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EFFECT OF LOAN CONTRACT TERMS IN FINANCING OF SMALL AND MEDIUM ENTERPRISES (SMEs) IN KENYA

(CASE OF MOMBASA COUNTY)

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Abstract— This study aims at assessing the effects of loan contract terms in formal financing on Small and Medium Enterprises (SMEs) in Kenya. Companies based in Mombasa County have been selected to represent the rest. The study uses the existing theoretical underpinnings to identify the loan contract terms and then the survey method to assess their impact. Specific to study, small and medium enterprises are defined as those employing one to fifty workers and having a capital investment up to Kshs. 5 million. This study aims at investigating how loan contract terms have hindered the acquisition of loans by SMEs hence denying them the opportunity for growth. Due to the existence of numerous SMEs in Mombasa, this study will be limited to those financed by Mombasa Municipality Trade Development Joint loan Board (MMTDJB). The rationale behind this choice is that it plays a big role in providing financing as well as professional and technical advice to customers on investment. Many SMEs however still seek for alternative financing due to the stringent loan contract terms. The study draws upon the different theories to give recommendations on policies and controls that will make loans more accessible to SMEs by making the loan contract terms more favourable

Index Terms— Small and Medium Enterprises (SMEs); Loan contract terms; Transaction costs; Principal-Agent costs; maturity; collateral; credit spread; credit risk.

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1.0 INTRODUCTION

Collateral, interest rates and debt spread are the common terms used to determine loan contracts. Problems arising from financial restatements are consistent with banks using tighter loan contract terms to overcome risk (Graham et al., 2008). Udell (2004) links overall loan portfolio performance to the tightening of bank credit standards and lending volumes. Rauh and Sufi (2009), and Demiroglu and James (2009) postulate that on average, riskier firms receive contracts with stricter covenants. In the case of Small and Medium Scale Enterprises (SMEs), accessing finance has been the most significant challenge for their creation, growth and sustainability. The problem was exacerbated by the economic crisis and recession leading to increased insolvency rates in most institutions, including Financial Institutions (Van den Heuvel, 2001). Banks' interest towards lending to SMEs dwindled because of the need to preserve and strengthen their capital base hence, only economically viable clients were maintained as the cost of capital escalated. Financial institutions, guided by increasing risk awareness, enacted new capital requirements in the loan contract terms (Mistrulli, 2004). SMEs were hard hit because it is more difficult for them to downsize as they are already small, they are individually less diversified in their economic activities, have a weaker financial structure and a lower or no credit rating, and are heavily dependent on credit because of fewer financing options (OECD, 2008). Evidence consistent with lenders using their default experience to make inference about their screening ability and adjusting contracts accordingly is available (Rajan and Winton, 1995).

Furthermore, contract tightening is most pronounced for borrowers who are dependent on a relatively small circle of lenders. SMEs have limited options for financing hence are highly affected by tightening of loan contract terms. More disconcerting is the fact that these Financial Institutions are normally considered the best source of technical expertise and professional guidance on investment, hence the SMEs ultimately end up being locked out.

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2.0 BACKGROUND OF THE STUDY

The importance of SMEs cannot be overemphasised as they play a major role in economic development. Much interest in SMEs is because they account for the majority of firms in an economy and represent a significant share of employment (de la Torre et al., 2010). It is also clear that most firms start as SMEs before they develop hence the need to facilitate the inception, growth and sustainability of SMEs. Numerous studies point out that SMEs are more financially constrained than large firms and in addition, lack of access to external finance which is a key obstacle to firm growth, especially for SMEs (Schiffer and Weder, 2001). Matambalya (2000) in his report on SMEs in Southern African Development Committee (SADC) economies reiterated the pivotal role of SMEs but also points

out their potential can be realized if they are facilitated on the knowledge and finance front. In Kenya the role of SMEs has been facilitated over the years with the latest being the introduction of alternative financing on the Nairobi Securities Exchange's (NSE) special segment GEMS to allow SMEs access financing.

2.1 Theoretical Framework

Loan contract terms are a function of both lender and borrower characteristics, and contract features (Coleman et al., 2002). The loan contract terms constituted in the lender- borrower relationship have been explained in terms of transaction costs and information asymmetry on the side of the lender and principal-agent costs consistent with the borrower.

2.2 Transaction costs theory

Transaction or contracting costs represent the explicit or implicit costs of facilitating exchanges (Lee, 2006). These costs are a result of five transactions technologies used to evaluate the borrower. The technologies include financial statement lending, small business credit scoring, asset-based lending, factoring, and trade credit (Berger and Udell, 2004). Financial statement lending requires the borrower to have informative financial statements and strong financial condition as reflected in the financial ratios calculated from these statements (Berger and Udell, 2004).

