing credit. Nineteen percent of the respondents disagreed that interest rate charged by financial institutions discouraged owners from accessing credit.

High interest rate on credit may discourage small and medium enterprise from borrowing thus reducing the accessibility of credit among them (Mole & Namusonge, 2016). According to a study by Mathea and Odongo (2014) on the effect of interest rates on the accessibility to credit by SMEs Gitaru Division, Kenya it was established that as the level of interest rates increased, the level of loan accessibility by SMEs decreased and vice versa.

Financial Institutions Cannot Waive Interest Rates When Business Collapse

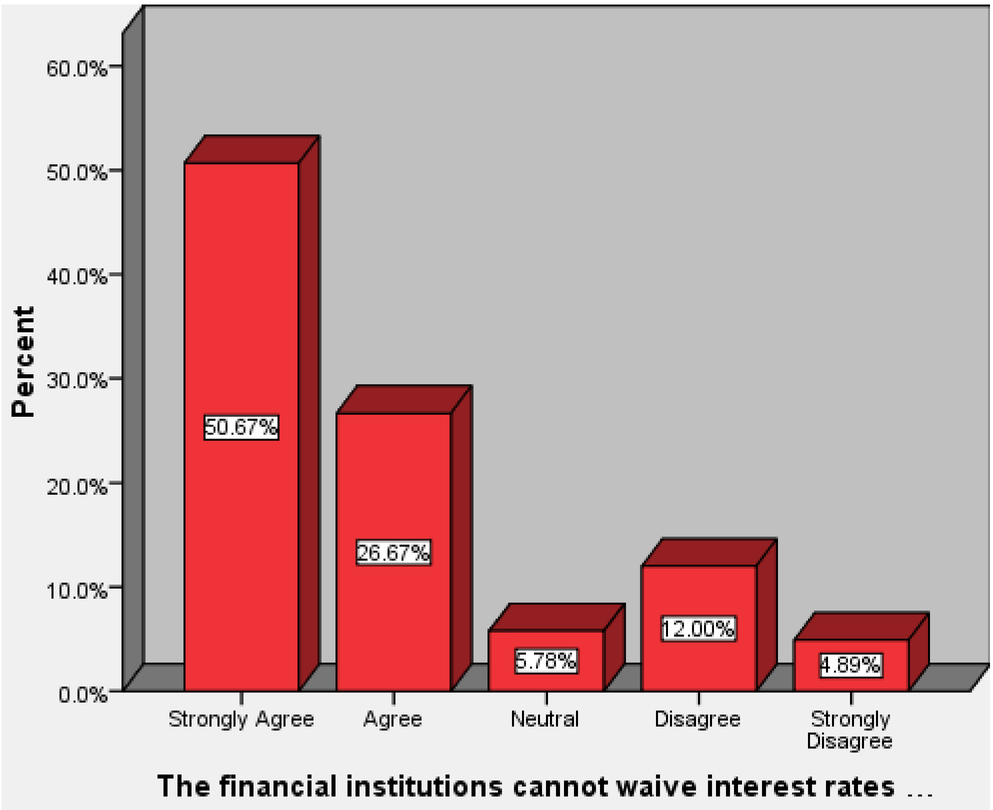

Figure 6: Financial Institutions Cannot Waive Interest Rates if Business Collapse

Source: (Survey Data, 2017)

In case the SME business collapsed, majority of the respondents at 77% agreed that financial institutions did not waive interest rates. Only seventeen percent of the respondents disagreed that financial institutions cannot waive interest rates in case the business collapsed. This failure could be attributed to the fact that financial institutions have already the collateral with them.

Table 1: Correlation between Financial Institution Failure to Waive Interest Rates When Business Collapse and the Value of Credit Depended on the Value of Collateral

		Value	Asymp. Std. Error	Approx. T	Approx. Sig.
Ordinal by Ordinal	Gamma	.408	.080	4.617	.000
N of Valid Cases		225			

Source: (Survey Data, 2017)

Results in Table 5.1 shows that there existed a positive correlation (0.408) between the value of collateral and whether the bank could waive interest rate in case the business collapsed. In case the owner of an SME borrowed huge amount of credit, the value of collateral had to be high so that in case the borrower failed to repay the loan, the lender would recover the loan plus interests.