Small business credit scoring transactions on the other hand depends on hard information about the SME and its owner mainly obtained from consumer credit bureaus and in some cases from commercial credit bureaus (Feldman 1997, Mester,1997). This method is relatively low cost since a modest fee is charged for the respective scores (Frame et al., 2001). Factoring essentially involves an outright sale of accounts receivable to a finance company or factoring department of a commercial bank (Lee, 2006). Under most factoring relationships the borrower outsources its credit and collections activities in addition to obtaining financing and utilizes an underwriting process that is based on hard information in this case, about the value of a "borrower's" accounts receivable (Berger and Udell, 2004). Under asset-based lending transaction technology, the lending institution considers the underlying assets of the firm, which acts as collateral as the primary source of repayment. Intensive monitoring of receivables and inventory and periodic (quarterly) field audits add significantly to the cost of asset-based lending and is highly dependent on the lending infrastructure. Trade credit transaction technology combines most of the aspects of the above technologies and is highly dependent on hard information.

2.3 Principal – Agent costs theory

The broad range of theories on the firm's choice of debt maturity in imperfect markets include contracting, maturity matching, tax, and refinancing risk quality hypotheses (Dennis et al., 2000). The principals or owners of the firm hire agents, or managers, to run the firm in the best interests of the principals. But ethical lapses, self-interest, or the owners' lack of trust in the managers can lead to conflicts of interest and suspicions between the two parties (Lee, 2006). This constitutes a cost as the agent tries to monitor and control the actions on the agent. For instance, agency costs arise from asset substitution and underinvestment as managers have an incentive to undertake more risky projects and/or to underinvest in low risk but positive NPV projects (Myers, 1977).

2.4 Information asymmetry costs theory

Contracting may be a problem where there is information asymmetry (Milgrom and Roberts, 1992). ''Adverse selection'' a phenomenon where managers with expertise can provide distorted information or/and manipulate reports to lenders and investors with respect to an evaluation of their end of period performance is exacerbated when combined with moral hazard and this reflects information asymmetry (Lee, 2006).

3.0 Effects of loan contract terms on SME's Performance.

This study identifies performance of the SME as being a component of Income generation, Competitive sustainability and growth. Income generation comprises activities that create wealth such as job creation, mobilising human and non- human resources, opening up new markets and providing flexible skilled and production base. Mead and Liedholm (1998) underscore the importance of SMEs in job creation in that they provide 25% of the work force. Mbeche (1998) did a study in Kenya which showed that SMEs provide a fall-back position for people losing their jobs. Matambalya, (2000b) using survey method on enterprises in Tanzania concluded that SMEs source their raw materials exclusively locally and due to their flexible spatial coverage are well represented in the rural areas. Competitive sustainability is determined by availability of finances. High transaction costs environment distort the entrepreneurial structure and retard entrepreneurial performance at all levels (Owens and Wood, 1997). Since most SMEs do not have the capital for internalization and do not have sufficient information technology (IT) and management information systems (MIS) they are competitively isolated. Growth Potential is a defining feature of entrepreneurial success. Business growth is critical to financial self-reliance and sustainability (Matambalya, 2000).Growth constitutes the strategic, financial, structural and organisational aspects. Moreno and Casilla (2008) and also Harris and Scillitoe (2010) explain factors that trigger growth such as new organizational structures, internal capabilities that allow for cost reduction, social capital of the entrepreneur, use of unique opportunities and new technologies. Facilitation of most of these require resources which are acquired using funds. Lack of finances has been pointed out as the major cause of lack of growth of SMEs

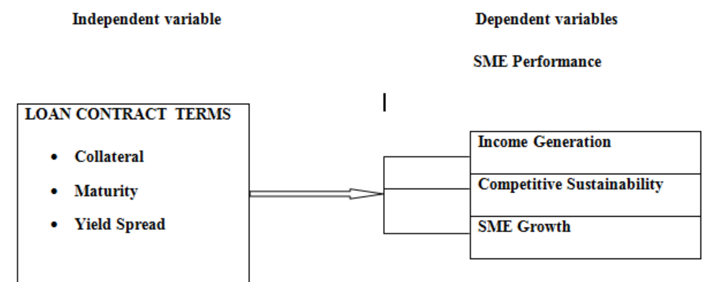

Fig. 1 Conceptual Framework

(Lilischkis and GmbH, 2011). This study therefore adopts the

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following conceptual framework to show the effect of the loan contract terms on SME performance.

4.0 Methodology

4.1 Research Design

This study adopted the mixed research design. Since the main objective of the research was to determine the effect of loan contract terms on SME performance, descriptive approach would be best design in giving insights and ideas about the objective. Quantitative data was obtained from the analysis of the financial statements of the respective SMEs.

4.2 Sample and Sample size

The expected sample for this study was drawn from Small and Medium Enterprises(SMEs) based on the Mombasa Island in the central business area. SMEs financed by Mombasa Municipality Trade Development Joint loan Board (MMTDJB). Out of the 249 SMEs, the study was based on 25 SMEs. This number was however increased to 30 to take care of the questionnaires which may not be returned This sample is representative because it covers over 10% of the total population.

4.3 Sampling Procedures

The sampling frame of the SMEs was a list of SMEs financed by MMTDJB. C.E.O participants were stratified according to gender to give an all-inclusive opinion. Simple random sampling was used to get the number of respondents in each stratum. All the sectors listed on the Nairobi Securities Exchange (NSE) were included in the sample. Proportionate sampling ensured that the sample reflected the relative numbers in the selected group for the sample population (Rosson, 2002).