How Interest Rates Charged on Loans Affected Performance of the Business

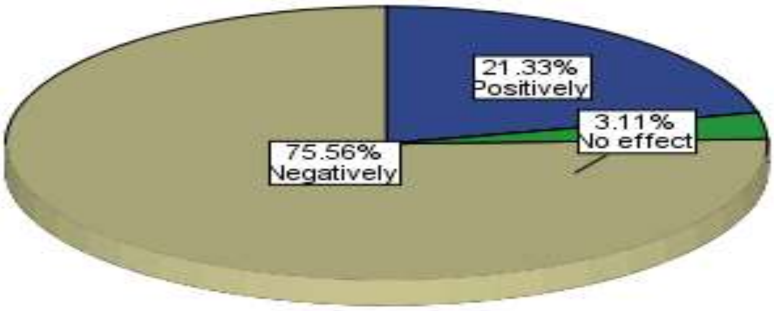

Figure 7: How Interest Rates Charged on Loans Affect Performance of the Business

Source: (Survey Data, 2017)

Seventy percent of the respondents indicated that the interest charged by the financial institutions affected their businesses negatively. Only 21 % of the respondents indicated that their businesses were affected positively. This agrees with the results that interest rates charged on business loan were too high as evidenced by 75% of the respondents as shown in Figure 7.

Test of Hypothesis

A test of hypothesis was run in order to establish whether there was any relationship between interest rates charged by the financial institutions on loans. The null hypothesis which was tested was stated as follows:

Ho_4: There is no significant relationship between interest rates and performance of SME business in Meru County.

The results of analysis are as shown in Table 2.

Table 2: Chi-square Test for Loan Interest Rates and Performance of SMEs

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	30.758	12	.002
Likelihood Ratio	34.549	12	.001
Linear-by-Linear Association	.048	1	.826
N of Valid Cases	225		

Source: (Survey Data, 2017)

Results in Table 5.2 indicates a p-value= 0.002. With α=5% it is clear that the p-value is less than the level of significance. Therefore, the null hypothesis is rejected. This study therefore concludes that at 5% level of significance, the null hypothesis that there was no significant relationship between loan interest rates and performance of SMEs in Meru County is rejected. There exists significant relationship between lending procedure and performance of small and medium enterprises.

SUMMARY, CONCLUSION AND RECOMMENDATIONS

Summary

This study revealed that interest rates charged on loans was too high, it was also established that financial institutions do share information with borrowers on how interest rate on loans advanced is computed or arrived at. These high interest rates on loans affected performance of most businesses negatively. The finding agrees with those of Nyumba et al, (2015), who found statistically significant relationship between interest rate and performance of SMEs. Similarly, the findings align with Mathea & Odongo, (2014) in their study on the effect of interest rates on the accessibility to credit by SMEs in Gitaru Division, Kenya it was established that as the level of as the level of interest rates increased, the level of loan accessibility by SMEs decreased and vice versa.

Conclusion

The chi square test to test hypothesis indicates a p-value= 0.002. With α=5% it is clear that the p-value is less than the level of significance. Therefore, the null hypothesis is rejected. This study therefore concludes that at 5% level of significance, the null hypothesis that there was no significant relationship between loan interest rates and performance of SMEs in Meru County is rejected. There exists significant relationship between interest rates and performance of small and medium enterprises in Meru County. This study covered SMEs across various sectors in Meru County. The research instruments were validated and proper analysis was done hence making the findings reliable and generalizable to SMEs in other counties in Kenya.

Recommendations

Financial institutions also need to make lending procedures as simplified as possible. Financial institutions need to give their customers favourable repayment period for example by giving them enough grace period by which loans obtained would have started contributing positively to the performance of small and medium enterprises. Although it is important that financial institutions protect themselves from bad debts, non-tangible collateral recommendation should be accepted. However, this should take place after thorough customers' background checks have been done. I recommend Interest fluctuations on performance of SMEs in Meru County for further studies.

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