4.4 Data Collection Methods

The three data collection methods used in this study are; Semi-Structured Group Discussions, Interviews and Questionnaires. Triangulation increases data validity. Questionnaires were self-administered to a cross section of 26 CEOs randomly selected from SMEs based in the central business district of whom 40% were females and 60% males. The sample size of 30 had been targeted (50% males and 50% females).

5.0 Data Analysis

The data analysis was based on the principle components of the loan contract, and how it affected the performance of SMEs. Questions used were drawn from various sub-scales of ''The presence of collateral'' scale (Mulford and Silins; 2001) and "The Presence of long periods of maturity" scale and "The presence of high yield spread"scale .The presence of collateral was assessed using a 5-point scale (5 questions; cronbachs alpha=.92).The presence of long periods of maturity was assessed using a 5-point scale (5 questions; cronbach's alpha=.89), The presence of high yield spread was tested using a 5-point scale (5 questions; cronbach's alpha=.72). A stepwise logic regression procedure to predict the effect versus no-effect of SME performance by the components of the loan contract where 4 classes of variables and were entered separately in the order below, and the ones retained at each step are the ones which significantly predicted membership of the group.

1) Demographic variables (age of institution in Mombasa county, sector in which the firm is)
2) The presence and the link between collateral and the performance of SMEs (e.g. link with Income generation, link with Competitive sustainability and link with growth)
3) Presence of link between long periods of maturity and the performance of SMEs. (e.g. link with Income generation, link with Competitive sustainability and link with growth).
4) Presence of link between high yield spread and the performance of SMEs. (e.g. link with Income generation, link with Competitive sustainability and link with growth).

The demographic variables were entered first to allow for control on their impact on performance of SMEs before assessing the ultimate impact of the loan contract terms on the performance of SMEs.

The table below shows the summary of the sample items, theoretical measures and reliability (cronbachs alpha).

	1	2 3 4	5	No. of items creating scale	Cronbach's alpha
Loan contract terms and SME performance	Strongly Agree		strongly Disagree		
Collateral	Loan contracts require presence of collateral			5	.92
Maturity	Loan contracts stipulate long loan maturity periods			5	.89
Yield spread	Debt instruments have high yield spreads.			5	.72

Table 1: Loan contract terms and SME performance

The chronbach's alphas shown above indicated that the perceived scales had enough variance hence suitable for inclusion in the multiple regression method to be used in the study in relation to establishing the effect of loan contract terms on SME performance. The chronbach's alphas were computed using SSPS to assess internal consistency of the resulting scales. Endorsing as ''True or agree'' an item affecting the performance of SMEs was scored as a 1.'' False or Disagree'' was scored as 0, whereas ''neither agree nor disagree'' or ''I don't know was scored as 0.5. These values were consequently used to create the regression model.

The dependent variable of the proposed model is SME performance, which represents Income generation, Competitive sustainability and growth of the SME. The independent variables include collateral, yield spread and loan maturity.

$$SMEP = \beta_0 + \beta_1(COL) + \beta_3(MAT) + \beta_4(YIELDS) + \alpha \ldots(1)$$

Where:
SMEP= SME performance

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COL= Collateral.
MAT= Loan maturity
YIELDS= Yield spread
α=Random error term.

The model was tested to know if it was valid in examining the factors that influence performance of SMEs. The null hypothesis for the test asserted that independent variables have no influence on SME performance. (HO: the model is not significant).The alternative hypothesis asserted that the independent variables have an influence on SME performance (Ha: the model is significant). The results of the equation were the p-value 0.01 was less than the critical value<0.05. The null hypothesis was rejected, and the alternative hypothesis accepted. Hence, the independent variables collateral, loan maturity an yield spread influence SME performance in Mombasa.

The significant loan contract terms that influence performance of SMEs were extracted by applying the t-test to 3 variables at 5% level of significance. The decision rule to reject the null hypothesis would be applied if the p-values obtained were less than 0.05. MS Excel was used in the regression analysis. The findings are as below in Table 2.

Models	B	t-values	p-values
Constant	1.782	4.984	0.01
Collateral	.232	1.442	.044
Loan maturity	.013	2.236	.043
Yield spread	.321	2.742	.038

Table 2. Dependent variable: SME performance affected (yes/no)

P-VALUE<0.05

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The regression table indicates that all the variables positively influence SME performance since the p-values are less than the critical value<0.05. This is because all the above independent variables are important in performance of SMEs.

6.0 Conclusion

This study shows that loan contract terms significantly affect SMEs' role of income generation, competitive sustainability and growth. Consequently, the following recommendations are given. First, banks should design special products for different sectors such as schools, fishing companies, and agricultural producers, taking into account their particular business needs. Second, banks should have separate, dedicated units to manage their relations with SMEs. Third, banks can also offer software packages to manage the SME accounts online, as well as advisory services. Fourth, banks should exploit scale effects, synergies, and linkages. Through this, banks not only broaden their sources of income, but also diversify risk in terms of lending to a new type of firms and deriving income from non-lending activities.

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